

# Kingsport Power Company

2019 Annual Report

Audited Financial Statements



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## GLOSSARY OF TERMS

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

Term	Meaning
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 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.
AEPTCo	AEP Transmission Company, LLC, a subsidiary of AEP Transmission Holdco, is an intermediate holding company that owns seven wholly-owned transmission companies.
AFUDC	Allowance for Funds Used During Construction.
APCo	Appalachian Power Company, an AEP electric utility subsidiary.
ARAM	Average Rate Assumption Method, an IRS approved method used to calculate the reversal of Excess ADIT for ratemaking purposes.
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.
Excess ADIT	Excess accumulated deferred income taxes.
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.
kV	Kilovolt.
MTM	Mark-to-Market.
OATT	Open Access Transmission Tariff.
OPCo	Ohio Power Company, an AEP electric utility subsidiary.
OPEB	Other Postretirement Benefits.
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.
ROE	Return on Equity.
RTO	Regional Transmission Organization, responsible for moving electricity over large interstate areas.
SEC	U.S. Securities and Exchange Commission.
Tax Reform	On December 22, 2017, President Trump signed into law legislation referred to as the “Tax Cuts and Jobs Act” (the TCJA). The TCJA includes significant changes to the Internal Revenue Code of 1986, including a reduction in the corporate federal income tax rate from 35% to 21% effective January 1, 2018.

<b>Term</b>	<b>Meaning</b>
TPUC	Tennessee Public Utility Commission, formerly known as Tennessee Regulatory Authority (TRA).
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.



## Report of Independent Auditors

To the Board of Directors and Management of  
Kingsport Power Company

We have audited the accompanying financial statements of Kingsport Power Company, which comprise the balance sheets as of December 31, 2019 and 2018, and the related statements of income, of changes in common shareholder's equity and of cash flows for the years then ended.

### ***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of the 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 the 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 our 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, we consider 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, 2019 and 2018, 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.

### ***Emphasis of Matter***

As discussed in Note 10 to the financial statements, the Company changed the manner in which it accounts for leases in 2019. Our opinion is not modified with respect to this matter.

  
March 26, 2020

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**KINGSPORT POWER COMPANY**  
**STATEMENTS OF INCOME**  
**For the Years Ended December 31, 2019 and 2018**  
**(in thousands)**

	<b>Years Ended December 31,</b>	
	<b>2019</b>	<b>2018</b>
<b>REVENUES</b>		
Electricity, Transmission and Distribution	\$ 157,668	\$ 162,762
Sales to AEP Affiliates	5,624	3,352
Other Revenues	441	240
<b>TOTAL REVENUES</b>	<b>163,733</b>	<b>166,354</b>
<b>EXPENSES</b>		
Purchased Electricity from AEP Affiliates	124,088	133,875
Other Operation	7,170	7,175
Maintenance	4,652	4,868
Depreciation and Amortization	7,953	7,285
Taxes Other Than Income Taxes	11,101	11,037
<b>TOTAL EXPENSES</b>	<b>154,964</b>	<b>164,240</b>
<b>OPERATING INCOME</b>	8,769	2,114
<b>Other Income (Expense):</b>		
Interest Income	—	26
Allowance for Equity Funds Used During Construction	69	161
Non-Service Cost Components of Net Periodic Benefit Cost	376	402
Interest Expense	(2,546)	(2,201)
<b>INCOME BEFORE INCOME TAX EXPENSE (BENEFIT)</b>	6,668	502
Income Tax Expense (Benefit)	239	(2,577)
<b>NET INCOME</b>	<b>\$ 6,429</b>	<b>\$ 3,079</b>

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

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

**KINGSPORT POWER COMPANY**  
**STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S EQUITY**  
**For the Years Ended December 31, 2019 and 2018**  
**(in thousands)**

	<u>Common Stock</u>	<u>Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Total</u>
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2017</b>	\$ 4,100	\$ 22,800	\$ 16,618	\$ 43,518
Capital Contribution from Parent		5,000		5,000
Net Income			3,079	3,079
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2018</b>	4,100	27,800	19,697	51,597
Capital Contribution from Parent		13,000		13,000
Net Income			6,429	6,429
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2019</b>	<u>\$ 4,100</u>	<u>\$ 40,800</u>	<u>\$ 26,126</u>	<u>\$ 71,026</u>

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

**KINGSPORT POWER COMPANY**  
**BALANCE SHEETS**  
**ASSETS**  
**December 31, 2019 and 2018**  
**(in thousands)**

	<b>December 31,</b>	
	<b>2019</b>	<b>2018</b>
<b>CURRENT ASSETS</b>		
Cash and Cash Equivalents	\$ 111	\$ 127
Accounts Receivable:		
Customers	3,882	4,329
Affiliated Companies	1,852	2,640
Accrued Unbilled Revenues	902	269
Miscellaneous	4	8
Allowance for Uncollectible Accounts	—	(2)
Total Accounts Receivable	6,640	7,244
Materials and Supplies	347	325
Accrued Tax Benefits	1,490	1,475
Prepayments	2,408	2,306
Other Current Assets	73	97
<b>TOTAL CURRENT ASSETS</b>	<b>11,069</b>	<b>11,574</b>
<b>PROPERTY, PLANT AND EQUIPMENT</b>		
Electric:		
Transmission	43,121	38,926
Distribution	189,413	173,780
Other Property, Plant and Equipment	10,235	8,983
Construction Work in Progress	13,921	9,346
<b>Total Property, Plant and Equipment</b>	256,690	231,035
Accumulated Depreciation and Amortization	77,746	76,708
<b>TOTAL PROPERTY, PLANT AND EQUIPMENT – NET</b>	<b>178,944</b>	<b>154,327</b>
<b>OTHER NONCURRENT ASSETS</b>		
Regulatory Assets	20,587	14,510
Deferred Charges and Other Noncurrent Assets	4,972	2,715
<b>TOTAL OTHER NONCURRENT ASSETS</b>	<b>25,559</b>	<b>17,225</b>
<b>TOTAL ASSETS</b>	<b>\$ 215,572</b>	<b>\$ 183,126</b>

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



**KINGSPORT POWER COMPANY**  
**BALANCE SHEETS**  
**LIABILITIES AND COMMON SHAREHOLDER'S EQUITY**  
**December 31, 2019 and 2018**

	<b>December 31,</b>	
	<b>2019</b>	<b>2018</b>
	<b>(in thousands)</b>	
<b>CURRENT LIABILITIES</b>		
Advances from Affiliates	\$ 14,499	\$ 14,948
Accounts Payable		
General	4,779	4,171
Affiliated Companies	13,455	13,940
Long-term Debt Due Within One Year – Affiliated	20,000	—
Customer Deposits	4,342	4,427
Accrued Taxes	1,999	1,957
Accrued Interest	1,816	1,713
Obligations Under Operating Leases	275	—
Other Current Liabilities	2,582	2,298
<b>TOTAL CURRENT LIABILITIES</b>	<b>63,747</b>	<b>43,454</b>
<b>NONCURRENT LIABILITIES</b>		
Long-term Debt – Affiliated	39,000	50,000
Deferred Income Taxes	24,082	21,212
Regulatory Liabilities and Deferred Investment Tax Credits	14,013	14,049
Employee Benefits and Pension Obligations	1,624	1,523
Obligations Under Operating Leases	1,603	—
Deferred Credits and Other Noncurrent Liabilities	477	1,291
<b>TOTAL NONCURRENT LIABILITIES</b>	<b>80,799</b>	<b>88,075</b>
<b>TOTAL LIABILITIES</b>	<b>144,546</b>	<b>131,529</b>
Rate Matters (Note 3)		
Commitments and Contingencies (Note 5)		
<b>COMMON SHAREHOLDER'S EQUITY</b>		
Common Stock – No Par Value:		
Authorized – 500,000 Shares		
Outstanding – 410,000 Shares	4,100	4,100
Paid-in Capital	40,800	27,800
Retained Earnings	26,126	19,697
<b>TOTAL COMMON SHAREHOLDER'S EQUITY</b>	<b>71,026</b>	<b>51,597</b>
<b>TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY</b>	<b>\$ 215,572</b>	<b>\$ 183,126</b>

