

Kentucky Power Company

2015 Second Quarter Report

Financial Statements



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GLOSSARY OF TERMS

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

Term	Meaning
AEGCo	AEP Generating Company, an AEP electric utility subsidiary.
AEP or Parent	American Electric Power Company, Inc., an electric utility holding company.
AEP Credit	AEP Credit, Inc., a consolidated variable interest entity of AEP which securitizes accounts receivable and accrued utility revenues for affiliated electric utility companies.
AEP System	American Electric Power System, an electric system, owned and operated by AEP subsidiaries.
AEPSC	American Electric Power Service Corporation, an AEP service subsidiary providing management and professional services to AEP and its subsidiaries.
AOCI	Accumulated Other Comprehensive Income.
ASU	Accounting Standards Update.
FASB	Financial Accounting Standards Board.
FERC	Federal Energy Regulatory Commission.
FGD	Flue Gas Desulfurization or scrubbers.
FTR	Financial Transmission Right, a financial instrument that entitles the holder to receive compensation for certain congestion-related transmission charges that arise when the power grid is congested resulting in differences in locational prices.
GAAP	Accounting Principles Generally Accepted in the United States of America.
I&M	Indiana Michigan Power Company, an AEP electric utility subsidiary.
IRS	Internal Revenue Service.
KPCo	Kentucky Power Company, an AEP electric utility subsidiary.
KPSC	Kentucky Public Service Commission.
MMBtu	Million British Thermal Units.
MTM	Mark-to-Market.
MW	Megawatt.
MWh	Megawatthour.
OPEB	Other Postretirement Benefit Plans.
OTC	Over the counter.
PJM	Pennsylvania - New Jersey - Maryland regional transmission organization.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
Rockport Plant	A generation plant, consisting of two 1,310 MW coal-fired generating units near Rockport, Indiana. AEGCo and I&M jointly-own Unit 1. In 1989, AEGCo and I&M entered into a sale-and-leaseback transaction with Wilmington Trust Company, an unrelated, unconsolidated trustee for Rockport Plant, Unit 2.
RTO	Regional Transmission Organization, responsible for moving electricity over large interstate areas.
SIA	System Integration Agreement, effective June 15, 2000, as amended, provides contractual basis for coordinated planning, operation and maintenance of the power supply sources of the combined AEP.
Utility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain utility subsidiaries.
VIE	Variable Interest Entity.

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF INCOME
For the Three and Six Months Ended June 30, 2015 and 2014
(in thousands)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
REVENUES				
Electric Generation, Transmission and Distribution	\$ 148,503	\$ 205,104	\$ 348,403	\$ 432,735
Sales to AEP Affiliates	2,577	1,275	3,934	6,690
Other Revenues	196	184	388	268
TOTAL REVENUES	<u>151,276</u>	<u>206,563</u>	<u>352,725</u>	<u>439,693</u>
EXPENSES				
Fuel and Other Consumables Used for Electric Generation	37,586	79,606	106,785	151,968
Purchased Electricity for Resale	6,165	2,057	17,961	5,170
Purchased Electricity from AEP Affiliates	25,711	27,938	49,268	59,360
Other Operation	19,749	18,940	40,080	38,805
Maintenance	18,896	17,724	37,185	36,366
Depreciation and Amortization	23,508	23,033	48,249	46,555
Taxes Other Than Income Taxes	5,395	5,287	10,999	10,590
TOTAL EXPENSES	<u>137,010</u>	<u>174,585</u>	<u>310,527</u>	<u>348,814</u>
OPERATING INCOME	14,266	31,978	42,198	90,879
Other Income (Expense):				
Interest Income	93	47	112	80
Allowance for Equity Funds Used During Construction	388	1,260	454	2,716
Interest Expense	<u>(11,183)</u>	<u>(9,241)</u>	<u>(22,220)</u>	<u>(18,342)</u>
INCOME BEFORE INCOME TAX EXPENSE	3,564	24,044	20,544	75,333
Income Tax Expense	<u>1,256</u>	<u>8,786</u>	<u>7,238</u>	<u>27,527</u>
NET INCOME	<u>\$ 2,308</u>	<u>\$ 15,258</u>	<u>\$ 13,306</u>	<u>\$ 47,806</u>

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

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

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
For the Three and Six Months Ended June 30, 2015 and 2014
(in thousands)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Net Income	<u>\$ 2,308</u>	<u>\$ 15,258</u>	<u>\$ 13,306</u>	<u>\$ 47,806</u>
<u>OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAXES</u>				
Cash Flow Hedges, Net of Tax of \$8 and \$1 for the Three Months Ended June 30, 2015 and 2014, Respectively, and \$16 and \$4 for the Six Months Ended June 30, 2015 and 2014, Respectively	15	(2)	30	8
Amortization of Pension and OPEB Deferred Costs, Net of Tax of \$9 and \$62 for the Three Months Ended June 30, 2015 and 2014, Respectively, and \$18 and \$125 for the Six Months Ended June 30, 2015 and 2014, Respectively	<u>17</u>	<u>116</u>	<u>33</u>	<u>233</u>
TOTAL OTHER COMPREHENSIVE INCOME	<u>32</u>	<u>114</u>	<u>63</u>	<u>241</u>
TOTAL COMPREHENSIVE INCOME	<u><u>\$ 2,340</u></u>	<u><u>\$ 15,372</u></u>	<u><u>\$ 13,369</u></u>	<u><u>\$ 48,047</u></u>

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

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S EQUITY
For the Six Months Ended June 30, 2015 and 2014
(in thousands)
(Unaudited)

	<u>Common Stock</u>	<u>Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total</u>
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2013	\$ 50,450	\$ 614,648	\$ 179,691	\$ (5,420)	\$ 839,369
Capital Contribution Returned to Parent		(100,000)			(100,000)
Common Stock Dividends			(30,000)		(30,000)
Other Changes in Common Shareholder's Equity		2,812			2,812
Net Income			47,806		47,806
Other Comprehensive Income				241	241
Pension and OPEB Adjustment Related to Kammer Plant				(1,308)	(1,308)
TOTAL COMMON SHAREHOLDER'S EQUITY - JUNE 30, 2014	<u>\$ 50,450</u>	<u>\$ 517,460</u>	<u>\$ 197,497</u>	<u>\$ (6,487)</u>	<u>\$ 758,920</u>
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2014	\$ 50,450	\$ 517,460	\$ 103,069	\$ (7,336)	\$ 663,643
Common Stock Dividends			(22,000)		(22,000)
Net Income			13,306		13,306
Other Comprehensive Income				63	63
Pension and OPEB Adjustment Related to Mitchell Plant				5,174	5,174
TOTAL COMMON SHAREHOLDER'S EQUITY - JUNE 30, 2015	<u>\$ 50,450</u>	<u>\$ 517,460</u>	<u>\$ 94,375</u>	<u>\$ (2,099)</u>	<u>\$ 660,186</u>

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

KENTUCKY POWER COMPANY
CONDENSED BALANCE SHEETS
ASSETS
June 30, 2015 and December 31, 2014
(in thousands)
(Unaudited)

