Date: December 5, 2013

Subject: Accounting Implications Memo Regarding the Kentucky Public Service Commission (KPSC) Approval of Kentucky Power Company's (KPCo) Stipulation and Settlement Agreement (Stipulation) to Transfer a Fifty Percent Interest the Mitchell Generation Station (Mitchell Plant) in Case No. 2012-00578

From: Tom Mitchell/Jeff Brubaker and Jason Yoder

To: Brian Frantz, Scott Travis, Ranie Wohnhas, Dale Patterson, Chuck Oberlin, Bruce Hutchins, Brian Lysiak, Lila Munsey, Bill Allen and Janet Swanger

The purpose of this memo is to document KPCo's accounting for the Stipulation approved with certain modifications by the KPSC which allows for the transfer of a fifty percent interest in the Mitchell Plant and changes to certain surcharges effective January 1, 2014.

Background

On December 12, 2012 KPCo filed an application seeking a Certificate of Public Convenience and Necessity (CPCN) for the proposed transfer of fifty percent of the Mitchell Plant. The Application also included a request to defer for future recovery $28 million related to FGD environmental study costs for Big Sandy Units 1 and 2.

Stipulation

On July 2, 2013 KPCo filed a Stipulation entered into by KPCo, Kentucky Industrial Utility Customers, Inc. (KIUC) and Sierra Club (Attachment 1). The Stipulation, among other provisions, included the following:

- Transfer of fifty percent of Mitchell Plant to KPCo at December 31, 2013
- Withdrawal of the pending rate case in Case No. 2013-00197
- KPCo agrees to file its next base case utilizing a September 30, 2014 test year
- Effective January 1, 2014, KPCo will implement an Asset Transfer Rider (ATR) designed to collect $44 million annually, with a true-up mechanism. When new base rates are established, the ATR will be used to recover Big Sandy 1 and Big Sandy 2 retirement costs
- Effective January 1, 2014 the Environmental Surcharge Factor will be zero until new base rates are set by the Commission. When new rates are set, the Flue Gas Desulfurization (FGD) costs related to the Mitchell Plant will be recovered through the Environmental Surcharge.

- Effective January 1, 2014 the System Sales Adjustment Factor will be zero. Calendar year off-system sales margins above $15,290,363 (amount in base rates) will be retained by KPCo until new base rates are set.
- Recovery of $28 million of cost incurred related to an FGD at Big Sandy.
- Agreement that the Company would provide $100,000 per year for five years for economic development which would not be recovered from ratepayers.
- Recovery of retirement costs of Big Sandy and other site related retirement costs that will not continue in use over a 25 year period (including a Weighted Average Cost of Capital (WACC)) when new rates are set in the next base case. The costs will be recovered in the Asset Transfer Rider-2 which would include over/under-recovery.
- If the Mitchell Plant is retired early, collection of the retirement costs with a debt-only carrying cost.
- If the Commission did not accept and approve the Stipulation without modification none of the signing parties were bound by any provision of the Stipulation.

Order

The KPSC issued its order on October 7, 2013 (Attachment 2) approving the Stipulation with modifications provided in Appendix B of the order. The modifications are summarized as follows:

- The Commission denied deferral for future recovery in a future base case the $28,113,304 FGD costs.
- The commitments to provide economic development were increased by the Commission to provide shareholder contributions of $233,000 per year for five years (from $100,000).
- The Commission clarified that KPCo's shareholder contribution commitment to assist energy management programs would be incremental funding for the school energy manager program, which could be for new school managers or additional funds for existing school managers, and that the funding is limited to schools in Lawrence and contiguous Kentucky counties impacted.
- The Commission clarified that KPCo would need to seek Commission approval to lower annual expenditures related to Demand Side Management (DSM) below $6 million.

On October 14, 2013, KPCO accepted and agreed to be bound by the modifications to the Stipulation set forth in Appendix B of the KPSC order (Attachment 3).

Accounting Implications

1) Rates

The rate changes are effective January 1, 2014 and will be implemented through the MACSS system by Customer Billings (Dale Patterson, Manager) on January 1, 2014 to implement the ATR and change the Environmental Surcharge Factor and the System Sales Adjustment Factor to zero until new base rates are set by the Commission. After these changes effective January 1, 2014, no further action will be required to properly bill

customers under the order and record the revenues on KPCo's ledger as functionalized by Revenue Accounting (Chuck Oberlin, Manager).

