

# Kentucky Power Company

2012 Third Quarter Report

Financial Statements



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## GLOSSARY OF TERMS

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

| Term                      | Meaning  |
|---------------------------|--|
| AEGCo                     | AEP Generating Company, an AEP electric utility subsidiary.  |
| AEP or Parent             | American Electric Power Company, Inc., a 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 integrated electric utility system, owned and operated by AEP's electric utility subsidiaries.  |
| AEPSC                     | American Electric Power Service Corporation, an AEP service subsidiary providing management and professional services to AEP and its subsidiaries.   |
| AOCI                      | Accumulated Other Comprehensive Income.  |
| APCo                      | Appalachian Power Company, an AEP electric utility subsidiary.   |
| CAA                       | Clean Air Act.   |
| CO <sub>2</sub>           | Carbon dioxide and other greenhouse gases.   |
| 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.  |
| IRS                       | Internal Revenue Service.  |
| IURC                      | Indiana Utility Regulatory Commission.   |
| Interconnection Agreement | An agreement by and among APCo, I&M, KPCo and OPCo, defining the sharing of costs and benefits associated with their respective generating plants.   |
| KPCo                      | Kentucky Power Company, an AEP electric utility subsidiary.  |
| KPSC                      | Kentucky Public Service Commission.  |
| MMBtu                     | Million British Thermal Units.   |
| MTM                       | Mark-to-Market.  |
| MW                        | Megawatt.  |
| MWh                       | Megawatthour.  |
| OPCo                      | Ohio Power Company, an AEP electric utility subsidiary.  |
| OPEB                      | Other Postretirement Benefit Plans.  |
| OTC                       | Over the counter.  |
| Risk Management Contracts | Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.   |
| Rockport Plant            | A generating plant, consisting of two 1,300 MW coal-fired generating units near Rockport, Indiana, owned by AEGCo and I&M.   |
| RTO                       | Regional Transmission Organization, responsible for moving electricity over large interstate areas.  |
| SIA                       | System Integration Agreement, effective June 15, 2000, provides contractual basis for coordinated planning, operation and maintenance of the power supply sources of the combined AEP.   |
| Utility Money Pool        | Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain utility subsidiaries.   |
| VIE                       | Variable Interest Entity.  |

**KENTUCKY POWER COMPANY**  
**CONDENSED STATEMENTS OF INCOME**  
For the Three and Nine Months Ended September 30, 2012 and 2011  
(in thousands)  
(Unaudited)

|   | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|---|---------------------------|------------------|--------------------------|------------------|
|   | <b>2012</b>               | <b>2011</b>      | <b>2012</b>              | <b>2011</b>      |
| <b>REVENUES</b>   |                           |                  |                          |                  |
| Electric Generation, Transmission and Distribution      | \$ 147,067                | \$ 167,533       | \$ 436,255               | \$ 501,647       |
| Sales to AEP Affiliates                                 | 16,394                    | 18,734           | 31,048                   | 55,169           |
| Other Revenues  | 149                       | 177              | 454                      | 420              |
| <b>TOTAL REVENUES</b>                                   | <b>163,610</b>            | <b>186,444</b>   | <b>467,757</b>           | <b>557,236</b>   |
| <b>EXPENSES</b>   |                           |                  |                          |                  |
| Fuel and Other Consumables Used for Electric Generation | 34,624                    | 47,994           | 91,219                   | 164,619          |
| Purchased Electricity for Resale                        | 2,291                     | 5,405            | 9,392                    | 16,990           |
| Purchased Electricity from AEP Affiliates               | 57,781                    | 60,207           | 157,307                  | 163,495          |
| Other Operation   | 14,264                    | 16,792           | 42,765                   | 48,101           |
| Maintenance   | 8,650                     | 13,611           | 34,429                   | 39,947           |
| Depreciation and Amortization                           | 13,761                    | 13,516           | 40,930                   | 40,376           |
| Taxes Other Than Income Taxes                           | 3,115                     | 3,056            | 9,362                    | 8,006            |
| <b>TOTAL EXPENSES</b>                                   | <b>134,486</b>            | <b>160,581</b>   | <b>385,404</b>           | <b>481,534</b>   |
| <b>OPERATING INCOME</b>                                 | <b>29,124</b>             | <b>25,863</b>    | <b>82,353</b>            | <b>75,702</b>    |
| <b>Other Income (Expense):</b>                          |                           |                  |                          |                  |
| Interest Income   | 81                        | 1,408            | 296                      | 1,620            |
| Allowance for Equity Funds Used During Construction     | 474                       | 300              | 1,976                    | 813              |
| Interest Expense  | (8,750)                   | (9,172)          | (26,414)                 | (27,545)         |
| <b>INCOME BEFORE INCOME TAX EXPENSE</b>                 | <b>20,929</b>             | <b>18,399</b>    | <b>58,211</b>            | <b>50,590</b>    |
| Income Tax Expense                                      | 6,719                     | 6,546            | 18,248                   | 18,395           |
| <b>NET INCOME</b>                                       | <b>\$ 14,210</b>          | <b>\$ 11,853</b> | <b>\$ 39,963</b>         | <b>\$ 32,195</b> |

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

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

**KENTUCKY POWER COMPANY**  
**CONDENSED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**  
**For the Three and Nine Months Ended September 30, 2012 and 2011**  
**(in thousands)**  
**(Unaudited)**

|   | <b>Three Months Ended</b> |                  | <b>Nine Months Ended</b> |                  |
|---|---------------------------|------------------|--------------------------|------------------|
|   | <b>2012</b>               | <b>2011</b>      | <b>2012</b>              | <b>2011</b>      |
| Net Income  | \$ 14,210                 | \$ 11,853        | \$ 39,963                | \$ 32,195        |
| <b><u>OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAXES</u></b>   |                           |                  |                          |                  |
| Cash Flow Hedges, Net of Tax of \$172 and \$83 for the Three Months Ended September 30, 2012 and 2011, Respectively, and \$139 and \$41 for the Nine Months Ended September 30, 2012 and 2011, Respectively | 320                       | (155)            | 259                      | 76               |
| <b>TOTAL COMPREHENSIVE INCOME</b>   | <b>\$ 14,530</b>          | <b>\$ 11,698</b> | <b>\$ 40,222</b>         | <b>\$ 32,271</b> |

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

**KENTUCKY POWER COMPANY**  
**CONDENSED STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S EQUITY**  
**For the Nine Months Ended September 30, 2012 and 2011**  
**(in thousands)**  
**(Unaudited)**

|   | <u>Common<br/>Stock</u> | <u>Paid-in<br/>Capital</u> | <u>Retained<br/>Earnings</u> | <u>Accumulated<br/>Other<br/>Comprehensive<br/>Income (Loss)</u> | <u>Total</u>      |
|---|-------------------------|----------------------------|------------------------------|--|-------------------|
| <b>TOTAL COMMON SHAREHOLDER'S<br/>EQUITY – DECEMBER 31, 2010</b>  | \$ 50,450               | \$ 238,750                 | \$ 157,467                   | \$ (451)   | \$ 446,216        |
| Common Stock Dividends  |                         |                            | (18,000)                     |  | (18,000)          |
| Subtotal – Common Shareholder's Equity                            |                         |                            |                              |  | <u>428,216</u>    |
| Net Income  |                         |                            | 32,195                       |  | 32,195            |
| Other Comprehensive Income  |                         |                            |                              | 76   | 76                |
| <b>TOTAL COMMON SHAREHOLDER'S<br/>EQUITY – SEPTEMBER 30, 2011</b> | <u>\$ 50,450</u>        | <u>\$ 238,750</u>          | <u>\$ 171,662</u>            | <u>\$ (375)</u>  | <u>\$ 460,487</u> |
| <b>TOTAL COMMON SHAREHOLDER'S<br/>EQUITY – DECEMBER 31, 2011</b>  | \$ 50,450               | \$ 238,750                 | \$ 171,841                   | \$ (625)   | \$ 460,416        |
| Common Stock Dividends  |                         |                            | (24,000)                     |  | (24,000)          |
| Subtotal – Common Shareholder's Equity                            |                         |                            |                              |  | <u>436,416</u>    |
| Net Income  |                         |                            | 39,963                       |  | 39,963            |
| Other Comprehensive Income  |                         |                            |                              | 259  | 259               |
| <b>TOTAL COMMON SHAREHOLDER'S<br/>EQUITY – SEPTEMBER 30, 2012</b> | <u>\$ 50,450</u>        | <u>\$ 238,750</u>          | <u>\$ 187,804</u>            | <u>\$ (366)</u>  | <u>\$ 476,638</u> |

