

Kentucky Power Company

2009 Third Quarter Report

Financial Statements



TABLE OF CONTENTS

	Page
Glossary of Terms	KPCo-i
Condensed Statements of Income – Unaudited	KPCo-1
Condensed Statements of Changes in Common Shareholder’s Equity and Comprehensive Income (Loss) – Unaudited	KPCo-2
Condensed Balance Sheets – Unaudited	KPCo-3
Condensed Statements of Cash Flows – Unaudited	KPCo-5
Condensed Notes to Condensed Financial Statements – Unaudited	KPCo-6

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.
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	American Electric Power System, an integrated electric utility system, owned and operated by AEP's electric utility subsidiaries.
AEP West companies	PSO, SWEPCo, TCC and TNC.
AEPSC	American Electric Power Service Corporation, a service subsidiary providing management and professional services to AEP and its subsidiaries.
ALJ	Administrative Law Judge.
AOCI	Accumulated Other Comprehensive Income.
APB	Accounting Principles Board Opinion.
APCo	Appalachian Power Company, an AEP electric utility subsidiary.
APSC	Arkansas Public Service Commission.
ASU	Accounting Standards Update issued by the Financial Accounting Standards Board.
CAA	Clean Air Act.
CO ₂	Carbon Dioxide.
CSPCo	Columbus Southern Power Company, an AEP electric utility subsidiary.
CSW	Central and South West Corporation, a subsidiary of AEP (Effective January 21, 2003, the legal name of Central and South West Corporation was changed to AEP Utilities, Inc.).
CSW Operating Agreement	Agreement, dated January 1, 1997, by and among PSO, SWEPCo, TCC and TNC governing generating capacity allocation. This agreement was amended in May 2006 to remove TCC and TNC. AEPSC acts as the agent.
DETM	Duke Energy Trading and Marketing L.L.C., a risk management counterparty.
EITF	Financial Accounting Standards Board's Emerging Issues Task Force.
EITF 06-10	EITF Issue No. 06-10 "Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements."
FASB	Financial Accounting Standards Board.
Federal EPA	United States Environmental Protection Agency.
FERC	Federal Energy Regulatory Commission.
FSP	FASB Staff Position.
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.
KGPCo	Kingsport Power Company, an AEP electric distribution subsidiary.
KPCo	Kentucky Power Company, an AEP electric utility subsidiary.
KPSC	Kentucky Public Service Commission.
kV	Kilovolt.
MISO	Midwest Independent Transmission System Operator.
MMBtu	Million British Thermal Units.
MTM	Mark-to-Market.
MWH	Megawatthour.
OCC	Corporation Commission of the State of Oklahoma.
OPCo	Ohio Power Company, an AEP electric utility subsidiary.

Term	Meaning
OPEB	Other Postretirement Benefit Plans.
OTC	Over the counter.
PJM	Pennsylvania – New Jersey – Maryland regional transmission organization.
PSO	Public Service Company of Oklahoma, an AEP electric utility subsidiary.
PUCT	Public Utility Commission of Texas.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
Rockport Plant	A generating plant, consisting of two 1,300 MW coal-fired generating units near Rockport, Indiana, owned by AEGCo and I&M.
RTO	Regional Transmission Organization.
SECA	Seams Elimination Cost Allocation.
SFAS	Statement of Financial Accounting Standards issued by the Financial Accounting Standards Board.
SFAS 157	Statement of Financial Accounting Standards No. 157, “Fair Value Measurements.”
SIA	System Integration Agreement.
SWEPCo	Southwestern Electric Power Company, an AEP electric utility subsidiary.
TCC	AEP Texas Central Company, an AEP electric utility subsidiary.
TNC	AEP Texas North Company, an AEP electric utility subsidiary.
Utility Money Pool	AEP System’s Utility Money Pool.
WPCo	Wheeling Power Company, an AEP electric distribution subsidiary.

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF INCOME
For the Three and Nine Months Ended September 30, 2009 and 2008
(in thousands)
(Unaudited)

	Three Months Ended		Nine Months Ended	
	2009	2008	2009	2008
REVENUES				
Electric Generation, Transmission and Distribution	\$ 139,868	\$ 171,257	\$ 435,871	\$ 446,468
Sales to AEP Affiliates	11,973	17,457	47,569	56,239
Other Revenues	312	158	2,245	506
TOTAL REVENUES	152,153	188,872	485,685	503,213
EXPENSES				
Fuel and Other Consumables Used for Electric Generation	42,330	52,723	143,248	116,196
Purchased Electricity for Resale	5,498	10,034	19,850	19,506
Purchased Electricity from AEP Affiliates	53,258	63,469	150,296	177,921
Other Operation	12,655	20,524	36,994	49,909
Maintenance	11,561	10,389	38,488	36,912
Depreciation and Amortization	13,100	11,996	38,878	35,895
Taxes Other Than Income Taxes	2,828	2,967	8,811	7,019
TOTAL EXPENSES	141,230	172,102	436,565	443,358
OPERATING INCOME	10,923	16,770	49,120	59,855
Other Income (Expense):				
Interest Income	53	209	165	2,050
Allowance for Equity Funds Used During Construction	159	251	137	928
Interest Expense	(9,109)	(7,058)	(23,842)	(21,409)
INCOME BEFORE INCOME TAX EXPENSE	2,026	10,172	25,580	41,424
Income Tax Expense	717	2,721	8,609	11,899
NET INCOME	\$ 1,309	\$ 7,451	\$ 16,971	\$ 29,525

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 Nine Months Ended September 30, 2009 and 2008
(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, 2007	\$ 50,450	\$ 208,750	\$ 128,583	\$ (814)	\$ 386,969
EITF 06-10 Adoption, Net of Tax of \$197			(365)		(365)
Common Stock Dividends			(7,500)		(7,500)
SUBTOTAL – COMMON SHAREHOLDER'S EQUITY					<u>379,104</u>
COMPREHENSIVE INCOME					
Other Comprehensive Income, Net of Taxes:					
Cash Flow Hedges, Net of Tax of \$236				439	439
NET INCOME			29,525		<u>29,525</u>
TOTAL COMPREHENSIVE INCOME					<u>29,964</u>
TOTAL COMMON SHAREHOLDER'S EQUITY – SEPTEMBER 30, 2008	<u>\$ 50,450</u>	<u>\$ 208,750</u>	<u>\$ 150,243</u>	<u>\$ (375)</u>	<u>\$ 409,068</u>
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2008	\$ 50,450	\$ 208,750	\$ 138,749	\$ 59	\$ 398,008
Capital Contribution from Parent		30,000			30,000
Common Stock Dividends			(13,500)		(13,500)
SUBTOTAL – COMMON SHAREHOLDER'S EQUITY					<u>414,508</u>
COMPREHENSIVE INCOME					
Other Comprehensive Loss, Net of Taxes:					
Cash Flow Hedges, Net of Tax of \$235				(437)	(437)
NET INCOME			16,971		<u>16,971</u>
TOTAL COMPREHENSIVE INCOME					<u>16,534</u>
TOTAL COMMON SHAREHOLDER'S EQUITY – SEPTEMBER 30, 2009	<u>\$ 50,450</u>	<u>\$ 238,750</u>	<u>\$ 142,220</u>	<u>\$ (378)</u>	<u>\$ 431,042</u>

See Condensed Notes to Condensed Financial Statements.

**KENTUCKY POWER COMPANY
CONDENSED BALANCE SHEETS**

ASSETS

September 30, 2009 and December 31, 2008

(in thousands)

(Unaudited)

	2009	2008
CURRENT ASSETS		
Cash and Cash Equivalents	\$ 545	\$ 646
Advances to Affiliates	4,197	-
Accounts Receivable:		
Customers	15,189	24,214
Affiliated Companies	12,798	6,721
Miscellaneous	98	83
Allowance for Uncollectible Accounts	(863)	(1,144)
Total Accounts Receivable	27,222	29,874
Fuel	43,335	29,440
Materials and Supplies	11,555	10,630
Risk Management Assets	17,157	13,760
Regulatory Asset for Under-Recovered Fuel Costs	-	9,953
Margin Deposits	6,830	5,207
Prepayments and Other Current Assets	6,831	5,751
TOTAL CURRENT ASSETS	117,672	105,261
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Production	546,261	533,998
Transmission	436,133	431,835
Distribution	559,287	528,711
Other Property, Plant and Equipment	64,119	65,485
Construction Work in Progress	28,208	46,650
Total Property, Plant and Equipment	1,634,008	1,606,679
Accumulated Depreciation and Amortization	504,570	476,568
TOTAL PROPERTY, PLANT AND EQUIPMENT – NET	1,129,438	1,130,111
OTHER NONCURRENT ASSETS		
Regulatory Assets	180,332	179,845
Long-term Risk Management Assets	11,693	10,860
Deferred Charges and Other Noncurrent Assets	35,008	41,884
TOTAL OTHER NONCURRENT ASSETS	227,033	232,589
TOTAL ASSETS	\$ 1,474,143	\$ 1,467,961

See Condensed Notes to Condensed Financial Statements.

