

# Kentucky Power Company

2018 First Quarter Report

Financial Statements



An **AEP** Company

---

BOUNDLESS ENERGY<sup>SM</sup>



## TABLE OF CONTENTS

---

## Page Number

---

Glossary of Terms	1
Condensed Statements of Income – Unaudited	3
Condensed Statements of Comprehensive Income (Loss) – Unaudited	4
Condensed Statements of Changes in Common Shareholder’s Equity – Unaudited	5
Condensed Balance Sheets – Unaudited	6
Condensed Statements of Cash Flows – Unaudited	8
Index of Condensed Notes to Condensed Financial Statements – Unaudited	9

**- THIS PAGE INTENTIONALLY LEFT BLANK -**

## 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	American Electric Power Company, Inc., an investor-owned electric public utility holding company which includes American Electric Power Company, Inc. (Parent) and majority owned consolidated subsidiaries and consolidated affiliates.
AEP Credit	AEP Credit, Inc., a consolidated variable interest entity of AEP which securitizes accounts receivable and accrued utility revenues for affiliated electric utility companies.
AEP East Companies	APCo, I&M, KPCo and OPCo.
AEP System	American Electric Power System, an electric system, owned and operated by AEP subsidiaries.
AEPSC	American Electric Power Service Corporation, an AEP service subsidiary providing management and professional services to AEP and its subsidiaries.
AFUDC	Allowance for Funds Used During Construction.
AGR	AEP Generation Resources Inc., a competitive AEP subsidiary that acquired the generation assets and liabilities of OPCo.
AOCI	Accumulated Other Comprehensive Income.
APCo	Appalachian Power Company, an AEP electric utility subsidiary.
ASU	Accounting Standards Update.
CWIP	Construction Work in Progress.
EIS	Energy Insurance Services, Inc., a nonaffiliated captive insurance company and consolidated variable interest entity of AEP.
ESP	Electric Security Plans, a PUCO requirement for electric utilities to adjust their rates by filing with the PUCO.
FAC	Fuel Adjustment Clause.
FASB	Financial Accounting Standards Board.
Federal EPA	United States Environmental Protection Agency.
FERC	Federal Energy Regulatory Commission.
FGD	Flue Gas Desulfurization or scrubbers.
FTR	Financial Transmission Right, a financial instrument that entitles the holder to receive compensation for certain congestion-related transmission charges that arise when the power grid is congested resulting in differences in locational prices.
GAAP	Accounting Principles Generally Accepted in the United States of America.
I&M	Indiana Michigan Power Company, an AEP electric utility subsidiary.
Interconnection Agreement	An agreement by and among APCo, I&M, KPCo, and OPCo which defined the sharing of costs and benefits associated with their respective generation plants. This agreement was terminated January 1, 2014.
IRS	Internal Revenue Service.
KPCo	Kentucky Power Company, an AEP electric utility subsidiary.
KPSC	Kentucky Public Service Commission.
MISO	Midwest Independent Transmission System Operator.
MLR	Member load ratio, the method used to allocate transactions among members of the Interconnection Agreement.
MMBtu	Million British Thermal Units.
MTM	Mark-to-Market.
MW	Megawatt.
MWh	Megawatthour.
NO <sub>x</sub>	Nitrogen oxide.
OATT	Open Access Transmission Tariff.
OPCo	Ohio Power Company, an AEP electric utility subsidiary.
OPEB	Other Postretirement Benefit Plans.

Operating Agreement	Agreement, dated January 1, 1997, as amended, by and among PCO and SWEPCo governing generating capacity allocation, energy pricing, and revenues and costs of third party sales. AEPSC acts as the agent.
OTC	Over the counter.
Parent	American Electric Power Company, Inc., the equity owner of AEP subsidiaries within the AEP consolidation.
PCA	Power Coordination Agreement among APCo, I&M, KPCo and WPCo.
PJM	Pennsylvania - New Jersey - Maryland regional transmissions organization.
PSO	Public Service Company of Oklahoma, an AEP electric utility subsidiary.
PUCO	Public Utilities Commission of Ohio.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
Rockport Plant	A generation plant, consisting of two 1,310 MW coal-fired generating units near Rockport, Indiana. AEGCo and I&M jointly-own Unit 1. In 1989, AEGCo and I&M entered into a sale-and-leaseback transaction with Wilmington Trust Company, an unrelated, unconsolidated trustee for Rockport Plant, Unit 2.
RTO	Regional Transmission Organization, responsible for moving electricity over large interstate areas.
SIA	System Integration Agreement, effective June 15, 2000, as amended, provides contractual basis for coordinated planning, operation and maintenance of the power supply sources of the combined AEP.
SO <sub>2</sub>	Sulfur dioxide.
SPP	Southwest Power Pool regional transmission organization.
SSO	Standard service offer.
SWEPCo	Southwestern Electric Power Company, an AEP electric utility subsidiary.
Tax Reform	On December 22, 2017, President Trump signed into law legislation referred to as the “Tax Cuts and Jobs Act” (the TCJA). The TCJA includes significant changes to the Internal Revenue Code of 1986, including a reduction in the corporate federal income tax rate from 35% to 21% effective January 1, 2018.
Utility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain utility subsidiaries.
VIE	Variable Interest Entity.
WPCo	Wheeling Power Company, an AEP electric utility subsidiary.

**KENTUCKY POWER COMPANY**  
**CONDENSED STATEMENTS OF INCOME**  
**For the Three Months Ended March 31, 2018 and 2017**  
**(in thousands)**  
**(Unaudited)**

	<b>Three Months Ended March 31,</b>	
<b>REVENUES</b>	<b>2018</b>	<b>2017</b>
Electric Generation, Transmission and Distribution	\$ 173,498	\$ 162,538
Sales to AEP Affiliates	3,238	3,251
Other Revenues	280	224
<b>TOTAL REVENUES</b>	<b>177,016</b>	<b>166,013</b>
<b>EXPENSES</b>		
Fuel and Other Consumables Used for Electric Generation	15,905	23,436
Purchased Electricity for Resale	19,361	14,415
Purchased Electricity from AEP Affiliates	26,313	23,104
Other Operation	26,952	28,158
Maintenance	17,704	20,312
Depreciation and Amortization	28,294	22,095
Taxes Other Than Income Taxes	6,072	5,735
<b>TOTAL EXPENSES</b>	<b>140,601</b>	<b>137,255</b>
<b>OPERATING INCOME</b>	<b>36,415</b>	<b>28,758</b>
<b>Other Income (Expense):</b>		
Interest Income	16	102
Carrying Costs Income	5	453
Allowance for Equity Funds Used During Construction	401	213
Non-Service Cost Components of Net Periodic Benefit Cost	1,013	405
Interest Expense	(9,374)	(11,469)
<b>INCOME BEFORE INCOME TAX EXPENSE</b>	<b>28,476</b>	<b>18,462</b>
Income Tax Expense	3,978	6,349
<b>NET INCOME</b>	<b>\$ 24,498</b>	<b>\$ 12,113</b>

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

*See Condensed Notes to Condensed Financial Statements beginning on page 9.*

**KENTUCKY POWER COMPANY**  
**CONDENSED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**  
**For the Three Months Ended March 31, 2018 and 2017**  
**(in thousands)**  
**(Unaudited)**

	<b>Three Months Ended March 31,</b>	
	<b>2018</b>	<b>2017</b>
Net Income	\$ 24,498	\$ 12,113
<b>OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAXES</b>		
Cash Flow Hedges, Net of Tax of \$0 and \$9 in 2018 and 2017, Respectively	—	16
Amortization of Pension and OPEB Deferred Costs, Net of Tax of \$(6) and \$4 in 2018 and 2017, Respectively	(22)	8
<b>TOTAL OTHER COMPREHENSIVE INCOME (LOSS)</b>	<b>(22)</b>	<b>24</b>
<b>TOTAL COMPREHENSIVE INCOME</b>	<b>\$ 24,476</b>	<b>\$ 12,137</b>

*See Condensed Notes to Condensed Financial Statements beginning on page 9.*



**KENTUCKY POWER COMPANY**  
**CONDENSED STATEMENTS OF CHANGES IN**  
**COMMON SHAREHOLDER'S EQUITY**  
**For the Three Months Ended March 31, 2018 and 2017**  
**(in thousands)**  
**(Unaudited)**