	June 30, 2015	December 31, 2014
CURRENT ASSETS		
Cash and Cash Equivalents	\$ 515	\$ 795
Accounts Receivable:		
Customers	13,711	21,125
Affiliated Companies	20,270	30,436
Accrued Unbilled Revenues	3,108	2,047
Miscellaneous	206	131
Allowance for Uncollectible Accounts	(186)	(87)
Total Accounts Receivable	<u>37,109</u>	<u>53,652</u>
Fuel	21,355	45,256
Materials and Supplies	27,632	34,499
Risk Management Assets	7,068	6,358
Deferred Income Tax Benefits	6,504	8,899
Accrued Tax Benefits	46,537	10,944
Regulatory Asset for Under-Recovered Fuel Costs	2,207	—
Prepayments and Other Current Assets	4,245	4,301
TOTAL CURRENT ASSETS	<u>153,172</u>	<u>164,704</u>
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Generation	1,182,389	1,161,100
Transmission	558,718	558,099
Distribution	742,369	727,569
Other Property, Plant and Equipment (December 31, 2014 Amount Includes 2015 Plant Retirement)	65,937	521,327
Construction Work in Progress	63,095	39,194
Total Property, Plant and Equipment	<u>2,612,508</u>	<u>3,007,289</u>
Accumulated Depreciation and Amortization	877,465	1,026,208
TOTAL PROPERTY, PLANT AND EQUIPMENT – NET	<u>1,735,043</u>	<u>1,981,081</u>
OTHER NONCURRENT ASSETS		
Regulatory Assets	498,369	229,827
Long-term Risk Management Assets	619	1,005
Employee Benefits and Pension Assets	13,685	12,810
Deferred Charges and Other Noncurrent Assets	12,973	20,081
TOTAL OTHER NONCURRENT ASSETS	<u>525,646</u>	<u>263,723</u>
TOTAL ASSETS	<u>\$ 2,413,861</u>	<u>\$ 2,409,508</u>

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

KENTUCKY POWER COMPANY
CONDENSED BALANCE SHEETS
LIABILITIES AND COMMON SHAREHOLDER'S EQUITY
June 30, 2015 and December 31, 2014
(Unaudited)

	June 30, 2015	December 31, 2014
(in thousands)		
CURRENT LIABILITIES		
Advances from Affiliates	\$ 27,176	\$ 45,128
Accounts Payable:		
General	31,304	42,315
Affiliated Companies	26,749	29,259
Long-term Debt Due Within One Year – Nonaffiliated	65,000	65,000
Risk Management Liabilities	2,647	3,256
Customer Deposits	26,745	26,343
Accrued Taxes	15,767	18,873
Accrued Interest	7,816	7,824
Regulatory Liability for Over-Recovered Fuel Costs	—	1,770
Provision for Refund	17,878	31,033
Other Current Liabilities	36,784	38,986
TOTAL CURRENT LIABILITIES	257,866	309,787
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated	779,639	754,555
Long-term Risk Management Liabilities	298	423
Deferred Income Taxes	625,215	575,495
Regulatory Liabilities and Deferred Investment Tax Credits	4,326	22,522
Asset Retirement Obligations	69,872	63,479
Employee Benefits and Pension Obligations	10,379	12,531
Deferred Credits and Other Noncurrent Liabilities	6,080	7,073
TOTAL NONCURRENT LIABILITIES	1,495,809	1,436,078
TOTAL LIABILITIES	1,753,675	1,745,865
Rate Matters (Note 4)		
Commitments and Contingencies (Note 5)		
COMMON SHAREHOLDER'S EQUITY		
Common Stock – Par Value – \$50 Per Share:		
Authorized – 2,000,000 Shares		
Outstanding – 1,009,000 Shares	50,450	50,450
Paid-in Capital	517,460	517,460
Retained Earnings	94,375	103,069
Accumulated Other Comprehensive Income (Loss)	(2,099)	(7,336)
TOTAL COMMON SHAREHOLDER'S EQUITY	660,186	663,643
TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY	\$ 2,413,861	\$ 2,409,508

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

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF CASH FLOWS
For the Six Months Ended June 30, 2015 and 2014
(in thousands)
(Unaudited)

	Six Months Ended June 30,	
	2015	2014
OPERATING ACTIVITIES		
Net Income	\$ 13,306	\$ 47,806
Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:		
Depreciation and Amortization	48,249	46,555
Deferred Income Taxes	43,286	(1,571)
Allowance for Equity Funds Used During Construction	(454)	(2,716)
Mark-to-Market of Risk Management Contracts	(1,059)	(1,482)
Pension Contributions to Qualified Plan Trust	(1,900)	(1,923)
Property Taxes	7,164	7,076
Fuel Over/Under-Recovery, Net	(3,977)	(13,026)
Provision for Refund	(13,155)	—
Change in Other Noncurrent Assets	(6,592)	1,203
Change in Other Noncurrent Liabilities	2,275	2,592
Changes in Certain Components of Working Capital:		
Accounts Receivable, Net	16,543	(20,280)
Fuel, Materials and Supplies	26,667	72,812
Accounts Payable	(7,872)	9,211
Accrued Taxes, Net	(38,699)	17,089
Other Current Assets	638	(426)
Other Current Liabilities	(9,815)	3,130
Net Cash Flows from Operating Activities	74,605	166,050
INVESTING ACTIVITIES		
Construction Expenditures	(59,866)	(44,812)
Change in Advances to Affiliates, Net	—	(49,348)
Other Investing Activities	861	(616)
Net Cash Flows Used for Investing Activities	(59,005)	(94,776)
FINANCING ACTIVITIES		
Capital Contribution Returned to Parent	—	(100,000)
Issuance of Long-term Debt – Nonaffiliated	24,546	64,780
Change in Advances from Affiliates, Net	(17,952)	(8,564)
Principal Payments for Capital Lease Obligations	(550)	(1,489)
Dividends Paid on Common Stock	(22,000)	(30,000)
Other Financing Activities	76	4,084
Net Cash Flows Used for Financing Activities	(15,880)	(71,189)
Net Increase (Decrease) in Cash and Cash Equivalents	(280)	85
Cash and Cash Equivalents at Beginning of Period	795	743
Cash and Cash Equivalents at End of Period	\$ 515	\$ 828
SUPPLEMENTARY INFORMATION		
Cash Paid for Interest, Net of Capitalized Amounts	\$ 21,718	\$ 17,891
Net Cash Paid for Income Taxes	106	5,788
Noncash Acquisitions Under Capital Leases	132	1,252
Construction Expenditures Included in Current Liabilities as of June 30,	11,081	20,184

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

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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, 2015 is not necessarily indicative of results that may be expected for the year ending December 31, 2015. The condensed financial statements are unaudited and should be read in conjunction with the audited 2014 financial statements and notes thereto, which are included in KPCo's 2014 Annual Report.

Management reviewed subsequent events through July 23, 2015, the date that the second quarter 2015 report was issued.

2. NEW ACCOUNTING PRONOUNCEMENTS

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

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

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

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

ASU 2014-09 "Revenue from Contracts with Customers" (ASU 2014-09)

In May 2014, the FASB issued ASU 2014-09 clarifying the method used to determine the timing and requirements for revenue recognition on the statements of income. Under the new standard, an entity must identify the performance obligations in a contract, the transaction price and allocate the price to specific performance obligations to recognize the revenue when the obligation is completed. The amendments in this update also require disclosure of sufficient information to allow users to understand the nature, amount, timing and uncertainty of revenue and cash flow arising from contracts.

