Kentucky Power Company

2007 Second Quarter Report

Financial Statements

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

Term	Meaning
AEP or Parent	American Electric Power Company, Inc.
AEP Consolidated	AEP and its majority owned consolidated subsidiaries and consolidated affiliates.
AEP Credit	AEP Credit, Inc., a subsidiary of AEP which factors accounts receivable and accrued utility revenues for affiliated domestic electric utility companies.
AEP East companies	APCo, CSPCo, I&M, KPCo and OPCo.
AEP System or the System	American Electric Power System, an integrated electric utility system, owned and operated by AEP's electric utility subsidiaries.
AEP System Power Pool or AEP Power Pool	Members are APCo, CSPCo, I&M, KPCo and OPCo. The Pool shares the generation, cost of generation and resultant wholesale off-system sales of the member companies.
AEP West companies	PSO, SWEPCo, TCC and TNC.
AEPSC	American Electric Power Service Corporation, a service subsidiary providing management and professional services to AEP and its subsidiaries.
ALJ	Administrative Law Judge.
APCo	Appalachian Power Company, an AEP electric utility subsidiary.
ARO	Asset Retirement Obligations.
CAA	Clean Air Act.
CSPCo	Columbus Southern Power Company, an AEP electric utility subsidiary.
CSW	Central and South West Corporation, a subsidiary of AEP (Effective January 21, 2003, the legal name of Central and South West Corporation was changed to AEP Utilities, Inc.).
EITF	Financial Accounting Standards Board's Emerging Issues Task Force.
FASB	Financial Accounting Standards Board.
Federal EPA	United States Environmental Protection Agency.
FERC	Federal Energy Regulatory Commission.
FIN	FASB Interpretation No.
FIN 48	FIN 48, "Accounting for Uncertainty in Income Taxes" and FASB Staff Position FIN 48-1 "Definition of *Settlement* in FASB Interpretation No. 48."
GAAP	Accounting Principles Generally Accepted in the United States of America.
IRS	Internal Revenue Service.
I&M	Indiana Michigan Power Company, an AEP electric utility subsidiary.
KPCo	Kentucky Power Company, an AEP electric utility subsidiary.
KPSC	Kentucky Public Service Commission.
kV	Kilovolt.
MTM	Mark-to-Market.
MW	Megawatt.
OCC	Corporation Commission of the State of Oklahoma.
OPCo	Ohio Power Company, an AEP electric utility subsidiary.
PJM	Pennsylvania – New Jersey – Maryland regional transmission organization.
PSO	Public Service Company of Oklahoma, an AEP electric utility subsidiary.
PUCT	Public Utility Commission of Texas.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
RTO	Regional Transmission Organization.
SEC	United States Securities and Exchange Commission.
SECA	Seams Elimination Cost Allocation.
SFAS	Statement of Financial Accounting Standards issued by the Financial Accounting Standards Board.
SFAS 71	Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation."
SFAS 133	Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities."
SFAS 157	Statement of Financial Accounting Standards No. 157, "Fair Value Measurements."

Term	Meaning
SFAS 158	Statement of Financial Accounting Standards No. 158, “Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans.”
SFAS 159	Statement of Financial Accounting Standards No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities.”
SIA	System Integration Agreement.
TCC	AEP Texas Central Company, an AEP electric utility subsidiary.
TNC	AEP Texas North Company, an AEP electric utility subsidiary.
Transmission Equalization Agreement	Transmission Equalization Agreement by and among APCo, CSPCo, I&M, KPCo and OPCo with AEPSC as agent, promoting the allocation of the cost of ownership and operation of the transmission system in proportion to their demand ratios.
Utility Money Pool	AEP System’s Utility Money Pool.
VaR	Value at Risk, a method to quantify risk exposure.

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF INCOME
For the Three and Six Months Ended June 30, 2007 and 2006
(in thousands)
(Unaudited)

	Three Months Ended 2007	Three Months Ended 2006	Six Months Ended 2007	Six Months Ended 2006
REVENUES				
Electric Generation, Transmission and Distribution	$ 123,280	$ 121,074	$ 263,766	$ 258,694
Sales to AEP Affiliates	11,162	14,109	24,623	28,077
Other	88	120	237	379
TOTAL	134,530	135,303	288,626	287,150
EXPENSES				
Fuel and Other Consumables Used for Electric Generation	40,121	31,790	78,425	75,756
Purchased Electricity for Resale	3,457	1,991	6,762	2,964
Purchased Electricity from AEP Affiliates	43,578	50,923	86,835	100,449
Other Operation	14,632	13,717	30,518	27,443
Maintenance	10,337	9,293	18,547	16,434
Depreciation and Amortization	11,730	11,593	23,526	23,072
Taxes Other Than Income Taxes	2,973	2,442	5,776	4,954
TOTAL	126,828	121,749	250,389	251,072
OPERATING INCOME	7,702	13,554	38,237	36,078
Other Income	96	105	222	372
Interest Expense	(7,201)	(7,440)	(14,212)	(14,736)
INCOME BEFORE INCOME TAXES	597	6,219	24,247	21,714
Income Tax Expense (Credit)	(633)	1,168	7,806	6,833
NET INCOME	$ 1,230	$ 5,051	$ 16,441	$ 14,881

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

See Condensed Notes to Condensed Financial Statements.