	<b>Common Stock</b>	<b>Paid-in Capital</b>	<b>Retained Earnings</b>	<b>Accumulated Other Comprehensive Income (Loss)</b>	<b>Total</b>
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2016</b>	\$ 50,450	\$ 526,135	\$ 93,170	\$ (1,354)	\$ 668,401
Common Stock Dividends			(8,750)		(8,750)
Net Income			12,113		12,113
Other Comprehensive Income				24	24
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – MARCH 31, 2017</b>	<u>\$ 50,450</u>	<u>\$ 526,135</u>	<u>\$ 96,533</u>	<u>\$ (1,330)</u>	<u>\$ 671,788</u>
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2017</b>	\$ 50,450	\$ 526,135	\$ 93,416	\$ 262	\$ 670,263
ASU 2018-02 Adoption			(56)	56	—
Net Income			24,498		24,498
Other Comprehensive Loss				(22)	(22)
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – MARCH 31, 2018</b>	<u>\$ 50,450</u>	<u>\$ 526,135</u>	<u>\$ 117,858</u>	<u>\$ 296</u>	<u>\$ 694,739</u>

*See Condensed Notes to Condensed Financial Statements beginning on page 9.*

**KENTUCKY POWER COMPANY**  
**CONDENSED BALANCE SHEETS**  
**ASSETS**  
**March 31, 2018 and December 31, 2017**  
**(in thousands)**  
**(Unaudited)**

	<b>March 31, 2018</b>	<b>December 31, 2017</b>
<b>CURRENT ASSETS</b>		
Cash and Cash Equivalents	\$ 324	\$ 909
Accounts Receivable:		
Customers	12,747	13,007
Affiliated Companies	24,340	32,019
Accrued Unbilled Revenues	8,678	6,667
Miscellaneous	69	179
Allowance for Uncollectible Accounts	(38)	(44)
Total Accounts Receivable	<u>45,796</u>	<u>51,828</u>
Fuel	20,896	18,006
Materials and Supplies	16,548	16,626
Risk Management Assets	940	1,851
Accrued Tax Benefits	5,460	6,909
Regulatory Asset for Under-Recovered Fuel Costs	5,649	82
Margin Deposits	5,957	2,880
Prepayments and Other Current Assets	6,745	12,975
<b>TOTAL CURRENT ASSETS</b>	<u>108,315</u>	<u>112,066</u>
<b>PROPERTY, PLANT AND EQUIPMENT</b>		
Electric:		
Generation	1,187,814	1,186,796
Transmission	580,733	579,144
Distribution	818,089	812,757
Other Property, Plant and Equipment	87,782	84,024
Construction Work in Progress	65,534	52,142
<b>Total Property, Plant and Equipment</b>	<u>2,739,952</u>	<u>2,714,863</u>
Accumulated Depreciation and Amortization	934,850	922,493
<b>TOTAL PROPERTY, PLANT AND EQUIPMENT – NET</b>	<u>1,805,102</u>	<u>1,792,370</u>
<b>OTHER NONCURRENT ASSETS</b>		
Regulatory Assets	357,788	353,568
Long-term Risk Management Assets	477	203
Employee Benefits and Pension Assets	22,457	21,720
Deferred Charges and Other Noncurrent Assets	22,027	25,966
<b>TOTAL OTHER NONCURRENT ASSETS</b>	<u>402,749</u>	<u>401,457</u>
<b>TOTAL ASSETS</b>	<u>\$ 2,316,166</u>	<u>\$ 2,305,893</u>

*See Condensed Notes to Condensed Financial Statements beginning on page 9.*

**KENTUCKY POWER COMPANY**  
**CONDENSED BALANCE SHEETS**  
**LIABILITIES AND COMMON SHAREHOLDER'S EQUITY**  
**March 31, 2018 and December 31, 2017**  
**(Unaudited)**

	<b>March 31, 2018</b>	<b>December 31, 2017</b>
<b>CURRENT LIABILITIES</b>	<b>(in thousands)</b>	
Advances from Affiliates	\$ 19,793	\$ 9,641
Accounts Payable:		
General	39,134	48,331
Affiliated Companies	26,948	34,944
Long-term Debt Due Within One Year – Nonaffiliated	75,000	75,000
Risk Management Liabilities	106	402
Customer Deposits	28,766	28,444
Accrued Taxes	20,082	24,785
Accrued Interest	6,777	7,848
Asset Retirement Obligations	21,884	19,735
Other Current Liabilities	20,876	24,634
<b>TOTAL CURRENT LIABILITIES</b>	<b>259,366</b>	<b>273,764</b>
<b>NONCURRENT LIABILITIES</b>		
Long-term Debt – Nonaffiliated	792,296	792,188
Long-term Risk Management Liabilities	70	36
Deferred Income Taxes	399,097	394,786
Regulatory Liabilities and Deferred Investment Tax Credits	131,677	130,162
Asset Retirement Obligations	24,139	31,503
Employee Benefits and Pension Obligations	6,366	6,932
Deferred Credits and Other Noncurrent Liabilities	8,416	6,259
<b>TOTAL NONCURRENT LIABILITIES</b>	<b>1,362,061</b>	<b>1,361,866</b>
<b>TOTAL LIABILITIES</b>	<b>1,621,427</b>	<b>1,635,630</b>
Rate Matters (Note 4)		
Commitments and Contingencies (Note 5)		
<b>COMMON SHAREHOLDER'S EQUITY</b>		
Common Stock – Par Value – \$50 Per Share:		
Authorized – 2,000,000 Shares		
Outstanding – 1,009,000 Shares	50,450	50,450
Paid-in Capital	526,135	526,135
Retained Earnings	117,858	93,416
Accumulated Other Comprehensive Income (Loss)	296	262
<b>TOTAL COMMON SHAREHOLDER'S EQUITY</b>	<b>694,739</b>	<b>670,263</b>
<b>TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY</b>	<b>\$ 2,316,166</b>	<b>\$ 2,305,893</b>

*See Condensed Notes to Condensed Financial Statements beginning on page 9.*

**KENTUCKY POWER COMPANY**  
**CONDENSED STATEMENTS OF CASH FLOWS**  
**For the Three Months Ended March 31, 2018 and 2017**  
**(in thousands)**  
**(Unaudited)**

	<b>Three Months Ended March 31,</b>	
	<b>2018</b>	<b>2017</b>
<b>OPERATING ACTIVITIES</b>		
<b>Net Income</b>	\$ 24,498	\$ 12,113
<b>Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:</b>		
Depreciation and Amortization	28,294	22,095
Deferred Income Taxes	2,299	5,842
Allowance for Equity Funds Used During Construction	(401)	(213)
Mark-to-Market of Risk Management Contracts	375	(268)
Property Taxes	3,753	3,777
Deferred Fuel Over/Under-Recovery, Net	(6,135)	(534)
Change in Other Noncurrent Assets	(14,331)	5,495
Change in Other Noncurrent Liabilities	1,695	(121)
<b>Changes in Certain Components of Working Capital:</b>		
Accounts Receivable, Net	6,032	10,146
Fuel, Materials and Supplies	(2,494)	233
Margin Deposits	(3,077)	2,537
Accounts Payable	(11,499)	(23,324)
Accrued Taxes, Net	(3,627)	(8,225)
Accrued Interest	(1,071)	(1,712)
Other Current Assets	6,250	(379)
Other Current Liabilities	(5,787)	(6,652)
<b>Net Cash Flows from Operating Activities</b>	<u>24,774</u>	<u>20,810</u>
<b>INVESTING ACTIVITIES</b>		
Construction Expenditures	(35,494)	(22,412)
Other Investing Activities	212	173
<b>Net Cash Flows Used for Investing Activities</b>	<u>(35,282)</u>	<u>(22,239)</u>
<b>FINANCING ACTIVITIES</b>		
Change in Advances from Affiliates, Net	10,152	10,365
Principal Payments for Capital Lease Obligations	(238)	(247)
Dividends Paid on Common Stock	—	(8,750)
Other Financing Activities	9	16
<b>Net Cash Flows from Financing Activities</b>	<u>9,923</u>	<u>1,384</u>
<b>Net Decrease in Cash and Cash Equivalents</b>	(585)	(45)
<b>Cash and Cash Equivalents at Beginning of Period</b>	909	859
<b>Cash and Cash Equivalents at End of Period</b>	<u>\$ 324</u>	<u>\$ 814</u>
<b>SUPPLEMENTARY INFORMATION</b>		
Cash Paid for Interest, Net of Capitalized Amounts	\$ 10,436	\$ 12,938
Net Cash Paid for Income Taxes	—	4
Noncash Acquisitions Under Capital Leases	10	109
Construction Expenditures Included in Current Liabilities as of March 31,	12,023	6,069

*See Condensed Notes to Condensed Financial Statements beginning on page 9.*

## INDEX OF CONDENSED NOTES TO CONDENSED FINANCIAL STATEMENTS

Note	Page Number
Significant Accounting Matters	10
New Accounting Pronouncements	11
Comprehensive Income	14
Rate Matters	15
Commitments, Guarantees and Contingencies	17
Benefit Plans	18
Derivatives and Hedging	19
Fair Value Measurements	24
Income Taxes	28
Financing Activities	30
Property, Plant and Equipment	32
Revenue From Contracts With Customers	33

## **1. SIGNIFICANT ACCOUNTING MATTERS**

### ***General***

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

In the opinion of management, the unaudited condensed interim financial statements reflect all normal and recurring accruals and adjustments necessary for a fair presentation of the net income, financial position and cash flows for the interim periods. Net income for the three months ended March 31, 2018 is not necessarily indicative of results that may be expected for the year ending December 31, 2018. The condensed financial statements are unaudited and should be read in conjunction with the audited 2017 financial statements and notes thereto, which are included in KPCo's 2017 Annual Report.

