

Kentucky Power Company

2014 Annual Report

Audited Financial Statements



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GLOSSARY OF TERMS

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

Term	Meaning
AEGCo	AEP Generating Company, an AEP electric utility subsidiary.
AEP or Parent	American Electric Power Company, Inc., an electric utility holding company.
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 East Companies	APCo, I&M, KPCo and OPCo.
AEP System	American Electric Power System, an electric system, owned and operated by AEP subsidiaries.
AEPES	AEP Energy Services, Inc., a subsidiary of AEP Resources, Inc.
AEPSC	American Electric Power Service Corporation, an AEP service subsidiary providing management and professional services to AEP and its subsidiaries.
AFUDC	Allowance for Funds Used During Construction.
AGR	AEP Generation Resources Inc., a nonregulated AEP subsidiary that acquired the generation assets and liabilities of OPCo.
AOCI	Accumulated Other Comprehensive Income.
APCo	Appalachian Power Company, an AEP electric utility subsidiary.
ASU	Accounting Standards Update.
CWIP	Construction Work in Progress.
EIS	Energy Insurance Services, Inc., a nonaffiliated captive insurance company and consolidated variable interest entity of AEP.
FAC	Fuel Adjustment Clause.
FASB	Financial Accounting Standards Board.
Federal EPA	United States Environmental Protection Agency.
FERC	Federal Energy Regulatory Commission.
FGD	Flue Gas Desulfurization or scrubbers.
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.
Interconnection Agreement	An agreement by and among APCo, I&M, KPCo and OPCo which defined the sharing of costs and benefits associated with their respective generation plants. This agreement was terminated January 1, 2014.
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.
MISO	Midwest Independent Transmission System Operator.
MLR	Member load ratio, the method used to allocate transactions among members of the Interconnection Agreement.
MMBtu	Million British Thermal Units.
MTM	Mark-to-Market.
MW	Megawatt.
MWh	Megawatthour.
NO _x	Nitrogen oxide.
OATT	Open Access Transmission Tariff.
OPCo	Ohio Power Company, an AEP electric utility subsidiary.
OPEB	Other Postretirement Benefit Plans.

Operating Agreement	Agreement, dated January 1, 1997, as amended, by and among PSO and SWEPCo governing generating capacity allocation, energy pricing, and revenues and costs of third party sales. AEPSC acts as the agent.
OTC	Over the counter.
PCA	Power Coordination Agreement.
PJM	Pennsylvania – New Jersey – Maryland regional transmission organization.
PSO	Public Service Company of Oklahoma, an AEP electric utility subsidiary.
PUCO	Public Utility Commission of Ohio.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
Rockport Plant	A generation plant, consisting of two 1,310 MW coal-fired generating units near Rockport, Indiana. AEGCo and I&M jointly-own Unit 1. In 1989, AEGCo and I&M entered into a sale-and-leaseback transaction with Wilmington Trust Company, an unrelated, unconsolidated trustee for Rockport Plant, Unit 2.
RTO	Regional Transmission Organization, responsible for moving electricity over large interstate areas.
SIA	System Integration Agreement, effective June 15, 2000, as amended, provides contractual basis for coordinated planning, operation and maintenance of the power supply sources of the combined AEP.
SO ₂	Sulfur dioxide.
SPP	Southwest Power Pool regional transmission organization.
SWEPCo	Southwestern Electric Power Company, an AEP electric utility subsidiary.
TCC	AEP Texas Central Company, an AEP electric utility subsidiary.
TNC	AEP Texas North Company, an AEP electric utility subsidiary.
Utility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain utility subsidiaries.
VIE	Variable Interest Entity.
WPCo	Wheeling Power Company, an AEP electric utility subsidiary.
WVPSC	Public Service Commission of West Virginia.

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholder of
Kentucky Power Company:

We have audited the accompanying financial statements of Kentucky Power Company (the "Company"), which comprise the balance sheets as of December 31, 2014 and 2013, and the related statements of income, comprehensive income (loss), changes in common shareholder's equity, and cash flows for each of the three years in the period ended December 31, 2014, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Kentucky Power Company as of December 31, 2014 and 2013, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2014 in accordance with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

Columbus, Ohio
February 20, 2015

KENTUCKY POWER COMPANY
STATEMENTS OF INCOME
For the Years Ended December 31, 2014, 2013 and 2012
(in thousands)

	Years Ended December 31,		
	2014	2013	2012
REVENUES			
Electric Generation, Transmission and Distribution	\$ 773,795	\$ 721,840	\$ 753,095
Sales to AEP Affiliates	7,514	103,731	70,776
Other Revenues	669	684	546
TOTAL REVENUES	781,978	826,255	824,417
EXPENSES			
Fuel and Other Consumables Used for Electric Generation	283,751	200,139	219,328
Purchased Electricity for Resale	14,389	11,003	11,319
Purchased Electricity from AEP Affiliates	116,243	269,088	223,649
Other Operation	84,491	75,038	75,410
Maintenance	71,812	66,977	63,125
Asset Impairments and Other Related Charges	—	32,847	—
Depreciation and Amortization	95,059	91,692	87,995
Taxes Other Than Income Taxes	21,308	20,272	19,659
TOTAL EXPENSES	687,053	767,056	700,485
OPERATING INCOME	94,925	59,199	123,932
Other Income (Expense):			
Interest Income	237	231	351
Allowance for Equity Funds Used During Construction	4,009	1,367	1,574
Interest Expense	(38,356)	(44,509)	(49,375)
INCOME BEFORE INCOME TAX EXPENSE	60,815	16,288	76,482
Income Tax Expense	22,437	7,382	23,507
NET INCOME	\$ 38,378	\$ 8,906	\$ 52,975

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

See Notes to Financial Statements beginning on page 10.

KENTUCKY POWER COMPANY
STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
For the Years Ended December 31, 2014, 2013 and 2012
(in thousands)

	Years Ended December 31,		
	2014	2013	2012
Net Income	\$ 38,378	\$ 8,906	\$ 52,975
<u>OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAXES</u>			
Cash Flow Hedges, Net of Tax of \$20, \$113 and \$117 in 2014, 2013 and 2012, Respectively	38	210	216
Amortization of Pension and OPEB Deferred Costs, Net of Tax of \$252, \$755 and \$687 in 2014, 2013 and 2012, Respectively	468	1,402	1,275
Pension and OPEB Funded Status, Net of Tax of \$600, \$4,168 and \$1,801 in 2014, 2013 and 2012, Respectively	(1,114)	7,741	3,345
TOTAL OTHER COMPREHENSIVE INCOME (LOSS)	(608)	9,353	4,836
TOTAL COMPREHENSIVE INCOME	\$ 37,770	\$ 18,259	\$ 57,811

See Notes to Financial Statements beginning on page 10.

KENTUCKY POWER COMPANY
STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S EQUITY
For the Years Ended December 31, 2014, 2013 and 2012
(in thousands)

	<u>Common Stock</u>	<u>Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total</u>
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2011	\$ 50,450	\$ 519,994	\$ 171,841	\$ (24,830)	\$ 717,455
Capital Contribution from Parent		11,542			11,542
Common Stock Dividends			(33,997)		(33,997)
Net Income			52,975		52,975
Other Comprehensive Income				4,836	4,836
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2012	50,450	531,536	190,819	(19,994)	752,811
Capital Contribution from Parent		83,112			83,112
Common Stock Dividends			(20,034)		(20,034)
Net Income			8,906		8,906
Other Comprehensive Income				9,353	9,353
Pension and OPEB Adjustment Related to Mitchell Plant				5,221	5,221
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2013	50,450	614,648	179,691	(5,420)	839,369
Capital Contribution Returned to Parent		(100,000)			(100,000)
Common Stock Dividends			(115,000)		(115,000)
Other Changes in Common Shareholder's Equity		2,812			2,812
Net Income			38,378		38,378
Other Comprehensive Loss				(608)	(608)
Pension and OPEB Adjustment Related to Kammer Plant				(1,308)	(1,308)
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2014	<u>\$ 50,450</u>	<u>\$ 517,460</u>	<u>\$ 103,069</u>	<u>\$ (7,336)</u>	<u>\$ 663,643</u>

See Notes to Financial Statements beginning on page 10.

KENTUCKY POWER COMPANY
BALANCE SHEETS
ASSETS
December 31, 2014 and 2013
(in thousands)

	December 31,	
	2014	2013
CURRENT ASSETS		
Cash and Cash Equivalents	\$ 795	\$ 743
Accounts Receivable:		
Customers	21,125	17,889
Affiliated Companies	30,436	9,781
Accrued Unbilled Revenues	2,047	857
Miscellaneous	131	75
Allowance for Uncollectible Accounts	(87)	(78)
Total Accounts Receivable	53,652	28,524
Fuel	45,256	92,313
Materials and Supplies	34,499	43,940
Risk Management Assets	6,358	4,356
Deferred Income Tax Benefits	8,899	—
Accrued Tax Benefits	10,944	5,249
Prepayments and Other Current Assets	4,301	3,284
TOTAL CURRENT ASSETS	164,704	178,409
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Generation	1,161,100	1,052,757
Transmission	558,099	507,844
Distribution	727,569	693,481
Other Property, Plant and Equipment (Including Plant to be Retired)	521,327	480,759
Construction Work in Progress	39,194	128,599
Total Property, Plant and Equipment	3,007,289	2,863,440
Accumulated Depreciation and Amortization	1,026,208	943,889
TOTAL PROPERTY, PLANT AND EQUIPMENT – NET	1,981,081	1,919,551
OTHER NONCURRENT ASSETS		
Regulatory Assets	229,827	216,360
Long-term Risk Management Assets	1,005	3,484
Employee Benefits and Pension Assets	12,810	11,446
Deferred Charges and Other Noncurrent Assets	20,081	20,207
TOTAL OTHER NONCURRENT ASSETS	263,723	251,497
TOTAL ASSETS	\$ 2,409,508	\$ 2,349,457

See Notes to Financial Statements beginning on page 10.

KENTUCKY POWER COMPANY
BALANCE SHEETS
LIABILITIES AND COMMON SHAREHOLDER'S EQUITY
December 31, 2014 and 2013

	December 31,	
	2014	2013
	(in thousands)	
CURRENT LIABILITIES		
Advances from Affiliates	\$ 45,128	\$ 8,564
Accounts Payable:		
General	42,315	21,619
Affiliated Companies	29,259	39,171
Long-term Debt Due Within One Year – Nonaffiliated	65,000	—
Risk Management Liabilities	3,256	1,828
Customer Deposits	26,343	25,211
Deferred Income Taxes	—	6,486
Accrued Taxes	18,873	20,801
Accrued Interest	7,824	6,678
Regulatory Liability for Over-Recovered Fuel Costs	1,770	2,851
Provision for Refund	31,033	—
Other Current Liabilities	38,986	19,411
TOTAL CURRENT LIABILITIES	309,787	152,620
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated	754,555	729,389
Long-term Debt – Affiliated	—	20,000
Long-term Risk Management Liabilities	423	2,105
Deferred Income Taxes	575,495	549,672
Regulatory Liabilities and Deferred Investment Tax Credits	22,522	22,926
Asset Retirement Obligations	63,479	20,526
Employee Benefits and Pension Obligations	12,531	6,041
Deferred Credits and Other Noncurrent Liabilities	7,073	6,809
TOTAL NONCURRENT LIABILITIES	1,436,078	1,357,468
TOTAL LIABILITIES	1,745,865	1,510,088
Rate Matters (Note 4)		
Commitments and Contingencies (Note 6)		
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	517,460	614,648
Retained Earnings	103,069	179,691
Accumulated Other Comprehensive Income (Loss)	(7,336)	(5,420)
TOTAL COMMON SHAREHOLDER'S EQUITY	663,643	839,369
TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY	\$ 2,409,508	\$ 2,349,457

See Notes to Financial Statements beginning on page 10.

KENTUCKY POWER COMPANY
STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2014, 2013 and 2012
(in thousands)

	Years Ended December 31,		
	2014	2013	2012
OPERATING ACTIVITIES			
Net Income	\$ 38,378	\$ 8,906	\$ 52,975
Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:			
Depreciation and Amortization	95,059	91,692	87,995
Deferred Income Taxes	9,157	12,440	10,168
Asset Impairments and Other Related Charges	—	32,847	—
Allowance for Equity Funds Used During Construction	(4,009)	(1,367)	(1,574)
Mark-to-Market of Risk Management Contracts	203	2,357	2,510
Pension Contributions to Qualified Plan Trust	(1,923)	—	(5,547)
Fuel Over/Under-Recovery, Net	(1,081)	(5,078)	4,790
Provision for Refund	31,033	—	—
Change in Other Noncurrent Assets	(3,844)	7,334	(13,338)
Change in Other Noncurrent Liabilities	7,919	(2,953)	697
Changes in Certain Components of Working Capital:			
Accounts Receivable, Net	(25,128)	55,144	(7,523)
Fuel, Materials and Supplies	56,498	3,130	(55,120)
Accounts Payable	1,265	(68,480)	3,429
Accrued Taxes, Net	(7,591)	4,013	(11,400)
Accrued Interest	1,146	(5,324)	(545)
Other Current Assets	(1,044)	3,817	607
Other Current Liabilities	17,230	(9,186)	2,974
Net Cash Flows from Operating Activities	<u>213,268</u>	<u>129,292</u>	<u>71,098</u>
INVESTING ACTIVITIES			
Construction Expenditures	(101,898)	(141,832)	(130,964)
Change in Advances to Affiliates, Net	—	—	70,332
Acquisitions of Assets	(1,403)	(563)	(419)
Proceeds from Sales of Assets	307	5,566	1,032
Other Investing Activities	519	—	—
Net Cash Flows Used for Investing Activities	<u>(102,475)</u>	<u>(136,829)</u>	<u>(60,019)</u>
FINANCING ACTIVITIES			
Capital Contribution from (Returned to) Parent	(100,000)	83,112	11,542
Issuance of Long-term Debt – Nonaffiliated	288,344	199,700	—
Change in Advances from Affiliates, Net	36,564	(4,795)	13,359
Retirement of Long-term Debt – Nonaffiliated	(200,000)	(250,000)	—
Retirement of Long-term Debt – Affiliated	(20,000)	—	—
Principal Payments for Capital Lease Obligations	(2,079)	(1,440)	(1,503)
Dividends Paid on Common Stock	(115,000)	(20,034)	(33,997)
Other Financing Activities	1,430	255	224
Net Cash Flows from (Used for) Financing Activities	<u>(110,741)</u>	<u>6,798</u>	<u>(10,375)</u>
Net Increase (Decrease) in Cash and Cash Equivalents	52	(739)	704
Cash and Cash Equivalents at Beginning of Period	743	1,482	778
Cash and Cash Equivalents at End of Period	<u>\$ 795</u>	<u>\$ 743</u>	<u>\$ 1,482</u>
SUPPLEMENTARY INFORMATION			
Cash Paid for Interest, Net of Capitalized Amounts	\$ 36,062	\$ 48,602	\$ 48,740
Net Cash Paid for Income Taxes	18,545	6,100	23,089
Noncash Acquisitions Under Capital Leases	1,471	3,448	2,136
Construction Expenditures Included in Current Liabilities as of December 31,	17,626	7,253	28,565

See Notes to Financial Statements beginning on page 10.

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1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

ORGANIZATION

As a public utility, KPCo engages in the generation and purchase of electric power, and the subsequent sale, transmission and distribution of that power to 171,000 retail customers in its service territory in eastern Kentucky. KPCo also sells power at wholesale to municipalities.

Effective January 1, 2014, the Interconnection Agreement and the AEP System Interim Allowance Agreement were terminated. Also effective January 1, 2014, the FERC approved a PCA among APCo, I&M and KPCo with AEPSC as the agent to coordinate the participants' respective power supply resources. Under the PCA, APCo, I&M and KPCo will be individually responsible for planning their respective capacity obligations. Further, the PCA allows, but does not obligate, APCo, I&M and KPCo to participate collectively under a common fixed resource requirement capacity plan in PJM and to participate in specified collective off-system sales and purchase activities.

Also effective January 1, 2014, the FERC approved the creation of a Bridge Agreement among AGR, APCo, I&M, KPCo and OPCo with AEPSC as the agent. The Bridge Agreement is an interim arrangement to: (a) address the treatment of purchases and sales made by AEPSC on behalf of member companies that extend beyond termination of the Interconnection Agreement and (b) address how member companies will fulfill their existing obligations under the PJM Reliability Assurance Agreement through the 2014/2015 PJM planning year. Under the Bridge Agreement, AGR is committed to meet capacity obligations of member companies.

Effective January 1, 2014, AEPSC conducts power, coal, natural gas, interest rate and, to a lesser extent, heating oil, gasoline and other risk management activities on behalf of APCo, I&M and KPCo. Power and natural gas risk management activities are allocated based on the three member companies' respective equity positions. Risk management activities primarily include the power and natural gas physical transactions, financially-settled swaps and exchange-traded futures. AEPSC settles the majority of the physical forward contracts by entering into offsetting contracts. KPCo shared in the revenues and expenses associated with these risk management activities with APCo and I&M.

Under a unit power agreement with AEGCo, an affiliated company, KPCo purchases 30% of AEGCo's 50% share of the total output of the 2,600 MW Rockport Plant capacity. Therefore, KPCo purchases 390 MWs of Rockport Plant capacity. The unit power agreement expires in December 2022. KPCo pays a demand charge for the right to receive the power, which is payable even if the power is not taken.