2) Transfer of Fifty Percent of Mitchell Plant

The KPSC approved the Stipulation which allows the transfer of the Mitchell Plant (fifty percent interest including associated assets and liabilities) on December 31, 2013. According to the Stipulation on page 4, the transfer will be at actual net book value as of December 31, 2013, including accumulated deferred income tax benefits as shown in RKW- Exhibit 2. The entries for the transfer should be recorded by Regulatory Accounting (Brian Frantz Manager) and Property Accounting (Janet Swanger, Manager) in December 2013 business. Note that Regulated Accounting (led by Scott Travis, Managing Director) will address the various transfer and disclosure issues including accounting for the effect of Mitchell employee liabilities.

The order did have one qualification on the NBV discussed on page 44 which states that:

> "In the event the West Virginia PSC approves APCo's request to acquire the remaining 50 percent undivided interest in the Mitchell Station at a NBV that is lower than the $536 million NBV proposed in the instant matter, Kentucky Power's authority to acquire Mitchell Station shall be limited to the NBV as found by the West Virginia PSC."

Regulatory and Finance (Ranie Wohnhas, Managing Director) along with input from legal is monitoring the impact of this ordering paragraph on the transfer of Mitchell Plant and will participate with accounting in the determination of any adjustments to Mitchell NBV to be recorded by Property Accounting (Janet Swanger, Manager).

Mitchell Plant Depreciation

Property Accounting (Janet Swanger, Manager) will continue to use existing OPCo depreciation rates for Mitchell Plant (Attachment 4) based on an estimated retirement date of 2031 until new rates are established in a future base case. Note that KPCo must propose that depreciation rates reflect a 2040 retirement date for the Mitchell units in its next base case.

3) ATR Over/Under

The Company will implement the ATR effective January 1, 2014 to initially recover a portion of KPCo's 50% interest in Mitchell Plant costs. The KPSC ordered over/under accounting and as shown on Exhibit 1-A of the order (Attachment 2) the tariff rate includes a monthly over/under-recovery adjustment.

Accounting for this rider is subject to the provisions for accounting for alternative revenue programs included in FASB ASC 980-60-25 (formerly EITF No, 92-7). ASC 980-605-25 addresses alternative revenue programs and segregates them into two categories, Type A and Type B. Type A programs adjust billings for the effects of weather abnormalities or broad external factors or to compensate the utility for demand-side management initiatives. Type B programs provide for additional billings (incentive awards) if the utility achieves certain objectives, such as reducing costs, reaching

specified milestones, or demonstratively improving customer service. Both types of programs enable the utility to adjust rates (usually as a surcharge).

ASC 980-605-25 addresses the accounting for revenues that are the subject of recovery mechanisms that do not qualify for deferral as a regulatory asset under ASC 980-340-25. ASC 980-605-25 concludes that once the specific events permitting billing of the additional revenues under Type A and Type B programs have been completed, the regulated utility shall recognize the additional revenues if all of the following conditions are met:

a. The program is established by an order from the utility's regulatory commission that allows for automatic adjustment of future rates. Verification of the adjustment to future rates by the regulator would not preclude the adjustment from being considered automatic.

b. The amount of additional revenues for the period is objectively determinable and is probable of recovery.

c. The additional revenues will be collected within 24 months following the end of the annual period in which they are recognized.

The requirements in ASC 980-605-25 are met as a Type A program which adjust billings for external factors (i.e. major change in utility power source) under the rider because the collection of revenues related to the rider is established by the Order (which provides probability of recovery), as it allows for monthly adjustment of future rates and the revenues are expected to be collected within 24 months.

Discussions with Regulatory Services (Bill Allen, Managing. Director) indicate that the $44 million annually should be compared on straight line basis to the actual monthly ATR revenues because the amount was not determined on an individual monthly basis. Each month beginning with January 2014 business, Regulated Accounting (Brian Frantz, Manager) will compare the monthly revenues from the ATR (which are provided by Revenue (Chuck Oberlin, Manager) to one twelfth of the $44 million annual ATR revenues. To the extent that the revenues collected are less than the monthly amount, the following journal should be recorded:

Account	Description	Debit	Credit
1823XXXX	Mitchell ATR under-recovery	$XXXXXX	
440-445,447	Revenue		$XXXXXX

To record under-recovery of KPSC approved Mitchell Plant recovery via the ATR.