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

**KINGSPORT POWER COMPANY**  
**STATEMENTS OF CASH FLOWS**  
**For the Years Ended December 31, 2019 and 2018**  
(in thousands)

	<b>Years Ended December 31,</b>	
	<b>2019</b>	<b>2018</b>
<b>OPERATING ACTIVITIES</b>		
<b>Net Income</b>	\$ 6,429	\$ 3,079
<b>Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:</b>		
Depreciation and Amortization	7,953	7,285
Deferred Income Taxes	1,366	(2,685)
Change in Regulatory Assets	(6,504)	(2,108)
Change in Other Noncurrent Assets	258	(1,371)
Change in Other Noncurrent Liabilities	(2,551)	(631)
<b>Changes in Certain Components of Working Capital:</b>		
Accounts Receivable, Net	813	1,127
Materials and Supplies	(22)	(41)
Accounts Payable	(689)	349
Accrued Taxes, Net	27	(549)
Other Current Assets	(45)	(130)
Other Current Liabilities	(1,261)	49
<b>Net Cash Flows from Operating Activities</b>	<u>5,774</u>	<u>4,374</u>
<b>INVESTING ACTIVITIES</b>		
Construction Expenditures	(29,005)	(25,356)
Change in Advances to Affiliates, Net	—	927
Proceeds from Sales of Assets	1,745	66
Other Investing Activities	35	154
<b>Net Cash Flows Used for Investing Activities</b>	<u>(27,225)</u>	<u>(24,209)</u>
<b>FINANCING ACTIVITIES</b>		
Capital Contribution from Parent	13,000	5,000
Issuance of Long-term Debt – Affiliated	9,000	—
Change in Advances from Affiliates, Net	(449)	14,948
Principal Payments for Finance Lease Obligations	(175)	(158)
Other Financing Activities	59	78
<b>Net Cash Flows from Financing Activities</b>	<u>21,435</u>	<u>19,868</u>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	(16)	33
<b>Cash and Cash Equivalents at Beginning of Period</b>	127	94
<b>Cash and Cash Equivalents at End of Period</b>	<u>\$ 111</u>	<u>\$ 127</u>
<b>SUPPLEMENTARY INFORMATION</b>		
Cash Paid for Interest, Net of Capitalized Amounts	\$ 2,400	\$ 2,098
Net Cash Paid (Received) for Income Taxes	(1,096)	825
Noncash Acquisitions Under Finance Leases	263	91
Construction Expenditures Included in Current Liabilities as of December 31,	3,165	2,280

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

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## **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 TPUC. 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 TPUC 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 TPUC 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 TPUC.

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 “Securitized Accounts 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:

<b>Percentage of Operating Revenues</b>	<b>2019</b>	<b>2018</b>
Customer Who Manufactures Paper Products	14%	13%
Customer Who Manufactures Chemical Products	12%	11%

<b>Percentage of Accounts Receivable</b>	<b>2019</b>	<b>2018</b>
Customer Who Manufactures Paper Products	12%	11%
Customer Who Manufactures Chemical Products	12%	10%

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 the revenue received for removal costs accrued exceeds 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.” When it becomes probable that an asset in service or an asset under construction will be abandoned and regulatory cost recovery has been disallowed or is not probable, the cost of that asset shall be removed from plant-in-service or construction work in progress and charged to expense.

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. KGPCo records the equity component of AFUDC in Allowance for Equity Funds Used During Construction and the debt component of AFUDC as a reduction to Interest Expense.

### ***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.

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.

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. 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. Investments classified as Other are valued using Net Asset Value as a practical expedient. Items classified as Other are primarily cash equivalent funds, common collective trusts, commingled funds, structured products, real estate, infrastructure and alternative credit investments. These investments do not have a readily determinable fair value or they contain redemption restrictions which may include the right to suspend redemptions under certain circumstances. Redemption restrictions may also prevent certain investments from being redeemed at the reporting date for the underlying value.

## ***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 or alternative revenues recognized in accordance with the guidance for "Regulated Operations") 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 revenue 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 TPUC.

#### *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. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which the temporary differences are expected to be recovered or settled. KGPCo revalued deferred tax assets and liabilities at the new federal corporate income tax rate of 21% in December 2017. See Note 9 for additional information related to Tax Reform.

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.

KGPCo applies the deferral methodology for the recognition of investment tax credits (ITC). 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. KGPCo's uncertain tax positions are immaterial to the financial statements.

#### *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:

<b>Pension Plan Assets</b>	<b>Target</b>
Equity	30%
Fixed Income	54%
Other Investments	15%
Cash and Cash Equivalents	1%

<b>OPEB Plans Assets</b>	<b>Target</b>
Equity	48%
Fixed Income	50%
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 or certain commingled funds). 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 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 opportunistic classifications.

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 investments.

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 to provide modest incremental income with a limited increase in risk. As of December 31, 2019 and 2018, the fair value of securities on loan as part of the program was \$246.3 million and \$240.7 million, respectively. Cash and securities obtained as collateral exceeded the fair value of the securities loaned as of December 31, 2019 and 2018.

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.

### ***Reclassifications***

Certain reclassifications have been made in the 2018 financial statements and notes to conform to the 2019 presentation.

### ***Correction of a Prior Period Misstatement***

In 2019, KGPCo recorded an out of period adjustment, which reduced Income Tax Expense by \$669 thousand, Deferred Income Tax liability by \$891 thousand and Regulatory Assets by \$222 thousand. The misstatement in the 2018 financial statements as well as the correcting entry in the 2019 financial statements was not material to either year.

### ***Subsequent Events***

Management reviewed subsequent events through March 26, 2020, the date that KGPCo's 2019 annual report was available to be issued.

## 2. NEW ACCOUNTING STANDARDS

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

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

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

New leasing standard implementation activities included the identification of the lease population within the AEP System as well as the sampling of representative lease contracts to analyze accounting treatment under the new accounting guidance. Based upon the completed assessments, management also prepared a gap analysis to outline new disclosure compliance requirements.

Management adopted ASU 2016-02 effective January 1, 2019 by means of a cumulative-effect adjustment to the balance sheets. Management elected the following practical expedients upon adoption:

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

Management concluded that the result of adoption would not materially change the volume of contracts that qualify as leases going forward. The adoption of the new standard did not materially impact results of operations or cash flows, but did have a material impact on the balance sheets. See Note 10 - Leases for additional disclosures required by the new standard.

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

In June 2016, the FASB issued ASU 2016-13 requiring the recognition of an allowance for expected credit losses for financial instruments within its scope. Examples of financial instruments that are in scope include trade receivables, certain financial guarantees, and held-to-maturity debt securities. The allowance for expected credit losses should be based on historical information, current conditions and reasonable and supportable forecasts. Entities are required to evaluate, and if necessary, recognize expected credit losses at the inception or initial acquisition of a financial instrument (or pool of financial instruments that share similar risk characteristics) subject to ASU 2016-13, and subsequently as of each reporting date. The new standard also revises the other-than-temporary impairment model for available-for-sale debt securities.