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

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

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

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

ASU 2015-03 "Simplifying the Presentation of Debt Issuance Costs" (ASU 2015-03)

In April 2015, the FASB issued ASU 2015-03 to simplify the presentation of debt issuance costs on the balance sheets. Under the new standard, debt issuance costs related to a recognized debt liability will be presented on the balance sheets as a direct deduction from the carrying amount of that debt liability, consistent with discounts. KPCo includes debt issuance costs in Deferred Charges and Other Noncurrent Assets on the condensed balance sheets. Debt issuance costs represent less than 1% of total long-term debt.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2015 with early adoption permitted. Management intends to early adopt ASU 2015-03 for the 2015 Annual Report.

ASU 2015-05 “Customer's Accounting for Fees Paid in a Cloud Computing Arrangement” (ASU 2015-05)

In April 2015, the FASB issued ASU 2015-05 to provide guidance to customers about whether a cloud computing arrangement includes a software license. The new accounting guidance is effective for interim and annual periods beginning after December 15, 2015 with early adoption permitted. Management is analyzing the impact of this new standard and, at this time, cannot estimate the impact of adoption on net income. Management plans to adopt ASU 2015-05 effective January 1, 2016.

ASU 2015-11 “Simplifying the Measurement of Inventory” (ASU 2015-11)

In July 2015, the FASB issued ASU 2015-11 to simplify the guidance on the subsequent measurement of inventory, excluding inventory measured using last-in, first out or the retail inventory method. Under the new standard, inventory should be at the lower of cost and net realizable value. The new accounting guidance is effective for interim and annual periods beginning after December 15, 2016 with early adoption permitted. Management is analyzing the impact of this new standard and, at this time, cannot estimate the impact of adoption on net income. Management plans to adopt ASU 2015-11 effective January 1, 2017.

3. COMPREHENSIVE INCOME

Presentation of Comprehensive Income

The following tables provide the components of changes in AOCI for the three and six months ended June 30, 2015 and 2014. All amounts in the following tables are presented net of related income taxes.

Changes in Accumulated Other Comprehensive Income (Loss) by Component For the Three Months Ended June 30, 2015

	<u>Cash Flow Hedges</u>			<u>Total</u>
	<u>Commodity</u>	<u>Interest Rate and Foreign Currency</u>	<u>Pension and OPEB</u>	
	(in thousands)			
Balance in AOCI as of March 31, 2015	\$ —	\$ (146)	\$ (1,985)	\$ (2,131)
Change in Fair Value Recognized in AOCI	—	—	—	—
Amounts Reclassified from AOCI	—	15	17	32
Net Current Period Other Comprehensive Income	—	15	17	32
Balance in AOCI as of June 30, 2015	<u>\$ —</u>	<u>\$ (131)</u>	<u>\$ (1,968)</u>	<u>\$ (2,099)</u>

Changes in Accumulated Other Comprehensive Income (Loss) by Component For the Three Months Ended June 30, 2014

	<u>Cash Flow Hedges</u>			<u>Total</u>
	<u>Commodity</u>	<u>Interest Rate and Foreign Currency</u>	<u>Pension and OPEB</u>	
	(in thousands)			
Balance in AOCI as of March 31, 2014	\$ 17	\$ (206)	\$ (6,412)	\$ (6,601)
Change in Fair Value Recognized in AOCI	22	—	—	22
Amounts Reclassified from AOCI	(39)	15	116	92
Net Current Period Other Comprehensive Income (Loss)	(17)	15	116	114
Balance in AOCI as of June 30, 2014	<u>\$ —</u>	<u>\$ (191)</u>	<u>\$ (6,296)</u>	<u>\$ (6,487)</u>

Changes in Accumulated Other Comprehensive Income (Loss) by Component For the Six Months Ended June 30, 2015

	<u>Cash Flow Hedges</u>			<u>Total</u>
	<u>Commodity</u>	<u>Interest Rate and Foreign Currency</u>	<u>Pension and OPEB</u>	
	(in thousands)			
Balance in AOCI as of December 31, 2014	\$ —	\$ (161)	\$ (7,175)	\$ (7,336)
Change in Fair Value Recognized in AOCI	—	—	—	—
Amounts Reclassified from AOCI	—	30	33	63
Net Current Period Other Comprehensive Income	—	30	33	63
Pension and OPEB Adjustment Related to Mitchell Plant	—	—	5,174	5,174
Balance in AOCI as of June 30, 2015	<u>\$ —</u>	<u>\$ (131)</u>	<u>\$ (1,968)</u>	<u>\$ (2,099)</u>

Changes in Accumulated Other Comprehensive Income (Loss) by Component For the Six Months Ended June 30, 2014

	<u>Cash Flow Hedges</u>			<u>Total</u>
	<u>Commodity</u>	<u>Interest Rate and Foreign Currency</u>	<u>Pension and OPEB</u>	
	(in thousands)			
Balance in AOCI as of December 31, 2013	\$ 23	\$ (222)	\$ (5,221)	\$ (5,420)
Change in Fair Value Recognized in AOCI	348	—	—	348
Amounts Reclassified from AOCI	(371)	31	233	(107)
Net Current Period Other Comprehensive Income (Loss)	(23)	31	233	241
Pension and OPEB Adjustment Related to Kammer Plant	—	—	(1,308)	(1,308)
Balance in AOCI as of June 30, 2014	<u>\$ —</u>	<u>\$ (191)</u>	<u>\$ (6,296)</u>	<u>\$ (6,487)</u>

Reclassifications from Accumulated Other Comprehensive Income

The following tables provide details of reclassifications from AOCI for the three and six months ended June 30, 2015 and 2014. The amortization of pension and OPEB AOCI components are included in the computation of net periodic pension and OPEB costs. See Note 6 for additional details.

**Reclassifications from Accumulated Other Comprehensive Income (Loss)
For the Three Months Ended June 30, 2015 and 2014**

	Amount of (Gain) Loss Reclassified from AOCI	
	Three Months Ended June 30, 2015	2014
	(in thousands)	
Gains and Losses on Cash Flow Hedges		
Commodity:		
Purchased Electricity for Resale	\$ —	\$ (60)
Subtotal – Commodity	—	(60)
Interest Rate and Foreign Currency:		
Interest Expense	23	23
Subtotal – Interest Rate and Foreign Currency	23	23
Reclassifications from AOCI, before Income Tax (Expense) Credit	23	(37)
Income Tax (Expense) Credit	8	(13)
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	15	(24)
Pension and OPEB		
Amortization of Prior Service Cost (Credit)	(10)	(53)
Amortization of Actuarial (Gains)/Losses	36	232
Reclassifications from AOCI, before Income Tax (Expense) Credit	26	179
Income Tax (Expense) Credit	9	63
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	17	116
Total Reclassifications from AOCI, Net of Income Tax (Expense) Credit	\$ 32	\$ 92

**Reclassifications from Accumulated Other Comprehensive Income (Loss)
For the Six Months Ended June 30, 2015 and 2014**

Gains and Losses on Cash Flow Hedges	Amount of (Gain) Loss Reclassified from AOCI	
	Six Months Ended June 30, 2015	Six Months Ended June 30, 2014
	(in thousands)	
Commodity:		
Purchased Electricity for Resale	\$ —	\$ (512)
Other Operation Expense	—	(3)
Maintenance Expense	—	(5)
Property, Plant and Equipment	—	(6)
Regulatory Assets/(Liabilities), Net (a)	—	(43)
Subtotal – Commodity	<u>—</u>	<u>(569)</u>
Interest Rate and Foreign Currency:		
Interest Expense	<u>46</u>	<u>46</u>
Subtotal – Interest Rate and Foreign Currency	<u>46</u>	<u>46</u>
Reclassifications from AOCI, before Income Tax (Expense) Credit	46	(523)
Income Tax (Expense) Credit	<u>16</u>	<u>(183)</u>
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	<u>30</u>	<u>(340)</u>
Pension and OPEB		
Amortization of Prior Service Cost (Credit)	(20)	(107)
Amortization of Actuarial (Gains)/Losses	<u>71</u>	<u>466</u>
Reclassifications from AOCI, before Income Tax (Expense) Credit	51	359
Income Tax (Expense) Credit	<u>18</u>	<u>126</u>
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	<u>33</u>	<u>233</u>
Total Reclassifications from AOCI, Net of Income Tax (Expense) Credit	<u>\$ 63</u>	<u>\$ (107)</u>

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

4. RATE MATTERS

As discussed in KPCo's 2014 Annual Report, KPCo is involved in rate and regulatory proceedings at the FERC and the KPSC. The Rate Matters note within KPCo's 2014 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 2015 and updates KPCo's 2014 Annual Report.

