Duke Energy Kentucky, Inc.
Financial Statements
and Independent Auditors' Report

December 31, 2016

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Glossary of Terms

The following terms or acronyms used in this document are defined below:

Term or Acronym	Definition
AFUDC	Allowance for Funds Used During Construction
ALJ	FERC Administrative Law Judge
AMI	Advanced Metering Infrastructure
ARO	Asset Retirement Obligation
ASRP	Accelerated Natural Gas Service Line Replacement Program
CCR	Coal Combustion Residuals
CO_2	Carbon Dioxide
CP	Capacity Performance
CPCN	Certificate of Public Convenience and Necessity
CPP	Clean Power Plan
CRC	Cinergy Receivables Company, LLC
Duke Energy	Duke Energy Corporation
Duke Energy Indiana	Duke Energy Indiana, LLC
Duke Energy Kentucky	Duke Energy Kentucky, Inc.
Duke Energy Ohio	Duke Energy Ohio, Inc.
EPA	U.S. Environmental Protection Agency
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
FRR	Fixed Resource Requirement
GAAP	Generally Accepted Accounting Principles in the U.S.
KPSC	Kentucky Public Service Commission
LIBOR	London Interbank Offered Rate
Master Trust	Master Retirement Trust
MISO	Midcontinent Independent System Operator, Inc.
MTEP	MISO Transmission Expansion Planning
MVP	Multi Value Projects
PJM	PJM Interconnection, LLC
Rider ASRP	Rate rider requested to recover cost of the ASRP
RTO	Regional Transmission Organization
U.S.	United States
VIE	Variable Interest Entity

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholder of
Duke Energy Kentucky, Inc.
Charlotte, North Carolina

We have audited the accompanying financial statements of Duke Energy Kentucky, Inc. (the "Company"), which comprise the balance sheets as of December 31, 2016 and 2015, and the related statements of operations, changes in equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

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

Deloitte & Touche LLP

March 13, 2017

DUKE ENERGY KENTUCKY, INC.
STATEMENTS OF OPERATIONS

	Years Ended December 31,	
(in thousands)	**2016**	**2015**
Operating Revenues:		
Electric	**$ 346,124**	$ 359,196
Natural gas	**90,216**	102,354
Total operating revenues	**436,340**	461,550
Operating Expenses:		
Fuel used in electric generation and purchased power	**132,681**	142,546
Cost of natural gas	**32,611**	41,610
Operation, maintenance and other	**140,573**	133,403
Depreciation and amortization	**43,668**	43,813
Property and other taxes	**14,637**	13,089
Total operating expenses	**364,170**	374,461
Gains on Sales of Assets, net	**28**	245
Operating Income	**72,198**	87,334
Other Income and Expenses, net	**2,321**	1,075
Interest Expense	**14,888**	14,172
Income Before Income Taxes	**59,631**	74,237
Income Tax Expense	**17,047**	28,061
Net Income	**$ 42,584**	$ 46,176

See Notes to Financial Statements

DUKE ENERGY KENTUCKY, INC.
BALANCE SHEETS

	December 31,	
(in thousands, except share amounts)	**2016**	**2015**
ASSETS		
Current Assets:		
Cash and cash equivalents	**$ 6,534**	$ 9,141
Receivables (net of allowance for doubtful accounts of $141 at 2016 and $195 at 2015)	**1,663**	5,488
Receivables from affiliated companies	**22,762**	11,499
Inventory	**49,037**	44,141
Regulatory assets	**7,623**	8,879
Collateral assets	**13,566**	13,749
Other	**5,706**	23,207
Total current assets	**106,891**	116,104
Other Assets	**2,470**	6,448
Property, Plant and Equipment:		
Cost	**2,116,219**	2,079,761
Accumulated depreciation and amortization	**(948,144)**	(923,578)
Net property, plant and equipment	**1,168,075**	1,156,183
Regulatory Assets and Deferred Debits:		
Regulatory assets	**92,462**	61,411
Other	**250**	332
Total regulatory assets and deferred debits	**92,712**	61,743
Total Assets	**$ 1,370,148**	$ 1,340,478
LIABILITIES AND EQUITY		
Current Liabilities:		
Accounts payable	**$ 31,636**	$ 25,654
Accounts payable to affiliated companies	**12,573**	14,426
Notes payable to affiliated companies	**19,656**	55,743
Taxes accrued	**14,082**	10,550
Interest accrued	**4,230**	3,343
Current maturities of long-term debt	**686**	101,519
Regulatory liabilities	**12,173**	2,668
Other	**18,561**	19,260
Total current liabilities	**113,597**	233,163
Long-Term Debt	**336,360**	192,508
Long-Term Debt Payable to Affiliated Companies	**25,000**	25,000
Deferred Credits and Other Liabilities:		
Deferred income taxes	**311,636**	289,642
Accrued pension and other post-retirement benefit costs	**14,975**	11,649
Asset retirement obligations	**52,822**	103,500
Regulatory liabilities	**51,878**	52,986
Other	**26,865**	27,598
Total deferred credits and other liabilities	**458,176**	485,375
Commitments and Contingencies		
Equity:		
Common Stock, $15.00 par value, 1,000,000 shares authorized and 585,333 shares outstanding at 2016 and 2015	**8,780**	8,780
Additional paid-in-capital	**167,494**	167,494
Retained earnings	**260,741**	228,158
Total equity	**437,015**	404,432
Total Liabilities and Equity	**$ 1,370,148**	$ 1,340,478

See Notes to Financial Statements

DUKE ENERGY KENTUCKY, INC.
STATEMENTS OF CASH FLOWS

	Years Ended December 31,	
(in thousands)	**2016**	**2015**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 42,584	$ 46,176
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	44,683	44,497
Gains on sales of assets, net	(28)	(245)
Deferred income taxes	17,988	23,462
Accrued pension and other post-retirement benefit costs	1,527	2,152
Contributions to qualified pension plans	(1,443)	(2,203)
Payments for asset retirement obligations	(4,757)	(3,858)
(Increase) decrease in:		
Receivables	3,799	(7,071)
Receivables from affiliated companies	(11,263)	14,068
Inventory	(4,896)	9,017
Other current assets	15,180	(10,443)
Increase (decrease) in:		
Accounts payable	660	(1,491)
Accounts payable to affiliated companies	(1,853)	1,163
Taxes accrued	7,028	2,645
Other current liabilities	8,235	1,743
Other assets	(8,862)	(10,207)
Other liabilities	14	527
Net cash provided by operating activities	108,596	109,932
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(100,899)	(69,234)
Other	(7,081)	(4,173)
Net cash used in investing activities	(107,980)	(73,407)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from the issuance of long-term debt	94,385	—
Payments for the redemption of long-term debt	(51,520)	(1,615)
Notes payable to affiliated companies	(36,087)	18,134
Dividends to parent	(10,001)	(55,000)
Other	—	(210)
Net cash used in financing activities	(3,223)	(38,691)
Net decrease in cash and cash equivalents	(2,607)	(2,166)
Cash and cash equivalents at beginning of period	9,141	11,307
Cash and cash equivalents at end of period	$ 6,534	$ 9,141
Supplemental Disclosures:		
Cash paid for interest, net of amount capitalized	$ 12,986	$ 13,492
Cash (received from) paid for income taxes	(18,845)	13,111
Significant non-cash transactions:		
Accrued capital expenditures	12,594	7,511

See Notes to Financial Statements

DUKE ENERGY KENTUCKY, INC.
STATEMENTS OF CHANGES IN EQUITY

(in thousands)	Common Stock	Additional Paid-in Capital	Retained Earnings	Total Equity
Balance at December 31, 2014	$ 8,780	$ 167,494	$ 236,982	$ 413,256
Net income	—	—	46,176	46,176
Dividends to parent	—	—	(55,000)	(55,000)
Balance at December 31, 2015	$ 8,780	$ 167,494	$ 228,158	$ 404,432
Net income	—	—	**42,584**	**42,584**
Dividends to parent	—	—	**(10,001)**	**(10,001)**
Balance at December 31, 2016	**$ 8,780**	**$ 167,494**	**$ 260,741**	**$ 437,015**

See Notes to Financial Statements

1. ORGANIZATION AND BASIS OF PRESENTATION

NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Duke Energy Kentucky, Inc. (Duke Energy Kentucky) is a combination electric and natural gas public utility company that provides service in northern Kentucky. Duke Energy Kentucky's principal lines of business include generation, transmission, distribution and sale of electricity, as well as the transportation and sale of natural gas. Duke Energy Kentucky is subject to the regulatory provisions of the Kentucky Public Service Commission (KPSC) and the Federal Energy Regulatory Commission (FERC). Duke Energy Kentucky's common stock is wholly owned by Duke Energy Ohio, Inc. (Duke Energy Ohio), an indirect wholly owned subsidiary of Duke Energy Corporation (Duke Energy).

Certain prior year amounts have been reclassified to conform to the current year presentation.

Other Current Assets and Liabilities

The following table provides detail of certain amounts included in Other within Current Assets or Current Liabilities.

		December 31,	
(in thousands)	**Location**	**2016**	**2015**
Income taxes receivable	Current Assets	**$ 1,209**	$ 13,410
Other receivable and prepaid assets	Current Assets	**535**	6,883
Collateral liabilities	Current Liabilities	**10,270**	10,131

SIGNIFICANT ACCOUNTING POLICIES

Use of Estimates

In preparing financial statements that conform to generally accepted accounting principles in the United States (U.S.) (GAAP), Duke Energy Kentucky must make estimates and assumptions that affect the reported amounts of assets and liabilities, the reported amounts of revenues and expenses and the disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

Regulatory Accounting

The majority of Duke Energy Kentucky's operations are subject to price regulation for the sale of electricity and natural gas by the KPSC or FERC. When prices are set on the basis of specific costs of the regulated operations and an effective franchise is in place such that sufficient natural gas or electric services can be sold to recover those costs, Duke Energy Kentucky applies regulatory accounting. Regulatory accounting changes the timing of the recognition of costs or revenues relative to a company that does not apply regulatory accounting. As a result, regulatory assets and regulatory liabilities are recognized on the Balance Sheets. Regulatory assets and liabilities are amortized consistent with the treatment of the related cost in the ratemaking process. See Note 2 for further information.

Regulated Fuel Costs and Purchased Power

Duke Energy Kentucky utilizes cost-tracking mechanisms, commonly referred to as fuel adjustment clauses. These clauses allow for the recovery of fuel and fuel-related costs and portions of purchased power costs through surcharges on customer rates. The difference between the costs incurred and the surcharge revenues is recorded as an adjustment to Operating Expenses - Fuel used in electric generation and purchased power or Operating Expenses - Cost of natural gas on the Statements of Operations with an off-setting impact on regulatory assets or liabilities.

Cash and Cash Equivalents

All highly liquid investments with maturities of three months or less at the date of acquisition are considered cash equivalents.

Inventory

Inventory is used for operations and is recorded primarily using the average cost method. Inventory related to regulated operations is valued at historical cost. Materials and supplies are recorded as inventory when purchased and subsequently charged to expense or capitalized to property, plant and equipment when installed. Reserves are established for excess and obsolete inventory. The components of inventory are presented in the table below.

	December 31,	
(in thousands)	**2016**	**2015**
Materials and supplies	**$ 21,964**	$ 22,550
Coal	**19,499**	16,282
Natural gas, oil and other	**7,574**	5,309
Total inventory	**$ 49,037**	$ 44,141

Property, Plant and Equipment

Property, plant and equipment are stated at the lower of depreciated historical cost net of any disallowances or fair value, if impaired. Duke Energy Kentucky capitalizes all construction-related direct labor and material costs, as well as indirect construction costs such as general engineering, taxes and financing costs. See "Allowance for Funds Used During Construction (AFUDC)" and "Asset Retirement Obligations (ARO)" below for further information on capitalized financing costs and legal obligations associated with the retirement of property, plant and equipment. Costs of renewals and betterments that extend the useful life of property, plant and equipment are also capitalized. The cost of repairs, replacements and major maintenance projects, which do not extend the useful life or increase the expected output of the asset, is expensed as incurred. Depreciation is generally computed over the estimated useful life of the asset using the composite straight-line method. Depreciation studies are conducted periodically to update composite rates and are approved by the KPSC and/or the FERC when required. The composite weighted average depreciation rates were 2.2 percent and 2.4 percent for the years ended December 31, 2016 and 2015, respectively.