Under the SIA, AEPSC allocates physical and financial revenues and expenses from transactions with neighboring utilities, power marketers and other power and natural gas risk management activities based upon the location of such activity, with margins resulting from trading and marketing activities originating in PJM and MISO generally accruing to the benefit of APCo, I&M and KPCo and trading and marketing activities originating in SPP generally accruing to the benefit of PSO and SWEPCo. Margins resulting from other transactions are allocated among APCo, I&M, KPCo, PSO and SWEPCo based upon the common shareholder's equity of these companies.

To minimize the credit requirements and operating constraints when operating within PJM, participating AEP companies, including KPCo, agreed to a netting of all payment obligations incurred by any of the AEP companies against all balances due to the AEP companies and to hold PJM harmless from actions that any one or more AEP companies may take with respect to PJM.

Corporate Separation

Background

On December 31, 2013, as approved by the FERC and the PUCO, OPCo transferred its generation assets and related generation liabilities at net book value to AGR. Also on December 31, 2013, AGR subsequently transferred at net book value a one-half interest (780 MW) in the Mitchell Plant to KPCo. The transfer of these generation assets and associated liabilities was approved by the FERC and the KPSC.

Significant Accounting Issues

AGR's transfer of a one-half ownership in the Mitchell Plant to KPCo at net book value qualifies as an acquisition of a business under common control. Pursuant to "Business Combinations" accounting guidance, KPCo retrospectively adjusted its financial statements as if the transfer had occurred at the beginning of the earliest period presented.

None of the OPCo regulatory assets and regulatory liabilities were transferred to KPCo. As previously approved by the PUCO, these regulatory assets and liabilities will be recovered/refunded primarily through OPCo non-bypassable riders.

Substantially all of the current income tax receivables and payables related to OPCo's generation activities prior to December 31, 2013 remained on OPCo's balance sheet. These current income tax receivables and payables are the responsibility of OPCo. Deferred tax assets and liabilities related to KPCo's acquired share of the Mitchell Plant were transferred to KPCo based upon the Mitchell Plant's related asset and liability values. Following these transfers, KPCo adjusted its deferred tax balances and related regulatory assets to reflect its respective deferred state tax rates.

Long-term Debt

On December 31, 2013, KPCo was assigned \$200 million of Long-term Debt - Nonaffiliated from AGR related to a term credit facility.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Rates and Service Regulation

KPCo's rates are regulated by the FERC and the KPSC. The FERC also regulates KPCo's affiliated transactions, including AEPSC intercompany service billings which are generally at cost, under the 2005 Public Utility Holding Company Act and the Federal Power Act. The FERC also has jurisdiction over the issuances and acquisitions of securities of the public utility subsidiaries, the acquisition or sale of certain utility assets and mergers with another electric utility or holding company. For non-power goods and services, the FERC requires a nonregulated affiliate to bill an affiliated public utility company at no more than market while a public utility must bill the higher of cost or market to a nonregulated affiliate. The KPSC also regulates certain intercompany transactions under its affiliate statutes. Both the FERC and state regulatory commissions are permitted to review and audit the relevant books and records of companies within a public utility holding company system.

The FERC regulates wholesale power markets, wholesale power transactions and wholesale transmission operations and rates. KPCo's wholesale power transactions are generally market-based. Wholesale power transactions are cost-based regulated when KPCo negotiates and files a cost-based contract with the FERC or the FERC determines that KPCo has "market power" in the region where the transaction occurs. KPCo has entered into wholesale power supply contracts with various municipalities that are FERC-regulated, cost-based contracts. These contracts are generally formula rate mechanisms, which are trued up to actual costs annually.

The KPSC regulates all of the distribution operations and rates and retail transmission rates on a cost basis. The KPSC also regulates the retail generation/power supply operations and rates.

In addition, the FERC regulates the SIA and the Transmission Agreement, all of which are still active and allocate shared system costs and revenues among the utility subsidiaries that are parties to each agreement. In accordance with management's October 2012 filing with the FERC, the Interconnection Agreement was terminated effective January 1, 2014. The AEP System Interim Allowance Agreement which provided for, among other things, the transfer of SO₂ emission allowances associated with transactions under the Interconnection Agreement was also terminated. In December 2013, the FERC issued orders approving the creation of a Power Coordination Agreement (PCA), effective January 1, 2014. Also effective January 1, 2014, the FERC approved the creation of a Bridge Agreement among AGR, APCo, I&M, KPCo and OPCo with AEPSC as the agent. Effective June 1, 2014, the FERC approved the cancellation of the System Transmission Integration Agreement.

Accounting for the Effects of Cost-Based Regulation

As a rate-regulated electric public utility company, KPCo's financial statements reflect the actions of regulators that result in the recognition of certain revenues and expenses in different time periods than enterprises that are not rate-regulated. In accordance with accounting guidance for "Regulated Operations," KPCo records regulatory assets (deferred expenses) and regulatory liabilities (deferred revenue reductions or refunds) to reflect the economic effects of regulation in the same accounting period by matching expenses with their recovery through regulated revenues and by matching income with its passage to customers in cost-based regulated rates.

Use of Estimates

The preparation of these financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. These estimates include but are not limited to inventory valuation, allowance for doubtful accounts, long-lived asset impairment, unbilled electricity revenue, valuation of long-term energy contracts, the effects of regulation, long-lived asset recovery, storm costs, the effects of contingencies and certain assumptions made in accounting for pension and postretirement benefits. The estimates and assumptions used are based upon management's evaluation of the relevant facts and circumstances as of the date of the financial statements. Actual results could ultimately differ from those estimates.

Cash and Cash Equivalents

Cash and Cash Equivalents include temporary cash investments with original maturities of three months or less.

Inventory

Fossil fuel inventories and materials and supplies inventories are carried at average cost.

Accounts Receivable

Customer accounts receivable primarily include receivables from wholesale and retail energy customers, receivables from energy contract counterparties related to risk management activities and customer receivables primarily related to other revenue-generating activities.

Revenue is recognized from electric power sales when power is delivered to customers. To the extent that deliveries have occurred but a bill has not been issued, KPCo accrues and recognizes, as Accrued Unbilled Revenues on the balance sheets, an estimate of the revenues for energy delivered since the last billing.

AEP Credit factors accounts receivable on a daily basis, excluding receivables from risk management activities, for KPCo. See "Sale of Receivables - AEP Credit" section of Note 14 for additional information.

Allowance for Uncollectible Accounts

Generally, AEP Credit records bad debt expense related to receivables purchased from KPCo under a sale of receivables agreement. For customer accounts receivables relating to risk management activities, accounts receivables are reviewed for bad debt reserves at a specific counterparty level basis. For miscellaneous accounts receivable, bad debt expense is recorded for all amounts outstanding 180 days or greater at 100%, unless specifically identified. Miscellaneous accounts receivable items open less than 180 days may be reserved using specific identification for bad debt reserves.

Concentrations of Credit Risk and Significant Customers

KPCo does not have any significant customers that comprise 10% or more of its operating revenues as of December 31, 2014.

Management monitors credit levels and the financial condition of KPCo's customers on a continuing basis to minimize credit risk. The KPSC allows recovery in rates for a reasonable level of bad debt costs. Management believes adequate provision for credit loss has been made in the accompanying financial statements.

Emission Allowances

KPCo records emission allowances at cost, including the annual SO₂ and NO_x emission allowance entitlements received at no cost from the Federal EPA. KPCo follows the inventory model for these allowances. Allowances expected to be consumed within one year are reported in Materials and Supplies. Allowances with expected consumption beyond one year are included in Deferred Charges and Other Noncurrent Assets. These allowances are consumed in the production of energy and are recorded in Fuel and Other Consumables Used for Electric Generation at an average cost. The purchases and sales of allowances are reported in the Operating Activities section of the statements of cash flows. The net margin on sales of emission allowances is included in Electric Generation, Transmission and Distribution Revenues for nonaffiliated transactions and in Sales to AEP Affiliates Revenues for affiliated transactions because of its integral nature to the production process of energy and KPCo's revenue optimization strategy for operations. The net margin on sales of emission allowances affects the determination of deferred fuel or deferred emission allowance costs and the amortization of regulatory assets.

Property, Plant and Equipment

Electric utility property, plant and equipment are stated at original cost. Additions, major replacements and betterments are added to the plant accounts. Under the group composite method of depreciation, continuous interim routine replacements of items such as boiler tubes, pumps, motors, etc. result in original cost retirements, less salvage, being charged to accumulated depreciation. The group composite method of depreciation assumes that on average, asset components are retired at the end of their useful lives and thus there is no gain or loss. The equipment in each primary electric plant account is identified as a separate group. The depreciation rates that are established take into account the past history of interim capital replacements and the amount of removal cost incurred and salvage received. These rates and the related lives are subject to periodic review. Removal costs are charged to regulatory liabilities. The costs of labor, materials and overhead incurred to operate and maintain the plants are included in operating expenses.

Long-lived assets are required to be tested for impairment when it is determined that the carrying value of the assets may no longer be recoverable or when the assets meet the held-for-sale criteria under the accounting guidance for "Impairment or Disposal of Long-lived Assets." When it becomes probable that an asset in service or an asset under construction will be abandoned and regulatory cost recovery has been disallowed, the cost of that asset shall be removed from plant-in-service or CWIP and charged to expense.

The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties, as opposed to a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and are used as the basis for the measurement, if available. In the absence of quoted prices for identical or similar assets in active markets, fair value is estimated using various internal and external valuation methods including cash flow analysis and appraisals.

Allowance for Funds Used During Construction

AFUDC represents the estimated cost of borrowed and equity funds used to finance construction projects that is capitalized and recovered through depreciation over the service life of regulated electric utility plant. KPCo records the equity component of AFUDC in Allowance for Equity Funds Used During Construction and the debt component of AFUDC as a reduction to Interest Expense.

Valuation of Nonderivative Financial Instruments

The book values of Cash and Cash Equivalents, Accounts Receivable, Advances from Affiliates and Accounts Payable approximate fair value because of the short-term maturity of these instruments.

Fair Value Measurements of Assets and Liabilities

The accounting guidance for “Fair Value Measurements and Disclosures” establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement). Where observable inputs are available for substantially the full term of the asset or liability, the instrument is categorized in Level 2. When quoted market prices are not available, pricing may be completed using comparable securities, dealer values, operating data and general market conditions to determine fair value. Valuation models utilize various inputs such as commodity, interest rate and, to a lesser degree, volatility and credit that include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in inactive markets, market corroborated inputs (i.e. inputs derived principally from, or correlated to, observable market data) and other observable inputs for the asset or liability. The amount of risk taken is determined by the Commercial Operations and Finance groups in accordance with established risk management policies as approved by the Finance Committee of AEP’s Board of Directors. The AEP System’s market risk oversight staff independently monitors risk policies, procedures and risk levels and provides members of the Commercial Operations Risk Committee (Regulated Risk Committee) various daily, weekly and/or monthly reports regarding compliance with policies, limits and procedures. The Regulated Risk Committee consists of AEPSC’s Chief Operating Officer, Chief Financial Officer, Executive Vice President of Generation, Senior Vice President of Commercial Operations and Chief Risk Officer.

For commercial activities, exchange traded derivatives, namely futures contracts, are generally fair valued based on unadjusted quoted prices in active markets and are classified as Level 1. Level 2 inputs primarily consist of OTC broker quotes in moderately active or less active markets, as well as exchange traded contracts where there is insufficient market liquidity to warrant inclusion in Level 1. Management verifies price curves using these broker quotes and classifies these fair values within Level 2 when substantially all of the fair value can be corroborated. Management typically obtains multiple broker quotes, which are nonbinding in nature, but are based on recent trades in the marketplace. When multiple broker quotes are obtained, the quoted bid and ask prices are averaged. In certain circumstances, a broker quote may be discarded if it is a clear outlier. Management uses a historical correlation analysis between the broker quoted location and the illiquid locations. If the points are highly correlated, these locations are included within Level 2 as well. Certain OTC and bilaterally executed derivative instruments are executed in less active markets with a lower availability of pricing information. Illiquid transactions, complex structured transactions, FTRs and counterparty credit risk may require nonmarket based inputs. Some of these inputs may be internally developed or extrapolated and utilized to estimate fair value. When such inputs have a significant impact on the measurement of fair value, the instrument is categorized as Level 3. The main driver of contracts being classified as Level 3 is the inability to substantiate energy price curves in the market. A significant portion of the Level 3 instruments have been economically hedged which greatly limits potential earnings volatility.

AEP utilizes its trustee’s external pricing service to estimate the fair value of the underlying investments held in the benefit plan trusts. AEP’s investment managers review and validate the prices utilized by the trustee to determine fair value. AEP’s management performs its own valuation testing to verify the fair values of the securities. AEP receives audit reports of the trustee’s operating controls and valuation processes. The trustee uses multiple pricing vendors for the assets held in the trusts.

Assets in the benefits trusts are classified using the following methods. Equities are classified as Level 1 holdings if they are actively traded on exchanges. Items classified as Level 1 are investments in money market funds, fixed income and equity mutual funds and domestic equity securities. They are valued based on observable inputs primarily unadjusted quoted prices in active markets for identical assets. Items classified as Level 2 are primarily investments in individual fixed income securities and cash equivalents funds. Fixed income securities generally do not trade on exchanges and do not have an official closing price but their valuation inputs are based on observable market data. Pricing vendors calculate bond valuations using financial models and matrices. The models use observable inputs including yields on benchmark securities, quotes by securities brokers, rating agency actions, discounts or premiums

on securities compared to par prices, changes in yields for U.S. Treasury securities, corporate actions by bond issuers, prepayment schedules and histories, economic events and, for certain securities, adjustments to yields to reflect changes in the rate of inflation. Other securities with model-derived valuation inputs that are observable are also classified as Level 2 investments. Investments with unobservable valuation inputs are classified as Level 3 investments. Benefit plan assets included in Level 3 are primarily real estate and private equity investments that are valued using methods requiring judgment including appraisals. The fair value of real estate investments is measured using market capitalization rates, recent sales of comparable investments and independent third-party appraisals. The fair value of private equity investments is measured using cost and purchase multiples, operating results, discounted future cash flows and market based comparable data. Depending on the specific situation, one or multiple approaches are used to determine the valuation of a real estate or private equity investment.

Deferred Fuel Costs

The cost of fuel and related emission allowances and emission control chemicals/consumables is charged to Fuel and Other Consumables Used for Electric Generation expense when the fuel is burned or the allowance or consumable is utilized. Fuel cost over-recoveries (the excess of fuel-related revenues over applicable fuel costs incurred) are generally deferred as current regulatory liabilities and under-recoveries (the excess of applicable fuel costs incurred over fuel-related revenues) are generally deferred as current regulatory assets. Fuel cost over-recovery and under-recovery balances are classified as noncurrent when there is a phase-in plan or the FAC has been suspended. These deferrals are amortized when refunded or when billed to customers in later months with the KPSC's review and approval. The amount of an over-recovery or under-recovery can also be affected by actions of the KPSC. On a routine basis, the KPSC reviews and/or audits KPCo's fuel procurement policies and practices, the fuel cost calculations and FAC deferrals. When a FAC under-recovery is no longer probable of recovery, KPCo adjusts its FAC deferrals and records a provision for estimated refunds to recognize these probable outcomes. Changes in fuel costs, including purchased power, are reflected in rates in a timely manner through the FAC.

Revenue Recognition

Regulatory Accounting

KPCo's financial statements reflect the actions of regulators that can result in the recognition of revenues and expenses in different time periods than enterprises that are not rate-regulated. Regulatory assets (deferred expenses) and regulatory liabilities (deferred revenue reductions or refunds) are recorded to reflect the economic effects of regulation in the same accounting period by matching expenses with their recovery through regulated revenues and by matching income with its passage to customers in cost-based regulated rates.

When regulatory assets are probable of recovery through regulated rates, KPCo records them as assets on its balance sheets. KPCo tests for probability of recovery at each balance sheet date or whenever new events occur. Examples of new events include the issuance of a regulatory commission order or passage of new legislation. If it is determined that recovery of a regulatory asset is no longer probable, KPCo writes off that regulatory asset as a charge against income.

Electricity Supply and Delivery Activities

KPCo recognizes revenues from retail and wholesale electricity sales and electricity transmission and distribution delivery services. KPCo recognizes the revenues on the statements of income upon delivery of the energy to the customer and includes unbilled as well as billed amounts.

Most of the power produced at KPCo's generation plants is sold to PJM. KPCo purchases power from PJM to supply power to its customers. Generally, these power sales and purchases are reported on a net basis in revenues on the statements of income. However, purchases of power in excess of sales to PJM, on an hourly net basis, used to serve retail load are recorded gross as Purchased Electricity for Resale on the statements of income.

Physical energy purchases arising from non-derivative contracts are accounted for on a gross basis in Purchased Electricity for Resale on the statements of income. Energy purchases arising from non-trading derivative contracts are recorded based on the transaction's facts and circumstances. Purchases under non-trading derivatives used to serve accrual based obligations are recorded in Purchased Electricity for Resale on the statements of income. All other non-trading derivative purchases are recorded net in revenues.