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

**KENTUCKY POWER COMPANY**  
**CONDENSED BALANCE SHEETS**  
**ASSETS**  
**September 30, 2012 and December 31, 2011**  
**(in thousands)**  
**(Unaudited)**

|  | <b>2012</b>         | <b>2011</b>         |
|--|---------------------|---------------------|
| <b>CURRENT ASSETS</b>                            |                     |                     |
| Cash and Cash Equivalents                        | \$ 489              | \$ 778              |
| Advances to Affiliates                           | 33,736              | 70,332              |
| Accounts Receivable:                             |                     |                     |
| Customers  | 13,055              | 15,445              |
| Affiliated Companies                             | 10,835              | 9,441               |
| Accrued Unbilled Revenues                        | 2,632               | 3,379               |
| Miscellaneous                                    | 115                 | 1,926               |
| Allowance for Uncollectible Accounts             | (22)                | (622)               |
| Total Accounts Receivable                        | 26,615              | 29,569              |
| Fuel   | 46,663              | 23,006              |
| Materials and Supplies                           | 18,626              | 27,152              |
| Risk Management Assets                           | 6,244               | 8,388               |
| Margin Deposits                                  | 2,178               | 3,409               |
| Prepayments and Other Current Assets             | 4,964               | 2,986               |
| <b>TOTAL CURRENT ASSETS</b>                      | <b>139,515</b>      | <b>165,620</b>      |
| <b>PROPERTY, PLANT AND EQUIPMENT</b>             |                     |                     |
| Electric:  |                     |                     |
| Generation                                       | 558,541             | 554,218             |
| Transmission                                     | 462,854             | 456,552             |
| Distribution                                     | 632,764             | 612,832             |
| Other Property, Plant and Equipment              | 64,145              | 60,390              |
| Construction Work in Progress                    | 74,286              | 71,290              |
| <b>Total Property, Plant and Equipment</b>       | 1,792,590           | 1,755,282           |
| Accumulated Depreciation and Amortization        | 600,481             | 573,871             |
| <b>TOTAL PROPERTY, PLANT AND EQUIPMENT – NET</b> | <b>1,192,109</b>    | <b>1,181,411</b>    |
| <b>OTHER NONCURRENT ASSETS</b>                   |                     |                     |
| Regulatory Assets                                | 224,631             | 214,860             |
| Long-term Risk Management Assets                 | 7,684               | 8,300               |
| Deferred Charges and Other Noncurrent Assets     | 41,540              | 23,793              |
| <b>TOTAL OTHER NONCURRENT ASSETS</b>             | <b>273,855</b>      | <b>246,953</b>      |
| <b>TOTAL ASSETS</b>                              | <b>\$ 1,605,479</b> | <b>\$ 1,593,984</b> |

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

**KENTUCKY POWER COMPANY**  
**CONDENSED BALANCE SHEETS**  
**LIABILITIES AND COMMON SHAREHOLDER'S EQUITY**  
**September 30, 2012 and December 31, 2011**  
**(Unaudited)**

|  | <b>2012</b>           | <b>2011</b>         |
|--|-----------------------|---------------------|
|  | <b>(in thousands)</b> |                     |
| <b>CURRENT LIABILITIES</b>                                 |                       |                     |
| <hr/>  |                       |                     |
| Accounts Payable:  |                       |                     |
| General  | \$ 35,288             | \$ 36,076           |
| Affiliated Companies                                       | 30,578                | 35,131              |
| Risk Management Liabilities                                | 3,651                 | 5,629               |
| Customer Deposits  | 22,539                | 22,074              |
| Accrued Taxes  | 18,185                | 19,436              |
| Accrued Interest   | 6,211                 | 7,754               |
| Regulatory Liability for Over-Recovered Fuel Costs         | 2,129                 | 3,138               |
| Other Current Liabilities                                  | 21,168                | 23,382              |
| <b>TOTAL CURRENT LIABILITIES</b>                           | <b>139,749</b>        | <b>152,620</b>      |
| <b>NONCURRENT LIABILITIES</b>                              |                       |                     |
| <hr/>  |                       |                     |
| Long-term Debt – Nonaffiliated                             | 529,180               | 529,055             |
| Long-term Debt – Affiliated                                | 20,000                | 20,000              |
| Long-term Risk Management Liabilities                      | 4,165                 | 2,734               |
| Deferred Income Taxes                                      | 353,076               | 338,656             |
| Regulatory Liabilities and Deferred Investment Tax Credits | 28,113                | 31,562              |
| Employee Benefits and Pension Obligations                  | 44,010                | 48,007              |
| Deferred Credits and Other Noncurrent Liabilities          | 10,548                | 10,934              |
| <b>TOTAL NONCURRENT LIABILITIES</b>                        | <b>989,092</b>        | <b>980,948</b>      |
| <b>TOTAL LIABILITIES</b>                                   | <b>1,128,841</b>      | <b>1,133,568</b>    |
| Rate Matters (Note 2)                                      |                       |                     |
| Commitments and Contingencies (Note 3)                     |                       |                     |
| <b>COMMON SHAREHOLDER'S EQUITY</b>                         |                       |                     |
| <hr/>  |                       |                     |
| Common Stock – Par Value – \$50 Per Share:                 |                       |                     |
| Authorized – 2,000,000 Shares                              |                       |                     |
| Outstanding – 1,009,000 Shares                             | 50,450                | 50,450              |
| Paid-in Capital  | 238,750               | 238,750             |
| Retained Earnings  | 187,804               | 171,841             |
| Accumulated Other Comprehensive Income (Loss)              | (366)                 | (625)               |
| <b>TOTAL COMMON SHAREHOLDER'S EQUITY</b>                   | <b>476,638</b>        | <b>460,416</b>      |
| <b>TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY</b>   | <b>\$ 1,605,479</b>   | <b>\$ 1,593,984</b> |

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



**KENTUCKY POWER COMPANY**  
**CONDENSED STATEMENTS OF CASH FLOWS**  
**For the Nine Months Ended September 30, 2012 and 2011**  
(in thousands)  
(Unaudited)

|   | <b>2012</b>     | <b>2011</b>     |
|---|-----------------|-----------------|
| <b>OPERATING ACTIVITIES</b>   |                 |                 |
| <b>Net Income</b>   | \$ 39,963       | \$ 32,195       |
| <b>Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:</b> |                 |                 |
| Depreciation and Amortization   | 40,930          | 40,376          |
| Deferred Income Taxes   | 6,947           | 8,855           |
| Net Recovery of (Deferral of) Storm Costs   | (9,159)         | 3,524           |
| Allowance for Equity Funds Used During Construction                                     | (1,976)         | (813)           |
| Mark-to-Market of Risk Management Contracts   | 2,531           | 2,621           |
| Property Taxes  | 7,612           | 5,840           |
| Fuel Over/Under-Recovery, Net   | (1,009)         | (1,187)         |
| Change in Other Noncurrent Assets   | (6,618)         | (3,276)         |
| Change in Other Noncurrent Liabilities  | 128             | (2,655)         |
| <b>Changes in Certain Components of Working Capital:</b>                                |                 |                 |
| Accounts Receivable, Net  | 2,955           | 20,375          |
| Fuel, Materials and Supplies  | (15,131)        | 13,048          |
| Accounts Payable  | (4,669)         | (22,941)        |
| Accrued Taxes, Net  | (101)           | (2,472)         |
| Other Current Assets  | 866             | 1,367           |
| Other Current Liabilities   | (2,321)         | (928)           |
| <b>Net Cash Flows from Operating Activities</b>   | <b>60,948</b>   | <b>93,929</b>   |
| <b>INVESTING ACTIVITIES</b>   |                 |                 |
| Construction Expenditures   | (73,536)        | (46,025)        |
| Change in Advances to Affiliates, Net   | 36,596          | (28,609)        |
| Acquisitions of Assets  | (19)            | (59)            |
| Proceeds from Sales of Assets   | 619             | 390             |
| <b>Net Cash Flows Used for Investing Activities</b>                                     | <b>(36,340)</b> | <b>(74,303)</b> |
| <b>FINANCING ACTIVITIES</b>   |                 |                 |
| Principal Payments for Capital Lease Obligations  | (921)           | (1,148)         |
| Dividends Paid on Common Stock  | (24,000)        | (18,000)        |
| Other Financing Activities  | 24              | 50              |
| <b>Net Cash Flows Used for Financing Activities</b>                                     | <b>(24,897)</b> | <b>(19,098)</b> |
| <b>Net Increase (Decrease) in Cash and Cash Equivalents</b>                             | (289)           | 528             |
| <b>Cash and Cash Equivalents at Beginning of Period</b>                                 | 778             | 281             |
| <b>Cash and Cash Equivalents at End of Period</b>                                       | <b>\$ 489</b>   | <b>\$ 809</b>   |
| <b>SUPPLEMENTARY INFORMATION</b>  |                 |                 |
| Cash Paid for Interest, Net of Capitalized Amounts                                      | \$ 27,369       | \$ 28,528       |
| Net Cash Paid for Income Taxes  | 9,373           | 7,272           |
| Noncash Acquisitions Under Capital Leases   | 412             | 8               |
| Construction Expenditures Included in Current Liabilities as of September 30,           | 6,838           | 3,495           |

