Kentucky Power Company

2011 Second Quarter Report

Financial Statements

TABLE OF CONTENTS

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 holding company.
AEP Credit	AEP Credit, Inc., a subsidiary of AEP which factors accounts receivable and accrued utility revenues for affiliated electric utility companies.
AEP East companies	APCo, CSPCo, I&M, KPCo and OPCo.
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 System or the 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, a 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.
ASU	Accounting Standard Update.
CAA	Clean Air Act.
CO_2	Carbon Dioxide and other greenhouse gases.
CSPCo	Columbus Southern Power Company, an AEP electric utility subsidiary.
Federal EPA	United States Environmental Protection Agency.
FERC	Federal Energy Regulatory Commission.
FTR	Financial Transmission Right, a financial instrument that entitles the holder to receive compensation for certain congestion-related transmission charges that arise when the power grid is congested resulting in differences in locational prices.
GAAP	Accounting Principles Generally Accepted in the United States of America.
I&M	Indiana Michigan Power Company, an AEP electric utility subsidiary.
KPCo	Kentucky Power Company, an AEP electric utility subsidiary.
KPSC	Kentucky Public Service Commission.
MISO	Midwest Independent Transmission System Operator.
MMBtu	Million British Thermal Units.
MTM	Mark-to-Market.
MW	Megawatt.
OPCo	Ohio Power Company, an AEP electric utility subsidiary.
OPEB	Other Postretirement Benefit Plans.
OTC	Over the counter.
PJM	Pennsylvania – New Jersey – Maryland, a RTO.
PSO	Public Service Company of Oklahoma, an AEP electric utility subsidiary.
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.
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.
SWEPCo	Southwestern Electric Power Company, an AEP electric utility subsidiary.

Term	Meaning
Utility Money Pool	AEP System's Utility Money Pool is the centralized funding mechanism AEP uses to meet the short term cash requirements of pool participants.
VIE	Variable Interest Entity.

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF OPERATIONS
For the Three and Six Months Ended June 30, 2011 and 2010
(in thousands)
(Unaudited)

	Three Months Ended 2011	Three Months Ended 2010	Six Months Ended 2011	Six Months Ended 2010
REVENUES				
Electric Generation, Transmission and Distribution	$ 155,023	$ 127,349	$ 334,114	$ 289,845
Sales to AEP Affiliates	19,520	9,613	36,435	20,945
Other Revenues	131	10	243	100
TOTAL REVENUES	174,674	136,972	370,792	310,890
EXPENSES				
Fuel and Other Consumables Used for Electric Generation	53,790	33,803	116,625	86,725
Purchased Electricity for Resale	6,583	4,467	11,585	9,337
Purchased Electricity from AEP Affiliates	52,818	50,727	103,288	102,724
Other Operation	15,194	23,255	31,309	38,340
Maintenance	15,339	10,956	26,336	19,171
Depreciation and Amortization	13,474	13,163	26,860	26,258
Taxes Other Than Income Taxes	2,914	3,432	4,950	6,486
TOTAL EXPENSES	160,112	139,803	320,953	289,041
OPERATING INCOME (LOSS)	14,562	(2,831)	49,839	21,849
Other Income (Expense):				
Interest Income	106	57	212	102
Allowance for Equity Funds Used During Construction	278	225	513	442
Interest Expense	(9,174)	(9,173)	(18,373)	(18,312)
INCOME (LOSS) BEFORE INCOME TAX EXPENSE (CREDIT)	5,772	(11,722)	32,191	4,081
Income Tax Expense (Credit)	2,300	(4,677)	11,849	1,635
NET INCOME (LOSS)	$ 3,472	$ (7,045)	$ 20,342	$ 2,446

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, 2011 and 2010
(in thousands)
(Unaudited)

	Common Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2009	$ 50,450	$ 238,750	$ 143,185	$ (601)	$ 431,784
Common Stock Dividends			(10,000)		(10,000)
SUBTOTAL – COMMON SHAREHOLDER'S EQUITY					421,784
COMPREHENSIVE INCOME					
Other Comprehensive Loss, Net of Taxes:					
Cash Flow Hedges, Net of Tax of $72				(133)	(133)
NET INCOME			2,446		2,446
TOTAL COMPREHENSIVE INCOME					2,313
TOTAL COMMON SHAREHOLDER'S EQUITY – JUNE 30, 2010	$ 50,450	$ 238,750	$ 135,631	$ (734)	$ 424,097
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2010	$ 50,450	$ 238,750	$ 157,467	$ (451)	$ 446,216
Common Stock Dividends			(10,000)		(10,000)
SUBTOTAL – COMMON SHAREHOLDER'S EQUITY					436,216
COMPREHENSIVE INCOME					
Other Comprehensive Income, Net of Taxes:					
Cash Flow Hedges, Net of Tax of $124				231	231
NET INCOME			20,342		20,342
TOTAL COMPREHENSIVE INCOME					20,573
TOTAL COMMON SHAREHOLDER'S EQUITY – JUNE 30, 2011	$ 50,450	$ 238,750	$ 167,809	$ (220)	$ 456,789

See Condensed Notes to Condensed Financial Statements.