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S EQUITY AND COMPREHENSIVE INCOME (LOSS)
For the Six Months Ended June 30, 2007 and 2006
(in thousands)
(Unaudited)

	Common Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
DECEMBER 31, 2005	$ 50,450	$ 208,750	$ 88,864	$ (223)	$ 347,841
Common Stock Dividends			(5,000)		(5,000)
TOTAL					342,841
COMPREHENSIVE INCOME					
Other Comprehensive Income, Net of Taxes:					
Cash Flow Hedges, Net of Tax of $1,478				2,744	2,744
NET INCOME			14,881		14,881
TOTAL COMPREHENSIVE INCOME					17,625
JUNE 30, 2006	$ 50,450	$ 208,750	$ 98,745	$ 2,521	$ 360,466
DECEMBER 31, 2006	$ 50,450	$ 208,750	$ 108,899	$ 1,552	$ 369,651
FIN 48 Adoption, Net of Tax			(786)		(786)
Common Stock Dividends			(8,999)		(8,999)
TOTAL					359,866
COMPREHENSIVE INCOME					
Other Comprehensive Income, Net of Taxes:					
Cash Flow Hedges, Net of Tax of $1,758				3,265	3,265
NET INCOME			16,441		16,441
TOTAL COMPREHENSIVE INCOME					19,706
JUNE 30, 2007	$ 50,450	$ 208,750	$ 115,555	$ 4,817	$ 379,572

See Condensed Notes to Condensed Financial Statements.

KENTUCKY POWER COMPANY
CONDENSED BALANCE SHEETS
ASSETS
June 30, 2007 and December 31, 2006
(in thousands)
(Unaudited)

	2007	2006
CURRENT ASSETS		
Cash and Cash Equivalents	$ 466	$ 702
Accounts Receivable:		
Customers	21,161	30,112
Affiliated Companies	10,673	10,540
Accrued Unbilled Revenues	4,157	3,602
Miscellaneous	285	327
Allowance for Uncollectible Accounts	(289)	(227)
Total Accounts Receivable	35,987	44,354
Fuel	19,307	16,070
Materials and Supplies	10,777	8,726
Risk Management Assets	22,350	25,624
Prepayments and Other	3,343	6,369
TOTAL	92,230	101,845
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Production	480,661	478,955
Transmission	401,889	394,419
Distribution	488,243	481,083
Other	60,623	61,089
Construction Work in Progress	21,805	29,587
Total	1,453,221	1,445,133
Accumulated Depreciation and Amortization	442,548	442,778
TOTAL - NET	1,010,673	1,002,355
OTHER NONCURRENT ASSETS		
Regulatory Assets	136,646	136,139
Long-term Risk Management Assets	17,552	21,282
Deferred Charges and Other	45,368	48,944
TOTAL	199,566	206,365
TOTAL ASSETS	$ 1,302,469	$ 1,310,565

See Condensed Notes to Condensed Financial Statements.

KENTUCKY POWER COMPANY
CONDENSED BALANCE SHEETS
LIABILITIES AND SHAREHOLDER'S EQUITY
June 30, 2007 and December 31, 2006
(Unaudited)

	2007	2006
	(in thousands)	
CURRENT LIABILITIES		
Advances from Affiliates	$ 29,719	$ 30,636
Accounts Payable:		
General	24,090	31,490
Affiliated Companies	16,128	23,658
Long-term Debt Due Within One Year – Nonaffiliated	322,549	322,048
Risk Management Liabilities	12,717	20,001
Customer Deposits	17,269	16,095
Accrued Taxes	19,160	18,775
Other	28,620	26,303
TOTAL	470,252	489,006
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated	104,968	104,920
Long-term Debt – Affiliated	20,000	20,000
Long-term Risk Management Liabilities	12,093	15,426
Deferred Income Taxes	241,297	242,133
Regulatory Liabilities and Deferred Investment Tax Credits	47,769	49,109
Deferred Credits and Other	26,518	20,320
TOTAL	452,645	451,908
TOTAL LIABILITIES	922,897	940,914
Commitments and Contingencies (Note 4)		
COMMON SHAREHOLDER'S EQUITY		
Common Stock – $50 Par Value Per Share:		
Authorized – 2,000,000 Shares		
Outstanding – 1,009,000 Shares	50,450	50,450
Paid-in Capital	208,750	208,750
Retained Earnings	115,555	108,899
Accumulated Other Comprehensive Income (Loss)	4,817	1,552
TOTAL	379,572	369,651
TOTAL LIABILITIES AND SHAREHOLDER'S EQUITY	$ 1,302,469	$ 1,310,565

See Condensed Notes to Condensed Financial Statements.

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF CASH FLOWS
For the Six Months Ended June 30, 2007 and 2006
(in thousands)
(Unaudited)

	2007	2006
OPERATING ACTIVITIES		
Net Income	$ 16,441	$ 14,881
Adjustments for Noncash Items:		
Depreciation and Amortization	23,526	23,072
Deferred Income Taxes	(1,042)	3,044
Mark-to-Market of Risk Management Contracts	1,942	(25)
Change in Other Noncurrent Assets	(827)	1,569
Change in Other Noncurrent Liabilities	(202)	1,396
Changes in Certain Components of Working Capital:		
Accounts Receivable, Net	4,650	11,538
Fuel, Materials and Supplies	(3,346)	(6,423)
Accounts Payable	(11,273)	(7,679)
Customer Deposits	1,174	(5,668)
Accrued Taxes, Net	1,673	3,180
Fuel Over/Under Recovery, Net	7,642	3,173
Other Current Assets	721	8,531
Other Current Liabilities	(3,546)	(1,993)
Net Cash Flows From Operating Activities	37,533	48,596
INVESTING ACTIVITIES		
Construction Expenditures	(27,771)	(34,458)
Other	361	477
Net Cash Flows Used For Investing Activities	(27,410)	(33,981)
FINANCING ACTIVITIES		
Change in Advances from Affiliates, Net	(917)	30,951
Retirement of Long-term Debt – Affiliated	-	(40,000)
Principal Payments for Capital Lease Obligations	(443)	(660)
Dividends Paid on Common Stock	(8,999)	(5,000)
Net Cash Flows Used For Financing Activities	(10,359)	(14,709)
Net Decrease in Cash and Cash Equivalents	(236)	(94)
Cash and Cash Equivalents at Beginning of Period	702	526
Cash and Cash Equivalents at End of Period	$ 466	$ 432
SUPPLEMENTARY INFORMATION		
Cash Paid for Interest, Net of Capitalized Amounts	$ 14,388	$ 14,543
Net Cash Paid for Income Taxes	821	185
Noncash Acquisitions Under Capital Leases	394	485
Construction Expenditures Included in Accounts Payable at June 30,	3,419	4,522

See Condensed Notes to Condensed Financial Statements.