In general, when Duke Energy Kentucky retires its regulated property, plant and equipment, original cost plus the cost of retirement, less salvage value, is charged to accumulated depreciation. However, when it becomes probable a regulated asset will be retired substantially in advance of its original expected useful life or will be abandoned, the cost of the asset and the corresponding accumulated depreciation is recognized as a separate asset. If the asset is still in operation, the net amount is classified as Generation facilities to be retired, net on the Balance Sheets. If the asset is no longer operating, the net amount is classified in Regulatory assets on the Balance Sheets. When it becomes probable that meters or other regulated mass utility assets will be abandoned, the cost of the assets and accumulated depreciation is reclassified to regulatory assets for the amounts recoverable in rates. The carrying value of the asset is based on historical cost if Duke Energy Kentucky is allowed to recover the remaining net book value and a return equal to at least the incremental borrowing rate. If not, an impairment is recognized to the extent the net book value of the asset exceeds the present value of future revenues discounted at the incremental borrowing rate.

When Duke Energy Kentucky sells entire regulated operating units, the original cost and accumulated depreciation and amortization balances are removed from Property, Plant and Equipment on the Balance Sheets. Any gain or loss is recorded in earnings, unless otherwise required by the applicable regulatory body.

See Note 6 for further information.

Allowance for Funds Used During Construction (AFUDC)

For regulated operations, the debt and equity costs of financing the construction of property, plant and equipment are reflected as AFUDC and capitalized as a component of the cost of property, plant and equipment. AFUDC equity is reported on the Statements of Operations as non-cash income in Other Income and Expenses, net. AFUDC debt is reported as a non-cash offset to Interest Expense. After construction is completed, Duke Energy Kentucky is permitted to recover these costs through their inclusion in rate base and the corresponding subsequent depreciation or amortization of those regulated assets.

AFUDC equity, a permanent difference for income taxes, reduces the effective tax rate when capitalized and increases the effective tax rate when depreciated or amortized.

Asset Retirement Obligations (ARO)

AROs are recognized for legal obligations associated with the retirement of property, plant and equipment. When recording an ARO the present value of the projected liability is recognized in the period in which it is incurred, if a reasonable estimate of fair value can be made, and the liability is accreted over time. For operating plants, the present value of the liability is added to the cost of the associated asset and depreciated over the remaining life of the asset. For retired plants, the present value of the liability is recorded as a regulatory asset unless determined not to be recoverable.

The present value of the initial obligation and subsequent updates are based on discounted cash flows, which include estimates regarding timing of future cash flows, selection of discount rates and cost escalation rates, among other factors. These estimates are subject to change. Depreciation expense is adjusted prospectively for any changes to the carrying amount of the associated asset. Duke Energy Kentucky receives amounts to fund the cost of the ARO from regulated revenues. As a result, the net of amounts recovered in regulated revenues, accretion expense and depreciation of the associated asset is deferred as a regulatory asset or liability.

Obligations for closure of ash basins are based upon discounted cash flows of estimated costs for site-specific plans, if known, or probability weightings of the potential closure methods if the closure plans are under development and multiple closure options are being considered and evaluated on a site-by-site basis.

See Note 5 for further information.

Comprehensive Income

Comprehensive income is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. Comprehensive income is the same as net income for all periods presented. Therefore, a separate statement of comprehensive income is not included in the accompanying financial statements.

Revenue Recognition and Unbilled Revenue

Revenues on sales of electricity and natural gas are recognized when service is provided or the product is delivered. Unbilled revenues are recognized be applying customer billing rates to the estimated volumes of energy or natural gas delivered but not yet billed. Unbilled revenues can vary significantly from period to period as a result of seasonality, weather, customer usage patterns, customer mix, average price in effect for customer classes, timing of rendering customer bills and meter reading schedules.

Duke Energy Kentucky sells, on a revolving basis, nearly all of its retail accounts receivable, including receivables for unbilled revenues, to an affiliate, Cinergy Receivables Company, LLC (CRC). As discussed further in Note 11, Duke Energy Kentucky accounts for the transfers of receivables to CRC as sales. Accordingly, the receivables sold are not reflected on the Balance Sheets. Receivables for unbilled revenues related to retail accounts receivable included in the sales of accounts receivable to CRC at December 31, 2016 and 2015, were $23 million and $16 million, respectively.

Unbilled revenues, which are recorded as Receivables on the Balance Sheets and exclude receivables sold to CRC, primarily include wholesale related revenues and totaled $79 thousand and $674 thousand at December 31, 2016 and 2015, respectively.

Derivatives and Hedging

Derivative and non-derivative instruments may be used in connection with commodity price and interest rate activities, including swaps, futures, forwards and options. All derivative instruments, except those that qualify for the normal purchase/normal sale exception, are recorded on the Balance Sheets at fair value. For activity subject to regulatory accounting, gains and losses on derivative contracts are reflected as regulatory assets or liabilities and not as other comprehensive income or current period income. As a result, changes in fair value of these derivatives have no immediate earnings impact.

See Note 9 for further information.

Unamortized Debt Premium, Discount and Expense

Premiums, discounts and expenses incurred with the issuance of outstanding long-term debt are amortized over the term of the debt issue. The gain or loss on extinguishment associated with refinancing higher-cost debt obligations used to finance regulated assets is amortized. Amortization expense is recorded as Interest Expense in the Statements of Operations and is reflected as Depreciation, amortization and accretion within Net cash provided by operating activities on the Statements of Cash Flows.

Premiums, discounts and expenses are presented as an adjustment to the carrying value of the debt amount and included in Long-Term Debt on the Balance Sheets presented.

Loss Contingencies and Environmental Liabilities

Contingent losses are recorded when it is probable a loss has occurred and can be reasonably estimated. When a range of the probable loss exists and no amount within the range is a better estimate than any other amount, the minimum amount in the range is recorded. Unless otherwise required by GAAP, legal fees are expensed as incurred.

Environmental liabilities are recorded on an undiscounted basis when environmental remediation or other liabilities become probable and can be reasonably estimated. Environmental expenditures related to past operations that do not generate current or future revenues are expensed. Environmental expenditures related to operations that generate current or future revenues are expensed or capitalized, respectively. Certain environmental expenditures receive regulatory accounting treatment and are recorded as regulatory assets.

See Notes 2 and 3 for further information.

Pension and Other Post-Retirement Benefit Plans

Duke Energy maintains qualified, non-qualified and other post-retirement benefit plans. Eligible employees of Duke Energy Kentucky participate in the respective qualified, non-qualified and other post-retirement benefit plans and Duke Energy Kentucky is allocated its proportionate share of benefit costs. See Note 12 for further information.

Income Taxes

Duke Energy and its subsidiaries file a consolidated federal income tax return and other state and foreign jurisdictional returns. Duke Energy Kentucky entered into a tax-sharing agreement with Duke Energy, and income taxes recorded represent amounts Duke Energy Kentucky would incur as a separate C-Corporation. Deferred income taxes have been provided for temporary differences between GAAP and tax bases of assets and liabilities because the differences create taxable or tax-deductible amounts for future periods. Investment tax credits associated with regulated operations are deferred and amortized as a reduction of income tax expense over the estimated useful lives of the related properties.

Positions taken or expected to be taken on tax returns, including the decision to exclude certain income or transactions from a return, are recognized in the financial statements when it is more likely than not the tax position can be sustained based solely on the technical merits of the position. The largest amount of tax benefit that is greater than 50 percent likely of being effectively settled is recorded. Management considers a tax position effectively settled when: (i) the taxing authority has completed its examination procedures, including all appeals and administrative reviews; (ii) Duke Energy Kentucky does not intend to appeal or litigate the tax position included in the completed examination; and (iii) it is remote the taxing authority would examine or re-examine the tax position. The amount of a tax return position that is not recognized in the financial statements is disclosed as an unrecognized tax benefit. If these unrecognized tax benefits are later recognized, then there will be a decrease in income tax expense or a reclassification between deferred and current taxes payable. If the portion of tax benefits that has been changes and those tax benefits are subsequently unrecognized, then the previously tax benefits may impact the financial statements through increasing income tax expense or a reclassification between deferred and current taxes payable. Changes in assumptions on tax benefits may also impact interest expense or interest income and may result in the recognition of tax penalties.

Tax-related interest and penalties are recorded in Interest Expense and Other Income and Expenses, net, in the Statements of Operations.

See Note 13 for further information.

NEW ACCOUNTING STANDARDS

The following new accounting standards were issued, but have not yet been adopted by Duke Energy Kentucky, as of December 31, 2016.

Revenue from Contracts with Customers. In May 2014, the Financial Accounting Standards Board (FASB) issued revised accounting guidance for revenue recognition from contracts with customers. The core principle of this guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The amendments in this update also require disclosure of sufficient information to allow users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Most of Duke Energy Kentucky's revenue is expected to be in scope of the new guidance. The majority of sales, including energy provided to residential customers, are from tariff offerings that provide natural gas or electricity without a defined contractual term ('at-will'). For such arrangements, Duke Energy Kentucky expects that the revenue from contracts with customers will be equivalent to the electricity or natural gas supplied and billed in that period (including estimated billings). As such, Duke Energy Kentucky does not expect that there will be a significant shift in the timing or pattern of revenue recognition for such sales. The evaluation of other revenue streams is ongoing, including long-term contracts with industrial customers.

Duke Energy Kentucky continues to evaluate what information would be most useful for users of the financial statements, including information already provided in disclosures outside of the financial statement footnotes. These additional disclosures could include the disaggregation of revenues by geographic location, type of service, customer class or by duration of contract ('at-will' versus contracted revenue). Revenues from contracts with customers, revenue recognized under regulated operations accounting and revenue from lease accounting will also be disclosed.

Duke Energy Kentucky intends to use the modified retrospective method of adoption effective January 1, 2018. This method results in a cumulative change effect that will be recorded as an adjustment to retained earnings as of January 1, 2018, as if the standard had always been in effect. Disclosures for 2018 will include a comparison to what would have been reported for 2018 under the current revenue recognition rules in order to assist financial statement users in understanding how revenue recognition has changed as a result of this standard and to facilitate comparability with prior year reported results, which are not restated under the modified retrospective approach.

Leases. In February 2016, the FASB issued revised accounting guidance for leases. The core principle of this guidance is that a lessee should recognize the assets and liabilities that arise from leases on the balance sheet.

For Duke Energy Kentucky, this guidance is effective for interim and annual periods beginning January 1, 2019, although it can be early adopted. The guidance is applied using a modified retrospective approach. Duke Energy Kentucky is currently evaluating the financial statement impact of adopting this standard. Other than an expected increase in assets and liabilities, the ultimate impact of the new standard has not yet been determined. Significant system enhancements may be required to facilitate the identification, tracking and reporting of potential leases based upon requirements of the new lease standard.

Financial Instruments Classification and Measurement. In January 2016, the FASB issued revised accounting guidance for the classification and measurement of financial instruments. Changes in the fair value of all equity securities will be required to be recorded in net income. Current GAAP allows some changes in fair value for available-for-sale equity securities to be recorded in Accumulated Other Comprehensive Income. Additional disclosures will be required to present separately the financial assets and financial liabilities by measurement category and form of financial asset. An entity's equity investments that are accounted for under the equity method of accounting are not included within the scope of the new guidance.

For Duke Energy Kentucky, the revised accounting guidance is effective for interim and annual periods beginning January 1, 2018, by recording a cumulative change effect that will be recorded as an adjustment to retained earnings as of January 1, 2018. This guidance is expected to have minimal impact on the Statements of Operations as changes in the fair value of most of the Duke Energy Kentucky's available-for-sale equity securities are deferred as regulatory assets or liabilities pursuant to accounting guidance for regulated operations.

2. REGULATORY MATTERS

REGULATORY ASSETS AND LIABILITIES

Duke Energy Kentucky records assets and liabilities that result from the ratemaking process. See Note 1 for further information.

The following table represents the regulatory assets and liabilities on the Balance Sheets.