KENTUCKY POWER COMPANY
CONDENSED BALANCE SHEETS
ASSETS
June 30, 2011 and December 31, 2010
(in thousands)
(Unaudited)

	2011	2010
CURRENT ASSETS		
Cash and Cash Equivalents	$ 596	$ 281
Advances to Affiliates	85,653	67,060
Accounts Receivable:		
Customers	16,631	21,652
Affiliated Companies	17,818	17,616
Accrued Unbilled Revenues	62	3,823
Miscellaneous	424	587
Allowance for Uncollectible Accounts	(662)	(623)
Total Accounts Receivable	34,273	43,055
Fuel	18,744	16,640
Materials and Supplies	13,289	24,378
Risk Management Assets	6,785	8,697
Accrued Tax Benefits	-	1,420
Margin Deposits	4,827	5,357
Prepayments and Other Current Assets	1,723	1,497
TOTAL CURRENT ASSETS	165,890	168,385
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Generation	555,197	553,589
Transmission	453,421	444,303
Distribution	600,501	590,606
Other Property, Plant and Equipment	64,075	63,982
Construction Work in Progress	30,828	34,093
Total Property, Plant and Equipment	1,704,022	1,686,573
Accumulated Depreciation and Amortization	560,898	542,443
TOTAL PROPERTY, PLANT AND EQUIPMENT – NET	1,143,124	1,144,130
OTHER NONCURRENT ASSETS		
Regulatory Assets	207,048	213,593
Long-term Risk Management Assets	6,853	8,030
Deferred Charges and Other Noncurrent Assets	38,561	37,946
TOTAL OTHER NONCURRENT ASSETS	252,462	259,569
TOTAL ASSETS	$ 1,561,476	$ 1,572,084

See Condensed Notes to Condensed Financial Statements.

KENTUCKY POWER COMPANY
CONDENSED BALANCE SHEETS
LIABILITIES AND SHAREHOLDER'S EQUITY
June 30, 2011 and December 31, 2010
(Unaudited)

	2011	2010
	(in thousands)	
CURRENT LIABILITIES		
Accounts Payable:		
General	$ 25,930	$ 33,334
Affiliated Companies	31,298	45,790
Risk Management Liabilities	3,997	5,959
Customer Deposits	20,964	19,692
Accrued Taxes	25,960	23,741
Accrued Interest	7,132	7,570
Other Current Liabilities	20,007	26,227
TOTAL CURRENT LIABILITIES	135,288	162,313
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated	528,972	528,888
Long-term Debt – Affiliated	20,000	20,000
Long-term Risk Management Liabilities	2,213	2,303
Deferred Income Taxes	323,737	316,389
Regulatory Liabilities and Deferred Investment Tax Credits	37,012	34,991
Employee Benefits and Pension Obligations	46,350	49,298
Deferred Credits and Other Noncurrent Liabilities	11,115	11,686
TOTAL NONCURRENT LIABILITIES	969,399	963,555
TOTAL LIABILITIES	1,104,687	1,125,868
Rate Matters (Note 3)		
Commitments and Contingencies (Note 4)		
COMMON SHAREHOLDER'S EQUITY		
Common Stock – Par Value – $50 Per Share:		
Authorized – 2,000,000 Shares		
Outstanding – 1,009,000 Shares	50,450	50,450
Paid-in Capital	238,750	238,750
Retained Earnings	167,809	157,467
Accumulated Other Comprehensive Income (Loss)	(220)	(451)
TOTAL COMMON SHAREHOLDER'S EQUITY	456,789	446,216
TOTAL LIABILITIES AND SHAREHOLDER'S EQUITY	$ 1,561,476	$ 1,572,084

See Condensed Notes to Condensed Financial Statements.

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF CASH FLOWS
For the Six Months Ended June 30, 2011 and 2010
(in thousands)
(Unaudited)

	2011	2010
OPERATING ACTIVITIES		
Net Income	$ 20,342	$ 2,446
Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:		
Depreciation and Amortization	26,860	26,258
Deferred Income Taxes	4,668	2,948
Allowance for Equity Funds Used During Construction	(513)	(442)
Mark-to-Market of Risk Management Contracts	1,369	1,480
Property Taxes	3,709	4,749
Fuel Over/Under-Recovery, Net	67	(380)
Change in Other Noncurrent Assets	17	869
Change in Other Noncurrent Liabilities	2,068	(984)
Changes in Certain Components of Working Capital:		
Accounts Receivable, Net	8,809	3,780
Fuel, Materials and Supplies	8,985	13,059
Accounts Payable	(20,183)	(22,918)
Customer Deposits	1,272	838
Accrued Taxes, Net	2,201	(6,295)
Other Current Assets	278	531
Other Current Liabilities	(2,578)	3,455
Net Cash Flows from Operating Activities	57,371	29,394
INVESTING ACTIVITIES		
Construction Expenditures	(27,987)	(22,652)
Change in Advances to Affiliates, Net	(18,593)	-
Acquisitions of Assets	(8)	(201)
Proceeds from Sales of Assets	301	506
Net Cash Flows Used for Investing Activities	(46,287)	(22,347)
FINANCING ACTIVITIES		
Change in Advances from Affiliates, Net	-	3,783
Principal Payments for Capital Lease Obligations	(769)	(875)
Dividends Paid on Common Stock	(10,000)	(10,000)
Other Financing Activities	-	1
Net Cash Flows Used for Financing Activities	(10,769)	(7,091)
Net Increase (Decrease) in Cash and Cash Equivalents	315	(44)
Cash and Cash Equivalents at Beginning of Period	281	494
Cash and Cash Equivalents at End of Period	$ 596	$ 450
SUPPLEMENTARY INFORMATION		
Cash Paid for Interest, Net of Capitalized Amounts	$ 18,376	$ 18,479
Net Cash Paid for Income Taxes	446	5,091
Noncash Acquisitions Under Capital Leases	8	4,177
Construction Expenditures Included in Current Liabilities at June 30,	3,271	2,134