Management adopted ASU 2016-13 and its related implementation guidance effective January 1, 2020, by means of a cumulative-effect adjustment to the balance sheets. The adoption of the new standard did not have a material impact to financial position, and had no impact on the results of operations or cash flows. Additionally, the adoption of the new standard did not result in any changes to current accounting systems.

Implementation activities included: (1) the identification and evaluation of the population of financial instruments within the AEP system that are subject to the new standard and, (2) the development of supporting valuation models to also contemplate appropriate metrics for current and supportable forecasted information. As required by ASU 2016-13, the financial instruments subject to the new standard were evaluated on a pool-basis to the extent such financial instruments shared similar risk characteristics.

Management continues to develop disclosures to comply with the requirements of ASU 2016-13 that are required in the first quarter of 2020. Management will continue to monitor for any potential industry implementation issues.

### **3. RATE MATTERS**

KGPCo is involved in rate and regulatory proceedings at the FERC and the TPUC. 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.

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

In 2016, seven parties filed a complaint at the FERC that alleged the base return on common equity used by AEP's transmission owning subsidiaries within PJM, including KGPCo, in calculating formula transmission rates under the PJM Open Access Transmission Tariff is excessive and should be reduced from 10.99% to 8.32%, effective upon the date of the complaint. In March 2018, AEP's transmission owning subsidiaries within PJM and six of the complainants filed a settlement agreement with the FERC (the seventh complainant abstained). The settlement agreement: (a) established a base return on equity for AEP's transmission owning subsidiaries within PJM of 9.85% (10.35% inclusive of the regional transmission organization incentive adder of 0.5%), effective January 1, 2018, (b) required AEP's transmission owning subsidiaries within PJM to provide a onetime refund of \$50 million, attributable from the date of the complaint through December 31, 2017, which was credited to customer bills in the second quarter of 2018 and (c) increased the cap on the equity portion of the capital structure to 55% from 50%. As part of the settlement agreement, AEP's transmission owning subsidiaries within PJM, including KGPCo, also filed updated transmission formula rates incorporating the reduction in the corporate federal income tax rate due to Tax Reform, effective January 1, 2018 and providing for the amortization of the portion of the Excess ADIT that is not subject to rate normalization requirements over a ten-year period through credits to the federal income tax expense component of the revenue requirement. In May 2019, the FERC approved the settlement agreement.

#### 4. EFFECTS OF REGULATION

Regulatory assets and liabilities are comprised of the following items:

	<u>December 31,</u> <u>2019</u>	<u>2018</u>	<u>Remaining</u> <u>Recovery Period</u>
	(in thousands)		
<b>Regulatory Assets:</b>			
<b>Noncurrent Regulatory Assets</b>			
<b>Regulatory assets approved for recovery:</b>			
<u>Regulatory Assets Currently Not Earning a Return</u>			
Targeted Reliability Plan and Major Storm Rider Costs	\$ 7,387	\$ 5,107	2 years
Fuel and Purchased Power Adjustment Rider	7,052	2,711	2 years
Pension and OPEB Funded Status	5,108	5,514	11 years
Postemployment Benefits	306	345	4 years
PJM Annual Formula Rate True Up	203	—	2 years
Peak Demand Reduction/Energy Efficiency	191	305	2 years
Rate Case Expenses	169	270	2 years
Medicare Subsidy	153	183	5 years
Other Regulatory Assets Approved for Recovery	18	75	various
<b>Total Regulatory Assets Approved for Recovery</b>	<u>20,587</u>	<u>14,510</u>	
<b>Total Noncurrent Regulatory Assets</b>	<u>\$ 20,587</u>	<u>\$ 14,510</u>	
	<u>December 31,</u> <u>2019</u>	<u>2018</u>	<u>Remaining</u> <u>Refund Period</u>
	(in thousands)		
<b>Regulatory Liabilities:</b>			
<b>Noncurrent Regulatory Liabilities and</b> <b>Deferred Investment Tax Credits</b>			
<b>Regulatory liabilities approved for payment:</b>			
<u>Regulatory Liabilities Currently Paying a Return</u>			
Asset Removal Costs	\$ 6,271	\$ 3,001	(b)
<b>Total Regulatory Liabilities Currently Paying a Return</b>	<u>6,271</u>	<u>3,001</u>	
<u>Regulatory Liabilities Currently Not Paying a Return</u>			
PJM Transmission Enhancement Refund	1,264	3,074	6 years
<b>Total Regulatory Liabilities Currently Not Paying a Return</b>	<u>1,264</u>	<u>3,074</u>	
<u>Income Tax Related Regulatory Liabilities (a)</u>			
Excess ADIT Associated with Certain Depreciable Property	11,580	11,722	(c)
Excess ADIT that is Not Subject to Rate Normalization Requirements	546	1,283	9 years
Income Taxes Subject to Flow Through	(5,648)	(5,031)	21 years
<b>Total Income Tax Related Regulatory Liabilities</b>	<u>6,478</u>	<u>7,974</u>	
<b>Total Regulatory Liabilities Approved for Payment</b>	<u>14,013</u>	<u>14,049</u>	
<b>Total Noncurrent Regulatory Liabilities and Deferred</b> <b>Investment Tax Credits</b>	<u>\$ 14,013</u>	<u>\$ 14,049</u>	

- (a) This balance primarily represents regulatory liabilities for Excess ADIT as a result of the reduction in the corporate federal income tax rate from 35% to 21% related to the enactment of Tax Reform. The regulatory liability balance predominately pays a return due to the inclusion of Excess ADIT in rate base. See “Federal Tax Reform” section of Note 9 for additional information.
- (b) Relieved as removal costs are incurred.
- (c) Refunded using ARAM.

## **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, 2019.

### **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, 2019, 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.

### *Claims Challenging Transition of American Electric Power System Retirement Plan to Cash Balance Formula*

The American Electric Power System Retirement Plan (the Plan) has received a letter written on behalf of four participants (the Claimants) making a claim for additional plan benefits and purporting to advance such claims on behalf of a class. When the Plan's benefit formula was changed in the year 2000, AEP provided a special provision for employees hired before January 1, 2001, allowing them to continue benefit accruals under the then benefit formula for a full 10 years alongside of the new cash balance benefit formula then being implemented. Employees who were hired on or after January 1, 2001 accrued benefits only under the new cash balance benefit formula. The Claimants have asserted claims that (a) the Plan violates the requirements under the Employee Retirement Income Security Act (ERISA) intended to preclude back-loading the accrual of benefits to the end of a participant's career; (b) the Plan violates the age discrimination prohibitions of ERISA and the Age Discrimination in Employment Act (ADEA); and (c) the company failed to provide required notice regarding the changes to the Plan. AEP has responded to the Claimants providing a reasoned explanation for why each of their claims have been denied, and offering an opportunity to appeal those determinations. Management will continue to defend against the claims. Management is unable to determine a range of potential losses that are reasonably possible of occurring.

## 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 on 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. 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:

Assumptions	Pension Plan		OPEB	
	December 31,			
	2019	2018	2019	2018
Discount Rate	3.25%	4.30%	3.30%	4.30%
Interest Crediting Rate	4.00%	4.00%	NA	NA
Rate of Compensation Increase	4.70% (a)	4.65% (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 2019, the rate of compensation increase assumed varies with the age of the employee, ranging from 3% per year to 11.5% per year, with the average increase shown in the table above.