Note that if an over-recovery previously existed, then the regulatory liability should be reduced to zero before recording the regulatory asset.

If there is an over recovery of the $44 million allowed recovery of Mitchell Plant costs, then the following entry should be recorded to reduce revenue:

Account	Description	Debit	Credit
440-445,447	Revenue	$XXXXXX	

254XXXX	Mitchell ATR over-recovery		$XXXXXX

To record over-recovery of KPSC approved Mitchell Plant cost recovery via the ATR.

Note that if an under-recovery previously existed, then the regulatory asset should be reduced to zero before recording the regulatory liability.

4) Cost Recovery of FGD and Other Deferred Costs
   a. The KPSC ordered that the provision of the Stipulation that allowed the Company to defer $28 million of FGD costs for future recovery in the next base case be stricken (Order, page 38). They stated that the impact to the ratepayer in light of the Mitchell plant costs was not reasonable. Additionally, the costs were over a long period of time but never resulted in a formal proposal from KPCo to the Commission for a decision to be made. Finally, the Commission found the cost unreasonable because the magnitude of the costs did not result in the addition of environmental equipment at Big Sandy.
   b. The KPSC decision raises doubt about the probability of recovery of the $28 million FGD costs because they have removed paragraph 8 from the Stipulation that would have allowed KPCo to defer and recover the $28 million in a future base case.
   c. Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 855-10 (Subsequent Events) addresses accounting for events that occur after the balance sheet date but before the financial statements are issued.
   d. This decision is considered a recordable subsequent event as defined by ASC 855-10-20 where the order provided additional evidence about conditions that existed at the date of the balance sheet. Deferral and recovery was objected to by intervenor testimony filed in the hearing urging the KPSC deny KPCo's request to defer and recover the $28 million (Attachment 5) which shows there was evidence in the record opposing recovery. Also, previous to the Commission order on the Settlement, the Company had determined as documented by legal that recovery was probable. The Commission's determination raised doubt that the Company's previous judgment that the $28 million was probable.
   e. KPCo had also filed for recovery of several other previously deferred costs including IGCC, CARRS and Carbon Capture and Storage (CCS). The Commission's decision to strike the provision of the Stipulation regarding the $28 million FGD raises similar doubts about the future recovery of these previously deferred costs which had been thought to be probable of recovery.
   f. Therefore, since KPCo has concluded that the Commission order is a recordable subsequent event, a provision for these deferred costs has been recorded by Regulatory Accounting (Brian Frantz Manager) in September 30, 2013 business as follows:

Account	**Description**	**Debit**	**Credit**
4265002	Other Deductions	$4,824,047	
1830004	Resv IGCC costs		$1,331,254
1830004	Resv CARRS site work		$2,619,935
1823325	Resv CCS FEED study		$872,858

To reserve KPCO IGCC costs, CARRS site engineering and survey work & CCS FEED Study.

Account	Description	Debit	Credit
4265002	Other Deductions	$28,023,271	
1830004	Resv BS FGD Landfill		$2,294,639
1830004	Resv BS FGD		$25,728,632

To reserve KPCo Big Sandy FGD and FGD landfill costs.

g. A provision is recorded on the books because Regulatory (Ranie Wohnhas, Mng. Director) plans to request recovery of the costs in the next KPCo base case. Additionally, Regulatory Accounting (Brad Funk Manager) will track any additional activity related to these accounts to ensure the reserves do not require additional adjustments in future periods.

5) KPSC Ordered Contributions to Economic Development

With the approval of the order, the KPSC also required KPCo to provide funding for economic development in the amount of $233,000 per year for five years. In September 2013 Regulated Accounting (Brian Frantz, Manager) recorded a liability of $1,165,000 ($233,000 times 5 years) as follows:

Account	Description	Debit	Credit
4265002	Other Deductions	$1,165,000	
2420088	Contributions – ST		$233,000
2284027	Contributions - LT		$932,000

To record the KPSC ordered contributions to be made for economic development.