KENTUCKY POWER COMPANY
CONDENSED BALANCE SHEETS
LIABILITIES AND SHAREHOLDER'S EQUITY
September 30, 2009 and December 31, 2008
(Unaudited)

	2009	2008
CURRENT LIABILITIES	(in thousands)	
Advances from Affiliates	\$ -	\$ 131,399
Accounts Payable:		
General	22,864	35,584
Affiliated Companies	21,643	45,245
Risk Management Liabilities	6,374	6,316
Customer Deposits	17,761	15,985
Accrued Taxes	9,272	11,903
Accrued Interest	6,217	7,009
Regulatory Liability for Over-Recovered Fuel Costs	4,820	-
Other Current Liabilities	17,236	22,517
TOTAL CURRENT LIABILITIES	106,187	275,958
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated	528,680	398,555
Long-term Debt – Affiliated	20,000	20,000
Long-term Risk Management Liabilities	4,789	5,630
Deferred Income Taxes	278,982	259,666
Regulatory Liabilities and Deferred Investment Tax Credits	40,499	46,135
Employee Benefits and Pension Obligations	50,983	51,819
Deferred Credits and Other Noncurrent Liabilities	12,981	12,190
TOTAL NONCURRENT LIABILITIES	936,914	793,995
TOTAL LIABILITIES	1,043,101	1,069,953
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	208,750
Retained Earnings	142,220	138,749
Accumulated Other Comprehensive Income (Loss)	(378)	59
TOTAL COMMON SHAREHOLDER'S EQUITY	431,042	398,008
TOTAL LIABILITIES AND SHAREHOLDER'S EQUITY	\$ 1,474,143	\$ 1,467,961

See Condensed Notes to Condensed Financial Statements.

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF CASH FLOWS
For the Nine Months Ended September 30, 2009 and 2008
(in thousands)
(Unaudited)

	2009	2008
OPERATING ACTIVITIES		
Net Income	\$ 16,971	\$ 29,525
Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:		
Depreciation and Amortization	38,878	35,895
Deferred Income Taxes	21,992	5,709
Allowance for Equity Funds Used During Construction	(137)	(928)
Mark-to-Market of Risk Management Contracts	(5,884)	1,494
Fuel Over/Under-Recovery, Net	14,773	(12,176)
Change in Other Noncurrent Assets	8,276	(987)
Change in Other Noncurrent Liabilities	1,365	(286)
Changes in Certain Components of Working Capital:		
Accounts Receivable, Net	2,945	6,264
Fuel, Materials and Supplies	(14,820)	(9,200)
Accounts Payable	(29,494)	7,051
Accrued Taxes, Net	(6,139)	510
Other Current Assets	(2,934)	(3,466)
Other Current Liabilities	(6,376)	(6,632)
Net Cash Flows from Operating Activities	39,416	52,773
INVESTING ACTIVITIES		
Construction Expenditures	(49,734)	(91,457)
Changes in Advances to Affiliates, Net	(4,197)	-
Acquisitions of Assets	(297)	-
Proceeds from Sales of Assets	622	577
Net Cash Flows Used for Investing Activities	(53,606)	(90,880)
FINANCING ACTIVITIES		
Capital Contribution from Parent	30,000	-
Issuance of Long-term Debt – Nonaffiliated	129,292	-
Change in Advances from Affiliates, Net	(131,399)	45,939
Principal Payments for Capital Lease Obligations	(547)	(604)
Dividends Paid on Common Stock	(13,500)	(7,500)
Other Financing Activities	243	-
Net Cash Flows from Financing Activities	14,089	37,835
Net Decrease in Cash and Cash Equivalents	(101)	(272)
Cash and Cash Equivalents at Beginning of Period	646	727
Cash and Cash Equivalents at End of Period	\$ 545	\$ 455
SUPPLEMENTARY INFORMATION		
Cash Paid for Interest, Net of Capitalized Amounts	\$ 29,776	\$ 24,376
Net Cash Received for Income Taxes	(2,416)	(231)
Noncash Acquisitions Under Capital Leases	794	237
Construction Expenditures Included in Accounts Payable at September 30,	2,834	9,634

See Condensed Notes to Condensed Financial Statements.

CONDENSED NOTES TO CONDENSED FINANCIAL STATEMENTS

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

1. SIGNIFICANT ACCOUNTING MATTERS

General

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

In the opinion of management, the unaudited condensed interim financial statements reflect all normal and recurring accruals and adjustments necessary for a fair presentation of the net income, financial position and cash flows for the interim periods. Net income for the three and nine months ended September 30, 2009 is not necessarily indicative of results that may be expected for the year ending December 31, 2009. Management reviewed subsequent events through the October 30, 2009 issuance date of KPCo's third quarter financial statements and footnotes. The accompanying condensed financial statements are unaudited and should be read in conjunction with the audited 2008 financial statements and notes thereto, which are included in KPCo's 2008 Annual Report.

Variable Interest Entities

The accounting guidance for "Variable Interest Entities" is a consolidation model that considers risk absorption of a variable interest entity (VIE), also referred to as variability. Entities are required to consolidate a VIE when it is determined that they 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 the 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.

KPCo holds a significant variable interest in AEPSC and AEGCo. AEPSC provides certain managerial and professional services to KPCo. AEP is the sole equity owner of AEPSC. The costs of the services are based on a direct charge or on a prorated basis and billed to KPCo and other AEP subsidiaries at AEPSC's cost. KPCo and other AEP subsidiaries have not provided financial or other support outside the reimbursement of costs for services rendered. The cost reimbursement nature of AEPSC finances its operations. There are no other terms or arrangements between AEPSC and KPCo and other AEP subsidiaries that could require additional financial support from KPCo and other AEP subsidiaries or expose them to losses outside of the normal course of business. AEPSC and its billings are subject to regulation by the FERC. KPCo and other AEP subsidiaries are exposed to losses to the extent they cannot recover the costs of AEPSC through their normal business operations. KPCo is considered to have a significant interest in the variability of AEPSC due to its activity in AEPSC's cost reimbursement structure. 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. Total billings from AEPSC for the three months ended September 30, 2009 and 2008 were \$8 million and \$11 million, respectively, and for the nine months ended September 30, 2009 and 2008 were \$25 million and \$34 million, respectively. The carrying amount of liabilities associated with AEPSC as of September 30, 2009 and December 31, 2008 were \$3 million and \$5 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, leases a 50% interest in Rockport Plant Unit 2 and owns 100% of the Lawrenceburg Generating Station. AEGCo sells all the output from the Rockport Plant to I&M and KPCo. KPCo has no involvement with AEGCo's interest in the Lawrenceburg Generating Station. 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 the nature of the AEP Power Pool, there is a sharing of the cost of Rockport Plant such that no member of the AEP Power Pool is the primary beneficiary of AEGCo's Rockport Plant. In the event AEGCo would require financing or other support outside the billings to KPCo, this financing would be provided by AEP. Total billings from AEGCo for the three months ended September 30, 2009 and 2008 were \$25 million and \$28 million, respectively, and for the nine months

ended September 30, 2009 and 2008 were \$78 million in both periods. The carrying amount of liabilities associated with AEGCo as of September 30, 2009 and December 31, 2008 were \$8 million and \$9 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

Revenue Recognition – Traditional Electricity Supply and Demand

Revenues are recognized from retail and wholesale electricity sales and electricity transmission and distribution delivery services. KPCo recognizes the revenues on its Condensed Statements of Income upon delivery of the energy to the customer and includes unbilled as well as billed amounts.

Most of the power produced at the generation plants of the AEP East companies is sold to PJM, the RTO operating in the east service territory. The AEP East companies purchase power from PJM to supply their customers. Generally, these power sales and purchases are reported on a net basis as revenues on the Condensed Statements of Income. However, in 2009, there were times when the AEP East companies were purchasers of power from PJM to serve retail load. These purchases were recorded gross as Purchased Electricity for Resale on the Condensed Statements of Income.

Physical energy purchases, including those from RTOs, that are identified as non-trading, are accounted for on a gross basis in Purchased Electricity for Resale on KPCo's Condensed Statements of Income.

2. NEW ACCOUNTING PRONOUNCEMENTS

Upon issuance of final pronouncements, management reviews the new accounting literature to determine the relevance, if any, to KPCo's business. The following represents a summary of new pronouncements issued or implemented in 2009 and standards issued but not implemented that management has determined relate to KPCo's operations.

Pronouncements Adopted During 2009

The following standards were effective during the first nine months of 2009. Consequently, the financial statements and footnotes reflect their impact.