### *Actuarial Assumptions for Net Periodic Benefit Costs*

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

Assumptions	Pension Plan		OPEB	
	Years Ended December 31,			
	2019	2018	2019	2018
Discount Rate	4.30%	3.65%	4.30%	3.60%
Interest Crediting Rate	4.00%	4.00%	NA	NA
Expected Return on Plan Assets	6.25%	6.00%	6.25%	6.00%
Rate of Compensation Increase	4.65% (a)	4.65% (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:

<b>Health Care Trend Rates</b>	<b>December 31,</b>	
	<b>2019</b>	<b>2018</b>
Initial	6.00%	6.25%
Ultimate	4.50%	5.00%
Year Ultimate Reached	2026	2024

***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, 2019, 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**

For the year ended December 31, 2019, the pension plans had an actuarial loss due to a decrease in the discount rate, partially offset by updates to the mortality table. For the year ended December 31, 2019, the OPEB plans had an actuarial loss due to a decrease in the discount rate and an update to the persistency assumption, partially offset by an update to the projected per capita cost assumption as well as savings resulting from legislation signed in December 2019 which eliminated two Affordable Care Act taxes. For the year ended December 31, 2018, the pension and OPEB plans had an actuarial gain due to an increase in the discount rate as well as updated estimates for future medical expenses in the OPEB plans. 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.

	<b>Pension Plan</b>		<b>OPEB</b>	
	<b>2019</b>	<b>2018</b>	<b>2019</b>	<b>2018</b>
	<b>(in thousands)</b>			
<b>Change in Benefit Obligation</b>				
Benefit Obligation as of January 1,	\$ 15,622	\$ 16,842	\$ 3,947	\$ 4,500
Service Cost	261	259	34	39
Interest Cost	648	608	161	156
Actuarial (Gain) Loss	1,127	(990)	23	(420)
Plan Amendments	—	—	(34)	—
Benefit Payments	(1,014)	(1,097)	(334)	(459)
Participant Contributions	—	—	112	130
Medicare Subsidy	—	—	1	1
<b>Benefit Obligation as of December 31,</b>	<b>\$ 16,644</b>	<b>\$ 15,622</b>	<b>\$ 3,910</b>	<b>\$ 3,947</b>
<b>Change in Fair Value of Plan Assets</b>				
Fair Value of Plan Assets as of January 1,	\$ 14,586	\$ 15,990	\$ 5,345	\$ 6,190
Actual Gain (Loss) on Plan Assets	1,910	(307)	798	(516)
Participant Contributions	—	—	112	130
Benefit Payments	(1,014)	(1,097)	(334)	(459)
<b>Fair Value of Plan Assets as of December 31,</b>	<b>\$ 15,482</b>	<b>\$ 14,586</b>	<b>\$ 5,921</b>	<b>\$ 5,345</b>
<b>Funded (Underfunded) Status as of December 31,</b>	<b>\$ (1,162)</b>	<b>\$ (1,036)</b>	<b>\$ 2,011</b>	<b>\$ 1,398</b>

**Amounts Recognized on the Balance Sheets**

	<b>Pension Plan</b>		<b>OPEB</b>	
	<b>2019</b>	<b>2018</b>	<b>2019</b>	<b>2018</b>
	<b>December 31,</b>			
	<b>(in thousands)</b>			
Deferred Charges and Other Noncurrent Assets – Prepaid Benefit Costs	\$ —	\$ —	\$ 2,011	\$ 1,398
Employee Benefits and Pension Obligations –Accrued Long-term Benefit Liability	(1,162)	(1,036)	—	—
<b>Funded (Underfunded) Status</b>	<b>\$ (1,162)</b>	<b>\$ (1,036)</b>	<b>\$ 2,011</b>	<b>\$ 1,398</b>

### *Amounts Included in Regulatory Assets*

The following table shows the components of the plans included in Regulatory Assets:

<b>Components</b>	<b>Pension Plan</b>		<b>OPEB</b>	
	<b>December 31,</b>			
	<b>2019</b>	<b>2018</b>	<b>2019</b>	<b>2018</b>
	<b>(in thousands)</b>			
Net Actuarial Loss	\$ 5,444	\$ 5,499	\$ 561	\$ 1,107
Prior Service Credit	—	—	(897)	(1,092)
<b>Recorded as</b>				
Regulatory Assets	\$ 5,444	\$ 5,499	\$ (336)	\$ 15

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

<b>Components</b>	<b>Pension Plan</b>		<b>OPEB</b>	
	<b>December 31,</b>			
	<b>2019</b>	<b>2018</b>	<b>2019</b>	<b>2018</b>
	<b>(in thousands)</b>			
Actuarial (Gain) Loss During the Year	\$ 124	\$ 215	\$ (473)	\$ 449
Amortization of Actuarial Loss	(179)	(272)	(73)	(32)
Prior Service Credit	—	—	(23)	—
Amortization of Prior Service Credit	—	—	218	217
<b>Change for the Year Ended December 31,</b>	<u>\$ (55)</u>	<u>\$ (57)</u>	<u>\$ (351)</u>	<u>\$ 634</u>

### *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.

### *Pension and OPEB Assets*

The fair value tables within Pension and OPEB 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:

<b>Pension Plan</b>		<b>OPEB</b>	
<b>December 31,</b>			
<b>2019</b>	<b>2018</b>	<b>2019</b>	<b>2018</b>
0.3%	0.3%	0.3%	0.3%

The following table presents the classification of pension plan assets for AEP within the fair value hierarchy as of December 31, 2019:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
	(in millions)					
Equities (a):						
Domestic	\$ 387.8	\$ —	\$ —	\$ —	\$ 387.8	7.8 %
International	609.1	—	—	—	609.1	12.1 %
Common Collective Trusts (c)	—	—	—	547.3	547.3	10.9 %
Subtotal – Equities	996.9	—	—	547.3	1,544.2	30.8 %
Fixed Income (a):						
United States Government and Agency Securities	(5.8)	1,248.6	—	—	1,242.8	24.8 %
Corporate Debt	—	1,143.7	—	—	1,143.7	22.8 %
Foreign Debt	—	211.6	—	—	211.6	4.2 %
State and Local Government	—	55.1	—	—	55.1	1.1 %
Other – Asset Backed	—	3.6	—	—	3.6	0.1 %
Subtotal – Fixed Income	(5.8)	2,662.6	—	—	2,656.8	53.0 %
Infrastructure (c)	—	—	—	85.8	85.8	1.7 %
Real Estate (c)	—	—	—	239.4	239.4	4.8 %
Alternative Investments (c)	—	—	—	448.3	448.3	8.9 %
Cash and Cash Equivalents (c)	—	24.4	—	37.2	61.6	1.2 %
Other – Pending Transactions and Accrued Income (b)	—	—	—	(20.7)	(20.7)	(0.4)%
<b>Total</b>	<b>\$ 991.1</b>	<b>\$ 2,687.0</b>	<b>\$ —</b>	<b>\$ 1,337.3</b>	<b>\$ 5,015.4</b>	<b>100.0 %</b>

- (a) Includes investment securities loaned to borrowers under the securities lending program. See the “Investments Held in Trust for Future Liabilities” section of Note 1 for additional information.
- (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.

