Kingsport Power Company

2016 Annual Report

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TN PUBLIC UTILITY COMMISSION
UTILITIES DIVISION

Audited Financial Statements

AMERICAN ELECTRIC POWER
BOUNDLESS ENERGY℠

TABLE OF CONTENTS	Page Number

GLOSSARY OF TERMS

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

Term	Meaning
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.
APCo	Appalachian Power Company, an AEP electric utility subsidiary.
ARO	Asset Retirement Obligation.
ASU	Accounting Standards Update.
EIS	Energy Insurance Services, Inc., a nonaffiliated captive insurance company and consolidated variable interest entity of AEP.
FASB	Financial Accounting Standards Board.
Federal EPA	United States Environmental Protection Agency.
FERC	Federal Energy Regulatory Commission.
FTR	Financial Transmission Right, a financial instrument that entitles the holder to receive compensation for certain congestion-related transmission charges that arise when the power grid is congested resulting in differences in locational prices.
I&M	Indiana Michigan Power Company, an AEP electric utility subsidiary.
IRS	Internal Revenue Service.
KGPCo	Kingsport Power Company, an AEP electric utility subsidiary.
KPCo	Kentucky Power Company, an AEP electric utility subsidiary.
MTM	Mark-to-Market.
OATT	Open Access Transmission Tariff.
OPCo	Ohio Power Company, an AEP electric utility subsidiary.
OPEB	Other Postretirement Benefit Plans.
OTC	Over the counter.
Parent	American Electric Power Company, Inc., the equity owner of AEP subsidiaries within the AEP consolidation.
PJM	Pennsylvania – New Jersey – Maryland regional transmission organization.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
TRA	Tennessee Regulatory Authority.
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.

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors and Shareholder of
Kingsport Power Company:

We have audited the accompanying financial statements of Kingsport Power Company (the "Company"), which comprise the balance sheets as of December 31, 2016 and 2015, and the related statements of operations, changes in common shareholder's equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Kingsport Power Company as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

Columbus, Ohio
March 30, 2017

KINGSPORT POWER COMPANY
STATEMENTS OF OPERATIONS
For the Years Ended December 31, 2016 and 2015
(in thousands)

	Years Ended December 31, 2016	2015
REVENUES		
Electricity, Transmission and Distribution	$ 151,224	$ 149,758
Sales to AEP Affiliates	3,301	3,213
Other Revenues	156	151
TOTAL REVENUES	154,681	153,122
EXPENSES		
Purchased Electricity from AEP Affiliates	126,566	132,145
Other Operation	7,266	6,793
Maintenance	3,915	3,065
Depreciation and Amortization	6,425	5,908
Taxes Other Than Income Taxes	8,395	6,616
TOTAL EXPENSES	152,567	154,527
OPERATING INCOME (LOSS)	2,114	(1,405)
Interest Expense	(1,457)	(1,517)
INCOME (LOSS) BEFORE INCOME TAX EXPENSE (CREDIT)	657	(2,922)
Income Tax Expense (Credit)	252	(1,371)
NET INCOME (LOSS)	$ 405	$ (1,551)

The common stock of KGPCo is wholly-owned by Parent.

See Notes to Financial Statements beginning on page 8.

KINGSPORT POWER COMPANY
STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S EQUITY
For the Years Ended December 31, 2016 and 2015
(in thousands)

	Common Stock	Paid-in Capital	Retained Earnings	Total
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2014	$ 4,100	$ 13,800	$ 13,377	$ 31,277
Common Stock Dividends			(100)	(100)
Net Loss			(1,551)	(1,551)
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2015	4,100	13,800	11,726	29,626
Capital Contribution from Parent		7,500		7,500
Net Income			405	405
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2016	$ 4,100	$ 21,300	$ 12,131	$ 37,531

See Notes to Financial Statements beginning on page 8.

KINGSPORT POWER COMPANY
BALANCE SHEETS
ASSETS
December 31, 2016 and 2015
(in thousands)

	December 31, 2016	December 31, 2015
CURRENT ASSETS		
Cash and Cash Equivalents	$ 87	$ 74
Accounts Receivable:		
Customers	2,634	1,427
Affiliated Companies	1,082	1,137
Accrued Unbilled Revenues	48	—
Miscellaneous	7	7
Total Accounts Receivable	3,771	2,571
Materials and Supplies	330	286
Accrued Tax Benefits	838	2,964
Prepayments	2,183	2,387
Other Current Assets	93	6
TOTAL CURRENT ASSETS	7,302	8,288
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Transmission	30,873	30,491
Distribution	148,967	141,650
Other Property, Plant and Equipment	6,521	5,553
Construction Work in Progress	7,719	4,687
Total Property, Plant and Equipment	194,080	182,381
Accumulated Depreciation and Amortization	71,414	66,492
TOTAL PROPERTY, PLANT AND EQUIPMENT – NET	122,666	115,889
OTHER NONCURRENT ASSETS		
Regulatory Assets	15,612	14,733
Deferred Charges and Other Noncurrent Assets	675	758
TOTAL OTHER NONCURRENT ASSETS	16,287	15,491
TOTAL ASSETS	$ 146,255	$ 139,668

See Notes to Financial Statements beginning on page 8.

KINGSPORT POWER COMPANY
BALANCE SHEETS
LIABILITIES AND COMMON SHAREHOLDER'S EQUITY
December 31, 2016 and 2015

	December 31,	
	2016	**2015**
CURRENT LIABILITIES	(in thousands)	
Advances from Affiliates	$ 28,438	$ 32,297
Accounts Payable:		
General	1,704	1,145
Affiliated Companies	13,559	13,879
Customer Deposits	4,331	4,276
Accrued Taxes	1,771	1,376
Accrued Interest	1,406	1,315
Other Current Liabilities	2,554	2,543
TOTAL CURRENT LIABILITIES	53,763	56,831
NONCURRENT LIABILITIES		
Long-term Debt – Affiliated	20,000	20,000
Deferred Income Taxes	31,862	30,226
Regulatory Liabilities and Deferred Investment Tax Credits	716	732
Employee Benefits and Pension Obligations	1,850	1,863
Deferred Credits and Other Noncurrent Liabilities	533	390
TOTAL NONCURRENT LIABILITIES	54,961	53,211
TOTAL LIABILITIES	108,724	110,042
Rate Matters (Note 3)		
Commitments and Contingencies (Note 5)		
COMMON SHAREHOLDER'S EQUITY		
Common Stock – No Par Value:		
Authorized – 500,000 Shares		
Outstanding – 410,000 Shares	4,100	4,100
Paid-in Capital	21,300	13,800
Retained Earnings	12,131	11,726
TOTAL COMMON SHAREHOLDER'S EQUITY	37,531	29,626
TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY	$ 146,255	$ 139,668

See Notes to Financial Statements beginning on page 8.

KINGSPORT POWER COMPANY
STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2016 and 2015
(in thousands)

	Years Ended December 31, 2016	2015
OPERATING ACTIVITIES		
Net Income (Loss)	$ 405	$ (1,551)
Adjustments to Reconcile Net Income (Loss) to Net Cash Flows from Operating Activities:		
Depreciation and Amortization	6,425	5,908
Deferred Income Taxes	1,664	1,913
Change in Other Noncurrent Assets	(1,376)	890
Change in Other Noncurrent Liabilities	688	236
Changes in Certain Components of Working Capital:		
Accounts Receivable, Net	(1,200)	1,310
Materials and Supplies	(44)	(9)
Accounts Payable	(213)	160
Accrued Taxes, Net	2,517	(2,458)
Other Current Assets	188	(132)
Other Current Liabilities	56	504
Net Cash Flows from Operating Activities	9,110	6,771
INVESTING ACTIVITIES		
Construction Expenditures	(12,994)	(17,194)
Other Investing Activities	376	439
Net Cash Flows Used for Investing Activities	(12,618)	(16,755)
FINANCING ACTIVITIES		
Capital Contribution from Parent	7,500	—
Change in Advances from Affiliates, Net	(3,859)	10,258
Principal Payments for Capital Lease Obligations	(146)	(177)
Dividends Paid on Common Stock	—	(100)
Other Financing Activities	26	—
Net Cash Flows from Financing Activities	3,521	9,981
Net Increase (Decrease) in Cash and Cash Equivalents	13	(3)
Cash and Cash Equivalents at Beginning of Period	74	77
Cash and Cash Equivalents at End of Period	$ 87	$ 74
SUPPLEMENTARY INFORMATION		
Cash Paid for Interest, Net of Capitalized Amounts	$ 1,331	$ 1,382
Net Cash Paid (Received) for Income Taxes	(3,381)	(812)
Noncash Acquisitions Under Capital Leases	248	2
Construction Expenditures Included in Current Liabilities as of December 31,	1,202	761

See Notes to Financial Statements beginning on page 8.

INDEX OF NOTES TO FINANCIAL STATEMENTS

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

ORGANIZATION

KGPCo is a wholly-owned subsidiary of AEP. KGPCo is engaged in the purchase of electric power and the subsequent sale, transmission and distribution of that power to approximately 48,000 retail customers in its service territory in Kingsport, Tennessee and the surrounding area. As a member of the AEP System, KGPCo's facilities are operated in conjunction with the facilities of certain other AEP affiliated utilities as an integrated utility system. All of the power KGPCo sells and distributes at retail is purchased from APCo, an affiliated AEP System company.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Rates and Service Regulation

KGPCo's wholesale rates are regulated by the FERC and its retail rates are regulated by the TRA. The FERC also regulates KGPCo's affiliated transactions, including AEPSC intercompany service billings which are generally at cost, under the 2005 Public Utility Holding Company Act and the Federal Power Act. The FERC also has jurisdiction over the issuances and acquisitions of securities, the acquisition or sale of certain utility assets and mergers with another electric utility or holding company. For non-power goods and services, the FERC requires a nonregulated affiliate to bill an affiliated public utility company at no more than market while a public utility must bill the higher of cost or market to a nonregulated affiliate. The TRA also regulates certain intercompany transactions under its affiliate statutes.