Regulatory Assets Pending Final Regulatory Approval

<u>Noncurrent Regulatory Assets</u>	<u>June 30, 2015</u>	<u>December 31, 2014</u>
	(in thousands)	
<u>Regulatory Assets Currently Not Earning a Return</u>		
Storm Related Costs	\$ —	\$ 12,146
Asset Retirement Obligation	—	8,287
Total Regulatory Assets Pending Final Regulatory Approval	<u>\$ —</u>	<u>\$ 20,433</u>

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

Plant Transfer

In October 2013, the KPSC issued an order that approved a modified settlement agreement which included the approval to transfer to KPCo a one-half interest in the Mitchell Plant, comprising 780 MW of average annual generating capacity. In December 2013, the transfer of a one-half interest in the Mitchell Plant to KPCo was completed. In December 2013, the Attorney General filed an appeal of the order with the Franklin County Circuit Court. In April 2015, the Franklin County Circuit Court issued an order that affirmed the KPSC's October 2013 order. In May 2015, the Attorney General filed an appeal of the April 2015 Franklin County Circuit Court order that had affirmed the KPSC's order.

Consistent with KPCo's December 2012 plant transfer filing with the KPSC, Big Sandy Plant, Unit 2 was retired in May 2015. Upon retirement, \$194 million was reclassified as Regulatory Assets on the condensed balance sheet related to the net book value of Big Sandy Plant, Unit 2 and the related asset retirement obligations, costs of removal and materials and supplies. These regulatory assets will be amortized over 25 years, effective July 2015.

Kentucky Fuel Adjustment Clause Review

In August 2014, the KPSC issued an order initiating a review of KPCo's FAC from November 2013 through April 2014. In January 2015, the KPSC issued an order disallowing certain FAC costs during the period of January 2014 through May 2015 while KPCo owned and operated both Big Sandy Plant, Unit 2 and its one-half interest in the Mitchell Plant. As a result of this order, KPCo recorded a regulatory disallowance of \$36 million in December 2014. In February 2015, KPCo filed an appeal of this order with the Franklin County Circuit Court. In April 2015, the Franklin County Circuit Court issued an order approving intervenors' requests to hold this case in abeyance until the KPSC issues a final order in KPCo's two-year FAC review case for the period November 2012 through October 2014.

2014 Kentucky Base Rate Case

In December 2014, KPCo filed a request with the KPSC for a net increase in rates of \$70 million, which consists of a \$75 million increase in rider rates, offset by a \$5 million decrease in annual base rates, to be effective July 2015 based upon a 10.62% return on common equity. The net increase reflects KPCo's ownership interest in the Mitchell Plant, riders to recover the Big Sandy Plant retirement and operational costs and the inclusion of an environmental compliance plan related to the Mitchell Plant FGD. Additionally, the filing included a request to recover deferred storm costs. In March 2015, intervenors filed testimony which recommended net increases in rates ranging from \$20 million to \$26 million. These increases consisted of proposed increases in rider rates ranging from \$55 million to \$63 million, offset by decreases in annual base rates ranging from \$35 million to \$37 million and based upon returns on common equity ranging from 8.65% to 8.75%. Intervenor recommendations included the recovery of deferred storm costs.

In April 2015, a non-unanimous stipulation agreement between KPCo and certain intervenors was filed with the KPSC. The parties to the stipulation recommended a net revenue increase of \$45 million, which consisted of a \$68 million increase in rider rates, offset by a \$23 million decrease in annual base rates, to be effective July 2015. The proposed net increase reflects KPCo's ownership interest in the Mitchell Plant, riders to recover the Big Sandy Plant retirement and operational costs and the inclusion of an environmental compliance plan. Additionally, the agreement included (a) recovery of \$12 million of deferred storm costs, (b) any difference between the actual off-system sales margins and the \$15 million included in the proposed annual base rates to be shared with 75% to the customer and 25% to KPCo and (c) dismissal of the KPCo and the Kentucky Industrial Utility Customers appeals of the KPSC order in the KPCo fuel adjustment clause review for November 2012 through October 2014.

In June 2015, the KPSC issued an order that approved a modified stipulation agreement. The order approved a net revenue increase of \$45 million, as proposed in the stipulation agreement, and contained modifications that included (a) approval to recover \$2 million of IGCC and certain carbon capture study costs, both over 25 years, (b) no deferral of certain PJM costs and (c) denial of the recovery of certain potential purchased power costs through a rider. Once this order becomes final and non-appealable, KPCo will withdraw its appeal of the KPSC order in the KPCo fuel adjustment clause review. See "Kentucky Fuel Adjustment Clause Review" section above.

5. COMMITMENTS, GUARANTEES AND CONTINGENCIES

KPCo is subject to certain claims and legal actions arising in its ordinary course of business. In addition, KPCo's business activities are subject to extensive governmental regulation related to public health and the environment. The ultimate outcome of such pending or potential litigation cannot be predicted. For current proceedings not specifically discussed below, management does not anticipate that the liabilities, if any, arising from such proceedings would have a material effect on the financial statements. The Commitments, Guarantees and Contingencies note within KPCo's 2014 Annual Report should be read in conjunction with this report.

GUARANTEES

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

Letter of Credit

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

Indemnifications and Other Guarantees

Contracts

KPCo enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. As of June 30, 2015, there were no material liabilities recorded for any indemnifications.

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

Master Lease Agreements

KPCo leases certain equipment under master lease agreements. Under the lease agreements, the lessor is guaranteed a residual value up to a stated percentage of either the unamortized balance or the equipment cost at the end of the lease term. If the actual fair value of the leased equipment is below the guaranteed residual value at the end of the lease term, KPCo is committed to pay the difference between the actual fair value and the residual value guarantee. Historically, at the end of the lease term the fair value has been in excess of the unamortized balance. As of June 30, 2015, the maximum potential loss for these lease agreements was \$1.5 million assuming the fair value of the equipment is zero at the end of the lease term.

6. BENEFIT PLANS

KPCo participates in an AEP sponsored qualified pension plan and an unfunded nonqualified pension plan. Substantially all of KPCo's employees are covered by the qualified plan or both the qualified and nonqualified pension plans. KPCo also participates in OPEB plans sponsored by AEP to provide health and life insurance benefits for retired employees.