The following table presents the classification of OPEB plan assets for AEP within the fair value hierarchy as of December 31, 2019:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
	(in millions)					
Equities:						
Domestic	\$ 312.2	\$ —	\$ —	\$ —	\$ 312.2	17.5%
International	251.5	—	—	—	251.5	14.1%
Common Collective Trusts (b)	—	—	—	260.8	260.8	14.7%
Subtotal – Equities	<u>563.7</u>	<u>—</u>	<u>—</u>	<u>260.8</u>	<u>824.5</u>	<u>46.3%</u>
Fixed Income:						
Common Collective Trust – Debt (b)	—	—	—	177.6	177.6	10.0%
United States Government and Agency Securities	(0.1)	214.4	—	—	214.3	12.0%
Corporate Debt	—	206.7	—	—	206.7	11.6%
Foreign Debt	—	35.5	—	—	35.5	2.0%
State and Local Government	58.8	14.8	—	—	73.6	4.1%
Other – Asset Backed	—	0.2	—	—	0.2	—%
Subtotal – Fixed Income	<u>58.7</u>	<u>471.6</u>	<u>—</u>	<u>177.6</u>	<u>707.9</u>	<u>39.7%</u>
Trust Owned Life Insurance:						
International Equities	—	60.2	—	—	60.2	3.4%
United States Bonds	—	151.6	—	—	151.6	8.5%
Subtotal – Trust Owned Life Insurance	<u>—</u>	<u>211.8</u>	<u>—</u>	<u>—</u>	<u>211.8</u>	<u>11.9%</u>
Cash and Cash Equivalents (b)	26.7	—	—	6.7	33.4	1.9%
Other – Pending Transactions and Accrued Income (a)	—	—	—	4.2	4.2	0.2%
<b>Total</b>	<u>\$ 649.1</u>	<u>\$ 683.4</u>	<u>\$ —</u>	<u>\$ 449.3</u>	<u>\$ 1,781.8</u>	<u>100.0%</u>

- (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.

The following table presents the classification of pension plan assets for AEP within the fair value hierarchy as of December 31, 2018:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
	(in millions)					
Equities (a):						
Domestic	\$ 277.3	\$ —	\$ —	\$ —	\$ 277.3	5.9%
International	384.1	—	—	—	384.1	8.2%
Options	—	18.3	—	—	18.3	0.4%
Common Collective Trusts (c)	—	—	—	370.1	370.1	7.9%
Subtotal – Equities	661.4	18.3	—	370.1	1,049.8	22.4%
Fixed Income (a):						
United States Government and Agency Securities	0.2	1,512.5	—	—	1,512.7	32.2%
Corporate Debt	—	1,082.9	—	—	1,082.9	23.0%
Foreign Debt	—	221.6	—	—	221.6	4.7%
State and Local Government	—	28.2	—	—	28.2	0.6%
Other – Asset Backed	—	7.4	—	—	7.4	0.2%
Subtotal – Fixed Income	0.2	2,852.6	—	—	2,852.8	60.7%
Infrastructure (c)	—	—	—	72.2	72.2	1.5%
Real Estate (c)	—	—	—	220.4	220.4	4.7%
Alternative Investments (c)	—	—	—	444.6	444.6	9.5%
Cash and Cash Equivalents (c)	(0.4)	36.3	—	11.9	47.8	1.0%
Other – Pending Transactions and Accrued Income (b)	—	—	—	8.3	8.3	0.2%
<b>Total</b>	<b>\$ 661.2</b>	<b>\$ 2,907.2</b>	<b>\$ —</b>	<b>\$ 1,127.5</b>	<b>\$ 4,695.9</b>	<b>100.0%</b>

- (a) Includes investment securities loaned to borrowers under the securities lending program. See the “Investments Held in Trust for Future Liabilities” section of Note 1 for additional information.
- (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.



The following table presents the classification of OPEB plan assets for AEP within the fair value hierarchy as of December 31, 2018:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
	(in millions)					
Equities:						
Domestic	\$ 233.3	\$ —	\$ —	\$ —	\$ 233.3	15.2 %
International	185.9	—	—	—	185.9	12.1 %
Options	—	4.3	—	—	4.3	0.3 %
Common Collective Trusts (b)	—	—	—	226.2	226.2	14.7 %
Subtotal – Equities	419.2	4.3	—	226.2	649.7	42.3 %
Fixed Income:						
Common Collective Trust – Debt (b)	—	—	—	163.6	163.6	10.7 %
United States Government and Agency Securities	0.2	181.5	—	—	181.7	11.8 %
Corporate Debt	—	188.6	—	—	188.6	12.3 %
Foreign Debt	—	35.0	—	—	35.0	2.3 %
State and Local Government	41.8	11.8	—	—	53.6	3.5 %
Other – Asset Backed	—	0.2	—	—	0.2	— %
Subtotal – Fixed Income	42.0	417.1	—	163.6	622.7	40.6 %
Trust Owned Life Insurance:						
International Equities	—	49.4	—	—	49.4	3.2 %
United States Bonds	—	154.4	—	—	154.4	10.1 %
Subtotal – Trust Owned Life Insurance	—	203.8	—	—	203.8	13.3 %
Cash and Cash Equivalents (b)	54.4	—	—	4.8	59.2	3.9 %
Other – Pending Transactions and Accrued Income (a)	—	—	—	(1.2)	(1.2)	(0.1)%
<b>Total</b>	<b>\$ 515.6</b>	<b>\$ 625.2</b>	<b>\$ —</b>	<b>\$ 393.4</b>	<b>\$ 1,534.2</b>	<b>100.0 %</b>

(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.

### ***Accumulated Benefit Obligation***

As of December 31, 2019 and 2018, the accumulated benefit obligation for the qualified pension plan was \$16.1 million and \$15.1 million, respectively.

### ***Obligations in Excess of Fair Values***

The tables below show the underfunded pension plan that had obligations in excess of plan assets.

#### ***Projected Benefit Obligation***

	<b>Underfunded Pension Plan</b>	
	<b>December 31,</b>	
	<b>2019</b>	<b>2018</b>
	<b>(in thousands)</b>	
Projected Benefit Obligation	\$ 16,644	\$ 15,622
Fair Value of Plan Assets	15,482	14,587
<b>Underfunded Projected Benefit Obligation</b>	<b><u>\$ (1,162)</u></b>	<b><u>\$ (1,035)</u></b>

#### ***Accumulated Benefit Obligation***

	<b>Underfunded Pension Plan</b>	
	<b>December 31,</b>	
	<b>2019</b>	<b>2018</b>
	<b>(in thousands)</b>	
Accumulated Benefit Obligation	\$ 16,140	\$ 15,115
Fair Value of Plan Assets	15,481	14,587
<b>Underfunded Accumulated Benefit Obligation</b>	<b><u>\$ (659)</u></b>	<b><u>\$ (528)</u></b>

### ***Estimated Future Benefit Payments and Contributions***

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:

	<b>Estimated Payments</b>	
	<b>Pension Plan</b>	<b>OPEB</b>
	<b>(in thousands)</b>	
2020	\$ 1,134	\$ 392
2021	1,126	387
2022	1,142	395
2023	1,206	394
2024	1,168	416
Years 2025 to 2029, in Total	5,698	2,089