SFAS 141 (revised 2007) "Business Combinations" (SFAS 141R)

In December 2007, the FASB issued SFAS 141R, improving financial reporting about business combinations and their effects. It established how the acquiring entity recognizes and measures the identifiable assets acquired, liabilities assumed, goodwill acquired, any gain on bargain purchases and any noncontrolling interest in the acquired entity. SFAS 141R no longer allows acquisition-related costs to be included in the cost of the business combination, but rather expensed in the periods they are incurred, with the exception of the costs to issue debt or equity securities which shall be recognized in accordance with other applicable GAAP. The standard requires disclosure of information for a business combination that occurs during the accounting period or prior to the issuance of the financial statements for the accounting period. SFAS 141R can affect tax positions on previous acquisitions. KPCo does not have any such tax positions that result in adjustments.

In April 2009, the FASB issued FSP SFAS 141(R)-1 "Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies." The standard clarifies accounting and disclosure for contingencies arising in business combinations. It was effective January 1, 2009.

KPCo adopted SFAS 141R, including the FSP, effective January 1, 2009. It is effective prospectively for business combinations with an acquisition date on or after January 1, 2009. KPCo had no business combinations in 2009. KPCo will apply it to any future business combinations. SFAS 141R is included in the "Business Combination" accounting guidance.

SFAS 160 “Noncontrolling Interests in Consolidated Financial Statements” (SFAS 160)

In December 2007, the FASB issued SFAS 160, modifying reporting for noncontrolling interest (minority interest) in consolidated financial statements. It requires noncontrolling interest be reported in equity and establishes a new framework for recognizing net income or loss and comprehensive income by the controlling interest. Upon deconsolidation due to loss of control over a subsidiary, the standard requires a fair value remeasurement of any remaining noncontrolling equity investment to be used to properly recognize the gain or loss. SFAS 160 requires specific disclosures regarding changes in equity interest of both the controlling and noncontrolling parties and presentation of the noncontrolling equity balance and income or loss for all periods presented.

KPCo adopted SFAS 160 effective January 1, 2009 with no impact on its financial statements or footnote disclosures. SFAS 160 is included in the “Consolidation” accounting guidance.

SFAS 161 “Disclosures about Derivative Instruments and Hedging Activities” (SFAS 161)

In March 2008, the FASB issued SFAS 161, enhancing disclosure requirements for derivative instruments and hedging activities. Affected entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how an entity accounts for derivative instruments and related hedged items and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance and cash flows. The standard requires that objectives for using derivative instruments be disclosed in terms of the primary underlying risk and accounting designation.

KPCo adopted SFAS 161 effective January 1, 2009. This standard increased disclosures related to derivative instruments and hedging activities. See Note 7. SFAS 161 is included in the “Derivatives and Hedging” accounting guidance.

SFAS 165 “Subsequent Events” (SFAS 165)

In May 2009, the FASB issued SFAS 165 incorporating guidance on subsequent events into authoritative accounting literature and clarifying the time following the balance sheet date which management reviewed for events and transactions that may require disclosure in the financial statements.

KPCo adopted this standard effective second quarter of 2009. The standard increased disclosure by requiring disclosure of the date through which subsequent events have been reviewed. The standard did not change management’s procedures for reviewing subsequent events. SFAS 165 is included in the “Subsequent Events” accounting guidance.

SFAS 168 “The FASB Accounting Standards CodificationTM and the Hierarchy of Generally Accepted Accounting Principles” (SFAS 168)

In June 2009, the FASB issued SFAS 168 establishing the FASB Accounting Standards CodificationTM as the authoritative source of accounting principles for preparation of financial statements and reporting in conformity with GAAP by nongovernmental entities.

KPCo adopted SFAS 168 effective third quarter of 2009. It required an update of all references to authoritative accounting literature. SFAS 168 is included in the “Generally Accepted Accounting Principles” accounting guidance.

EITF Issue No. 08-5 “Issuer’s Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement” (EITF 08-5)

In September 2008, the FASB ratified the consensus on liabilities with third-party credit enhancements when the liability is measured and disclosed at fair value. The consensus treats the liability and the credit enhancement as two units of accounting. Under the consensus, the fair value measurement of the liability does not include the effect of the third-party credit enhancement. Consequently, changes in the issuer’s credit standing without the support of the credit enhancement affect the fair value measurement of the issuer’s liability. Entities will need to provide disclosures about the existence of any third-party credit enhancements related to their liabilities. In the period of adoption, entities must disclose the valuation method(s) used to measure the fair value of liabilities within its scope and any change in the fair value measurement method that occurs as a result of its initial application.

KPCo adopted EITF 08-5 effective January 1, 2009. With the adoption of FSP SFAS 107-1 and APB 28-1, it is applied to the fair value of long-term debt. The application of this standard had an immaterial effect on the fair value of debt outstanding. EITF 08-5 is included in the “Fair Value Measurements and Disclosures” accounting guidance.

EITF Issue No. 08-6 “Equity Method Investment Accounting Considerations” (EITF 08-6)

In November 2008, the FASB ratified the consensus on equity method investment accounting including initial and allocated carrying values and subsequent measurements. It requires initial carrying value be determined using the SFAS 141R cost allocation method. When an investee issues shares, the equity method investor should treat the transaction as if the investor sold part of its interest.

KPCo adopted EITF 08-6 effective January 1, 2009 with no impact on the financial statements. It was applied prospectively. EITF 08-6 is included in the “Investments – Equity Method and Joint Ventures” accounting guidance.

FSP SFAS 107-1 and APB 28-1 “Interim Disclosures about Fair Value of Financial Instruments” (FSP SFAS 107-1 and APB 28-1)

In April 2009, the FASB issued FSP SFAS 107-1 and APB 28-1 requiring disclosure about the fair value of financial instruments in all interim reporting periods. The standard requires disclosure of the method and significant assumptions used to determine the fair value of financial instruments.

KPCo adopted the standard effective second quarter of 2009. This standard increased the disclosure requirements related to financial instruments. See “Fair Value Measurements of Long-term Debt” section of Note 8. FSP SFAS 107-1 and APB 28-1 is included in the “Financial Instruments” accounting guidance.

FSP SFAS 115-2 and SFAS 124-2 “Recognition and Presentation of Other-Than-Temporary Impairments” (FSP SFAS 115-2 and SFAS 124-2)

In April 2009, the FASB issued FSP SFAS 115-2 and SFAS 124-2 amending the other-than-temporary impairment (OTTI) recognition and measurement guidance for debt securities. For both debt and equity securities, the standard requires disclosure for each interim reporting period of information by security class similar to previous annual disclosure requirements.

KPCo adopted the standard effective second quarter of 2009 with no impact on its financial statements or disclosures. FSP SFAS 115-2 and SFAS 124-2 is included in the “Investments – Debt and Equity Securities” accounting guidance.

FSP SFAS 142-3 “Determination of the Useful Life of Intangible Assets” (SFAS 142-3)

In April 2008, the FASB issued SFAS 142-3 amending factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset. The standard is expected to improve consistency between the useful life of a recognized intangible asset and the period of expected cash flows used to measure its fair value.

KPCo adopted SFAS 142-3 effective January 1, 2009. The guidance is prospectively applied to intangible assets acquired after the effective date. The standard’s disclosure requirements are applied prospectively to all intangible assets as of January 1, 2009. The adoption of this standard had no impact on the financial statements. SFAS 142-3 is included in the “Intangibles – Goodwill and Other” accounting guidance.

FSP SFAS 157-2 “Effective Date of FASB Statement No. 157” (SFAS 157-2)

In February 2008, the FASB issued SFAS 157-2 which delays the effective date of SFAS 157 to fiscal years beginning after November 15, 2008 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). As defined in SFAS 157, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value hierarchy gives the highest priority

to unadjusted quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. In the absence of quoted prices for identical or similar assets or investments in active markets, fair value is estimated using various internal and external valuation methods including cash flow analysis and appraisals.

KPCo adopted SFAS 157-2 effective January 1, 2009. KPCo will apply these requirements to applicable fair value measurements which include new asset retirement obligations and impairment analyses related to long-lived assets, equity investments, goodwill and intangibles. KPCo did not record any fair value measurements for nonrecurring nonfinancial assets and liabilities in the first nine months of 2009. SFAS 157-2 is included in the “Fair Value Measurements and Disclosures” accounting guidance.

FSP SFAS 157-4 “Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly” (FSP SFAS 157-4)

In April 2009, the FASB issued FSP SFAS 157-4 providing additional guidance on estimating fair value when the volume and level of activity for an asset or liability has significantly decreased, including guidance on identifying circumstances indicating when a transaction is not orderly. Fair value measurements shall be based on the price that would be received to sell an asset or paid to transfer a liability in an orderly (not a distressed sale or forced liquidation) transaction between market participants at the measurement date under current market conditions. The standard also requires disclosures of the inputs and valuation techniques used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, for both interim and annual periods.

KPCo adopted the standard effective second quarter of 2009. The standard had no impact on the financial statements but increased disclosure requirements. See “Fair Value Measurements of Financial Assets and Liabilities” section of Note 8. FSP SFAS 157-4 is included in the “Fair Value Measurements and Disclosures” accounting guidance.

Pronouncements Effective in the Future

The following standards will be effective in the future and their impacts will be disclosed at that time.