### ***Subsequent Events***

Management reviewed subsequent events through April 26, 2018, the date that the first quarter 2018 report was available to be issued.

## **2. NEW ACCOUNTING PRONOUNCEMENTS**

During FASB's standard-setting process and upon issuance of final pronouncements, management reviews the new accounting literature to determine its relevance, if any, to KPCo's business. The following pronouncements will impact the financial statements.

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

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

Management adopted ASU 2014-09 effective January 1, 2018, by means of the modified retrospective approach for all contracts. The adoption of ASU 2014-09 did not have a material impact on results of operations, financial position or cash flows. In that regard, the application of the new standard did not cause any significant differences in any individual financial statement line items had those line items been presented in accordance with the guidance that was in effect prior to the adoption of the new standard. Further, given the lack of material impact to the financial statements, the adoption of the new standard did not give rise to any material changes in KPCo's previously established accounting policies for revenue. See Note 12 - Revenue from Contracts with Customers for additional disclosures required by the new standard.

### ***ASU 2016-02 "Accounting for Leases" (ASU 2016-02)***

In February 2016, the FASB issued ASU 2016-02 increasing the transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheets and disclosing key information about leasing arrangements. Under the new standard, an entity must recognize an asset and liability for operating leases on the balance sheets. Additionally, a capital lease will be known as a finance lease going forward. Leases with lease terms of 12 months or longer will be subject to the new requirements. Fundamentally, the criteria used to determine lease classification will remain the same, but will be more subjective under the new standard.

The new accounting guidance is effective for annual periods beginning after December 15, 2019, with early adoption permitted. Initial decisions were made to apply the guidance by means of a modified retrospective approach. The modified retrospective approach will require lessees and lessors to recognize and measure leases at the beginning of the earliest period presented; however, the FASB is currently evaluating draft guidance which would provide an optional expedient to adopt the new lease requirements through a cumulative-effect adjustment in the period of adoption. Management continues to monitor these standard-setting activities that may impact the transition requirements of the lease standard.

During 2016 and 2017, lease contract assessments were completed. The AEP System lease population was identified and representative lease contracts were sampled. Based upon the completed assessments, management prepared a system gap analysis to outline new disclosure compliance requirements compared to current system capabilities. Multiple lease system options were also evaluated. Management plans to elect certain of the following practical expedients upon adoption:

<b>Practical Expedient</b>	<b>Description</b>
Overall Expedients (for leases commenced prior to adoption date and must be adopted as a package)	Do not need to reassess whether any expired or existing contracts are/or contain leases, do not need to reassess the lease classification for any expired or existing leases and do not need to reassess initial direct costs for any existing leases.
Lease and Non-lease Components (elect by class of underlying asset)	Elect as an accounting policy to not separate non-lease components from lease components and instead account for each lease and associated non-lease component as a single lease component.
Short-term Lease (elect by class of underlying asset)	Elect as an accounting policy to not apply the recognition requirements to short-term leases.
Lease term	Elect to use hindsight to determine the lease term.
Existing and expired land easements not previously accounted for as leases	Elect optional transition practical expedient to not evaluate under Topic 842 existing or expired land easements that were not previously accounted for as leases under the current leases guidance in Topic 840.

Evaluation of new lease contracts continues and the process of implementing a compliant lease system solution began in the third quarter of 2017. Management expects the new standard to impact financial position and, at this time, cannot estimate the impact. Management expects no impact to results of operations or cash flows.

Management continues to monitor industry implementation issues as well as FASB's ongoing standard-setting activities that may result in the issuance of additional targeted improvements to the new lease guidance. Management plans to adopt ASU 2016-02 effective January 1, 2019.

#### ***ASU 2016-13 "Measurement of Credit Losses on Financial Instruments" (ASU 2016-13)***

In June 2016, the FASB issued ASU 2016-13 requiring an allowance to be recorded for all expected credit losses for financial assets. The allowance for credit losses is based on historical information, current conditions and reasonable and supportable forecasts. The new standard also makes revisions to the other than temporary impairment model for available-for-sale debt securities. Disclosures of credit quality indicators in relation to the amortized cost of financing receivables are further disaggregated by year of origination.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2020, with early adoption permitted for interim and annual periods beginning after December 15, 2018. The amendments will be applied through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. Management is analyzing the impact of this new standard and, at this time, cannot estimate the impact of adoption on net income. Management plans to adopt ASU 2016-13 effective January 1, 2020.

#### ***ASU 2017-07 "Compensation - Retirement Benefits" (ASU 2017-07)***

In March 2017, the FASB issued ASU 2017-07 requiring that an employer report the service cost component of pension and postretirement benefits in the same line item or items as other compensation costs. The other components of net benefit cost are required to be presented on the statements of income separately from the service cost component and outside of a subtotal of income from operations. In addition, only the service cost component will be eligible for capitalization as applicable following labor.

Management adopted ASU 2017-07 effective January 1, 2018. Presentation of the non-service components on a separate line outside of operating income was applied on a retrospective basis, using the amounts disclosed in the benefit plan note for the estimation basis as a practical expedient. Capitalization of only the service cost component was applied on a prospective basis.

#### ***ASU 2017-12 "Derivatives and Hedging" (ASU 2017-12)***

In August 2017, the FASB issued ASU 2017-12 amending the recognition and presentation requirements for hedge accounting activities. The objectives are to improve the financial reporting of hedging relationships to better portray the economic results of an entity's risk management activities in its financial statements and reduce the complexity of applying hedge accounting. Under the new standard, the concept of recognizing hedge ineffectiveness within the statements of income for cash flow hedges, which has historically been immaterial to AEP, will be eliminated. In addition, certain required tabular disclosures relating to fair value and cash flow hedges will be modified.



The new accounting guidance is effective for interim and annual periods beginning after December 15, 2019, with early adoption permitted for any interim or annual period after August 2017. Management is analyzing the impact of this new standard, including the possibility of early adoption, and at this time, cannot estimate the impact of adoption on results of operations, financial position or cash flows.

***ASU 2018-02 “Reclassification of Certain Tax Effects from AOCI” (ASU 2018-02)***

In February 2018, the FASB issued ASU 2018-02 allowing a reclassification from AOCI to Retained Earnings for stranded tax effects resulting from Tax Reform. The accounting guidance for “Income Taxes” requires deferred tax assets and liabilities to be adjusted for the effect of a change in tax law or rates with the effect included in income from continuing operations in the reporting period that includes the enactment date of the tax change. This guidance is applicable for the tax effects of items in AOCI that were originally recognized in Other Comprehensive Income. As a result and absent the new guidance in this ASU, the tax effects of items within AOCI would not reflect the newly enacted corporate tax rate.

Management adopted ASU 2018-02 effective January 1, 2018, electing to reclassify the effects of the change in the federal corporate tax rate due to Tax Reform from AOCI to Retained Earnings. A portion of the reclassification was recorded to Regulatory Liabilities to adjust the tax effects of certain interest rate hedges in AEP's regulated jurisdictions that were previously deferred as a part of the accounting for Tax Reform. There were no other effects from Tax Reform that impacted AOCI. Management applied the new guidance at the beginning of the period of adoption. The adoption of the new standard did not have a material impact on the statement of financial position and did not impact results of operations or cash flows.

### 3. COMPREHENSIVE INCOME

#### *Presentation of Comprehensive Income*

The following tables provide the components of changes in AOCI and details of reclassifications from AOCI for the three months ended March 31, 2018 and 2017. The amortization of pension and OPEB AOCI components are included in the computation of net periodic pension and OPEB costs. See Note 6 for additional details.