In general, KPCo records expenses when purchased electricity is received and when expenses are incurred, with the exception of certain power purchase contracts that are derivatives and accounted for using MTM accounting. KPCo defers the unrealized MTM amounts as regulatory assets (for losses) and regulatory liabilities (for gains).

Energy Marketing and Risk Management Activities

AEPSC, on behalf of the APCo, I&M and KPCo, engages in wholesale power and natural gas marketing and risk management activities focused on wholesale markets where the AEP System owns assets and adjacent markets. These activities include the purchase and sale of energy under forward contracts at fixed and variable prices. These contracts include physical transactions, exchange-traded futures, and to a lesser extent, OTC swaps and options. Certain energy marketing and risk management transactions are with RTOs.

KPCo recognizes revenues and expenses from wholesale marketing and risk management transactions that are not derivatives upon delivery of the commodity. KPCo uses MTM accounting for wholesale marketing and risk management transactions that are derivatives unless the derivative is designated in a qualifying cash flow hedge relationship or a normal purchase or sale. The realized gains and losses on wholesale marketing and risk management transactions are included in revenues or expense based on the transaction's facts and circumstances. The unrealized MTM amounts are deferred as regulatory assets (for losses) and regulatory liabilities (for gains). Unrealized MTM gains and losses are included on the balance sheets as Risk Management Assets or Liabilities as appropriate.

Certain qualifying wholesale marketing and risk management derivative transactions are designated as hedges of variability in future cash flows as a result of forecasted transactions (cash flow hedge). KPCo initially records the effective portion of the cash flow hedge's gain or loss as a component of AOCI. When the forecasted transaction is realized and affects net income, KPCo subsequently reclassifies the gain or loss on the hedge from AOCI into revenues or expenses within the same financial statement line item as the forecasted transaction on the statements of income. KPCo defers the ineffective portion as regulatory assets (for losses) and regulatory liabilities (for gains). See "Accounting for Cash Flow Hedging Strategies" section of Note 10.

Maintenance

Maintenance costs are expensed as incurred. If it becomes probable that KPCo will recover specifically-incurred costs through future rates, a regulatory asset is established to match the expensing of those maintenance costs with their recovery in cost-based regulated revenues.

Income Taxes and Investment Tax Credits

KPCo uses the liability method of accounting for income taxes. Under the liability method, deferred income taxes are provided for all temporary differences between the book and tax basis of assets and liabilities which will result in a future tax consequence.

When the flow-through method of accounting for temporary differences is reflected in regulated revenues (that is, when deferred taxes are not included in the cost of service for determining regulated rates for electricity), deferred income taxes are recorded and related regulatory assets and liabilities are established to match the regulated revenues and tax expense.

Investment tax credits are accounted for under the flow-through method except where regulatory commissions have reflected investment tax credits in the rate-making process on a deferral basis. Investment tax credits that have been deferred are amortized over the life of the plant investment.

KPCo accounts for uncertain tax positions in accordance with the accounting guidance for “Income Taxes.” KPCo classifies interest expense or income related to uncertain tax positions as interest expense or income as appropriate and classifies penalties as Other Operation expense.

Excise Taxes

As an agent for some state and local governments, KPCo collects from customers certain excise taxes levied by those state or local governments on customers. KPCo does not recognize these taxes as revenue or expense.

Debt

Gains and losses from the reacquisition of debt used to finance regulated electric utility plants are deferred and amortized over the remaining term of the reacquired debt in accordance with their rate-making treatment unless the debt is refinanced. If the reacquired debt is refinanced, the reacquisition costs are generally deferred and amortized over the term of the replacement debt consistent with its recovery in rates.

Debt discount or premium and debt issuance expenses are deferred and amortized generally utilizing the straight-line method over the term of the related debt. The straight-line method approximates the effective interest method and is consistent with the treatment in rates for regulated operations. The net amortization expense is included in Interest Expense on the statements of income.

Investments Held in Trust for Future Liabilities

AEP has several trust funds with significant investments intended to provide for future payments of pension and OPEB benefits. All of the trust funds’ investments are diversified and managed in compliance with all laws and regulations. The investment strategy for trust funds is to use a diversified portfolio of investments to achieve an acceptable rate of return while managing the interest rate sensitivity of the assets relative to the associated liabilities. To minimize investment risk, the trust funds are broadly diversified among classes of assets, investment strategies and investment managers. Management regularly reviews the actual asset allocations and periodically rebalances the investments to targeted allocations when appropriate. Investment policies and guidelines allow investment managers in approved strategies to use financial derivatives to obtain or manage market exposures and to hedge assets and liabilities. The investments are reported at fair value under the “Fair Value Measurements and Disclosures” accounting guidance.

Benefit Plans

All benefit plan assets are invested in accordance with each plan’s investment policy. The investment policy outlines the investment objectives, strategies and target asset allocations by plan.

The investment philosophies for AEP’s benefit plans support the allocation of assets to minimize risks and optimize net returns. Strategies used include:

- Maintaining a long-term investment horizon.
- Diversifying assets to help control volatility of returns at acceptable levels.
- Managing fees, transaction costs and tax liabilities to maximize investment earnings.
- Using active management of investments where appropriate risk/return opportunities exist.
- Keeping portfolio structure style-neutral to limit volatility compared to applicable benchmarks.
- Using alternative asset classes such as real estate and private equity to maximize return and provide additional portfolio diversification.

The investment policy for the pension fund allocates assets based on the funded status of the pension plan. The objective of the asset allocation policy is to reduce the investment volatility of the plan over time. Generally, more of the investment mix will be allocated to fixed income investments as the plan becomes better funded. Assets will be transferred away from equity investments into fixed income investments based on the market value of plan assets compared to the plan's projected benefit obligation. The current target asset allocations are as follows:

<u>Pension Plan Assets</u>	<u>Target</u>
Equity	30.0 %
Fixed Income	55.0 %
Other Investments	15.0 %
<u>OPEB Plans Assets</u>	<u>Target</u>
Equity	65.0 %
Fixed Income	33.0 %
Cash	2.0 %

The investment policy for each benefit plan contains various investment limitations. The investment policies establish concentration limits for securities and prohibit the purchase of securities issued by AEP (with the exception of proportionate and immaterial holdings of AEP securities in passive index strategies). However, the investment policies do not preclude the benefit trust funds from receiving contributions in the form of AEP securities, provided that the AEP securities acquired by each plan may not exceed the limitations imposed by law. Each investment manager's portfolio is compared to a diversified benchmark index.

For equity investments, the limits are as follows:

- No security in excess of 5% of all equities.
- Cash equivalents must be less than 10% of an investment manager's equity portfolio.
- No individual stock may be more than 10% and 7% for pension and OPEB investments, respectively, of each manager's equity portfolio.
- No investment in excess of 5% of an outstanding class of any company.
- No securities may be bought or sold on margin or other use of leverage.

For fixed income investments, the concentration limits must not exceed:

- 3% in any single issuer.
- 5% for private placements.
- 5% for convertible securities.
- 60% for bonds rated AA+ or lower.
- 50% for bonds rated A+ or lower.
- 10% for bonds rated BBB- or lower.

For obligations of non-government issuers within the fixed income portfolio, the following limitations apply:

- AAA rated debt: a single issuer should account for no more than 5% of the portfolio.
- AA+, AA, AA- rated debt: a single issuer should account for no more than 3% of the portfolio.
- Debt rated A+ or lower: a single issuer should account for no more than 2% of the portfolio.
- No more than 10% of the portfolio may be invested in high yield and emerging market debt combined at any time.

A portion of the pension assets is invested in real estate funds to provide diversification, add return and hedge against inflation. Real estate properties are illiquid, difficult to value and not actively traded. The pension plan uses external real estate investment managers to invest in commingled funds that hold real estate properties. To mitigate investment risk in the real estate portfolio, commingled real estate funds are used to ensure that holdings are diversified by region, property type and risk classification. Real estate holdings include core, value-added and development risk classifications and some investments in Real Estate Investment Trusts, which are publicly traded real estate securities.

A portion of the pension assets is invested in private equity. Private equity investments add return and provide diversification and typically require a long-term time horizon to evaluate investment performance. Private equity is classified as an alternative investment because it is illiquid, difficult to value and not actively traded. The pension plan uses limited partnerships and commingled funds to invest across the private equity investment spectrum. The private equity holdings are with multiple general partners who help monitor the investments and provide investment selection expertise. The holdings are currently comprised of venture capital, buyout and hybrid debt and equity investment instruments. Commingled private equity funds are used to enhance the holdings' diversity.

AEP participates in a securities lending program with BNY Mellon to provide incremental income on idle assets and to provide income to offset custody fees and other administrative expenses. AEP lends securities to borrowers approved by BNY Mellon in exchange for collateral. All loans are collateralized by at least 102% of the loaned asset's market value and the collateral is invested. The difference between the rebate owed to the borrower and the collateral rate of return determines the earnings on the loaned security. The securities lending program's objective is providing modest incremental income with a limited increase in risk.

Trust owned life insurance (TOLI) underwritten by The Prudential Insurance Company is held in the OPEB plan trusts. The strategy for holding life insurance contracts in the taxable Voluntary Employees' Beneficiary Association trust is to minimize taxes paid on the asset growth in the trust. Earnings on plan assets are tax-deferred within the TOLI contract and can be tax-free if held until claims are paid. Life insurance proceeds remain in the trust and are used to fund future retiree medical benefit liabilities. With consideration to other investments held in the trust, the cash value of the TOLI contracts is invested in two diversified funds. A portion is invested in a commingled fund with underlying investments in stocks that are actively traded on major international equity exchanges. The other portion of the TOLI cash value is invested in a diversified, commingled fixed income fund with underlying investments in government bonds, corporate bonds and asset-backed securities.

Cash and cash equivalents are held in each trust to provide liquidity and meet short-term cash needs. Cash equivalent funds are used to provide diversification and preserve principal. The underlying holdings in the cash funds are investment grade money market instruments including commercial paper, certificates of deposit, treasury bills and other types of investment grade short-term debt securities. The cash funds are valued each business day and provide daily liquidity.

Comprehensive Income (Loss)

Comprehensive income (loss) is defined as the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. Comprehensive income (loss) has two components: net income (loss) and other comprehensive income (loss).

Earnings Per Share (EPS)

KPCo is a wholly-owned subsidiary of AEP. Therefore, KPCo is not required to report EPS.

Supplementary Income Statement Information

The following table provides the components of Depreciation and Amortization for the years ended December 31, 2014, 2013 and 2012:

Depreciation and Amortization	Years Ended December 31,		
	2014	2013	2012
	(in thousands)		
Depreciation and Amortization of Property, Plant and Equipment	\$ 94,770	\$ 91,403	\$ 87,706
Amortization of Regulatory Assets and Liabilities	289	289	289
Total Depreciation and Amortization	\$ 95,059	\$ 91,692	\$ 87,995

Subsequent Events

Management reviewed subsequent events through February 20, 2015, the date that KPCo's 2014 annual report was issued.

2. NEW ACCOUNTING PRONOUNCEMENTS

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

ASU 2014-08 "Presentation of Financial Statements and Property, Plant and Equipment" (ASU 2014-08)

In April 2014, the FASB issued ASU 2014-08 changing the presentation of discontinued operations on the statements of income and other requirements for reporting discontinued operations. Under the new standard, a disposal of a component or a group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results when the component meets the criteria to be classified as held-for-sale or is disposed. The amendments in this update also require additional disclosures about discontinued operations and disposal of an individually significant component of an entity that does not qualify for discontinued operations. This standard must be prospectively applied to all reporting periods presented in financial reports issued after the effective date.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2014. If applicable, this standard will change the presentation of financial statements but will not affect the calculation of net income, comprehensive income or earnings per share. Management adopted ASU 2014-08 effective January 1, 2015. Management expects no impact on the financial statements in the first quarter of 2015.

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, 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 new accounting guidance is effective for interim and annual periods beginning after December 15, 2016. Early adoption is not permitted. As applicable, this standard may change the amount of revenue recognized in the income statements in each reporting period. Management is analyzing the impact of this new standard and, at this time, cannot estimate the impact of adoption on revenue or net income. Management plans to adopt ASU 2014-09 effective January 1, 2017.

ASU 2015-01 "Income Statement – Extraordinary and Unusual Items" (ASU 2015-01)

In January 2015, the FASB issued ASU 2015-01 eliminating the concept of extraordinary items for presentation on the face of the income statement. Under the new standard, a material event or transaction that is unusual in nature, infrequent or both shall be reported as a separate component of income from continuing operations. Alternatively, it may be disclosed in the notes to financial statements.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2015. Early adoption is permitted if applied from the beginning of a fiscal year. As applicable, this standard may change the presentation of amounts in the income statements. Management plans to adopt ASU 2015-01 effective January 1, 2016.

3. COMPREHENSIVE INCOME

Presentation of Comprehensive Income

The following tables provide the components of changes in AOCI for the years ended December 31, 2014 and 2013. All amounts in the following tables are presented net of related income taxes.

Changes in Accumulated Other Comprehensive Income (Loss) by Component For the Year Ended December 31, 2014

	Cash Flow Hedges		Pension and OPEB		Total
	Commodity	Interest Rate and Foreign Currency	Amortization of Deferred Costs	Changes in Funded Status	
	(in thousands)				
Balance in AOCI as of December 31, 2013	\$ 23	\$ (222)	\$ 2,677	\$ (7,898)	\$ (5,420)
Change in Fair Value Recognized in AOCI	347	—	—	(1,114)	(767)
Amounts Reclassified from AOCI	(370)	61	468	—	159
Net Current Period Other					
Comprehensive Income (Loss)	(23)	61	468	(1,114)	(608)
Pension and OPEB Adjustment Related to Kammer Plant	—	—	—	(1,308)	(1,308)
Balance in AOCI as of December 31, 2014	<u>\$ —</u>	<u>\$ (161)</u>	<u>\$ 3,145</u>	<u>\$ (10,320)</u>	<u>\$ (7,336)</u>

Changes in Accumulated Other Comprehensive Income (Loss) by Component For the Year Ended December 31, 2013

	Cash Flow Hedges		Pension and OPEB		Total
	Commodity	Interest Rate and Foreign Currency	Amortization of Deferred Costs	Changes in Funded Status	
	(in thousands)				
Balance in AOCI as of December 31, 2012	\$ (127)	\$ (282)	\$ 1,275	\$ (20,860)	\$ (19,994)
Change in Fair Value Recognized in AOCI	152	—	—	7,741	7,893
Amounts Reclassified from AOCI	(2)	60	1,402	—	1,460
Net Current Period Other					
Comprehensive Income	150	60	1,402	7,741	9,353
Pension and OPEB Adjustment Related to Mitchell Plant	—	—	—	5,221	5,221
Balance in AOCI as of December 31, 2013	<u>\$ 23</u>	<u>\$ (222)</u>	<u>\$ 2,677</u>	<u>\$ (7,898)</u>	<u>\$ (5,420)</u>

Reclassifications from Accumulated Other Comprehensive Income

The following tables provide details of reclassifications from AOCI for the years ended December 31, 2014 and 2013. The amortization of pension and OPEB AOCI components are included in the computation of net periodic pension and OPEB costs. See Note 8 for additional details.

Reclassifications from Accumulated Other Comprehensive Income (Loss) For the Years Ended December 31, 2014 and 2013

	Amount of (Gain) Loss Reclassified from AOCI	
	Years Ended December 31,	
	2014	2013
	(in thousands)	
Gains and Losses on Cash Flow Hedges		
Commodity:		
Electric Generation, Transmission and Distribution Revenues	\$ —	\$ (64)
Purchased Electricity for Resale	(513)	84
Other Operation Expense	(3)	(8)
Maintenance Expense	(5)	(5)
Property, Plant and Equipment	(6)	(11)
Regulatory Assets/(Liabilities), Net (a)	(43)	—
Subtotal – Commodity	<u>(570)</u>	<u>(4)</u>
Interest Rate and Foreign Currency:		
Interest Expense	93	93
Subtotal – Interest Rate and Foreign Currency	<u>93</u>	<u>93</u>
Reclassifications from AOCI, before Income Tax (Expense) Credit	(477)	89
Income Tax (Expense) Credit	(168)	31
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	<u>(309)</u>	<u>58</u>
Pension and OPEB		
Amortization of Prior Service Cost (Credit)	(214)	(364)
Amortization of Actuarial (Gains)/Losses	935	2,521
Reclassifications from AOCI, before Income Tax (Expense) Credit	721	2,157
Income Tax (Expense) Credit	253	755
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	<u>468</u>	<u>1,402</u>
Total Reclassifications from AOCI, Net of Income Tax (Expense) Credit	<u>\$ 159</u>	<u>\$ 1,460</u>

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

The following table provides details on designated, 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 for the year ended December 31, 2012. All amounts in the following table is presented net of related income taxes.

**Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges
Year Ended December 31, 2012**

	<u>Commodity</u>	<u>Interest Rate</u> <u>(in thousands)</u>	<u>Total</u>
Balance in AOCI as of December 31, 2011	\$ (283)	\$ (342)	\$ (625)
Changes in Fair Value Recognized in AOCI	(246)	—	(246)
Amount of (Gain) or Loss Reclassified from AOCI to Statement of Income/within Balance Sheet:			
Electric Generation, Transmission and Distribution Revenues	(16)	—	(16)
Purchased Electricity for Resale	427	—	427
Other Operation Expense	(5)	—	(5)
Maintenance Expense	—	—	—
Interest Expense	—	60	60
Property, Plant and Equipment	(4)	—	(4)
Regulatory Assets (a)	—	—	—
Regulatory Liabilities (a)	—	—	—
Balance in AOCI as of December 31, 2012	<u>\$ (127)</u>	<u>\$ (282)</u>	<u>\$ (409)</u>

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

4. RATE MATTERS

KPCo is involved in rate and regulatory proceedings at the FERC and the KPSC. Rate matters can have a material impact on net income, cash flows and possibly financial condition. KPCo's recent significant rate orders and pending rate filings are addressed in this note.

Plant Transfer

In December 2012, KPCo filed a request with the KPSC for approval to transfer at net book value to KPCo a one-half interest in the Mitchell Plant, comprising 780 MW of average annual generating capacity. KPCo also requested that costs related to the Big Sandy Plant, Unit 2 FGD project be established as a regulatory asset. As of December 31, 2014, the net book value of Big Sandy Plant, Unit 2 was \$253 million, before cost of removal, including materials and supplies inventory and CWIP. See "Regulated Generating Unit to be Retired Before or During 2016" section of Note 5.

In October 2013, the KPSC issued an order approving a modified settlement agreement between KPCo, Kentucky Industrial Utility Customers, Inc. and the Sierra Club. The modified settlement approved the transfer of a one-half interest in the Mitchell Plant to KPCo at net book value on December 31, 2013 with the limitation that the net book value of the Mitchell Plant transfer not exceed the amount to be determined by a WVPSC order. In December 2014, the WVPSC issued the Mitchell Plant transfer order with no disallowances. The modified settlement agreement approved by the KPSC also included the implementation of an Asset Transfer Rider to collect \$44 million annually effective January 2014, subject to true-up, and allowed KPCo to retain any off-system sales margins above the \$15.3 million annual level in base rates. Additionally, the settlement allows for KPCo to file a Certificate of Public Convenience and Necessity to convert Big Sandy Plant, Unit 1 to natural gas, provided the cost is approximately \$60 million, and addressed potential greenhouse gas initiatives on the Mitchell Plant. The settlement also approved recovery, including a return, of coal-related retirement costs related to Big Sandy Plant over 25 years when base rates are set (no earlier than June 2015) in the next base rate case, but rejected KPCo's request to defer FGD project costs for Big Sandy Plant, Unit 2. In December 2013, the transfer of a one-half interest in the Mitchell Plant to KPCo was completed.

In December 2013, the Attorney General filed an appeal with the Franklin County Circuit Court. In May 2014, KPCo's motion to dismiss the appeal was denied. In May 2014, KPCo filed motions for reconsideration and clarification with the Franklin County Circuit Court. In June 2014, the motion for reconsideration was denied but the motion to clarify was granted, thereby limiting the appeal to the issues of law presented in the Attorney General's appeal. If any part of the KPSC order is overturned, it could reduce future net income and cash flows and impact financial condition.

Kentucky Fuel Adjustment Clause Review

In August 2014, the KPSC issued an order initiating a review of KPCo's FAC from November 2013 through April 2014. In January 2015, the KPSC issued an order disallowing certain FAC costs during the period of January 2014 through May 2015 while KPCo owns and operates both Big Sandy Plant, Unit 2 and its one-half interest in the Mitchell Plant. Additionally, the KPSC directed KPCo to refund to customers \$13 million of fuel costs, by the end of the second quarter of 2015, collected during the FAC review period of January 2014 through April 2014. As a result of this order, KPCo recorded a regulatory disallowance of \$36 million in December 2014. In February 2015, KPCo filed an appeal of this order with the Franklin County Circuit Court.

2014 Kentucky Base Rate Case

In December 2014, KPCo filed a request with the KPSC for an increase in rates of \$70 million, which consists of a \$75 million increase in rider rates, offset by a \$5 million decrease in annual base rates, to be effective July 2015. The net increase reflects KPCo's ownership interest in the Mitchell Plant, riders to recover the Big Sandy Plant retirement and operational costs and the inclusion of an environmental compliance plan related to the Mitchell Plant FGD. Additionally, the filing included a request to recover deferred storm costs. If any of these costs are not recoverable, it could reduce future net income and cash flows and impact financial condition.

5. EFFECTS OF REGULATION

Regulated Generating Unit to be Retired Before or During 2016

The following regulated generating unit is probable of abandonment. Accordingly, CWIP and Plant in Service has been reclassified as Other Property, Plant and Equipment on the balance sheet as of December 31, 2014. The following table summarizes the plant investment and cost of removal, currently being recovered, for the generating unit as of December 31, 2014.

<u>Plant Name and Unit</u>	<u>Gross Investment</u>	<u>Accumulated Depreciation</u>	<u>Net Investment</u>	<u>Cost of Removal Regulatory Liability</u>	<u>Expected Retirement Date</u>	<u>Remaining Recovery Period</u>
	(in thousands)					
Big Sandy Plant, Unit 2	\$ 454,771	\$ 207,413	\$ 247,358	\$ 50,502	2015	26 years
Total	<u>\$ 454,771</u>	<u>\$ 207,413</u>	<u>\$ 247,358</u>	<u>\$ 50,502</u>		

Regulatory Assets and Liabilities

Regulatory assets and liabilities are comprised of the following items:

<u>Regulatory Assets:</u>	<u>December 31,</u>		<u>Remaining</u>
	<u>2014</u>	<u>2013</u>	<u>Recovery Period</u>
	(in thousands)		
<u>Noncurrent Regulatory Assets</u>			
<u>Regulatory assets pending final regulatory approval:</u>			
<u>Regulatory Assets Currently Not Earning a Return</u>			
Storm Related Costs	\$ 12,146	\$ 12,146	
Asset Retirement Obligation	8,287	—	
Total Regulatory Assets Pending Final Regulatory Approval	<u>20,433</u>	<u>12,146</u>	
<u>Regulatory assets approved for recovery:</u>			
<u>Regulatory Assets Currently Earning a Return</u>			
Other Regulatory Assets Approved for Recovery	1,159	1,422	various
<u>Regulatory Assets Currently Not Earning a Return</u>			
Income Taxes, Net	159,150	154,603	21 years
Pension and OPEB Funded Status	36,460	32,458	13 years
Postemployment Benefits	4,527	4,530	4 years
Storm Related Costs	2,349	7,048	1 year
Medicare Subsidy	2,166	2,383	10 years
Unrealized Loss on Forward Commitments	1,835	—	3 years
Other Regulatory Assets Approved for Recovery	1,748	1,770	various
Total Regulatory Assets Approved for Recovery	<u>209,394</u>	<u>204,214</u>	
Total Noncurrent Regulatory Assets	<u>\$ 229,827</u>	<u>\$ 216,360</u>	

Regulatory Liabilities:	December 31,		Remaining
	2014	2013	Refund Period
	(in thousands)		
<u>Current Regulatory Liability</u>			
Over-recovered Fuel Costs - does not pay a return	<u>\$ 1,770</u>	<u>\$ 2,851</u>	1 year
<u>Noncurrent Regulatory Liabilities and Deferred Investment Tax Credits</u>			
Regulatory liabilities approved for payment:			
<u>Regulatory Liabilities Currently Paying a Return</u>			
Asset Removal Costs	\$ 16,768	\$ 19,231	(a)
<u>Regulatory Liabilities Currently Not Paying a Return</u>			
Unrealized Gain on Forward Commitments	5,563	3,259	3 years
Other Regulatory Liabilities Approved for Payment	191	436	various
Total Regulatory Liabilities Approved for Payment	<u>22,522</u>	<u>22,926</u>	
Total Noncurrent Regulatory Liabilities and Deferred Investment Tax Credits	<u>\$ 22,522</u>	<u>\$ 22,926</u>	

(a) Relieved as removal costs are incurred.

6. 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 cannot be predicted. 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.

COMMITMENTS

Construction and Commitments

KPCo has substantial construction commitments to support its operations and environmental investments. In managing the overall construction program and in the normal course of business, KPCo contractually commits to third-party construction vendors for certain material purchases and other construction services. KPCo also purchases fuel, materials, supplies, services and property, plant and equipment under contract as part of its normal course of business. Certain supply contracts contain penalty provisions for early termination.

The following table summarizes KPCo's actual contractual commitments as of December 31, 2014:

<u>Contractual Commitments</u>	<u>Less Than 1 Year</u>	<u>2-3 Years</u>	<u>4-5 Years</u>	<u>After 5 Years</u>	<u>Total</u>
			(in thousands)		
Fuel Purchase Contracts (a)	\$ 187,786	\$ 268,526	\$ 243,546	\$ 298,202	\$ 998,060
Energy and Capacity Purchase Contracts	36,415	73,537	79,312	124,740	314,004
Construction Contracts for Capital Assets (b)	1,484	—	—	—	1,484
Total	<u>\$ 225,685</u>	<u>\$ 342,063</u>	<u>\$ 322,858</u>	<u>\$ 422,942</u>	<u>\$ 1,313,548</u>

- (a) Represents contractual commitments to purchase coal and other consumables as fuel for electric generation along with related transportation of the fuel.
- (b) Represents only capital assets for which there are signed contracts. Actual payments are dependent upon and may vary significantly based upon the decision to build, regulatory approval schedules, timing and escalation of project costs.

GUARANTEES

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

Letter of Credit

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

Indemnifications and Other Guarantees

Contracts

KPCo enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. As of December 31, 2014, 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 pursuant to the SIA.

Lease Obligations

KPCo leases certain equipment under master lease agreements. See “Master Lease Agreements” section of Note 13 for disclosure of lease residual value guarantees.

CONTINGENCIES

Insurance and Potential Losses

KPCo maintains insurance coverage normal and customary for an electric utility, subject to various deductibles. KPCo also maintains property and casualty insurance that may cover certain physical damage or third-party injuries caused by cyber security incidents. Insurance coverage includes all risks of physical loss or damage to assets, subject to insurance policy conditions and exclusions. Covered property generally includes power plants, substations, facilities and inventories. Excluded property generally includes transmission and distribution lines, poles and towers. The insurance programs also generally provide coverage against loss arising from certain claims made by third parties and are in excess of KPCo’s retentions. Coverage is generally provided by a combination of the protected cell of EIS and/or various industry mutual and/or commercial insurance carriers.

Some potential losses or liabilities may not be insurable or the amount of insurance carried may not be sufficient to meet potential losses and liabilities, including, but not limited to, liabilities relating to a cyber security incident. Future losses or liabilities, if they occur, which are not completely insured, unless recovered from customers, could reduce future net income and cash flows and impact financial condition.

The Comprehensive Environmental Response Compensation and Liability Act (Superfund) and State Remediation

By-products from the generation of electricity include materials such as ash, slag and sludge. Coal combustion by-products, which constitute the overwhelming percentage of these materials, are typically treated and deposited in captive disposal facilities or are beneficially utilized. In addition, the generation plants and transmission and distribution facilities have used asbestos, polychlorinated biphenyls and other hazardous and nonhazardous materials. KPCo currently incurs costs to dispose of these substances safely.

Superfund addresses clean-up of hazardous substances that have been released to the environment. The Federal EPA administers the clean-up programs. Several states have enacted similar laws. As of December 31, 2014, there is one site for which KPCo has received an information request which could lead to a Potentially Responsible Party designation. In the instance where KPCo has been named a defendant, disposal or recycling activities were in accordance with the then-applicable laws and regulations. Superfund does not recognize compliance as a defense, but imposes strict liability on parties who fall within its broad statutory categories. Liability has been resolved for a number of sites with no significant effect on net income.

Management evaluates the potential liability for each site separately, but several general statements can be made about potential future liability. Allegations that materials were disposed at a particular site are often unsubstantiated and the quantity of materials deposited at a site can be small and often nonhazardous. Although Superfund liability has been interpreted by the courts as joint and several, typically many parties are named for each site and several of the parties are financially sound enterprises. At present, management’s estimates do not anticipate material cleanup costs for identified sites.

7. IMPAIRMENT

2013

Big Sandy Plant, Unit 2 FGD Project

In the third quarter of 2013, KPCo recorded a pretax write-off of \$33 million in Asset Impairments and Other Related Charges on the statement of income primarily related to the Big Sandy Plant, Unit 2 FGD project as disallowed by the KPSC.

8. BENEFIT PLANS

For a discussion of investment strategy, investment limitations, target asset allocations and the classification of investments within the fair value hierarchy, see “Investments Held in Trust for Future Liabilities” and “Fair Value Measurements of Assets and Liabilities” sections of Note 1.

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.

KPCo recognizes its funded status associated with defined benefit pension and OPEB plans in its balance sheets. Disclosures about the plans are required by the “Compensation - Retirement Benefits” accounting guidance. KPCo recognizes an asset for a plan’s overfunded status or a liability for a plan’s underfunded status and recognizes, as a component of other comprehensive income, the changes in the funded status of the plan that arise during the year that are not recognized as a component of net periodic benefit cost. KPCo records a regulatory asset instead of other comprehensive income for qualifying benefit costs of regulated operations that for ratemaking purposes are deferred for future recovery. The cumulative funded status adjustment is equal to the remaining unrecognized deferrals for unamortized actuarial losses or gains, prior service costs and transition obligations, such that remaining deferred costs result in an AOCI equity reduction or regulatory asset and deferred gains result in an AOCI equity addition or regulatory liability.

Actuarial Assumptions for Benefit Obligations

The weighted-average assumptions as of December 31 of each year used in the measurement of KPCo’s benefit obligations are shown in the following table:

<u>Assumptions</u>	<u>Pension Plans</u>		<u>Other Postretirement Benefit Plans</u>	
	<u>2014</u>	<u>2013</u>	<u>2014</u>	<u>2013</u>
Discount Rate	4.00%	4.70%	4.00%	4.70%
Rate of Compensation Increase	4.35% (a)	4.50% (a)	NA	NA

(a) Rates are for base pay only. In addition, an amount is added to reflect target incentive compensation for exempt employees and overtime and incentive pay for nonexempt employees.

NA Not applicable.

A duration-based method is used to determine the discount rate for the plans. A hypothetical portfolio of high quality corporate bonds is constructed with cash flows matching the benefit plan liability. The composite yield on the hypothetical bond portfolio is used as the discount rate for the plan.

For 2014, the rate of compensation increase assumed varies with the age of the employee, ranging from 3.5% per year to 12% per year, with an average increase of 4.35%.

Updated mortality assumptions based on mortality tables issued by the Society of Actuaries in October 2014 were used for the December 31, 2014 benefit obligation measurements. These updates resulted in approximate benefit obligation increases of \$4.5 million for the pension plans and \$298 thousand for the OPEB plans.

Actuarial Assumptions for Net Periodic Benefit Costs

The weighted-average assumptions as of January 1 of each year used in the measurement of KPCo's benefit costs are shown in the following table:

	Pension Plans			Other Postretirement Benefit Plans		
	2014	2013	2012	2014	2013	2012
Discount Rate	4.70%	3.95%	4.55%	4.70%	3.95%	4.75%
Expected Return on Plan Assets	6.00%	6.50%	7.25%	6.75%	7.00%	7.25%
Rate of Compensation Increase	4.50%	4.50%	4.50%	NA	NA	NA

NA Not applicable.

The expected return on plan assets was determined by evaluating historical returns, the current investment climate (yield on fixed income securities and other recent investment market indicators), rate of inflation and current prospects for economic growth.

The health care trend rate assumptions as of January 1 of each year used for OPEB plans measurement purposes are shown below:

Health Care Trend Rates	2014	2013
Initial	6.50%	6.75%
Ultimate	5.00%	5.00%
Year Ultimate Reached	2020	2020

Assumed health care cost trend rates have a significant effect on the amounts reported for the OPEB health care plans. A 1% change in assumed health care cost trend rates would have the following effects:

	1% Increase		1% Decrease	
	(in thousands)			
Effect on Total Service and Interest Cost Components of Net Periodic Postretirement Health Care Benefit Cost	\$	103	\$	(79)
Effect on the Health Care Component of the Accumulated Postretirement Benefit Obligation		2,237		(1,770)

Significant Concentrations of Risk within Plan Assets

In addition to establishing the target asset allocation of plan assets, the investment policy also places restrictions on securities to limit significant concentrations within plan assets. The investment policy establishes guidelines that govern maximum market exposure, security restrictions, prohibited asset classes, prohibited types of transactions, minimum credit quality, average portfolio credit quality, portfolio duration and concentration limits. The guidelines were established to mitigate the risk of loss due to significant concentrations in any investment. The plans are monitored to control security diversification and ensure compliance with the investment policy. As of December 31, 2014, the assets were invested in compliance with all investment limits. See "Investments Held in Trust for Future Liabilities" section of Note 1 for limit details.

Benefit Plan Obligations, Plan Assets and Funded Status as of December 31, 2014 and 2013

The following tables provide a reconciliation of the changes in the plans' benefit obligations, fair value of plan assets and funded status as of December 31. The benefit obligation for the defined benefit pension and OPEB plans are the projected benefit obligation and the accumulated benefit obligation, respectively.