(in thousands)	December 31, 2016	2015	Recovery/Refund Period Ends
Regulatory Assets[(a)]:			
Accrued pension and other post-retirement benefits	$ 31,620	$ 28,289	(b)
East Bend deferrals	32,267	16,465	(c)
Demand side management/Energy efficiency costs	1,661	6,663	(c)(d)
Hedge costs and other deferrals	5,521	6,221	(e)
Storm cost deferrals	4,913	4,913	(c)
AROs – coal ash	11,412	4,425	(c)(h)
Vacation accrual	1,348	1,440	2017
Deferred debt expense	1,455	1,721	2036
Natural gas purchase costs	3,937	579	2017
Carbon management research grant	1,600	1,400	(c)
Deferred gas integrity costs	2,173	—	(c)
Net regulatory asset (liability) related to income taxes	2,178	(1,826)	(h)
Total regulatory assets	100,085	70,290	
Less: current portion	7,623	8,879	
Total noncurrent regulatory assets	$ 92,462	$ 61,411	
Regulatory Liabilities[(a)]:			
Costs of removal	$ 45,878	$ 48,032	(f)
Accrued pension and other post-retirement benefits	5,550	4,937	(b)
Hedge costs and other deferrals	2,502	979	(e)
Deferred fuel	8,456	973	2017
Profit sharing mechanism	1,215	717	2017
Other	450	16	(c)
Total regulatory liabilities	64,051	55,654	
Less: current portion	12,173	2,668	
Total noncurrent regulatory liabilities	$ 51,878	$ 52,986	

(a) Regulatory assets and liabilities are excluded from rate base unless otherwise noted.
(b) The accrued pension and OPEB regulatory asset is expected to be recovered over average remaining service periods of active employees covered by the benefit plans, which is approximately nine years. See Note 12 for further information.
(c) The expected recovery or refund period varies for these amounts or has not been determined.
(d) Deferred costs are recovered through a rider mechanism.
(e) Recovery varies over the life of the associated instrument.
(f) Represents funds received from customers to cover future removal of property, plant and equipment from retired or abandoned sites as property is retired. Included in rate base and recovered over the life of associated assets.
(g) Certain amounts are recovered through rates.

RATE RELATED INFORMATION

The KPSC approves rates for retail electric and natural gas services within the Commonwealth of Kentucky. The FERC approves rates for electric sales to wholesale customers served under cost-based rates, as well as sales of transmission service.

East Bend Coal Ash Basin Filings

On December 2, 2016, Duke Energy Kentucky filed with the KPSC a request for a certificate of public convenience and necessity (CPCN) for construction projects necessary to close and repurpose an ash basin at the East Bend Station necessitated by current and proposed U.S. Environmental Protection Agency (EPA) regulations. Duke Energy Kentucky is targeting a completion date in fourth quarter 2018 for these projects and estimates a total cost of approximately $93 million. Duke Energy Kentucky has requested an order to be issued by April 30, 2017.

On June 10, 2015, Duke Energy Kentucky filed an application with the KPSC seeking approval to record ARO amounts and other compliance obligations related to the disposal of coal combustion residuals (CCR) at the East Bend Station as regulatory assets and to defer costs incurred, including carrying costs. The application was approved in December 2015.

Refer to Note 5 for further information on the EPA rule to regulate the disposal of CCR from electric utilities as solid waste.

Dry Bottom Ash Conversion

On July 28, 2016, Duke Energy Kentucky filed with the KPSC a request for approval of a CPCN to convert to dry bottom ash at the East Bend station. The project is necessary to comply with various environmental law requirements. The project is estimated to cost approximately $25 million. On February 23, 2017, the KPSC granted a CPCN for the project.

Big Bone Pipeline Project

On May 11, 2016, Duke Energy Kentucky filed with the KPSC a request for approval of a CPCN to construct a new natural gas pipeline and related facilities. The project will provide for needed capacity on the Duke Energy Kentucky natural gas delivery system and will provide greater reliability of the overall delivery system. The project is estimated to be completed prior to the 2017 winter heating season at a total cost of approximately $14 million. On November 28, 2016, the KPSC granted a CPCN for the project.

Natural Gas Pipeline Testing Costs

On April 29, 2016, Duke Energy Kentucky filed an application with the KPSC requesting approval to defer approximately $2 million of unplanned operations and maintenance expense related to pressure testing of natural gas pipelines which will be completed in 2017. The testing is required to comply with regulations promulgated by the Pipeline and Hazardous Materials Safety Administration. The KPSC approved the application on July 22, 2016.

Advanced Metering Infrastructure (AMI)

On April 25, 2016, Duke Energy Kentucky filed with the KPSC an application for approval of a CPCN for the construction of AMI. Duke Energy Kentucky anticipates that the estimated $49 million project, if approved, will take approximately two years to complete. Duke Energy Kentucky also requested approval to establish a regulatory asset of approximately $10 million for the remaining book value of existing meter equipment and inventory that will be replaced. On July 20, 2016, the Kentucky Attorney General, the only intervenor in the proceeding, moved to dismiss the application. Duke Energy Kentucky filed its opposition to the Kentucky Attorney General's motion to dismiss on July 27, 2016. On September 28, 2016, the KPSC denied the Kentucky Attorney General's motion to dismiss and granted Duke Energy Kentucky's motion to file rebuttal testimony. Duke Energy Kentucky and the Kentucky Attorney General entered into a stipulation resolving the matters raised in the application. An evidentiary hearing was held on December 8, 2016. Duke Energy Kentucky cannot predict the outcome of this matter.

Accelerated Natural Gas Service Line Replacement Program

On July 6, 2015, Duke Energy Kentucky filed an application for approval of an accelerated natural gas service line replacement program (ASRP). Under the ASRP, Duke Energy Kentucky proposed to replace certain natural gas service lines on an accelerated basis over a five year period. Through the ASRP, Duke Energy Kentucky also proposed to complete preliminary survey and investigation work related to natural gas service lines that are customer-owned and for which it does not have valid records and, further, to relocate interior natural gas meters to suitable exterior locations where such relocation can be accomplished. Duke Energy Kentucky currently estimates capital and operations and maintenance expenditures under the ASRP will total approximately $38 million. The filing also sought approval of a rider for ASRP expenditures to be recovered (Rider ASRP), which Duke Energy Kentucky would update on an annual basis.

Duke Energy Kentucky reached a settlement with the lone intervenor, the Kentucky Attorney General, which included the following key terms: (i) 9.7 percent return on equity; (ii) meter relocations only where code violations exist; (iii) one year rate stay-out, with exceptions; and, (iv) an annual $1.00 per month cap on Rider ASRP rate increases for residential customers. On February 2, 2016, the KPSC issued an order approving the settlement. On July 1, 2016, Duke Energy Kentucky filed its annual ASRP projections, rate and tariffs application with the KPSC requesting an August 2016 effective date. The KPSC determined an investigation into the reasonableness of the proposed rates was necessary and suspended the effective date through December 2016. On December 16, 2016, the KPSC denied the original proposed rates and approved revised rates, effective January 2017.

East Bend Station

On December 30, 2014, Duke Energy Kentucky acquired The Dayton Power and Light Company's 31 percent interest in the jointly owned East Bend Station for approximately $12.4 million. Duke Energy Kentucky owns 100 percent of the East Bend Station as a result of the acquisition. The KPSC approved the deferral of incremental operations and maintenance costs related to the additional ownership interest above amounts currently reflected in base rates. At December 31, 2016, Duke Energy Kentucky had approximately $23 million included in Regulatory assets related to incremental operations and maintenance costs for East Bend.

The purchase price, in accordance with FERC guidelines, was reflected with The Dayton Power & Light Company's historical original cost as an increase to property, plant and equipment and accumulated depreciation as of December 31, 2015. Based on FERC methodology, Duke Energy Kentucky is required to apply depreciation rates to the original historical plant cost, not the $12.4 million purchase price. As a result, the purchase price will be fully depreciated over a four-year period, not the remaining useful life of the assets of 27 years. On August 20, 2015, the KPSC approved Duke Energy Kentucky's application to use the purchase price as the value of the newly acquired interest in the East Bend Station for depreciation and ratemaking purposes and to create a regulatory asset for the excess FERC-mandated depreciation to be recovered over the remaining useful life of the assets. At December 31, 2016, Duke Energy Kentucky had approximately $9 million included in Regulatory assets related to excess depreciation.

Regional Transmission Organization (RTO) Realignment

Duke Energy Ohio and Duke Energy Kentucky transferred control of their transmission assets to effect a RTO realignment from Midcontinent Independent System Operator, Inc. (MISO) to PJM Interconnection, LLC (PJM), effective December 31, 2011.

On December 22, 2010, the KPSC approved Duke Energy Kentucky's request to effect the RTO realignment, subject to a commitment not to seek double-recovery in a future rate case of the transmission expansion fees that may be charged by MISO and PJM in the same period or overlapping periods. Duke Energy Kentucky is not currently recovering PJM or MISO transmission expansion fees through current base rates.

Upon its exit from MISO on December 31, 2011, Duke Energy Kentucky recorded a liability and expense for its exit obligation and share of MISO Transmission Expansion Planning (MTEP) costs, excluding Multi Value Projects (MVP). This liability was recorded within Other in Current Liabilities and Other in Deferred Credits and Other Liabilities on the Balance Sheets.

The following table provides a reconciliation of the beginning and ending balance of recorded obligations related to the withdrawal from MISO.

(in thousands)	December 31, 2015	Provision / Adjustments	Cash Reductions	December 31, 2016
MISO withdrawal liability	$ 19,931	$ 724	$ (1,203)	$ 19,452

MVP

MISO approved 17 MVP proposals prior to Duke Energy Ohio and Duke Energy Kentucky's exit from MISO on December 31, 2011. Construction of these projects is expected to continue through 2020. Costs of these projects, including operating and maintenance costs, property and income taxes, depreciation and an allowed return, are allocated and billed to MISO transmission owners.

On December 29, 2011, MISO filed a tariff with the FERC providing for the allocation of MVP costs to a withdrawing owner based on monthly energy usage. The FERC set for hearing (i) whether MISO's proposed cost allocation methodology to transmission owners who withdrew from MISO prior to January 1, 2012 is consistent with the tariff at the time of their withdrawal from MISO and, (ii) if not, what the amount of and methodology for calculating any MVP cost responsibility should be. In 2012, MISO estimated Duke Energy Kentucky's MVP obligation over the period from 2012 to 2071 at $450 million, on an undiscounted basis. On July 16, 2013, a FERC Administrative Law Judge (ALJ) issued an initial decision. Under this initial decision, Duke Energy Ohio and Duke Energy Kentucky would be liable for MVP costs. Duke Energy Ohio and Duke Energy Kentucky filed exceptions to the initial decision, requesting FERC to overturn the ALJ's decision.

On October 29, 2015, the FERC issued an order reversing the ALJ's decision. The FERC ruled the cost allocation methodology is not consistent with the MISO tariff and that Duke Energy Ohio and Duke Energy Kentucky have no liability for MVP costs after withdrawal from MISO. On May 19, 2016, the FERC denied the request for rehearing filed by MISO and the MISO Transmission Owners. On July 15, 2016, the MISO Transmission Owners filed a petition for review with the U.S. Court of Appeals for the Sixth Circuit. Duke Energy Kentucky cannot predict the outcome of this matter.

FERC Transmission Return on Equity and MTEP Cost Settlement

On October 14, 2011, Duke Energy Ohio and Duke Energy Kentucky submitted with the FERC proposed modifications to the PJM Interconnection Open Access Transmission Tariff pertaining to recovery of the transmission revenue requirement as PJM transmission owners. The filing was made in connection with Duke Energy Ohio's and Duke Energy Kentucky's move from MISO to PJM effective December 31, 2011. On April 24, 2012, the FERC issued an order accepting the proposed filing effective January 1, 2012, except that the order denied a request to recover certain costs associated with the move from MISO to PJM without prejudice to the right to submit another filing seeking such recovery and including certain additional evidence, and set the rate of return on equity of 12.38 percent for settlement and hearing. On April 16, 2015, the FERC approved a settlement agreement between Duke Energy Ohio, Duke Energy Kentucky and six PJM transmission customers with load in the Duke Energy Ohio and Duke Energy Kentucky zone. The principal terms of the settlement agreement are that, effective upon the date of FERC approval, (i) the return on equity for wholesale transmission service is reduced to 11.38 percent, (ii) the settling parties agreed not to seek a change in the return on equity that would be effective prior to June 1, 2017, and (iii) Duke Energy Ohio and Duke Energy Kentucky will recover 30 percent of the wholesale portion of costs arising from their obligation to pay any portion of the costs of projects included in any MTEP that was approved prior to the date of Duke Energy Ohio's and Duke Energy Kentucky's integration into PJM.

OTHER REGULATORY MATTERS

PJM Capacity Performance Proposal

On June 9, 2015, the FERC ruled in favor of PJM on a revised Tariff and Reliability Assurance Agreement including implementation of a Capacity Performance (CP) proposal and to amend sections of the Operating Agreement related to generation non-performance. The CP proposal includes performance-based penalties for non-compliance. Duke Energy Kentucky is a Fixed Resource Requirement (FRR) entity, and therefore is subject to the compliance standards through its FRR plans. A partial CP obligation will apply to Duke Energy Kentucky in the delivery year beginning June 1, 2019, with full compliance beginning June 1, 2020.

Duke Energy Kentucky is evaluating potential strategies for compliance and required investment. The regulatory treatment of CP compliance costs and potential penalties has not been determined. The ruling could result in an adverse impact on Duke Energy Kentucky's future results of operations and cash flows. Duke Energy Kentucky cannot predict the outcome of this matter.