CONDENSED NOTES TO CONDENSED FINANCIAL STATEMENTS

1. SIGNIFICANT ACCOUNTING MATTERS

General

The accompanying unaudited condensed financial statements and footnotes were prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information. Accordingly, they do not include all the information and footnotes required by GAAP for complete financial statements.

In the opinion of management, the unaudited interim financial statements reflect all normal and recurring accruals and adjustments necessary for a fair presentation of the results of operations, financial position and cash flows for the interim periods. The results of operations for the six months ended June 30, 2007 are not necessarily indicative of results that may be expected for the year ending December 31, 2007. The accompanying condensed financial statements are unaudited and should be read in conjunction with the audited 2006 financial statements and notes thereto, which are included in KPCo’s 2006 Annual Report as filed with the SEC on February 28, 2007.

Revenue Recognition

Traditional Electricity Supply and Delivery Activities

KPCo recognizes revenues from retail and wholesale electricity supply sales and electricity transmission and distribution delivery services. KPCo recognizes the revenues in the financial statements upon delivery of the energy to the customer and include unbilled as well as billed amounts.

Most of the power produced at the generation plants of the AEP East companies is sold to PJM, the RTO operating in the east service territory, and the AEP East companies purchase power back from the same RTO to supply power to KPCo’s load. These power sales and purchases are reported on a net basis as revenues in the financial statements. Other RTOs in which KPCo operates do not function in the same manner as PJM. They function as balancing organizations and not as an exchange.

Physical energy purchases, including those from all RTOs that are identified as non-trading, but excluding PJM purchases described in the preceding paragraph, are accounted for on a gross basis in Purchased Electricity for Resale in the financial statements.

In general, KPCo records expenses upon receipt of purchased electricity and when expenses are incurred. The unrealized MTM amounts are deferred as regulatory assets (for losses) and regulatory liabilities (for gains).

Energy Marketing and Risk Management Activities

KPCo engages in wholesale electricity, coal and emission allowances marketing and risk management activities focused on wholesale markets where KPCo owns assets. KPCo’s activities include the purchase and sale of energy under forward contracts at fixed and variable prices and the buying and selling of financial energy contracts which include exchange traded futures and options, and over-the-counter options and swaps. KPCo engages in certain energy marketing and risk management transactions with RTOs.

KPCo recognizes revenues and expenses from wholesale marketing and risk management transactions that are not derivatives upon delivery of the commodity. KPCo uses MTM accounting for wholesale marketing and risk management transactions that are derivatives unless the derivative is designated in a qualifying cash flow or fair value hedge relationship, or as a normal purchase or sale. The unrealized and realized gains and losses on wholesale marketing and risk management transactions that are accounted for using MTM are included in revenues in the financial statements on a net basis. The unrealized MTM amounts are deferred as regulatory assets (for losses) and regulatory liabilities (for gains). Unrealized MTM gains and losses are included on the balance sheets as Risk Management Assets or Liabilities as appropriate.

Certain wholesale marketing and risk management transactions are designated as hedges of future cash flows as a result of forecasted transactions, a future cash flow (cash flow hedge) or a hedge of a recognized asset, liability or firm commitment (fair value hedge). The gains or losses on derivatives designated as fair value hedges are recognized in revenues in the financial statements in the period of change together with the offsetting losses or gains on the hedged item attributable to the risks being hedged. For derivatives designated as cash flow hedges, the effective portion of the derivative's gain or loss is initially reported as a component of Accumulated Other Comprehensive Income (Loss) and, depending upon the specific nature of the risk being hedged, subsequently reclassified into revenues or fuel expenses in the financial statements when the forecasted transaction is realized and affects earnings. KPCo defers the ineffective portion as regulatory assets (for losses) and regulatory liabilities (for gains).

Components of Accumulated Other Comprehensive Income (Loss) (AOCI)

AOCI is included on the balance sheets in the common shareholder's equity section. AOCI for KPCo as of June 30, 2007 and December 31, 2006 is shown in the following table.

Components	June 30, 2007	December 31, 2006
	(in thousands)	
Cash Flow Hedges	$ 4,817	$ 1,552

Accounting for Asset Retirement Obligations (ARO)

As a result of SFAS 143 "Accounting for Asset Retirement Obligations" (SFAS 143), KPCo records a liability at fair value for any legal obligations for future asset retirements when the related assets are acquired or constructed. Upon establishment of a legal liability, SFAS 143 requires a corresponding ARO asset to be established, which will be depreciated over its useful life. Upon final settlement of an ARO, any difference between the ARO liability and actual costs is recognized as income or expense.

The following is a reconciliation of the June 30, 2007 aggregate carrying amount of ARO for KPCo:

ARO at January 1, 2007	Accretion Expense	Liabilities Incurred	Liabilities Settled	Revisions in Cash Flow Estimates	ARO at June 30, 2007
		(in thousands)			
$ 1,175	$ 34	$ -	$ (276)	$ -	$ 933

KPCo's aggregate carrying amount includes ARO related to asbestos removal.