Components of Net Periodic Benefit Cost

The following tables provide the components of KPCo's net periodic benefit cost (credit) for the plans for the three and six months ended June 30, 2015 and 2014:

	Pension Plans		Other Postretirement Benefit Plans	
	Three Months Ended June 30,		Three Months Ended June 30,	
	2015	2014	2015	2014
	(in thousands)			
Service Cost	\$ 670	\$ 575	\$ 86	\$ 118
Interest Cost	1,831	2,011	488	601
Expected Return on Plan Assets	(2,495)	(2,419)	(1,015)	(1,059)
Amortization of Prior Service Cost (Credit)	13	14	(606)	(606)
Amortization of Net Actuarial Loss	947	1,116	156	186
Net Periodic Benefit Cost (Credit)	\$ 966	\$ 1,297	\$ (891)	\$ (760)

	Pension Plans		Other Postretirement Benefit Plans	
	Six Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
	(in thousands)			
Service Cost	\$ 1,340	\$ 1,150	\$ 172	\$ 236
Interest Cost	3,663	4,021	976	1,202
Expected Return on Plan Assets	(4,991)	(4,837)	(2,030)	(2,119)
Amortization of Prior Service Cost (Credit)	26	28	(1,212)	(1,212)
Amortization of Net Actuarial Loss	1,893	2,233	311	373
Net Periodic Benefit Cost (Credit)	\$ 1,931	\$ 2,595	\$ (1,783)	\$ (1,520)

7. BUSINESS SEGMENTS

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

8. DERIVATIVES AND HEDGING

OBJECTIVES FOR UTILIZATION OF DERIVATIVE INSTRUMENTS

KPCo is exposed to certain market risks as a major power producer and participant in the wholesale electricity, natural gas, coal and emission allowance markets. These risks include commodity price risk, interest rate risk and credit risk. These risks represent the risk of loss that may impact KPCo due to changes in the underlying market prices or rates. AEPSC, on behalf of KPCo, manages these risks using derivative instruments.

STRATEGIES FOR UTILIZATION OF DERIVATIVE INSTRUMENTS TO ACHIEVE OBJECTIVES

Risk Management Strategies

The strategy surrounding the use of derivative instruments primarily focuses on managing risk exposures, future cash flows and creating value utilizing both economic and formal hedging strategies. The risk management strategies also include the use of derivative instruments for trading purposes, focusing on seizing market opportunities to create value driven by expected changes in the market prices of the commodities in which AEPSC transacts on behalf of KPCo. To accomplish these objectives, AEPSC, on behalf of KPCo, primarily employs risk management contracts including physical and financial forward purchase-and-sale contracts and, to a lesser extent, OTC swaps and options. Not all risk management contracts meet the definition of a derivative under the accounting guidance for “Derivatives and Hedging.” Derivative risk management contracts elected normal under the normal purchases and normal sales scope exception are not subject to the requirements of this accounting guidance.

AEPSC, on behalf of KPCo, enters into power, coal, natural gas, interest rate and, to a lesser extent, heating oil, gasoline and other commodity contracts to manage the risk associated with the energy business. AEPSC, on behalf of KPCo, enters into interest rate derivative contracts in order to manage the interest rate exposure associated with KPCo’s commodity portfolio. For disclosure purposes, such risks are grouped as “Commodity,” as these risks are related to energy risk management activities. AEPSC, on behalf of KPCo, also engages in risk management of interest rate risk associated with debt. The amount of risk taken is determined by the Commercial Operations and Finance groups in accordance with the established risk management policies as approved by the Finance Committee of AEP’s Board of Directors.

The following table represents the gross notional volume of the KPCo’s outstanding derivative contracts as of June 30, 2015 and December 31, 2014:

Notional Volume of Derivative Instruments

Primary Risk Exposure	Volume		Unit of Measure
	June 30, 2015	December 31, 2014	
	(in thousands)		
Commodity:			
Power	16,248	6,689	MWhs
Coal	93	233	Tons
Natural Gas	70	87	MMBtus
Heating Oil and Gasoline	357	261	Gallons
Interest Rate	\$ 738	\$ 1,047	USD

Cash Flow Hedging Strategies

AEPSC, on behalf of KPCo, enters into and designates as cash flow hedges certain derivative transactions for the purchase and sale of power (“Commodity”) in order to manage the variable price risk related to forecasted purchases and sales. Management monitors the potential impacts of commodity price changes and, where appropriate, enters into derivative transactions to protect profit margins for a portion of future electricity sales and purchases. KPCo does not hedge all commodity price risk.

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

AEPSC, on behalf of KPCo, enters into a variety of interest rate derivative transactions in order to manage interest rate risk exposure. AEPSC, on behalf of KPCo, also enters into interest rate derivative contracts to manage interest rate exposure related to future borrowings of fixed-rate debt. KPCo does not hedge all interest rate exposure.

ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND THE IMPACT ON KPCo's FINANCIAL STATEMENTS

The accounting guidance for "Derivatives and Hedging" requires recognition of all qualifying derivative instruments as either assets or liabilities on the condensed balance sheets at fair value. The fair values of derivative instruments accounted for using MTM accounting or hedge accounting are based on exchange prices and broker quotes. If a quoted market price is not available, the estimate of fair value is based on the best information available including valuation models that estimate future energy prices based on existing market and broker quotes, supply and demand market data and assumptions. In order to determine the relevant fair values of the derivative instruments, KPCo applies valuation adjustments for discounting, liquidity and credit quality.

Credit risk is the risk that a counterparty will fail to perform on the contract or fail to pay amounts due. Liquidity risk represents the risk that imperfections in the market will cause the price to vary from estimated fair value based upon prevailing market supply and demand conditions. Since energy markets are imperfect and volatile, there are inherent risks related to the underlying assumptions in models used to fair value risk management contracts. Unforeseen events may cause reasonable price curves to differ from actual price curves throughout a contract's term and at the time a contract settles. Consequently, there could be significant adverse or favorable effects on future net income and cash flows if market prices are not consistent with management's estimates of current market consensus for forward prices in the current period. This is particularly true for longer term contracts. Cash flows may vary based on market conditions, margin requirements and the timing of settlement of KPCo's risk management contracts.

According to the accounting guidance for "Derivatives and Hedging," KPCo reflects the fair values of derivative instruments subject to netting agreements with the same counterparty net of related cash collateral. For certain risk management contracts, KPCo is required to post or receive cash collateral based on third party contractual agreements and risk profiles. For the June 30, 2015 and December 31, 2014 condensed balance sheets, KPCo netted \$0 and \$67 thousand, respectively, of cash collateral received from third parties against short-term and long-term risk management assets and \$149 thousand and \$24 thousand, respectively, of cash collateral paid to third parties against short-term and long-term risk management liabilities.

The following tables represent the gross fair value impact of KPCo's derivative activity on the condensed balance sheets as of June 30, 2015 and December 31, 2014:

**Fair Value of Derivative Instruments
June 30, 2015**

Balance Sheet Location	Risk Management Contracts		Hedging Contracts		Gross Amounts of Risk Management Assets/Liabilities Recognized	Gross Amounts Offset in the Statement of Financial Position (b)	Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)
	Commodity (a)	Commodity (a)	Interest Rate (a)	Interest Rate (a)			
	(in thousands)						
Current Risk Management Assets	\$ 10,056	\$ —	\$ —	\$ —	\$ 10,056	\$ (2,988)	\$ 7,068
Long-term Risk Management Assets	677	—	—	—	677	(58)	619
Total Assets	10,733	—	—	—	10,733	(3,046)	7,687
Current Risk Management Liabilities	5,784	—	—	—	5,784	(3,137)	2,647
Long-term Risk Management Liabilities	356	—	—	—	356	(58)	298
Total Liabilities	6,140	—	—	—	6,140	(3,195)	2,945
Total MTM Derivative Contract Net Assets (Liabilities)	\$ 4,593	\$ —	\$ —	\$ —	\$ 4,593	\$ 149	\$ 4,742

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

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

- (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."
- (c) There are no derivative contracts subject to a master netting arrangement or similar agreement which are not offset in the statement of financial position.