See Condensed Notes to Condensed Financial Statements.

INDEX OF CONDENSED NOTES TO CONDENSED FINANCIAL STATEMENTS

1. SIGNIFICANT ACCOUNTING MATTERS

General

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

In the opinion of management, the unaudited condensed interim financial statements reflect all normal and recurring accruals and adjustments necessary for a fair presentation of the net income, financial position and cash flows for the interim periods. Net income for the three and six months ended June 30, 2011 is not necessarily indicative of results that may be expected for the year ending December 31, 2011. The condensed financial statements are unaudited and should be read in conjunction with the audited 2010 financial statements and notes thereto, which are included in KPCo's 2010 Annual Report.

Management reviewed subsequent events through July 29, 2011, the date that the second quarter 2011 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 and other factors. Management believes that significant assumptions and judgments were applied consistently. There have been no changes to the reporting of VIEs in the financial statements where it is concluded that KPCo is the primary beneficiary. In addition, KPCo 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 June 30, 2011 and 2010 were $8 million and $11 million, respectively, and for the six months ended June 30, 2011 and 2010 were $16 million and $20 million, respectively. The carrying amount of liabilities associated with AEPSC as of June 30, 2011 and December 31, 2010 were $3 million and $3 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

AEGCo, a wholly-owned subsidiary of AEP, is consolidated by AEP. AEGCo owns a 50% ownership interest in Rockport Plant Unit 1 and leases a 50% interest in Rockport Plant Unit 2. AEGCo sells all the output from the Rockport Plant to I&M and KPCo. AEP 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 June 30, 2011 and 2010 were $21 million and $21 million, respectively and for the six months ended June 30, 2011 and 2010 were $44 million and $45 million, respectively. The carrying amount of liabilities associated with AEGCo as of June 30, 2011 and December 31, 2010 were $8 million and $10 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

2. NEW ACCOUNTING PRONOUNCEMENTS

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

Pronouncements Issued During 2011

The following standard was issued during the first six months of 2011. The following paragraphs discuss its impact on future financial statements.

ASU 2011-05 "Presentation of Comprehensive Income" (ASU 2011-05)

In June 2011, the FASB issued ASU 2011-05 eliminating the option to present the components of other comprehensive income as a part of the statement of shareholders' equity. The standard requires other comprehensive income be presented as part of a single continuous statement of comprehensive income or in a statement of other comprehensive income immediately following the statement of net income. Reclassification adjustments from other comprehensive income to net income must be presented on the face of the financial statements. This standard must be retrospectively applied to all reporting periods presented in financial reports issued after the effective date.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2011. This standard will change the presentation of the financial statements but will not affect the calculation of net income or comprehensive income. KPCo will adopt ASU 2011-05 effective January 1, 2012.

3. RATE MATTERS

As discussed in KPCo's 2010 Annual Report, KPCo is involved in rate and regulatory proceedings at the FERC and the KPSC. The Rate Matters note within KPCo's 2010 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 2011 and updates KPCo's 2010 Annual Report.

FERC Rate Matters

Seams Elimination Cost Allocation (SECA) Revenue Subject to Refund

In 2004, AEP eliminated transaction-based through-and-out transmission service (T&O) charges in accordance with FERC orders and collected, at the FERC's direction, load-based charges, referred to as RTO SECA, to partially mitigate the loss of T&O revenues on a temporary basis through March 2006. Intervenors objected to the temporary SECA rates. 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 from 2004 through 2006 when the SECA rates terminated. KPCo's portion of recognized gross SECA revenues was $17 million.

In 2006, a FERC Administrative Law Judge (ALJ) 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. The ALJ also found that any unpaid SECA rates must be paid in the recommended reduced amount.

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 supports AEP's position and requires a compliance filing to be filed with the FERC by August 2010. In June 2010, AEP and other affected companies filed a joint request for rehearing with the FERC.

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.

Settlements approved by the FERC consumed $10 million of the reserve for refunds applicable to $112 million of SECA revenue. In December 2010, the FERC issued an order approving a settlement agreement resulting in the collection of $2 million of previously deemed uncollectible SECA revenue. Therefore, the AEP East companies reduced their reserves for net refunds for SECA settlements by $2 million. The balance in the reserve for future settlements as of June 30, 2011 was $32 million. KPCo's portion of the reserve balance as of June 30, 2011 was $2.4 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. The AEP East companies could also potentially receive payments up to approximately $10 million including estimated interest of $3 million. KPCo's portion of the potential refund payments and potential payments to be received are $1.5 million and $800 thousand, respectively. A decision is pending from the FERC.