Reclassifications

Certain prior period financial statement items have been reclassified to conform to current period presentation. These revisions had no impact on KPCo's previously reported results of operations or changes in shareholder's equity.

2. NEW ACCOUNTING PRONOUNCEMENTS

Upon issuance of exposure drafts or final pronouncements, management thoroughly reviews the new accounting literature to determine the relevance, if any, to KPCo's business. The following represents a summary of new pronouncements issued or implemented in 2007 and standards issued but not implemented that management has determined relate to the KPCo's operations.

SFAS 157 "Fair Value Measurements" (SFAS 157)

In September 2006, the FASB issued SFAS 157, enhancing existing guidance for fair value measurement of assets and liabilities and instruments measured at fair value that are classified in shareholder's equity. The statement defines fair value, establishes a fair value measurement framework and expands fair value disclosures. It emphasizes that fair value is market-based with the highest measurement hierarchy being market prices in active markets. The standard requires fair value measurements be disclosed by hierarchy level and an entity include its own credit standing in the measurement of its liabilities and modifies the transaction price presumption.

SFAS 157 is effective for interim and annual periods in fiscal years beginning after November 15, 2007. Management expects that the adoption of this standard will impact MTM valuations of certain contracts, but is unable to quantify the effect. Although the statement is applied prospectively upon adoption, the effect of certain transactions is applied retrospectively as of the beginning of the fiscal year of application, with a cumulative effect adjustment to the appropriate balance sheet items. KPCo will adopt SFAS 157 effective January 1, 2008.

SFAS 159 "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS 159)

In February 2007, the FASB issued SFAS 159, permitting entities to choose to measure many financial instruments and certain other items at fair value. The standard also establishes presentation and disclosure requirements designed to facilitate comparison between entities that choose different measurement attributes for similar types of assets and liabilities.

SFAS 159 is effective for annual periods in fiscal years beginning after November 15, 2007. If the fair value option is elected, the effect of the first remeasurement to fair value is reported as a cumulative effect adjustment to the opening balance of retained earnings. In the event KPCo elects the fair value option promulgated by this standard, the valuations of certain assets and liabilities may be impacted. The statement is applied prospectively upon adoption. KPCo will adopt SFAS 159 effective January 1, 2008. Management expects the adoption of this standard to have an immaterial impact on the financial statements.

EITF Issue No. 06-11 "Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards" (EITF 06-11)

In June 2007, the FASB ratified the EITF consensus on the treatment of income tax benefits of dividends on employee share-based compensation. The issue is how a company should recognize the income tax benefit received on dividends that are paid to employees holding equity-classified nonvested shares, equity-classified nonvested share units, or equity-classified outstanding share options and charged to retained earnings under SFAS 123R, "Share-Based Payments." Under EITF 06-11, a realized income tax benefit from dividends or dividend equivalents that are charged to retained earnings and are paid to employees for equity-classified nonvested equity shares, nonvested equity share units, and outstanding equity share options should be recognized as an increase to additional paid-in capital.

EITF 06-11 will be applied prospectively to the income tax benefits of dividends on equity-classified employee share-based payment awards that are declared in fiscal years beginning after September 15, 2007. Management expects that the adoption of this standard will have an immaterial effect on the financial statements. KPCo will adopt EITF 06-11 effective January 1, 2008.

FIN 48 "Accounting for Uncertainty in Income Taxes" and FASB Staff Position FIN 48-1 "Definition of Settlement in FASB Interpretation No. 48" (FIN 48)

In July 2006, the FASB issued FASB Interpretation No. 48 "Accounting for Uncertainty in Income Taxes" and in May 2007, the FASB issued FASB Staff Position FIN 48-1 "Definition of *Settlement* in FASB Interpretation No. 48." FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements by prescribing a recognition threshold (whether a tax position is more likely than not to be sustained) without which, the benefit of that position is not recognized in the financial statements. It requires a measurement determination for recognized tax positions based on the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

FIN 48 requires that the cumulative effect of applying this interpretation be reported and disclosed as an adjustment to the opening balance of retained earnings for that fiscal year and presented separately. KPCo adopted FIN 48 effective January 1, 2007. The impact of this interpretation was an unfavorable adjustment to retained earnings of $786,000.

FIN 39-1 “Amendment of FASB Interpretation No. 39” (FIN 39)

In April 2007, the FASB issued FIN 39-1. It amends FASB Interpretation No. 39, “Offsetting of Amounts Related to Certain Contracts” by replacing the interpretation’s definition of contracts with the definition of derivative instruments per SFAS 133. It also requires entities that offset fair values of derivatives with the same party under a netting agreement to also net the fair values (or approximate fair values) of related cash collateral. The entities must disclose whether or not they offset fair values of derivatives and related cash collateral and amounts recognized for cash collateral payables and receivables at the end of each reporting period.

FIN 39-1 is effective for fiscal years beginning after November 15, 2007. Management expects this standard to change the method of netting certain balance sheet amounts but is unable to quantify the effect. It requires retrospective application as a change in accounting principle for all periods presented. KPCo will adopt FIN 39-1 effective January 1, 2008.

Future Accounting Changes

The FASB’s standard-setting process is ongoing and until new standards have been finalized and issued by FASB, management cannot determine the impact on the reporting of operations and financial position that may result from any such future changes. The FASB is currently working on several projects including business combinations, revenue recognition, liabilities and equity, derivatives disclosures, emission allowances, leases, insurance, subsequent events and related tax impacts. Management also expects to see more FASB projects as a result of its desire to converge International Accounting Standards with GAAP. The ultimate pronouncements resulting from these and future projects could have an impact on future results of operations and financial position.