### *Components of Net Periodic Benefit Cost*

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

	Pension Plan		OPEB	
	2019	2018	Years Ended December 31,	
			2019	2018
			(in thousands)	
Service Cost	\$ 261	\$ 259	\$ 34	\$ 39
Interest Cost	648	608	161	156
Expected Return on Plan Assets	(907)	(898)	(312)	(355)
Amortization of Prior Service Cost	—	—	(218)	(217)
Amortization of Net Actuarial Loss	179	272	73	32
<b>Net Periodic Benefit Cost (Credit)</b>	181	241	(262)	(345)
Capitalized Portion	(144)	(151)	(19)	(23)
<b>Net Periodic Benefit Cost (Credit) Recognized in Expense</b>	\$ 37	\$ 90	\$ (281)	\$ (368)

### *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 \$194 thousand in 2019 and \$197 thousand in 2018.

## **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, 2019 and 2018 were 31 thousand gallons and 56 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, 2019 and 2018 balance sheets, KGPCo had no netting of cash collateral received from third parties against short-term and long-term risk management assets and netted \$0 and \$20 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, 2019**

<b>Balance Sheet Location</b>	<b>Risk Management Contracts Commodity (a)</b>	<b>Gross Amounts Offset in the Statement of Financial Position (b)</b>	<b>Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)</b>
		(in thousands)	
Other Current Assets	\$ 1	\$ —	\$ 1
Deferred Charges and Other Noncurrent Assets	—	—	—
<b>Total Assets</b>	<b>1</b>	<b>—</b>	<b>1</b>
Other Current Liabilities	—	—	—
Deferred Credits and Other Noncurrent Liabilities	—	—	—
<b>Total Liabilities</b>	<b>—</b>	<b>—</b>	<b>—</b>
<b>Total MTM Derivative Contract Net Assets</b>	<b>\$ 1</b>	<b>\$ —</b>	<b>\$ 1</b>

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

<b>Balance Sheet Location</b>	<b>Risk Management Contracts Commodity (a)</b>	<b>Gross Amounts Offset in the Statement of Financial Position (b)</b>	<b>Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)</b>
		(in thousands)	
Other Current Assets	\$ —	\$ —	\$ —
Deferred Charges and Other Noncurrent Assets	—	—	—
<b>Total Assets</b>	<b>—</b>	<b>—</b>	<b>—</b>
Other Current Liabilities	27	(20)	7
Deferred Credits and Other Noncurrent Liabilities	—	—	—
<b>Total Liabilities</b>	<b>27</b>	<b>(20)</b>	<b>7</b>
<b>Total MTM Derivative Contract Net Assets</b>	<b>\$ (27)</b>	<b>\$ 20</b>	<b>\$ (7)</b>

- (a) Derivative instruments within this category are reported gross. These instruments are subject to master netting agreements and are presented on the balance sheets on a net basis in accordance with the accounting guidance for "Derivatives and Hedging."
- (b) Amounts include counterparty netting of risk management and hedging contracts and associated cash collateral in accordance with the accounting guidance for "Derivatives and Hedging."
- (c) All derivative contracts subject to a master netting arrangement or similar agreement which are 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,	
	2019	2018
	(in thousands)	
Other Operation	\$ (4)	\$ 9
Maintenance	(7)	15
Regulatory Assets (a)	27	(27)
Regulatory Liability (a)	—	(18)
<b>Total Gain (Loss) on Risk Management Contracts</b>	<b>\$ 16</b>	<b>\$ (21)</b>

- (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,			
	2019		2018	
	<u>Book Value</u>	<u>Fair Value</u>	<u>Book Value</u>	<u>Fair Value</u>
	(in thousands)			
Long-term Debt	\$ 59,000	\$ 62,842	\$ 50,000	\$ 48,896

### *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, 2019**

<u>Risk Management Assets</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
Risk Management Commodity Contracts (a)	\$ —	\$ 1	\$ —	\$ —	\$ 1

#### **Assets and Liabilities Measured at Fair Value on a Recurring Basis**

**December 31, 2018**

<u>Risk Management Liabilities</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
Risk Management Commodity Contracts (a)	\$ —	\$ 27	\$ —	\$ (20)	\$ 7

(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, 2019, KGPCo had no liabilities measured at fair value on a recurring basis. As of December 31, 2018, KGPCo had no assets measured at fair value on a recurring basis.

There were no transfers between Level 1 and Level 2 during the years ended December 31, 2019 and 2018.

## 9. INCOME TAXES

### *Income Tax Expense (Benefit)*

The details of KGPCo's Income Tax Expense (Benefit) are as follows:

	<b>Year Ended December 31,</b>	
	<b>2019</b>	<b>2018</b>
	<b>(in thousands)</b>	
<b>Federal:</b>		
Current	\$ (1,126)	\$ 108
Deferred	1,611	(2,810)
<b>Total Federal</b>	<u>485</u>	<u>(2,702)</u>
<b>State and Local:</b>		
Current	(1)	—
Deferred	(245)	125
<b>Total State and Local</b>	<u>(246)</u>	<u>125</u>
<b>Income Tax Expense (Benefit)</b>	<u>\$ 239</u>	<u>\$ (2,577)</u>



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:

	<b>Years Ended December 31,</b>	
	<b>2019</b>	<b>2018</b>
	<b>(in thousands)</b>	
Net Income	\$ 6,429	\$ 3,079
Income Tax Expense (Benefit)	239	(2,577)
<b>Pretax Income</b>	<b>\$ 6,668</b>	<b>\$ 502</b>
Income Taxes on Pretax Income at Statutory Rate (21%)	\$ 1,400	\$ 105
Increase (Decrease) in Income Taxes Resulting from the Following Items:		
Depreciation	9	171
Removal Costs	114	(170)
AFUDC	(55)	(68)
State and Local Income Taxes, Net	(194)	98
Tax Reform Excess ADIT Reversal	(404)	(2,452)
Other	(631)	(261)
<b>Income Tax Expense (Benefit)</b>	<b>\$ 239</b>	<b>\$ (2,577)</b>
<b>Effective Income Tax Rate</b>	<b>3.6 %</b>	<b>(513.3)%</b>

### *Net Deferred Tax Liability*

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

	<b>December 31,</b>	
	<b>2019</b>	<b>2018</b>
	<b>(in thousands)</b>	
Deferred Tax Assets	\$ 6,348	\$ 4,937
Deferred Tax Liabilities	(30,430)	(26,149)
<b>Net Deferred Tax Liabilities</b>	<b>\$ (24,082)</b>	<b>\$ (21,212)</b>
Property Related Temporary Differences	\$ (20,064)	\$ (16,541)
Amounts Due to/(from) Customers for Future Income Taxes	3,123	631
Deferred State Income Taxes	(5,406)	(4,631)
Accrued Pensions	350	400
Regulatory Assets	(3,990)	(1,241)
State Net Operating Loss, Net of Federal Benefit	1,443	1,221
All Other, Net	462	(1,051)
<b>Net Deferred Tax Liabilities</b>	<b>\$ (24,082)</b>	<b>\$ (21,212)</b>

### ***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 by the IRS for all years through 2015. During the third quarter of 2019, AEP and subsidiaries elected to amend the 2014 and 2015 federal returns and as such the IRS may examine only the amended items on the 2014 and 2015 federal returns.

### ***Net Income Tax Operating Loss Carryforward***

KGPCo has Tennessee state net income tax operating loss carryforwards of \$28.1 million and \$23.8 million in 2019 and 2018, respectively. As a result, KGPCo recognized deferred state income tax benefits of \$1.8 million and \$1.5 million in 2019 and 2018, respectively. Management anticipates future taxable income will be sufficient to realize the state net income tax operating loss tax benefits before the state carryforward expires for Tennessee between 2029 and 2034.