The table below presents KPCo's activity of derivative risk management contracts for the three and six months ended June 30, 2015 and 2014:

**Amount of Gain (Loss) Recognized on
Risk Management Contracts
For the Three and Six Months Ended June 30, 2015 and 2014**

<u>Location of Gain (Loss)</u>	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2015</u>	<u>2014</u>	<u>2015</u>	<u>2014</u>
	(in thousands)			
Electric Generation, Transmission and Distribution Revenues	\$ 310	\$ 904	\$ 2,157	\$ 7,844
Sales to AEP Affiliates	249	—	249	—
Other Operation Expense	(21)	—	(52)	—
Maintenance Expense	(29)	—	(71)	—
Purchased Electricity for Resale	319	—	2,573	—
Fuel and Other Consumables Used for Electric Generation	(4)	7	(13)	8
Regulatory Assets (a)	(301)	—	(267)	—
Regulatory Liabilities (a)	4,176	1,816	545	2,936
Total Gain on Risk Management Contracts	<u>\$ 4,699</u>	<u>\$ 2,727</u>	<u>\$ 5,121</u>	<u>\$ 10,788</u>

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

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. Certain derivatives that economically hedge future commodity risk are recorded in the same expense line item on the condensed statements of income as that of the associated risk. However, unrealized and some realized gains and losses for both trading and non-trading derivative instruments are recorded as regulatory assets (for losses) or regulatory liabilities (for gains), in accordance with the accounting guidance for "Regulated Operations."

In connection with OPCo's June 2012 - May 2015 ESP, the PUCO ordered OPCo to conduct energy and capacity auctions for its entire SSO load for delivery beginning in June 2015, see Note 4 - Rate Matters. These auctions resulted in a range of products, including 12-month, 24-month, and 36-month periods. The delivery period for each contract is scheduled to start on the first day of June of each year, immediately following the auction. Certain affiliated Vertically Integrated Utility and Generation & Marketing segment entities participated in the auction process and were awarded tranches of OPCo's SSO load. The underlying contracts are derivatives subject to the accounting guidance for "Derivatives and Hedging" and are accounted for using MTM accounting, unless the contract has been designated as a normal purchase or normal sale. The following table represents the affiliated portion of KPCo's assets and liabilities on the condensed balance sheet resulting from these transactions:

June 30, 2015	
Risk Management Assets	Regulatory Liabilities and Deferred Investment Tax Credits
(in thousands)	
\$	924
\$	924

Accounting for Cash Flow Hedging Strategies

For cash flow hedges (i.e. hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), KPCo initially reports the effective portion of the gain or loss on the derivative instrument as a component of Accumulated Other Comprehensive Income (Loss) on the condensed balance sheets until the period the hedged item affects Net Income. KPCo recognizes any hedge ineffectiveness as a regulatory asset (for losses) or a regulatory liability (for gains).

Realized gains and losses on derivative contracts for the purchase and sale of power designated as cash flow hedges are included in Revenues 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, 2015, KPCo did not designate power derivatives as cash flow hedges. During the three and six months ended June 30, 2014, KPCo designated power derivatives as cash flow hedges.

KPCo reclassifies gains and losses on heating oil and gasoline derivative contracts designated as cash flow hedges from Accumulated Other Comprehensive Income (Loss) on its 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. Cash flow hedge accounting for these derivative contracts was immaterial and was discontinued effective March 31, 2014.

KPCo reclassifies gains and losses on interest rate derivative hedges related to debt financings from Accumulated Other Comprehensive Income (Loss) on its condensed balance sheets into Interest Expense on its condensed statements of income in those periods in which hedged interest payments occur. During the three and six months ended June 30, 2015 and 2014, KPCo did not designate any interest rate derivatives as cash flow hedges.

During the three and six months ended June 30, 2015 and 2014, hedge ineffectiveness was immaterial or nonexistent for all cash flow hedge strategies disclosed above.

For details on designated, effective cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on KPCo's condensed balance sheets and the reasons for changes in cash flow hedges for the three and six months ended June 30, 2015 and 2014, see Note 3.

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on KPCo's condensed balance sheets as of June 30, 2015 and December 31, 2014 were:

**Impact of Cash Flow Hedges on the Condensed Balance Sheet
June 30, 2015**

	<u>Commodity</u>	<u>Interest Rate</u> (in thousands)	<u>Total</u>
Hedging Assets (a)	\$ —	\$ —	\$ —
Hedging Liabilities (a)	—	—	—
AOCI Loss Net of Tax	—	(131)	(131)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	—	(60)	(60)

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

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

- (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, 2015, KPCo is not hedging (with contracts subject to the accounting guidance for "Derivatives and Hedging") its exposure to variability in future cash flows related to forecasted transactions.

Credit Risk

AEPSC, on behalf of KPCo, limits credit risk in KPCo's wholesale marketing and trading activities by assessing the creditworthiness of potential counterparties before entering into transactions with them and continuing to evaluate their creditworthiness on an ongoing basis. AEPSC, on behalf of KPCo, uses Moody's, Standard and Poor's and current market-based qualitative and quantitative data as well as financial statements to assess the financial health of counterparties on an ongoing basis.

When AEPSC, on behalf of KPCo, uses standardized master agreements, these agreements may include collateral requirements. These master agreements facilitate the netting of cash flows associated with a single counterparty. Cash, letters of credit and parental/affiliate guarantees may be obtained as security from counterparties in order to mitigate credit risk. The collateral agreements require a counterparty to post cash or letters of credit in the event an exposure exceeds the established threshold. The threshold represents an unsecured credit limit which may be supported by a parental/affiliate guaranty, as determined in accordance with AEP's credit policy. In addition, collateral agreements allow for termination and liquidation of all positions in the event of a failure or inability to post collateral.

Collateral Triggering Events

Under the tariffs of the RTOs and Independent System Operators (ISOs) and a limited number of derivative and non-derivative contracts primarily related to competitive retail auction loads, KPCo is obligated to post an additional amount of collateral if certain credit ratings decline below investment grade. The amount of collateral required fluctuates based on market prices and total exposure. On an ongoing basis, AEP's risk management organization assesses the appropriateness of these collateral triggering items in contracts. KPCo has not experienced a downgrade below investment grade. The following table represents KPCo's exposure if credit ratings were to decline below a specified rating threshold as of June 30, 2015 and December 31, 2014:

	June 30, 2015	December 31, 2014
	(in thousands)	
Fair Value of Contracts with Credit Downgrade Triggers	\$ —	\$ —
Amount of Collateral KPCo Would Have been Required to Post for Derivative Contracts as well as Derivative and Non-Derivative Contracts Subject to the Same Master Netting Arrangement	—	—
Amount of Collateral KPCo Would Have Been Required to Post Attributable to RTOs and ISOs	660	1,303
Amount of Collateral Attributable to Other Contracts	65	14