3. RATE MATTERS

As discussed in KPCo’s 2006 Annual Report, KPCo is involved in rate and regulatory proceedings at the FERC and the KPSC. The Rate Matters note within the 2006 Annual Report should be read in conjunction with this report to gain a complete understanding of material rate matters still pending that could impact results of operations, cash flows and possibly financial condition. The following discusses ratemaking developments in 2007 and updates the 2006 Annual Report.

Environmental Surcharge Filing

In July 2006, KPCo filed for approval of an amended environmental compliance plan and revised tariff to implement an adjusted environmental surcharge. KPCo estimates the amended environmental compliance plan and revised tariff would increase revenues over 2006 levels by approximately $2 million in 2007 and $6 million in 2008 for a total of $8 million of additional revenue at current cost projections. In January 2007, the KPSC issued an order approving KPCo’s proposed plan and surcharge. Future recovery is based upon actual environmental costs and is subject to periodic review and approval by the KPSC.

In November 2006, the Kentucky Attorney General and the Kentucky Industrial Utility Consumers (KIUC) filed an appeal with the Kentucky Court of Appeals of the Franklin Circuit Court’s 2006 order upholding the KPSC’s 2005 Environmental Surcharge order. In KPCo’s order, the KPSC approved recovery of its environmental costs at its Big Sandy Plant and its share of environmental costs incurred as a result of the AEP Power Pool capacity settlement. The KPSC has allowed KPCo to recover these FERC-approved allocated costs, via the environmental surcharge, since the KPSC’s first environmental surcharge order in 1997. KPCo presently recovers $7 million a year in environmental surcharge revenues.

In March 2007, the KPSC issued an order, at the request of the Kentucky Attorney General, stating the environmental surcharge collections authorized in the January 2007 order that are associated with out-of-state generating facilities should be collected over the six months beginning March 2007, subject to refund, pending the outcome of the Court of Appeals process. At this time, management is unable to predict the outcome of this proceeding and its effect on KPCo’s current environmental surcharge revenues or on the January 2007 KPSC order increasing KPCo’s environmental rates. If the appeal is successful, future results of operations and cash flows could be adversely affected.

Transmission Rate Proceedings at the FERC

The FERC PJM Regional Transmission Rate Proceeding

At AEP's urging, the FERC instituted an investigation of PJM's zonal rate regime, indicating that the present rate regime may need to be replaced through establishment of regional rates that would compensate AEP and other transmission owners for the regional transmission facilities they provide to PJM, which provides service for the benefit of customers throughout PJM. In September 2005, AEP and a nonaffiliated utility (Allegheny Power or AP) jointly filed a regional transmission rate design proposal with the FERC. This filing proposed and supported a new PJM rate regime generally referred to as a Highway/Byway rate design.

Parties to the regional rate proceeding proposed the following rate regimes:

- AEP/AP proposed a Highway/Byway rate design in which:
  - The cost of all transmission facilities in the PJM region operated at 345 kV or higher would be included in a "Highway" rate that all load serving entities (LSEs) would pay based on peak demand. The AEP/AP proposal would produce about $125 million in net revenues per year for AEP from users in other zones of PJM.
  - The cost of transmission facilities operating at lower voltages would be collected in the zones where those costs are presently charged under PJM's existing rate design.
- Two other utilities, Baltimore Gas & Electric Company (BG&E) and Old Dominion Electric Cooperative (ODEC), proposed a Highway/Byway rate that includes transmission facilities above 200 kV in the Highway rate, which would have produced lower net revenues for AEP than the AEP/AP proposal.
- In another competing Highway/Byway proposal, a group of LSEs proposed rates that would include existing 500 kV and higher voltage facilities and new facilities above 200 kV in the Highway rate, which would also have produced lower net revenues for AEP than the AEP/AP proposal.
- In January 2006, the FERC staff issued testimony and exhibits supporting phase-in of a PJM-wide flat rate or "Postage Stamp" type of rate design that would socialize the cost of all transmission facilities. The proposed rate design would have initially produced much lower net transmission revenues for AEP than the AEP/AP proposal, but could produce slightly higher net revenues when fully phased in.

All of these proposals were challenged by a majority of other transmission owners in the PJM region, who favored continuation of the existing PJM rate design which provides AEP with no compensation for through and out traffic on its east zone transmission system. Hearings were held in April 2006 and the ALJ issued an initial decision in July 2006. The ALJ found the existing PJM zonal rate design to be unjust and determined that it should be replaced. The ALJ found that the Highway/Byway rates proposed by AEP/AP and BG&E/ODEC to be just and reasonable alternatives. The ALJ also found FERC staff's proposed Postage Stamp rate to be just and reasonable and recommended that it be adopted. The ALJ also found that the effective date of the rate change should be April 1, 2006 to coincide with SECA rate elimination. Because the Postage Stamp rate was found to produce greater cost shifts than other proposals, the judge also recommended that the new regional design be phased-in. Without a phase-in, the Postage Stamp method would produce more revenue for AEP than the AEP/AP proposal. However, the proposed phase-in of Postage Stamp rates would delay the full favorable impact of those new regional rates until about 2012.

AEP filed briefs noting exceptions to the initial decision and replies to the exceptions of other parties. AEP argued that a phase-in should not be required. Nevertheless, AEP argued that if the FERC adopts the Postage Stamp rate and a phase-in plan, the revenue collections curtailed by the phase-in should be deferred and paid later with interest.

Since the FERC's decision in 2005 to cease through-and-out rates and replace them temporarily with SECA rates which ceased on April 1, 2006, the AEP East companies increased their retail rates in all states except Indiana and Michigan to recover lost through-and-out transmission service (T&O) and SECA revenues.