KGPCo purchases electricity at wholesale from APCo. The FERC regulates KGPCo's cost-based wholesale power transactions with APCo. The TRA regulates KGPCo's bundled transmission and distribution rates on a cost basis.

KGPCo's purchased power agreement with APCo includes a component for the recovery of transmission costs under the FERC's OATT. The transmission cost component of purchased power is cost-based and regulated by the TRA.

In addition, the FERC regulates the Transmission Agreement, which allocates shared system costs and revenues to the utility subsidiaries that are parties to the agreement.

Both the FERC and state regulatory commissions are permitted to review and audit the books and records of any company within a public utility holding company system.

Accounting for the Effects of Cost-Based Regulation

As a rate-regulated electric public utility company, KGPCo's financial statements reflect the actions of regulators that result in the recognition of certain revenues and expenses in different time periods than enterprises that are not rate-regulated. In accordance with accounting guidance for "Regulated Operations," KGPCo records regulatory assets (deferred expenses) and regulatory liabilities (deferred revenue reductions or refunds) to reflect the economic effects of regulation in the same accounting period by matching expenses with their recovery through regulated revenues and by matching income with its passage to customers in cost-based regulated rates.

Use of Estimates

The preparation of these financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. These estimates include but are not limited to inventory valuation, allowance for doubtful accounts, long-lived asset impairment, unbilled electricity revenue, the effects of regulation, long-lived asset recovery, storm costs, the effects of contingencies and certain assumptions made in accounting for pension and postretirement benefits. The estimates and assumptions used are based upon management's evaluation of the relevant facts and circumstances as of the date of the financial statements. Actual results could ultimately differ from those estimates.

Cash and Cash Equivalents

Cash and Cash Equivalents include temporary cash investments with original maturities of three months or less.

Inventory

Materials and supplies inventories are carried at average cost.

Accounts Receivable

Customer accounts receivable primarily include receivables from retail energy customers. Revenue is recognized from electric power sales when power is delivered to customers. To the extent that deliveries have occurred but a bill has not been issued, KGPCo accrues and recognizes, as Accrued Unbilled Revenues on the balance sheets, an estimate of the revenues for energy delivered since the last billing.

AEP Credit factors accounts receivable on a daily basis, excluding receivables from risk management activities, for KGPCo. See "Sale of Receivables – AEP Credit" section of Note 11 for additional information.

Allowance for Uncollectible Accounts

Generally, AEP Credit records bad debt expense related to receivables purchased from KGPCo under a sale of receivables agreement. For other accounts receivable, bad debt expense is recorded for all amounts outstanding 180 days or greater at 100%, unless specifically identified. Accounts receivable items open less than 180 days may be reserved using specific identification for bad debt reserves.

Concentrations of Credit Risk and Significant Customers

Two of KGPCo's industrial customers who manufacture paper and chemical products account for the following percentages of total operating revenues for the years ended December 31 and accounts receivable as of December 31:

Percentage of Operating Revenues	2016	2015
Customer Who Manufactures Paper Products	13%	14%
Customer Who Manufactures Chemical Products	12%	12%

Percentage of Accounts Receivable	2016	2015
Customer Who Manufactures Paper Products	13%	15%
Customer Who Manufactures Chemical Products	10%	12%

Management monitors credit levels and the financial condition of KGPCo's customers on a continuing basis to minimize credit risk. Management believes adequate provision for credit loss has been made in the accompanying financial statements.

Property, Plant and Equipment

Electric utility property, plant and equipment are stated at original cost. Additions, major replacements and betterments are added to the plant accounts. Under the group composite method of depreciation, continuous interim routine replacements of items such as poles, transformers, etc. result in original cost retirements, less salvage, being charged to accumulated depreciation. The group composite method of depreciation assumes that on average, asset components are retired at the end of their useful lives and thus there is no gain or loss. The equipment in each primary electric plant account is identified as a separate group. The depreciation rates that are established take into account the past history of interim capital replacements and the amount of removal cost incurred and salvage received. These rates and the related lives are subject to periodic review. Removal costs accrued are typically recorded as regulatory liabilities when removal costs accrued exceed actual removal costs incurred. The asset removal costs liability is relieved as removal costs are incurred. A regulatory asset balance will occur if actual removal costs incurred exceed accumulated removal costs accrued.

The costs of labor, materials and overhead incurred to operate and maintain the facilities are included in operating expenses.

Long-lived assets are required to be tested for impairment when it is determined that the carrying value of the assets may no longer be recoverable or when the assets meet the held-for-sale criteria under the accounting guidance for "Impairment or Disposal of Long-lived Assets."

The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties, as opposed to a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and are used as the basis for the measurement, if available. In the absence of quoted prices for identical or similar assets in active markets, fair value is estimated using various internal and external valuation methods including cash flow analysis and appraisals.

Allowance for Funds Used During Construction

AFUDC represents the estimated cost of borrowed and equity funds used to finance construction projects that is capitalized and recovered through depreciation over the service life of a regulated electric utility facility.

Valuation of Nonderivative Financial Instruments

The book values of Cash and Cash Equivalents, Accounts Receivable, Advances from Affiliates and Accounts Payable approximate fair value because of the short-term maturity of these instruments.

Fair Value Measurements of Assets and Liabilities

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

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

AEP utilizes its trustee's external pricing service to estimate the fair value of the underlying investments held in the benefit plan trusts. AEP's investment managers review and validate the prices utilized by the trustee to determine fair value. AEP's management performs its own valuation testing to verify the fair values of the securities. AEP receives audit reports of the trustee's operating controls and valuation processes. The trustee uses multiple pricing vendors for the assets held in the trusts.

Assets in the benefits trusts are classified using the following methods. Equities are classified as Level 1 holdings if they are actively traded on exchanges. Items classified as Level 1 are investments in money market funds, fixed income and equity mutual funds and domestic equity securities. They are valued based on observable inputs primarily unadjusted quoted prices in active markets for identical assets. Items classified as Level 2 are primarily investments in individual fixed income securities and cash equivalent funds. Fixed income securities generally do not trade on exchanges and do not have an official closing price but their valuation inputs are based on observable market data. Pricing vendors calculate bond valuations using financial models and matrices. The models use observable inputs including yields on benchmark securities, quotes by securities brokers, rating agency actions, discounts or premiums on securities compared to par prices, changes in yields for U.S. Treasury securities, corporate actions by bond issuers, prepayment schedules and histories, economic events and, for certain securities, adjustments to yields to reflect changes in the rate of inflation. Other securities with model-derived valuation inputs that are observable are also classified as Level 2 investments. Investments with unobservable valuation inputs are classified as Level 3 investments. Benefit plan assets included in Level 3 are primarily real estate, infrastructure and private equity investments that are valued using methods requiring judgment including appraisals. The fair value of real estate investments and infrastructure is measured using market capitalization rates, recent sales of comparable investments and independent third-party appraisals. The fair value of private equity investments is measured using cost and purchase multiples, operating results, discounted future cash flows and market based comparable data. Depending on the specific situation, one or multiple approaches are used to determine the valuation of a real estate, infrastructure or private equity investment.

Revenue Recognition

Regulatory Accounting

KGPCo's financial statements reflect the actions of regulators that can result in the recognition of revenues and expenses in different time periods than enterprises that are not rate-regulated. Regulatory assets (deferred expenses) and regulatory liabilities (deferred revenue reductions or refunds) are recorded to reflect the economic effects of regulation in the same accounting period by matching expenses with their recovery through regulated revenues and by matching income with its passage to customers in cost-based regulated rates.

When regulatory assets are probable of recovery through regulated rates, KGPCo records them as assets on its balance sheets. KGPCo tests for probability of recovery at each balance sheet date or whenever new events occur. Examples of new events include the issuance of a regulatory commission order or passage of new legislation. If it is determined that recovery of a regulatory asset is no longer probable, KGPCo writes off that regulatory asset as a charge against income.

Electricity Supply and Delivery Activities

KGPCo recognizes retail revenues upon delivery of the energy to the customer and includes billed revenue as well as an accrual of electricity delivered but unbilled at year-end. In general, expenses are recorded when purchased electricity is received and when expenses are incurred. Changes in the fuel component of affiliated purchased power are expensed as incurred. The fuel rate billed to the customer is on a two-month lag, as permitted by the TRA.

Maintenance

Maintenance costs are expensed as incurred. If it becomes probable that KGPCo will recover specifically-incurred costs through future rates, a regulatory asset is established to match the expensing of those maintenance costs with their recovery in cost-based regulated revenues.

Income Taxes and Investment Tax Credits

KGPCo uses the liability method of accounting for income taxes. Under the liability method, deferred income taxes are provided for all temporary differences between the book and tax basis of assets and liabilities which will result in a future tax consequence.

When the flow-through method of accounting for temporary differences is reflected in regulated revenues (that is, when deferred taxes are not included in the cost of service for determining regulated rates for electricity), deferred income taxes are recorded and related regulatory assets and liabilities are established to match the regulated revenues and tax expense.

Investment tax credits (ITC) were historically accounted for under the flow-through method, except where regulatory commissions reflected ITC in the rate-making process. In the third quarter of 2016, KGPCo and other AEP subsidiaries changed accounting for the recognition of ITC and elected to apply the preferred deferral methodology. This change had no financial impact to KGPCo.

Deferred ITC is amortized to income tax expense over the life of the asset. Amortization of deferred ITC begins when the asset is placed into service, except where regulatory commissions reflect ITC in the rate-making process, then amortization begins when the cash tax benefit is recognized.

KGPCo accounts for uncertain tax positions in accordance with the accounting guidance for "Income Taxes." KGPCo classifies interest expense or income related to uncertain tax positions as interest expense or income as appropriate and classifies penalties as Other Operation expense.