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

## **INDEX OF CONDENSED NOTES TO CONDENSED FINANCIAL STATEMENTS**

1. Significant Accounting Matters
2. Rate Matters
3. Commitments, Guarantees and Contingencies
4. Benefit Plans
5. Business Segments
6. Derivatives and Hedging
7. Fair Value Measurements
8. Income Taxes
9. Financing Activities
10. Sustainable Cost Reductions

## **1. SIGNIFICANT ACCOUNTING MATTERS**

### ***General***

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

In the opinion of management, the unaudited condensed interim financial statements reflect all normal and recurring accruals and adjustments necessary for a fair presentation of the net income, financial position and cash flows for the interim periods. Net income for the three and nine months ended September 30, 2012 is not necessarily indicative of results that may be expected for the year ending December 31, 2012. The condensed financial statements are unaudited and should be read in conjunction with the audited 2011 financial statements and notes thereto, which are included in KPCo's 2011 Annual Report.

Management reviewed subsequent events through October 26, 2012, the date that the third quarter 2012 report was issued.

### ***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 three months ended September 30, 2012 and 2011 were \$8 million and \$9 million, respectively, and for the nine months ended September 30, 2012 and 2011 were \$23 million and \$24 million, respectively. The carrying amount of liabilities associated with AEPSC as of September 30, 2012 and December 31, 2011 were both \$3 million. 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 guarantees all the debt obligations of AEGCo. KPCo is considered to have a significant interest in AEGCo due to its transactions. KPCo is exposed to losses to the extent it cannot recover the costs of AEGCo through its normal business operations. Due to AEP management's control over AEGCo, KPCo is not considered the primary beneficiary of AEGCo. In the event AEGCo would require financing or other support outside the billings to KPCo, this financing would be provided by AEP. Total billings from AEGCo for the three

months ended September 30, 2012 and 2011 were both \$28 million, respectively and for the nine months ended September 30, 2012 and 2011 were \$76 million and \$72 million, respectively. The carrying amount of liabilities associated with AEGCo as of September 30, 2012 and December 31, 2011 was \$9 million and \$9 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

## 2. RATE MATTERS

As discussed in KPCo's 2011 Annual Report, KPCo is involved in rate and regulatory proceedings at the FERC and the KPSC. The Rate Matters note within KPCo's 2011 Annual Report should be read in conjunction with this report to gain a complete understanding of material rate matters still pending that could impact net income, cash flows and possibly financial condition. The following discusses ratemaking developments in 2012 and updates KPCo's 2011 Annual Report.

### *Regulatory Assets Not Yet Being Recovered*

| <u>Noncurrent Regulatory Assets (excluding fuel)</u>   | <u>September 30,</u><br><u>2012</u> | <u>December 31,</u><br><u>2011</u> |
|--|-------------------------------------|------------------------------------|
| <b>Regulatory assets not yet being recovered pending future proceedings to determine the recovery method and timing:</b> | (in thousands)                      |                                    |
| <u>Regulatory Assets Currently Not Earning a Return</u>  |                                     |                                    |
| Storm Related Costs  | \$ 12,683                           | \$ -                               |
| Mountaineer Carbon Capture and Storage Commercial Scale Facility   | 875                                 | 905                                |
| <b>Total Regulatory Assets Not Yet Being Recovered</b>   | <u>\$ 13,558</u>                    | <u>\$ 905</u>                      |

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

### *Big Sandy Unit 2 FGD System*

In May 2012, KPCo withdrew its application to the KPSC seeking approval of a Certificate of Public Convenience and Necessity to retrofit Big Sandy Unit 2 with a dry FGD system. KPCo is currently re-evaluating its options to meet the short and long-term energy needs of its customers at the most reasonable costs. As of September 30, 2012, KPCo has incurred \$30 million related to the FGD project. Management intends to pursue recovery of all costs related to the FGD project. If KPCo is not ultimately permitted to recover its incurred costs, it would reduce future net income and cash flows.

## FERC Rate Matters

### *Seams Elimination Cost Allocation (SECA) Revenue Subject to Refund*

In 2004, AEP eliminated transaction-based through-and-out transmission service charges and collected, at the FERC's direction, load-based charges, referred to as RTO SECA through March 2006. Intervenors objected and the FERC set SECA rate issues for hearing and ordered that the SECA rate revenues be collected, subject to refund. The AEP East companies recognized gross SECA revenues of \$220 million. KPCo's portion of recognized gross SECA revenues was \$17 million.

In 2006, a FERC Administrative Law Judge issued an initial decision finding that the SECA rates charged were unfair, unjust and discriminatory and that new compliance filings and refunds should be made.

AEP filed briefs jointly with other affected companies asking the FERC to reverse the decision. In May 2010, the FERC issued an order that generally supported AEP's position and required a compliance filing.

The AEP East companies provided reserves for net refunds for SECA settlements totaling \$44 million applicable to the \$220 million of SECA revenues collected. KPCo provided a reserve of \$3.3 million.

In August 2010, the affected companies, including the AEP East companies, filed a compliance filing with the FERC. If the compliance filing is accepted, the AEP East companies would have to pay refunds of approximately \$20 million including estimated interest of \$5 million. KPCo's portion of the potential refund payments is \$1.5 million. A decision is pending from the FERC.

Not all parties have agreed to the compliance filing. In August 2012, the FERC issued an order approving a settlement agreement resulting in the October 2012 collection of \$8 million of previously deemed uncollectible SECA revenue. There was no change in the reserve for net refunds due to the remaining uncertainty around negotiations with certain parties who have not agreed to the compliance filing. The balance in the reserve for future settlements as of September 30, 2012 was \$31 million. KPCo's portion of the reserve balance as of September 30, 2012 was \$2.4 million.

Based on the analysis of the May 2010 order, the compliance filing and recent settlements, management believes that the reserve is adequate to pay the refunds, including interest, that will be required should the compliance filing be made final. Management cannot predict the ultimate outcome of this proceeding at the FERC which could impact future net income and cash flows.

### ***Possible Termination of the Interconnection Agreement***

In December 2010, each of the members of the Interconnection Agreement gave notice to AEPSC and each other of its decision to terminate the Interconnection Agreement effective as of December 31, 2013 or such other date as ordered by the FERC. Management intends to file an application with the FERC in the fourth quarter of 2012 to terminate the Interconnection Agreement. It is unknown whether the Interconnection Agreement will be replaced by a new agreement among some or all of the members, whether individual companies will enter into bilateral or multi-party contracts with each other for power sales and purchases or asset transfers, or if each company will choose to operate independently. If any of the members of the Interconnection Agreement experience decreases in revenues or increases in costs as a result of the termination of the Interconnection Agreement and are unable to recover the change in revenues and costs through rates, prices or additional sales, it could reduce future net income and cash flows.

## **3. 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. The Commitments, Guarantees and Contingencies note within KPCo's 2011 Annual Report should be read in conjunction with this report.

### **GUARANTEES**

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

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

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

KPCo enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. As of September 30, 2012, there were no material liabilities recorded for any indemnifications.

KPCo is jointly and severally liable for activity conducted by AEPSC on behalf of the AEP East companies related to purchase power and sale activity conducted pursuant to the SIA.