Based on the AEP East companies' analysis of the May 2010 order and the compliance filing, management believes that the reserve is adequate to pay the refunds, including interest, that will be required should the May 2010 order or 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 AEP Power Pool members gave notice to AEPSC and each other of their decision to terminate the Interconnection Agreement effective January 2014 or such other date approved by FERC, subject to state regulatory input. No filings have been made at the FERC. It is unknown at this time whether the AEP Power Pool 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. This decision to terminate is subject to management's ongoing evaluation. The AEP Power Pool members may revoke their notices of termination. If any of the AEP Power Pool members experience decreases in revenues or increases in costs as a result of the termination of the AEP Power Pool 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.

PJM/MISO Market Flow Calculation Settlement Adjustments

During 2009, an analysis conducted by MISO and PJM discovered several instances of unaccounted for power flows on numerous coordinated flowgates. These flows affected the settlement data for congestion revenues and expenses and dated back to the start of the MISO market in 2005. In January 2011, PJM and MISO reached a settlement agreement where the parties agreed to net various issues to zero. In June 2011, the FERC approved the settlement agreement.

4. 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 adverse effect on the financial statements. The Commitments, Guarantees and Contingencies note within KPCo's 2010 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.

Indemnifications and Other Guarantees

Contracts

KPCo enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. As of June 30, 2011, there were 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 purchase power and sale activity conducted pursuant to the SIA.

Master Lease Agreements

KPCo leases certain equipment under master lease agreements. In December 2010, management signed a new master lease agreement with GE Capital Commercial Inc. (GE) to replace existing operating and capital leases with GE. These assets were included in existing master lease agreements that were to be terminated in 2011 since GE exercised the termination provision related to these leases in 2008. Certain previously leased assets were not included in the 2010 refinancing, but were purchased in January 2011.

For equipment under the GE master lease agreements, the lessor is guaranteed receipt of up to 78% of the unamortized balance of the equipment at the end of the lease term. If the fair value of the leased equipment is below the unamortized balance at the end of the lease term, KPCo is committed to pay the difference between the fair value and the unamortized balance, with the total guarantee not to exceed 78% of the unamortized balance. For equipment under other master 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. At June 30, 2011, the maximum potential loss for these lease agreements was approximately $560 thousand assuming the fair value of the equipment is zero at the end of the lease term. Historically, at the end of the lease term the fair value has been in excess of the unamortized balance.

CONTINGENCIES

Carbon Dioxide 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 trial court dismissed the lawsuits.

In September 2009, the Second Circuit Court of Appeals issued a ruling on appeal remanding the cases to the Federal District Court for the Southern District of New York. The Second Circuit held that the issues of climate change and global warming do not raise political questions and that Congress' refusal to regulate CO_2 emissions does not mean that plaintiffs must wait for an initial policy determination by Congress or the President's administration to secure the relief sought in their complaints. The court stated that Congress could enact comprehensive legislation to regulate CO_2 emissions or that the Federal EPA could regulate CO_2 emissions under existing CAA authorities and that either of these actions could override any decision made by the district court under federal common law. The Second Circuit did not rule on whether the plaintiffs could proceed with their state common law nuisance claims. In 2010, the U.S. Supreme Court granted the defendants' petition for review. In June 2011, the U.S. Supreme Court reversed and remanded the case to the Court of Appeals, finding that plaintiffs' federal common law claims are displaced by the regulatory authority granted to the Federal EPA under the CAA.

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_2 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. Management believes the claims are without merit, and in addition to other defenses, are barred by the doctrine of collateral estoppel and the applicable statute of limitations. Management intends to vigorously 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_2 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 refiling in state court. The plaintiffs appealed the decision. Briefing is complete and no date has been set for oral argument. The defendants requested that the court defer setting this case for oral argument until after the Supreme Court issues its decision in the CO_2 public nuisance case discussed above. The court entered an order deferring argument until after June 2011 and the parties requested supplemental briefing on the impact of the Supreme Court's decision. Management believes the action is without merit and intends to defend against the claims. Management is unable to determine a range of potential losses that are reasonably possible of occurring.

5. 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 six months ended June 30, 2011 and 2010:

	Pension Plan		Other Postretirement Benefit Plans	
	Three Months Ended June 30,		Three Months Ended June 30,	
	2011	2010	2011	2010
	(in thousands)			
Service Cost	$ 347	$ 637	$ 235	$ 265
Interest Cost	1,439	1,475	729	738
Expected Return on Plan Assets	(1,838)	(1,914)	(758)	(710)
Amortization of Transition Obligation	-	-	-	122
Amortization of Prior Service Cost (Credit)	38	38	(8)	-
Amortization of Net Actuarial Loss	738	513	187	183
Net Periodic Benefit Cost	$ 724	$ 749	$ 385	$ 598

	Pension Plan		Other Postretirement Benefit Plans	
	Six Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
	(in thousands)			
Service Cost	$ 694	$ 1,274	$ 470	$ 530
Interest Cost	2,878	2,950	1,457	1,476
Expected Return on Plan Assets	(3,675)	(3,827)	(1,515)	(1,420)
Amortization of Transition Obligation	-	-	-	244
Amortization of Prior Service Cost (Credit)	75	75	(17)	-
Amortization of Net Actuarial Loss	1,476	1,026	375	366
Net Periodic Benefit Cost	$ 1,448	$ 1,498	$ 770	$ 1,196

6. BUSINESS SEGMENTS

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

7. 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

Trading Strategies

The strategy surrounding the use of derivative instruments for trading purposes focuses 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.