### ***Federal Tax Reform and Legislation***

The IRS has issued new regulations that provide guidance regarding the additional first-year depreciation deduction under Section 168(k). The proposed regulations reflect changes as a result of Tax Reform and affect taxpayers with qualified depreciable property acquired and placed in-service after September 27, 2017. Generally, KGPCo will not be eligible for any bonus depreciation for property acquired and placed in-service after December 31, 2017.

During the fourth quarter of 2018, the IRS proposed new regulations that reflect changes as a result of Tax Reform concerning potential limitations on the deduction of business interest expense. These regulations require an allocation of net interest expense between regulated and competitive businesses within the consolidated tax return. This allocation is based upon net tax basis, and the proposed regulations provide a de minimis test under which all interest is deductible if less than 10% is allocable to the competitive businesses. Management continues to review and evaluate the proposed regulations and at this time expect to be able to deduct materially all business interest expense under this de minimis provision.

## 10. LEASES

KGPCo leases property, plant and equipment including, but not limited to, fleet, information technology and real estate leases. These leases require payments of non-lease components, including related property taxes, operating and maintenance costs. As of the adoption date of ASU 2016-02, management elected not to separate non-lease components from associated lease components in accordance with the accounting guidance for “Leases.” Many of these leases have purchase or renewal options. Leases not renewed are often replaced by other leases. Options to renew or purchase a lease are included in the measurement of lease assets and liabilities if it is reasonably certain that KGPCo will exercise the option.

Lease obligations are measured using the discount rate implicit in the lease when that rate is readily determinable. KGPCo has visibility into the rate implicit in the lease when assets are leased from selected financial institutions under master leasing agreements. When the implicit rate is not readily determinable, KGPCo measures its lease obligation using its estimated secured incremental borrowing rate. Incremental borrowing rates are comprised of an underlying risk free rate and a secured credit spread relative to the lessee on a matched maturity basis.

Operating lease rentals and finance lease amortization costs are generally charged to Other Operation and Maintenance expense in accordance with rate-making treatment for regulated operations. Effective in 2019, interest on finance lease liabilities is generally charged to Interest Expense. Finance lease interest for periods prior to 2019 were charged to Other Operation and Maintenance expense. Lease costs associated with capital projects are included in Property, Plant and Equipment on the balance sheets. For regulated operations with finance leases, a finance lease asset and offsetting liability are recorded at the present value of the remaining lease payments for each reporting period. Finance leases for nonregulated property are accounted for as if the assets were owned and financed. The components of rental costs were as follows:

Lease Rental Costs	Years Ended December 31,	
	2019	2018
	(in thousands)	
Operating Lease Cost	\$ 349	\$ 595
Finance Lease Cost:		
Amortization of Right-of-Use Assets	175	159
Interest on Lease Liabilities	22	20
<b>Total Lease Rental Costs (a)</b>	<b>\$ 546</b>	<b>\$ 774</b>

(a) Excludes variable and short-term lease costs, which were immaterial for the twelve months ended December 31, 2019.

Supplemental information related to leases as of and for the twelve months ended December 31, 2019 are shown in the tables below.

Lease Type	Weighted-Average Remaining Lease Term (years):	Weighted-Average Discount Rate
Operating Leases	7.48	3.65%
Finance Leases	5.18	4.43%
<b>Cash paid for amounts included in the measurement of lease liabilities:</b>		
(in thousands)		
Operating Cash Flows from Operating Leases	\$	343
Operating Cash Flows from Finance Leases		22
Financing Cash Flows from Finance Leases		175
Non-cash Acquisitions Under Operating Leases	\$	602

The following tables show the property, plant and equipment under finance leases and noncurrent assets under operating leases and related obligations recorded on KGPCo's balance sheets. Unless shown as a separate line on the balance sheets due to materiality, net operating lease assets are included in Deferred Charges and Other Noncurrent Assets, current finance lease obligations are included in Other Current Liabilities and long-term finance lease obligations are included in Deferred Credits and Other Noncurrent Liabilities on the balance sheets. Lease obligations are not recognized on the balance sheets for lease agreements with a lease term of less than twelve months.

	<b>December 31,</b>	
	<b>2019</b>	<b>2018</b>
	<b>(in thousands)</b>	
<b>Electric Property, Plant and Equipment Under Finance Leases</b>		
Total Electric Property, Plant and Equipment – Other	\$ 1,035	\$ 964
Accumulated Amortization	479	496
<b>Net Electric Property, Plant and Equipment Under Finance</b>	<b>\$ 556</b>	<b>\$ 468</b>
<b>Obligations Under Finance Leases</b>		
Noncurrent Liability	\$ 380	\$ 315
Liability Due Within One Year	176	153
<b>Total Obligations Under Finance Leases</b>	<b>\$ 556</b>	<b>\$ 468</b>

	<b>December 31, 2019</b>	
	<b>(in thousands)</b>	
<b>Operating Lease Assets</b>	<b>\$ 1,876</b>	
<b>Obligations Under Operating Leases</b>		
Noncurrent Liability	\$ 1,603	
Liability Due Within One Year	275	
<b>Total Obligations Under Operating Leases</b>	<b>\$ 1,878</b>	

Future minimum lease payments consisted of the following as of December 31, 2019:

<b>Future Minimum Lease Payments</b>	<b>Finance Leases</b>	<b>Operating Leases</b>
	<b>(in thousands)</b>	
2020	\$ 195	\$ 346
2021	121	328
2022	80	289
2023	66	255
2024	59	233
Later Years	100	713
<b>Total Future Minimum Lease Payments</b>	<b>621</b>	<b>2,164</b>
Less: Imputed Interest	65	286
<b>Estimated Present Value of Future Minimum Lease Payments</b>	<b>\$ 556</b>	<b>\$ 1,878</b>

Future minimum lease payments consisted of the following as of December 31, 2018:

<u>Future Minimum Lease Payments</u>	<u>Finance Leases</u>	<u>Operating Leases</u>
	(in thousands)	
2019	\$ 170	\$ 555
2020	135	528
2021	66	500
2022	40	471
2023	28	282
Later Years	80	327
<b>Total Future Minimum Lease Payments</b>	<u>519</u>	<u>\$ 2,663</u>
Less: Imputed Interest	51	
<b>Estimated Present Value of Future Minimum Lease Payments</b>	<u>\$ 468</u>	

### ***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 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 amount guaranteed. As of December 31, 2019, the maximum potential loss for these lease agreements was \$252 thousand assuming the fair value of the equipment is zero at the end of the lease term.

### ***Lessor Activity***

KGPCo's lessor activity was immaterial as of and for the twelve months ended December 31, 2019.

## 11. FINANCING ACTIVITIES

### *Long-term Debt*

The following table details long-term debt outstanding:

Type of Debt	Maturity	Weighted-Average Interest Rate as of December 31, 2019	Interest Rate Ranges as of December 31,		Outstanding as of December 31,	
			2019	2018	2019	2018
Notes Payable - Affiliated	2020-2029	3.23%	3.19%-4.52%	3.19%-4.52%	\$ 59,000	\$ 50,000
<b>Total Long-term Debt Outstanding</b>					<u>\$ 59,000</u>	<u>\$ 50,000</u>

### *Dividend Restrictions*

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

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

The most restrictive dividend limitation for KGPCo is through the Federal Power Act. As of December 31, 2019, the maximum amount of restricted net assets of KGPCo that may not be distributed to Parent in the form of a loan, advance or dividend was \$44.9 million.