ASU 2009-05 “Measuring Liabilities at Fair Value” (ASU 2009-05)

In August 2009, the FASB issued ASU 2009-05 updating the “Fair Value Measurement and Disclosures” accounting guidance. The guidance specifies the valuation techniques that should be used to fair value a liability in the absence of a quoted price in an active market.

The new accounting guidance is effective for interim and annual periods beginning after the issuance date. Although management has not completed an analysis, management does not expect this update to have a material impact on the financial statements. KPCo will adopt ASU 2009-05 effective fourth quarter of 2009.

ASU 2009-12 “Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)” (ASU 2009-12)

In September 2009, the FASB issued ASU 2009-12 updating the “Fair Value Measurement and Disclosures” accounting guidance for the fair value measurement of investments in certain entities that calculate net asset value per share (or its equivalent). The guidance permits a reporting entity to measure the fair value of an investment within its scope on the basis of the net asset value per share of the investment (or its equivalent).

The new accounting guidance is effective for interim and annual periods ending after December 15, 2009. Although management has not completed an analysis, management does not expect this update to have a material impact on the financial statements. KPCo will adopt ASU 2009-12 effective fourth quarter of 2009.

ASU 2009-13 “Multiple-Deliverable Revenue Arrangements” (ASU 2009-13)

In October 2009, the FASB issued ASU 2009-13 updating the “Revenue Recognition” accounting guidance by providing criteria for separating consideration in multiple-deliverable arrangements. It establishes a selling price hierarchy for determining the price of a deliverable and expands the disclosures related to a vendor’s multiple-deliverable revenue arrangements.

The new accounting guidance is effective prospectively for arrangements entered into or materially modified in years beginning after June 15, 2010. Although management has not completed an analysis, management does not expect this update to have a material impact on the financial statements. KPCo will adopt ASU 2009-13 effective January 1, 2011.

SFAS 166 “Accounting for Transfers of Financial Assets” (SFAS 166)

In June 2009, the FASB issued SFAS 166 clarifying when a transfer of a financial asset should be recorded as a sale. The standard defines participating interest to establish specific conditions for a sale of a portion of a financial asset. This standard must be applied to all transfers after the effective date.

SFAS 166 is effective for interim and annual reporting in fiscal years beginning after November 15, 2009. Early adoption is prohibited. Management continues to review the impact of this standard. KPCo will adopt SFAS 166 effective January 1, 2010. SFAS 166 is included in the “Transfers and Servicing” accounting guidance.

SFAS 167 “Amendments to FASB Interpretation No. 46(R)” (SFAS 167)

In June 2009, the FASB issued SFAS 167 amending the analysis an entity must perform to determine if it has a controlling interest in a variable interest entity (VIE). This new guidance provides that the primary beneficiary of a VIE must have both:

- The power to direct the activities of the VIE that most significantly impact the VIE’s economic performance.
- The obligation to absorb the losses of the entity that could potentially be significant to the VIE or the right to receive benefits from the entity that could potentially be significant to the VIE.

The standard also requires separate presentation on the face of the statement of financial position for assets which can only be used to settle obligations of a consolidated VIE and liabilities for which creditors do not have recourse to the general credit of the primary beneficiary.

SFAS 167 is effective for interim and annual reporting in fiscal years beginning after November 15, 2009. Early adoption is prohibited. Management continues to review the impact of the changes in the consolidation guidance on the financial statements. This standard will increase disclosure requirements related to transactions with VIEs and may change the presentation of consolidated VIE’s assets and liabilities on KPCo’s balance sheets. KPCo will adopt SFAS 167 effective January 1, 2010. SFAS 167 is included in the “Consolidation” accounting guidance.

FSP SFAS 132R-1 “Employers’ Disclosures about Postretirement Benefit Plan Assets” (FSP SFAS 132R-1)

In December 2008, the FASB issued FSP SFAS 132R-1 providing additional disclosure guidance for pension and OPEB plan assets. The rule requires disclosure of investment policies including target allocations by investment class, investment goals, risk management policies and permitted or prohibited investments. It specifies a minimum of investment classes by further dividing equity and debt securities by issuer grouping. The standard adds disclosure requirements including hierarchical classes for fair value and concentration of risk.

This standard is effective for fiscal years ending after December 15, 2009. Management expects this standard to increase the disclosure requirements related to AEP’s benefit plans. KPCo will adopt the standard effective for the 2009 Annual Report. FSP SFAS 132R-1 is included in the “Compensation – Retirement Benefits” accounting guidance.

Future Accounting Changes

The FASB’s standard-setting process is ongoing and until new standards have been finalized and issued by the FASB, management cannot determine the impact on the reporting of operations and financial position that may result from any such future changes. The FASB is currently working on several projects including revenue recognition, contingencies, financial instruments, emission allowances, leases, insurance, hedge accounting, discontinued

operations and income tax. Management also expects to see more FASB projects as a result of its desire to converge International Accounting Standards with GAAP. The ultimate pronouncements resulting from these and future projects could have an impact on future net income and financial position.

3. RATE MATTERS

As discussed in KPCo's 2008 Annual Report, KPCo is involved in rate and regulatory proceedings at the FERC and the KPSC. The Rate Matters note within KPCo's 2008 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 2009 and updates KPCo's 2008 Annual Report.

Kentucky Storm Restoration Expenses

During 2009, KPCo experienced severe storms causing significant customer outages. In August 2009, KPCo filed a petition with the Kentucky Public Service Commission (KPSC) for an order seeking authorization to defer approximately \$10 million of incremental storm restoration expense for review and recovery in KPCo's next base rate proceeding. The requested deferral of the previously expensed \$10 million is in addition to the annual \$2 million of storm-related operation and maintenance expense included in KPCo's current base rates. Management is unable to predict the outcome of this petition. A decision is expected from the KPSC during the fourth quarter of 2009.

Validity of Nonstatutory Surcharges

In August 2007, the Franklin County Circuit Court concluded the KPSC did not have the authority to order a surcharge for a gas company subsidiary of Duke Energy absent a full cost of service rate proceeding due to the lack of statutory authority. The Kentucky Attorney General (AG) notified the KPSC that the Franklin County Circuit Court judge's order in the Duke Energy case can be interpreted to include other existing surcharges, rates or fees established outside of the context of a general rate case proceeding and not specifically authorized by statute, including fuel clauses. Both the KPSC and Duke Energy appealed the Franklin County Circuit Court decision.

Although this order is not directly applicable, KPCo has existing surcharges which are not specifically authorized by statute. These include KPCo's fuel clause surcharge, the annual Rockport Plant capacity surcharge, the merger surcredit and the off-system sales credit rider. On an annual basis, these surcharges recently ranged from revenues of approximately \$10 million to a reduction of revenues of \$2 million due to the volatility of these surcharges. The KPSC asked interested parties to brief the issue in KPCo's fuel cost proceeding. The AG responded that the KPCo fuel clause should be invalidated because the KPSC lacked the authority to implement a fuel clause for KPCo without a full rate case review. The KPSC issued an order stating that the KPSC has the authority to provide for surcharges and surcredits until the court of appeals rules otherwise.

In November 2008, the Kentucky Court of Appeals concluded that Duke Energy's surcharge was illegal. However, the order stated that the "decision was premised on the nature of the long-term capital improvements proposed by Duke Energy as distinguished from the fuel and other surcharges that are fluctuating and unanticipated. The latter have been approved by the Kentucky Supreme Court and remain the law." In February 2009, the Kentucky Court of Appeals denied the KPSC request for appeal of the Franklin County Circuit Court decision. In March 2009, the KPSC filed for a discretionary review of the related Duke Energy case with the Kentucky Supreme Court. Management believes that all of KPCo's variable rate mechanisms are valid and would be upheld if challenged.

FERC Rate Matters

Regional Transmission Rate Proceedings at the FERC

SECA Revenue Subject to Refund

Effective December 1, 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 31, 2006. Intervenors objected to the temporary SECA rates, raising various issues. As a result, the FERC set SECA rate issues for hearing

and ordered that the SECA rate revenues be collected, subject to refund. The AEP East companies paid SECA rates to other utilities at considerably lesser amounts than they collected. If a refund is ordered, the AEP East companies would also receive refunds related to the SECA rates they paid to third parties. The AEP East companies recognized gross SECA revenues of \$220 million from December 2004 through March 2006 when the SECA rates terminated leaving the AEP East companies and ultimately their internal load retail customers to make up the short fall in revenues. KPCo's portion of recognized gross SECA revenues was \$17 million.

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

In September 2006, AEP filed briefs jointly with other affected companies noting exceptions to the ALJ's initial decision and asking the FERC to reverse the decision in large part. Management believes, based on advice of legal counsel, that the FERC should reject the ALJ's initial decision because it contradicts prior related FERC decisions, which are presently subject to rehearing. Furthermore, management believes the ALJ's findings on key issues are largely without merit. AEP and SECA ratepayers are engaged in settlement discussions in an effort to settle the SECA issue. However, if the ALJ's initial decision is upheld in its entirety, it could result in a refund of a portion or all of the unsettled SECA revenues.