The obligation ordered by the KPSC is a liability for GAAP according to FASB ASC 720-25 – Other Expenses – Contributions made. This subtopic provides the guidance on accounting for contributions made. The KPSC order has established a contribution (specifically an unconditional promise to give) and therefore KPCo needs to recognize a liability and offsetting expense. Additionally, these contributions provide no identifiable benefit to KPCo through reduced cost or additional revenue. Typically, unconditional promises will be recognized at their present value of future cash flows except for those amounts to be paid in less than one year. However, KPSC will record the amount at its nominal value due to low applicable interest rates because there is an immaterial difference between the nominal amount and the present value.

Note due to the complexity and magnitude of the other issues in the Stipulation including KPCo's acceptance of the Mitchell Plant transfer no liability was recorded (prior to the order). However, it is appropriate to record the liability in the third quarter 2013 given the existence of the potential obligation included in the Stipulation.

Regulatory and Finance (Ranie Wohnhas, Managing Director), will track the monthly expenditures related to these funds and will be responsible for coding invoices prior to payment using appropriate chartfields including cost component and projects.

The payments will be charged to the respective FERC account 228 – Accumulated Misc. Operating Provision as long as a portion of the obligation remains a long-term liability either directly or after reclasses recorded by Regulatory Accounting (Brad Funk, Manager) for those expenses that cannot be charged directly to the liability due to system limitations.

Each quarter, Regulated Accounting (Brian Frantz Manager) will review the liability to determine the proper classification between current and long term. When the account balance in the respective FERC account 228 – Accumulated Misc Operating Provision reaches zero, then the payments should be made to account 242 – Misc Current & Accrued Liabilities until the total obligation is reduced to zero.

Note also that the Commission ordered that the program implemented under the Stipulation (paragraph 12) to help fund energy management at schools be shareholder funded instead of recovered through demand side management (DSM) cost recovery. The $75,000 to be funded in 2014 and $50,000 to be funded in 2015 were not accrued in September 2013 because they will provide KPCo future energy efficiency benefits. As such these are period costs to be expensed as incurred similar to other DSM activities.

6) Off-System Sales (OSS) Margins Sharing
As noted in the Rates section above, the KPCo system sales clause tariff was modified so that the rate is zero effective January 1, 2014. Therefore, sharing of OSS margins shall cease effective January 1, 2014. In January 2014 business Fuel Accounting (Brian Lysiak, Supervisor) will calculate the final true-up for December 2013 and cease the calculation of over/under on OSS margins going forward.

7) Fuel Adjustment Clause (FAC)
Effective January 1, 2014, KPCo's 50% share of Mitchell related fuel costs shall be included in the calculation of charges or credits under the KPCo FAC as coordinated by Regulatory Services (Lila Munsey, Manager) and Fuel Accounting (Brian Lysiak, Supervisor).

8) Entry on Rehearing,Withdrawal of Pending Base Case No. 2013-00197 and Appeal
On November 15, 2013 the Commission denied the Kentucky Attorney General's request for rehearing.

On November 18, 2013 KPCo withdrew its application for a base case.

On December 4, 2013 the Kentucky Attorney General filed an appeal of the Commission's decision approving the Mitchell Plant transfer with the Franklin Circuit Court in Frankfort, Kentucky. The appeal included a request for an injunction to stop the transfer. KPCo management and legal are assessing the impact if any on the Mitchell Plant transfer.

9) Earnings Offset
There is no EO related to O&M due to this subject order.

Attachments

Cc: with attachments:

Rich Mueller	Tyler Ross
Nick Roger – D&T	George Fackler D&T

Cc: without attachments:

Greg Adams	John Huneck	Eric Wittine	Betsy Sekula
Michele Bair	Pam Sicilian	Ollie Sever	Hector Garcia
Mike Baird	Jennifer McLravy	Brian Tierney	Shelli Sloan
Jeff Bartsch	Rich Munczinski	Janet Tully-Green	
Joe Buonaiuto	Danielle Dorsey	Julie Williams	
Kellie Conklin	Phil Nelson	Greg Pauley	
Lonni Dieck	Mark Pyle	Brad Funk	
Pam Flemming	Julie Sloat	Larry Foust	
Renee Hawkins	Franz Messner	Jim Keeton	