Risk Management Strategies

The strategy surrounding the use of derivative instruments focuses on managing risk exposures, future cash flows and creating value utilizing both economic and formal hedging strategies. 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 June 30, 2011 and December 31, 2010:

Notional Volume of Derivative Instruments

	Volume		
	June 30, 2011	**December 31, 2010**	**Unit of Measure**
	(in thousands)		
Commodity:			
Power	56,183	40,277	MWHs
Coal	2,618	3,280	Tons
Natural Gas	579	449	MMBtus
Heating Oil and Gasoline	323	274	Gallons
Interest Rate	$ 8,901	$ 2,008	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 mitigate price risk of future fuel purchases. For disclosure purposes, these contracts are included with other hedging activity 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 anticipated borrowings of fixed-rate debt. The anticipated 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 because some fixed assets are purchased 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 balance sheet 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 June 30, 2011 and December 31, 2010 balance sheets, KPCo netted $598 thousand and $400 thousand, respectively, of cash collateral received from third parties against short-term and long-term risk management assets and $2.2 million and $3.4 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 June 30, 2011 and December 31, 2010:

Fair Value of Derivative Instruments
June 30, 2011

	Risk Management Contracts	Hedging Contracts			
Balance Sheet Location	**Commodity (a)**	**Commodity (a)**	**Interest Rate (a)**	**Other (a) (b)**	**Total**
		(in thousands)			
Current Risk Management Assets	$ 39,949	$ 791	$ -	$ (33,955)	$ 6,785
Long-term Risk Management Assets	15,925	143	-	(9,215)	6,853
Total Assets	55,874	934	-	(43,170)	13,638
Current Risk Management Liabilities	38,874	578	-	(35,455)	3,997
Long-term Risk Management Liabilities	11,968	94	-	(9,849)	2,213
Total Liabilities	50,842	672	-	(45,304)	6,210
Total MTM Derivative Contract Net Assets (Liabilities)	$ 5,032	$ 262	$ -	$ 2,134	$ 7,428

Fair Value of Derivative Instruments
December 31, 2010

	Risk Management Contracts	Hedging Contracts			
Balance Sheet Location	**Commodity (a)**	**Commodity (a)**	**Interest Rate (a)**	**Other (a) (b)**	**Total**
		(in thousands)			
Current Risk Management Assets	$ 60,231	$ 418	$ -	$ (51,952)	$ 8,697
Long-term Risk Management Assets	16,978	148	-	(9,096)	8,030
Total Assets	77,209	566	-	(61,048)	16,727
Current Risk Management Liabilities	59,107	490	-	(53,638)	5,959
Long-term Risk Management Liabilities	13,265	146	-	(11,108)	2,303
Total Liabilities	72,372	636	-	(64,746)	8,262
Total MTM Derivative Contract Net Assets (Liabilities)	$ 4,837	$ (70)	$ -	$ 3,698	$ 8,465

(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 dedesignated risk management contracts.

The table below presents KPCo's activity of derivative risk management contracts for the three and six months ended June 30, 2011 and 2010:

Amount of Gain (Loss) Recognized on
Risk Management Contracts
For the Three and Six Months Ended June 30, 2011 and 2010

	Three Months Ended June 30,		Six Months Ended June 30,	
Location of Gain (Loss)	**2011**	**2010**	**2011**	**2010**
		(in thousands)		
Electric Generation, Transmission and Distribution Revenues	$ 885	$ (27)	$ 2,986	$ 4,608
Sales to AEP Affiliates	2	(15)	5	(756)
Regulatory Assets (a)	(43)	-	50	-
Regulatory Liabilities (a)	275	(605)	111	(66)
Total Gain (Loss) on Risk Management Contracts	$ 1,119	$ (647)	$ 3,152	$ 3,786

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

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 six months ended June 30, 2011 and 2010, KPCo did not employ 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 derivatives contracts for the purchase and sale of power, coal, natural gas and heating oil and gasoline 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 six months ended June 30, 2011 and 2010, KPCo designated commodity derivatives as cash flow hedges.

KPCo reclassifies gains and losses on financial fuel 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 six months ended June 30, 2011 and 2010, 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) into Interest Expense in those periods in which hedged interest payments occur. During the three and six months ended June 30, 2011 and 2010, KPCo did not designate any cash flow hedging strategies for interest rate derivative 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 six months ended June 30, 2011 and 2010, KPCo did not employ any foreign currency hedges.