Based on anticipated settlements, the AEP East companies provided reserves for net refunds for current and future SECA settlements totaling \$39 million and \$5 million in 2006 and 2007, respectively, applicable to a total of \$220 million of SECA revenues. KPCo provided reserves of \$2.9 million and \$400 thousand in 2006 and 2007, respectively.

In February 2009, a settlement agreement was approved by the FERC resulting in the completion of a \$1 million settlement applicable to \$20 million of SECA revenue. Including this most recent settlement, AEP has completed settlements totaling \$10 million applicable to \$112 million of SECA revenues. The balance in the reserve for future settlements as of September 30, 2009 was \$34 million. KPCo's portion of the reserve balance at September 30, 2009 was \$2.6 million. As of September 30, 2009, there were no in-process settlements.

Management cannot predict the ultimate outcome of future settlement discussions or future FERC proceedings or court appeals, if any. However, if the FERC adopts the ALJ's decision and/or AEP cannot settle all of the remaining unsettled claims within the remaining amount reserved for refund, it will have an adverse effect on future net income and cash flows. Based on advice of external FERC counsel, recent settlement experience and the expectation that most of the unsettled SECA revenues will be settled, management believes that the available reserve of \$34 million is adequate to settle the remaining \$108 million of contested SECA revenues. If the remaining unsettled SECA claims are settled for considerably more than the to-date settlements or if the remaining unsettled claims cannot be settled and are awarded a refund by the FERC greater than the remaining reserve balance, it could have an adverse effect on net income. Cash flows will be adversely impacted by any additional settlements or ordered refunds.

The FERC PJM Regional Transmission Rate Proceeding

With the elimination of T&O rates, the expiration of SECA rates and after considerable administrative litigation at the FERC in which AEP sought to mitigate the effect of the T&O rate elimination, the FERC failed to implement a regional rate in PJM. As a result, the AEP East companies' retail customers incur the bulk of the cost of the existing AEP east transmission zone facilities even though other non-affiliated entities transmit power over AEP's lines. However, the FERC ruled that the cost of any new 500 kV and higher voltage transmission facilities built in PJM would be shared by all customers in the region. It is expected that most of the new 500 kV and higher voltage transmission facilities will be built in other zones of PJM, not AEP's zone. The AEP East companies will need to obtain state regulatory approvals for recovery of any costs of new facilities that are assigned to them by PJM. In February 2008, AEP filed a Petition for Review of the FERC orders in this case in the United States Court of Appeals. In August 2009, the United States Court of Appeals issued an opinion affirming FERC's refusal to implement a regional rate design in PJM.

The AEP East companies filed for and in 2006 obtained increases in their wholesale transmission rates to recover lost revenues previously applied to reduce those rates. The AEP East companies sought and received retail rate increases in Ohio, Virginia, West Virginia and Kentucky. In January and March 2009, the AEP East companies received retail rate increases in Tennessee and Indiana, respectively, which recognized the higher retail transmission costs resulting from the loss of wholesale transmission revenues from T&O transactions. As a result, the AEP East companies are now recovering approximately 98% of the lost T&O transmission revenues from their retail customers. The remaining 2% is being incurred by I&M until it can revise its rates in Michigan to recover the lost revenues.

The FERC PJM and MISO Regional Transmission Rate Proceeding

In the SECA proceedings, the FERC ordered the RTOs and transmission owners in the PJM/MISO region (the Super Region) to file, by August 1, 2007, a proposal to establish a permanent transmission rate design for the Super Region to be effective February 1, 2008. All of the transmission owners in PJM and MISO, with the exception of AEP and one MISO transmission owner, elected to support continuation of zonal rates in both RTOs. In September 2007, AEP filed a formal complaint proposing a highway/byway rate design be implemented for the Super Region where users pay based on their use of the transmission system. AEP argued the use of other PJM and MISO facilities by AEP is not as large as the use of the AEP East companies' transmission by others in PJM and MISO and, as a result, the use of zonal rates would be unfair and discriminatory to AEP's East zone retail customers. Therefore, a regional rate design change is required to recognize that the provision and use of transmission service in the Super Region is not sufficiently uniform between transmission owners and users to justify zonal rates. In January 2008, the FERC denied AEP's complaint. AEP filed a rehearing request with the FERC in March 2008. In December 2008, the FERC denied AEP's request for rehearing. In February 2009, AEP filed an appeal in the U.S. Court of Appeals. If the court appeal is successful, earnings could benefit for a certain period of time due to regulatory lag until the AEP East companies reduce future retail revenues in their next fuel or base rate proceedings to reflect the resultant additional wholesale transmission T&O revenues reduction of transmission cost to retail customers. This case is pending before the U.S. Court of Appeals which in August 2009 ruled against AEP in a similar case. See "The FERC PJM Regional Transmission Rate Proceeding" section above.

Allocation of Off-system Sales Margins

In August 2008, the OCC filed a complaint at the FERC alleging that AEP inappropriately allocated off-system sales margins between the AEP East companies and the AEP West companies and did not properly allocate off-system sales margins within the AEP West companies. The PUCT, the APSC and the Oklahoma Industrial Energy Consumers intervened in this filing. In November 2008, the FERC issued a final order concluding that AEP inappropriately deviated from off-system sales margin allocation methods in the SIA and the CSW Operating Agreement for the period June 2000 through March 2006. The FERC ordered AEP to recalculate and reallocate the off-system sales margins in compliance with the SIA and to have the AEP East companies issue refunds to the AEP West companies. Although the FERC determined that AEP deviated from the CSW Operating Agreement, the FERC determined the allocation methodology was reasonable. The FERC ordered AEP to submit a revised CSW Operating Agreement for the period June 2000 to March 2006. In December 2008, AEP filed a motion for rehearing and a revised CSW Operating Agreement for the period June 2000 to March 2006. The motion for rehearing is still pending. In January 2009, AEP filed a compliance filing with the FERC and refunded approximately \$250 million from the AEP East companies to the AEP West companies. Following authorized regulatory treatment, the AEP West companies shared a portion of SIA margins with their customers during the period June 2000 to March 2006. In December 2008, the AEP West companies recorded a provision for refund reflecting the sharing. Management cannot predict the outcome of the requested FERC rehearing proceeding or any future state regulatory proceedings but believes the AEP West companies' provision for refund regarding related future state regulatory proceedings is adequate.

Modification of the Transmission Agreement (TA)

APCo, CSPCo, I&M, KPCo and OPCo are parties to the TA entered into in 1984, as amended, that provides for a sharing of the cost of transmission lines operated at 138-kV and above and transmission stations operated at 345kV and above. In June 2009, AEPSC, on behalf of the parties to the TA, filed with the FERC a request to modify the TA. Under the proposed amendments, WPCo and KGPCo will be added as parties to the TA. In addition, the amendments would provide for the allocation of PJM transmission costs on the basis of the TA parties' 12-month coincident peak

and reimburse the majority of PJM transmission revenues based on individual cost of service instead of the MLR method used in the present TA. AEPSC requested the effective date to be the first day of the month following a final non-appealable FERC order. The delayed effective date was approved by the FERC in August 2009 when the FERC accepted the new TA for filing. Settlement discussions are in process. Management is unable to predict the effect, if any, it will have on future net income and cash flows due to timing of the implementation by various state regulators of the FERC's new approved TA.

PJM Transmission Formula Rate Filing

In July 2008, AEP filed an application with the FERC to increase its open access transmission tariff (OATT) rates for wholesale transmission service within PJM by \$63 million annually. The filing seeks to implement a formula rate allowing annual adjustments reflecting future changes in the AEP East companies' cost of service. In September 2008, the FERC issued an order conditionally accepting AEP's proposed formula rate, subject to a compliance filing, established a settlement proceeding with an ALJ and delayed the requested October 2008 effective date for five months. In October 2008, AEP filed the required compliance filing and began settlement discussions with the intervenors and FERC staff. The settlement discussions are currently ongoing.

The requested increase, which the AEP East companies began billing in April 2009 for service as of March 1, 2009, will produce a \$63 million annualized increase in revenues. Approximately \$8 million of the increase will be collected from nonaffiliated customers within PJM. The remaining \$55 million requested would be billed to the AEP East companies but would be offset by compensation from PJM for use of the AEP East companies' transmission facilities so that retail rates for jurisdictions other than Ohio are not directly affected.

In May 2009, the first annual update of the formula rate was filed with the FERC which reflected increased transmission service revenue requirements of approximately \$32 million on an annualized basis, effective for service as of July 1, 2009 to be billed in August 2009. Approximately \$4 million of the increase will be collected from nonaffiliated customers within PJM.

Under the formula, the second annual update will be filed effective July 1, 2010 and each year thereafter. Also, beginning with the July 1, 2010 update, the rates each year will include an adjustment to true-up the prior year's collections to the actual costs for the prior year. Management is unable to predict the outcome of the settlement discussions or any further proceedings that might be necessary if settlement discussions are not successful.