3. COMMITMENTS AND CONTINGENCIES

GENERAL INSURANCE

Duke Energy Kentucky has insurance and/or reinsurance coverage either directly or through indemnification from Duke Energy's captive insurance company, Bison Insurance Company Limited, and its affiliates, consistent with companies engaged in similar commercial operations with similar type properties. Duke Energy Kentucky's coverage includes (i) commercial general liability coverage for liabilities arising to third parties for bodily injury and property damage; (ii) workers' compensation; (iii) automobile liability coverage; and (iv) property coverage for all real and personal property damage. Real and personal property damage coverage excludes electric transmission and distribution lines, but includes damages arising from boiler and machinery breakdowns, earthquakes, flood damage and extra expense, but not outage or replacement power coverage. All coverage is subject to certain deductibles or retentions, sublimits, exclusions, terms and conditions that are common for companies with similar types of operations. Duke Energy Kentucky self-insures its electric transmission and distribution lines against loss due to storm damage and other natural disasters.

The cost of Duke Energy Kentucky's coverage can fluctuate year to year reflecting claims history and conditions of the insurance and reinsurance markets.

In the event of a loss, terms and amounts of insurance and reinsurance available might not be adequate to cover claims and other expenses incurred. Uninsured losses and other expenses, to the extent not recovered by other sources, could have a material effect on Duke Energy Kentucky's results of operations, cash flows or financial position. Duke Energy Kentucky is responsible to the extent losses may exceed limits of the coverage available.

ENVIRONMENTAL

Duke Energy Kentucky is subject to federal, state, and local regulations regarding air and water quality, hazardous and solid waste disposal, and other environmental matters. These regulations can be changed from time to time, imposing new obligations on Duke Energy Kentucky.

Remediation Activities

In addition to the AROs discussed in Note 5, Duke Energy Kentucky is responsible for environmental remediation at various sites. These include some properties that are part of ongoing operations and sites formerly owned or used by Duke Energy Kentucky. These sites are in various stages of investigation, remediation and monitoring. Managed in conjunction with relevant federal, state and local agencies, remediation activities vary based upon site condition and location, remediation requirements, complexity and sharing of responsibility. If remediation activities involve joint and several liability provisions, strict liability, or cost recovery or contribution actions, Duke Energy Kentucky could potentially be held responsible for environmental impacts caused by other potentially responsible parties, and may also benefit from insurance policies or contractual indemnities that cover some or all cleanup costs. Liabilities are recorded when losses become probable and are reasonably estimable. The total costs that may be incurred cannot be estimated because the extent of environmental impact, allocation among potentially responsible parties, remediation alternatives and/or regulatory decisions have not yet been determined. Additional costs associated with remediation activities are likely to be incurred in the future and could be significant. Costs are typically expensed as Operation, maintenance and other in the Statements of Operations unless regulatory recovery of the costs is deemed probable.

Duke Energy Kentucky has accrued approximately $670 thousand and $515 thousand of probable and estimable costs related to its various environmental sites in Other within Deferred Credits and Other Liabilities on the Condensed Balance Sheets as of December 31, 2016 and 2015, respectively. Additional losses in excess of recorded reserves are expected to be immaterial for the stages of investigation, remediation and monitoring for the environmental sites that have been evaluated. The maximum amount of the range for all stages of Duke Energy Kentucky's environmental sites cannot be determined at this time.

Clean Power Plan (CPP)

On October 23, 2015, the EPA published in the Federal Register the CPP rule for regulating carbon dioxide (CO_2) emissions from existing fossil fuel-fired electric generating units. The CPP establishes CO_2 emission rates and mass cap goals that apply to fossil fuel-fired generation. Petitions challenging the CPP have been filed by several groups and on February 9, 2016, the Supreme Court issued a stay of the final CPP rule, halting implementation of the CPP until legal challenges are resolved. Kentucky has suspended work on the CPP in response to the stay. Oral arguments before 10 of the 11 judges on the D.C. Circuit Court were heard on September 27, 2016. The court is expected to decide the case in early 2017.

Compliance with CPP could cause the industry to replace coal-fired generation with natural gas and renewables. Costs to operate coal-fired generation plants continue to grow due to increasing environmental compliance requirements, including ash management costs unrelated to CPP, which may result in the retirement of coal-fired generation plants earlier than the current useful lives. If the CPP is ultimately upheld by the courts and implementation goes forward, Duke Energy Kentucky could incur increased fuel, purchased power, operation and maintenance and other costs for replacement generation as a result of this rule. Due to the uncertainties related to the implementation of the CPP, Duke Energy Kentucky cannot predict the outcome of these matters. Duke Energy Kentucky continues to evaluate the need to retire generating facilities and plans to seek regulatory recovery, where appropriate, for amounts that have not been recovered upon asset retirements. However, recovery is subject to future regulatory approval, including the recovery of carrying costs on remaining book values, and therefore cannot be assured.

LITIGATION

Duke Energy Kentucky is involved in other legal, tax and regulatory proceedings arising in the ordinary course of business, some of which involve significant amounts. Duke Energy Kentucky believes the final disposition of these proceedings will not have a material effect on its results of operations, cash flows or financial position. Duke Energy Kentucky expenses legal costs related to the defense of loss contingencies as incurred.

OTHER COMMITMENTS AND CONTINGENCIES

General

As part of its normal business, Duke Energy Kentucky is party to various financial guarantees, performance guarantees and other contractual commitments to extend guarantees of credit and other assistance to various third parties. These guarantees involve elements of performance and credit risk which are not included on the Balance Sheets. The possibility of Duke Energy Kentucky having to honor its contingencies is largely dependent upon future operations of various third parties or the occurrence of certain future events.

Operating and Capital Lease Commitments

Duke Energy Kentucky leases vehicles, computer equipment and other property and equipment with various terms and expiration dates. Capitalized lease obligations are classified as Long-Term Debt on the Balance Sheets. Amortization of assets recorded under capital leases is included in Depreciation and amortization on the Statements of Operations.

Rental expense for operating leases, which is included in Operation, maintenance and other on the Statements of Operations, was $3 million and $2 million for the years ended December 31, 2016 and 2015, respectively.

The following table presents future minimum lease payments under operating leases, which at inception had a non-cancelable term of more than one year, and capital leases as of December 31, 2016.

(in thousands)	Operating Leases	Capital Leases
2017	$ 1,996	$ 816
2018	1,856	1,016
2019	998	481
2020	764	250
2021	622	—
Thereafter	791	—
Minimum annual payments	7,027	2,563
Less: amount representing interest	—	(411)
Total	$ 7,027	$ 2,152

4. DEBT AND CREDIT FACILITIES

SUMMARY OF DEBT AND RELATED TERMS

The following table summarizes outstanding debt.

			December 31,	
(in thousands)	Weighted Average Interest Rate	Year Due	2016	2015
Unsecured debt	4.79%	2019 - 2046	$ 260,000	$ 215,000
Capital leases	6.00%	2018 - 2020	2,152	3,672
Tax-exempt bonds[(a)(b)]	1.05%	2027	76,720	76,720
Money pool borrowings[(b)(c)]	0.99%		44,656	80,743
Unamortized debt discount and premium, net			(338)	(389)
Unamortized debt issuance costs			(1,488)	(976)
Total debt	3.60%		$ 381,702	$ 374,770
Short-term money pool borrowings			(19,656)	(55,743)
Current maturities of long-term debt			(686)	(101,519)
Total long-term debt			$ 361,360	$ 217,508

(a) Includes $27 million that is secured by a bilateral letter of credit agreement.
(b) Floating-rate debt. At December 31, 2015, the weighted average interest rate was 0.73% for tax-exempt bonds.
(c) Includes $25 million classified as Long-Term Debt Payable to Affiliated Companies on the Balance Sheets.

MATURITIES AND CALL OPTIONS

The following table shows the annual maturities of long-term debt for the next five years and thereafter.

(in thousands)	December 31, 2016
2017	$ 686
2018	887
2019	100,230
2020	25,181
2021	48,512
Thereafter	186,550
Total long-term debt, including current maturities	$ 362,046

Duke Energy Kentucky has the ability under certain debt facilities to call and repay the obligation prior to its scheduled maturity. Therefore, the actual timing of future cash repayments could be materially different than as presented above.

SHORT-TERM OBLIGATIONS CLASSIFIED AS LONG-TERM DEBT

Tax-exempt bonds that may be put to Duke Energy Kentucky at the option of the holder and money pool borrowings, which are short-term obligations by nature, are classified as long-term due to Duke Energy Kentucky's intent and ability to utilize such borrowings as long-term financing. As Duke Energy's Master Credit Facility and Duke Energy Kentucky's other bilateral letter of credit agreements have non-cancelable terms in excess of one year as of the balance sheet date, Duke Energy Kentucky has the ability to refinance these short-term obligations on a long-term basis. See "Available Credit Facilities" below for additional information.

At December 31, 2016 and 2015, $27 million of tax-exempt bonds and $25 million of money pool borrowings were classified as Long-Term Debt and Long-Term Debt Payable to Affiliated Companies, respectively, on the Balance Sheets.

SIGNIFICANT DEBT ISSUANCES

In January 2016, Duke Energy Kentucky issued $95 million of unsecured debentures, of which $45 million carry a fixed interest rate of 3.42 percent and mature January 15, 2026, and $50 million carry a fixed interest rate of 4.45 percent and mature January 15, 2046. Proceeds were used to refinance existing debt, including money pool borrowings, capital expenditures and for general corporate purposes.

AVAILABLE CREDIT FACILITIES

Duke Energy has a Master Credit Facility with a capacity of $7.5 billion through January 2020. Duke Energy Kentucky has borrowing capacity under the Master Credit Facility up to a specified sublimit. Duke Energy has the unilateral ability at any time to increase or decrease Duke Energy Kentucky's borrowing sublimit, subject to a maximum sublimit. The amount available to Duke Energy Kentucky under the Master Credit Facility may be reduced to backstop issuances of commercial paper, certain letters of credit and variable-rate demand tax-exempt bonds that may be put to Duke Energy Kentucky at the option of the holder. At December 31, 2016, Duke Energy Kentucky had a borrowing sublimit of $150 million and available capacity of $119 million under the Master Credit Facility.

Duke Energy Kentucky and Duke Energy Indiana, LLC (Duke Energy Indiana), a wholly owned subsidiary of Duke Energy, collectively have a $156 million bilateral letter of credit agreement expiring February 2019. Duke Energy Kentucky and Duke Energy Indiana may request the issuance of letters of credit up to $27 million and $129 million, respectively, on their behalf to support various series of tax-exempt bonds. This credit facility may not be used for any purpose other than to support the tax-exempt bonds.

OTHER DEBT MATTERS

Money Pool

Duke Energy Kentucky receives support for its short-term borrowing needs through participation with Duke Energy and certain of its subsidiaries in a money pool arrangement. Under this arrangement, those companies with short-term funds may provide short-term loans to affiliates participating under this arrangement. The money pool is structured such that Duke Energy Kentucky separately manages its cash needs and working capital requirements. Accordingly, there is no net settlement of receivables and payables related to the money pool between the money pool participants.

Money pool receivable balances are reflected within Notes receivable from affiliated companies in the Balance Sheets. The change in receivables is reflected within Investing Activities on the Statements of Cash Flows. Money pool payable balances are reflected within either Notes payable to affiliated companies or Long-Term Debt Payable to Affiliated Companies on the Balance Sheets. The change in payables are reflected within Financing Activities on the Statements of Cash Flows.

Restrictive Debt Covenants

Duke Energy Kentucky's debt and credit agreements contain various financial and other covenants. Failure to meet those covenants beyond applicable grace periods could result in accelerated due dates and/or termination of the agreements. As of December 31, 2016, Duke Energy Kentucky was in compliance with all covenants related to its debt agreements. In addition, some credit agreements may allow for acceleration of payments or termination of the agreements due to nonpayment, or the acceleration of other significant indebtedness of the borrower or some of its subsidiaries. None of the debt or credit agreements contain material adverse change clauses.

5. ASSET RETIREMENT OBLIGATIONS

Duke Energy Kentucky records an ARO when it has a legal obligation to incur retirement costs associated with the retirement of a long-lived asset and the obligation can be reasonably estimated. Certain assets have an indeterminate life, and thus the fair value of the retirement obligation is not reasonably estimable. A liability for these AROs will be recorded when a fair value is determinable.