#### **Changes in Accumulated Other Comprehensive Income (Loss) by Component For the Three Months Ended March 31, 2018**

	<b>Pension and OPEB</b>
	<b>(in thousands)</b>
<b>Balance in AOCI as of December 31, 2017</b>	\$ 262
Change in Fair Value Recognized in AOCI	—
Amount of (Gain) Loss Reclassified from AOCI	
Amortization of Prior Service Cost (Credit)	(56)
Amortization of Actuarial (Gains)/Losses	28
Reclassifications from AOCI, before Income Tax (Expense) Credit	(28)
Income Tax (Expense) Credit	(6)
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	(22)
Net Current Period Other Comprehensive Income (Loss)	(22)
ASU 2018-02 Adoption	56
<b>Balance in AOCI as of March 31, 2018</b>	<b>\$ 296</b>

(a) See Note 2 - New Accounting Pronouncements for additional information.

#### **Changes in Accumulated Other Comprehensive Income (Loss) by Component For the Three Months Ended March 31, 2017**

	<b>Cash Flow Hedge - Interest Rate</b>	<b>Pension and OPEB</b>	<b>Total</b>
	<b>(in thousands)</b>		
<b>Balance in AOCI as of December 31, 2016</b>	\$ (41)	\$ (1,313)	\$ (1,354)
Change in Fair Value Recognized in AOCI	—	—	—
Amount of (Gain) Loss Reclassified from AOCI			
Interest Expense	23	—	23
Amortization of Prior Service Cost (Credit)	—	(55)	(55)
Amortization of Actuarial (Gains)/Losses	—	67	67
Reclassifications from AOCI, before Income Tax (Expense) Credit	23	12	35
Income Tax (Expense) Credit	7	4	11
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	16	8	24
Net Current Period Other Comprehensive Income (Loss)	16	8	24
<b>Balance in AOCI as of March 31, 2017</b>	<b>\$ (25)</b>	<b>\$ (1,305)</b>	<b>\$ (1,330)</b>

#### 4. RATE MATTERS

As discussed in KPCo's 2017 Annual Report, KPCo is involved in rate and regulatory proceedings at the FERC and the KPSC. The Rate Matters note within KPCo's 2017 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 2018 and updates KPCo's 2017 Annual Report.

##### *Regulatory Assets Pending Final Regulatory Approval*

<b>Noncurrent Regulatory Assets</b>	<b>March 31, 2018</b>	<b>December 31, 2017</b>
	<b>(in thousands)</b>	
<u>Regulatory Assets Currently Earning a Return</u>		
Rockport Deferral	\$ 3,031	\$ —
<u>Regulatory Assets Currently Not Earning a Return</u>		
Big Sandy, Unit 1 Operating Rider	1,083	—
Other Regulatory Assets Pending Final Regulatory Approval	63	50
<b>Total Regulatory Assets Pending Final Regulatory Approval</b>	<u>\$ 4,177</u>	<u>\$ 50</u>

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

##### *2017 Kentucky Base Rate Case*

In January 2018, the KPSC issued an order approving a non-unanimous settlement agreement with certain modifications resulting in an annual revenue increase of \$12 million, effective January 2018, based on a 9.7% return on equity. The KPSC's primary revenue requirement modification to the settlement agreement was a \$14 million annual revenue reduction for the decrease in the corporate federal income tax rate due to Tax Reform. The KPSC approved: (a) the deferral of a total of \$50 million of Rockport Plant Unit Power Agreement expenses for the years 2018 through 2022, with the manner and timing of recovery of the deferral to be addressed in KPCo's next base rate case, (b) the recovery/return of 80% of certain annual PJM OATT expenses above/below the corresponding level recovered in base rates, (c) KPCo's commitment to not file a base rate case for three years with rates effective no earlier than 2021 and (d) increased depreciation expense based upon updated Big Sandy Plant, Unit 1 depreciation rates using a 20-year depreciable life.

In February 2018, KPCo filed with the KPSC for rehearing of the January 2018 base case order and requested an additional \$2.3 million of annual revenue increases related to: (a) the calculation of federal income tax expense, (b) recovery of purchased power costs associated with forced outages and (c) capital structure adjustments. Also in February 2018, an intervenor filed for rehearing recommending that the reduced corporate federal income tax rate be reflected in lower purchased power expense related to the Rockport UPA. In February 2018, the KPSC issued an order granting rehearing of these items, with exception of the capital structure adjustments, which was denied by the KPSC.

##### *PJM Transmission Rates*

In June 2016, PJM transmission owners, including KPCo and various state commissions filed a settlement agreement at the FERC to resolve outstanding issues related to cost responsibility for charges to transmission customers for certain transmission facilities that operate at or above 500 kV. In July 2016, certain parties filed comments at the FERC contesting the settlement agreement. Upon final FERC approval, PJM would implement a transmission enhancement charge adjustment through the PJM OATT, billable through 2025. Management expects that any refunds received would generally be returned to retail customers through existing state rider mechanisms.

### ***FERC Transmission Complaint - AEP's PJM Participants***

In October 2016, seven parties filed a complaint at the FERC that alleged the base return on common equity used by AEP's transmission owning subsidiaries within PJM, including KPCo, in calculating formula transmission rates under the PJM OATT is excessive and should be reduced from 10.99% to 8.32%, effective upon the date of the complaint. In November 2017, a FERC order set the matter for hearing and settlement procedures. In March 2018, AEP's transmission owning subsidiaries within PJM and six of the complainants filed a settlement agreement with the FERC (the seventh complainant abstained). If approved by the FERC the settlement agreement (a) establishes a base ROE for AEP's transmission owning subsidiaries within PJM of 9.85% (10.35% inclusive of the RTO incentive adder of 0.5%), effective January 1, 2018, (b) requires AEP's transmission owning subsidiaries within PJM to provide a one-time refund of \$50 million, attributable from the date of the complaint through December 31, 2017, to be credited to customer bills in the second quarter of 2018 and (c) increases the cap on the equity portion of the capital structure to 55% from 50%. As part of the settlement agreement, AEP's transmission owning subsidiaries within PJM also filed updated transmission formula rates incorporating the reduction in the corporate federal income tax rate due to Tax Reform, effective January 1, 2018 and providing for the amortization of the portion of the excess accumulated deferred income taxes that are not subject to the normalization method of accounting, ratably over a ten year period through credits to the federal income tax expense component of the revenue requirement. In April 2018, an ALJ accepted the interim settlement rates, pending the FERC's consideration of the settlement, and the rates are subject to refund or surcharge, with interest.

In April 2018, certain intervenors filed comments at the FERC recommending a base ROE of 8.48% and a one-time refund of \$184 million. In addition, the FERC trial staff filed comments recommending a base ROE of 8.41% and one-time refund of \$175 million. Also in April 2018, another intervenor recommended the refund be calculated in accordance with the base ROE that will ultimately be approved by the FERC. Management intends to file reply comments providing further support for the 9.85% base ROE agreed to in the settlement agreement.

Management believes the \$50 million refund in the settlement agreement is the best estimate of the probable liability. If the FERC orders revenue reductions in excess of the terms of the settlement agreement, it could reduce future net income and cash flows and impact financial condition. A decision from the FERC is pending.

### ***Modifications to AEP's PJM Transmission Rates***

In November 2016, AEP's transmission owning subsidiaries within PJM filed an application at the FERC to modify the PJM OATT formula transmission rate calculation, including an adjustment to recover a tax-related regulatory asset and a shift from historical to projected expenses. In March 2017, the FERC accepted the proposed modifications effective January 1, 2017, subject to refund, and set this matter for hearing and settlement procedures. The modified PJM OATT formula rates are based on projected calendar year financial activity and projected plant balances. In December 2017, AEP's transmission owning subsidiaries within PJM filed an uncontested settlement agreement with the FERC resolving all outstanding issues. In April 2018, the FERC approved the uncontested settlement agreement and rates were implemented effective January 1, 2018.

## **5. COMMITMENTS, GUARANTEES AND CONTINGENCIES**

KPCo is subject to certain claims and legal actions arising in its ordinary course of business. In addition, KPCo's business activities are subject to extensive governmental regulation related to public health and the environment. The ultimate outcome of such pending or potential litigation against KPCo cannot be predicted. Management accrues contingent liabilities only when management concludes that it is both probable that a liability has been incurred at the date of the financial statements and the amount of loss can be reasonably estimated. When management determines that it is not probable, but rather reasonably possible that a liability has been incurred at the date of the financial statements, management discloses such contingencies and the possible loss or range of loss if such estimate can be made. Any estimated range is based on currently available information and involves elements of judgment and significant uncertainties. Any estimated range of possible loss may not represent the maximum possible loss exposure. Circumstances change over time and actual results may vary significantly from estimates.