Excise Taxes

As an agent for some state and local governments, KGPCo collects from customers certain excise taxes levied by those state or local governments on customers. KGPCo does not recognize these taxes as revenue or expense.

Pension and OPEB Plans

KGPCo participates in an AEP sponsored qualified pension plan. Substantially all of KGPCo's employees are covered by the qualified plan. KGPCo also participates in OPEB plans sponsored by AEP to provide health and life insurance benefits for retired employees. KGPCo is allocated a proportionate share of benefit costs and accounts for its participation in these plans as multiple-employer plans. See Note 6 - Benefit Plans for additional information including significant accounting policies associated with the plans.

Investments Held in Trust for Future Liabilities

AEP has several trust funds with significant investments intended to provide for future payments of pension and OPEB benefits. All of the trust funds' investments are diversified and managed in compliance with all laws and regulations. The investment strategy for the trust funds is to use a diversified portfolio of investments to achieve an acceptable rate of return while managing the investment risk of the assets relative to the associated liabilities. To minimize investment risk, the trust funds are broadly diversified among classes of assets, investment strategies and investment managers. Management regularly reviews the actual asset allocations and periodically rebalances the investments to targeted allocations when appropriate. Investment policies and guidelines allow investment managers in approved strategies to use financial derivatives to obtain or manage market exposures and to hedge assets and liabilities. The investments are reported at fair value under the "Fair Value Measurements and Disclosures" accounting guidance.

Benefit Plans

All benefit plan assets are invested in accordance with each plan's investment policy. The investment policy outlines the investment objectives, strategies and target asset allocations by plan.

The investment philosophies for AEP's benefit plans support the allocation of assets to minimize risks and optimize net returns. Strategies used include:

- Maintaining a long-term investment horizon.
- Diversifying assets to help control volatility of returns at acceptable levels.
- Managing fees, transaction costs and tax liabilities to maximize investment earnings.
- Using active management of investments where appropriate risk/return opportunities exist.
- Keeping portfolio structure style-neutral to limit volatility compared to applicable benchmarks.
- Using alternative asset classes such as real estate and private equity to maximize return and provide additional portfolio diversification.

The objective of the investment policy for the pension fund is to maintain the funded status of the plan while providing for growth in the plan assets to offset the growth in the plan liabilities. The current target asset allocations are as follows:

Pension Plan Assets	Target
Equity	25%
Fixed Income	59%
Other Investments	15%
Cash and Cash Equivalents	1%

OPEB Plans Assets	Target
Equity	65%
Fixed Income	33%
Cash and Cash Equivalents	2%

The investment policy for each benefit plan contains various investment limitations. The investment policies establish concentration limits for securities and prohibit the purchase of securities issued by AEP (with the exception of proportionate and immaterial holdings of AEP securities in passive index strategies). However, the investment policies do not preclude the benefit trust funds from receiving contributions in the form of AEP securities, provided that the AEP securities acquired by each plan may not exceed the limitations imposed by law.

For equity investments, the concentration limits are as follows:

- No security in excess of 5% of all equities.
- Cash equivalents must be less than 10% of an investment manager's equity portfolio.
- No individual stock may be more than 10% and 7% for pension and OPEB investments, respectively, of each manager's equity portfolio.
- No investment in excess of 5% of an outstanding class of any company.
- No securities may be bought or sold on margin or other use of leverage.

For fixed income investments, each investment manager's portfolio is compared to investment grade, diversified long and intermediate benchmark indices.

A portion of the pension assets is invested in real estate funds to provide diversification, add return and hedge against inflation. Real estate properties are illiquid, difficult to value and not actively traded. The pension plan uses external real estate investment managers to invest in commingled funds that hold real estate properties. To mitigate investment risk in the real estate portfolio, commingled real estate funds are used to ensure that holdings are diversified by region, property type and risk classification. Real estate holdings include core, value-added and development risk classifications and some investments in Real Estate Investment Trusts, which are publicly traded real estate securities.

A portion of the pension assets is invested in private equity. Private equity investments add return and provide diversification and typically require a long-term time horizon to evaluate investment performance. Private equity is classified as an alternative investment because it is illiquid, difficult to value and not actively traded. The pension plan uses limited partnerships and commingled funds to invest across the private equity investment spectrum. The private equity holdings are with multiple general partners who help monitor the investments and provide investment selection expertise. The holdings are currently comprised of venture capital, buyout and hybrid debt and equity investment instruments. Commingled private equity funds are used to enhance the holdings' diversity.

AEP participates in a securities lending program with BNY Mellon to provide incremental income on idle assets and to provide income to offset custody fees and other administrative expenses. AEP lends securities to borrowers approved by BNY Mellon in exchange for collateral. All loans are collateralized by at least 102% of the loaned asset's market value and the collateral is invested. The difference between the rebate owed to the borrower and the collateral rate of return determines the earnings on the loaned security. The securities lending program's objective is providing modest incremental income with a limited increase in risk.

Trust owned life insurance (TOLI) underwritten by The Prudential Insurance Company is held in the OPEB plan trusts. The strategy for holding life insurance contracts in the taxable Voluntary Employees' Beneficiary Association trust is to minimize taxes paid on the asset growth in the trust. Earnings on plan assets are tax-deferred within the TOLI contract and can be tax-free if held until claims are paid. Life insurance proceeds remain in the trust and are used to fund future retiree medical benefit liabilities. With consideration to other investments held in the trust, the cash value of the TOLI contracts is invested in two diversified funds. A portion is invested in a commingled fund with underlying investments in stocks that are actively traded on major international equity exchanges. The other portion of the TOLI cash value is invested in a diversified, commingled fixed income fund with underlying investments in government bonds, corporate bonds and asset-backed securities.

Cash and cash equivalents are held in each trust to provide liquidity and meet short-term cash needs. Cash equivalent funds are used to provide diversification and preserve principal. The underlying holdings in the cash funds are investment grade money market instruments including commercial paper, certificates of deposit, treasury bills and other types of investment grade short-term debt securities. The cash funds are valued each business day and provide daily liquidity.

Subsequent Events

Management reviewed subsequent events through March 30, 2017, the date that KGPCo's 2016 annual report was available to be issued.

2. NEW ACCOUNTING PRONOUNCEMENTS

Upon issuance of final pronouncements, management reviews the new accounting literature to determine its relevance, if any, to KGPCo's business. The following final 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 clarifying the method used to determine the timing and requirements for revenue recognition on the statements of income. Under the new standard, an entity must identify the performance obligations in a contract, 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.

The FASB deferred implementation of ASU 2014-09 under the terms in ASU 2015-14, "Revenue from Contracts with Customers (Topic: 606): Deferral of the Effective Date." The new accounting guidance is effective for interim and annual periods beginning after December 15, 2018, with early adoption permitted.

Management continues to analyze the impact of the new revenue standard and related ASUs. During 2016, initial revenue contract assessments were completed. Material revenue streams were identified within the AEP System and representative contract/transaction types were sampled. Performance obligations identified within each material revenue stream were evaluated to determine whether the obligations were satisfied at a point in time or over time. Contracts determined to be satisfied over time generally qualified for the invoicing practical expedient since the invoiced amounts reasonably represented the value to customers of performance obligations fulfilled to date. Based upon the completed assessments, management does not expect a material impact to the timing of revenue recognized or net income and plans to elect the modified retrospective transition approach upon adoption. Management also continues to monitor unresolved industry implementation issues, including items related to collectability and alternative revenue programs, and will analyze the related impacts to revenue recognition. Management plans to adopt ASU 2014-09 effective January 1, 2018.

ASU 2015-11 "Simplifying the Measurement of Inventory" (ASU 2015-11)

In July 2015, the FASB issued ASU 2015-11 simplifying the guidance on the subsequent measurement of inventory, excluding inventory measured using last-in, first-out or the retail inventory method. Under the new standard, inventory should be at the lower of cost and net realizable value. The new accounting guidance is effective for interim and annual periods beginning after December 15, 2016 with early adoption permitted. Management adopted ASU 2015-11 prospectively, effective January 1, 2017. There was no impact on results of operations, financial position or cash flows at adoption.

ASU 2016-01 "Recognition and Measurement of Financial Assets and Financial Liabilities" (ASU 2016-01)

In January 2016, the FASB issued ASU 2016-01 enhancing the reporting model for financial instruments. Under the new standard, equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) are required to be measured at fair value with changes in fair value recognized in net income. The new standard also amends disclosure requirements and requires separate presentation of financial assets and liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements. The amendments also clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2018 with early adoption permitted. The amendments should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. 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 2016-01 effective January 1, 2018.

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 sheet 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. The guidance should be applied 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.

Management continues to analyze the impact of the new lease standard. During 2016, initial 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. Lease system options are currently being evaluated. Management plans to elect certain of the following practical expedients upon adoption:

Practical Expedient	Description
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.

Management expects the new standard to impact financial position, but not results of operations or cash flows. Management also continues to monitor unresolved industry implementation issues, including items related to renewables and Purchase Power and Sale Agreements, pole attachments, easements and right-of-ways, and will analyze the related impacts to lease accounting. Management plans to adopt ASU 2016-02 effective January 1, 2019.

ASU 2016-09 "Compensation – Stock Compensation" (ASU 2016-09)

In March 2016, the FASB issued ASU 2016-09 simplifying the accounting for share-based payment transactions including the income tax consequences, classification of awards as either equity or liabilities and classification on the statements of cash flows. Under the new standard, all excess tax benefits and tax deficiencies (including tax benefits of dividends on share-based payment awards) should be recognized as income tax expense or benefit on the statements of income. Under current GAAP, excess tax benefits are recognized in additional paid-in capital while tax deficiencies are recognized either as an offset to accumulated excess tax benefits, if any, or on the statements of income.