## *Master Lease Agreements*

KPCo leases certain equipment under master lease agreements. Under the lease agreements, the lessor is guaranteed a residual value up to a stated percentage of either the unamortized balance or the equipment cost at the end of the lease term. If the actual fair value of the leased equipment is below the guaranteed residual value at the end of the lease term, KPCo is committed to pay the difference between the actual fair value and the residual value guarantee. Historically, at the end of the lease term the fair value has been in excess of the unamortized balance. As of September 30, 2012, the maximum potential loss for these lease agreements was approximately \$884 thousand assuming the fair value of the equipment is zero at the end of the lease term.

## **CONTINGENCIES**

### *Carbon Dioxide Public Nuisance Claims*

In October 2009, the Fifth Circuit Court of Appeals reversed a decision by the Federal District Court for the District of Mississippi dismissing state common law nuisance claims in a putative class action by Mississippi residents asserting that CO<sub>2</sub> emissions exacerbated the effects of Hurricane Katrina. The Fifth Circuit held that there was no exclusive commitment of the common law issues raised in plaintiffs' complaint to a coordinate branch of government and that no initial policy determination was required to adjudicate these claims. The court granted petitions for rehearing. An additional recusal left the Fifth Circuit without a quorum to reconsider the decision and the appeal was dismissed, leaving the district court's decision in place. Plaintiffs filed a petition with the U.S. Supreme Court asking the court to remand the case to the Fifth Circuit and reinstate the panel decision. The petition was denied in January 2011. Plaintiffs refiled their complaint in federal district court. The court ordered all defendants to respond to the refiled complaints in October 2011. In March 2012, the court granted the defendants' motion for dismissal on several grounds, including the doctrine of collateral estoppel and the applicable statute of limitations. Plaintiffs appealed the decision to the Fifth Circuit Court of Appeals. Management will continue to defend against the claims. Management is unable to determine a range of potential losses that are reasonably possible of occurring.

### *Alaskan Villages' Claims*

In 2008, the Native Village of Kivalina and the City of Kivalina, Alaska filed a lawsuit in Federal Court in the Northern District of California against AEP, AEPSC and 22 other unrelated defendants including oil and gas companies, a coal company and other electric generating companies. The complaint alleges that the defendants' emissions of CO<sub>2</sub> contribute to global warming and constitute a public and private nuisance and that the defendants are acting together. The complaint further alleges that some of the defendants, including AEP, conspired to create a false scientific debate about global warming in order to deceive the public and perpetuate the alleged nuisance. The plaintiffs also allege that the effects of global warming will require the relocation of the village at an alleged cost of \$95 million to \$400 million. In October 2009, the judge dismissed plaintiffs' federal common law claim for nuisance, finding the claim barred by the political question doctrine and by plaintiffs' lack of standing to bring the claim. The judge also dismissed plaintiffs' state law claims without prejudice to refile in state court. The plaintiffs appealed the decision. In September 2012, the Ninth Circuit Court of Appeals affirmed the trial court's decision, holding that the CAA displaced Kivalina's claims for damages. Plaintiffs have filed a petition for rehearing by the full court. Management believes the action is without merit and will continue to defend against the claims. Management is unable to determine a range of potential losses that are reasonably possible of occurring.

#### 4. BENEFIT PLANS

KPCo participates in an AEP sponsored qualified pension plan which covers substantially all of KPCo's employees. KPCo also participates in OPEB plans sponsored by AEP to provide medical and life insurance benefits for retired employees.

##### *Components of Net Periodic Benefit Cost*

The following tables provide the components of KPCo's net periodic benefit cost for the plans for the three and nine months ended September 30, 2012 and 2011:

|   | <u>Pension Plan</u>                     |   | <u>Other Postretirement Benefit Plans</u> |   |
|---|---|---|---|---|
|   | <u>Three Months Ended September 30,</u> | <u>Three Months Ended September 30,</u> | <u>Three Months Ended September 30,</u>   | <u>Three Months Ended September 30,</u> |
|   | <u>2012</u>                             | <u>2011</u>                             | <u>2012</u>                               | <u>2011</u>                             |
|   | (in thousands)                          |   |   |   |
| Service Cost                                | \$ 353                                  | \$ 347                                  | \$ 252                                    | \$ 234                                  |
| Interest Cost                               | 1,366                                   | 1,440                                   | 709                                       | 728                                     |
| Expected Return on Plan Assets              | (1,848)                                 | (1,838)                                 | (727)                                     | (757)                                   |
| Amortization of Prior Service Cost (Credit) | 21                                      | 38                                      | (126)                                     | (9)                                     |
| Amortization of Net Actuarial Loss          | 919                                     | 737                                     | 391                                       | 188                                     |
| <b>Net Periodic Benefit Cost</b>            | <b>\$ 811</b>                           | <b>\$ 724</b>                           | <b>\$ 499</b>                             | <b>\$ 384</b>                           |

|   | <u>Pension Plan</u>                    |  | <u>Other Postretirement Benefit Plans</u> |  |
|---|--|--|---|--|
|   | <u>Nine Months Ended September 30,</u> | <u>Nine Months Ended September 30,</u> | <u>Nine Months Ended September 30,</u>    | <u>Nine Months Ended September 30,</u> |
|   | <u>2012</u>                            | <u>2011</u>                            | <u>2012</u>                               | <u>2011</u>                            |
|   | (in thousands)                         |  |   |  |
| Service Cost                                | \$ 1,059                               | \$ 1,041                               | \$ 755                                    | \$ 704                                 |
| Interest Cost                               | 4,098                                  | 4,318                                  | 2,127                                     | 2,185                                  |
| Expected Return on Plan Assets              | (5,544)                                | (5,513)                                | (2,183)                                   | (2,272)                                |
| Amortization of Prior Service Cost (Credit) | 63                                     | 113                                    | (378)                                     | (26)                                   |
| Amortization of Net Actuarial Loss          | 2,758                                  | 2,213                                  | 1,175                                     | 563                                    |
| <b>Net Periodic Benefit Cost</b>            | <b>\$ 2,434</b>                        | <b>\$ 2,172</b>                        | <b>\$ 1,496</b>                           | <b>\$ 1,154</b>                        |

#### 5. BUSINESS SEGMENTS

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

#### 6. 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, coal and emission allowances. These risks include commodity price risk, interest rate risk, credit risk and, to a lesser extent, foreign currency exchange 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 forward purchase and sale contracts, financial forward purchase and sale contracts and financial swap instruments. 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 degree, heating oil and gasoline, emission allowance 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 financing and foreign currency risk associated with future purchase obligations denominated in foreign currencies. 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 the KPCo’s outstanding derivative contracts as of September 30, 2012 and December 31, 2011:

#### **Notional Volume of Derivative Instruments**

|                          | Volume                |                      | Unit of<br>Measure |
|--------------------------|-----------------------|----------------------|--------------------|
|                          | September 30,<br>2012 | December 31,<br>2011 |                    |
|                          | (in thousands)        |                      |                    |
| Commodity:               |                       |                      |                    |
| Power                    | 28,537                | 35,858               | MWhs               |
| Coal                     | 464                   | 783                  | Tons               |
| Natural Gas              | 2,230                 | 1,676                | MMBtus             |
| Heating Oil and Gasoline | 218                   | 274                  | Gallons            |
| Interest Rate            | \$ 5,813              | \$ 6,566             | USD                |

#### ***Fair Value Hedging Strategies***

AEPSC, on behalf of KPCo, enters into interest rate derivative transactions as part of an overall strategy to manage the mix of fixed-rate and floating-rate debt. Certain interest rate derivative transactions effectively modify KPCo’s exposure to interest rate risk by converting a portion of KPCo’s fixed-rate debt to a floating rate. Provided specific criteria are met, these interest rate derivatives are designated as fair value hedges.

#### ***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, coal, natural gas and heating oil and gasoline (“Commodity”) in order to manage the variable price risk related to the forecasted purchase and sale of these commodities. 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 fuel or energy 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. For disclosure purposes, these contracts are included with other hedging activities as “Commodity.” 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. Some interest rate derivative transactions effectively modify exposure to interest rate risk by converting a portion of floating-rate debt to a fixed rate. 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. The forecasted fixed-rate debt offerings have a high probability of occurrence as the proceeds will be used to fund existing debt maturities and projected capital expenditures. KPCo does not hedge all interest rate exposure.