For current proceedings not specifically discussed below, management does not anticipate that the liabilities, if any, arising from such proceedings would have a material effect on the financial statements. The Commitments, Guarantees and Contingencies note within KPCo's 2017 Annual Report should be read in conjunction with this report.

### **GUARANTEES**

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

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

##### *Contracts*

KPCo enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. As of March 31, 2018, there were no material liabilities recorded for any indemnifications.

AEpsc conducts power purchase and sale activity on behalf of APCo, I&M, KPCo and WPCo, who are jointly and severally liable for activity conducted on their behalf.

##### *Master Lease Agreements*

KPCo leases certain equipment under master lease agreements. Under the lease agreements, the lessor is guaranteed a residual value up to a stated percentage of either the unamortized balance or the equipment cost at the end of the lease term. If the actual fair value of the leased equipment is below the guaranteed residual value at the end of the lease term, KPCo is committed to pay the difference between the actual fair value and the residual value guarantee. Historically, at the end of the lease term the fair value has been in excess of the unamortized balance. As of March 31, 2018, the maximum potential loss for these lease agreements was \$1.6 million assuming the fair value of the equipment is zero at the end of the lease term.

## 6. BENEFIT PLANS

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

### *Components of Net Periodic Benefit Cost*

The following table provides the components of KPCo's net periodic benefit cost (credit) for the plans:

	<b>Pension Plans</b>		<b>OPEB</b>	
	<b>Three Months Ended March 31, 2018</b>	<b>Three Months Ended March 31, 2017</b>	<b>Three Months Ended March 31, 2018</b>	<b>Three Months Ended March 31, 2017</b>
	<b>(in thousands)</b>			
Service Cost	\$ 703	\$ 729	\$ 82	\$ 83
Interest Cost	1,686	1,787	431	539
Expected Return on Plan Assets	(2,651)	(2,575)	(986)	(960)
Amortization of Prior Service Cost (Credit)	—	12	(606)	(606)
Amortization of Net Actuarial Loss	755	719	91	348
<b>Net Periodic Benefit Cost (Credit)</b>	<b>\$ 493</b>	<b>\$ 672</b>	<b>\$ (988)</b>	<b>\$ (596)</b>

## 7. DERIVATIVES AND HEDGING

### OBJECTIVES FOR UTILIZATION OF DERIVATIVE INSTRUMENTS

AEPSC is agent for and transacts on behalf of KPCo.

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

### STRATEGIES FOR UTILIZATION OF DERIVATIVE INSTRUMENTS TO ACHIEVE OBJECTIVES

#### *Risk Management Strategies*

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

KPCo utilizes power, capacity, natural gas, interest rate and, to a lesser extent, heating oil, gasoline and other commodity contracts to manage the risk associated with the energy business. KPCo utilizes interest rate derivative contracts in order to manage the interest rate exposure associated with its commodity portfolio. For disclosure purposes, such risks are grouped as “Commodity,” as these risks are related to energy risk management activities. KPCo also utilizes derivative contracts to manage 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 the Board of Directors.

The following table represents the gross notional volume of KPCo’s outstanding derivative contracts:

#### Notional Volume of Derivative Instruments

Primary Risk Exposure	Volume		Unit of Measure
	March 31, 2018	December 31, 2017	
	(in thousands)		
Commodity:			
Power	7,947	10,812	MWhs
Natural Gas	1,161	206	MMBtus
Heating Oil and Gasoline	224	52	Gallons

## *Cash Flow Hedging Strategies*

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

KPCo utilizes a variety of interest rate derivative transactions in order to manage interest rate risk exposure. KPCo also utilizes interest rate derivative contracts to manage interest rate exposure related to future borrowings of fixed-rate debt. KPCo does not hedge all interest rate exposure.

## **ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND THE IMPACT ON KPCo’s FINANCIAL STATEMENTS**

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

Credit risk is the risk that a counterparty will fail to perform on the contract or fail to pay amounts due. Liquidity risk represents the risk that imperfections in the market will cause the price to vary from estimated fair value based upon prevailing market supply and demand conditions. Since energy markets are imperfect and volatile, there are inherent risks related to the underlying assumptions in models used to fair value risk management contracts. Unforeseen events may cause reasonable price curves to differ from actual price curves throughout a contract’s term and at the time a contract settles. Consequently, there could be significant adverse or favorable effects on future net income and cash flows if market prices are not consistent with management’s estimates of current market consensus for forward prices in the current period. This is particularly true for longer term contracts. Cash flows may vary based on market conditions, margin requirements and the timing of settlement of 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 March 31, 2018 and December 31, 2017 balance sheets, KPCo netted \$42 thousand and \$379 thousand, respectively, of cash collateral received from third parties against short-term and long-term risk management assets and \$51 thousand and \$589 thousand, respectively, of cash collateral paid to third parties against short-term and long-term risk management liabilities.



The following tables represent the gross fair value of KPCo's derivative activity on the balance sheets:

**Fair Value of Derivative Instruments  
March 31, 2018**

<u>Balance Sheet Location</u>	<u>Risk Management Contracts – Commodity (a)</u>	<u>Gross Amounts Offset in the Statement of Financial Position (b)</u>	<u>Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)</u>
		(in thousands)	
Current Risk Management Assets	\$ 6,001	\$ (5,061)	\$ 940
Long-term Risk Management Assets	2,096	(1,619)	477
<b>Total Assets</b>	<u>8,097</u>	<u>(6,680)</u>	<u>1,417</u>
Current Risk Management Liabilities	5,153	(5,047)	106
Long-term Risk Management Liabilities	1,712	(1,642)	70
<b>Total Liabilities</b>	<u>6,865</u>	<u>(6,689)</u>	<u>176</u>
<b>Total MTM Derivative Contract Net Assets</b>	<u>\$ 1,232</u>	<u>\$ 9</u>	<u>\$ 1,241</u>

**Fair Value of Derivative Instruments  
December 31, 2017**

<u>Balance Sheet Location</u>	<u>Risk Management Contracts – Commodity (a)</u>	<u>Gross Amounts Offset in the Statement of Financial Position (b)</u>	<u>Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)</u>
		(in thousands)	
Current Risk Management Assets	\$ 12,043	\$ (10,192)	\$ 1,851
Long-term Risk Management Assets	469	(266)	203
<b>Total Assets</b>	<u>12,512</u>	<u>(10,458)</u>	<u>2,054</u>
Current Risk Management Liabilities	10,831	(10,429)	402
Long-term Risk Management Liabilities	275	(239)	36
<b>Total Liabilities</b>	<u>11,106</u>	<u>(10,668)</u>	<u>438</u>
<b>Total MTM Derivative Contract Net Assets</b>	<u>\$ 1,406</u>	<u>\$ 210</u>	<u>\$ 1,616</u>

- (a) Derivative instruments within these categories are reported gross. These instruments are subject to master netting agreements and are presented on the balance sheets on a net basis in accordance with the accounting guidance for "Derivatives and Hedging."
- (b) Amounts include counterparty netting of risk management and hedging contracts and associated cash collateral in accordance with the accounting guidance for "Derivatives and Hedging."
- (c) There are no derivative contracts subject to a master netting arrangement or similar agreement which are not offset in the statement of financial position.

The table below presents KPCo's activity of derivative risk management contracts:

**Amount of Gain (Loss) Recognized on  
Risk Management Contracts**

<u>Location of Gain (Loss)</u>	<u>Three Months Ended March 31,</u>	
	<u>2018</u>	<u>2017</u>
	(in thousands)	
Electric Generation, Transmission and Distribution Revenues	\$ (166)	\$ 38
Other Operation	13	3
Maintenance	14	5
Purchased Electricity for Resale	59	1,502
Regulatory Assets (a)	—	14
Regulatory Liabilities (a)	4,180	325
<b>Total Gain on Risk Management Contracts</b>	<u>\$ 4,100</u>	<u>\$ 1,887</u>

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

Certain qualifying derivative instruments have been designated as normal purchase or normal sale contracts, as provided in the accounting guidance for “Derivatives and Hedging.” Derivative contracts that have been designated as normal purchases or normal sales under that accounting guidance are not subject to MTM accounting treatment and are recognized on the statements of income on an accrual basis.