The new accounting guidance is effective for annual periods beginning after December 15, 2017. Early adoption is permitted in any interim or annual period. Certain provisions require retrospective/modified retrospective transition while others are to be applied prospectively. Management adopted ASU 2016-09 effective January 1, 2017. There was no impact on results of operations, financial position or cash flows at adoption.

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 2016-18 "Restricted Cash" (ASU 2016-18)

In November 2016, the FASB issued ASU 2016-18 clarifying the treatment of restricted cash on the statements of cash flows. Under the new standard, amounts considered restricted cash will be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts on the statements of cash flows.

The new accounting guidance is effective for annual periods beginning after December 15, 2018. Early adoption is permitted in any interim or annual period. The guidance will be applied by means of a retrospective approach. Management is analyzing the impact of the new standard. Management plans to adopt ASU 2016-18 effective for the 2017 Annual Report.

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 to be included in the same line item or items as other compensation costs. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations. In addition, only the service cost component will be eligible for capitalization as applicable following labor.

The new accounting guidance is effective for annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Early adoption is permitted as of the beginning of an annual period for which financial statements have not been issued or made available for issuance. Management is analyzing the impact of the new standard. Management plans to adopt ASU 2017-07 effective January 1, 2018.

3. <u>RATE MATTERS</u>

KGPCo is involved in rate and regulatory proceedings at the FERC and the TRA. Rate matters can have a material impact on net income, cash flows and possibly financial condition. KGPCo's recent significant rate orders and pending rate filings are addressed in this note.

Tennessee Base Rate Case

In August 2016, the TRA approved a settlement agreement that included an $8 million annual increase in base rates with a 9.85% return on common equity, effective September 2016.

4. EFFECTS OF REGULATION

Regulatory assets and liabilities are comprised of the following items:

	December 31, 2016	December 31, 2015	Remaining Recovery Period
	(in thousands)		
Regulatory Assets:			
Noncurrent Regulatory Assets			
Regulatory assets pending final regulatory approval:			
Regulatory Assets Currently Not Earning a Return			
Storm Related Costs	$ 1,505	$ 1,505	
Peak Demand Reduction/Energy Efficiency	—	307	
Total Regulatory Assets Pending Final Regulatory Approval	1,505	1,812	
Regulatory assets approved for recovery:			
Regulatory Assets Currently Not Earning a Return			
Pension and OPEB Funded Status	6,653	6,238	12 years
Income Taxes, Net	6,025	6,045	20 years
Peak Demand Reduction/Energy Efficiency	473	—	5 years
Rate Case Expenses	472	—	5 years
Medicare Subsidy	244	275	8 years
Postemployment Benefits	240	332	5 years
Other Regulatory Assets Approved for Recovery	—	31	
Total Regulatory Assets Approved for Recovery	14,107	12,921	
Total Noncurrent Regulatory Assets	$ 15,612	$ 14,733	

	December 31, 2016	December 31, 2015	Remaining Refund Period
	(in thousands)		
Regulatory Liabilities:			
Noncurrent Regulatory Liabilities and Deferred Investment Tax Credits			
Regulatory liabilities approved for payment:			
Regulatory Liabilities Currently Paying a Return			
Asset Removal Costs	$ 106	$ 732	(a)
Regulatory Liabilities Currently Not Paying a Return			
Fuel and Purchased Power Adjustment Rider	596	—	2 years
Other Regulatory Liabilities Approved for Payment	14	—	various
Total Regulatory Liabilities Approved for Payment	716	732	
Total Noncurrent Regulatory Liabilities and Deferred Investment Tax Credits	$ 716	$ 732	

(a) Relieved as removal costs are incurred.

5. COMMITMENTS, GUARANTEES AND CONTINGENCIES

KGPCo is subject to certain claims and legal actions arising in its ordinary course of business. In addition, KGPCo'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 KGPCo 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.

COMMITMENTS

KGPCo has construction commitments to support its operations and investments. In managing the overall construction program and in the normal course of business, KGPCo contractually commits to third-party construction vendors for certain material purchases and other construction services. KGPCo also purchases materials, supplies, services and property, plant and equipment under contract as part of its normal course of business. Certain supply contracts contain penalty provisions for early termination.

In accordance with the accounting guidance for "Commitments", KGPCo had no actual contractual commitments as of December 31, 2016.

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

KGPCo 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 December 31, 2016, there were no material liabilities recorded for any indemnifications.

Lease Obligations

KGPCo leases certain equipment under master lease agreements. See "Master Lease Agreements" section of Note 10 for disclosure of lease residual value guarantees.

CONTINGENCIES

Insurance and Potential Losses

KGPCo maintains insurance coverage normal and customary for an electric utility, subject to various deductibles. KGPCo also maintains property and casualty insurance that may cover certain physical damage or third-party injuries caused by cyber security incidents. Insurance coverage includes all risks of physical loss or damage to assets, subject to insurance policy conditions and exclusions. Covered property generally includes substations, facilities and inventories. Excluded property generally includes transmission and distribution lines, poles and towers. The insurance programs also generally provide coverage against loss arising from certain claims made by third parties and are in excess of KGPCo's retentions. Coverage is generally provided by a combination of the protected cell of EIS and/or various industry mutual and/or commercial insurance carriers.

Some potential losses or liabilities may not be insurable or the amount of insurance carried may not be sufficient to meet potential losses and liabilities, including, but not limited to, liabilities relating to a cyber security incident. Future losses or liabilities, if they occur, which are not completely insured, unless recovered from customers, could reduce future net income and cash flows and impact financial condition.

The Comprehensive Environmental Response Compensation and Liability Act (Superfund) and State Remediation

KGPCo's transmission and distribution facilities have used asbestos, polychlorinated biphenyls and other hazardous and nonhazardous materials. KGPCo currently incurs costs to dispose of these substances safely.

Superfund addresses clean-up of hazardous substances that have been released to the environment. The Federal EPA administers the clean-up programs. Several states have enacted similar laws. Superfund does not recognize compliance as a defense, but imposes strict liability on parties who fall within its broad statutory categories. At present, management's estimates do not anticipate material cleanup costs.

6. BENEFIT PLANS

For a discussion of investment strategy, investment limitations, target asset allocations and the classification of investments within the fair value hierarchy, see "Fair Value Measurements of Assets and Liabilities" and "Investments Held in Trust for Future Liabilities" sections of Note 1.

KGPCo participates in an AEP sponsored qualified pension plan which covers substantially all of KGPCo's employees. KGPCo also participates in OPEB plans sponsored by AEP to provide health and life insurance benefits for retired employees.

KGPCo recognizes the funded status associated with defined benefit pension and OPEB plans in its balance sheets. Disclosures about the plans are required by the "Compensation – Retirement Benefits" accounting guidance. KGPCo recognizes an asset for a plan's overfunded status or a liability for a plan's underfunded status and recognizes, as a component of other comprehensive income, the changes in the funded status of the plan that arise during the year that are not recognized as a component of net periodic benefit cost. KGPCo records a regulatory asset instead of other comprehensive income for qualifying benefit costs of regulated operations that for ratemaking purposes are deferred for future recovery. The cumulative funded status adjustment is equal to the remaining unrecognized deferrals for unamortized actuarial losses or gains, prior service costs and transition obligations, such that remaining deferred costs result in a regulatory asset and deferred gains result in a regulatory liability.

Actuarial Assumptions for Benefit Obligations

The weighted-average assumptions used in the measurement of benefit obligations are shown in the following table:

	Pension Plan		Other Postretirement Benefit Plans	
	December 31,			
Assumptions	**2016**	**2015**	**2016**	**2015**
Discount Rate	4.05%	4.30%	4.10%	4.30%
Rate of Compensation Increase	4.50% (a)	4.70% (a)	NA	NA

(a) Rates are for base pay only. In addition, an amount is added to reflect target incentive compensation for exempt employees and overtime and incentive pay for nonexempt employees.
NA Not applicable.

A duration-based method is used to determine the discount rate for the plans. A hypothetical portfolio of high quality corporate bonds is constructed with cash flows matching the benefit plan liability. The composite yield on the hypothetical bond portfolio is used as the discount rate for the plan.

For 2016, the rate of compensation increase assumed varies with the age of the employee, ranging from 3.5% per year to 12% per year, with an average increase of 4.5%.

Actuarial Assumptions for Net Periodic Benefit Costs

The weighted-average assumptions used in the measurement of benefit costs are shown in the following table:

	Pension Plan		Other Postretirement Benefit Plans	
	January 1,			
Assumptions	**2016**	**2015**	**2016**	**2015**
Discount Rate	4.30%	4.00%	4.30%	4.00%
Expected Return on Plan Assets	6.00%	6.00%	7.00%	6.75%
Rate of Compensation Increase	4.50% (a)	4.70% (a)	NA	NA

(a) Rates are for base pay only. In addition, an amount is added to reflect target incentive compensation for exempt employees and overtime and incentive pay for nonexempt employees.
NA Not applicable.

The expected return on plan assets was determined by evaluating historical returns, the current investment climate (yield on fixed income securities and other recent investment market indicators), rate of inflation, third party forecasts and current prospects for economic growth.

The health care trend rate assumptions used for OPEB plans measurement purposes are shown below:

Health Care Trend Rates	January 1, 2016	2015
Initial	7.00%	6.25%
Ultimate	5.00%	5.00%
Year Ultimate Reached	2024	2020

Assumed health care cost trend rates have a significant effect on the amounts reported for the OPEB health care plans. A 1% change in assumed health care cost trend rates would have the following effects:

	1% Increase (in thousands)	1% Decrease
Effect on Total Service and Interest Cost Components of Net Periodic Postretirement Health Care Benefit Cost	$ 7	$ (6)
Effect on the Health Care Component of the Accumulated Postretirement Benefit Obligation	165	(145)

Significant Concentrations of Risk within Plan Assets

In addition to establishing the target asset allocation of plan assets, the investment policy also places restrictions on securities to limit significant concentrations within plan assets. The investment policy establishes guidelines that govern maximum market exposure, security restrictions, prohibited asset classes, prohibited types of transactions, minimum credit quality, average portfolio credit quality, portfolio duration and concentration limits. The guidelines were established to mitigate the risk of loss due to significant concentrations in any investment. The plans are monitored to control security diversification and ensure compliance with the investment policy. As of December 31, 2016, the assets were invested in compliance with all investment limits. See "Investments Held in Trust for Future Liabilities" section of Note 1 for limit details.