During the three and six months ended June 30, 2011 and 2010, hedge ineffectiveness was immaterial or nonexistent for all 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 six months ended June 30, 2011 and 2010. 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 June 30, 2011

	Commodity	Interest Rate	Total
		(in thousands)	
Balance in AOCI as of March 31, 2011	$ 72	$ (388)	$ (316)
Changes in Fair Value Recognized in AOCI	(13)	-	(13)
Amount of (Gain) or Loss Reclassified from AOCI			
to Income Statement/within Balance Sheet:			
Electric Generation, Transmission and Distribution Revenues	176	-	176
Purchased Electricity for Resale	(41)	-	(41)
Other Operation Expense	(11)	-	(11)
Maintenance Expense	(15)	-	(15)
Interest Expense	-	15	15
Property, Plant and Equipment	(15)	-	(15)
Balance in AOCI as of June 30, 2011	$ 153	$ (373)	$ (220)

Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges
For the Three Months Ended June 30, 2010

	Commodity	Interest Rate	Total
		(in thousands)	
Balance in AOCI as of March 31, 2010	$ (505)	$ (448)	$ (953)
Changes in Fair Value Recognized in AOCI	131	-	131
Amount of (Gain) or Loss Reclassified from AOCI			
to Income Statement/within Balance Sheet:			
Electric Generation, Transmission and Distribution Revenues	29	-	29
Purchased Electricity for Resale	62	-	62
Other Operation Expense	(5)	-	(5)
Maintenance Expense	(6)	-	(6)
Interest Expense	-	15	15
Property, Plant and Equipment	(7)	-	(7)
Balance in AOCI as of June 30, 2010	$ (301)	$ (433)	$ (734)

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

	Commodity	Interest Rate	Total
		(in thousands)	
Balance in AOCI as of December 31, 2010	$ (48)	$ (403)	$ (451)
Changes in Fair Value Recognized in AOCI	40	-	40
Amount of (Gain) or Loss Reclassified from AOCI			
to Income Statement/within Balance Sheet:			
Electric Generation, Transmission and Distribution Revenues	172	-	172
Purchased Electricity for Resale	46	-	46
Other Operation Expense	(16)	-	(16)
Maintenance Expense	(20)	-	(20)
Interest Expense	-	30	30
Property, Plant and Equipment	(21)	-	(21)
Balance in AOCI as of June 30, 2011	$ 153	$ (373)	$ (220)

Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges
For the Six Months Ended June 30, 2010

	Commodity	Interest Rate	Total
		(in thousands)	
Balance in AOCI as of December 31, 2009	$ (138)	$ (463)	$ (601)
Changes in Fair Value Recognized in AOCI	(397)	-	(397)
Amount of (Gain) or Loss Reclassified from AOCI			
to Income Statement/within Balance Sheet:			
Electric Generation, Transmission and Distribution Revenues	54	-	54
Purchased Electricity for Resale	205	-	205
Other Operation Expense	(7)	-	(7)
Maintenance Expense	(9)	-	(9)
Interest Expense	-	30	30
Property, Plant and Equipment	(9)	-	(9)
Balance in AOCI as of June 30, 2010	$ (301)	$ (433)	$ (734)

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on KPCo's Condensed Balance Sheets at June 30, 2011 and December 31, 2010 were:

Impact of Cash Flow Hedges on the Condensed Balance Sheet
June 30, 2011

	Commodity	Interest Rate	Total
		(in thousands)	
Hedging Assets (a)	$ 374	$ -	$ 374
Hedging Liabilities (a)	112	-	112
AOCI Gain (Loss) Net of Tax	153	(373)	(220)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	118	(60)	58

Impact of Cash Flow Hedges on the Condensed Balance Sheet
December 31, 2010

	Commodity	Interest Rate	Total
		(in thousands)	
Hedging Assets (a)	$ 81	$ -	$ 81
Hedging Liabilities (a)	151	-	151
AOCI Loss Net of Tax	(48)	(403)	(451)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	(48)	(60)	(108)

(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 June 30, 2011, the maximum length of time that KPCo is hedging (with contracts subject to the accounting guidance for "Derivatives and Hedging") exposure to variability in future cash flows related to forecasted transactions is 35 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. Management does not anticipate a downgrade below investment grade. The following table represents: (a) the 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 June 30, 2011 and December 31, 2010:

	June 30, 2011	December 31, 2010
	(in thousands)	
Liabilities for Derivative Contracts with Credit Downgrade Triggers	$ 2,013	$ 1,368
Amount of Collateral KPCo Would Have Been Required to Post	1,559	2,614
Amount Attributable to RTO and ISO Activities	1,559	2,608

As of June 30, 2011 and December 31, 2010, 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. Management does not anticipate a non-performance event under these provisions. 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 June 30, 2011 and December 31, 2010:

	June 30, 2011	December 31, 2010
	(in thousands)	
Liabilities for Contracts with Cross Default Provisions Prior to Contractual Netting Arrangements	$ 13,405	$ 15,930
Amount of Cash Collateral Posted	636	1,376
Additional Settlement Liability if Cross Default Provision is Triggered	3,925	4,926

8. FAIR VALUE MEASUREMENTS

Fair Value Hierarchy and Valuation Techniques

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

For commercial activities, exchange traded derivatives, namely futures contracts, are generally fair valued based on unadjusted quoted prices in active markets and are classified as Level 1. Level 2 inputs primarily consist of OTC broker quotes in moderately active or less active markets, as well as exchange traded contracts where there is insufficient market liquidity to warrant inclusion in Level 1. Management verifies price curves using these broker quotes and classifies these fair values within Level 2 when substantially all of the fair value can be corroborated. Management typically obtains multiple broker quotes, which are 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 and FTRs 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.