Change in Benefit Obligation	Pension Plans		Other Postretirement Benefit Plans	
	2014	2013	2014	2013
	(in thousands)			
Benefit Obligation as of January 1,	\$ 169,432	\$ 183,994	\$ 50,806	\$ 66,513
Service Cost	2,299	1,763	472	750
Interest Cost	8,041	7,074	2,405	2,491
Actuarial (Gain) Loss	18,130	(13,578)	100	(15,950)
Benefit Payments	(8,678)	(9,821)	(4,582)	(4,423)
Participant Contributions	—	—	1,413	1,198
Medicare Subsidy	—	—	204	227
Benefit Obligation as of December 31,	\$ 189,224	\$ 169,432	\$ 50,818	\$ 50,806
Change in Fair Value of Plan Assets				
Fair Value of Plan Assets as of January 1,	\$ 169,578	\$ 165,534	\$ 62,925	\$ 60,402
Actual Gain on Plan Assets	22,019	13,865	3,872	5,748
Company Contributions	1,923	—	—	—
Participant Contributions	—	—	1,413	1,198
Benefit Payments	(8,678)	(9,821)	(4,582)	(4,423)
Fair Value of Plan Assets as of December 31,	\$ 184,842	\$ 169,578	\$ 63,628	\$ 62,925
Funded (Underfunded) Status as of December 31,	\$ (4,382)	\$ 146	\$ 12,810	\$ 12,119

Amounts Recognized on the Balance Sheets as of December 31, 2014 and 2013

	Pension Plans		Other Postretirement Benefit Plans	
	2014	2013	December 31, 2014	December 31, 2013
	(in thousands)			
Employee Benefits and Pension Assets – Prepaid Benefit Costs	\$ —	\$ 146	\$ 12,810	\$ 11,300
Employee Benefits and Pension Obligations – Accrued Long-term Benefit Liability	(4,382)	—	—	819
Funded (Underfunded) Status	\$ (4,382)	\$ 146	\$ 12,810	\$ 12,119

Amounts Included in AOCI and Regulatory Assets as of December 31, 2014 and 2013

Components	Pension Plans		Other Postretirement Benefit Plans	
	2014	2013	December 31, 2014	December 31, 2013
	(in thousands)			
Net Actuarial Loss	\$ 56,506	\$ 51,587	\$ 12,921	\$ 12,769
Prior Service Cost (Credit)	153	203	(22,082)	(24,069)
Recorded as				
Regulatory Assets	\$ 43,989	\$ 42,089	\$ (7,529)	\$ (9,631)
Deferred Income Taxes	4,434	3,395	(571)	(584)
Net of Tax AOCI	8,236	6,306	(1,061)	(1,085)

Components of the change in amounts included in AOCI and Regulatory Assets during the years ended December 31, 2014 and 2013 are as follows:

Components	Pension Plans		Other Postretirement Benefit Plans	
	December 31,			
	2014	2013	2014	2013
	(in thousands)			
Actuarial (Gain) Loss During the Year	\$ 9,392	\$ (17,611)	\$ 461	\$ (17,745)
Amortization of Actuarial Loss	(4,466)	(6,393)	(746)	(2,283)
Amortization of Prior Service Credit (Cost)	(57)	(56)	2,424	2,399
Change for the Year	\$ 4,869	\$ (24,060)	\$ 2,139	\$ (17,629)

Pension and Other Postretirement Benefits Plans' Assets

The following table presents the classification of pension plan assets within the fair value hierarchy as of December 31, 2014:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
	(in thousands)					
Equities:						
Domestic	\$ 21,902	\$ —	\$ —	\$ —	\$ 21,902	11.9 %
International	18,686	—	—	—	18,686	10.1 %
Options	—	524	—	—	524	0.3 %
Real Estate Investment Trusts	2,020	—	—	—	2,020	1.1 %
Common Collective Trust – Global	—	14,030	—	—	14,030	7.6 %
Common Collective Trust – International	—	688	—	—	688	0.4 %
Subtotal – Equities	42,608	15,242	—	—	57,850	31.4 %
Fixed Income:						
Common Collective Trust – Debt	—	1,124	—	—	1,124	0.6 %
United States Government and Agency Securities	—	16,739	—	—	16,739	9.0 %
Corporate Debt	—	66,958	—	—	66,958	36.2 %
Foreign Debt	—	14,909	—	—	14,909	8.1 %
State and Local Government	—	555	—	—	555	0.3 %
Other – Asset Backed	—	1,084	—	—	1,084	0.6 %
Subtotal – Fixed Income	—	101,369	—	—	101,369	54.8 %
Infrastructure	—	—	465	—	465	0.3 %
Real Estate	—	—	8,774	—	8,774	4.7 %
Alternative Investments	—	—	14,097	—	14,097	7.6 %
Securities Lending	—	8,177	—	—	8,177	4.4 %
Securities Lending Collateral (a)	—	—	—	(8,242)	(8,242)	(4.5)%
Cash and Cash Equivalents	—	1,982	—	—	1,982	1.1 %
Other – Pending Transactions and Accrued Income (b)	—	—	—	370	370	0.2 %
Total	\$ 42,608	\$ 126,770	\$ 23,336	\$ (7,872)	\$ 184,842	100.0 %

(a) Amounts in "Other" column primarily represent an obligation to repay collateral received as part of the Securities Lending Program.

(b) Amounts in "Other" column primarily represent accrued interest, dividend receivables and transactions pending settlement.

The following table sets forth a reconciliation of changes in the fair value of assets classified as Level 3 in the fair value hierarchy for the pension assets:

	<u>Infrastructure</u>	<u>Real Estate</u>	<u>Alternative Investments</u>	<u>Total Level 3</u>
	(in thousands)			
Balance as of January 1, 2014	\$ —	\$ 8,575	\$ 11,865	\$ 20,440
Actual Return on Plan Assets				
Relating to Assets Still Held as of the Reporting Date	—	(439)	1,450	1,011
Relating to Assets Sold During the Period	—	(1,527)	714	(813)
Purchases and Sales	465	2,165	68	2,698
Transfers into Level 3	—	—	—	—
Transfers out of Level 3	—	—	—	—
Balance as of December 31, 2014	<u>\$ 465</u>	<u>\$ 8,774</u>	<u>\$ 14,097</u>	<u>\$ 23,336</u>

The following table presents the classification of OPEB plan assets within the fair value hierarchy as of December 31, 2014:

<u>Asset Class</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>	<u>Year End Allocation</u>
	(in thousands)					
Equities:						
Domestic	\$ 17,509	\$ —	\$ —	\$ —	\$ 17,509	27.5%
International	21,283	—	—	—	21,283	33.5%
Options	—	615	—	—	615	1.0%
Common Collective Trust – Global	—	1,112	—	—	1,112	1.8%
Subtotal – Equities	<u>38,792</u>	<u>1,727</u>	<u>—</u>	<u>—</u>	<u>40,519</u>	<u>63.8%</u>
Fixed Income:						
Common Collective Trust Debt	—	3,897	—	—	3,897	6.1%
United States Government and Agency Securities	—	2,670	—	—	2,670	4.2%
Corporate Debt	—	4,713	—	—	4,713	7.4%
Foreign Debt	—	801	—	—	801	1.3%
State and Local Government	—	221	—	—	221	0.3%
Other – Asset Backed	—	186	—	—	186	0.3%
Subtotal – Fixed Income	<u>—</u>	<u>12,488</u>	<u>—</u>	<u>—</u>	<u>12,488</u>	<u>19.6%</u>
Trust Owned Life Insurance:						
International Equities	—	387	—	—	387	0.6%
United States Bonds	—	7,965	—	—	7,965	12.5%
Subtotal – Trust Owned Life Insurance	<u>—</u>	<u>8,352</u>	<u>—</u>	<u>—</u>	<u>8,352</u>	<u>13.1%</u>
Cash and Cash Equivalents	1,757	360	—	—	2,117	3.3%
Other – Pending Transactions and Accrued Income (a)	—	—	—	152	152	0.2%
Total	<u>\$ 40,549</u>	<u>\$ 22,927</u>	<u>\$ —</u>	<u>\$ 152</u>	<u>\$ 63,628</u>	<u>100.0%</u>

(a) Amounts in "Other" column primarily represent accrued interest, dividend receivables and transactions pending settlement.

The following table presents the classification of pension plan assets within the fair value hierarchy as of December 31, 2013:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
	(in thousands)					
Equities:						
Domestic	\$ 39,294	\$ —	\$ —	\$ —	\$ 39,294	23.2 %
International	18,522	—	—	—	18,522	10.9 %
Real Estate Investment Trusts	2,084	—	—	—	2,084	1.2 %
Common Collective Trust – International	—	352	—	—	352	0.2 %
Subtotal – Equities	59,900	352	—	—	60,252	35.5 %
Fixed Income:						
Common Collective Trust – Debt	—	933	—	—	933	0.5 %
United States Government and Agency Securities	—	13,922	—	—	13,922	8.2 %
Corporate Debt	—	57,592	—	—	57,592	34.0 %
Foreign Debt	—	12,372	—	—	12,372	7.3 %
State and Local Government	—	1,007	—	—	1,007	0.6 %
Other – Asset Backed	—	1,198	—	—	1,198	0.7 %
Subtotal – Fixed Income	—	87,024	—	—	87,024	51.3 %
Real Estate	—	—	8,575	—	8,575	5.0 %
Alternative Investments	—	—	11,865	—	11,865	7.0 %
Securities Lending	—	1,266	—	—	1,266	0.8 %
Securities Lending Collateral (a)	—	—	—	(1,627)	(1,627)	(0.9)%
Cash and Cash Equivalents	—	1,749	—	—	1,749	1.0 %
Other – Pending Transactions and Accrued Income (b)	—	—	—	474	474	0.3 %
Total	\$ 59,900	\$ 90,391	\$ 20,440	\$ (1,153)	\$ 169,578	100.0 %

- (a) Amounts in "Other" column primarily represent an obligation to repay collateral received as part of the Securities Lending Program.
- (b) Amounts in "Other" column primarily represent accrued interest, dividend receivables and transactions pending settlement.

The following table sets forth a reconciliation of changes in the fair value of assets classified as Level 3 in the fair value hierarchy for the pension assets:

	Real Estate	Alternative Investments	Total Level 3
	(in thousands)		
Balance as of January 1, 2013	\$ 7,740	\$ 6,894	\$ 14,634
Actual Return on Plan Assets			
Relating to Assets Still Held as of the Reporting Date	1,197	532	1,729
Relating to Assets Sold During the Period	—	537	537
Purchases and Sales	(362)	3,902	3,540
Transfers into Level 3	—	—	—
Transfers out of Level 3	—	—	—
Balance as of December 31, 2013	\$ 8,575	\$ 11,865	\$ 20,440

The following table presents the classification of OPEB plan assets within the fair value hierarchy as of December 31, 2013:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
	(in thousands)					
Equities:						
Domestic	\$ 17,535	\$ —	\$ —	\$ —	\$ 17,535	27.9%
International	22,796	—	—	—	22,796	36.2%
Common Collective Trust – Global	—	544	—	—	544	0.9%
Subtotal – Equities	40,331	544	—	—	40,875	65.0%
Fixed Income:						
Common Collective Trust – Debt	—	3,255	—	—	3,255	5.2%
United States Government and Agency Securities	—	2,093	—	—	2,093	3.3%
Corporate Debt	—	4,078	—	—	4,078	6.5%
Foreign Debt	—	796	—	—	796	1.2%
State and Local Government	—	171	—	—	171	0.3%
Other – Asset Backed	—	301	—	—	301	0.5%
Subtotal – Fixed Income	—	10,694	—	—	10,694	17.0%
Trust Owned Life Insurance:						
International Equities	—	490	—	—	490	0.8%
United States Bonds	—	7,836	—	—	7,836	12.4%
Subtotal – Trust Owned Life Insurance	—	8,326	—	—	8,326	13.2%
Cash and Cash Equivalents	2,527	325	—	—	2,852	4.5%
Other – Pending Transactions and Accrued Income (a)	—	—	—	178	178	0.3%
Total	\$ 42,858	\$ 19,889	\$ —	\$ 178	\$ 62,925	100.0%

(a) Amounts in "Other" column primarily represent accrued interest, dividend receivables and transactions pending settlement.

Determination of Pension Expense

The determination of pension expense or income is based on a market-related valuation of assets which reduces year-to-year volatility. This market-related valuation recognizes investment gains or losses over a five-year period from the year in which they occur. Investment gains or losses for this purpose are the difference between the expected return calculated using the market-related value of assets and the actual return.

The accumulated benefit obligation for the pension plans is as follows:

Accumulated Benefit Obligation	December 31,	
	2014	2013
	(in thousands)	
Qualified Pension Plan	\$ 185,344	\$ 166,951
Nonqualified Pension Plan	4	—
Total	\$ 185,348	\$ 166,951

For the underfunded pension plans that had an accumulated benefit obligation in excess of plan assets, the projected benefit obligation, accumulated benefit obligation and fair value of plan assets of these plans as of December 31, 2014 were as follows:

	Underfunded Pension Plans	
	December 31, 2014	
	(in thousands)	
Projected Benefit Obligation	\$	189,224
Accumulated Benefit Obligation	\$	185,348
Fair Value of Plan Assets		184,842
Underfunded Accumulated Benefit Obligation	\$	(506)

Estimated Future Benefit Payments and Contributions

KPCo expects contributions and payments for the pension plans of \$2.3 million during 2015. The estimated contributions to the pension trust are at least the minimum amount required by the Employee Retirement Income Security Act and additional discretionary contributions may also be made to maintain the funded status of the plan.

The table below reflects the total benefits expected to be paid from the plan or from KPCo's assets. The payments include the participants' contributions to the plan for their share of the cost. Effective for employees hired after December 2013, retiree medical coverage will not be provided. Future benefit payments are dependent on the number of employees retiring, whether the retiring employees elect to receive pension benefits as annuities or as lump sum distributions, future integration of the benefit plans with changes to Medicare and other legislation, future levels of interest rates and variances in actuarial results. The estimated payments for pension benefits and OPEB are as follows:

	Estimated Payments			
	Pension Plans		Other Postretirement Benefit Plans	
	(in thousands)			
2015	\$	9,872	\$	4,373
2016		10,001		4,482
2017		10,363		4,562
2018		10,966		4,564
2019		11,777		4,616
Years 2020 to 2024, in Total		63,212		25,108

Components of Net Periodic Benefit Cost

The following table provides the components of net periodic benefit cost (credit) for the years ended December 31, 2014, 2013 and 2012:

	Pension Plans			Other Postretirement Benefit Plans		
	Years Ended December 31,					
	2014	2013	2012	2014	2013	2012
	(in thousands)					
Service Cost	\$ 2,299	\$ 1,763	\$ 2,231	\$ 472	\$ 750	\$ 1,636
Interest Cost	8,041	7,074	7,762	2,405	2,491	3,821
Expected Return on Plan Assets	(9,672)	(9,832)	(11,290)	(4,239)	(3,999)	(3,931)
Amortization of Prior Service Cost (Credit)	57	56	120	(2,424)	(2,399)	(676)
Amortization of Net Actuarial Loss	4,466	6,393	5,225	746	2,283	2,117
Net Periodic Benefit Cost (Credit)	5,191	5,454	4,048	(3,040)	(874)	2,967
Capitalized Portion	(1,809)	(2,372)	(1,388)	1,059	380	(1,018)
Net Periodic Benefit Cost (Credit) Recognized in Expense	\$ 3,382	\$ 3,082	\$ 2,660	\$ (1,981)	\$ (494)	\$ 1,949

Estimated amounts expected to be amortized to net periodic benefit costs (credits) and the impact on the balance sheet during 2015 are shown in the following table:

Components	Pension Plans	Other Postretirement Benefit Plans
	(in thousands)	
Net Actuarial Loss	\$ 3,891	\$ 570
Prior Service Cost (Credit)	53	(2,424)
Total Estimated 2015 Amortization	\$ 3,944	\$ (1,854)
Expected to be Recorded as		
Regulatory Asset	\$ 3,219	\$ (1,715)
Deferred Income Taxes	254	(49)
Net of Tax AOCI	471	(90)
Total	\$ 3,944	\$ (1,854)

American Electric Power System Retirement Savings Plan

KPCo participates in an AEP sponsored defined contribution retirement savings plan, the American Electric Power System Retirement Savings Plan, for substantially all employees. This qualified plan offers participants an opportunity to contribute a portion of their pay, includes features under Section 401(k) of the Internal Revenue Code and provides for matching contributions. The matching contributions to the plan are 100% of the first 1% of eligible employee contributions and 70% of the next 5% of contributions. The cost for matching contributions totaled \$2.5 million in 2014, \$2.3 million in 2013 and \$2.3 million in 2012.

9. BUSINESS SEGMENTS

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

10. DERIVATIVES AND HEDGING

OBJECTIVES FOR UTILIZATION OF DERIVATIVE INSTRUMENTS

KPCo is exposed to certain market risks as a major power producer and marketer of wholesale electricity, natural gas, coal and emission allowances. 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. AEPSC, on behalf of KPCo, manages these risks using derivative instruments.

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, focusing on seizing market opportunities to create value driven by expected changes in the market prices of the commodities in which AEPSC transacts on behalf of KPCo. To accomplish these objectives, AEPSC, on behalf of 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.