Benefit Plan Obligations, Plan Assets and Funded Status as of December 31, 2016 and 2015

The following table provides a reconciliation of the changes in the plans' benefit obligations, fair value of plan assets and funded status. The benefit obligation for the defined benefit pension and OPEB plans are the projected benefit obligation and the accumulated benefit obligation, respectively.

	Pension Plan		Other Postretirement Benefit Plans	
	2016	2015	2016	2015
Change in Benefit Obligation	(in thousands)			
Benefit Obligation as of January 1,	$ 16,170	$ 17,804	$ 5,049	$ 5,055
Service Cost	223	230	31	32
Interest Cost	684	662	208	193
Actuarial (Gain) Loss	456	(1,431)	(17)	141
Benefit Payments	(1,097)	(1,095)	(496)	(513)
Participant Contributions	—	—	154	139
Medicare Subsidy	—	—	2	2
Benefit Obligation as of December 31,	$ 16,436	$ 16,170	$ 4,931	$ 5,049
Change in Fair Value of Plan Assets				
Fair Value of Plan Assets as of January 1,	$ 14,656	$ 15,893	$ 5,737	$ 6,329
Actual Gain (Loss) on Plan Assets	1,008	(406)	96	(218)
Company Contributions	242	264	—	—
Participant Contributions	—	—	154	139
Benefit Payments	(1,097)	(1,095)	(496)	(513)
Fair Value of Plan Assets as of December 31,	$ 14,809	$ 14,656	$ 5,491	$ 5,737
Funded (Underfunded) Status as of December 31,	$ (1,627)	$ (1,514)	$ 560	$ 688

Amounts Recognized on the Balance Sheets

	Pension Plan		Other Postretirement Benefit Plans	
	December 31,			
	2016	2015	2016	2015
	(in thousands)			
Deferred Charges and Other Noncurrent Assets – Prepaid Benefit Costs	$ —	$ —	$ 560	$ 688
Employee Benefits and Pension Obligations – Accrued Long-term Benefit Liability	(1,627)	(1,514)	—	—
Funded (Underfunded) Status	$ (1,627)	$ (1,514)	$ 560	$ 688

Amounts Included in Regulatory Assets

	Pension Plan		Other Postretirement Benefit Plans	
	December 31,			
	2016	2015	2016	2015
Components	(in thousands)			
Net Actuarial Loss	$ 6,348	$ 6,306	$ 1,829	$ 1,670
Prior Service Cost (Credit)	3	7	(1,527)	(1,745)
Recorded as				
Regulatory Assets	$ 6,351	$ 6,313	$ 302	$ (75)

Components of the change in amounts included in Regulatory Assets are as follows:

	Pension Plan		Other Postretirement Benefit Plans	
	2016	2015	2016	2015
Components	(in thousands)			
Actuarial (Gain) Loss During the Year	$ 312	$ (174)	$ 270	$ 740
Amortization of Actuarial Loss	(270)	(343)	(111)	(62)
Amortization of Prior Service Credit (Cost)	(4)	(4)	218	218
Change for the Year Ended December 31,	$ 38	$ (521)	$ 377	$ 896

Pension and Other Postretirement Benefits Plans' Assets

The fair value tables within Pension and Other Postretirement Benefits Plans' Assets present the classification of assets for AEP within the fair value hierarchy. All Level 1, 2, 3 and Other amounts can be allocated to KGPCo using the percentages in the table below:

Pension Plan		Other Postretirement Benefit Plans	
December 31,			
2016	2015	2016	2015
0.3%	0.3%	0.4%	0.4%

The following table presents the classification of pension plan assets for AEP within the fair value hierarchy as of December 31, 2016:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
			(in millions)			
Equities:						
Domestic	$ 354.7	$ —	$ —	$ —	$ 354.7	7.3 %
International	439.2	—	—	—	439.2	9.1 %
Options	—	20.0	—	—	20.0	0.4 %
Real Estate Investment Trusts	3.1	—	—	—	3.1	0.1 %
Common Collective Trusts (c)	—	14.0	—	400.5	414.5	8.6 %
Subtotal – Equities	797.0	34.0	—	400.5	1,231.5	25.5 %
Fixed Income:						
Common Collective Trust – Debt (c)	—	—	—	32.3	32.3	0.7 %
United States Government and Agency Securities (c)	—	423.3	—	17.7	441.0	9.1 %
Corporate Debt (c)	—	1,932.2	—	10.0	1,942.2	40.2 %
Foreign Debt (c)	—	373.7	—	12.1	385.8	8.0 %
State and Local Government	—	11.5	—	—	11.5	0.2 %
Other – Asset Backed (c)	—	5.4	—	7.4	12.8	0.3 %
Subtotal – Fixed Income	—	2,746.1	—	79.5	2,825.6	58.5 %
Infrastructure	—	—	57.6	—	57.6	1.2 %
Real Estate	—	—	254.9	—	254.9	5.3 %
Alternative Investments	—	—	411.1	—	411.1	8.5 %
Securities Lending	—	161.6	—	—	161.6	3.4 %
Securities Lending Collateral (a)	—	—	—	(163.3)	(163.3)	(3.4)%
Cash and Cash Equivalents (c)	—	—	—	29.7	29.7	0.6 %
Other – Pending Transactions and Accrued Income (b)	—	—	—	18.6	18.6	0.4 %
Total	$ 797.0	$ 2,941.7	$ 723.6	$ 365.0	$ 4,827.3	100.0 %

(a) Amounts in "Other" column primarily represent an obligation to repay collateral received as part of the Securities Lending Program.
(b) Amounts in "Other" column primarily represent accrued interest, dividend receivables and transactions pending settlement.
(c) Amounts in "Other" column represent investments for which fair value is measured using net asset value per share in accordance with ASU 2015-07, Disclosure for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent), which was retrospectively applied to prior periods.

The following table sets forth a reconciliation of changes in the fair value of AEP's assets classified as Level 3 in the fair value hierarchy for the pension assets:

	Foreign Debt	Infrastructure	Real Estate	Alternative Investments	Total Level 3
			(in millions)		
Balance as of January 1, 2016	$ 0.1	$ 42.0	$ 253.7	$ 378.7	$ 674.5
Actual Return on Plan Assets					
Relating to Assets Still Held as of the Reporting Date	—	5.9	5.3	13.7	24.9
Relating to Assets Sold During the Period	—	0.9	23.2	21.1	45.2
Purchases and Sales	(0.1)	8.8	(27.3)	(2.4)	(21.0)
Transfers into Level 3	—	—	—	—	—
Transfers out of Level 3	—	—	—	—	—
Balance as of December 31, 2016	$ —	$ 57.6	$ 254.9	$ 411.1	$ 723.6

The following table presents the classification of OPEB plan assets for AEP within the fair value hierarchy as of December 31, 2016:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
			(in millions)			
Equities:						
Domestic	$ 517.1	$ —	$ —	$ —	$ 517.1	33.5 %
International	435.5	—	—	—	435.5	28.2 %
Options	—	15.2	—	—	15.2	1.0 %
Common Collective Trusts (b)	—	10.9	—	20.5	31.4	2.0 %
Subtotal – Equities	952.6	26.1	—	20.5	999.2	64.7 %
Fixed Income:						
Common Collective Trust – Debt (b)	—	—	—	93.7	93.7	6.0 %
United States Government and Agency Securities	—	64.7	—	—	64.7	4.2 %
Corporate Debt	—	121.6	—	—	121.6	7.9 %
Foreign Debt	—	18.6	—	—	18.6	1.2 %
State and Local Government	—	3.0	—	—	3.0	0.2 %
Other – Asset Backed	—	5.9	—	—	5.9	0.4 %
Subtotal – Fixed Income	—	213.8	—	93.7	307.5	19.9 %
Trust Owned Life Insurance:						
International Equities (b)	—	—	—	110.1	110.1	7.1 %
United States Bonds (b)	—	—	—	97.4	97.4	6.3 %
Subtotal – Trust Owned Life Insurance	—	—	—	207.5	207.5	13.4 %
Cash and Cash Equivalents	24.0	10.5	—	—	34.5	2.2 %
Other – Pending Transactions and Accrued Income (a)	—	—	—	(2.8)	(2.8)	(0.2)%
Total	$ 976.6	$ 250.4	$ —	$ 318.9	$ 1,545.9	100.0 %

(a) Amounts in "Other" column primarily represent accrued interest, dividend receivables and transactions pending settlement.
(b) Amounts in "Other" column represent investments for which fair value is measured using net asset value per share in accordance with ASU 2015-07, Disclosure for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent), which was retrospectively applied to prior periods.