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. 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 June 30, 2011 and December 31, 2010 are summarized in the following table:

	June 30, 2011		December 31, 2010	
	Book Value	Fair Value	Book Value	Fair Value
	(in thousands)			
Long-term Debt	$ 548,972	$ 641,786	$ 548,888	$ 628,623

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 June 30, 2011 and December 31, 2010. As required by the accounting guidance for "Fair Value Measurements and Disclosures," financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Management's assessment of the significance of a particular input to the fair value measurement requires judgment and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels. There have not been any significant changes in management's valuation techniques.

Assets and Liabilities Measured at Fair Value on a Recurring Basis
June 30, 2011

	Level 1	Level 2	Level 3	Other	Total
Assets:			(in thousands)		
Risk Management Assets					
Risk Management Commodity Contracts (a) (c)	$ 198	$ 51,167	$ 3,521	$ (42,185)	$ 12,701
Cash Flow Hedges:					
Commodity Hedges (a)	-	924	-	(550)	374
Dedesignated Risk Management Contracts (b)	-	-	-	563	563
Total Risk Management Assets	$ 198	$ 52,091	$ 3,521	$ (42,172)	$ 13,638
Liabilities:					
Risk Management Liabilities					
Risk Management Commodity Contracts (a) (c)	$ 191	$ 47,280	$ 2,383	$ (43,756)	$ 6,098
Cash Flow Hedges:					
Commodity Hedges (a)	-	651	11	(550)	112
Total Risk Management Liabilities	$ 191	$ 47,931	$ 2,394	$ (44,306)	$ 6,210

Assets and Liabilities Measured at Fair Value on a Recurring Basis
December 31, 2010

	Level 1	Level 2	Level 3	Other	Total
Assets:			(in thousands)		
Risk Management Assets					
Risk Management Commodity Contracts (a) (c)	$ 350	$ 73,753	$ 2,862	$ (61,018)	$ 15,947
Cash Flow Hedges:					
Commodity Hedges (a)	-	549	-	(468)	81
Dedesignated Risk Management Contracts (b)	-	-	-	699	699
Total Risk Management Assets	$ 350	$ 74,302	$ 2,862	$ (60,787)	$ 16,727
Liabilities:					
Risk Management Liabilities					
Risk Management Commodity Contracts (a) (c)	$ 343	$ 69,996	$ 1,789	$ (64,017)	$ 8,111
Cash Flow Hedges:					
Commodity Hedges (a)	-	619	-	(468)	151
Total Risk Management Liabilities	$ 343	$ 70,615	$ 1,789	$ (64,485)	$ 8,262

(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 six months ended June 30, 2011 and 2010.

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:

Three Months Ended June 30, 2011	Net Risk Management Assets (Liabilities)
	(in thousands)
Balance as of March 31, 2011	$ 1,146
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)	(681)
Unrealized Gain (Loss) Included in Net Income (or Changes in Net Assets) Relating to Assets Still Held at the Reporting Date (a)	-
Realized and Unrealized Gains (Losses) Included in Other Comprehensive Income	(11)
Purchases, Issuances and Settlements (c)	1,019
Transfers into Level 3 (d) (f)	236
Transfers out of Level 3 (e) (f)	(45)
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	(537)
Balance as of June 30, 2011	$ 1,127

Three Months Ended June 30, 2010	Net Risk Management Assets (Liabilities)
	(in thousands)
Balance as of March 31, 2010	$ 3,908
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)	(1,744)
Unrealized Gain (Loss) Included in Net Income (or Changes in Net Assets) Relating to Assets Still Held at the Reporting Date (a)	-
Realized and Unrealized Gains (Losses) Included in Other Comprehensive Income	-
Purchases, Issuances and Settlements (c)	1,005
Transfers into Level 3 (d) (f)	279
Transfers out of Level 3 (e) (f)	(420)
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	(774)
Balance as of June 30, 2010	$ 2,254

Six Months Ended June 30, 2011	Net Risk Management Assets (Liabilities)
	(in thousands)
Balance as of December 31, 2010	$ 1,073
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)	(525)
Unrealized Gain (Loss) Included in Net Income (or Changes in Net Assets) Relating to Assets Still Held at the Reporting Date (a)	-
Realized and Unrealized Gains (Losses) Included in Other Comprehensive Income	(11)
Purchases, Issuances and Settlements (c)	824
Transfers into Level 3 (d) (f)	255
Transfers out of Level 3 (e) (f)	(592)
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	103
Balance as of June 30, 2011	$ 1,127

Six Months Ended June 30, 2010	Net Risk Management Assets (Liabilities)
	(in thousands)
Balance as of December 31, 2009	$ 1,899
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)	270
Unrealized Gain (Loss) Included in Net Income (or Changes in Net Assets) Relating to Assets Still Held at the Reporting Date (a)	-
Realized and Unrealized Gains (Losses) Included in Other Comprehensive Income	-
Purchases, Issuances and Settlements (c)	(876)
Transfers into Level 3 (d) (f)	122
Transfers out of Level 3 (e) (f)	(362)
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	1,201
Balance as of June 30, 2010	$ 2,254

(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.