AEPSC, on behalf of KPCo, enters into power, 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. AEPSC, on behalf of KPCo, enters into interest rate derivative contracts in order to manage the interest rate exposure associated with KPCo’s commodity portfolio. For disclosure purposes, such risks are grouped as “Commodity,” as these risks are related to energy risk management activities. AEPSC, on behalf of KPCo, also engages in risk management of interest rate risk associated with debt. 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 AEP’s Board of Directors.

The following table represents the gross notional volume of KPCo’s outstanding derivative contracts as of December 31, 2014 and 2013:

Notional Volume of Derivative Instruments

Primary Risk Exposure	Volume		Unit of Measure
	December 31, 2014	December 31, 2013	
	(in thousands)		
Commodity:			
Power	6,689	10,071	MWhs
Coal	233	2	Tons
Natural Gas	87	509	MMBtus
Heating Oil and Gasoline	261	261	Gallons
Interest Rate	\$ 1,047	\$ 2,615	USD

Cash Flow Hedging Strategies

AEPSC, on behalf of KPCo, enters into and designates as cash flow hedges 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's vehicle fleet is exposed to gasoline and diesel fuel price volatility. AEPSC, on behalf of KPCo, enters into financial heating oil and gasoline derivative contracts in order to mitigate price risk of future fuel purchases. Cash flow hedge accounting for these derivative contracts was discontinued effective March 31, 2014. For disclosure purposes, these contracts were included with other hedging activities as "Commodity" as of December 31, 2013. In March 2014, these contracts were grouped as "Commodity" with other risk management activities. KPCo does not hedge all fuel price risk.

AEPSC, on behalf of KPCo, enters into a variety of interest rate derivative transactions in order to manage interest rate risk exposure. AEPSC, on behalf of KPCo, also enters into 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 KPCo's 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 December 31, 2014 and 2013 balance sheets, KPCo netted \$67 thousand and \$0, respectively, of cash collateral received from third parties against short-term and long-term risk management assets and \$24 thousand and \$1 million, 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 impact of KPCo's derivative activity on the balance sheets as of December 31, 2014 and 2013:

**Fair Value of Derivative Instruments
December 31, 2014**

Balance Sheet Location	Risk Management Contracts		Hedging Contracts		Gross Amounts of Risk Management Assets/Liabilities Recognized	Gross Amounts Offset in the Statement of Financial Position (b)	Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)
	Commodity (a)	Commodity (a)	Interest Rate (a)	Interest Rate (a)			
	(in thousands)						
Current Risk Management Assets	\$ 8,631	\$ —	\$ —	\$ —	\$ 8,631	\$ (2,273)	\$ 6,358
Long-term Risk Management Assets	1,060	—	—	—	1,060	(55)	1,005
Total Assets	9,691	—	—	—	9,691	(2,328)	7,363
Current Risk Management Liabilities	5,487	—	—	—	5,487	(2,231)	3,256
Long-term Risk Management Liabilities	477	—	—	—	477	(54)	423
Total Liabilities	5,964	—	—	—	5,964	(2,285)	3,679
Total MTM Derivative Contract Net Assets (Liabilities)	\$ 3,727	\$ —	\$ —	\$ —	\$ 3,727	\$ (43)	\$ 3,684

**Fair Value of Derivative Instruments
December 31, 2013**

Balance Sheet Location	Risk Management Contracts		Hedging Contracts		Gross Amounts of Risk Management Assets/Liabilities Recognized	Gross Amounts Offset in the Statement of Financial Position (b)	Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)
	Commodity (a)	Commodity (a)	Interest Rate (a)	Interest Rate (a)			
	(in thousands)						
Current Risk Management Assets	\$ 9,520	\$ 85	\$ —	\$ —	\$ 9,605	\$ (5,249)	\$ 4,356
Long-term Risk Management Assets	4,306	—	—	—	4,306	(822)	3,484
Total Assets	13,826	85	—	—	13,911	(6,071)	7,840
Current Risk Management Liabilities	7,583	65	—	—	7,648	(5,820)	1,828
Long-term Risk Management Liabilities	2,970	—	—	—	2,970	(865)	2,105
Total Liabilities	10,553	65	—	—	10,618	(6,685)	3,933
Total MTM Derivative Contract Net Assets (Liabilities)	\$ 3,273	\$ 20	\$ —	\$ —	\$ 3,293	\$ 614	\$ 3,907

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

The table below presents KPCo's activity of derivative risk management contracts for the years ended December 31, 2014, 2013 and 2012:

**Amount of Gain (Loss) Recognized on
Risk Management Contracts**

Location of Gain (Loss)	Years Ended December 31,		
	2014	2013	2012
	(in thousands)		
Electric Generation, Transmission and Distribution Revenues	\$ 13,303	\$ 1,483	\$ (1,597)
Fuel and Other Consumables Used for Electric Generation	(9)	—	—
Regulatory Assets (a)	(2,778)	—	—
Regulatory Liabilities (a)	2,304	(1,029)	1,047
Total Gain (Loss) on Risk Management Contracts	\$ 12,820	\$ 454	\$ (550)

- (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.

KPCo’s 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. 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 recognizes any hedge ineffectiveness as a regulatory asset (for losses) or a regulatory liability (for gains).

Realized gains and losses on derivative contracts for the purchase and sale of power designated as cash flow hedges are included in 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 2014, 2013 and 2012, KPCo designated power derivatives as cash flow hedges.

KPCo reclassifies gains and losses on heating oil and gasoline derivative contracts designated as cash flow hedges from Accumulated Other Comprehensive Income (Loss) on its balance sheets into Other Operation expense, Maintenance expense or Depreciation and Amortization expense, as it relates to capital projects, on the statements of income. During 2013 and 2012, KPCo designated heating oil and gasoline derivatives as cash flow hedges. The impact of cash flow hedge accounting for these derivative contracts was immaterial and was discontinued effective March 31, 2014.

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 2014, 2013 and 2012, KPCo did not designate any interest rate derivatives as cash flow hedges.

During 2014, 2013 and 2012, hedge ineffectiveness was immaterial or nonexistent for all cash flow hedge strategies disclosed above.

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

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on KPCo's balance sheets as of December 31, 2014 and 2013 were:

**Impact of Cash Flow Hedges on the Balance Sheet
December 31, 2014**

	<u>Commodity</u>	<u>Interest Rate</u> (in thousands)	<u>Total</u>
Hedging Assets (a)	\$ —	\$ —	\$ —
Hedging Liabilities (a)	—	—	—
AOCI Loss Net of Tax	—	(161)	(161)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	—	(60)	(60)

**Impact of Cash Flow Hedges on the Balance Sheet
December 31, 2013**

	<u>Commodity</u>	<u>Interest Rate</u> (in thousands)	<u>Total</u>
Hedging Assets (a)	\$ 79	\$ —	\$ 79
Hedging Liabilities (a)	59	—	59
AOCI Gain (Loss) Net of Tax	23	(222)	(199)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	23	(60)	(37)

- (a) Hedging Assets and Hedging Liabilities are included in Risk Management Assets and Liabilities on KPCo's balance sheets.

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 December 31, 2014, 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

AEPSC, on behalf of KPCo, 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. AEPSC, on behalf of KPCo, 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.

When AEPSC, on behalf of KPCo, uses standardized master agreements, these agreements may include collateral requirements. These master agreements facilitate the netting of cash flows associated with a single counterparty. Cash, letters of credit and parental/affiliate guarantees may be obtained as security from counterparties in order to mitigate credit risk. The collateral agreements require a counterparty 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, collateral agreements allow for termination and liquidation of all positions in the event of a failure or inability to post collateral.

Collateral Triggering Events

Under the tariffs of the RTOs and Independent System Operators (ISOs) and a limited number of derivative and non-derivative contracts primarily related to competitive retail auction loads, KPCo is obligated to post an additional amount of collateral if certain credit ratings decline below investment grade. The amount of collateral required fluctuates based on market prices and total exposure. On an ongoing basis, AEP's risk management organization assesses the appropriateness of these collateral triggering items in contracts. KPCo has not experienced a downgrade below investment grade. The following table represents KPCo's exposure if credit ratings were to decline below a specified rating threshold as of December 31, 2014 and 2013:

	December 31,	
	2014	2013
	(in thousands)	
Fair Value of Contracts with Credit Downgrade Triggers	\$ —	\$ 118
Amount of Collateral KPCo Would Have been Required to Post for Derivative Contracts as well as Derivative and Non-Derivative Contracts Subject to the Same Master Netting Arrangement	—	—
Amount of Collateral KPCo Would Have Been Required to Post Attributable to RTOs and ISOs	1,303	522
Amount of Collateral Attributable to Other Contracts	14	43

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 in excess of \$50 million. 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 by KPCo and (c) if a cross-default provision would have been triggered, the settlement amount that would be required after considering KPCo's contractual netting arrangements as of December 31, 2014 and 2013:

	December 31,	
	2014	2013
	(in thousands)	
Liabilities for Contracts with Cross Default Provisions Prior to Contractual Netting Arrangements	\$ 1,859	\$ 4,039
Amount of Cash Collateral Posted	—	—
Additional Settlement Liability if Cross Default Provision is Triggered	1,852	3,817

11. FAIR VALUE MEASUREMENTS

Fair Value Measurements of Long-term Debt

The fair values of Long-term Debt are based on quoted market prices, without credit enhancements, for the same or similar issues and the current interest rates offered for instruments with similar maturities classified as Level 2 measurement inputs. These instruments are not marked-to-market. The estimates presented are not necessarily indicative of the amounts that could be realized in a current market exchange.

The book values and fair values of KPCo's Long-term Debt as of December 31, 2014 and 2013 are summarized in the following table:

	December 31,			
	2014		2013	
	<u>Book Value</u>	<u>Fair Value</u>	<u>Book Value</u>	<u>Fair Value</u>
	(in thousands)			
Long-term Debt	\$ 819,555	\$ 948,967	\$ 749,389	\$ 841,594

Fair Value Measurements of Financial Assets and Liabilities

For a discussion of fair value accounting and the classification of assets and liabilities within the fair value hierarchy, see the "Fair Value Measurements of Assets and Liabilities" section of Note 1.

The following tables set forth, by level within the fair value hierarchy, KPCo's financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2014 and 2013. 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 December 31, 2014

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
Assets:	(in thousands)				
Risk Management Assets					
Risk Management Commodity Contracts (a) (b)	<u>\$ 42</u>	<u>\$ 5,328</u>	<u>\$ 4,320</u>	<u>\$ (2,327)</u>	<u>\$ 7,363</u>
Liabilities:					
Risk Management Liabilities					
Risk Management Commodity Contracts (a) (b)	<u>\$ 47</u>	<u>\$ 5,523</u>	<u>\$ 393</u>	<u>\$ (2,284)</u>	<u>\$ 3,679</u>

**Assets and Liabilities Measured at Fair Value on a Recurring Basis
December 31, 2013**

Assets:	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
Risk Management Assets					
Risk Management Commodity Contracts (a) (b)	\$ 170	\$ 11,168	\$ 2,487	\$ (6,064)	\$ 7,761
Cash Flow Hedges:					
Commodity Hedges (a)	—	85	—	(6)	79
Total Risk Management Assets	<u>\$ 170</u>	<u>\$ 11,253</u>	<u>\$ 2,487</u>	<u>\$ (6,070)</u>	<u>\$ 7,840</u>

Liabilities:

Risk Management Liabilities					
Risk Management Commodity Contracts (a) (b)	\$ 144	\$ 10,092	\$ 316	\$ (6,678)	\$ 3,874
Cash Flow Hedges:					
Commodity Hedges (a)	—	65	—	(6)	59
Total Risk Management Liabilities	<u>\$ 144</u>	<u>\$ 10,157</u>	<u>\$ 316</u>	<u>\$ (6,684)</u>	<u>\$ 3,933</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 have been no transfers between Level 1 and Level 2 during the years ended December 31, 2014, 2013 and 2012.

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

<u>Year Ended December 31, 2014</u>	<u>Net Risk Management Assets (Liabilities) (in thousands)</u>
Balance as of December 31, 2013	\$ 2,171
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)	5,490
Purchases, Issuances and Settlements (c)	(6,084)
Transfers into Level 3 (d) (e)	(750)
Transfers out of Level 3 (e) (f)	(7)
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	3,107
Balance as of December 31, 2014	<u>\$ 3,927</u>
<u>Year Ended December 31, 2013</u>	<u>Net Risk Management Assets (Liabilities) (in thousands)</u>
Balance as of December 31, 2012	\$ 2,199
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)	(732)
Purchases, Issuances and Settlements (c)	101
Transfers into Level 3 (d) (e)	273
Transfers out of Level 3 (e) (f)	(187)
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	517
Balance as of December 31, 2013	<u>\$ 2,171</u>

Year Ended December 31, 2012	Net Risk Management Assets (Liabilities) (in thousands)
Balance as of December 31, 2011	\$ 416
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)	(1,071)
Realized and Unrealized Gains (Losses) Included in Other Comprehensive Income	5
Purchases, Issuances and Settlements (c)	2,282
Transfers into Level 3 (d) (e)	309
Transfers out of Level 3 (e) (f)	(434)
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	692
Balance as of December 31, 2012	<u>\$ 2,199</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) Represents the settlement of risk management commodity contracts for the reporting period.
- (d) Represents existing assets or liabilities that were previously categorized as Level 2.
- (e) Transfers are recognized based on their value at the beginning of the reporting period that the transfer occurred.
- (f) Represents existing assets or liabilities that were previously categorized as Level 3.
- (g) Relates to the net gains (losses) of those contracts that are not reflected on KPCo's statements of income. These net gains (losses) are recorded as regulatory assets/liabilities.

The following tables quantify the significant unobservable inputs used in developing the fair value of Level 3 positions as of December 31, 2014 and 2013:

**Significant Unobservable Inputs
December 31, 2014**

	Fair Value		Valuation Technique	Significant Unobservable Input (a)	Forward Price Range		
	Assets	Liabilities			Low	High	Weighted Average
	(in thousands)						
Energy Contracts	\$ 2,088	\$ 370	Discounted Cash Flow	Forward Market Price	\$ 13.43	\$ 123.02	\$ 52.47
FTRs	2,232	23	Discounted Cash Flow	Forward Market Price	(14.63)	20.02	1.01
Total	<u>\$ 4,320</u>	<u>\$ 393</u>					

**Significant Unobservable Inputs
December 31, 2013**

	Fair Value		Valuation Technique	Significant Unobservable Input (a)	Forward Price Range	
	Assets	Liabilities			Low	High
	(in thousands)					
Energy Contracts	\$ 1,924	\$ 198	Discounted Cash Flow	Forward Market Price	\$ 13.04	\$ 80.50
FTRs	563	118	Discounted Cash Flow	Forward Market Price	(5.10)	10.44
Total	<u>\$ 2,487</u>	<u>\$ 316</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 December 31, 2014:

**Sensitivity of Fair Value Measurements
December 31, 2014**

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)

12. INCOME TAXES

The details of KPCo's income taxes as reported are as follows:

	Years Ended December 31,		
	2014	2013	2012
	(in thousands)		
Income Tax Expense (Credit):			
Current	\$ 13,376	\$ (4,828)	\$ 13,617
Deferred	9,157	12,440	10,168
Deferred Investment Tax Credits	(96)	(230)	(278)
Income Tax Expense	<u>\$ 22,437</u>	<u>\$ 7,382</u>	<u>\$ 23,507</u>

The following is a reconciliation of the difference between the amount of federal income taxes computed by multiplying book income before income taxes by the federal statutory tax rate and the amount of income taxes reported:

	Years Ended December 31,		
	2014	2013	2012
	(in thousands)		
Net Income	\$ 38,378	\$ 8,906	\$ 52,975
Income Tax Expense	22,437	7,382	23,507
Pretax Income	<u>\$ 60,815</u>	<u>\$ 16,288</u>	<u>\$ 76,482</u>
Income Taxes on Pretax Income at Statutory Rate (35%)	\$ 21,285	\$ 5,701	\$ 26,769
Increase (Decrease) in Income Taxes resulting from the following items:			
Depreciation	2,474	2,648	2,382
AFUDC	(1,623)	(749)	(894)
Removal Costs	(2,816)	(2,475)	(3,885)
Investment Tax Credits, Net	(96)	(230)	(278)
State and Local Income Taxes, Net	2,973	1,581	1,535
Tax Adjustments	372	1,097	(1,076)
Other	(132)	(191)	(1,046)
Income Tax Expense	<u>\$ 22,437</u>	<u>\$ 7,382</u>	<u>\$ 23,507</u>
Effective Income Tax Rate	36.9 %	45.3 %	30.7 %

The following table shows elements of KPCo's net deferred tax liability and significant temporary differences:

	December 31,	
	2014	2013
	(in thousands)	
Deferred Tax Assets	\$ 80,297	\$ 56,347
Deferred Tax Liabilities	(646,893)	(612,505)
Net Deferred Tax Liabilities	<u>\$ (566,596)</u>	<u>\$ (556,158)</u>
Property Related Temporary Differences	\$ (465,514)	\$ (436,812)
Amounts Due from Customers for Future Federal Income Taxes	(29,974)	(29,842)
Deferred State Income Taxes	(84,002)	(80,357)
Deferred Income Taxes on Other Comprehensive Loss	3,950	2,918
Regulatory Assets	(15,446)	(17,063)
All Other, Net	24,390	4,998
Net Deferred Tax Liabilities	<u>\$ (566,596)</u>	<u>\$ (556,158)</u>

AEP System Tax Allocation Agreement

KPCo joins in the filing of a consolidated federal income tax return with its affiliates in the AEP System. The allocation of the AEP System's current consolidated federal income tax to the AEP System companies allocates the benefit of current tax losses to the AEP System companies giving rise to such losses in determining their current tax expense. The tax benefit of the Parent is allocated to its subsidiaries with taxable income. With the exception of the loss of the Parent, the method of allocation reflects a separate return result for each company in the consolidated group.