The following table presents the classification of pension plan assets for AEP within the fair value hierarchy as of December 31, 2015:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
			(in millions)			
Equities:						
Domestic	$ 315.7	$ —	$ —	$ —	$ 315.7	6.6 %
International	402.3	—	—	—	402.3	8.4 %
Options	—	15.6	—	—	15.6	0.3 %
Real Estate Investment Trusts	4.0	—	—	—	4.0	0.1 %
Common Collective Trusts (c)	—	16.1	—	369.7	385.8	8.1 %
Subtotal – Equities	722.0	31.7	—	369.7	1,123.4	23.5 %
Fixed Income:						
Common Collective Trust – Debt (c)	—	—	—	34.2	34.2	0.7 %
United States Government and Agency Securities (c)	—	397.8	—	24.1	421.9	8.9 %
Corporate Debt (c)	—	1,964.2	—	19.0	1,983.2	41.6 %
Foreign Debt (c)	—	405.4	0.1	16.0	421.5	8.8 %
State and Local Government	—	12.8	—	—	12.8	0.3 %
Other – Asset Backed (c)	—	15.8	—	7.6	23.4	0.5 %
Subtotal – Fixed Income	—	2,796.0	0.1	100.9	2,897.0	60.8 %
Infrastructure	—	—	42.0	—	42.0	0.9 %
Real Estate	—	—	253.7	—	253.7	5.3 %
Alternative Investments	—	—	378.7	—	378.7	8.0 %
Securities Lending	—	263.0	—	—	263.0	5.5 %
Securities Lending Collateral (a)	—	—	—	(264.7)	(264.7)	(5.5)%
Cash and Cash Equivalents (c)	—	1.2	—	47.4	48.6	1.0 %
Other – Pending Transactions and Accrued Income (b)	—	—	—	25.9	25.9	0.5 %
Total	$ 722.0	$ 3,091.9	$ 674.5	$ 279.2	$ 4,767.6	100.0 %

(a) Amounts in "Other" column primarily represent an obligation to repay collateral received as part of the Securities Lending Program.
(b) Amounts in "Other" column primarily represent accrued interest, dividend receivables and transactions pending settlement.
(c) Amounts in "Other" column represent investments for which fair value is measured using net asset value per share in accordance with ASU 2015-07, Disclosure for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent), which was retrospectively applied to prior periods.

The following table sets forth a reconciliation of changes in the fair value of AEP's assets classified as Level 3 in the fair value hierarchy for the pension assets:

	Foreign Debt	Infrastructure	Real Estate	Alternative Investments	Total Level 3
			(in millions)		
Balance as of January 1, 2015	$ 0.1	$ 12.5	$ 235.8	$ 378.9	$ 627.3
Actual Return on Plan Assets					
Relating to Assets Still Held as of the Reporting Date	—	(3.6)	12.5	(25.9)	(17.0)
Relating to Assets Sold During the Period	—	0.3	23.8	37.6	61.7
Purchases and Sales	—	32.8	(18.4)	(11.9)	2.5
Transfers into Level 3	—	—	—	—	—
Transfers out of Level 3	—	—	—	—	—
Balance as of December 31, 2015	$ 0.1	$ 42.0	$ 253.7	$ 378.7	$ 674.5

The following table presents the classification of OPEB plan assets for AEP within the fair value hierarchy as of December 31, 2015:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
			(in millions)			
Equities:						
Domestic	$ 465.1	$ —	$ —	$ —	$ 465.1	29.5%
International	484.3	—	—	—	484.3	30.7%
Options	—	15.6	—	—	15.6	1.0%
Common Collective Trusts (b)	—	12.6	—	19.0	31.6	2.0%
Subtotal – Equities	949.4	28.2	—	19.0	996.6	63.2%
Fixed Income:						
Common Collective Trust – Debt (b)	—	—	—	100.9	100.9	6.4%
United States Government and Agency Securities	—	58.4	—	—	58.4	3.7%
Corporate Debt	—	117.7	—	—	117.7	7.4%
Foreign Debt	—	20.7	—	—	20.7	1.3%
State and Local Government	—	4.2	—	—	4.2	0.3%
Other – Asset Backed	—	8.4	—	—	8.4	0.5%
Subtotal – Fixed Income	—	209.4	—	100.9	310.3	19.6%
Trust Owned Life Insurance:						
International Equities (b)	—	—	—	28.3	28.3	1.8%
United States Bonds (b)	—	—	—	184.3	184.3	11.7%
Subtotal – Trust Owned Life Insurance	—	—	—	212.6	212.6	13.5%
Cash and Cash Equivalents	44.9	7.2	—	—	52.1	3.3%
Other – Pending Transactions and Accrued Income (a)	—	—	—	5.8	5.8	0.4%
Total	$ 994.3	$ 244.8	$ —	$ 338.3	$ 1,577.4	100.0%

(a) Amounts in "Other" column primarily represent accrued interest, dividend receivables and transactions pending settlement.

(b) Amounts in "Other" column represent investments for which fair value is measured using net asset value per share in accordance with ASU 2015-07, Disclosure for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent), which was retrospectively applied to prior periods.

Determination of Pension Expense

The determination of pension expense or income is based on a market-related valuation of assets which reduces year-to-year volatility. This market-related valuation recognizes investment gains or losses over a five-year period from the year in which they occur. Investment gains or losses for this purpose are the difference between the expected return calculated using the market-related value of assets and the actual return.

As of December 31, 2016 and 2015, the accumulated benefit obligation for the qualified pension plan was $16.1 million and $15.8 million, respectively.

For the underfunded pension plan that had an accumulated benefit obligation in excess of plan assets, the projected benefit obligation, accumulated benefit obligation and fair value of plan assets of the plan were as follows:

	Underfunded Pension Plan	
	December 31,	
	2016	2015
	(in thousands)	
Projected Benefit Obligation	$ 16,436	$ 16,170
Accumulated Benefit Obligation	$ 16,058	$ 15,848
Fair Value of Plan Assets	14,809	14,656
Underfunded Accumulated Benefit Obligation	$ (1,249)	$ (1,192)

Estimated Future Benefit Payments and Contributions

KGPCo expects contributions for the pension plan of $288 thousand during 2017. The estimated contributions to the pension trust are at least the minimum amount required by the Employee Retirement Income Security Act and additional discretionary contributions may be made to maintain the funded status of the plan.

The table below reflects the total benefits expected to be paid from the plan's assets. The payments include the participants' contributions to the plan for their share of the cost. Future benefit payments are dependent on the number of employees retiring, whether the retiring employees elect to receive pension benefits as annuities or as lump sum distributions, future integration of the benefit plans with changes to Medicare and other legislation, future levels of interest rates and variances in actuarial results. The estimated payments for pension benefits and OPEB are as follows:

	Estimated Payments	
	Pension Plan	Other Postretirement Benefit Plans
	(in thousands)	
2017	$ 1,095	$ 512
2018	1,096	525
2019	1,138	505
2020	1,066	514
2021	1,097	515
Years 2022 to 2026, in Total	5,759	2,580

Components of Net Periodic Benefit Cost

The following table provides the components of net periodic benefit cost (credit):

	Pension Plan		Other Postretirement Benefit Plans	
	Years Ended December 31,			
	2016	2015	2016	2015
	(in thousands)			
Service Cost	$ 223	$ 230	$ 31	$ 32
Interest Cost	684	662	208	193
Expected Return on Plan Assets	(865)	(851)	(382)	(404)
Amortization of Prior Service Cost (Credit)	4	4	(218)	(218)
Amortization of Net Actuarial Loss	270	343	111	62
Net Periodic Benefit Cost (Credit)	316	388	(250)	(335)
Capitalized Portion	(155)	(200)	123	173
Net Periodic Benefit Cost (Credit) Recognized in Expense	$ 161	$ 188	$ (127)	$ (162)

Estimated amounts expected to be amortized to net periodic benefit costs (credits) and the impact on the balance sheet during 2017 are shown in the following table:

	Pension Plan	Other Postretirement Benefit Plans
Components	(in thousands)	
Net Actuarial Loss	$ 270	$ 122
Prior Service Cost (Credit)	3	(218)
Total Estimated 2017 Amortization	$ 273	$ (96)
Expected to be Recorded as		
Regulatory Asset	$ 273	$ (96)
Total	$ 273	$ (96)

American Electric Power System Retirement Savings Plan

KGPCo participates in an AEP sponsored defined contribution retirement savings plan, the American Electric Power System Retirement Savings Plan, for substantially all employees. This qualified plan offers participants an opportunity to contribute a portion of their pay, includes features under Section 401(k) of the Internal Revenue Code and provides for matching contributions. The matching contributions to the plan are 100% of the first 1% of eligible employee contributions and 70% of the next 5% of contributions. The cost for matching contributions totaled $186 thousand in 2016 and $167 thousand in 2015.

7. DERIVATIVES AND HEDGING

AEPSC is agent for and transacts on behalf of KGPCo.

Risk Management Strategies

KGPCo's vehicle fleet is exposed to gasoline and diesel fuel price volatility. KGPCo utilizes financial heating oil and gasoline derivative contracts in order to mitigate price risk of future fuel purchases. KGPCo does not hedge all fuel price risk. The gross notional volumes of KGPCo's outstanding derivative contracts for heating oil and gasoline as of December 31, 2016 and 2015 were 52 thousand gallons and 51 thousand gallons, respectively.

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

According to the accounting guidance for "Derivatives and Hedging," KGPCo 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, KGPCo is required to post or receive cash collateral based on third party contractual agreements and risk profiles. For the December 31, 2016 and 2015 balance sheets, KGPCo netted $6 thousand and $0, respectively, of cash collateral received from third parties against short-term and long-term risk management assets and $0 and $13 thousand, respectively, of cash collateral paid to third parties against short-term and long-term risk management liabilities.