9. 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 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.

KPCo and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2001. KPCo and other AEP subsidiaries have completed the exam for the years 2001 through 2006 and have issues that are being pursued at the appeals level. In April 2011, the IRS's examination of the years 2007 and 2008 was concluded with a settlement of all outstanding issues. The settlement will not have a material impact on net income, cash flows or financial condition. 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 adverse 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.

Federal Legislation

The Patient Protection and Affordable Care Act and the related Health Care and Education Reconciliation Act (Health Care Acts) were enacted in March 2010. The Health Care Acts amend tax rules so that the portion of employer health care costs that are reimbursed by the Medicare Part D prescription drug subsidy will no longer be deductible by the employer for federal income tax purposes effective for years beginning after December 31, 2012. Because of the loss of the future tax deduction, a reduction in the deferred tax asset related to the nondeductible OPEB liabilities accrued to date was recorded by KPCo in March 2010. This reduction, which was offset by recording net tax regulatory assets, did not materially affect KPCo's net income, cash flows or financial condition.

The Small Business Jobs Act (the Act) was enacted in September 2010. Included in the Act was a one-year extension of the 50% bonus depreciation provision. The Tax Relief, Unemployment Insurance Reauthorization and the Job Creation Act of 2010 extended the life of research and development, employment and several energy tax credits originally scheduled to expire at the end of 2010. In addition, the Act extended the time for claiming bonus depreciation and increased the deduction to 100% for part of 2010 and 2011. The enacted provisions will not have a material impact on KPCo's net income or financial condition.

State Tax Legislation

Michigan repealed its Business Tax regime in May 2011 and replaced it with a traditional corporate net income tax with a rate of 6%. The enacted provision will not have a material impact on KPCo's net income, cash flows or financial condition.

10. FINANCING ACTIVITIES

Long-term Debt

KPCo did not have any long-term debt issuances or retirements during the first six months of 2011.

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 par value of the common stock multiplied by the number of shares outstanding. 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 its subsidiaries. The corporate borrowing program includes a Utility Money Pool, which funds the 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 June 30, 2011 and December 31, 2010 is included in Advances to Affiliates on KPCo's balance sheets. KPCo's Utility Money Pool activity and corresponding authorized borrowing limits for the six months ended June 30, 2011 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	Loans to Utility Money Pool as of June 30, 2011	Authorized Short-Term Borrowing Limit
		(in thousands)			
$ -	$ 110,375	$ -	$ 86,437	$ 85,653	$ 250,000

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, 2011 and 2010 are summarized in the following table:

Year	Maximum Interest Rates for Funds Borrowed from Utility Money Pool	Minimum Interest Rates for Funds Borrowed from Utility Money Pool	Maximum Interest Rates for Funds Loaned to Utility Money Pool	Minimum Interest Rates for Funds Loaned to Utility Money Pool	Average Interest Rates for Funds Borrowed from Utility Money Pool	Average Interest Rates for Funds Loaned to Utility Money Pool
2011	- %	- %	0.56 %	0.06 %	- %	0.29 %
2010	0.51 %	0.09 %	0.36 %	0.09 %	0.34 %	0.16 %

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 on KPCo's income statement. KPCo manages and services its accounts receivable sold.

In July 2011, AEP Credit renewed its receivables securitization agreement. The agreement provides commitments of $750 million from bank conduits to finance receivables from AEP Credit with an increase to $800 million for the months of July, August and September to accommodate seasonal demand. A commitment of $375 million, with the seasonal increase to $425 million for the months of July, August and September, expires in June 2012 and the remaining commitment of $375 million expires in June 2014.

KPCo's amount of accounts receivable and accrued unbilled revenues sold under the sale of receivables agreement was $55 million and $63 million as of June 30, 2011 and December 31, 2010, respectively.

The fees paid by KPCo to AEP Credit for customer accounts receivable sold were $538 thousand and $1.1 million for the three and six months ended June 30, 2011, respectively, and $512 thousand and $1.1 million for the three and six months ended June 30, 2010, respectively.

KPCo's proceeds on the sale of receivables to AEP Credit were $129 million and $302 million for the three and six months ended June 30, 2011, respectively, and $112 million and $257 million for the three and six months ended June 30, 2010, respectively.

11. COST REDUCTION INITIATIVES

In April 2010, management began initiatives to decrease both labor and non-labor expenses with a goal of achieving significant reductions in operation and maintenance expenses. A total of 2,461 positions was eliminated across the AEP System as a result of process improvements, streamlined organizational designs and other efficiencies. Most of the affected employees terminated employment May 31, 2010. The severance program provided two weeks of base pay for every year of service along with other severance benefits.

KPCo recorded a charge of $11.7 million to Other Operation expense during the second quarter of 2010 primarily related to severance benefits as the result of headcount reduction initiatives.

The following table shows the cost reduction activity for the six months ended June 30, 2011:

Balance at December 31, 2010	Incurred	Settled	Adjustments	Balance at June 30, 2011
		(in thousands)		
$ 1,018	$ -	$ (374)	$ (332)	$ 312

The remaining accrual is included in Other Current Liabilities on the Condensed Balance Sheets.