The accounting for the changes in the fair value of a derivative instrument depends on whether it qualifies for and has been designated as part of a hedging relationship and further, on the type of hedging relationship. Depending on the exposure, management designates a hedging instrument as a fair value hedge or a cash flow hedge.

For contracts that have not been designated as part of a hedging relationship, the accounting for changes in fair value depends on whether the derivative instrument is held for trading purposes. Unrealized and realized gains and losses on derivative instruments held for trading purposes are included in revenues on a net basis on KPCo’s statements of income. Unrealized and realized gains and losses on derivative instruments not held for trading purposes are included in revenues or expenses on KPCo’s statements of income depending on the relevant facts and circumstances. Certain derivatives that economically hedge future commodity risk are recorded in the same expense line item on the statements of income as that of the associated risk. However, unrealized and some realized gains and losses for both trading and non-trading derivative instruments are recorded as regulatory assets (for losses) or regulatory liabilities (for gains), in accordance with the accounting guidance for “Regulated Operations.”

### ***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 balance sheets until the period the hedged item affects Net Income. KPCo would recognize any hedge ineffectiveness as a regulatory asset (for losses) or a regulatory liability (for gains) if applicable.

Realized gains and losses on derivative contracts for the purchase and sale of power designated as cash flow hedges are included in Total Revenues or Purchased Electricity for Resale on KPCo’s statements of income, or in Regulatory Assets or Regulatory Liabilities on KPCo’s balance sheets, depending on the specific nature of the risk being hedged. During the three months ended March 31, 2018 and 2017, KPCo did not apply cash flow hedging to outstanding power derivatives.

KPCo reclassifies gains and losses on interest rate derivative hedges related to debt financings from Accumulated Other Comprehensive Income (Loss) on its balance sheets into Interest Expense on its statements of income in those periods in which hedged interest payments occur. During the three months ended March 31, 2018 and 2017, KPCo did not apply cash flow hedging to outstanding interest rate derivatives.

During the three months ended March 31, 2018 and 2017, hedge ineffectiveness was immaterial or nonexistent for all cash flow hedge strategies disclosed above.

For details on effective cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on KPCo’s balance sheets and the reasons for changes in cash flow hedges, see Note 3.

There is no impact of cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on KPCo’s balance sheets as of March 31, 2018 and December 31, 2017.

The actual amounts that KPCo reclassifies from Accumulated Other Comprehensive Income (Loss) to Net Income can differ due to market price changes. As of March 31, 2018, KPCo is not hedging (with contracts subject to the accounting guidance for “Derivatives and Hedging”) its exposure to variability in future cash flows related to forecasted transactions.

## ***Credit Risk***

Management mitigates 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. Management uses Moody's Investor's Service Inc., S&P Global Inc. and current market-based qualitative and quantitative data as well as financial statements to assess the financial health of counterparties on an ongoing basis.

Master agreements are typically used to facilitate the netting of cash flows associated with a single counterparty and may include collateral requirements. Collateral requirements in the form of cash, letters of credit and parental/affiliate guarantees may be obtained as security from counterparties in order to mitigate credit risk. A counterparty is required 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, master agreements allow for termination and liquidation of all positions in the event of a failure or inability to post collateral.

## ***Collateral Triggering Events***

### *Credit Downgrade Triggers*

A limited number of derivative contracts include collateral triggering events, which include a requirement to maintain certain credit ratings. On an ongoing basis, AEP's risk management organization assesses the appropriateness of these collateral triggering events in contracts. KPCo has not experienced a downgrade below a specified credit rating threshold that would require the posting of additional collateral. As of March 31, 2018 and December 31, 2017, KPCo did not have derivative contracts with collateral triggering events in a net liability position.

### *Cross-Default Triggers*

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

	<b>March 31, 2018</b>	<b>December 31, 2017</b>
	<b>(in thousands)</b>	
Liabilities for Contracts with Cross Default Provisions Prior to Contractual Netting Arrangements	\$ 7	\$ 120
Additional Settlement Liability if Cross Default Provision is Triggered	3	104

## 8. FAIR VALUE MEASUREMENTS

### *Fair Value Hierarchy and Valuation Techniques*

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

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

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

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

The book values and fair values of KPCo’s Long-term Debt are summarized in the following table:

	<u>March 31, 2018</u>		<u>December 31, 2017</u>	
	<u>Book Value</u>	<u>Fair Value</u>	<u>Book Value</u>	<u>Fair Value</u>
	(in thousands)			
Long-term Debt	\$ 867,296	\$ 935,107	\$ 867,188	\$ 976,163

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

The following tables set forth, by level within the fair value hierarchy, KPCo's financial assets and liabilities that were accounted for at fair value on a recurring basis. As 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 March 31, 2018**

<b>Assets:</b>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
<b>Risk Management Assets</b>					
Risk Management Commodity Contracts (a) (b)	<u>\$ 111</u>	<u>\$ 5,060</u>	<u>\$ 1,259</u>	<u>\$ (5,013)</u>	<u>\$ 1,417</u>
<b>Liabilities:</b>					
<b>Risk Management Liabilities</b>					
Risk Management Commodity Contracts (a) (b)	<u>\$ 108</u>	<u>\$ 4,965</u>	<u>\$ 125</u>	<u>\$ (5,022)</u>	<u>\$ 176</u>

#### **Assets and Liabilities Measured at Fair Value on a Recurring Basis December 31, 2017**

<b>Assets:</b>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
<b>Risk Management Assets</b>					
Risk Management Commodity Contracts (a) (b)	<u>\$ —</u>	<u>\$ 10,440</u>	<u>\$ 2,000</u>	<u>\$ (10,386)</u>	<u>\$ 2,054</u>
<b>Liabilities:</b>					
<b>Risk Management Liabilities</b>					
Risk Management Commodity Contracts (a) (b)	<u>\$ —</u>	<u>\$ 10,847</u>	<u>\$ 187</u>	<u>\$ (10,596)</u>	<u>\$ 438</u>

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

There were no transfers between Level 1 and Level 2 during the three months ended March 31, 2018 and 2017.

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:

<b>Three Months Ended March 31, 2018</b>	<b>Net Risk Management Assets (Liabilities) (in thousands)</b>
<b>Balance as of December 31, 2017</b>	\$ 1,813
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)	5,037
Settlements	(5,989)
Changes in Fair Value Allocated to Regulated Jurisdictions (c)	273
<b>Balance as of March 31, 2018</b>	<u>\$ 1,134</u>
<b>Three Months Ended March 31, 2017</b>	<b>Net Risk Management Assets (Liabilities) (in thousands)</b>
<b>Balance as of December 31, 2016</b>	\$ 198
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)	1,381
Settlements	(1,730)
Changes in Fair Value Allocated to Regulated Jurisdictions (c)	353
<b>Balance as of March 31, 2017</b>	<u>\$ 202</u>

- (a) Included in revenues on KPCo's statements of income.
- (b) Represents the change in fair value between the beginning of the reporting period and the settlement of the risk management commodity contract.
- (c) Relates to the net gains (losses) of those contracts that are not reflected on KPCo's statements of income. These net gains (losses) are recorded as regulatory assets/liabilities.

The following tables quantify the significant unobservable inputs used in developing the fair value of Level 3 positions:

**Significant Unobservable Inputs  
March 31, 2018**

	Fair Value		Valuation Technique	Significant Unobservable Input (a)	Input/Range		Weighted Average
	Assets	Liabilities			Low	High	
	(in thousands)						
Energy Contracts	\$ 473	\$ 57	Discounted Cash Flow	Forward Market Price	\$ 20.56	\$ 46.25	\$ 33.30
FTRs	786	68	Discounted Cash Flow	Forward Market Price	(0.39)	5.87	0.67
<b>Total</b>	<u>\$ 1,259</u>	<u>\$ 125</u>					

**Significant Unobservable Inputs  
December 31, 2017**

	Fair Value		Valuation Technique	Significant Unobservable Input (a)	Input/Range		Weighted Average
	Assets	Liabilities			Low	High	
	(in thousands)						
Energy Contracts	\$ 153	\$ 86	Discounted Cash Flow	Forward Market Price	\$ 20.52	\$ 195.00	\$ 33.80
FTRs	1,847	101	Discounted Cash Flow	Forward Market Price	(0.73)	5.75	0.66
<b>Total</b>	<u>\$ 2,000</u>	<u>\$ 187</u>					

(a) Represents market prices in dollars per MWh.