### *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, 2019 and 2018 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)					
2019	\$ 28,631	\$ —	\$ 13,528	\$ —	\$ 14,499	\$ 30,000
2018	19,462	18,089	8,342	5,647	14,948	30,000

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

<b>Years Ended December 31,</b>	<b>Maximum Interest Rates for Funds Borrowed from the Utility Money Pool</b>	<b>Minimum Interest Rates for Funds Borrowed from the Utility Money Pool</b>	<b>Maximum Interest Rates for Funds Loaned to the Utility Money Pool</b>	<b>Minimum Interest Rates for Funds Loaned to the Utility Money Pool</b>	<b>Average Interest Rates for Funds Borrowed from the Utility Money Pool</b>	<b>Average Interest Rates for Funds Loaned to the Utility Money Pool</b>
2019	3.43%	1.77%	—%	—%	2.57%	—%
2018	2.97%	1.81%	2.91%	1.83%	2.28%	2.06%

Interest expense and interest income related to the Utility Money Pool are included in Interest Expense and Interest Income, respectively, on KGPCo's statements of income. For amounts borrowed from and advances to the Utility Money Pool, KGPCo incurred the following amounts of interest expense and earned the following amounts of interest income:

	<b>Years Ended December 31,</b>	
	<b>2019</b>	<b>2018</b>
	<b>(in thousands)</b>	
Interest Expense	\$ 352	\$ 152
Interest Income	—	25

#### ***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 and expires in July 2021.

KGPCo's factored accounts receivable revenues were \$11.5 million and \$13.6 million as of December 31, 2019 and 2018, respectively. KGPCo's factored accrued unbilled revenues were \$1.6 million and \$1.6 million as of December 31, 2019 and 2018, respectively.

The fees paid by KGPCo to AEP Credit for customer accounts receivable sold were \$706 thousand and \$692 thousand for the years ended December 31, 2019 and 2018, respectively.

KGPCo's proceeds on the sale of receivables to AEP Credit were \$151 million and \$162 million as of December 31, 2019 and 2018, 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 “Securitized Accounts 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 \$38 thousand and \$343 thousand for these services for the years ended December 31, 2019 and 2018, 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 \$102.5 million and \$113 million for the years ended December 31, 2019 and 2018, 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 TPUC 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. For the years ended December 31, 2019 and 2018, KGPCo had a regulatory asset of \$7.1 million and \$2.7 million, respectively. The activity above is excluded from the Transmission Agreement activity discussed below.

### *Transmission Agreement (TA)*

APCo, I&M, KGPCo, KPCo, OPCo and WPCo (AEP East Companies) are parties to the TA, which defines how transmission costs through PJM OATT are allocated among the AEP East Companies 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, 2019 and 2018 were \$5.6 million and \$3 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, 2019 and 2018 were \$25.9 million and \$19.9 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:

	<b>Years Ended December 31,</b>	
	<b>2019</b>	<b>2018</b>
	<b>(in thousands)</b>	
Sales	\$ 1,745	\$ 66
Purchases	4,834	480

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

### *Global Borrowing Notes*

As of December 31, 2019, AEP has four intercompany notes in place with KGPCo and at December 31, 2018, AEP had three intercompany notes 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.

### *Charitable Contributions to AEP Foundation*

The American Electric Power Foundation is funded by American Electric Power and its utility operating units. The Foundation provides a permanent, ongoing resource for charitable initiatives and multi-year commitments in the communities served by AEP and initiatives outside of AEP’s 11-state service area. In 2019, KGPCo contributed \$158 thousand to the AEP Foundation which was recorded in Other Operation on the statements of income.



### ***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, 2019 and 2018 were \$8.8 million and \$6.6 million, respectively. The carrying amount of liabilities associated with AEPSC as of December 31, 2019 and 2018 was \$1.3 million and \$890 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:

<u>Functional Class of Property</u>	<u>Years Ended December 31,</u>	
	<u>2019</u>	<u>2018</u>
Transmission	1.4%	1.5%
Distribution	3.5%	3.4%
Other	10.5%	11.0%

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 \$192 thousand and \$163 thousand in 2019 and 2018, respectively, and are included in Interest Expense on KGPCo's statements of income.

## 15. REVENUE FROM CONTRACTS WITH CUSTOMERS

### *Disaggregated Revenues from Contracts with Customers*

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

	Years Ended December 31,	
	2019	2018
	(in thousands)	
<b>Retail Revenues:</b>		
Residential Revenues	\$ 60,318	\$ 62,718
Commercial Revenues	36,688	37,373
Industrial Revenues	53,709	56,796
Other Retail Revenues	3,972	3,893
<b>Total Retail Revenues</b>	<u>154,687</u>	<u>160,780</u>
<b>Wholesale Revenues:</b>		
Transmission Revenues (a)	<u>5,563</u>	<u>3,593</u>
<b>Total Wholesale Revenues</b>	<u>5,563</u>	<u>3,593</u>
Other Revenues from Contracts with Customers (a)	<u>2,382</u>	<u>1,960</u>
<b>Total Revenues from Contracts with Customers</b>	<u>162,632</u>	<u>166,333</u>
<b>Other Revenues:</b>		
Alternative Revenues	<u>1,101</u>	<u>21</u>
<b>Total Other Revenues</b>	<u>1,101</u>	<u>21</u>
<b>Total Revenues</b>	<u>\$ 163,733</u>	<u>\$ 166,354</u>

(a) Amounts include affiliated and nonaffiliated revenues.

### *Performance Obligations*

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

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

#### *Retail Revenues*

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

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

## *Wholesale Revenues - Transmission*

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

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

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

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

As of December 31, 2019, the fixed performance obligations related to KGPCo were immaterial.

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

Contract assets are recognized when KGPCo has a right to consideration that is conditional upon the occurrence of an event other than the passage of time, such as future performance under a contract. KGPCo did not have material contract assets as of December 31, 2019 and 2018.

When KGPCo receives consideration, or such consideration is unconditionally due from a customer prior to transferring goods or services to the customer under the terms of a sales contract, they recognize a contract liability on the balance sheet in the amount of that consideration. Revenue for such consideration is subsequently recognized in the period or periods in which the remaining performance obligations in the contract are satisfied. KGPCo did not have material contract liabilities as of December 31, 2019 and 2018.

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

Accounts receivable from contracts with customers are presented on KGPCo's balance sheets within the Accounts Receivable - Customers line item. KGPCo's balances for receivables from contracts that are not recognized in accordance with the accounting guidance for "Revenue from Contracts with Customers" included in Accounts Receivable - Customers were not material as of December 31, 2019. See "Securitized Accounts Receivable - AEP Credit" section of Note 11 for additional information related to AEP Credit's securitized accounts receivable.

The amount of affiliated accounts receivable from contracts with customers included in Accounts Receivable - Affiliated Companies on KGPCo's balance sheets were \$447 thousand and \$1.5 million, respectively as of December 31, 2019 and 2018.

### ***Contract Costs***

Contract costs to obtain or fulfill a contract are accounted for under the guidance for "Other Assets and Deferred Costs" and presented as a single asset and neither bifurcated nor reclassified between current and noncurrent assets on KGPCo's balance sheets. Contract costs to acquire a contract are amortized in a manner consistent with the transfer of goods or services to the customer in Other Operation on KGPCo's statements of income. KGPCo did not have material contract costs as of December 31, 2019 and 2018.