Duke Energy Kentucky's regulated electric and regulated natural gas operations accrue costs of removal for property that does not have an associated legal retirement obligation based on regulatory orders from the KPSC. These costs of removal are recorded as a regulatory liability in accordance with regulatory accounting treatment. See Note 2 for the estimated cost of removal for assets without an associated legal retirement obligation, which are included in Regulatory liabilities on the Balance Sheets as of December 31, 2016 and 2015.

In April 2015, the EPA published a rule to regulate the disposal of CCR from electric utilities as solid waste. The federal regulation classifies CCR as nonhazardous waste and allows for beneficial use of CCR with some restrictions. The regulation applies to all new and existing landfills, new and existing surface impoundments receiving CCR and existing surface impoundments that are no longer receiving CCR but contain liquid located at stations currently generating electricity (regardless of fuel source). The rule establishes requirements regarding landfill design, structural integrity design and assessment criteria for surface impoundments, groundwater monitoring and protection procedures and other operational and reporting procedures to ensure the safe disposal and management of CCR. As a result of the EPA rule, Duke Energy Kentucky recorded additional ARO amounts during 2015 for estimated ash basin closure costs at the East Bend Station. In addition to the requirements of the federal CCR regulation, CCR landfills and surface impoundments are also independently regulated by the state of Kentucky.

The ARO amount recorded on the Balance Sheets is based upon estimated closure costs for impacted ash impoundments. The amount recorded represents the discounted cash flows for estimated closure costs based upon either specific closure plans or the probability weightings of the potential closure methods as evaluated on a site-by-site basis. Actual costs to be incurred will be dependent upon factors that vary from site to site. The most significant factors are the method and time frame of closure at the individual sites. Closure methods considered include removing the water from the basins, consolidating material as necessary and capping the ash with a synthetic barrier, excavating and relocating the ash to a lined structural fill or lined landfill, or recycling the ash for concrete or some other beneficial use. The ultimate method and timetable for closure will be in compliance with standards set by federal and state regulations.

During 2016, Duke Energy Kentucky updated its coal ash ARO liability estimate based on additional site-specific information about the related costs, methods and timing of work to be performed. The ARO amount will be adjusted as additional information is gained through the closure and post-closure process, including acceptance and approval of compliance approaches which may change management assumptions, and may result in a material change to the balance.

Asset retirement costs associated with coal ash AROs at the East Bend Station are included within Property, Plant and Equipment on the Balance Sheets.

The following table presents the changes in the liability associated with AROs.

	Years Ended December 31,	
(in thousands)	**2016**	**2015**
Balance at beginning of period[(a)]	**$ 103,500**	$ 8,122
Accretion expense	**4,034**	3,391
Liabilities settled[(b)]	**(4,757)**	(4,443)
Liabilities incurred in the current year[(c)]	**—**	115,723
Revisions to estimates of cash flows[(d)]	**(49,955)**	(19,293)
Balance at end of period	**$ 52,822**	$ 103,500

(a) 2015 amount primarily relates to the retirement of natural gas mains, asbestos removal and closure of landfills at fossil generation facilities.
(b) Settlement of liabilities related to ash basin closure costs at the East Bend Station.
(c) 2015 amount represents AROs incurred as a result of the EPA's rule for disposal of CCR as solid waste. See Note 2 for further discussion of the approval granted by the KPSC to defer costs related to ash basin closure at the East Bend Station.
(d) Primarily related to ash basin closure costs.

Cost recovery related to ash basin closures will be pursued through the normal ratemaking process with the KPSC which permits recovery of necessary and prudently incurred costs associated with Duke Energy Kentucky's regulated operations.

6. PROPERTY, PLANT AND EQUIPMENT

The following table summarizes property, plant and equipment.

(in thousands)	Estimated Useful Life (Years)	December 31, 2016	2015
Land		$ 26,007	$ 24,475
Plant:			
Electric generation, distribution and transmission[(a)]	8 – 100	1,496,729	1,509,240
Natural gas transmission and distribution[(a)]	12 – 50	459,165	438,055
Other buildings and improvements	15 – 100	11,554	11,674
Equipment	5 – 25	17,549	16,464
Construction in process		63,833	43,361
Other	5 – 10	41,382	36,492
Total property, plant and equipment		2,116,219	2,079,761
Accumulated depreciation and amortization[(b)]		(948,144)	(923,578)
Net property, plant and equipment[(c)]		$ 1,168,075	$ 1,156,183

(a) Includes capitalized lease amounts of $28 million and $32 million at December 31, 2016 and 2015, respectively.
(b) Includes accumulated amortization of capitalized leases of $7 million at December 31, 2016 and 2015.
(c) The debt component of AFUDC totaled $537 thousand and $225 thousand at December 31, 2016 and 2015, respectively.

7. OTHER INCOME AND EXPENSES, NET

The components of Other Income and Expenses, net on the Statements of Operations are as follows.

(in thousands)	Years Ended December 31, 2016	2015
Income/(Expense):		
Interest income	$ 990	$ 1,019
AFUDC equity	1,332	620
Other	(1)	(564)
Other Income and Expenses, net	$ 2,321	$ 1,075

8. RELATED PARTY TRANSACTIONS

Duke Energy Kentucky engages in related party transactions, which are generally performed at cost and in accordance with KPSC and FERC regulations. Material amounts related to transactions with related parties included in the Statements of Operations are presented in the following table.

(in thousands)	Years Ended December 31, 2016	2015
Corporate governance and shared service expenses[(a)]	$ 83,100	$ 77,884

(a) Duke Energy Kentucky is charged its proportionate share of costs, primarily related to human resources, employee benefits, legal and accounting fees, as well as other third party costs, from an unconsolidated affiliate that is a consolidated affiliate of Duke Energy. These amounts are recorded in Operation, maintenance and other within Operating Expenses on the Statements of Operations.

In addition to the amounts presented above, Duke Energy Kentucky records the impact on net income of other affiliate transactions, including rental of office space, participation in a money pool arrangement with Duke Energy and certain of its subsidiaries, other operational transactions and its proportionate share of certain charged expenses. The net impact of these transactions was not material for each of the years ended December 31, 2016 and 2015.

Certain trade receivables have been sold by Duke Energy Kentucky to CRC, an unconsolidated entity formed by a subsidiary of Duke Energy. The proceeds obtained from the sales of receivables are largely cash but do include a subordinated note from CRC for a portion of the purchase price. See Notes 1 and 11 for further information related to the sales of these receivables.

See the Balance Sheets for amounts due to or due from related parties.

Intercompany Income Taxes

Duke Energy and its subsidiaries file a consolidated federal income tax return and other state and jurisdictional returns. Duke Energy Kentucky has a tax sharing agreement with Duke Energy for the allocation of consolidated tax liabilities and benefits. Income taxes recorded represent amounts Duke Energy Kentucky would incur as a separate C-Corporation. Duke Energy Kentucky had an immaterial intercompany tax payable balance at December 31, 2016, and an intercompany tax receivable balance of $13 million at December 31, 2015.

9. DERIVATIVES AND HEDGING

COMMODITY PRICE RISK

Duke Energy Kentucky has limited exposure to market price changes of fuel and emission allowance costs incurred for its retail customers due to the use of cost tracking and recovery mechanisms. Duke Energy Kentucky does have exposure to the impact of market fluctuations in the prices of electricity, fuel and emission allowances associated with its generation output not utilized to serve retail operations or committed load (off-system, wholesale power sales). Duke Energy Kentucky's outstanding commodity derivatives are financial transmission rights.

See Note 10 for additional information on the fair value of commodity derivatives.

INTEREST RATE RISK

Duke Energy Kentucky is exposed to changes in interest rates as a result of its issuance or anticipated issuance of variable-rate and fixed-rate debt. Interest rate risk is managed by limiting variable-rate exposure to a percentage of total debt and by monitoring changes in interest rates.

To manage risk associated with changes in interest rates, Duke Energy Kentucky may enter into financial contracts including interest rate swaps and U.S. Treasury lock agreements. The notional amount of interest rate swaps outstanding was $26.7 million at December 31, 2016 and December 31, 2015. Financial contracts entered into by Duke Energy Kentucky are not designated as a hedge because they are accounted for under regulatory accounting. With regulatory accounting, the mark-to-market gains or losses are deferred as regulatory liabilities or assets. Regulatory assets and liabilities are amortized consistent with the treatment of related costs in the ratemaking process. The accrual of interest on swaps is recorded as Interest Expense on the Statements of Operations.

See Note 10 for additional information on the fair value of interest rate derivatives.

CREDIT RISK

Duke Energy Kentucky analyzes the financial condition of counterparties prior to entering into agreements and establishes credit limits and monitors the appropriateness of those limits on an ongoing basis. Credit limits and collateral requirements for retail electric customers are established by the KPSC.

Duke Energy Kentucky's industry has historically operated under negotiated credit lines for physical delivery contracts. Duke Energy Kentucky may use master collateral agreements to mitigate certain credit exposures. The collateral agreements require certain counterparties to post cash or letters of credit for the amount of exposure in excess of an established threshold. The threshold amount represents an unsecured credit limit determined in accordance with the corporate credit policy. Collateral agreements also provide that the inability to post collateral is sufficient cause to terminate contracts and liquidate all positions.

Duke Energy Kentucky also obtains cash or letters of credit from customers to provide credit support outside of collateral agreements, where appropriate, based on its financial analysis of the customer and the regulatory or contractual terms and conditions applicable to each transaction.

10. FAIR VALUE MEASUREMENTS

Fair value is the exchange price in an orderly transaction between market participants to sell an asset or transfer a liability at the measurement date. The fair value definition focuses on an exit price versus the acquisition cost. Fair value measurements use market data or assumptions market participants would use in pricing the asset or liability, including assumptions about risk and the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, corroborated by market data or generally unobservable. Valuation techniques maximize the use of observable inputs and minimize the use of unobservable inputs. A midmarket pricing convention (the midpoint price between bid and ask prices) is permitted for use as a practical expedient.

Fair value measurements are classified in three levels based on the fair value hierarchy:

Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity can access at the measurement date. An active market is one in which transactions for an asset or liability occur with sufficient frequency and volume to provide ongoing pricing information.

Level 2 – A fair value measurement utilizing inputs other than quoted prices included in Level 1 that are observable, either directly or indirectly, for an asset or liability. Inputs include (i) quoted prices for similar assets or liabilities in active markets, (ii) quoted prices for identical or similar assets or liabilities in markets that are not active, (iii) and inputs other than quoted market prices that are observable for the asset or liability, such as interest rate curves and yield curves observable at commonly quoted intervals, volatilities, and credit spreads. A Level 2 measurement cannot have more than an insignificant portion of its valuation based on unobservable inputs. Instruments in this category include non-exchange-traded derivatives, such as over-the-counter forwards, swaps and options; certain marketable debt securities; and financial instruments traded in less than active markets.

Level 3 – Any fair value measurement which includes unobservable inputs for more than an insignificant portion of the valuation. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value. Level 3 measurements may include longer-term instruments that extend into periods in which observable inputs are not available.

Fair value accounting guidance permits entities to elect to measure certain financial instruments that are not required to be accounted for at fair value, such as equity method investments or the company's own debt, at fair value. Duke Energy Kentucky has not elected to record any of these items at fair value.

Transfers between levels represent assets or liabilities that were previously (i) categorized at a higher level for which the inputs to the estimate became less observable or (ii) classified at a lower level for which the inputs became more observable during the period. Duke Energy Kentucky's policy is to recognize transfers between levels of the fair value hierarchy at the end of the period. There were no transfers between levels 1, 2 or 3 during the years ended December 31, 2016 and 2015.

Interest rate derivatives

Most over-the-counter interest rate contract derivatives are valued using financial models which utilize observable inputs for similar instruments and are classified as Level 2. Inputs include forward interest rate curves, notional amounts, interest rates and credit quality of the counterparties.

QUANTITATIVE DISCLOSURES

The following tables provide recorded balances for assets and liabilities measured at fair value on a recurring basis on the Balance Sheets. Derivative amounts in the table below exclude cash collateral.

	December 31, 2016			
(in thousands)	Total Fair Value	Level 1	Level 2	Level 3
Derivative assets[a]	$ 4,916	$ —	$ —	$ 4,916
Derivative liabilities[b]	(5,944)	—	(5,944)	—
Net (liabilities) assets	$ (1,028)	$ —	$ (5,944)	$ 4,916

	December 31, 2015			
(in thousands)	Total Fair Value	Level 1	Level 2	Level 3
Derivative assets[a]	$ 2,913	$ —	$ —	$ 2,913
Derivative liabilities[b]	(6,678)	(27)	(6,651)	—
Net (liabilities) assets	$ (3,765)	$ (27)	$ (6,651)	$ 2,913

(a) Included in Other within Current Assets and Other Assets on the Balance Sheets. Amounts relate to financial transmission rights.
(b) Included in Other within Current Liabilities and Other within Deferred Credits and Other Liabilities on the Balance Sheets. The amounts classified as Level 2 relate to interest rate swaps.