Transmission Agreement (TA)

Certain transmission facilities placed in service in 1998 in KPCo's service territory were inadvertently excluded from the AEP East companies' TA calculation. As a result, KPCo did not receive a TA credit for this equipment from the other TA member companies. The amount involved was \$7 million annually. It was not discovered until February 2009. KPCo's base electric rates were adjusted only once, in April 2006, during the period in which the error was in effect. Effective January 2009, the allocation was revised to give KPCo its full TA credit prospectively and the KPSC staff and attending intervenors were informed about the revision at a meeting in April 2009. Management does not believe that it is probable that a material retroactive rate adjustment will result.

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 the 2008 Annual Report should be read in conjunction with this report.

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. Prior to September 30, 2009, KPCo entered into sale agreements including indemnifications with a maximum exposure that was not significant. There are no material liabilities recorded for any indemnifications.

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

Master Lease Agreements

KPCo leases certain equipment under master lease agreements. GE Capital Commercial Inc. (GE) notified management in November 2008 that they elected to terminate the Master Leasing Agreements in accordance with the termination rights specified within the contract. In 2011, KPCo will be required to purchase all equipment under the lease and pay GE an amount equal to the unamortized value of all equipment then leased. In December 2008, management signed new master lease agreements with one-year commitment periods that include lease terms of up to 10 years. Management expects to enter into replacement leasing arrangements for the equipment affected by this notification prior to the termination date of 2011.

For equipment under the GE master lease agreements that expire prior to 2011, the lessor is guaranteed receipt of up to 87% of the unamortized balance of the equipment at the end of the lease term. If the fair market value of the leased equipment is below the unamortized balance at the end of the lease term, KPCo is committed to pay the difference between the fair market value and the unamortized balance, with the total guarantee not to exceed 87% of the unamortized balance. Under the new master lease agreements, the lessor is guaranteed receipt of up to 68% of the unamortized balance at the end of the lease term. If the actual fair market 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 actual fair market value and unamortized balance, with the total guarantee not to exceed 68% of the unamortized balance. At September 30, 2009, the maximum potential loss for these lease agreements was approximately \$251 thousand assuming the fair market value of the equipment is zero at the end of the lease term. Historically, at the end of the lease term the fair market value has been in excess of the unamortized balance.

CONTINGENCIES

Carbon Dioxide (CO₂) 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 CO₂ 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 dismissal of this lawsuit was appealed to the Second Circuit Court of Appeals. In April 2007, the U.S. Supreme Court issued a decision holding that the Federal EPA has authority to regulate emissions of CO₂ and other greenhouse gases (GHG) under the CAA. The Second Circuit requested supplemental briefs addressing the impact of the Supreme Court's decision on this case.

In September 2009, the Second Circuit Court issued a ruling vacating the dismissal and remanding the case 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 GHG 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 CO₂ emissions or that the Federal EPA could regulate CO₂ 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. Management believes the actions are without merit and intends to continue to defend against the claims including seeking further review by the Second Circuit and, if necessary, the United States Supreme Court.

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 GHG 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. AEP companies, including KPCo, were initially dismissed from this case without prejudice, but are named as a defendant in a pending fourth amended complaint.

Alaskan Villages' Claims

In February 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 CO₂ contribute to global warming and constitute a public and private nuisance and that the defendants are acting together. The complaint further alleges that some of the defendants, including AEP, conspired to create a false scientific debate about global warming in order to deceive the public and perpetuate the alleged nuisance. The plaintiffs also allege that the effects of global warming will require the relocation of the village at an alleged cost of \$95 million to \$400 million. In October 2009, the judge dismissed plaintiffs' federal common law claim for nuisance, finding the claim barred by the political question doctrine and by plaintiffs' lack of standing to bring the claim. The judge also dismissed plaintiffs' state law claims without prejudice to refile in state court.

FERC Long-term Contracts

In 2002, the FERC held a hearing related to a complaint filed by Nevada Power Company and Sierra Pacific Power Company (the Nevada utilities). The complaint sought to break long-term contracts entered during the 2000 and 2001 California energy price spike which the customers alleged were "high-priced." The complaint alleged that KPCo and other AEP subsidiaries sold power at unjust and unreasonable prices because the market for power was allegedly dysfunctional at the time such contracts were executed. In 2003, the FERC rejected the complaint. In 2006, the U.S. Court of Appeals for the Ninth Circuit reversed the FERC order and remanded the case to the FERC for further proceedings. That decision was appealed to the U.S. Supreme Court. In June 2008, the U.S. Supreme Court affirmed the validity of contractually-agreed rates except in cases of serious harm to the public. The U.S. Supreme Court affirmed the Ninth Circuit's remand on two issues, market manipulation and excessive burden on consumers. The FERC initiated remand procedures and gave the parties time to attempt to settle the issues. Management recorded a provision in 2008. In September 2009, the parties reached a settlement and a portion of the provision was reversed.

5. BENEFIT PLANS

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

Components of Net Periodic Benefit Cost

The following tables provide the components of AEP's net periodic benefit cost for the plans for the three and nine months ended September 30, 2009 and 2008:

	Pension Plans		Other Postretirement Benefit Plans	
	Three Months Ended September 30,		Three Months Ended September 30,	
	2009	2008	2009	2008
	(in millions)			
Service Cost	\$ 26	\$ 25	\$ 11	\$ 10
Interest Cost	64	62	27	28
Expected Return on Plan Assets	(80)	(84)	(21)	(27)
Amortization of Transition Obligation	-	-	7	7
Amortization of Net Actuarial Loss	14	10	11	3
Net Periodic Benefit Cost	\$ 24	\$ 13	\$ 35	\$ 21

	Pension Plans		Other Postretirement Benefit Plans	
	Nine Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
	(in millions)			
Service Cost	\$ 78	\$ 75	\$ 32	\$ 31
Interest Cost	191	187	82	84
Expected Return on Plan Assets	(241)	(252)	(61)	(83)
Amortization of Transition Obligation	-	-	20	21
Amortization of Net Actuarial Loss	44	29	32	8
Net Periodic Benefit Cost	\$ 72	\$ 39	\$ 105	\$ 61

The following table provides KPCo's net periodic benefit cost for the plans for the three and nine months ended September 30, 2009 and 2008:

	Pension Plans		Other Postretirement Benefit Plans	
	2009		2008	
	(in thousands)			
Three Months Ended September 30,	\$ 555	\$ 249	\$ 808	\$ 417
Nine Months Ended September 30,	1,664	747	2,424	1,218

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 power producer and marketer of wholesale electricity, coal and emission allowances. These risks include commodity price risk, interest rate risk and credit risk. These risks represent the risk of loss that may impact KPCo due to changes in the underlying market prices or rates. AEPSC, on behalf of KPCo, manages these risks using derivative instruments.

Strategies for Utilization of Derivative Instruments to Achieve Objectives

The strategy surrounding the use of derivative instruments focuses on managing risk exposures, future cash flows and creating value based on open trading positions by 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 electricity, coal, natural gas, interest rate and to a lesser degree heating oil, 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. The amount of risk taken is determined by the Commercial Operations and Finance groups in accordance with the established risk management policies as approved by the Finance Committee of AEP’s Board of Directors.

The following table represents the gross notional volume of KPCo’s outstanding derivative contracts as of September 30, 2009:

**Notional Volume of Derivative Instruments
September 30, 2009**

<u>Primary Risk Exposure</u>	<u>Volume</u> (in thousands)	<u>Unit of Measure</u>
Commodity:		
Power	34,748	MWHs
Coal	3,184	Tons
Natural Gas	5,009	MMBtus
Heating Oil and Gasoline	693	Gallons
Interest Rate	\$ 4,240	USD

Fair Value Hedging Strategies

At certain times, AEPSC, on behalf of KPCo, enters into interest rate derivative transactions in order to manage existing fixed interest rate risk exposure. These 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. During 2009 and 2008, this strategy was not actively employed.

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 electricity, coal and natural gas (“Commodity”) in order to manage the variable price risk related to the forecasted purchase and sale of these commodities. KPCo 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. During 2009 and 2008, KPCo designated cash flow hedging relationships using these commodities.

KPCo’s vehicle fleet is exposed to gasoline and diesel fuel price volatility. AEPSC, on behalf of KPCo, enters into financial gasoline and heating oil derivative contracts in order mitigate price risk of future fuel purchases. KPCo does not hedge all fuel price risk. During 2009, KPCo designated cash flow hedging strategies of forecasted fuel purchases. This strategy was not active for KPCo during 2008. For disclosure purposes, these contracts are included with other hedging activity as “Commodity.”

AEPSC, on behalf of KPCo, enters into a variety of interest rate derivative transactions in order to manage interest rate risk exposure. KPCo 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. During 2009 and 2008, KPCo did not have any active interest rate cash flow hedge strategies.