The following table provides sensitivity of fair value measurements to increases (decreases) in significant unobservable inputs related to Energy Contracts and FTRs as of March 31, 2018 and December 31, 2017:

**Sensitivity of Fair Value Measurements**

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

## 9. INCOME TAXES

### *Federal Tax Reform*

In December 2017, legislation referred to as Tax Reform was signed into law. Tax Reform includes significant changes to the Internal Revenue Code of 1986, as amended, (the Code) and had a material impact on KPCo's financial statements in the reporting period of its enactment. Tax Reform lowered the corporate federal income tax rate from 35% to 21%. Tax Reform provisions related to regulated public utilities generally allow for the continued deductibility of interest expense, eliminate bonus depreciation for certain property acquired after September 27, 2017 and continue certain rate normalization requirements for accelerated depreciation benefits.

### *Provisional Amounts*

KPCo applied Staff Accounting Bulletin 118 (SAB 118), issued by the SEC staff in December 2017, and made reasonable estimates for the measurement and accounting of the effects of Tax Reform which are reflected in the financial statements as provisional amounts based on the best information available. In January 2018, the FASB issued guidance allowing non-public entities to apply SAB 118. SAB 118 provides for up to a one year period to complete the required analysis and accounting for Tax Reform referred to as the measurement period. While KPCo was able to make reasonable estimates of the impact of Tax Reform in 2017, the final impact may differ from the recorded provisional amounts to the extent refinements are made to the estimated cumulative differences or as a result of additional guidance or technical corrections that may be issued by the IRS that may impact management's interpretation and assumptions utilized. The measurement period adjustments recorded during the first quarter of 2018 to the provisional amounts were immaterial. KPCo expects to complete the analysis of the provisional items during the second half of 2018.

### *Reduction in the Corporate Federal Income Tax Rate - Pending Rate Reductions*

State utility commissions have issued orders or instructions requiring public utilities, including KPCo, to record liabilities to reflect the impact of the reduction in the corporate federal income tax rate in excess of the enacted corporate federal income tax rate of 21% beginning in 2018. Prior to the implementation of new base rates effective January 18, 2018, KPCo reflected a decrease of \$1.5 million in Total Revenues for estimated provisions for refund related to the reduction in the corporate federal tax rate for the three months ended March 31, 2018. The implemented base rates included the change in corporate federal tax rate. KPCo also recorded an increase of \$353 thousand in Current Liabilities and an increase of \$1.1 million in Deferred Credits and Other Noncurrent Liabilities for estimated provisions for refund related to the reduction in the corporate federal tax rate as of March 31, 2018.

### *Excess Accumulated Deferred Income Taxes - Pending Rate Reductions*

As reflected in KPCo's estimated annual ETR for 2018, KPCo began amortizing the excess accumulated deferred income taxes (Excess ADIT) associated with certain depreciable property subject to rate normalization requirements using the average rate assumption method (ARAM) during the first quarter of 2018. The amortization resulted in a reduction in the Excess ADIT balance recorded in Regulatory Liabilities and Deferred Investment Tax Credits and a reduction in Income Tax Expense. As a result of state utility commission orders or instructions, in the first quarter of 2018 KPCo recorded \$959 thousand of estimated provisions for revenue refund offsetting the amortization of the Excess ADIT.

In addition, with respect to Excess ADIT balances recorded in Regulatory Liabilities and Deferred Investment Tax Credits that are not subject to rate normalization requirements, KPCo continues to work with the KPSC to determine the appropriate mechanism, amount and time period to provide these benefits of Tax Reform to customers. The corresponding reduction in Income Tax Expense will be reported in the interim period in which these benefits of Tax Reform are provided to customers.



### ***Effective Tax Rates (ETR)***

The interim ETR for KPCo reflects the estimated annual ETR for 2018 and 2017, adjusted for tax expense associated with certain discrete items. The interim ETR of 14% and 34.4% in 2018 and 2017, respectively, differs from the federal statutory tax rate of 21% and 35% in 2018 and 2017, respectively, primarily due to the amortization of excess accumulated deferred income taxes associated with certain depreciable property using ARAM and other book/tax differences which are accounted for on a flow-through basis.

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

KPCo and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2011. The IRS examination of years 2011 through 2013 started in April 2014. KPCo and other AEP subsidiaries received a Revenue Agents Report in April 2016, completing the 2011 through 2013 audit cycle indicating an agreed upon audit. The 2011 through 2013 audit was submitted to the Congressional Joint Committee on Taxation for approval. The Joint Committee referred the audit back to the IRS exam team for further consideration. To resolve the issue under consideration, KPCo and other AEP subsidiaries and the IRS exam team agreed to utilize the Fast Track Settlement Program in December 2017. The program was completed in March 2018 and tax years 2014 and 2015 were added to the IRS examination to reflect the impact of the Fast Track changes that were carried forward to 2014 and 2015.

Although the outcome of tax audits is uncertain, in management's opinion, adequate provisions for federal income taxes have been made for potential liabilities resulting from such matters. In addition, KPCo accrues interest on these uncertain tax positions. Management is not aware of any issues for open tax years that upon final resolution are expected to materially impact net income.

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

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

In April 2018, the Kentucky legislature enacted House Bill 366 (HB 366) adopting significant changes to Kentucky's corporate income tax code. HB 366 amended and reduced the corporate tax rate from a graduated rate with a maximum 6% rate to a single 5% corporate tax rate. HB 366 also modified the apportionment formula from a traditional three-factor formula of property, payroll, and double weighted sales to a single sales factor apportionment. The corporate income tax changes under HB 366 are effective for tax years beginning on or after January 1, 2018. The legislation is not expected to materially impact KPCo's net income, cash flows or financial condition.

## 10. FINANCING ACTIVITIES

### *Long-term Debt*

KPCo did not have any long-term debt issuances or retirements during the first three months of 2018.

### *Dividend Restrictions*

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

All of the dividends declared by KPCo are subject to a Federal Power Act restriction that prohibits the payment of dividends out of capital accounts without regulatory approval; payment of dividends is allowed out of retained earnings only.

KPCo has credit agreements that contain a covenant that limit its debt to capitalization ratio to 67.5%. As of March 31, 2018, KPCo did not exceed its debt to capitalization limit. The method for calculating outstanding debt and capitalization is contractually defined in the credit agreements.

The Federal Power Act restriction does not limit the ability of KPCo to pay dividends out of retained earnings.

### *Corporate Borrowing Program – AEP System*

The AEP System uses a corporate borrowing program to meet the short-term borrowing needs of AEP's subsidiaries. The corporate borrowing program includes a Utility Money Pool, which funds AEP's utility subsidiaries. The AEP System Utility Money Pool operates in accordance with the terms and conditions of the AEP System Utility Money Pool agreement filed with the FERC. The amounts of outstanding borrowings from the Utility Money Pool as of March 31, 2018 and December 31, 2017 are included in Advances from Affiliates on KPCo's balance sheets. KPCo's Utility Money Pool activity and corresponding authorized borrowing limits for the three months ended March 31, 2018 are described in the following table:

<b>Maximum Borrowings from the Utility Money Pool</b>	<b>Maximum Loans to the Utility Money Pool</b>	<b>Average Borrowings from the Utility Money Pool</b>	<b>Average Loans to the Utility Money Pool</b>	<b>Borrowings from the Utility Money Pool as of March 31, 2018</b>	<b>Authorized Short-Term Borrowing Limit</b>
(in thousands)					
\$ 22,269	\$ 13,667	\$ 8,268	\$ 5,084	\$ 19,793	\$ 180,000

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool are summarized in the following table:

<b>Three Months Ended March 31,</b>	<b>Maximum Interest Rate for Funds Borrowed from the Utility Money Pool</b>	<b>Minimum Interest Rate for Funds Borrowed from the Utility Money Pool</b>	<b>Maximum Interest Rate for Funds Loaned to the Utility Money Pool</b>	<b>Minimum Interest Rate for Funds Loaned to the Utility Money Pool</b>	<b>Average Interest Rate for Funds Borrowed from the Utility Money Pool</b>	<b>Average Interest Rate for Funds Loaned to the Utility Money Pool</b>
2018	2.42%	1.83%	2.31%	1.84%	2.00%	1.92%
2017	1.27%	0.95%	1.15%	0.92%	1.14%	0.97%

### ***Securitized Accounts Receivables – AEP Credit***

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

AEP Credit's receivables securitization agreement provides a commitment of \$750 million from bank conduits to purchase receivables and expires in June 2019.

KPCo's amounts of accounts receivable and accrued unbilled revenues sold under the sale of receivables agreement were \$47.6 million and \$45.6 million as of March 31, 2018 and December 31, 2017, respectively.