The following table provides a reconciliation of beginning and ending balances of assets and liabilities measured at fair value on a recurring basis where the determination of fair value includes significant unobservable inputs (Level 3).

	Derivatives (net)	
	Years Ended December 31,	
(in thousands)	2016	2015
Balance at beginning of period	$ 2,913	$ 1,033
Purchases, sales, issuances and settlements:		
Purchases	4,921	4,611
Settlements	(4,441)	(3,113)
Total gains included on the Balance Sheets as regulatory assets or liabilities	1,523	382
Balance at end of period	$ 4,916	$ 2,913

OTHER FAIR VALUE DISCLOSURES

The fair value of long-term debt, including current maturities, is summarized in the following table. Judgment is required in interpreting market data to develop the estimates of fair value. Accordingly, the estimates determined are not necessarily indicative of the amounts Duke Energy Kentucky could have settled in current markets. The fair value of long-term debt is determined using Level 2 measurements.

	December 31, 2016		December 31, 2015	
(in thousands)	Book value	Fair value	Book value	Fair value
Long-Term debt, including current maturities	$ 362,046	$ 380,386	$ 319,027	$ 332,620

At both December 31, 2016 and December 31, 2015, the fair value of cash and cash equivalents, accounts and notes receivable, and accounts and notes payable are not materially different from their carrying amounts because of the short-term nature of these instruments and/or because the stated rates approximate market rates.

11. VARIABLE INTEREST ENTITIES

A variable interest entity (VIE) is an entity that is evaluated for consolidation using more than a simple analysis of voting control. The analysis to determine whether an entity is a VIE considers contracts with an entity, credit support for an entity, the adequacy of the equity investment of an entity, and the relationship of voting power to the amount of equity invested in an entity. This analysis is performed either upon the creation of a legal entity or upon the occurrence of an event requiring reevaluation, such as a significant change in an entity's assets or activities. A qualitative analysis of control determines the party that consolidates a VIE. This assessment is based on (i) what party has the power to direct the most significant activities of the VIE that impact its economic performance and (ii) what party has rights to receive benefits or is obligated to absorb losses that are significant to the VIE. The analysis of the party that consolidates a VIE is a continual reassessment.

Cinergy Receivables Company

CRC is a bankruptcy remote, special purpose entity that is an affiliate of Duke Energy Kentucky. As discussed below, Duke Energy Kentucky does not consolidate CRC as it is not the primary beneficiary. On a revolving basis, CRC buys certain accounts receivable arising from the sale of electricity, natural gas and related services from Duke Energy Kentucky. CRC borrows amounts under a credit facility to buy the receivables from Duke Energy Kentucky. Borrowing availability from the credit facility is limited to the amount of qualified receivables sold to CRC. The sole source of funds to satisfy the related debt obligation is cash collections from the receivables. Depending on experience with collections, additional equity infusions to CRC may be required by Duke Energy to maintain a minimum equity balance of $3 million. There were no infusions to CRC during the years ended December 31, 2016 and 2015.

The proceeds Duke Energy Kentucky receives from the sale of receivables to CRC are typically 75 percent cash and 25 percent in the form of a subordinated note from CRC. The subordinated note is a retained interest in the receivables sold. Duke Energy Kentucky had receivables of $18.4 million and $10.1 million from CRC at December 31, 2016 and December 31, 2015, respectively. These balances are included in Receivables from affiliated companies on the Balance Sheets.

CRC is considered a VIE because (i) equity capitalization is insufficient to support its operations, (ii) power to direct the activities that most significantly impact economic performance of the entity are not performed by the equity holder and (iii) deficiencies in net worth of CRC are funded by Duke Energy. The most significant activities that impact the economic performance of CRC are decisions made to manage delinquent receivables. Duke Energy consolidates CRC as it makes these decisions. Duke Energy Kentucky does not consolidate CRC. No financial support was provided to this non-consolidated VIE during the years ended December 31, 2016 or 2015, or is expected to be provided in the future, that was not previously contractually required.

The subordinated note held by Duke Energy Kentucky is stated at fair value. Carrying values of retained interests are determined by allocating carrying value of the receivables between assets sold and interests retained based on relative fair value. The allocated basis of the subordinated notes are not materially different than their face value because (i) the receivables generally turnover in less than two months, (ii) credit losses are reasonably predictable due to the broad customer base and lack of significant concentration and (iii) the equity in CRC is subordinate to all retained interests and thus would absorb losses first. The hypothetical effect on fair value of the retained interests assuming both a 10 percent and a 20 percent unfavorable variation in credit losses or discount rates is not material due to the short turnover of receivables and historically low credit loss history. Interest accrues to Duke Energy Kentucky on the retained interests using the acceptable yield method. This method generally approximates the stated rate on the notes since the allocated basis and the face value are nearly equivalent. An impairment charge is recorded against the carrying value of both retained interests and purchased beneficial interest whenever it is determined that an other-than-temporary impairment has occurred. Duke Energy Kentucky's maximum exposure to loss does not exceed the carrying value.

Key assumptions used in estimating fair value in 2016 and 2015 are detailed in the following table.

	2016	**2015**
Anticipated credit loss ratio	**0.5%**	0.5%
Discount rate	**1.5%**	1.2%
Receivables turnover rate	**11.5%**	11.4%

The following table presents gross and net receivables sold.

(in thousands)	**December 31, 2016**	**December 31, 2015**
Receivables sold	**$ 58,903**	$ 46,253
Less: Retained interests	**18,390**	10,137
Net receivables sold	**$ 40,513**	$ 36,116

The following table presents sales and cash flows related to receivables sold.

(in thousands)	Years Ended December 31, 2016	2015
Sales:		
Receivables sold	**$ 438,249**	$ 440,339
Loss recognized on sale	**1,627**	1,553
Cash flows:		
Cash proceeds from receivables sold	**$ 428,369**	$ 450,208
Collection fees received	**219**	220
Return received on retained interests	**647**	670

Cash flows from the sale of receivables are reflected within Operating Activities on the Statements of Cash Flows.

Collection fees received in connection with the servicing of transferred accounts receivable are included in Operation, maintenance, and other on the Statements of Operations. The loss recognized on the sale of receivables is calculated monthly by multiplying the receivables sold during the month by the required discount which is derived monthly utilizing a three-year weighted average formula that considers charge-off history, late charge history and turnover history on the sold receivables, as well as a component for the time value of money. The discount rate, or component for the time value of money, is calculated monthly by summing the prior month-end London Interbank Offered Rate (LIBOR) plus a fixed rate of 1.00 percent.

12. EMPLOYEE BENEFIT PLANS

DEFINED BENEFIT RETIREMENT PLANS

Duke Energy Kentucky participates in qualified and non-qualified defined benefit retirement plans and other post-retirement benefit plans sponsored by Duke Energy. Duke Energy allocates pension and other post-retirement obligations and costs related to these plans to Duke Energy Kentucky. The plans cover most employees using a cash balance formula. Under a cash balance formula, a plan participant accumulates a retirement benefit consisting of pay credits based upon a percentage of current eligible earnings based on age and/or years of service and interest credits. Certain employees are covered under plans that use a final average earnings formula. Under these average earnings formulas, a plan participant accumulates a retirement benefit equal to the sum of percentages of their (i) highest three-year or four-year average earnings, (ii) highest three-year or four-year average earnings in excess of covered compensation per year of participation (maximum of 35 years), and/or (iii) highest three-year average earnings times years of participation in excess of 35 years. Duke Energy also maintains, and Duke Energy Kentucky participates in, non-qualified, non-contributory defined benefit retirement plans which cover certain executives. As of January 1, 2014, the qualified and non-qualified non-contributory defined benefit plans are closed to new and rehired non-union and certain unionized employees.

Duke Energy uses a December 31 measurement date for its defined benefit retirement plan assets and obligations.

Duke Energy's policy is to fund amounts on an actuarial basis to provide assets sufficient to meet benefit payments to be paid to plan participants. Actual contributions for Duke Energy Kentucky were $1,443 thousand and $2,203 thousand for the years ended December 31, 2016 and 2015, respectively. Anticipated contributions for 2017 for Duke Energy Kentucky are $1,375 thousand.

Net periodic benefit costs disclosed in the tables below represent the cost of the respective plan for the periods presented. However, portions of the net periodic benefit cost disclosed in the tables have been capitalized as a component of property, plant and equipment. Amounts presented in the tables below represent the amounts of pension and other post-retirement benefit cost allocated by Duke Energy for employees of Duke Energy Kentucky. Additionally, Duke Energy Kentucky is allocated its proportionate share of pension and other post-retirement benefit cost for employees of Duke Energy's shared services affiliate that provides support to Duke Energy Kentucky. These allocated amounts are included in the governance and shared services costs discussed in Note 8.

QUALIFIED PENSION PLANS

Components of Net Periodic Pension Costs

(in thousands)	Years Ended December 31, 2016	2015
Service cost	**$ 1,459**	$ 1,471
Interest cost on projected benefit obligation	**4,368**	3,857
Expected return on plan assets	**(6,156)**	(5,732)
Amortization of prior service cost	**4**	52
Amortization of loss	**1,677**	2,108
Other	**91**	80
Net periodic pension costs	**$ 1,443**	$ 1,836

Amounts Recognized in Regulatory Assets

(in thousands)	December 31, 2016	December 31, 2015
Regulatory assets, net increase	$ 3,636	$ 3,827

Reconciliation of Funded Status to Net Amount Recognized

(in thousands)	Years Ended December 31, 2016	Years Ended December 31, 2015
Change in Projected Benefit Obligation:		
Obligation at prior measurement date	$ 100,829	$ 97,507
Service cost	1,459	1,471
Interest cost	4,368	3,857
Actuarial losses (gains)	6,203	(1,211)
Transfers [(a)]	2,003	6,452
Plan amendments	(450)	(79)
Benefits paid	(8,345)	(7,168)
Obligation at measurement date	$ 106,067	$ 100,829
Accumulated Benefit Obligation	$ 102,223	$ 97,632
Change in Fair Value of Plan Assets:		
Plan assets at prior measurement date	$ 96,373	$ 95,391
Actual return on plan assets	6,778	(505)
Benefits paid	(8,345)	(7,168)
Employer contributions	1,443	2,203
Transfers [(a)]	2,003	6,452
Plan assets at measurement date	$ 98,252	$ 96,373

(a) Transfers represents net amounts associated with plan participants that have moved to/from other Duke Energy subsidiaries.

Amounts Recognized in the Balance Sheets

(in thousands)	December 31, 2016	December 31, 2015
Prefunded pension[(a)]	$ 1,716	$ 1,121
Noncurrent pension liability[(b)]	9,531	5,577
Net liability recognized	$ (7,815)	$ (4,456)
Regulatory assets	$ 28,959	$ 25,323
Amounts to be reported in net periodic pension expense in the next year:		
Unrecognized net actuarial loss	$ 1,407	
Unrecognized prior service credit	62	

(a) Included in Other within Investments and Other Assets on the Balance Sheets.
(b) Included in Accrued pension and other post-retirement benefit costs on the Balance Sheets.

Information for Plans with Accumulated Benefit Obligation in Excess of Plan Assets

(in thousands)	December 31, 2016	December 31, 2015
Projected benefit obligation	$ 92,663	$ 87,665
Accumulated benefit obligation	88,820	84,801
Fair Value of plan assets	83,132	82,088

Assumptions Used for Pension Benefits Accounting

	December 31, 2016	2015
Benefit Obligations:		
Discount rate	4.10%	4.40%
Salary increase	4.40%	4.40%
Net Periodic Benefit Cost:		
Discount rate	4.40%	4.10%
Salary increase	4.40%	4.40%
Expected long-term rate of return on plan assets	6.50%	6.50%

The discount rate used to determine the current year pension obligation and following year's pension expense is based on a bond selection-settlement portfolio approach. This approach develops a discount rate by selecting a portfolio of high quality corporate bonds that generate sufficient cash flow to provide for the projected benefit payments of the plan. The selected bond portfolio is derived from a universe of non-callable corporate bonds rated Aa quality or higher. After the bond portfolio is selected, a single interest rate is determined that equates the present value of the plan's projected benefit payments discounted at this rate with the market value of the bonds selected.