In addition, a majority of KPCo's non-exchange traded commodity contracts contain cross-default provisions that, if triggered, would permit the counterparty to declare a default and require settlement of the outstanding payable. These cross-default provisions could be triggered if there was a non-performance event by Parent or the obligor under outstanding debt or a third party obligation in excess of \$50 million. On an ongoing basis, AEP's risk management organization assesses the appropriateness of these cross-default provisions in the contracts. The following table represents: (a) the fair value of these derivative liabilities subject to cross-default provisions prior to consideration of contractual netting arrangements, (b) the amount this exposure has been reduced by cash collateral posted by KPCo and (c) if a cross-default provision would have been triggered, the settlement amount that would be required after considering KPCo's contractual netting arrangements as of June 30, 2015 and December 31, 2014:

	June 30, 2015	December 31, 2014
	(in thousands)	
Liabilities for Contracts with Cross Default Provisions Prior to Contractual Netting Arrangements	\$ 1,397	\$ 1,859
Amount of Cash Collateral Posted	—	—
Additional Settlement Liability if Cross Default Provision is Triggered	1,380	1,852

9. FAIR VALUE MEASUREMENTS

Fair Value Hierarchy and Valuation Techniques

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

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

Fair Value Measurements of Long-term Debt

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

The book values and fair values of KPCo’s Long-term Debt as of June 30, 2015 and December 31, 2014 are summarized in the following table:

	<u>June 30, 2015</u>		<u>December 31, 2014</u>	
	<u>Book Value</u>	<u>Fair Value</u>	<u>Book Value</u>	<u>Fair Value</u>
	<u>(in thousands)</u>			
Long-term Debt	\$ 844,639	\$ 945,825	\$ 819,555	\$ 948,967

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, 2015 and December 31, 2014. 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, 2015

Assets:	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
Risk Management Assets					
Risk Management Commodity Contracts (a) (b)	<u>\$ 36</u>	<u>\$ 4,750</u>	<u>\$ 5,913</u>	<u>\$ (3,012)</u>	<u>\$ 7,687</u>
Liabilities:					
Risk Management Liabilities					
Risk Management Commodity Contracts (a) (b)	<u>\$ 40</u>	<u>\$ 5,927</u>	<u>\$ 139</u>	<u>\$ (3,161)</u>	<u>\$ 2,945</u>

Assets and Liabilities Measured at Fair Value on a Recurring Basis December 31, 2014

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

(a) Amounts in "Other" column primarily represent counterparty netting of risk management and hedging contracts and associated cash collateral under the accounting guidance for "Derivatives and Hedging."

(b) Substantially comprised of power contracts.

There were no transfers between Level 1 and Level 2 during the three and six months ended June 30, 2015 and 2014.

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, 2015	Net Risk Management Assets (Liabilities) (in thousands)
Balance as of March 31, 2015	\$ 1,670
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)	(221)
Purchases, Issuances and Settlements (c)	(697)
Transfers out of Level 3 (e) (f)	240
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	4,782
Balance as of June 30, 2015	\$ 5,774
Three Months Ended June 30, 2014	Net Risk Management Assets (Liabilities) (in thousands)
Balance as of March 31, 2014	\$ 1,450
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)	(754)
Purchases, Issuances and Settlements (c)	(13)
Transfers into Level 3 (d) (e)	37
Transfers out of Level 3 (e) (f)	1
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	2,865
Balance as of June 30, 2014	\$ 3,586
Six Months Ended June 30, 2015	Net Risk Management Assets (Liabilities) (in thousands)
Balance as of December 31, 2014	\$ 3,927
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)	365
Purchases, Issuances and Settlements (c)	(3,489)
Transfers out of Level 3 (e) (f)	240
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	4,731
Balance as of June 30, 2015	\$ 5,774
Six Months Ended June 30, 2014	Net Risk Management Assets (Liabilities) (in thousands)
Balance as of December 31, 2013	\$ 2,171
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)	5,375
Purchases, Issuances and Settlements (c)	(5,921)
Transfers into Level 3 (d) (e)	(749)
Transfers out of Level 3 (e) (f)	(1)
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	2,711
Balance as of June 30, 2014	\$ 3,586

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

The following tables quantify the significant unobservable inputs used in developing the fair value of Level 3 positions as of June 30, 2015 and December 31, 2014:

**Significant Unobservable Inputs
June 30, 2015**

	<u>Fair Value</u>		<u>Valuation Technique</u>	<u>Significant Unobservable Input (a)</u>	<u>Forward Price Range</u>		
	<u>Assets</u>	<u>Liabilities</u>			<u>Low</u>	<u>High</u>	<u>Weighted Average</u>
	(in thousands)						
Energy Contracts	\$ 2,774	\$ 37	Discounted Cash Flow	Forward Market Price	\$15.36	\$ 56.30	\$ 35.88
FTRs	3,139	102	Discounted Cash Flow	Forward Market Price	(6.16)	9.87	1.57
Total	<u>\$ 5,913</u>	<u>\$ 139</u>					

**Significant Unobservable Inputs
December 31, 2014**

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

(a) Represents market prices in dollars per MWh.

The following table provides sensitivity of fair value measurements to increases (decreases) in significant unobservable inputs related to Energy Contracts and FTRs as of June 30, 2015:

**Sensitivity of Fair Value Measurements
June 30, 2015**

<u>Significant Unobservable Input</u>	<u>Position</u>	<u>Change in Input</u>	<u>Impact on Fair Value Measurement</u>
Forward Market Price	Buy	Increase (Decrease)	Higher (Lower)
Forward Market Price	Sell	Increase (Decrease)	Lower (Higher)

10. INCOME TAXES

AEP System Tax Allocation Agreement

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

Federal and State Income Tax Audit Status

KPCo and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2011. The IRS examination of years 2011, 2012 and 2013 started in April 2014. Although the outcome of tax audits is uncertain, in management's opinion, adequate provisions for federal income taxes have been made for potential liabilities resulting from such matters. In addition, KPCo accrues interest on these uncertain tax positions. Management is not aware of any issues for open tax years that upon final resolution are expected to materially impact KPCo's net income.

KPCo and other AEP subsidiaries file income tax returns in various state and local jurisdictions. These taxing authorities routinely examine the tax returns. KPCo and other AEP subsidiaries are currently under examination in several state and local jurisdictions. However, it is possible that previously filed tax returns have positions that may be challenged by these tax authorities. Management believes that adequate provisions for income taxes have been made for potential liabilities resulting from such challenges and that the ultimate resolution of these audits will not materially impact KPCo's net income. KPCo is no longer subject to state or local income tax examinations by tax authorities for years before 2009.

11. FINANCING ACTIVITIES

Long-term Debt

Long-term debt issued during the first six months of 2015 is shown in the table below:

<u>Type of Debt</u>	<u>Principal Amount (a) (in thousands)</u>	<u>Interest Rate (%)</u>	<u>Due Date</u>
Other Long-term Debt	\$ 25,000	Variable	2018

(a) Amount indicated on the statement of cash flows is net of issuance costs and premium or discount and will not tie to the issuance amount.

Dividend Restrictions

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

Federal Power Act

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

Leverage Restrictions

Pursuant to the credit agreement leverage restrictions, KPCo must maintain a percentage of debt to total capitalization at a level that does not exceed 67.5%.