At times, KPCo is exposed to foreign currency exchange rate risks primarily when KPCo purchases certain fixed assets from foreign suppliers. In accordance with AEP's risk management policy, AEPSC, on behalf of KPCo, may enter into foreign currency derivative transactions to protect against the risk of increased cash outflows resulting from a foreign currency's appreciation against the dollar. KPCo does not hedge all foreign currency 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 condensed 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 September 30, 2012 and December 31, 2011 balance sheets, KPCo netted \$476 thousand and \$908 thousand, respectively, of cash collateral received from third parties against short-term and long-term risk management assets and \$2.1 million and \$6.1 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 condensed balance sheets as of September 30, 2012 and December 31, 2011:

**Fair Value of Derivative Instruments  
September 30, 2012**

| <u>Balance Sheet Location</u>                                 | <u>Risk Management Contracts</u> |                      | <u>Hedging Contracts</u> |                  | <u>Total</u>    |
|---|----------------------------------|----------------------|--------------------------|------------------|-----------------|
|   | <u>Commodity (a)</u>             | <u>Commodity (a)</u> | <u>Interest Rate (a)</u> | <u>Other (b)</u> |                 |
|   | (in thousands)                   |                      |                          |                  |                 |
| Current Risk Management Assets                                | \$ 33,013                        | \$ 266               | \$ -                     | \$ (27,035)      | \$ 6,244        |
| Long-term Risk Management Assets                              | 16,565                           | 59                   | -                        | (8,940)          | 7,684           |
| <b>Total Assets</b>   | <u>49,578</u>                    | <u>325</u>           | <u>-</u>                 | <u>(35,975)</u>  | <u>13,928</u>   |
| Current Risk Management Liabilities                           | 31,410                           | 353                  | -                        | (28,112)         | 3,651           |
| Long-term Risk Management Liabilities                         | 13,672                           | 84                   | -                        | (9,591)          | 4,165           |
| <b>Total Liabilities</b>                                      | <u>45,082</u>                    | <u>437</u>           | <u>-</u>                 | <u>(37,703)</u>  | <u>7,816</u>    |
| <b>Total MTM Derivative Contract Net Assets (Liabilities)</b> | <u>\$ 4,496</u>                  | <u>\$ (112)</u>      | <u>\$ -</u>              | <u>\$ 1,728</u>  | <u>\$ 6,112</u> |

**Fair Value of Derivative Instruments  
December 31, 2011**

| <u>Balance Sheet Location</u>                                 | <u>Risk Management Contracts</u> |                      | <u>Hedging Contracts</u> |                  | <u>Total</u>    |
|---|----------------------------------|----------------------|--------------------------|------------------|-----------------|
|   | <u>Commodity (a)</u>             | <u>Commodity (a)</u> | <u>Interest Rate (a)</u> | <u>Other (b)</u> |                 |
|   | (in thousands)                   |                      |                          |                  |                 |
| Current Risk Management Assets                                | \$ 49,249                        | \$ 221               | \$ -                     | \$ (41,082)      | \$ 8,388        |
| Long-term Risk Management Assets                              | 21,107                           | 18                   | -                        | (12,825)         | 8,300           |
| <b>Total Assets</b>   | <u>70,356</u>                    | <u>239</u>           | <u>-</u>                 | <u>(53,907)</u>  | <u>16,688</u>   |
| Current Risk Management Liabilities                           | 49,793                           | 595                  | -                        | (44,759)         | 5,629           |
| Long-term Risk Management Liabilities                         | 17,362                           | 74                   | -                        | (14,702)         | 2,734           |
| <b>Total Liabilities</b>                                      | <u>67,155</u>                    | <u>669</u>           | <u>-</u>                 | <u>(59,461)</u>  | <u>8,363</u>    |
| <b>Total MTM Derivative Contract Net Assets (Liabilities)</b> | <u>\$ 3,201</u>                  | <u>\$ (430)</u>      | <u>\$ -</u>              | <u>\$ 5,554</u>  | <u>\$ 8,325</u> |

- (a) Derivative instruments within these categories are reported gross. These instruments are subject to master netting agreements and are presented on the condensed 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." Amounts also include de-designated risk management contracts.

The table below presents KPCo's activity of derivative risk management contracts for the three and nine months ended September 30, 2012 and 2011:

**Amount of Gain (Loss) Recognized on  
Risk Management Contracts  
For the Three and Nine Months Ended September 30, 2012 and 2011**

| Location of Gain (Loss)  | Three Months Ended<br>September 30, |                 | Nine Months Ended<br>September 30, |                 |
|--|-------------------------------------|-----------------|------------------------------------|-----------------|
|  | 2012                                | 2011            | 2012                               | 2011            |
|  | (in thousands)                      |                 |                                    |                 |
| Electric Generation, Transmission and<br>Distribution Revenues | \$ 362                              | \$ 213          | \$ (1,209)                         | \$ 3,199        |
| Sales to AEP Affiliates  | -                                   | 22              | -                                  | 27              |
| Fuel and Other Consumables Used for Electric Generation        | -                                   | (1)             | -                                  | (1)             |
| Regulatory Assets (a)  | (35)                                | 43              | (26)                               | 93              |
| Regulatory Liabilities (a)                                     | (600)                               | (412)           | 1,317                              | (301)           |
| <b>Total Gain (Loss) on Risk Management Contracts</b>          | <b>\$ (273)</b>                     | <b>\$ (135)</b> | <b>\$ 82</b>                       | <b>\$ 3,017</b> |

(a) Represents realized and unrealized gains and losses subject to regulatory accounting treatment recorded as either current or noncurrent on the condensed 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 condensed 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 condensed 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 condensed 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 Fair Value Hedging Strategies***

For fair value hedges (i.e. hedging the exposure to changes in the fair value of an asset, liability or an identified portion thereof attributable to a particular risk), the gain or loss on the derivative instrument as well as the offsetting gain or loss on the hedged item associated with the hedged risk affects Net Income during the period of change.

KPCo records realized and unrealized gains or losses on interest rate swaps that qualify for fair value hedge accounting treatment and any offsetting changes in the fair value of the debt being hedged in Interest Expense on KPCo's condensed statements of income. During the three and nine months ended September 30, 2012 and 2011, KPCo did not designate any fair value hedging strategies.

### ***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 condensed 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, coal and natural gas designated as cash flow hedges are included in Revenues, Fuel and Other Consumables Used for Electric Generation or Purchased Electricity for Resale on KPCo's condensed statements of income, or in Regulatory Assets or Regulatory Liabilities on KPCo's condensed balance sheets, depending on the specific nature of the risk being hedged. During the three and nine months ended September 30, 2012 and 2011, KPCo designated power, coal and natural gas 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 condensed balance sheets into Other Operation expense, Maintenance expense or Depreciation and Amortization expense, as it relates to capital projects, on the condensed statements of income. During the three and nine months ended September 30, 2012 and 2011, KPCo designated heating oil and gasoline derivatives as cash flow hedges.

KPCo reclassifies gains and losses on interest rate derivative hedges related to debt financings from Accumulated Other Comprehensive Income (Loss) on its condensed balance sheets into Interest Expense on its condensed statements of income in those periods in which hedged interest payments occur. During the three and nine months ended September 30, 2012 and 2011, KPCo did not designate any interest rate derivatives as cash flow hedges.

The accumulated gains or losses related to foreign currency hedges are reclassified from Accumulated Other Comprehensive Income (Loss) on KPCo's condensed balance sheets into Depreciation and Amortization expense on the condensed statements of income over the depreciable lives of the fixed assets that were designated as the hedged items in qualifying foreign currency hedging relationships. During the three and nine months ended September 30, 2012 and 2011, KPCo did not designate any foreign currency derivatives as cash flow hedges.

During the three and nine months ended September 30, 2012 and 2011, hedge ineffectiveness was immaterial or nonexistent for all cash flow hedge strategies disclosed above.

The following tables provide details on designated, effective cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on KPCo's condensed balance sheets and the reasons for changes in cash flow hedges for the three and nine months ended September 30, 2012 and 2011. All amounts in the following tables are presented net of related income taxes.

**Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges  
For the Three Months Ended September 30, 2012**

|   | <u>Commodity</u> | <u>Interest Rate</u> | <u>Total</u>    |
|---|------------------|----------------------|-----------------|
|   | (in thousands)   |                      |                 |
| <b>Balance in AOCI as of June 30, 2012</b>  | \$ (374)         | \$ (312)             | \$ (686)        |
| Changes in Fair Value Recognized in AOCI  | 273              | -                    | 273             |
| Amount of (Gain) or Loss Reclassified from AOCI<br>to Statement of Income/within Balance Sheet: |                  |                      |                 |
| Electric Generation, Transmission and Distribution Revenues                                     | (4)              | -                    | (4)             |
| Purchased Electricity for Resale  | 33               | -                    | 33              |
| Other Operation Expense   | (1)              | -                    | (1)             |
| Maintenance Expense   | 3                | -                    | 3               |
| Interest Expense  | -                | 15                   | 15              |
| Property, Plant and Equipment   | 1                | -                    | 1               |
| Regulatory Assets (a)   | -                | -                    | -               |
| Regulatory Liabilities (a)  | -                | -                    | -               |
| <b>Balance in AOCI as of September 30, 2012</b>   | <u>\$ (69)</u>   | <u>\$ (297)</u>      | <u>\$ (366)</u> |

**Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges  
For the Three Months Ended September 30, 2011**

|   | <u>Commodity</u> | <u>Interest Rate</u> | <u>Total</u>    |
|---|------------------|----------------------|-----------------|
|   | (in thousands)   |                      |                 |
| <b>Balance in AOCI as of June 30, 2011</b>  | \$ 153           | \$ (373)             | \$ (220)        |
| Changes in Fair Value Recognized in AOCI  | (151)            | -                    | (151)           |
| Amount of (Gain) or Loss Reclassified from AOCI<br>to Statement of Income/within Balance Sheet: |                  |                      |                 |
| Electric Generation, Transmission and Distribution Revenues                                     | 35               | -                    | 35              |
| Purchased Electricity for Resale  | (29)             | -                    | (29)            |
| Other Operation Expense   | (10)             | -                    | (10)            |
| Maintenance Expense   | (11)             | -                    | (11)            |
| Interest Expense  | -                | 16                   | 16              |
| Property, Plant and Equipment   | (14)             | -                    | (14)            |
| Regulatory Assets (a)   | 9                | -                    | 9               |
| Regulatory Liabilities (a)  | -                | -                    | -               |
| <b>Balance in AOCI as of September 30, 2011</b>   | <u>\$ (18)</u>   | <u>\$ (357)</u>      | <u>\$ (375)</u> |

**Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges  
For the Nine Months Ended September 30, 2012**

|   | <u>Commodity</u> | <u>Interest Rate</u> | <u>Total</u>    |
|---|------------------|----------------------|-----------------|
|   | (in thousands)   |                      |                 |
| <b>Balance in AOCI as of December 31, 2011</b>  | \$ (283)         | \$ (342)             | \$ (625)        |
| Changes in Fair Value Recognized in AOCI  | (171)            | -                    | (171)           |
| Amount of (Gain) or Loss Reclassified from AOCI<br>to Statement of Income/within Balance Sheet: |                  |                      |                 |
| Electric Generation, Transmission and Distribution Revenues                                     | (7)              | -                    | (7)             |
| Purchased Electricity for Resale  | 398              | -                    | 398             |
| Other Operation Expense   | (4)              | -                    | (4)             |
| Maintenance Expense   | 1                | -                    | 1               |
| Interest Expense  | -                | 45                   | 45              |
| Property, Plant and Equipment   | (3)              | -                    | (3)             |
| Regulatory Assets (a)   | -                | -                    | -               |
| Regulatory Liabilities (a)  | -                | -                    | -               |
| <b>Balance in AOCI as of September 30, 2012</b>   | <u>\$ (69)</u>   | <u>\$ (297)</u>      | <u>\$ (366)</u> |

**Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges  
For the Nine Months Ended September 30, 2011**

|   | <u>Commodity</u> | <u>Interest Rate</u> | <u>Total</u>    |
|---|------------------|----------------------|-----------------|
|   | (in thousands)   |                      |                 |
| <b>Balance in AOCI as of December 31, 2010</b>  | \$ (48)          | \$ (403)             | \$ (451)        |
| Changes in Fair Value Recognized in AOCI  | (111)            | -                    | (111)           |
| Amount of (Gain) or Loss Reclassified from AOCI<br>to Statement of Income/within Balance Sheet: |                  |                      |                 |
| Electric Generation, Transmission and Distribution Revenues                                     | 207              | -                    | 207             |
| Purchased Electricity for Resale  | 17               | -                    | 17              |
| Other Operation Expense   | (26)             | -                    | (26)            |
| Maintenance Expense   | (31)             | -                    | (31)            |
| Interest Expense  | -                | 46                   | 46              |
| Property, Plant and Equipment   | (35)             | -                    | (35)            |
| Regulatory Assets (a)   | 9                | -                    | 9               |
| Regulatory Liabilities (a)  | -                | -                    | -               |
| <b>Balance in AOCI as of September 30, 2011</b>   | <u>\$ (18)</u>   | <u>\$ (357)</u>      | <u>\$ (375)</u> |

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

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on KPCo's condensed balance sheets as of September 30, 2012 and December 31, 2011 were:

**Impact of Cash Flow Hedges on the Condensed Balance Sheet  
September 30, 2012**

|  | <u>Commodity</u> | <u>Interest Rate</u> | <u>Total</u> |
|--|------------------|----------------------|--------------|
|  |                  | (in thousands)       |              |
| Hedging Assets (a)   | \$ 190           | \$ -                 | \$ 190       |
| Hedging Liabilities (a)  | 302              | -                    | 302          |
| AOCI Loss Net of Tax   | (69)             | (297)                | (366)        |
| Portion Expected to be Reclassified to Net<br>Income During the Next Twelve Months | (52)             | (60)                 | (112)        |

**Impact of Cash Flow Hedges on the Condensed Balance Sheet  
December 31, 2011**

|  | <u>Commodity</u> | <u>Interest Rate</u> | <u>Total</u> |
|--|------------------|----------------------|--------------|
|  |                  | (in thousands)       |              |
| Hedging Assets (a)   | \$ 91            | \$ -                 | \$ 91        |
| Hedging Liabilities (a)  | 521              | -                    | 521          |
| AOCI Loss Net of Tax   | (283)            | (342)                | (625)        |
| Portion Expected to be Reclassified to Net<br>Income During the Next Twelve Months | (247)            | (60)                 | (307)        |

- (a) Hedging Assets and Hedging Liabilities are included in Risk Management Assets and Liabilities on KPCo's condensed 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 September 30, 2012, the maximum length of time that KPCo is hedging (with contracts subject to the accounting guidance for "Derivatives and Hedging") its exposure to variability in future cash flows related to forecasted transactions is 20 months.

***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.

AEPSC, on behalf of KPCo, uses standardized master agreements which 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: (a) KPCo's aggregate fair value of such derivative contracts, (b) the amount of collateral KPCo would have been required to post for all derivative and non-derivative contracts if the credit ratings had declined below investment grade and (c) how much was attributable to RTO and ISO activities as of September 30, 2012 and December 31, 2011:

|   | <b>September 30,<br/>2012</b> | <b>December 31,<br/>2011</b> |
|---|-------------------------------|------------------------------|
|   | <b>(in thousands)</b>         |                              |
| Liabilities for Derivative Contracts with Credit Downgrade Triggers | \$ 432                        | \$ 2,117                     |
| Amount of Collateral KPCo Would Have Been Required to Post          | 1,233                         | 1,314                        |
| Amount Attributable to RTO and ISO Activities                       | 862                           | 1,314                        |

As of September 30, 2012 and December 31, 2011, KPCo was not required to post any collateral.