NON-QUALIFIED PENSION PLANS

Components of Net Periodic Pension Costs

(in thousands)	Years Ended December 31, 2016	2015
Interest cost on projected benefit obligation	$ 6	$ 6
Amortization of actuarial loss	5	9
Net periodic pension costs	$ 11	$ 15

Amounts Recognized in Regulatory Assets

(in thousands)	December 31, 2016	2015
Regulatory assets, net decrease	$ —	$ (13)

Reconciliation of Funded Status to Net Amount Recognized

(in thousands)	Years Ended December 31, 2016	2015
Change in Projected Benefit Obligation:		
Obligation at prior measurement date	$ 141	$ 148
Interest cost	6	6
Actuarial losses (gains)	4	(2)
Benefits paid	(11)	(11)
Obligation at measurement date	$ 140	$ 141
Accumulated Benefit Obligation	$ 140	$ 141
Change in Fair Value of Plan Assets:		
Plan assets at prior measurement date	$ —	$ —
Benefits paid	(11)	(11)
Employer contributions	11	11
Plan assets at measurement date	$ —	$ —

Amounts Recognized in the Balance Sheets

	December 31,	
(in thousands)	**2016**	**2015**
Current pension liability[(a)]	**$ 10**	$ 10
Noncurrent pension liability[(b)]	**130**	131
Total accrued pension liability	**$ 140**	$ 141
Regulatory assets	**$ 51**	$ 51
Amounts to be recognized in net periodic pension expense in the next year:		
Unrecognized net actuarial loss	**$ 4**	

(a) Included in Other within Current Liabilities on the Balance Sheets.
(b) Included in Accrued pension and other post-retirement benefit costs on the Balance Sheets.

Information for Plans with Accumulated Benefit Obligation in Excess of Plan Assets

	December 31,	
(in thousands)	**2016**	**2015**
Projected benefit obligation	**$ 140**	$ 141
Accumulated benefit obligation	**140**	141

Assumptions Used for Pension Benefits Accounting

	December 31,	
	2016	**2015**
Benefit Obligations:		
Discount rate	**4.10%**	4.40%
Salary increase	**4.40%**	4.40%
Net Periodic Benefit Cost:		
Discount rate	**4.40%**	4.10%
Salary increase	**4.40%**	4.40%

The discount rate used to determine the current year pension obligation and following year's pension expense is based on a bond selection-settlement portfolio approach. This approach develops a discount rate by selecting a portfolio of high quality corporate bonds that generate sufficient cash flow to provide for the projected benefit payments of the plan. The selected bond portfolio is derived from a universe of non-callable corporate bonds rated Aa quality or higher. After the bond portfolio is selected, a single interest rate is determined that equates the present value of the plan's projected benefit payments discounted at this rate with the market value of the bonds selected.

OTHER POST-RETIREMENT BENEFIT PLANS

Duke Energy provides, and Duke Energy Kentucky participates in, some health care and life insurance benefits for retired employees on a contributory and non-contributory basis. Employees are eligible for these benefits if they have met age and service requirements at retirement, as defined in the plans. The health care benefits include medical, dental, and prescription drug coverage and are subject to certain limitations, such as deductibles and co-payments.

Duke Energy did not make any pre-funding contributions to its other post-retirement benefit plans during the years ended December 31, 2016 and 2015.

Components of Net Periodic Other Post-Retirement Benefit Costs

	Years Ended December 31,	
(in thousands)	**2016**	**2015**
Service cost	**$ 91**	$ 112
Interest cost on projected benefit obligation	**288**	305
Expected return on plan assets	**(61)**	(51)
Amortization of prior service credit	**175**	(70)
Amortization of (gain) loss	**(420)**	5
Net periodic pension costs	**$ 73**	$ 301

Amounts Recognized in Regulatory Assets and Regulatory Liabilities

(in thousands)	December 31, 2016	2015
Regulatory assets, net decrease	$ (305)	$ (331)
Regulatory liabilities, net increase	612	1,103

Reconciliation of Funded Status to Accrued Other Post-Retirement Benefit Costs

(in thousands)	Years Ended December 31, 2016	2015
Change in Projected Benefit Obligation:		
Accumulated post-retirement benefit obligation at prior measurement date	$ 6,845	$ 7,751
Service cost	91	112
Interest cost	288	305
Plan participants' contributions	189	215
Actuarial gains	(107)	(996)
Transfers [(a)]	242	414
Plan amendments	(377)	(396)
Benefits paid	(615)	(560)
Accumulated post-retirement benefit obligation at measurement date	$ 6,556	$ 6,845
Change in Fair Value of Plan Assets:		
Plan assets at prior measurement date	$ 1,198	$ 1,180
Actual return on plan assets	86	(23)
Plan participants' contributions	189	215
Benefits paid	(615)	(560)
Transfers [(a)]	240	143
Employer contributions	421	243
Plan assets at measurement date	$ 1,519	$ 1,198

(a) Transfers represents net amounts associated with plan participants that have moved to/from other Duke Energy subsidiaries.

Amounts Recognized in the Balance Sheets

(in thousands)	December 31, 2016	2015
Current post-retirement liability[(a)]	$ 165	$ 169
Noncurrent post-retirement liability[(b)]	4,872	5,478
Total accrued post-retirement liability	$ 5,037	$ 5,647
Regulatory assets	$ 2,610	$ 2,915
Regulatory liabilities	$ 5,550	$ 4,938
Amounts to be recognized in net periodic pension expense in the next year:		
Unrecognized net actuarial loss	$ (424)	
Unrecognized prior service credit	$ (184)	

(a) Included in Other within Current Liabilities on the Balance Sheets.
(b) Included in Accrued pension and other post-retirement benefit costs on the Balance Sheets.

Assumptions Used for Other Post-Retirement Benefits Accounting

	December 31, 2016	2015
Benefit Obligations:		
Discount rate	4.10%	4.40%
Net Periodic Benefit Cost:		
Discount rate	4.40%	4.10%
Expected long-term rate of return on plan assets	6.50%	6.50%

The discount rate used to determine the current year other post-retirement benefits obligation and following year's other postretirement benefits expense is based on a bond selection-settlement portfolio approach. This approach develops a discount rate by selecting a portfolio of high quality corporate bonds that generate sufficient cash flow to provide for the projected benefit payments of the plan. The selected bond portfolio is derived from a universe of non-callable corporate bonds rated Aa quality or higher. After the bond portfolio is selected, a single interest rate is determined that equates the present value of the plan's projected benefit payments discounted at this rate with the market value of the bonds selected.

Assumed Health Care Cost Trend Rate

	December 31,	
	2016	**2015**
Health care cost trend rate assumed for next year	**7.00%**	7.50%
Rate to which the cost trend is assumed to decline (the ultimate trend rate)	**4.75%**	4.75%
Year that the rate reaches the ultimate trend rate	**2023**	2023

Expected Benefit Payments

The following table presents Duke Energy's expected benefit payments to participants on behalf of Duke Energy Kentucky in its qualified, non-qualified and other post-retirement benefit plans over the next 10 years. These benefit payments reflect expected future service, as appropriate.

(in thousands)	Qualified Plans	Non-Qualified Plans	Other Post-Retirement Plans	Total
Years ending December 31,				
2017	$ 6,448	$ 11	$ 873	$ 7,332
2018	6,776	11	801	7,588
2019	7,015	11	633	7,659
2020	7,707	10	566	8,283
2021	8,937	10	568	9,515
2022–2026	39,262	51	2,565	41,878

MASTER RETIREMENT TRUST (MASTER TRUST)

The assets for the Duke Energy Kentucky plans discussed above are derived from the Master Trust that is held by Duke Energy and, as such, Duke Energy Kentucky is allocated its proportionate share of assets discussed below. Assets for both the qualified pension and other post-retirement benefits are maintained in the Master Trust. Duke Energy assumes pension and other post-retirement plan assets will generate a long-term rate of return of 6.50 percent. The expected long-term rate of return was developed using a weighted average calculation of expected returns based primarily on future expected returns across asset classes considering the use of active asset managers, where applicable. The asset allocation targets were set after considering the investment objective and the risk profile. Equity securities are held for their high expected return. Debt securities are primarily held to hedge the qualified pension plan liability. Hedge funds, real estate and other global securities are held for diversification. Investments within asset classes are diversified to achieve broad market participation and reduce the impact of individual managers or investments.

Duke Energy has a de-risking investment strategy for the Duke Energy Master Trust. As the funded status of the pension plans increase, the targeted allocation to return seeking assets will be reduced and the targeted allocation to fixed-income assets will be increased to better manage Duke Energy's pension liability and reduce funded status volatility. Duke Energy regularly reviews its actual asset allocation and periodically rebalances its investments to the targeted allocation when considered appropriate.

The following table presents target and actual asset allocations for the Master Trust at December 31, 2016 and 2015.

		Actual Allocation at December 31,	
Asset Category	**Target Allocation**	**2016**	**2015**
U.S. equity securities	10%	**11%**	11%
Non-U.S. equity securities	8%	**8%**	8%
Global equity securities	10%	**10%**	10%
Global private equity securities	3%	**2%**	2%
Debt securities	63%	**63%**	63%
Hedge funds	2%	**2%**	2%
Real estate and cash	2%	**2%**	2%
Other global securities	2%	**2%**	2%
Total	100%	**100%**	100%

EMPLOYEE SAVINGS PLAN

Duke Energy Kentucky also participates in employee savings plans sponsored by Duke Energy. Most employees participate in a matching contribution formula where Duke Energy provides a matching contribution generally equal to 100 percent of employee before-tax and Roth 401(k) contributions and, as applicable, after-tax contributions of up to 6 percent of eligible pay per period.

As of January 1, 2014, for new and rehired non-union and certain unionized employees who are not eligible to participate in Duke Energy's defined benefit plans, an additional employer contribution of 4 percent of eligible pay per pay period, which is subject to a three-year vesting schedule, is provided to the employee's savings plan account.

Duke Energy Kentucky's expense related to its proportionate share of pretax employer contributions and the additional 4 percent employer contribution was $720 thousand and $888 thousand for the years ended December 31, 2016 and 2015, respectively.

13. INCOME TAXES

INCOME TAX EXPENSE

Components of Income Tax Expense

	Years Ended December 31,	
(in thousands)	**2016**	**2015**
Current income taxes:		
Federal	**$ (580)**	$ 4,844
State	**(361)**	(245)
Total current income taxes	**(941)**	4,599
Deferred income taxes:		
Federal	**15,181**	19,825
State	**2,939**	3,810
Total deferred income taxes	**18,120**	23,635
Investment tax credit amortization	**(132)**	(173)
Total income tax expense included in Statements of Operations	**$ 17,047**	$ 28,061

Statutory Rate Reconciliation

The following table presents a reconciliation of income tax expense at the U.S. federal statutory tax rate to actual tax expense.

	Years Ended December 31,	
(in thousands)	**2016**	**2015**
Income tax expense, computed at the statutory rate of 35 percent	**$ 20,871**	$ 25,983
State income tax, net of federal income tax effect	**1,676**	2,317
Federal true-up	**(5,269)**	341
Other items, net	**(231)**	(580)
Total income tax expense	**$ 17,047**	$ 28,061
Effective tax rates[a]	**28.6%**	37.8%

(a) The decrease in the effective tax rate was primarily due to an immaterial out of period adjustment related to deferred tax balances associated with property, plant and equipment.

DEFERRED TAXES

Net Deferred Income Tax Liability Components

	Years Ended December 31,	
(in thousands)	**2016**	**2015**
Deferred credits and other liabilities	$ 50	$ 495
Tax credits and net operating loss carryforwards	3,668	375
Pension, postretirement and other employee benefits	6,436	5,461
Other	359	2,077
Investments and other liabilities	1,468	2,331
Total deferred income tax assets	11,981	10,739
Accelerated depreciation rates	(298,205)	(278,603)
Regulatory assets and deferred debits, net	(25,412)	(21,778)
Total deferred income tax liabilities	(323,617)	(300,381)
Net deferred income tax liabilities	$ (311,636)	$ (289,642)

UNRECOGNIZED TAX BENEFITS

The following table presents changes to unrecognized tax benefits.

	Years Ended December 31,	
(in thousands)	**2016**	**2015**
Unrecognized tax benefits – January 1	$ 52	$ 52
Unrecognized tax benefits increases (decreases):		
Gross increases – tax positions in prior periods	4	—
Decreases due to settlements	(56)	—
Unrecognized tax benefits – December 31	$ —	$ 52

OTHER TAX MATTERS

The following table includes interest recognized in the Statements of Operations and the Balance Sheets.

	As of December 31,	
(in thousands)	**2016**	**2015**
Net interest income recognized related to income taxes	$ 8	$ 18
Interest receivable related to income taxes	—	224

Duke Energy Kentucky is no longer subject to U.S. federal examination for years before 2015. With few exceptions, Duke Energy Kentucky is no longer subject to state, local or non-U.S. income tax examinations by tax authorities for years before 2008.