In April 2007, the FERC issued an order reversing the ALJ decision. The FERC ruled that the current PJM rate design is just and reasonable for existing transmission facilities. However, the FERC ruled that the cost of new facilities of 500 kV and above would be shared among all PJM participants. As a result of this order, the AEP East companies' retail customers will bear the full cost of the existing AEP east transmission zone facilities although others use them. Presently AEP is collecting the full cost of those facilities from its retail customers with the exception of Indiana and Michigan customers. As a result of this order, the AEP East companies' customers will also be charged a share of the cost of future new 500 kV and higher voltage transmission facilities built in PJM, most of which are expected to be upgrades of the facilities in other zones of PJM. The AEP East companies will need to obtain regulatory approvals for recovery of any costs of new facilities that are assigned to them as a result of this order, if upheld. AEP has requested rehearing of this order. Management cannot estimate at this time what effect, if any, this order will have on their future construction of new east transmission facilities, results of operations, cash flows and financial condition.

The AEP East companies presently recover from retail customers approximately 85% of the lost T&O/SECA transmission revenues of $128 million a year.

SECA Revenue Subject to Refund

The AEP East companies ceased collecting T&O revenues in accordance with FERC orders, and collected SECA rates to mitigate the loss of T&O revenues from December 1, 2004 through March 31, 2006, when SECA rates expired. Intervenors objected to the SECA rates, raising various issues. As a result, the FERC set SECA rate issues for hearing and ordered that the SECA rate revenues be collected, subject to refund or surcharge. The AEP East companies paid SECA rates to other utilities at considerably lesser amounts than collected. If a refund is ordered, the AEP East companies would also receive refunds related to the SECA rates they paid to third parties. The AEP East companies recognized gross SECA revenues of $220 million. KPCo's portion of recognized gross SECA revenues is $17 million. Approximately $19 million of these recorded SECA revenues billed by PJM were not collected. The AEP East companies filed a motion with the FERC to force payment of these uncollected SECA billings.

In August 2006, a FERC ALJ issued an initial decision, finding that the rate design for the recovery of SECA charges was flawed and that a large portion of the "lost revenues" reflected in the SECA rates was not recoverable. The ALJ found that the SECA rates charged were unfair, unjust and discriminatory and that new compliance filings and refunds should be made. The ALJ also found that the unpaid SECA rates must be paid in the recommended reduced amount.

Since the implementation of SECA rates in December 2004, the AEP East companies recorded approximately $220 million of gross SECA revenues, subject to refund. In 2006, the AEP East companies provided reserves of $37 million in net refunds for current and future SECA settlements with all of AEP's SECA customers. KPCo's portion of the reserve is $3 million. The AEP East companies reached settlements with certain SECA customers related to approximately $69 million of such revenues for a net refund of $3 million. The AEP East companies are in the process of completing two settlements-in-principle on an additional $36 million of SECA revenues and expect to make net refunds of $4 million when those settlements are approved. Thus, completed and in-process settlements cover $105 million of SECA revenues and will consume about $7 million of the reserves for refunds, leaving approximately $115 million of contested SECA revenues and $30 million of refund reserves. If the ALJ's initial decision were upheld in its entirety, it would disallow approximately $90 million of the AEP East companies' remaining $115 million of unsettled gross SECA revenues. Based on recent settlement experience and the expectation that most of the $115 million of unsettled SECA revenues will be settled, management believes that the remaining reserve will be adequate.

In September 2006, AEP, together with Exelon Corporation and The Dayton Power and Light Company, filed an extensive post-hearing brief and reply brief noting exceptions to the ALJ's initial decision and asking the FERC to reverse the decision in large part. Management believes that the FERC should reject the initial decision because it contradicts prior related FERC decisions, which are presently subject to rehearing. Furthermore, management believes the ALJ's findings on key issues are largely without merit. As directed by the FERC, management is working to settle the remaining $115 million of unsettled revenues within the remaining reserve balance. Although management believes it has meritorious arguments and can settle with the remaining customers within the amount provided, management cannot predict the ultimate outcome of ongoing settlement talks and, if necessary, any future FERC proceedings or court appeals. If the FERC adopts the ALJ's decision and/or AEP cannot settle a significant portion of the remaining unsettled claims within the amount provided, it will have an adverse effect on future results of operations and cash flows.

Allocation of Off-system Sales Margins

In 2002, TCC and TNC filed with the PUCT seeking to reconcile fuel costs and to establish deferred fuel balances. The PUCT issued final orders in each of these proceedings that resulted in significant disallowances, including an assertion that the allocation of off-system sales margins between AEP East companies and AEP West companies was inconsistent with the FERC-approved SIA and that the AEP West companies should have been allocated greater margins.

In 2006, the Federal District Court issued orders precluding the PUCT from enforcing the off-system sales reallocation portion of its ruling in the final TNC and TCC fuel reconciliation proceedings. The Federal court ruled, in both cases, that the FERC, not the PUCT, has jurisdiction over the allocation. The PUCT appealed both Federal District Court decisions to the United States Court of Appeals. In TNC's case, the Court of Appeals affirmed the District Court's decision. In April 2007, PUCT petitioned the United States Supreme Court for a review of the Court of Appeals' order.

In a review of PSO's 2001 fuel and purchased power practices, parties alleged the same misallocations as in the Texas case. The OCC expanded the scope of the proceeding to include the off-system sales margin issue for the year 2002. In July 2005, the OCC staff and two intervenors filed testimony in which they quantified the alleged improperly allocated off-system sales margins between AEP East companies and AEP West companies. Their overall recommendations would result in a significant increase in off-system sales margins allocated to PSO through December 2004.

In 2004, an Oklahoma ALJ found that the OCC lacks authority to examine whether AEP deviated from the FERC-approved allocation methodology and held that any such complaints should be addressed at the FERC. The OCC has not ruled on appeals by intervenors of the ALJ's finding.