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

Fair Value of Derivative Instruments
December 31, 2016

Balance Sheet Location	Risk Management Contracts Commodity (a)	Hedging Contracts Commodity (a)	Gross Amounts of Risk Management Assets/ Liabilities Recognized	Gross Amounts Offset in the Statement of Financial Position (b)	Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)
			(in thousands)		
Other Current Assets	$ 14	$ —	$ 14	$ (6)	$ 8
Deferred Charges and Other Noncurrent Assets	—	—	—	—	—
Total Assets	14	—	14	(6)	8
Other Current Liabilities	—	—	—	—	—
Deferred Credits and Other Noncurrent Liabilities	—	—	—	—	—
Total Liabilities	—	—	—	—	—
Total MTM Derivative Contract Net Assets (Liabilities)	$ 14	$ —	$ 14	$ (6)	$ 8

Fair Value of Derivative Instruments
December 31, 2015

Balance Sheet Location	Risk Management Contracts Commodity (a)	Hedging Contracts Commodity (a)	Gross Amounts of Risk Management Assets/ Liabilities Recognized	Gross Amounts Offset in the Statement of Financial Position (b)	Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)
			(in thousands)		
Other Current Assets	$ —	$ —	$ —	$ —	$ —
Deferred Charges and Other Noncurrent Assets	—	—	—	—	—
Total Assets	—	—	—	—	—
Other Current Liabilities	23	—	23	(13)	10
Deferred Credits and Other Noncurrent Liabilities	—	—	—	—	—
Total Liabilities	23	—	23	(13)	10
Total MTM Derivative Contract Net Assets (Liabilities)	$ (23)	$ —	$ (23)	$ 13	$ (10)

(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 represent 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 KGPCo's activity of derivative risk management contracts:

Amount of Gain (Loss) Recognized on
Risk Management Contracts

Location of Gain (Loss)	Years Ended December 31, 2016	2015
	(in thousands)	
Other Operation Expense	$ (7)	$ (11)
Maintenance Expense	(14)	(11)
Regulatory Assets (a)	23	(2)
Regulatory Liability (a)	14	—
Total Gain (Loss) on Risk Management Contracts	$ 16	$ (24)

(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 KGPCo'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 KGPCo'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."

8. FAIR VALUE MEASUREMENTS

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 KGPCo's Long-term Debt are summarized in the following table:

	December 31,			
	2016		2015	
	Book Value	Fair Value	Book Value	Fair Value
	(in thousands)			
Long-term Debt	$ 20,000	$ 21,608	$ 20,000	$ 21,351

Fair Value Measurements of Financial Assets and Liabilities

For a discussion of fair value accounting and the classification of assets and liabilities within the fair value hierarchy, see the "Fair Value Measurements of Assets and Liabilities" section of Note 1.

The following tables set forth, by level within the fair value hierarchy, KGPCo'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
December 31, 2016

Risk Management Assets	Level 1	Level 2	Level 3	Other	Total
			(in thousands)		
Risk Management Commodity Contracts (a)	$ —	$ 14	$ —	$ (6)	$ 8

Assets and Liabilities Measured at Fair Value on a Recurring Basis
December 31, 2015

Risk Management Liabilities	Level 1	Level 2	Level 3	Other	Total
			(in thousands)		
Risk Management Commodity Contracts (a)	$ —	$ 23	$ —	$ (13)	$ 10

(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."

As of December 31, 2016, KGPCo had no liabilities measured at fair value on a recurring basis. As of December 31, 2015, KGPCo had no assets measured at fair value on a recurring basis.

There have been no transfers between Level 1 and Level 2 during the years ended December 31, 2016 and 2015.

9. INCOME TAXES

The details of KGPCo's income taxes as reported are as follows:

		Year Ended December 31, 2016 (in thousands)
Federal:		
Current	$	(1,309)
Deferred		1,664
Deferred Investment Tax Credits		—
Total Federal		355
State and Local:		
Current		(103)
Deferred		—
Deferred Investment Tax Credits		—
Total State and Local		(103)
Income Tax Expense	$	252

		Year Ended December 31, 2015 (in thousands)
Income Tax Expense (Credit):		
Current	$	(3,281)
Deferred		1,913
Deferred Investment Tax Credits		(3)
Income Tax Expense (Credit)	$	(1,371)

The following is a reconciliation of the difference between the amount of federal income taxes computed by multiplying book income before income taxes by the federal statutory tax rate and the amount of income taxes reported:

	Years Ended December 31,			
	2016		2015	
	(in thousands)			
Net Income (Loss)	$	405	$	(1,551)
Income Tax Expense (Credit)		252		(1,371)
Pretax Income (Loss)	$	657	$	(2,922)
Income Taxes on Pretax Income (Loss) at Statutory Rate (35%)	$	230	$	(1,023)
Increase (Decrease) in Income Taxes Resulting from the Following Items:				
Depreciation		224		189
Investment Tax Credits, Net		—		(3)
Removal Costs		(251)		(292)
State and Local Income Taxes, Net		(67)		(197)
Other		116		(45)
Income Tax Expense (Credit)	$	252	$	(1,371)
Effective Income Tax Rate		38.4 %		46.9 %

The following table shows elements of KGPCo's net deferred tax liability and significant temporary differences:

	December 31,			
	2016		2015	
	(in thousands)			
Deferred Tax Assets	$	1,115	$	573
Deferred Tax Liabilities		(32,977)		(30,799)
Net Deferred Tax Liabilities	$	(31,862)	$	(30,226)
Property Related Temporary Differences	$	(26,328)	$	(24,314)
Amounts Due from Customers for Future Federal Income Taxes		(961)		(1,014)
Deferred State Income Taxes		(3,271)		(3,147)
Accrued Pensions		933		871
Regulatory Assets		(2,665)		(2,505)
All Other, Net		430		(117)
Net Deferred Tax Liabilities	$	(31,862)	$	(30,226)

AEP System Tax Allocation Agreement

KGPCo 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 consolidated net operating loss of the AEP System is allocated to each company in the consolidated group with taxable losses. The tax benefit of the Parent is allocated to its subsidiaries with taxable income. With the exception of the allocation of the consolidated AEP System net operating loss and the loss of the Parent, the method of allocation reflects a separate return result for each company in the consolidated group.

Federal and State Income Tax Audit Status

KGPCo and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2011. The IRS examination of years 2011, 2012 and 2013 started in April 2014. AEP and 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. 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, KGPCo 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.

KGPCo and other AEP subsidiaries file income tax returns in various state and local jurisdictions. These taxing authorities routinely examine the tax returns. KGPCo 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. KGPCo is no longer subject to state or local income tax examinations by tax authorities for years before 2009.

Net Income Tax Operating Loss Carryforward

In 2016, KGPCo recognized a federal net income tax operating loss of $1 million, driven primarily by bonus depreciation. As of December 31, 2016, KGPCo had $350 thousand of unrealized federal net operating loss carryforward tax benefits. Management anticipates future taxable income will be sufficient to realize the remaining net income tax operating loss tax benefits before the federal carryforward expires after 2036.

Tax Credit Carryforward

As of December 31, 2016 and 2015, KGPCo had federal general business tax credit carryforwards of $22 thousand and $37 thousand, respectively. Management anticipates future federal taxable income will be sufficient to realize the tax benefits of the federal tax credits before they expire unused.

Uncertain Tax Positions

KGPCo recognizes interest accruals related to uncertain tax positions in interest income or expense as applicable, and penalties in Other Operation expense in accordance with the accounting guidance for "Income Taxes." KGPCo's uncertain tax positions are immaterial to the financial statements.

Federal Tax Legislation

The Protecting Americans from Tax Hikes Act of 2015 (PATH) included an extension of the 50% bonus depreciation for three years through 2017, phasing down to 40% in 2018 and 30% in 2019. PATH also provided for the extension of research and development, employment and several energy tax credits for 2015. PATH also includes provisions to extend the wind energy production tax credit through 2016 with a three-year phase-out (2017-2019), and to extend the 30% temporary solar investment tax credit for three years through 2019 and with a two-year phase-out (2020-2021). PATH also provided for a permanent extension of the Research and Development tax credit. The enacted provisions did not materially impact KGPCo's net income or financial condition but will have a favorable impact on future cash flows.

10. LEASES

Leases of property, plant and equipment are for remaining periods up to 10 years and require payments of related property taxes, maintenance and operating costs. The majority of the leases have purchase or renewal options and will be renewed or replaced by other leases.

Lease rentals for both operating and capital leases are generally charged to Other Operation and Maintenance expense in accordance with rate-making treatment for regulated operations. For capital leases, a capital lease asset and offsetting liability are recorded at the present value of the remaining lease payments for each reporting period. The components of rental costs are as follows:

Lease Rental Costs	Years Ended December 31, 2016	2015
	(in thousands)	
Net Lease Expense on Operating Leases	$ 581	$ 524
Amortization of Capital Leases	147	178
Interest on Capital Leases	19	23
Total Lease Rental Costs	$ 747	$ 725

The following table shows the property, plant and equipment under capital leases and related obligations recorded on KGPCo's balance sheets. Capital lease obligations are included in Other Current Liabilities and Deferred Credits and Other Noncurrent Liabilities on KGPCo's balance sheets.

	December 31, 2016	2015
	(in thousands)	
Electric Property, Plant and Equipment Under Capital Leases		
Total Electric Property, Plant and Equipment – Other	$ 855	$ 774
Accumulated Amortization	265	285
Net Electric Property, Plant and Equipment Under Capital Leases	$ 590	$ 489
Obligations Under Capital Leases		
Noncurrent Liability	$ 451	$ 346
Liability Due Within One Year	139	143
Total Obligations Under Capital Leases	$ 590	$ 489

Future minimum lease payments consisted of the following as of December 31, 2016:

Future Minimum Lease Payments	Capital Leases	Noncancelable Operating Leases
	(in thousands)	
2017	$ 160	$ 528
2018	151	367
2019	113	143
2020	88	107
2021	39	79
Later Years	112	188
Total Future Minimum Lease Payments	663	$ 1,412
Less Estimated Interest Element	73	
Estimated Present Value of Future Minimum Lease Payments	$ 590	

Master Lease Agreements

KGPCo 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, KGPCo 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 December 31, 2016, the maximum potential loss for these lease agreements was approximately $165 thousand assuming the fair value of the equipment is zero at the end of the lease term.