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 September 30, 2012 and December 31, 2011:

|   | <b>September 30,<br/>2012</b> | <b>December 31,<br/>2011</b> |
|---|-------------------------------|------------------------------|
|   | <b>(in thousands)</b>         |                              |
| Liabilities for Contracts with Cross Default Provisions Prior to Contractual Netting Arrangements | \$ 12,917                     | \$ 16,265                    |
| Amount of Cash Collateral Posted  | 15                            | 1,715                        |
| Additional Settlement Liability if Cross Default Provision is Triggered                           | 6,616                         | 5,841                        |

## **7. FAIR VALUE MEASUREMENTS**

### ***Fair Value Hierarchy and Valuation Techniques***

The accounting guidance for "Fair Value Measurements and Disclosures" establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement). Where observable inputs are available for substantially the full term of the asset or liability, the instrument is categorized in Level 2. When quoted market prices are not available, pricing may be completed using comparable securities, dealer values, operating data and general market conditions to determine fair value. Valuation models utilize various inputs such as commodity, interest rate and, to a lesser degree, volatility and credit that include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in inactive markets, market corroborated inputs (i.e. inputs derived principally from, or correlated to, observable market data) and other observable inputs for the asset or liability. The AEP System's market risk oversight staff independently monitors its valuation policies and procedures and provides members of the Commercial Operations Risk Committee (CORC) various daily, weekly and monthly reports, regarding compliance with policies and procedures. The CORC consists of AEPSC's Chief Operation Officer, Chief Financial Officer, 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 non-binding 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. Long-dated and illiquid complex or structured transactions, FTRs and counterparty credit risk can introduce the need for internally developed modeling inputs based upon extrapolations and assumptions of observable market data 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 the 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.

***Fair Value Measurements of Long-term Debt***

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

The book values and fair values of KPCo’s Long-term Debt as of September 30, 2012 and December 31, 2011 are summarized in the following table:

|                | <u>September 30, 2012</u> |                   | <u>December 31, 2011</u> |                   |
|----------------|---------------------------|-------------------|--------------------------|-------------------|
|                | <u>Book Value</u>         | <u>Fair Value</u> | <u>Book Value</u>        | <u>Fair Value</u> |
|                | (in thousands)            |                   |                          |                   |
| Long-term Debt | \$ 549,180                | \$ 713,898        | \$ 549,055               | \$ 685,628        |

### *Fair Value Measurements of Financial Assets and Liabilities*

The following tables set forth, by level within the fair value hierarchy, KPCo's financial assets and liabilities that were accounted for at fair value on a recurring basis as of September 30, 2012 and December 31, 2011. As required by the accounting guidance for "Fair Value Measurements and Disclosures," financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Management's assessment of the significance of a particular input to the fair value measurement requires judgment and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels. There have not been any significant changes in management's valuation techniques.

#### **Assets and Liabilities Measured at Fair Value on a Recurring Basis September 30, 2012**

| <b>Assets:</b>                              | <u>Level 1</u> | <u>Level 2</u>   | <u>Level 3</u>  | <u>Other</u>       | <u>Total</u>     |
|---|----------------|------------------|-----------------|--------------------|------------------|
|   | (in thousands) |                  |                 |                    |                  |
| <b>Risk Management Assets</b>               |                |                  |                 |                    |                  |
| Risk Management Commodity Contracts (a) (c) | \$ 862         | \$ 43,664        | \$ 4,680        | \$ (35,586)        | \$ 13,620        |
| Cash Flow Hedges:                           |                |                  |                 |                    |                  |
| Commodity Hedges (a)                        | -              | 267              | 58              | (135)              | 190              |
| De-designated Risk Management Contracts (b) | -              | -                | -               | 118                | 118              |
| <b>Total Risk Management Assets</b>         | <u>\$ 862</u>  | <u>\$ 43,931</u> | <u>\$ 4,738</u> | <u>\$ (35,603)</u> | <u>\$ 13,928</u> |
| <b>Liabilities:</b>                         |                |                  |                 |                    |                  |
| <b>Risk Management Liabilities</b>          |                |                  |                 |                    |                  |
| Risk Management Commodity Contracts (a) (c) | \$ 387         | \$ 41,797        | \$ 2,526        | \$ (37,196)        | \$ 7,514         |
| Cash Flow Hedges:                           |                |                  |                 |                    |                  |
| Commodity Hedges (a)                        | -              | 437              | -               | (135)              | 302              |
| <b>Total Risk Management Liabilities</b>    | <u>\$ 387</u>  | <u>\$ 42,234</u> | <u>\$ 2,526</u> | <u>\$ (37,331)</u> | <u>\$ 7,816</u>  |

#### **Assets and Liabilities Measured at Fair Value on a Recurring Basis December 31, 2011**

| <b>Assets:</b>                              | <u>Level 1</u> | <u>Level 2</u>   | <u>Level 3</u>  | <u>Other</u>       | <u>Total</u>     |
|---|----------------|------------------|-----------------|--------------------|------------------|
|   | (in thousands) |                  |                 |                    |                  |
| <b>Risk Management Assets</b>               |                |                  |                 |                    |                  |
| Risk Management Commodity Contracts (a) (c) | \$ 990         | \$ 63,922        | \$ 5,379        | \$ (54,018)        | \$ 16,273        |
| Cash Flow Hedges:                           |                |                  |                 |                    |                  |
| Commodity Hedges (a)                        | -              | 232              | -               | (141)              | 91               |
| De-designated Risk Management Contracts (b) | -              | -                | -               | 324                | 324              |
| <b>Total Risk Management Assets</b>         | <u>\$ 990</u>  | <u>\$ 64,154</u> | <u>\$ 5,379</u> | <u>\$ (53,835)</u> | <u>\$ 16,688</u> |
| <b>Liabilities:</b>                         |                |                  |                 |                    |                  |
| <b>Risk Management Liabilities</b>          |                |                  |                 |                    |                  |
| Risk Management Commodity Contracts (a) (c) | \$ 536         | \$ 61,607        | \$ 4,947        | \$ (59,248)        | \$ 7,842         |
| Cash Flow Hedges:                           |                |                  |                 |                    |                  |
| Commodity Hedges (a)                        | -              | 646              | 16              | (141)              | 521              |
| <b>Total Risk Management Liabilities</b>    | <u>\$ 536</u>  | <u>\$ 62,253</u> | <u>\$ 4,963</u> | <u>\$ (59,389)</u> | <u>\$ 8,363</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) Represents contracts that were originally MTM but were subsequently elected as normal under the accounting guidance for "Derivatives and Hedging." At the time of the normal election, the MTM value was frozen and no longer fair valued. This MTM value will be amortized into revenues over the remaining life of the contracts.
- (c) Substantially comprised of power contracts.

There were no transfers between Level 1 and Level 2 during the three and nine months ended September 30, 2012 and 2011.

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:

| <b>Three Months Ended September 30, 2012</b>  | <b>Net Risk Management<br/>Assets (Liabilities)<br/>(in thousands)</b> |
|---|--|
| <b>Balance as of June 30, 2012</b>  | \$ 2,577   |
| Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)  | (709)  |
| Unrealized Gain (Loss) Included in Net Income (or Changes in Net Assets)<br>Relating to Assets Still Held at the Reporting Date (a) | -  |
| Realized and Unrealized Gains (Losses) Included in Other Comprehensive Income   | 81   |
| Purchases, Issuances and Settlements (c)  | 186  |
| Transfers into Level 3 (d) (f)  | 131  |
| Transfers out of Level 3 (e) (f)  | (57)   |
| Changes in Fair Value Allocated to Regulated Jurisdictions (g)  | 3  |
| <b>Balance as of September 30, 2012</b>   | <b>\$ 2,212</b>  |

| <b>Three Months Ended September 30, 2011</b>  | <b>Net Risk Management<br/>Assets (Liabilities)<br/>(in thousands)</b> |
|---|--|
| <b>Balance as of June 30, 2011</b>  | \$ 1,127   |
| Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)  | (963)  |
| Unrealized Gain (Loss) Included in Net Income (or Changes in Net Assets)<br>Relating to Assets Still Held at the Reporting Date (a) | -  |
| Realized and Unrealized Gains (Losses) Included in Other Comprehensive Income   | (1)  |
| Purchases, Issuances and Settlements (c)  | 76   |
| Transfers into Level 3 (d) (f)  | -  |
| Transfers out of Level 3 (e) (f)  | (55)   |
| Changes in Fair Value Allocated to Regulated Jurisdictions (g)  | (23)   |
| <b>Balance as of September 30, 2011</b>   | <b>\$ 161</b>  |