If the position taken by the federal court in Texas applies to PSO's case, the OCC would be preempted from disallowing fuel recoveries for alleged improper allocations of off-system sales margins between AEP East companies and AEP West companies due to lack of jurisdiction. The OCC or another party may file a complaint at the FERC alleging the allocation of off-system sales margins is improper which could result in an adverse effect on future results of operations and cash flows for the AEP East companies. To date, there has been no claim asserted at the FERC that AEP deviated from the approved allocation methodologies. Management is unable to predict the ultimate effect, if any, of these fuel clause proceedings and any future FERC proceedings on results of operations, cash flows and financial condition.

4. <u>COMMITMENTS, GUARANTEES AND CONTINGENCIES</u>

KPCo is subject to certain claims and legal actions arising in its ordinary course of business. In addition, 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 adverse effect on the financial statements. The Commitments, Guarantees and Contingencies note within the 2006 Annual Report should be read in conjunction with this report.

GUARANTEES

There are certain immaterial liabilities recorded for guarantees in accordance with FASB Interpretation No. 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." There is no collateral held in relation to any guarantees. In the event any guarantee is drawn, there is no recourse to third parties.

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. Prior to June 30, 2007 KPCo entered into sale agreements including indemnifications with a maximum exposure that was not significant. There are no material liabilities recorded for any indemnifications.

KPCo, along with the other AEP East companies, PSO and SWEPCo, are jointly and severally liable for activity conducted by AEPSC on behalf of the AEP East companies, PSO and SWEPCo related to power purchase and sale activity conducted pursuant to the SIA.

Master Operating Lease

KPCo leases certain equipment under a master operating lease. Under the lease agreement, the lessor is guaranteed to receive up to 87% of the unamortized balance of the equipment at the end of the lease term. If the fair market value of the leased equipment is below the unamortized balance at the end of the lease term, KPCo has committed to pay the difference between the fair market value and the unamortized balance, with the total guarantee not to exceed 87% of the unamortized balance. At June 30, 2007, the maximum potential loss for these lease agreements assuming the fair market value of the equipment is zero at the end of the lease term is $2 million.

CONTINGENCIES

Carbon Dioxide (CO_2) Public Nuisance Claims

In 2004, eight states and the City of New York filed an action in federal district court for the Southern District of New York against AEP, AEPSC, Cinergy Corp, Xcel Energy, Southern Company and Tennessee Valley Authority. The Natural Resources Defense Council, on behalf of three special interest groups, filed a similar complaint against the same defendants. The actions allege that CO_2 emissions from the defendants' power plants constitute a public nuisance under federal common law due to impacts of global warming, and sought injunctive relief in the form of specific emission reduction commitments from the defendants. The defendants' motion to dismiss the lawsuits was granted in September 2005. The dismissal was appealed to the Second Circuit Court of Appeals. Briefing and oral argument have concluded. On April 2, 2007, the U.S. Supreme Court issued a decision holding that the Federal EPA has authority to regulate emissions of CO_2 and other greenhouse gases under the CAA, which may impact the Second Circuit's analysis of these issues. The Second Circuit requested supplemental briefs addressing the impact of the Supreme Court's decision on this case. Management believes the actions are without merit and intends to defend against the claims.

FERC Long-term Contracts

In 2002, the FERC held a hearing related to a complaint filed by Nevada Power Company and Sierra Pacific Power Company (the Nevada utilities). The complaint sought to break long-term contracts entered during the 2000 and 2001 California energy price spike which the customers alleged were "high-priced." The complaint alleged that KPCo and certain other AEP subsidiaries sold power at unjust and unreasonable prices because the market for power was allegedly dysfunctional at the time such contracts were executed. An ALJ recommended rejection of the complaint, holding that the markets for future delivery were not dysfunctional, and that the Nevada utilities failed to demonstrate that the public interest required that changes be made to the contracts. In June 2003, the FERC issued an order affirming the ALJ's decision. In December 2006, the U.S. Court of Appeals for the Ninth Circuit reversed the FERC order and remanded the case to the FERC for further proceedings. In May 2007, KPCo, along with other sellers involved in the case including other AEP subsidiaries, sought review of the Ninth Circuit's decision by the U.S. Supreme Court. The Solicitor General of the United States has asked the Supreme Court for an extension of time, until August 6, 2007, to respond to the petitions for review. Management is unable to predict the outcome of these proceedings or their impact on future results of operations and cash flows. Management asserted claims against certain companies that sold power to KPCo and certain other AEP subsidiaries, which was resold to the Nevada utilities, seeking to recover a portion of any amounts owed to the Nevada utilities.

5. BENEFIT PLANS

KPCo participates in AEP sponsored qualified pension plans and nonqualified pension plans. A substantial majority of employees are covered by either one qualified plan or both a qualified and a nonqualified pension plan. In addition, KPCo participates in other postretirement benefit plans sponsored by AEP to provide medical and death benefits for retired employees.

KPCo adopted SFAS 158 as of December 31, 2006 and recorded a SFAS 71 regulatory asset for qualifying SFAS 158 costs of regulated operations that for ratemaking purposes are deferred for future recovery.