11. FINANCING ACTIVITIES

Long-term Debt

The following table details long-term debt outstanding:

Type of Debt	Maturity	Interest Rate as of December 31, 2016	2015	Outstanding as of December 31, 2016	2015
				(in thousands)	
Notes Payable – Affiliated	2020	4.52%	4.52%	$ 20,000	$ 20,000
Total Long-term Debt Outstanding				$ 20,000	$ 20,000

Dividend Restrictions

Federal Power Act

The Federal Power Act prohibits KGPCo from participating "in the making or paying of any dividends of such public utility from any funds properly included in capital account." This restriction does not limit the ability of KGPCo 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 December 31, 2016 and 2015 are included in Advances from Affiliates on KGPCo's balance sheets. KGPCo's Utility Money Pool activity and corresponding authorized borrowing limits are described in the following table:

Years Ended December 31,	Maximum Borrowings from the Utility Money Pool	Maximum Loans to the Utility Money Pool	Average Borrowings from the Utility Money Pool	Average Loans to the Utility Money Pool	Borrowings from the Utility Money Pool as of December 31,	Authorized Short-Term Borrowing Limit
			(in thousands)			
2016	$ 38,292	$ —	$ 28,988	$ —	$ 28,438	$ 50,000
2015	40,660	—	27,034	—	32,297	50,000

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

Years Ended December 31,	Maximum Interest Rates for Funds Borrowed from the Utility Money Pool	Minimum Interest Rates for Funds Borrowed from the Utility Money Pool	Maximum Interest Rates for Funds Loaned to the Utility Money Pool	Minimum Interest Rates for Funds Loaned to the Utility Money Pool	Average Interest Rates for Funds Borrowed from the Utility Money Pool	Average Interest Rates for Funds Loaned to the Utility Money Pool
2016	1.02%	0.69%	—%	—%	0.82%	—%
2015	0.87%	0.37%	—%	—%	0.48%	—%

Interest expense related to the Utility Money Pool is included in Interest Expense in KGPCo's statements of income. For amounts borrowed from the Utility Money Pool, KGPCo incurred $242 thousand and $132 thousand of interest expense for the years ended December 31, 2016 and 2015, respectively.

Securitized Accounts Receivables – AEP Credit

Under a sale of receivables arrangement, KGPCo 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 KGPCo's receivables. The costs of customer accounts receivable sold are reported in Other Operation expense on KGPCo's statements of income. KGPCo manages and services its accounts receivable sold.

AEP Credit's receivables securitization agreement provides a commitment of $750 million from bank conduits to purchase receivables. The agreement was increased in June 2014 from $700 million and expires in June 2018.

KGPCo's factored accounts receivable revenues were $13.4 million and $11.6 million as of December 31, 2016 and 2015, respectively. KGPCo's factored accrued unbilled revenues were $1.7 million and $1 million as of December 31, 2016 and 2015, respectively.

The fees paid by KGPCo to AEP Credit for customer accounts receivable sold were $579 thousand and $669 thousand for the years ended December 31, 2016 and 2015, respectively.

KGPCo's proceeds on the sale of receivables to AEP Credit were $144.8 million and $149.6 million as of December 31, 2016 and 2015, respectively.

12. RELATED PARTY TRANSACTIONS

For other related party transactions, also see "AEP System Tax Allocation Agreement" section of Note 9 in addition to "Corporate Borrowing Program – AEP System" and "Sale of Receivables – AEP Credit" sections of Note 11.

Affiliated Revenues and Purchases

KGPCo provides transmission services directly to APCo which are approved by the FERC. KGPCo's revenues of $21 thousand and $46 thousand for these services for the years ended December 31, 2016 and 2015, respectively, were recorded in Sales to AEP Affiliates on KGPCo's statements of income. KGPCo also purchases all of its power from APCo based on a FERC-approved rate. KGPCo's purchases of $104.1 million and $113.8 million for the years ended December 31, 2016 and 2015, respectively, were recorded in Purchased Electricity from AEP Affiliates on KGPCo's statements of income. Effective September 1, 2016, KGPCo implemented the Fuel and Purchased Power Adjustment Rider (FPPAR) rates per the approved TRA order in KGPCo's base rate case, which included, for the first time, monthly over-recovery or under-recovery accounting for the difference between the actual total costs billed monthly to KGPCo from APCo, and the actual monthly revenues recorded under the FPPAR. As of December 31, 2016, KGPCo had a regulatory liability of $596 thousand. The activity above is excluded from the Transmission Agreement activity discussed below.

Transmission Agreement (TA)

APCo, I&M, KGPCo, KPCo, OPCo and WPCo are parties to the TA, effective November 2010, which defines how transmission costs through PJM OATT are allocated among the AEP East Companies, KGPCo and WPCo on a 12-month average coincident peak basis.

KGPCo's revenues recorded in Sales to AEP Affiliates on its statements of income as a result of the TA for the years ended December 31, 2016 and 2015 were $3.3 million and $3.2 million, respectively. KGPCo's charges recorded in Purchased Electricity from AEP Affiliates on its statements of income as a result of the TA for the years ended December 31, 2016 and 2015 were $21.9 million and $18.3 million, respectively.

Sales and Purchases of Property

KGPCo had affiliated sales and purchases of meters and transformers. There were no gains or losses recorded on the transactions. The following table shows the sales and purchases that were recorded at net book value:

	Years Ended December 31, 2016	2015
	(in thousands)	
Sales	$ 218	$ 165
Purchases	516	422

The amounts above are recorded in Property, Plant and Equipment on the balance sheets.

Global Borrowing Notes

As of December 31, 2016 and 2015, AEP has an intercompany note in place with KGPCo. The debt is reflected in Long-term Debt –Affiliated on KGPCo's balance sheets. KGPCo accrues interest for its share of the global borrowing and remits the interest to AEP. The accrued interest is reflected in Accrued Interest on KGPCo's balance sheets.

Intercompany Billings

KGPCo performs certain utility services for other AEP subsidiaries when necessary or practical. The costs of these services are billed on a direct-charge basis, whenever possible, or on reasonable bases of proration for services that benefit multiple companies. The billings for services are made at cost and include no compensation for the use of equity capital.

13. VARIABLE INTEREST ENTITIES

The accounting guidance for "Variable Interest Entities" is a consolidation model that considers if a company has a variable interest in a VIE. A VIE is a legal entity that possesses any of the following conditions: the entity's equity at risk is not sufficient to permit the legal entity to finance its activities without additional subordinated financial support, equity owners are unable to direct the activities that most significantly impact the legal entity's economic performance (or they possess disproportionate voting rights in relation to the economic interest in the legal entity), or the equity owners lack the obligation to absorb the legal entity's expected losses or the right to receive the legal entity's expected residual returns. Entities are required to consolidate a VIE when it is determined that they have a controlling financial interest in a VIE and therefore, are the primary beneficiary of that VIE, as defined by the accounting guidance for "Variable Interest Entities". In determining whether KGPCo is the primary beneficiary of a VIE, management considers whether KGPCo has the power to direct the most significant activities of the VIE and is obligated to absorb losses or receive the expected residual returns that are significant to the VIE. Management believes that significant assumptions and judgments were applied consistently. KGPCo is not the primary beneficiary of any VIE and has not provided financial or other support to any VIE that was not previously contractually required.

AEPSC provides certain managerial and professional services to AEP's subsidiaries. Parent is the sole equity owner of AEPSC. AEP management controls the activities of AEPSC. The costs of the services are based on a direct charge or on a prorated basis and billed to the AEP subsidiary companies at AEPSC's cost. AEP subsidiaries have not provided financial or other support outside the reimbursement of costs for services rendered. AEPSC finances its operations through cost reimbursement from other AEP subsidiaries. There are no other terms or arrangements between AEPSC and any of the AEP subsidiaries that could require additional financial support from an AEP subsidiary or expose them to losses outside of the normal course of business. AEPSC and its billings are subject to regulation by the FERC. AEP subsidiaries are exposed to losses to the extent they cannot recover the costs of AEPSC through their normal business operations. AEP subsidiaries are considered to have a significant interest in AEPSC due to their activity in AEPSC's cost reimbursement structure. However, AEP subsidiaries do not have control over AEPSC. AEPSC is consolidated by AEP. In the event AEPSC would require financing or other support outside the cost reimbursement billings, this financing would be provided by AEP. KGPCo's total billings from AEPSC for the years ended December 31, 2016 and 2015 were $6.8 million and $6.6 million, respectively. The carrying amount of liabilities associated with AEPSC as of December 31, 2016 and 2015 was $982 thousand and $881 thousand, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

14. PROPERTY, PLANT AND EQUIPMENT

Depreciation

KGPCo provides for depreciation of Property, Plant and Equipment on a straight-line basis over the estimated useful lives of property, generally using composite rates by functional class. The following table provides the annual composite depreciation rates by functional class:

	Years Ended December 31,	
Functional Class of Property	**2016**	**2015**
Transmission	2.2%	2.6%
Distribution	3.5%	3.4%
Other	11.1%	10.0%

Expenditures for demolition and removal of property, plant and equipment are charged to the accumulated provision for depreciation and recovered through depreciation charges included in rates. The higher composite depreciation rate in the other class of property compared to the rate of transmission and distribution is due to capitalized software, which has a relatively shorter expected useful life compared to the transmission and distribution functional property classes.

The composite depreciation rate generally includes a component for removal costs, which is credited to Accumulated Depreciation and Amortization. Actual removal costs incurred are charged to Accumulated Depreciation and Amortization. Any excess of accrued removal costs over actual removal costs incurred is reclassified from Accumulated Depreciation and Amortization and reflected as a regulatory liability.

Asset Retirement Obligations

KGPCo has identified, but not recognized, ARO liabilities related to electric transmission and distribution assets, as a result of certain easements on property on which assets are owned. Generally, such easements are perpetual and require only the retirement and removal of assets upon the cessation of the property's use. The retirement obligation is not estimable for such easements since KGPCo plans to use its facilities indefinitely. The retirement obligation would only be recognized if and when KGPCo abandons or ceases the use of specific easements, which is not expected.

Allowance for Funds Used During Construction

KGPCo's amounts of allowance for borrowed funds used during construction were $40 thousand and $17 thousand in 2016 and 2015, respectively, and are included in Interest Expense on KGPCo's statements of income.