The fees paid by KPCo to AEP Credit for customer accounts receivable sold were \$935 thousand and \$793 thousand for the three months ended March 31, 2018 and 2017, respectively.

KPCo's proceeds on the sale of receivables to AEP Credit were \$167 million and \$161.4 million for the three months ended March 31, 2018 and 2017, respectively.

## 11. PROPERTY, PLANT AND EQUIPMENT

### *Asset Retirement Obligations (ARO)*

KPCo records ARO in accordance with the accounting guidance for “Asset Retirement and Environmental Obligations” for the retirement of ash disposal facilities and asbestos removal.

The following is a reconciliation of the aggregate carrying amounts of ARO for KPCo:

<u>ARO as of December 31, 2017</u>	<u>Accretion Expense</u>	<u>Liabilities Incurred</u>	<u>Liabilities Settled</u>	<u>Revisions in Cash Flow Estimates</u>	<u>ARO as of March 31, 2018</u>
\$ 51,238	\$ 613	\$ —	\$ (10,059)	\$ 4,231	\$ 46,023

(in thousands)

## 12. REVENUE FROM CONTRACTS WITH CUSTOMERS

### *Disaggregated Revenues from Contracts with Customers*

The table below represents KPCo's revenues from contracts with customers, net of respective provisions for refund, by type of revenue:

	<b>Three Months Ended March 31, 2018</b>
	<b>(in thousands)</b>
<b>Retail Revenues:</b>	
Residential Revenues	\$ 80,983
Commercial Revenues	40,738
Industrial Revenues	38,972
Other Retail Revenues	503
<b>Total Retail Revenues</b>	<b>161,196</b>
<b>Wholesale Revenues:</b>	
Generation Revenues	5,684
Generation Revenues – Affiliated	68
Transmission Revenues	3,427
Transmission Revenues – Affiliated	2,943
<b>Total Wholesale Revenues</b>	<b>12,122</b>
Other Revenues from Contracts with Customers	4,790
Other Revenues from Contracts with Customers - Affiliated	227
<b>Total Revenues from Contracts with Customers</b>	<b>178,335</b>
<b>Other Revenues:</b>	
Alternative Revenues	(1,319)
<b>Total Other Revenues</b>	<b>(1,319)</b>
<b>Total Revenues</b>	<b>\$ 177,016</b>

### *Performance Obligations*

KPCo has performance obligations as part of its normal course of business. A performance obligation is a promise to transfer a distinct good or service, or a series of distinct goods or services that are substantially the same and have the same pattern of transfer to a customer. The invoice practical expedient within the accounting guidance for "Revenue from Contracts with Customers" allows for the recognition of revenue from performance obligations in the amount of consideration to which there is a right to invoice the customer and when the amount for which there is a right to invoice corresponds directly to the value transferred to the customer.

The purpose of the invoice practical expedient is to depict an entity's measure of progress toward completion of the performance obligation within a contract and can only be applied to performance obligations that are satisfied over time and when the invoice is representative of services provided to date. KPCo elected to apply the invoice practical expedient to recognize revenue for performance obligations satisfied over time as the invoices from the respective revenue streams are representative of services or goods provided to date to the customer. Performance obligations for KPCo are summarized as follows:

#### *Retail Revenues*

KPCo has performance obligations to generate, transmit and distribute electricity for sale to rate-regulated retail customers. The performance obligation to deliver electricity is satisfied over time as the customer simultaneously receives and consumes the benefits provided. Revenues are variable as they are subject to the customer's usage requirements.

Rate-regulated retail customers typically have the right to discontinue receiving service at will, therefore these contracts between KPCo and their customers for rate-regulated services are generally limited to the services requested and received to date for such arrangements. Retail customers are generally billed on a monthly basis, and payment is typically due within 15 to 20 days after the issuance of the invoice.

#### *Wholesale Revenues - Generation*

KPCo has performance obligations to sell electricity to wholesale customers from generation assets in PJM. The performance obligation to deliver electricity from generation assets is satisfied over time as the customer simultaneously receives and consumes the benefits provided. Wholesale generation revenues are variable as they are subject to the customer's usage requirements.

KPCo also has performance obligations to stand ready in order to promote grid reliability. Stand ready services are sold into PJM's Reliability Pricing Model (RPM) capacity market. RPM entails a base auction and at least three incremental auctions for a specific PJM delivery year, with the incremental auctions spanning three years. The performance obligation to stand ready is satisfied over time and the consideration for which is variable until the occurrence of the third incremental auction, at which point the performance obligation becomes fixed.

Payments from the RTO for stand ready services are typically received within one week from the issuance of the invoice, which is typically issued weekly. Gross margin resulting from generation sales are primarily subject to margin sharing agreements with customers, where the revenues are reflected gross in the disaggregated revenue table above.

#### *Wholesale Revenues - Transmission*

KPCo has performance obligations to transmit electricity to wholesale customers through assets owned and operated by KPCo and other AEP subsidiaries. The performance obligation to provide transmission services in PJM encompass a time frame greater than a year, where the performance obligation within PJM is partially fixed for a period of one year or less. Payments from the RTO for transmission services are typically received within one week from the issuance of the invoice, which is issued weekly for PJM.

KPCo collects revenues through Transmission Formula Rates. The FERC-approved rates establish the annual transmission revenue requirement (ATRR) and transmission service rates for transmission owners. The formula rates establish rates for a one year period and also include a true-up calculation for the prior year's billings, allowing for over/under-recovery of the transmission owner's ATRR. The annual true-ups meet the definition of alternative revenues in accordance with the accounting guidance for "Regulated Operations," and are therefore presented as such in the disaggregated revenue table above.

#### *Wholesale Revenues - Transmission Affiliated*

APCo, I&M, KGPCo, KPCo, OPCo and WPCo (AEP East Companies) are parties to the Transmission Agreement (TA), which defines how transmission costs are allocated among the AEP East Companies on a 12-month average coincident peak basis. AEPTCo is a load serving entity within PJM providing transmission services to affiliates in accordance with the OATT and TA. Affiliate revenues as a result of the TA are reflected as Transmission Revenues - Affiliated in the disaggregated revenue table above.

### ***Fixed Performance Obligations***

The following table represents KPCo's remaining fixed performance obligations satisfied over time as of March 31, 2018. Fixed performance obligations primarily include wholesale transmission services, electricity sales for fixed amounts of energy and stand ready services into PJM's RPM market.

<u>Less Than 1 Year</u>	<u>2-3 Years</u>	<u>4-5 Years</u>	<u>After 5 Years</u>	<u>Total (a)</u>
(in thousands)				
\$ 17,445	\$ 2,816	\$ 2,816	\$ 1,408	\$ 24,485

(a) Amounts include affiliated and nonaffiliated revenues.

### ***Contract Assets and Liabilities***

Contract assets are recognized when KPCo has a right to consideration that is conditional upon the occurrence of an event other than the passage of time, such as future performance under a contract. KPCo does not have any material contract assets as of March 31, 2018.

When KPCo receives consideration, or such consideration is unconditionally due from a customer prior to transferring goods or services to the customer under the terms of a sales contract, they recognize a contract liability on the balance sheet in the amount of that consideration. Revenue for such consideration is subsequently recognized in the period or periods in which the remaining performance obligations in the contract are satisfied. KPCo's contract liabilities typically arise from advanced payments of services provided primarily with respect to joint use agreements for utility poles. KPCo does not have any material contract liabilities as of March 31, 2018.

### ***Accounts Receivable from Contracts with Customers***

Accounts receivable from contracts with customers are presented on KPCo's balance sheets within the Accounts Receivable - Customers line item. KPCo's balances for receivables from contracts that are not recognized in accordance with the accounting guidance for "Revenue from Contracts with Customers" included in Accounts Receivable - Customers are not material as of March 31, 2018. See "Securitized Accounts Receivable - AEP Credit" section of Note 10 for additional information related to AEP Credit's securitized accounts receivable.

The following table represents the amount of affiliated accounts receivable from contracts with customers included in Accounts Receivable - Affiliated Companies on the Registrant Subsidiaries' balance sheets:

<u>March 31, 2018</u>	<u>January 1, 2018</u>
(in millions)	
\$ 5,315	\$ 5,175

### ***Contract Costs***

Contract costs to obtain or fulfill a contract are accounted for under the guidance for "Other Assets and Deferred Costs" and presented as a single asset and neither bifurcated nor reclassified between current and noncurrent assets on KPCo's balance sheets. Contract costs to acquire a contract are amortized in a manner consistent with the transfer of goods or services to the customer in Other Operation on KPCo's income statements. KPCo does not have material contract costs as of March 31, 2018.