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 in 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 September 30, 2009 and December 31, 2008 balance sheets, KPCo netted \$2 million and \$468 thousand of cash collateral received from third parties against short-term and long-term risk management assets, respectively, and \$6.6 million and \$1.2 million of cash collateral paid to third parties against short-term and long-term risk management liabilities, respectively.

The following table represents the gross fair value impact of KPCo's derivative activity on the Condensed Balance Sheet as of September 30, 2009.

Fair Value of Derivative Instruments
September 30, 2009
(in thousands)

<u>Balance Sheet Location</u>	Risk Management Contracts		Hedging Contracts		Total
	Commodity	Commodity	Interest Rate	Other (a) (b)	
	(a)	(a)	(a)		
Current Risk Management Assets	\$ 98,668	\$ 1,069	\$ -	\$ (82,580)	\$ 17,157
Long-term Risk Management Assets	41,260	263	-	(29,830)	11,693
Total Assets	139,928	1,332	-	(112,410)	28,850
Current Risk Management Liabilities	90,656	977	-	(85,259)	6,374
Long-term Risk Management Liabilities	37,578	351	-	(33,140)	4,789
Total Liabilities	128,234	1,328	-	(118,399)	11,163
Total MTM Derivative Contract Net Assets (Liabilities)	\$ 11,694	\$ 4	\$ -	\$ 5,989	\$ 17,687

- (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 represent counterparty netting of risk management contracts, associated cash collateral in accordance with the accounting guidance for "Derivatives and Hedging" and dedesignated risk management contracts.

The table below presents KPCo's activity of derivative risk management contracts for the three and nine months ended September 30, 2009:

Amount of Gain (Loss) Recognized on Risk Management Contracts

<u>Location of Gain (Loss)</u>	<u>Three Months Ended September 30, 2009</u>	<u>Nine Months Ended September 30, 2009</u>
	(in thousands)	
Electric Generation, Transmission and Distribution Revenues	\$ 4,210	\$ 15,985
Sales to AEP Affiliates	(96)	(1,869)
Regulatory Assets	-	-
Regulatory Liabilities	1,229	1,848
Total Gain on Risk Management Contracts	\$ 5,343	\$ 15,964

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, KPCo 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. 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. 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. Unrealized and 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), KPCo recognizes 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 in Net Income during the period of change.

KPCo records realized gains or losses on interest rate swaps that qualify for fair value hedge accounting treatment and any offsetting changes in the fair value of the debt being hedged, in Interest Expense on KPCo's Condensed Statements of Income. During the three and nine months ended September 30, 2009 and 2008, this strategy was not actively employed.

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 transactions for the purchase and sale of electricity, coal and natural gas designated as cash flow hedges are included in Revenues, Fuel and Other Consumables Used for Electric Generation or Purchased Electricity for Resale on KPCo's Condensed Statements of Income, or Regulatory Assets or Regulatory Liabilities in KPCo's Condensed Balance Sheet, depending on the specific nature of the risk being hedged. KPCo does not hedge all variable price risk exposure related to commodities. During the three and nine months ended September 30, 2009 and 2008, KPCo recognized immaterial amounts of hedge ineffectiveness.

Beginning in 2009, AEPSC on behalf of KPCo, executed financial heating oil and gasoline derivative contracts to hedge the price risk of its diesel fuel and gasoline purchased. KPCo reclassifies gains and losses on financial fuel derivative contracts designated as cash flow hedges from Accumulated Other Comprehensive Income (Loss) on the Condensed Balance Sheets into Other Operation and Maintenance Expense or Depreciation and Amortization Expense, as it relates to capital projects, on the Condensed Statements of Income. KPCo does not hedge all fuel price exposure. During the three and nine months ended September 30, 2009, KPCo recognized no hedge ineffectiveness related to this hedge strategy.

KPCo reclassifies gains and losses on interest rate derivative hedges related to debt financing from Accumulated Other Comprehensive Income (Loss) into Interest Expense in those periods in which hedged interest payments occur. During the three and nine months ended September 30, 2009 and 2008, this strategy was not actively employed.

The following tables provide details on designated, effective cash flow hedges included in AOCI on KPCo's Condensed Balance Sheets and the reasons for changes in cash flow hedges for the three and nine months ended September 30, 2009. All amounts in the following table are presented net of related income taxes.

Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges
For the Three Months Ended September 30, 2009
(in thousands)

	<u>Commodity</u>	<u>Interest Rate</u>	<u>Total</u>
Beginning Balance in AOCI as of July 1, 2009	\$ 478	\$ (493)	\$ (15)
Changes in Fair Value Recognized in AOCI	(98)	-	(98)
Amount of (Gain) or Loss Reclassified from AOCI to Income Statement/within Balance Sheets:			
Electric Generation, Transmission and Distribution Revenues	(691)	-	(691)
Fuel and Other Consumables Used for Electric Generation	(9)	-	(9)
Purchased Electricity for Resale	425	-	425
Interest Expense	-	15	15
Property, Plant and Equipment	(5)	-	(5)
Ending Balance in AOCI as of September 30, 2009	<u>\$ 100</u>	<u>\$ (478)</u>	<u>\$ (378)</u>

Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges
For the Nine Months Ended September 30, 2009
(in thousands)

	<u>Commodity</u>	<u>Interest Rate</u>	<u>Total</u>
Beginning Balance in AOCI as of January 1, 2009	\$ 584	\$ (525)	\$ 59
Changes in Fair Value Recognized in AOCI	(84)	-	(84)
Amount of (Gain) or Loss Reclassified from AOCI to Income Statement/within Balance Sheets:			
Electric Generation, Transmission and Distribution Revenues	(1,364)	-	(1,364)
Fuel and Other Consumables Used for Electric Generation	(10)	-	(10)
Purchased Electricity for Resale	980	-	980
Interest Expense	-	47	47
Property, Plant and Equipment	(6)	-	(6)
Ending Balance in AOCI as of September 30, 2009	<u>\$ 100</u>	<u>\$ (478)</u>	<u>\$ (378)</u>

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on KPCo's Condensed Balance Sheet at September 30, 2009 were:

**Impact of Cash Flow Hedges on the Condensed Balance Sheet
September 30, 2009**

	<u>Commodity</u>	<u>Interest Rate</u>	<u>Total</u>
	(in thousands)		
Hedging Assets (a)	\$ 688	\$ -	\$ 688
Hedging Liabilities (a)	(684)	-	(684)
AOCI Gain (Loss) Net of Tax	100	(478)	(378)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	157	(60)	97

(a) Hedging Assets and Hedging Liabilities are included in Risk Management Assets and Liabilities on KPCo's Condensed Balance Sheet.

The actual amounts that KPCo reclassifies from Accumulated Other Comprehensive Income (Loss) to Net Income can differ from the estimate above due to market price changes. As of September 30, 2009, 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 17 months.

Credit Risk

Management 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. KPCo uses Moody's, S&P and current market-based qualitative and quantitative data to assess the financial health of counterparties on an ongoing basis. If an external rating is not available, an internal rating is generated utilizing a quantitative tool developed by Moody's to estimate probability of default that corresponds to an implied external agency credit rating.

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 a limited number of derivative and non-derivative counterparty contracts primarily related to pre-2002 risk management activities and under the tariffs of the RTOs and Independent System Operators (ISOs), KPCo is obligated to post an 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, the risk management organization assesses the appropriateness of these collateral triggering items in contracts. Management believes that a downgrade below investment grade is unlikely. As of September 30, 2009, the aggregate value of such contracts was \$1.9 million and KPCo was not required to post any collateral. KPCo would have been required to post \$1.9 million of collateral at September 30, 2009 if certain credit ratings had declined below investment grade of which \$1.8 million was attributable to RTO and ISO activities.

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 non-performance event under borrowed debt in excess of \$50 million. On an ongoing basis, AEPSC's risk management organization assesses the appropriateness of these cross-default provisions in the contracts. As of September 30, 2009, the fair value of these derivative liabilities subject to

cross-default provisions totaled \$48.5 million prior to consideration of contractual netting arrangements. This exposure has been reduced by cash collateral posted of \$668 thousand. Management believes that a non-performance event under these provisions is unlikely. If a cross-default provision would have been triggered, an additional settlement of \$8.8 million would be required after considering KPCo's contractual netting arrangements.

8. FAIR VALUE MEASUREMENTS

With the adoption of new accounting guidance, KPCo is required to provide certain fair value disclosures which were previously only required in the annual report. The new accounting guidance did not change the method to calculate the amounts reported on KPCo's Condensed Balance Sheets.

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 at September 30, 2009 and December 31, 2008 are summarized in the following table:

	<u>September 30, 2009</u>		<u>December 31, 2008</u>	
	<u>Book Value</u>	<u>Fair Value</u>	<u>Book Value</u>	<u>Fair Value</u>
	(in thousands)			
Long-term Debt	\$ 548,680	\$ 598,314	\$ 418,555	\$ 366,108

Fair Value Measurements of Financial Assets and Liabilities

As described in KPCo's 2008 Annual Report, 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). The Derivatives, Hedging and Fair Value Measurements note within KPCo's 2008 Annual Report should be read in conjunction with this report.