| <b>Nine Months Ended September 30, 2012</b>   | <b>Net Risk Management<br/>Assets (Liabilities)<br/>(in thousands)</b> |
|---|--|
| <b>Balance as of December 31, 2011</b>  | \$ 416   |
| Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)  | (1,052)  |
| Unrealized Gain (Loss) Included in Net Income (or Changes in Net Assets)<br>Relating to Assets Still Held at the Reporting Date (a) | -  |
| Realized and Unrealized Gains (Losses) Included in Other Comprehensive Income   | 63   |
| Purchases, Issuances and Settlements (c)  | 2,163  |
| Transfers into Level 3 (d) (f)  | 860  |
| Transfers out of Level 3 (e) (f)  | (1,031)  |
| Changes in Fair Value Allocated to Regulated Jurisdictions (g)  | 793  |
| <b>Balance as of September 30, 2012</b>   | <b>\$ 2,212</b>  |

| Nine Months Ended September 30, 2011  | Net Risk Management<br>Assets (Liabilities) |            |
|---|---|------------|
|   | (in thousands)                              |            |
| <b>Balance as of December 31, 2010</b>  | \$  | 1,073      |
| Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)  |   | (501)      |
| Unrealized Gain (Loss) Included in Net Income (or Changes in Net Assets)<br>Relating to Assets Still Held at the Reporting Date (a) |   | -          |
| Realized and Unrealized Gains (Losses) Included in Other Comprehensive Income   |   | (10)       |
| Purchases, Issuances and Settlements (c)  |   | 603        |
| Transfers into Level 3 (d) (f)  |   | 272        |
| Transfers out of Level 3 (e) (f)  |   | (635)      |
| Changes in Fair Value Allocated to Regulated Jurisdictions (g)  |   | (641)      |
| <b>Balance as of September 30, 2011</b>   | <u>\$</u>                                   | <u>161</u> |

- (a) Included in revenues on KPCo's condensed 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) Represents existing assets or liabilities that were previously categorized as Level 3.
- (f) Transfers are recognized based on their value at the beginning of the reporting period that the transfer occurred.
- (g) Relates to the net gains (losses) of those contracts that are not reflected on KPCo's condensed statements of income. These net gains (losses) are recorded as regulatory assets/liabilities.

The following table quantifies the significant unobservable inputs used in developing the fair value of Level 3 positions as of September 30, 2012:

|                  | Fair Value      |                 | Valuation<br>Technique | Significant<br>Unobservable Input (a) | Forward Price Range |          |
|------------------|-----------------|-----------------|------------------------|---------------------------------------|---------------------|----------|
|                  | Assets          | Liabilities     |                        |                                       | Low                 | High     |
|                  | (in thousands)  |                 |                        |                                       |                     |          |
| Energy Contracts | \$ 4,268        | \$ 2,094        | Discounted Cash Flow   | Forward Market Price                  | \$ 10.45            | \$ 63.25 |
| FTRs             | 470             | 432             | Discounted Cash Flow   | Forward Market Price                  | (3.81)              | 9.92     |
| <b>Total</b>     | <u>\$ 4,738</u> | <u>\$ 2,526</u> |                        |                                       |                     |          |

- (a) Represents market prices in dollars per MWh.

## 8. INCOME TAXES

### *AEP System Tax Allocation Agreement*

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

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

KPCo and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2009. KPCo and other AEP subsidiaries completed the examination of the years 2007 and 2008 in April 2011 and settled all outstanding issues on appeal for the years 2001 through 2006 in October 2011. The settlements did not have a material impact on KPCo and other AEP subsidiaries' net income, cash flows or financial condition. The IRS examination of years 2009 and 2010 started in October 2011. 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 have a material effect on 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 and KPCo and other AEP subsidiaries are currently under examination in several state and local jurisdictions. Management believes that previously filed tax returns have positions that may be challenged by these tax authorities. However, 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. With few exceptions, KPCo is no longer subject to state or local income tax examinations by tax authorities for years before 2000. In March 2012, AEP settled all outstanding franchise tax issues with the State of Ohio for the years 2000 through 2009. The settlements did not have a material impact on KPCo's net income, cash flows or financial condition.

### ***State Tax Legislation***

During the third quarter of 2012, it was determined that the state of West Virginia had achieved certain minimum levels of shortfall reserve funds and thus, the West Virginia corporate income tax rate will be reduced from 7.75% to 7.0% in 2013. The enacted provisions will not have a material impact on KPCo's net income, cash flows or financial condition.

## **9. FINANCING ACTIVITIES**

### ***Long-term Debt***

KPCo did not have any long-term debt issuances or retirements during the first nine months of 2012.

### ***Dividend Restrictions***

#### ***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 value of the common stock. This restriction does not limit the ability of KPCo to pay dividends out of retained earnings.

### ***Utility Money Pool – AEP System***

The AEP System uses a corporate borrowing program to meet the short-term borrowing needs of the 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 approved in a regulatory order. The amount of outstanding loans to the Utility Money Pool as of September 30, 2012 and December 31, 2011 is included in Advances to Affiliates on KPCo's condensed balance sheets. KPCo's Utility Money Pool activity and corresponding authorized borrowing limits for the nine months ended September 30, 2012 are described in the following table:

| <b>Maximum Borrowings from Utility Money Pool</b> | <b>Maximum Loans to Utility Money Pool</b> | <b>Average Borrowings from Utility Money Pool</b> | <b>Average Loans to Utility Money Pool</b> | <b>Loans to Utility Money Pool as of September 30, 2012</b> | <b>Authorized Short-Term Borrowing Limit</b> |
|---|--|---|--|---|--|
| (in thousands)                                    |  |   |  |   |  |
| \$ -  | \$ 80,205                                  | \$ -  | \$ 52,170                                  | \$ 33,736   | \$ 250,000                                   |

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool for the nine months ended September 30, 2012 and 2011 are summarized in the following table:

| <b>Nine Months Ended September 30,</b> | <b>Maximum Interest Rates for Funds Borrowed from Utility Money Pool</b> | <b>Minimum Interest Rates for Funds Borrowed from Utility Money Pool</b> | <b>Maximum Interest Rates for Funds Loaned to Utility Money Pool</b> | <b>Minimum Interest Rates for Funds Loaned to Utility Money Pool</b> | <b>Average Interest Rates for Funds Borrowed from Utility Money Pool</b> | <b>Average Interest Rates for Funds Loaned to Utility Money Pool</b> |
|--|--|--|--|--|--|--|
| 2012                                   | -  | -  | 0.56 %   | 0.44 %   | -  | 0.48 %   |
| 2011                                   | -  | -  | 0.56 %   | 0.06 %   | -  | 0.32 %   |

### ***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 condensed statements of income. KPCo manages and services its accounts receivable sold.

In June 2012, AEP Credit renewed its receivables securitization agreement. The agreement provides commitments of \$700 million from bank conduits to finance receivables from AEP Credit. A commitment of \$385 million expires in June 2013 and the remaining commitment of \$315 million expires in June 2015.

KPCo's amount of accounts receivable and accrued unbilled revenues sold under the sale of receivables agreement was \$37 million and \$52 million as of September 30, 2012 and December 31, 2011, respectively.

The fees paid by KPCo to AEP Credit for customer accounts receivable sold for the three months ended September 30, 2012 and 2011 were \$605 thousand and \$586 thousand, respectively, and for the nine months ended September 30, 2012 and 2011 were \$1.9 million and \$1.7 million, respectively.

KPCo's proceeds on the sale of receivables to AEP Credit for the three months ended September 30, 2012 and 2011 were \$122 million and \$139 million, respectively, and for the nine months ended September 30, 2012 and 2011 were \$387 million and \$441 million, respectively.

## **10. SUSTAINABLE COST REDUCTIONS**

In April 2012, management initiated a process to identify employee repositioning opportunities and efficiencies that will result in sustainable cost savings. The process will result in involuntary severances and is expected to be completed in early 2013. The severance program provides two weeks of base pay for every year of service along with other severance benefits.

KPCo recorded charges to expense in 2012 related to the sustainable cost reductions initiative.

| <b>Expense Allocation from AEPSC</b> | <b>Incurred</b> | <b>Settled</b> | <b>Remaining Balance at September 30, 2012</b> |
|--------------------------------------|-----------------|----------------|--|
| <b>(in thousands)</b>                |                 |                |  |
| \$ 351                               | \$ 90           | \$ (440)       | \$ 1   |

These expenses relate primarily to severance benefits. They are included primarily in Other Operation on the condensed statements of income and Other Current Liabilities on the condensed balance sheets. At this time, management is unable to estimate the total amount to be incurred in future periods related to this initiative or to quantify the effects on future net income, cash flows and financial condition.