Components of Net Periodic Benefit Cost

The following table provides the components of AEP's net periodic benefit cost for the plans for the three and six months ended June 30, 2007 and 2006:

	Pension Plans		Other Postretirement Benefit Plans	
Three Months Ended June 30, 2007 and 2006	**2007**	**2006**	**2007**	**2006**
	(in millions)			
Service Cost	$ 23	$ 24	$ 11	$ 10
Interest Cost	57	57	26	25
Expected Return on Plan Assets	(82)	(83)	(26)	(23)
Amortization of Transition Obligation	-	-	7	7
Amortization of Net Actuarial Loss	14	19	3	5
Net Periodic Benefit Cost	$ 12	$ 17	$ 21	$ 24

	Pension Plans		Other Postretirement Benefit Plans	
Six Months Ended June 30, 2007 and 2006	**2007**	**2006**	**2007**	**2006**
	(in millions)			
Service Cost	$ 47	$ 48	$ 21	$ 20
Interest Cost	116	114	52	50
Expected Return on Plan Assets	(167)	(166)	(52)	(46)
Amortization of Transition Obligation	-	-	14	14
Amortization of Net Actuarial Loss	29	39	6	10
Net Periodic Benefit Cost	$ 25	$ 35	$ 41	$ 48

The following table provides the net periodic benefit cost for the plans for the three and six months ended June 30, 2007 and 2006:

	Pension Plans		Other Postretirement Benefit Plans	
	2007	**2006**	**2007**	**2006**
	(in thousands)			
Three Months Ended	$ 254	$ 358	$ 427	$ 513
Six Months Ended	509	716	853	1,026

6. INCOME TAXES

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 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 approximates a separate return result for each company in the consolidated group.

Audit Status

KPCo also files income tax returns in various state and local jurisdictions. With few exceptions, KPCo and other AEP subsidiaries are no longer subject to U.S. federal, state and local income tax examinations by tax authorities for years before 2000. The IRS and other taxing authorities routinely examine the tax returns. Management believes that KPCo and other AEP subsidiaries have filed tax returns with positions that may be challenged by the tax authorities. KPCo and other AEP subsidiaries are currently under examination in several state and local jurisdictions. However, management does not believe that the ultimate resolution of these audits will materially impact results of operations.

The AEP System settled with the IRS on all issues from the audits of consolidated federal income tax returns for years prior to 1997. The AEP System effectively settled all outstanding proposed IRS adjustments for years 1997 through 1999 and through June 2000 for the CSW pre-merger tax period and anticipates payment for the agreed adjustments to occur during 2007. Returns for the years 2000 through 2005 are presently being audited by the IRS and management anticipates that the audit of the 2000 through 2003 years will be completed by the end of 2007.

FIN 48 Adoption

KPCo adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, KPCo recognized a $786,000 increase in the liabilities for unrecognized tax benefits, as well as related interest expense and penalties, which was accounted for as a reduction to the January 1, 2007 balance of retained earnings.

At January 1, 2007, the total amount of unrecognized tax benefits under FIN 48 was $3.4 million. Management believes it is reasonably possible that there will be a $1.4 million net decrease in unrecognized tax benefits due to the settlement of audits and the expiration of statute of limitations within 12 months of the reporting date. KPCo's total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate was $0.6 million. There are $2.5 million of tax positions, for which the ultimate deductibility is highly certain but the timing of such deductibility is uncertain. Because of the impact of deferred tax accounting, other than interest and penalties, the disallowance of the shorter deductibility period would not affect the annual effective tax rate but would accelerate the payment of cash to the taxing authority to an earlier period.

Prior to the adoption of FIN 48, KPCo and other AEP subsidiaries recorded interest and penalty accruals related to income tax positions in tax accrual accounts. With the adoption of FIN 48, KPCo and other AEP subsidiaries began recognizing interest accruals related to income tax positions in interest expense and penalties in Other Operations. As of January 1, 2007, KPCo accrued $1.2 million for the payment of uncertain interest and penalties.

7. FINANCING ACTIVITIES

Long-term Debt

There were no long-term debt issuances or retirements during the first six months of 2007.

In July 2007, KPCo retired $125 million of 5.50% Senior Unsecured Notes due in 2007.

Lines of Credit

The AEP System uses a corporate borrowing program to meet the short-term borrowing needs of its subsidiaries. The corporate borrowing program includes a Utility Money Pool, which funds the utility subsidiaries. The AEP System corporate borrowing program operates in accordance with the terms and conditions approved in a regulatory order. The amount of outstanding loans (borrowings) to/from the Utility Money Pool as of June 30, 2007 and December 31, 2006 are included in Advances to/from Affiliates on KPCo's balance sheets. KPCo's Utility Money Pool activity and corresponding authorized borrowing limits for the six months ended June 30, 2007 are described in the following table:

Maximum Borrowings from Utility Money Pool	Maximum Loans to Utility Money Pool	Average Borrowings from Utility Money Pool	Average Loans to Utility Money Pool	Borrowings from Utility Money Pool as of June 30, 2007	Authorized Short-Term Borrowing Limit
		(in thousands)			
$ 46,317	$ -	$ 29,528	$ -	$ 29,719	$ 200,000

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool for the six months ended June 30, 2007 and 2006 are summarized in the following table:

	Maximum Interest Rates for Funds Borrowed from the Utility Money Pool	Minimum Interest Rates for Funds Borrowed from the Utility Money Pool	Maximum Interest Rates for Funds Loaned to the Utility Money Pool	Minimum Interest Rates For Funds Loaned to the Utility Money Pool	Average Interest Rate for Funds Borrowed from the Utility Money Pool	Average Interest Rate for Funds Loaned to the Utility Money Pool
			(in percentage)			
2007	5.46	5.30	-	-	5.36	-
2006	5.39	4.37	5.12	4.19	4.98	4.97

Dividend Restrictions

Under the Federal Power Act, KPCo is restricted from paying dividends out of stated capital.

Sale of Receivables – AEP Credit

In July 2007, AEP extended AEP Credit's sale of receivables agreement. The sale of receivables agreement provides commitments of $600 million from a bank conduit to purchase receivables from AEP Credit. This agreement will expire in November 2007. AEP intends to renew or replace this agreement. AEP Credit purchases accounts receivable through purchase agreements with KPCo.