Federal and State Income Tax Audit Status

KPCo and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2011. The IRS examination of years 2011, 2012 and 2013 started in April 2014. 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.

Tax Credit Carryforward

As of December 31, 2014, KPCo has unused federal income tax credits of \$275 thousand, not all of which have an expiration date. Included in the credit carryforward are federal general business tax credits of \$261 thousand. If these credits are not utilized, the federal general business tax credits will expire in the years 2029 through 2033.

KPCo anticipates future federal taxable income will be sufficient to realize the tax benefits of the federal tax credits before they expire unused.

Uncertain Tax Positions

KPCo recognizes interest accruals related to uncertain tax positions in interest income or expense as applicable, and penalties in Other Operation expense in accordance with the accounting guidance for "Income Taxes."

The following table shows amounts reported for interest expense, interest income and reversal of prior period interest expense:

	Years Ended December 31,		
	2014	2013	2012
	(in thousands)		
Interest Expense	\$ 20	\$ —	\$ 23
Interest Income	—	99	—
Reversal of Prior Period Interest Expense	71	—	—

The following table shows balances for amounts accrued for the receipt of interest and the payment of interest and penalties:

	December 31,	
	2014	2013
	(in thousands)	
Accrual for Receipt of Interest	\$ —	\$ 1
Accrual for Payment of Interest and Penalties	—	98

The reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	<u>2014</u>	<u>2013</u>	<u>2012</u>
		(in thousands)	
Balance as of January 1,	\$ 608	\$ 1,333	\$ 1,608
Increase – Tax Positions Taken During a Prior Period	—	—	—
Decrease – Tax Positions Taken During a Prior Period	—	(725)	(93)
Increase – Tax Positions Taken During the Current Year	—	—	—
Decrease – Tax Positions Taken During the Current Year	—	—	—
Increase – Settlements with Taxing Authorities	2	—	—
Decrease – Settlements with Taxing Authorities	—	—	(182)
Decrease – Lapse of the Applicable Statute of Limitations	(610)	—	—
Balance as of December 31,	<u>\$ —</u>	<u>\$ 608</u>	<u>\$ 1,333</u>

The total amount of unrecognized tax benefits (costs) that, if recognized, would affect the effective tax rate is \$0 for 2014, 2013 and 2012. Management believes there will be no significant net increase or decrease in unrecognized tax benefits within 12 months of the reporting date.

Federal Tax Legislation

The American Taxpayer Relief Act of 2012 (the 2012 Act) was enacted in January 2013. Included in the 2012 Act was a one-year extension of the 50% bonus depreciation. The 2012 Act also retroactively extended the life of research and development, employment and several energy tax credits, which expired at the end of 2011. The enacted provisions will not materially impact KPCo's net income or financial condition but did have a favorable impact on cash flows in 2013.

The Tax Increase Prevention Act of 2014 (the 2014 Act) was enacted in December 2014. Included in the 2014 Act was a one-year extension of the 50% bonus depreciation. The 2014 Act also retroactively extended the life of research and development, employment and several energy tax credits, which expired at the end of 2013. The enacted provisions did not materially impact KPCo's net income or financial condition but will have a favorable impact on future cash flows.

Federal Tax Regulations

In 2013, the U.S. Treasury Department issued final and re-proposed regulations regarding the deduction and capitalization of expenditures related to tangible property, effective for the tax years beginning in 2014. In addition, the IRS issued Revenue Procedures under the Industry Issue Resolutions program that provides specific guidance for the implementation of the regulations for the electric utility industry. These final regulations did not materially impact KPCo's net income, cash flows or financial condition.

State Tax Legislation

In May 2011, Michigan repealed its Business Tax regime and replaced it with a traditional corporate net income tax rate of 6%, effective January 1, 2012.

During the third quarter of 2013, it was determined that the state of West Virginia had achieved certain minimum levels of shortfall reserve funds. As a result, the West Virginia corporate income tax rate was reduced from 7% to 6.5% in 2014.

The enacted provisions did not materially impact KPCo's net income, cash flows or financial condition.

13. LEASES

Leases of property, plant and equipment are for remaining periods up to 10 years and require payments of related property taxes, maintenance and operating costs. The majority of the leases have purchase or renewal options and will be renewed or replaced by other leases.

Lease rentals for both operating and capital leases are generally charged to Other Operation and Maintenance expense in accordance with rate-making treatment for regulated operations. For capital leases, a capital lease asset and offsetting liability are recorded at the present value of the remaining lease payments for each reporting period. The components of rental costs are as follows:

Lease Rental Costs	Years Ended December 31,		
	2014	2013	2012
		(in thousands)	
Net Lease Expense on Operating Leases	\$ 1,466	\$ 1,387	\$ 1,141
Amortization of Capital Leases	1,112	1,743	1,710
Interest on Capital Leases	189	311	311
Total Lease Rental Costs	\$ 2,767	\$ 3,441	\$ 3,162

The following table shows the property, plant and equipment under capital leases and related obligations recorded on KPCo's balance sheets. Capital lease obligations are included in Other Current Liabilities and Deferred Credits and Other Noncurrent Liabilities on KPCo's balance sheets.

	December 31,	
	2014	2013
	(in thousands)	
Property, Plant and Equipment Under Capital Leases		
Generation	\$ 2,517	\$ 2,854
Other Property, Plant and Equipment	4,120	3,425
Total Property, Plant and Equipment Under Capital Leases	6,637	6,279
Accumulated Amortization	2,348	1,869
Net Property, Plant and Equipment Under Capital Leases	\$ 4,289	\$ 4,410
Obligations Under Capital Leases		
Noncurrent Liability	\$ 3,099	\$ 3,420
Liability Due Within One Year	1,190	990
Total Obligations Under Capital Leases	\$ 4,289	\$ 4,410

Future minimum lease payments consisted of the following as of December 31, 2014:

Future Minimum Lease Payments	Capital Leases	Noncancelable Operating Leases
	(in thousands)	
2015	\$ 1,311	\$ 1,823
2016	1,073	1,786
2017	903	1,625
2018	601	1,340
2019	284	1,112
Later Years	565	3,136
Total Future Minimum Lease Payments	4,737	\$ 10,822
Less Estimated Interest Element	448	
Estimated Present Value of Future Minimum Lease Payments	\$ 4,289	

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 December 31, 2014, the maximum potential loss for these lease agreements was approximately \$1.5 million assuming the fair value of the equipment is zero at the end of the lease term.

14. FINANCING ACTIVITIES

Long-term Debt

The following details long-term debt outstanding as of December 31, 2014 and 2013:

Type of Debt (a)	Maturity	Weighted Average	Interest Rate Ranges as of		Outstanding as of	
		Interest rate as of December 31, 2014	December 31, 2014	December 31, 2013	December 31, 2014	December 31, 2013
(in thousands)						
Senior Unsecured Notes	2017-2039	5.81%	4.18%-8.13%	5.625%-8.13%	\$ 730,000	\$ 530,000
Pollution Control Bonds (b)	2015 (c)	0.05%	0.05%		65,000	—
Notes Payable – Affiliated	2015			5.25%	—	20,000
Other Long-term Debt	2015-2018	1.74%	1.74%	1.188%	25,000	200,000
Unamortized Discount, Net					(445)	(611)
Total Long-term Debt Outstanding					<u>819,555</u>	<u>749,389</u>
Long-term Debt Due Within One Year					<u>65,000</u>	<u>—</u>
Long-term Debt					<u>\$ 754,555</u>	<u>\$ 749,389</u>

- (a) In 2014 and subsequent to the corporate separation process, management realigned KPCo's debt portfolio by type of debt.
(b) For KPCo's pollution control bond, the interest rate is subject to periodic adjustment and may be purchased on demand at periodic interest adjustment dates. Insurance policies support certain series.
(c) KPCo's pollution control bond is subject to redemption earlier than the maturity date. Consequently, this bond has been classified for maturity purposes as Long-term Debt Due Within One Year - Nonaffiliated on KPCo's balance sheet.

Long-term debt outstanding as of December 31, 2014 is payable as follows:

	2015	2016	2017	2018	2019	After 2019	Total
(in thousands)							
Principal Amount	\$ 65,000	\$ —	\$ 325,000	\$ 25,000	\$ —	\$ 405,000	\$ 820,000
Unamortized Discount, Net							(445)
Total Long-term Debt Outstanding							<u>\$ 819,555</u>

Dividend Restrictions

KPCo pays dividends to Parent provided funds are legally available. Various financing arrangements and regulatory requirements may impose certain restrictions on the ability of KPCo to transfer funds to Parent in the form of dividends.

Federal Power Act

The Federal Power Act prohibits KPCo from participating “in the making or paying of any dividends of such public utility from any funds properly included in capital account.” The term “capital account” is not defined in the Federal Power Act or its regulations. Management understands “capital account” to mean the book value of the common stock. This restriction does not limit the ability of KPCo to pay dividends out of retained earnings.

Leverage Restrictions

Pursuant to the credit agreement leverage restrictions, KPCo must maintain a percentage of debt to total capitalization at a level that does not exceed 67.5%. As of December 31, 2014, none of KPCo's retained earnings have restrictions related to the payment of dividends to Parent.

Utility Money Pool – 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 December 31, 2014 and 2013 are included in Advances from Affiliates on KPCo's balance sheets. KPCo's Utility Money Pool activity and corresponding authorized borrowing limits for the years ended December 31, 2014 and 2013 are described in the following table:

<u>Year</u>	<u>Maximum Borrowings from the Utility Money Pool</u>	<u>Maximum Loans to the Utility Money Pool</u>	<u>Average Borrowings from the Utility Money Pool</u>	<u>Average Loans to the Utility Money Pool</u>	<u>Borrowings from the Utility Money Pool as of December 31,</u>	<u>Authorized Short-Term Borrowing Limit</u>
(in thousands)						
2014	\$ 52,414	\$ 86,715	\$ 24,309	\$ 40,255	\$ 45,128	\$ 250,000
2013	32,649	31,421	10,911	14,584	8,564	250,000

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool for the years ended December 31, 2014, 2013 and 2012 are summarized in the following table:

<u>Years Ended December 31,</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>
2014	0.59%	0.24%	0.33%	0.26%	0.31%	0.28%
2013	0.43%	0.29%	0.41%	0.24%	0.37%	0.32%
2012	0.42%	0.42%	0.56%	0.39%	0.42%	0.48%

Interest expense and interest income related to the Utility Money Pool are included in Interest Expense and Interest Income, respectively, on KPCo's statements of income. For amounts borrowed from and advanced to the Utility Money Pool, KPCo incurred the following amounts of interest expense and earned the following amounts of interest income, respectively, for the years ended December 31, 2014, 2013 and 2012:

	<u>Years Ended December 31,</u>		
	<u>2014</u>	<u>2013</u>	<u>2012</u>
	(in thousands)		
Interest Expense	\$ 46	\$ 12	\$ 1
Interest Income	47	36	222

Sale of Receivables – AEP Credit

Under a sale of receivables arrangement, KPCo sells, without recourse, certain of its customer accounts receivable and accrued unbilled revenue balances to AEP Credit and is charged a fee based on AEP Credit's financing costs, administrative costs and uncollectible accounts experience for KPCo's receivables. The costs of customer accounts receivable sold are reported in Other Operation expense on KPCo's statements of income. KPCo manages and services its accounts receivable sold.

AEP Credit's receivables securitization agreement provides a commitment of \$750 million from bank conduits to purchase receivables. The agreement was increased in June 2014 from \$700 million and expires in June 2016.

KPCo's amounts of accounts receivable and accrued unbilled revenues sold under the sale of receivables agreement were \$46 million and \$43 million as of December 31, 2014 and 2013, respectively.

The fees paid by KPCo to AEP Credit for customer accounts receivable sold were \$3 million, \$2 million and \$2 million, respectively, for each of the years ended December 31, 2014, 2013 and 2012.

KPCo's proceeds on the sale of receivables to AEP Credit were \$604 million, \$522 million and \$517 million for the years ended December 31, 2014, 2013 and 2012, respectively.

15. RELATED PARTY TRANSACTIONS

For other related party transactions, also see “AEP System Tax Allocation Agreement” section of Note 12 in addition to “Utility Money Pool – AEP System” and “Sale of Receivables – AEP Credit” sections of Note 14.

Interconnection Agreement

In accordance with management’s December 2010 announcement and October 2012 filing with the FERC, the Interconnection Agreement was terminated effective January 1, 2014. The AEP System Interim Allowance Agreement which provided for, among other things, the transfer of SO₂ emission allowances associated with transactions under the Interconnection Agreement was also terminated.

APCo, I&M, KPCo, OPCo and AEPSC were parties to the Interconnection Agreement which defined the sharing of costs and benefits associated with the respective generation plants. This sharing was based upon each AEP utility subsidiary’s MLR and was calculated monthly on the basis of each AEP utility subsidiary’s maximum peak demand in relation to the sum of the maximum peak demands of all four AEP utility subsidiaries during the preceding 12 months.

Effective January 1, 2014, the FERC approved the following agreements. See "Organization" section of Note 1.

- A Power Coordination Agreement among APCo, I&M and KPCo with AEPSC as the agent to coordinate the participants’ respective power supply resources.
- A Bridge Agreement among AGR, APCo, I&M, KPCo and OPCo with AEPSC as the agent to address open commitments related to the termination of the Interconnection Agreement and responsibilities to PJM.
- A Power Supply Agreement between AGR and OPCo for AGR to supply capacity and energy needs of OPCo's retail load.

AEPSC conducts power, coal, natural gas, interest rate and, to a lesser extent, heating oil, gasoline and other risk management activities on behalf of APCo, I&M, KPCo, PSO and SWEPCo. Effective January 1, 2014, power and natural gas risk management activities for APCo, I&M and KPCo are allocated based on the three member companies’ respective equity positions, while power and natural gas risk management activities for PSO and SWEPCo are allocated based on the Operating Agreement. Prior to January 1, 2014, power and natural gas risk management activities were allocated under the SIA to former members of the Interconnection Agreement, PSO and SWEPCo. Risk management activities primarily include power and natural gas physical transactions, financially-settled swaps and exchange-traded futures. AEPSC settles the majority of the physical forward contracts by entering into offsetting contracts.

Operating Agreement

PSO, SWEPCo and AEPSC are parties to the Operating Agreement which was approved by the FERC. The Operating Agreement requires PSO and SWEPCo to maintain adequate annual planning reserve margins and requires that capacity in excess of the required margins be made available for sale to other operating companies as capacity commitments. In January 2014, the FERC approved a modification of the Operating Agreement to address changes resulting from an anticipated March 2014 SPP power market change. Subsequently and in March 2014, SPP changed from an energy imbalance service market to a fully integrated power market. In alignment with the new SPP integrated power market and according to the modified Operating Agreement, PSO and SWEPCo operate as standalone entities and offer their respective generation into the SPP power market. SPP then economically dispatches resources. By offering their resources separately, PSO and SWEPCo no longer purchase or sell energy to each other to serve their respective internal load or off-system sales.

System Integration Agreement (SIA)

Under the SIA, AEPSC allocates physical and financial revenues and expenses from transactions with neighboring utilities, power marketers and other power and natural gas risk management activities based upon the location of such activity. Margins resulting from trading and marketing activities originating in PJM and MISO generally accrue to the benefit of APCo, I&M and KPCo, while trading and marketing activities originating in SPP generally accrue to the benefit of PSO and SWEPCo. Margins resulting from other transactions are allocated among APCo, I&M, KPCo, PSO and SWEPCo based upon the equity positions of these companies.

The SIA was designed to function as an umbrella agreement in addition to the Interconnection Agreement (prior to January 1, 2014) and the Operating Agreement, each of which controlled the distribution of revenues and expenses.

Affiliated Revenues and Purchases

The following table shows the revenues derived from sales under the Interconnection Agreement, direct sales to affiliates, net transmission agreement sales and other revenues for the years ended December 31, 2014, 2013 and 2012:

Related Party Revenues	Years Ended December 31,		
	2014	2013	2012
	(in thousands)		
Sales under Interconnection Agreement	\$ 5,480 (a)	\$ 79,909	\$ 60,198
Direct Sales to West Affiliates	—	119	64
Transmission Agreement Sales	1,726	862	3,022
Other Revenues	308	22,841	7,492
Total Affiliated Revenues	\$ 7,514	\$ 103,731	\$ 70,776

(a) Includes December 2013 true-up activity subsequent to agreement termination.

The following table shows the purchased power expenses incurred for purchases under the Interconnection Agreement and from affiliates for the years ended December 31, 2014, 2013 and 2012:

Related Party Purchases	Years Ended December 31,		
	2014	2013	2012
	(in thousands)		
Purchases under Interconnection Agreement	\$ 1,242 (a)	\$ 161,293	\$ 121,267
Direct Purchases from West Affiliates	—	1	11
Direct Purchases from AEGCo	115,001	107,794	102,371
Total Affiliated Purchases	\$ 116,243	\$ 269,088	\$ 223,649

(a) Includes December 2013 true-up activity subsequent to agreement termination.