Utility Money Pool – AEP System

The AEP System uses a corporate borrowing program to meet the short-term borrowing needs of AEP’s subsidiaries. The corporate borrowing program includes a Utility Money Pool, which funds AEP’s utility subsidiaries. The AEP System Utility Money Pool operates in accordance with the terms and conditions of the AEP System Utility Money Pool agreement filed with the FERC. The amounts of outstanding loans to (borrowings from) the Utility Money Pool as of June 30, 2015 and December 31, 2014 are included in Advances to Affiliates and Advances from Affiliates, respectively, on KPCo’s condensed balance sheets. KPCo’s Utility Money Pool activity and corresponding authorized borrowing limits for the six months ended June 30, 2015 are described in the following table:

<u>Maximum Borrowings from the Utility Money Pool</u>	<u>Maximum Loans to the Utility Money Pool</u>	<u>Average Borrowings from the Utility Money Pool</u>	<u>Average Loans to the Utility Money Pool</u>	<u>Borrowings from the Utility Money Pool as of June 30, 2015</u>	<u>Authorized Short-Term Borrowing Limit</u>
(in thousands)					
\$ 52,477	\$ 8,362	\$ 21,382	\$ 3,264	\$ 27,176	\$ 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, 2015 and 2014 are summarized in the following table:

Six Months Ended June 30,	Maximum Interest Rate for Funds Borrowed from the Utility Money Pool	Minimum Interest Rate for Funds Borrowed from the Utility Money Pool	Maximum Interest Rate for Funds Loaned to the Utility Money Pool	Minimum Interest Rate for Funds Loaned to the Utility Money Pool	Average Interest Rate for Funds Borrowed from the Utility Money Pool	Average Interest Rate for Funds Loaned to the Utility Money Pool
2015	0.59%	0.39%	0.54%	0.42%	0.47%	0.51%
2014	0.33%	0.24%	0.33%	0.26%	0.28%	0.31%

Sale of Receivables – AEP Credit

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

AEP Credit's receivables securitization agreement provides a commitment of \$750 million from bank conduits to purchase receivables. The agreement was increased in June 2014 from \$700 million and expires in June 2017.

KPCo's amounts of accounts receivable and accrued unbilled revenues sold under the sale of receivables agreement were \$36.2 million and \$46 million as of June 30, 2015 and December 31, 2014, respectively.

The fees paid by KPCo to AEP Credit for customer accounts receivable sold for the three months ended June 30, 2015 and 2014 were \$713 thousand and \$633 thousand, respectively, and for the six months ended June 30, 2015 and 2014 were \$1.6 million and \$1.4 million, respectively.

KPCo's proceeds on the sale of receivables to AEP Credit for the three months ended June 30, 2015 and 2014 were \$118 million and \$141 million, respectively, and for the six months ended June 30, 2015 and 2014 were \$273 million and \$320 million, respectively.

12. VARIABLE INTEREST ENTITIES

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

AEPSC provides certain managerial and professional services to AEP’s subsidiaries. AEP is the sole equity owner of AEPSC. AEP management controls the activities of AEPSC. The costs of the services are based on a direct charge or on a prorated basis and billed to the AEP subsidiary companies at AEPSC’s cost. AEP subsidiaries have not provided financial or other support outside the reimbursement of costs for services rendered. AEPSC finances its operations through cost reimbursement from other AEP subsidiaries. There are no other terms or arrangements between AEPSC and any of the AEP subsidiaries that could require additional financial support from an AEP subsidiary or expose them to losses outside of the normal course of business. AEPSC and its billings are subject to regulation by the FERC. AEP subsidiaries are exposed to losses to the extent they cannot recover the costs of AEPSC through their normal business operations. AEP subsidiaries are considered to have a significant interest in AEPSC due to their activity in AEPSC’s cost reimbursement structure. However, AEP subsidiaries do not have control over AEPSC. AEPSC is consolidated by AEP. In the event AEPSC would require financing or other support outside the cost reimbursement billings, this financing would be provided by AEP. KPCo’s total billings from AEPSC for the three months ended June 30, 2015 and 2014 were \$16 million and \$12 million, respectively, and for the six months ended June 30, 2015 and 2014 were \$29 million and \$25 million, respectively. The carrying amount of liabilities associated with AEPSC as of June 30, 2015 and December 31, 2014 was \$5 million and \$8 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

AEGCo, a wholly-owned subsidiary of AEP, is consolidated by AEP. AEGCo owns a 50% ownership interest in Rockport Plant, Unit 1 and leases a 50% interest in Rockport Plant, Unit 2. AEGCo sells all the output from the Rockport Plant to I&M and KPCo. AEP has agreed to provide AEGCo with the funds necessary to satisfy all of the debt obligations of AEGCo. KPCo is considered to have a significant interest in AEGCo due to these transactions. KPCo is exposed to losses to the extent it cannot recover the costs of AEGCo through its normal business operations. Due to AEP management’s control over AEGCo, KPCo is not considered the primary beneficiary of AEGCo. In the event AEGCo would require financing or other support outside the billings to KPCo, this financing would be provided by AEP. Total billings from AEGCo for the three months ended June 30, 2015 and 2014 were \$26 million and \$28 million, respectively, and for the six months ended June 30, 2015 and 2014 were \$49 million and \$58 million, respectively. The carrying amount of liabilities associated with AEGCo as of June 30, 2015 and December 31, 2014 was \$10 million and \$9 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

13. PROPERTY, PLANT AND EQUIPMENT

Asset Retirement Obligations (ARO)

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

KPCo recorded an increase in asset retirement obligations in the second quarter of 2015, partially related to the final Coal Combustion Residual Rule, which was published in the Federal Register in April 2015. The Federal EPA now regulates the disposal and beneficial re-use of coal combustion residuals (CCR), including fly ash and bottom ash generated at coal-fired electric generating units and also FGD gypsum generated at some coal-fired plants. The Federal EPA regulates CCR as a non-hazardous solid waste and established minimum federal solid waste management standards. Noncash increases related to the CCR Rule are recorded as Property, Plant and Equipment.

The following is a reconciliation of the June 30, 2015 and December 31, 2014 aggregate carrying amounts of ARO for KPCo:

<u>ARO as of December 31, 2014</u>	<u>Accretion Expense</u>	<u>Liabilities Incurred</u>	<u>Liabilities Settled</u>	<u>Revisions in Cash Flow Estimates</u>	<u>ARO as of June 30, 2015</u>
(in thousands)					
\$ 65,699	\$ 1,707	\$ 2,145	\$ (1,052)	\$ 12,843	\$ 81,342

14. DISPOSITION PLANT SEVERANCE

Management retired several generation plants or units of plants during 2015. These plant closures resulted in involuntary severances. The severance program provides two weeks of base pay for every year of service along with other severance benefits.

The disposition plant severance activity for the six months ended June 30, 2015 is described in the following table:

<u>Balance as of December 31, 2014</u>	<u>Expense Allocation from AEPSC</u>	<u>Incurred</u>	<u>Settled</u>	<u>Adjustments</u>	<u>Remaining Balance as of March 31, 2015</u>
(in thousands)					
\$ 4,539	\$ (2)	\$ 69	\$ (309)	(a) \$ —	\$ 4,297

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

KPCo recorded a charge of \$4 million to Other Operation expense in December 2014 related to employees at the disposition plants. These expenses, net of adjustments, relate primarily to severance benefits and are included primarily in Other Operation expense on the condensed statements of income. The remaining liability is included in Other Current Liabilities on the condensed balance sheets. KPCo incurred additional charges during the second quarter of 2015 as severance plans were finalized after the plants were retired. Management does not expect additional severance costs to be incurred related to this initiative.