Exchange traded derivatives, namely futures contracts, are generally fair valued based on unadjusted quoted prices in active markets and are classified within 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. Where observable inputs are available for substantially the full term of the asset or liability, the instrument is categorized in Level 2. Certain OTC and bilaterally executed derivative instruments are executed in less active markets with a lower availability of pricing information. In addition, 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 in Level 3. Valuation models utilize various inputs 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 following tables set forth by level within the fair value hierarchy KPCo's financial assets and liabilities that were accounted for at fair value on a recurring basis as of September 30, 2009 and December 31, 2008. 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 as of September 30, 2009

Assets:	Level 1	Level 2	Level 3	Other	Total
	(in thousands)				
Risk Management Assets					
Risk Management Contracts (a)	\$ 1,133	\$ 132,426	\$ 5,556	\$ (112,977)	\$ 26,138
Cash Flow and Fair Value Hedges (a)	-	1,326	-	(638)	688
Dedesignated Risk Management Contracts (b)	-	-	-	2,024	2,024
Total Risk Management Assets	\$ 1,133	\$ 133,752	\$ 5,556	\$ (111,591)	\$ 28,850

Liabilities:

Risk Management Liabilities					
Risk Management Contracts (a)	\$ 1,232	\$ 125,398	\$ 790	\$ (117,639)	\$ 9,781
Cash Flow and Fair Value Hedges (a)	-	1,322	-	(638)	684
DETM Assignment (c)	-	-	-	698	698
Total Risk Management Liabilities	\$ 1,232	\$ 126,720	\$ 790	\$ (117,579)	\$ 11,163

Assets and Liabilities Measured at Fair Value on a Recurring Basis as of December 31, 2008

Assets:	Level 1	Level 2	Level 3	Other	Total
	(in thousands)				
Risk Management Assets					
Risk Management Contracts (a)	\$ 3,443	\$ 140,387	\$ 2,561	\$ (125,636)	\$ 20,755
Cash Flow and Fair Value Hedges (a)	-	1,418	-	(302)	1,116
Dedesignated Risk Management Contracts (b)	-	-	-	2,749	2,749
Total Risk Management Assets	\$ 3,443	\$ 141,805	\$ 2,561	\$ (123,189)	\$ 24,620

Liabilities:

Risk Management Liabilities					
Risk Management Contracts (a)	\$ 4,021	\$ 132,087	\$ 848	\$ (126,370)	\$ 10,586
Cash Flow and Fair Value Hedges (a)	-	544	-	(302)	242
DETM Assignment (c)	-	-	-	1,118	1,118
Total Risk Management Liabilities	\$ 4,021	\$ 132,631	\$ 848	\$ (125,554)	\$ 11,946

- (a) Amounts in "Other" column primarily represent counterparty netting of risk management contracts and associated cash collateral under the accounting guidance for "Derivatives and Hedging."
- (b) "Dedesignated Risk Management Contracts" are 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 will be amortized into revenues over the remaining life of the contract.
- (c) See "Natural Gas Contracts with DETM" section of Note 12 in KPCo's 2008 Annual Report.

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

Three Months Ended September 30, 2009	Net Risk Management Assets (Liabilities) (in thousands)
Balance as of July 1, 2009	\$ 2,801
Realized (Gain) Loss Included in Net Income (or Changes in Net Assets) (a)	(557)
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	-
Transfers in and/or out of Level 3 (b)	468
Changes in Fair Value Allocated to Regulated Jurisdictions (c)	2,054
Balance as of September 30, 2009	<u>\$ 4,766</u>

Nine Months Ended September 30, 2009	Net Risk Management Assets (Liabilities) (in thousands)
Balance as of January 1, 2009	\$ 1,713
Realized (Gain) Loss Included in Net Income (or Changes in Net Assets) (a)	(1,379)
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	-
Transfers in and/or out of Level 3 (b)	(70)
Changes in Fair Value Allocated to Regulated Jurisdictions (c)	4,502
Balance as of September 30, 2009	<u>\$ 4,766</u>

Three Months Ended September 30, 2008	Net Risk Management Assets (Liabilities) (in thousands)
Balance as of July 1, 2008	\$ (3,970)
Realized (Gain) Loss Included in Net Income (or Changes in Net Assets) (a)	956
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	-
Transfers in and/or out of Level 3 (b)	1,196
Changes in Fair Value Allocated to Regulated Jurisdictions (c)	831
Balance as of September 30, 2008	<u>\$ (987)</u>

Nine Months Ended September 30, 2008	Net Risk Management Assets (Liabilities) (in thousands)
Balance as of January 1, 2008	\$ (157)
Realized (Gain) Loss Included in Net Income (or Changes in Net Assets) (a)	79
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	-
Transfers in and/or out of Level 3 (b)	(146)
Changes in Fair Value Allocated to Regulated Jurisdictions (c)	(763)
Balance as of September 30, 2008	\$ (987)

- (a) Included in revenues on KPCo's Condensed Statements of Income.
- (b) "Transfers in and/or out of Level 3" represent existing assets or liabilities that were either previously categorized as a higher level for which the inputs to the model became unobservable or assets and liabilities that were previously classified as Level 3 for which the lowest significant input became observable during the period.
- (c) "Changes in Fair Value Allocated to Regulated Jurisdictions" 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.

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 2000. 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. The years 2007 and 2008 are currently under examination. Although the outcome of tax audits is uncertain, in management's opinion, adequate provisions for 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, along with other AEP subsidiaries, files 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 KPCo and other AEP subsidiaries have filed tax returns with positions that may be challenged by these tax authorities. However, management does not believe that the ultimate resolution of these audits will 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.

KPCo is changing the tax method of accounting for the definition of a unit of property for generation assets. This change will provide a favorable cash flow benefit to KPCo in 2009 and 2010.

Federal Tax Legislation

The American Recovery and Reinvestment Act of 2009 was signed into law by the President in February 2009. It provided for several new grant programs and expanded tax credits and an extension of the 50% bonus depreciation provision enacted in the Economic Stimulus Act of 2008. The enacted provisions are not expected to have a material impact on net income or financial condition. However, management forecasts the bonus depreciation provision could provide a significant favorable cash flow benefit in 2009.

10. FINANCING ACTIVITIES

Long-term Debt

Long-term debt issued during the first nine months of 2009 were:

<u>Type of Debt</u>	<u>Principal Amount</u> (in thousands)	<u>Interest Rate</u>	<u>Due Date</u>
Senior Unsecured Notes	\$ 40,000	7.25%	2021
Senior Unsecured Notes	30,000	8.03%	2029
Senior Unsecured Notes	60,000	8.13%	2039

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 (borrowings) to/from the Utility Money Pool as of September 30, 2009 and December 31, 2008 are included in Advances to/from Affiliates on KPCo's balance sheets. KPCo's Utility Money Pool activity and corresponding authorized borrowing limits for the nine months ended September 30, 2009 are described in the following table:

<u>Maximum Borrowings from Utility Money Pool</u>	<u>Maximum Loans to Utility Money Pool</u>	<u>Average Borrowings from Utility Money Pool</u>	<u>Average Loans to Utility Money Pool</u>	<u>Loans to Utility Money Pool as of September 30, 2009</u>	<u>Authorized Short-Term Borrowing Limit</u>
(in thousands)					
\$ 174,108	\$ 18,403	\$ 122,132	\$ 8,493	\$ 4,197	\$ 250,000

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool for the nine months ended September 30, 2009 and 2008 are summarized in the following table:

	<u>Maximum Interest Rates for Funds Borrowed from the Utility Money Pool</u>	<u>Minimum Interest Rates for Funds Borrowed from the Utility Money Pool</u>	<u>Maximum Interest Rates for Funds Loaned to the Utility Money Pool</u>	<u>Minimum Interest Rates for Funds Loaned to the Utility Money Pool</u>	<u>Average Interest Rate for Funds Borrowed from the Utility Money Pool</u>	<u>Average Interest Rate for Funds Loaned to the Utility Money Pool</u>
2009	2.28%	0.27%	0.63%	0.28%	1.33%	0.50%
2008	5.37%	2.91%	-	-	3.24%	-

Credit Facilities

KPCo and certain other companies in the AEP System have a \$627 million 3-year credit agreement. Under the facility, letters of credit may be issued. As of September 30, 2009, there were no outstanding amounts for KPCo under this credit facility. KPCo and certain other companies in the AEP System had a \$350 million 364-day credit agreement that expired in April 2009.

Sales of Receivables

AEP Credit has a sale of receivables agreement with banks and commercial paper conduits. Under the sale of receivables agreement, AEP Credit sells an interest in the receivables it acquires from affiliated utility subsidiaries to the commercial paper conduits and banks and receives cash.

In July 2009, AEP Credit renewed and increased its sale of receivables agreement. The sale of receivables agreement provides a commitment of \$750 million from bank conduits to purchase receivables. This agreement will expire in July 2010. The previous sale of receivables agreement provided a commitment of \$700 million.