The above summarized related party revenues and expenses are reported in Sales to AEP Affiliates and Purchased Electricity from AEP Affiliates on KPCo's statements of income.

System Transmission Integration Agreement (STIA)

AEP's STIA provided for the integration and coordination of the planning, operation and maintenance of transmission facilities. Since the FERC approved the cancellation of the STIA effective June 1, 2014, the coordinated planning, operation and maintenance of transmission facilities are the responsibility of the RTOs and the STIA is no longer necessary. Similar to the SIA, the STIA functioned as an umbrella agreement in addition to the Transmission Agreement (TA) and the Transmission Coordination Agreement (TCA). The TA and TCA are both still active. The STIA contained two service schedules that governed:

- The allocation of transmission costs and revenues.
- The allocation of third-party transmission costs and revenues and AEP System dispatch costs.

APCo, I&M, KGPCo, KPCo, OPCo and WPCo are parties to the TA, effective November 2010, which defines how transmission costs through PJM OATT are allocated among the AEP East Companies, KGPCo and WPCo on a 12-month average coincident peak basis.

KPCo's net charges recorded as a result of the TA for the years ended December 31, 2014, 2013 and 2012 were \$7.5 million, \$3 million and \$1.1 million, respectively, and were recorded in Other Operation expenses on KPCo's statements of income.

PSO, SWEPCo and AEPSC are parties to the TCA, dated January 1, 1997, by and among PSO, SWEPCo and AEPSC, in connection with the operation of the transmission assets of the two AEP utility subsidiaries. The TCA has been approved by the FERC and establishes a coordinating committee, which is charged with overseeing the coordinated planning of the transmission facilities of the parties to the agreement.

Unit Power Agreements (UPA)

A UPA between AEGCo and I&M (the I&M Power Agreement) provides for the sale by AEGCo to I&M of all the power (and the energy associated therewith) available to AEGCo at the Rockport Plant unless it is sold to another utility. Subsequently, I&M assigns 30% of the power to KPCo. I&M is obligated, whether or not power is available from AEGCo, to pay as a demand charge for the right to receive such power (and as an energy charge for any associated energy taken by I&M) net of amounts received by AEGCo from any other sources, sufficient to enable AEGCo to pay all its operating and other expenses, including a rate of return on the common equity of AEGCo as approved by the FERC. The I&M Power Agreement will continue in effect until the expiration of the lease term of Unit 2 of the Rockport Plant unless extended in specified circumstances.

Pursuant to an assignment between I&M and KPCo and a UPA between KPCo and AEGCo, AEGCo sells KPCo 30% of the power (and the energy associated therewith) available to AEGCo from both units of the Rockport Plant. KPCo pays to AEGCo in consideration for the right to receive such power the same amounts which I&M would have paid AEGCo under the terms of the I&M Power Agreement for such entitlement. The KPCo UPA ends in December 2022.

I&M Barging, Urea Transloading and Other Services

I&M provides barging, urea transloading and other transportation services to affiliates. Urea is a chemical used to control NO_x emissions at certain generation plants in the AEP System. KPCo recorded expenses of \$5 million, \$4 million and \$1.6 million in 2014, 2013 and 2012, respectively, for urea transloading provided by I&M. These expenses were recorded as fuel expenses or other operation expenses.

Central Machine Shop

APCo operates a facility which repairs and rebuilds specialized components for the generation plants across the AEP System. APCo defers the cost of performing these services on the balance sheet, then transfers the cost to the affiliate for reimbursement. KPCo recorded its assigned portion of these billings as capital or maintenance expenses depending on the nature of the services received. These billings are recoverable from customers. KPCo's billed amounts were \$1.2 million, \$1.1 million and \$647 thousand for the years ended December 31, 2014, 2013 and 2012, respectively.

Affiliate Railcar Agreement

KPCo has an agreement providing for the use of its affiliates' leased or owned railcars when available. The agreement specifies that the company using the railcar will be billed, at cost, by the company furnishing the railcar. KPCo recorded these costs in Fuel on the balance sheets and such costs are recoverable from customers. The following table shows the net effect of the railcar agreement on KPCo's balance sheets:

Billing Company	December 31,	
	2014	2013
	(in thousands)	
AGR	\$ —	\$ (20)
APCo	134	26

Sales and Purchases of Property

KPCo had affiliated sales and purchases of electric property individually amounting to \$100 thousand or more, sales and purchases of meters and transformers, and sales and purchases of transmission property. There were no gains or losses recorded on the transactions. The following table shows the sales and purchases, recorded at net book value, for the years ended December 31, 2014, 2013 and 2012:

	Years Ended December 31,		
	2014	2013	2012
	(in thousands)		
Sales	\$ 307	\$ 951	\$ 1,032
Purchases	349	1,702	1,078

The amounts above are recorded in Property, Plant and Equipment on the balance sheets.

Global Borrowing Notes

As of December 31, 2013, AEP had an intercompany note in place with KPCo. The debt is reflected in Long-term Debt – Affiliated on KPCo’s balance sheet. KPCo accrued interest for its share of the global borrowing and remitted the interest to AEP. The accrued interest is reflected in Accrued Interest on KPCo’s balance sheet.

Intercompany Billings

KPCo performs certain utility services for other AEP subsidiaries when necessary or practical. The costs of these services are billed on a direct-charge basis, whenever possible, or on reasonable basis of proration for services that benefit multiple companies. The billings for services are made at cost and include no compensation for the use of equity capital.

16. VARIABLE INTEREST ENTITIES

The accounting guidance for “Variable Interest Entities” is a consolidation model that considers if a company has a controlling financial interest in a VIE. A controlling financial interest will have both (a) the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance and (b) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. Entities are required to consolidate a VIE when it is determined that they have a controlling financial interest in a VIE and therefore, are the primary beneficiary of that VIE, as defined by the accounting guidance for “Variable Interest Entities.” In determining whether KPCo is the primary beneficiary of a VIE, management considers factors such as equity at risk, the amount of the VIE’s variability KPCo absorbs, guarantees of indebtedness, voting rights including kick-out rights, the power to direct the VIE, variable interests held by related parties and other factors. Management believes that significant assumptions and judgments were applied consistently. KPCo is not the primary beneficiary of any VIE and has not provided financial or other support to any VIE that was not previously contractually required.

AEPSC provides certain managerial and professional services to AEP’s subsidiaries. AEP is the sole equity owner of AEPSC. AEP management controls the activities of AEPSC. The costs of the services are based on a direct charge or on a prorated basis and billed to the AEP subsidiary companies at AEPSC’s cost. AEP subsidiaries have not provided financial or other support outside the reimbursement of costs for services rendered. AEPSC finances its operations through cost reimbursement from other AEP subsidiaries. There are no other terms or arrangements between AEPSC and any of the AEP subsidiaries that could require additional financial support from an AEP subsidiary or expose them to losses outside of the normal course of business. AEPSC and its billings are subject to regulation by the FERC. AEP subsidiaries are exposed to losses to the extent they cannot recover the costs of AEPSC through their normal business operations. AEP subsidiaries are considered to have a significant interest in AEPSC due to their activity in AEPSC’s cost reimbursement structure. However, AEP subsidiaries do not have control over AEPSC. AEPSC is consolidated by AEP. In the event AEPSC would require financing or other support outside the cost reimbursement billings, this financing would be provided by AEP. KPCo’s total billings from AEPSC for the years ended December 31, 2014, 2013 and 2012 were \$53 million, \$38 million and \$40 million, respectively. The carrying amount of liabilities associated with AEPSC as of December 31, 2014 and 2013 was \$8 million and \$4 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

AEGCo, a wholly-owned subsidiary of AEP, is consolidated by AEP. AEGCo owns a 50% ownership interest in Rockport Plant, Unit 1 and leases a 50% interest in Rockport Plant, Unit 2. AEGCo sells all the output from the Rockport Plant to I&M and KPCo. AEP has agreed to provide AEGCo with the funds necessary to satisfy all of the debt obligations of AEGCo. KPCo is considered to have a significant interest in AEGCo due to these transactions. KPCo is exposed to losses to the extent it cannot recover the costs of AEGCo through its normal business operations. Due to AEP management’s control over AEGCo, KPCo is not considered the primary beneficiary of AEGCo. In the event AEGCo would require financing or other support outside the billings to KPCo, this financing would be provided by AEP. Total billings from AEGCo for the years ended December 31, 2014, 2013 and 2012 were \$115 million, \$108 million and \$102 million, respectively. The carrying amount of liabilities associated with AEGCo as of December 31, 2014 and 2013 was \$9 million and \$11 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

17. PROPERTY, PLANT AND EQUIPMENT

Depreciation

KPCo provides for depreciation of Property, Plant and Equipment on a straight-line basis over the estimated useful lives of property, generally using composite rates by functional class. The following tables provide KPCo's annual property information:

2014		Regulated				Nonregulated			
Functional Class of Property	Property, Plant and Equipment	Accumulated Depreciation	Annual Composite		Property, Plant and Equipment	Accumulated Depreciation	Annual Composite		
			Rate	Depreciable Life Ranges			Rate	Depreciable Life Ranges	
	(in thousands)			(in years)	(in thousands)			(in years)	
Generation	\$ 1,161,100	\$ 336,849	3.5%	40-60	\$ —	\$ —	NA	NA	
Transmission	558,099	177,378	1.6%	25-75	—	—	NA	NA	
Distribution	727,569	235,808	3.4%	11-75	—	—	NA	NA	
CWIP	39,194	(6,876)	NM	NM	—	—	NA	NA	
Other	515,797	282,831	4.2%	20-75	5,530	218	NM	NM	
Total	\$ 3,001,759	\$ 1,025,990			\$ 5,530	\$ 218			

2013		Regulated (a)				Nonregulated			
Functional Class of Property	Property, Plant and Equipment	Accumulated Depreciation	Annual Composite		Property, Plant and Equipment	Accumulated Depreciation	Annual Composite		
			Rate	Depreciable Life Ranges			Rate	Depreciable Life Ranges	
	(in thousands)			(in years)	(in thousands)			(in years)	
Generation	\$ 1,052,757	\$ 365,645	3.7%	40-60	\$ —	\$ —	NA	NA	
Transmission	507,844	172,604	1.8%	25-75	—	—	NA	NA	
Distribution	693,481	216,771	3.4%	11-75	—	—	NA	NA	
CWIP	128,599	(8,320)	NM	NM	—	—	NA	NA	
Other	475,229	196,977	4.3%	20-75	5,530	212	NM	NM	
Total	\$ 2,857,910	\$ 943,677			\$ 5,530	\$ 212			

2012		Regulated		Nonregulated (a)	
Functional Class of Property		Annual Composite Depreciation Rate	Depreciable Life Ranges	Annual Composite Depreciation Rate	Depreciable Life Ranges
			(in years)		(in years)
Generation		3.8%	40-50	3.8%	60
Transmission		1.6%	25-75	2.3%	NM
Distribution		3.4%	11-75	NA	NA
CWIP		NM	NM	NM	NM
Other		7.2%	20-75	NM	NM

(a) For 2013, KPCo's ownership in the Mitchell Plant is included in the Regulated amounts listed above. For 2012, KPCo's ownership in the Mitchell Plant is included in the Nonregulated amounts listed above.

NA Not applicable.

NM Not meaningful.

The composite depreciation rate generally includes a component for nonasset retirement obligation (non-ARO) removal costs, which is credited to Accumulated Depreciation and Amortization. Actual removal costs incurred are charged to Accumulated Depreciation and Amortization. Any excess of accrued non-ARO removal costs over actual removal costs incurred is reclassified from Accumulated Depreciation and Amortization and reflected as a regulatory liability.

Asset Retirement Obligations (ARO)

KPCo records ARO in accordance with the accounting guidance for “Asset Retirement and Environmental Obligations” for the retirement of asbestos removal. KPCo has identified, but not recognized, ARO liabilities related to electric transmission and distribution assets, as a result of certain easements on property on which assets are owned. Generally, such easements are perpetual and require only the retirement and removal of assets upon the cessation of the property’s use. The retirement obligation is not estimable for such easements since KPCo plans to use its facilities indefinitely. The retirement obligation would only be recognized if and when KPCo abandons or ceases the use of specific easements, which is not expected.

The following is a reconciliation of the 2014 and 2013 aggregate carrying amounts of ARO for KPCo:

<u>Year</u>	<u>ARO as of January 1,</u>	<u>Accretion Expense</u>	<u>Liabilities Incurred</u>	<u>Liabilities Settled</u>	<u>Revisions in Cash Flow Estimates</u>	<u>ARO as of December 31,</u>
	(in thousands)					
2014	\$ 20,526	\$ 2,309	\$ 42,578	\$ (643)	\$ 929	\$ 65,699
2013	8,759	742	—	(255)	11,280	20,526

Allowance for Funds Used During Construction (AFUDC)

KPCo’s amounts of allowance for borrowed and equity funds used during construction are summarized in the following table:

	<u>Years Ended December 31,</u>		
	<u>2014</u>	<u>2013</u>	<u>2012</u>
	(in thousands)		
Allowance for Equity Funds Used During Construction	\$ 4,009	\$ 1,367	\$ 1,574
Allowance for Borrowed Funds Used During Construction	2,048	3,047	2,275

Jointly-owned Electric Facilities

KPCo has a 50.0% ownership share of Units 1 and 2 at the Mitchell Generating Station. In addition to KPCo, the Mitchell Generating Station is jointly-owned by AGR. Using its own financing, each participating company is obligated to pay its share of the costs in the same proportion as its ownership interest. KPCo’s proportionate share of the operating costs associated with this facility is included in its statements of income and the investment and accumulated depreciation are reflected in its balance sheets under Property, Plant and Equipment as follows:

	<u>Fuel Type</u>	<u>Percent of Ownership</u>	<u>Utility Plant in Service</u>	<u>Construction Work in Progress</u>	<u>Accumulated Depreciation</u>
(in thousands)					
KPCo's Share as of December 31, 2014					
Mitchell Generating Station, Units 1 and 2 (a)	Coal	50.0 %	\$ 1,007,186	\$ 16,132	\$ 339,803
KPCo's Share as of December 31, 2013					
Mitchell Generating Station, Units 1 and 2 (a)	Coal	50.0 %	\$ 907,304	\$ 75,253	\$ 305,170

(a) Operated by KPCo.

18. COST REDUCTION PROGRAMS

2014 Disposition Plant Severance

Management intends to retire several generation plants or units of plants during 2015. The plant closures will result in involuntary severances. The severance program provides two weeks of base pay for every year of service along with other severance benefits.

KPCo recorded a charge to Other Operation expense in December 2014 related to employees at the disposition plants.

<u>Expense Allocation from AEPSC</u>	<u>Incurred</u>	<u>Settled</u>	<u>Adjustments</u>	<u>Remaining Balance as of December 31, 2014</u>
\$ 88	\$ 3,551	\$ 900 (a)	\$ —	\$ 4,539

(a) Settled includes amounts received from affiliates for expenses related to intercompany billing for operation and maintenance of affiliate plant.

These expenses, net of adjustments, relate primarily to severance benefits and are included primarily in Other Operation expense on the statements of income. Management does not expect additional costs to be incurred related to this initiative.

2012 Sustainable Cost Reductions

In April 2012, management initiated a process to identify strategic repositioning opportunities and efficiencies that will result in sustainable cost savings. Management selected a consulting firm to facilitate an organizational and process evaluation and a second firm to evaluate current employee benefit programs. The process resulted in involuntary severances and was completed by the end of the first quarter of 2013. The severance program provides two weeks of base pay for every year of service along with other severance benefits.

KPCo recorded charges to Other Operation expense of \$(221) thousand and \$2 million for the years ended December 31, 2013 and 2012, respectively, primarily related to the sustainable cost reductions initiative.

19. UNAUDITED QUARTERLY FINANCIAL INFORMATION

In management's opinion, the unaudited quarterly information reflects all normal and recurring accruals and adjustments necessary for a fair presentation of the results of operations for interim periods. Quarterly results are not necessarily indicative of a full year's operations because of various factors. KPCo's unaudited quarterly financial information is as follows:

	<u>March 31</u>	<u>2014 Quarterly Periods Ended</u>		<u>December 31</u>
		<u>June 30</u>	<u>September 30</u>	
		<u>(in thousands)</u>		
Total Revenues	\$ 233,130	\$ 206,563	\$ 199,082	\$ 143,203 (a)
Operating Income (Loss)	58,901	31,978	27,265	(23,219) (a)
Net Income (Loss)	32,548	15,258	11,801	(21,229) (a)
		<u>2013 Quarterly Periods Ended</u>		
	<u>March 31</u>	<u>June 30</u>	<u>September 30</u>	<u>December 31</u>
		<u>(in thousands)</u>		
Total Revenues	\$ 230,644	\$ 181,549	\$ 211,536	\$ 202,526
Operating Income (Loss)	32,607	18,214	(14,044) (b)	22,422
Net Income (Loss)	14,403	4,985	(16,513) (b)	6,031

(a) Includes a regulatory disallowance for FAC (see Note 4).

(b) Includes a regulatory disallowance for Big Sandy Plant, Unit 2 (see Note 7).

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