14. SUBSEQUENT EVENTS

Management has evaluated these financial statements and notes to financial statements for any significant events occurring after the balance sheet date and through the issuance date.

Duke Energy Kentucky, Inc.
Financial Statements
and Independent Auditors' Report

December 31, 2017

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DUKE ENERGY KENTUCKY, INC.

December 31, 2017

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Glossary of Terms

The following terms or acronyms used in this document are defined below:

Term or Acronym	Definition
ADIT	Accumulated Deferred Income Tax
AFUDC	Allowance for Funds Used During Construction
ALJ	FERC Administrative Law Judge
AMI	Advanced Metering Infrastructure
ANPRM	Advance Notice of Proposed Rulemaking
ARO	Asset Retirement Obligation
ASC	Accounting Standards Codification
CCR	Coal Combustion Residuals
CO_2	Carbon Dioxide
CP	Capacity Performance
CPCN	Certificate of Public Convenience and Necessity
CPP	Clean Power Plan
CRC	Cinergy Receivables Company, LLC
Duke Energy	Duke Energy Corporation
Duke Energy Indiana	Duke Energy Indiana, LLC
Duke Energy Kentucky	Duke Energy Kentucky, Inc.
Duke Energy Ohio	Duke Energy Ohio, Inc.
EPA	U.S. Environmental Protection Agency
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
FRR	Fixed Resource Requirement
GAAP	Generally Accepted Accounting Principles in the U.S.
IRS	Internal Revenue Service
KPSC	Kentucky Public Service Commission
LIBOR	London Interbank Offered Rate
Master Trust	Master Retirement Trust
MISO	Midcontinent Independent System Operator, Inc.
MVP	Multi Value Projects
NPR	Notice of Proposed Rulemaking
PJM	PJM Interconnection, LLC
RTO	Regional Transmission Organization
SAB 118	Staff Accounting Bulletin No. 118, Income Tax Accounting Implications of the Tax Cuts and Jobs Act
Tax Act	Tax Cut and Jobs Act
U.S.	United States
VIE	Variable Interest Entity

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholder of
Duke Energy Kentucky, Inc.
Charlotte, North Carolina

We have audited the accompanying financial statements of Duke Energy Kentucky, Inc. (the "Company"), which comprise the balance sheets as of December 31, 2017 and 2016, and the related statements of operations, changes in equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Duke Energy Kentucky, Inc. as of December 31, 2017 and 2016, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Deloitte + Touche LLP

March 14, 2018

DUKE ENERGY KENTUCKY, INC.
STATEMENTS OF OPERATIONS

	Years Ended December 31,	
(in thousands)	**2017**	**2016**
Operating Revenues:		
Electric	**$ 337,118**	$ 346,124
Natural gas	**93,620**	90,216
Total operating revenues	**430,738**	436,340
Operating Expenses:		
Fuel used in electric generation and purchased power	**119,156**	132,681
Cost of natural gas	**37,249**	32,611
Operation, maintenance and other	**143,321**	140,573
Depreciation and amortization	**47,667**	43,668
Property and other taxes	**14,339**	14,637
Impairment charges	**1,190**	—
Total operating expenses	**362,922**	364,170
(Loss) Gain on Sales of Assets, net	**(99)**	28
Operating Income	**67,717**	72,198
Other Income and Expenses, net	**4,599**	2,321
Interest Expense	**14,078**	14,888
Income Before Income Taxes	**58,238**	59,631
Income Tax (Benefit) Expense	**(1,161)**	17,047
Net Income	**$ 59,399**	$ 42,584

See Notes to Financial Statements

DUKE ENERGY KENTUCKY, INC.
BALANCE SHEETS

	December 31,	
(in thousands, except share amounts)	**2017**	**2016**
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 1,687	$ 6,534
Receivables (net of allowance for doubtful accounts of $234 at 2017 and $141 at 2016)	3,537	1,663
Receivables from affiliated companies	22,286	22,762
Notes receivable from affiliated companies	14,671	—
Inventory	43,793	49,037
Regulatory assets	4,356	7,623
Collateral assets	1,975	13,566
Other	2,913	5,706
Total current assets	95,218	106,891
Property, Plant and Equipment:		
Cost	$ 2,292,085	$ 2,116,219
Accumulated depreciation and amortization	(977,244)	(948,144)
Net property, plant and equipment	1,314,841	1,168,075
Other Noncurrent Assets		
Regulatory Assets	118,738	92,462
Other	2,175	2,720
Total other noncurrent assets	120,913	95,182
Total Assets	$ 1,530,972	$ 1,370,148
LIABILITIES AND EQUITY		
Current Liabilities:		
Accounts payable	$ 48,797	$ 31,636
Accounts payable to affiliated companies	15,774	12,573
Notes payable to affiliated companies	—	19,656
Taxes accrued	17,602	14,082
Interest accrued	5,387	4,230
Current maturities of long-term debt	885	686
Asset retirement obligations	3,378	—
Regulatory liabilities	6,892	12,173
Other	17,335	18,561
Total current liabilities	116,050	113,597
Long-term Debt	425,295	336,360
Long-term Debt payable to affiliated companies	25,000	25,000
Other Noncurrent Liabilities		
Deferred income taxes	186,437	311,636
Asset retirement obligations	51,204	52,822
Regulatory liabilities	171,617	51,878
Accrued pension and other post-retirement benefit costs	17,418	14,975
Other	26,537	26,865
Total other noncurrent liabilities	453,213	458,176
Commitments and Contingencies		
Equity		
Common Stock, $15.00 par value, 1,000,000 shares authorized and 585,333 shares outstanding	8,780	8,780
Additional paid-in-capital	182,494	167,494
Retained earnings	320,140	260,741
Total equity	511,414	437,015
Total Liabilities and Equity	$ 1,530,972	$ 1,370,148

See Notes to Financial Statements

DUKE ENERGY KENTUCKY, INC.
STATEMENTS OF CASH FLOWS

	Years Ended December 31,	
(in thousands)	**2017**	**2016**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 59,399	$ 42,584
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization	48,235	44,683
Equity component of AFUDC	(3,358)	(1,332)
Losses (Gains) on sales of assets, net	99	(28)
Impairment charges	1,190	—
Deferred income taxes	12,367	17,988
Accrued pension and other post-retirement benefit costs	578	1,527
Contributions to qualified pension plans	(1,324)	(1,443)
Payments for asset retirement obligations	(7,132)	(4,757)
(Increase) decrease in:		
Receivables	(1,663)	3,799
Receivables from affiliated companies	476	(11,263)
Inventory	6,521	(4,896)
Collateral assets	11,590	183
Other current assets	3,104	14,997
Increase (decrease) in:		
Accounts payable	(2,237)	660
Accounts payable to affiliated companies	3,201	(1,853)
Taxes accrued	3,520	7,028
Other current liabilities	(7,791)	8,235
Other assets	(12,893)	(7,530)
Other liabilities	(1,996)	14
Net cash provided by operating activities	111,886	108,596
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(180,271)	(100,899)
Notes receivable from affiliated companies	(14,671)	—
Other	(5,866)	(7,081)
Net cash used in investing activities	(200,808)	(107,980)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from the issuance of long-term debt	89,615	94,385
Payments for the redemption of long-term debt	(686)	(51,520)
Notes payable to affiliated companies	(19,656)	(36,087)
Capital contributions from parent	15,000	—
Dividends to parent	—	(10,001)
Other	(198)	—
Net cash provided by (used in) financing activities	84,075	(3,223)
Net decrease in cash and cash equivalents	(4,847)	(2,607)
Cash and cash equivalents at beginning of period	6,534	9,141
Cash and cash equivalents at end of period	$ 1,687	$ 6,534
Supplemental Disclosures:		
Cash paid for interest, net of amount capitalized	$ 12,352	$ 12,986
Cash received from income taxes	(15,767)	(18,845)
Significant non-cash transactions:		
Accrued capital expenditures	32,369	12,594

See Notes to Financial Statements

DUKE ENERGY KENTUCKY, INC.
STATEMENTS OF CHANGES IN EQUITY

(in thousands)	Common Stock	Additional Paid-in Capital	Retained Earnings	Total Equity
Balance at December 31, 2015	$ 8,780	$ 167,494	$ 228,158	$ 404,432
Net income	—	—	42,584	42,584
Dividends to parent	—	—	(10,001)	(10,001)
Balance at December 31, 2016	$ 8,780	$ 167,494	$ 260,741	$ 437,015
Net income	**—**	**—**	**59,399**	**59,399**
Contribution from parent	**—**	**15,000**	**—**	**15,000**
Balance at December 31, 2017	**$ 8,780**	**$ 182,494**	**$ 320,140**	**$ 511,414**

See Notes to Financial Statements

1. ORGANIZATION AND BASIS OF PRESENTATION

NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Duke Energy Kentucky, Inc. (Duke Energy Kentucky) is a combination electric and natural gas public utility company that provides service in northern Kentucky. Duke Energy Kentucky's principal lines of business include generation, transmission, distribution and sale of electricity, as well as the transportation and sale of natural gas. Duke Energy Kentucky is subject to the regulatory provisions of the Kentucky Public Service Commission (KPSC) and the Federal Energy Regulatory Commission (FERC). Duke Energy Kentucky's common stock is wholly owned by Duke Energy Ohio, Inc. (Duke Energy Ohio), an indirect wholly owned subsidiary of Duke Energy Corporation (Duke Energy).

Certain prior year amounts have been reclassified to conform to the current year presentation.

Other Current Liabilities

The following table provides detail of certain amounts included in Other within Current Liabilities.

		December 31,	
(in thousands)	**Location**	**2017**	**2016**
Customer Deposits	Current Liabilities	**9,860**	10,270

SIGNIFICANT ACCOUNTING POLICIES

Use of Estimates

In preparing financial statements that conform to generally accepted accounting principles in the United States (U.S.) (GAAP), Duke Energy Kentucky must make estimates and assumptions that affect the reported amounts of assets and liabilities, the reported amounts of revenues and expenses and the disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

Regulatory Accounting

The majority of Duke Energy Kentucky's operations are subject to price regulation for the sale of electricity and natural gas by the KPSC or FERC. When prices are set on the basis of specific costs of the regulated operations and an effective franchise is in place such that sufficient natural gas or electric services can be sold to recover those costs, Duke Energy Kentucky applies regulatory accounting. Regulatory accounting changes the timing of the recognition of costs or revenues relative to a company that does not apply regulatory accounting. As a result, regulatory assets and regulatory liabilities are recognized on the Balance Sheets. Regulatory assets and liabilities are amortized consistent with the treatment of the related cost in the ratemaking process. See Note 2 for further information.

Regulated Fuel and Purchased Gas Adjustment Clauses

Duke Energy Kentucky utilizes cost-tracking mechanisms, commonly referred to as fuel adjustment clauses. These clauses allow for the recovery of fuel and fuel-related costs and portions of purchased power costs through surcharges on customer rates. The difference between the costs incurred and the surcharge revenues is recorded as an adjustment to Operating Expenses - Fuel used in electric generation and purchased power or Operating Expenses - Cost of natural gas on the Statements of Operations with an off-setting impact on regulatory assets or liabilities.

Cash and Cash Equivalents

All highly liquid investments with maturities of three months or less at the date of acquisition are considered cash equivalents.

Inventory

Inventory is used for operations and is recorded primarily using the average cost method. Inventory related to regulated operations is valued at historical cost. Materials and supplies are recorded as inventory when purchased and subsequently charged to expense or capitalized to property, plant and equipment when installed. Inventory, including excess or obsolete inventory, is written-down to the lower of cost or market value. Once inventory has been written-down, it creates a new cost basis for the inventory that is not subsequently written-up. Provisions for inventory write-offs were not material at December 31, 2017, and 2016. The components of inventory are presented in the table below.

	December 31,	
(in thousands)	**2017**	**2016**
Materials and supplies	**$ 19,300**	$ 21,964
Coal	**17,354**	19,499
Natural gas, oil and other	**7,139**	7,574
Total inventory	**$ 43,793**	$ 49,037

Long-Lived Asset Impairments

Duke Energy Kentucky evaluates long-lived assets for impairment when circumstances indicate the carrying value of those assets may not be recoverable. An impairment exists when a long-lived asset's carrying value exceeds the estimated undiscounted cash flows expected to result from the use and eventual disposition of the asset. The estimated cash flows may be based on alternative expected outcomes that are probability weighted. If the carrying value of the long-lived asset is not recoverable based on these estimated future undiscounted cash flows, the carrying value of the asset is written-down to its then-current estimated fair value and an impairment charge is recognized.

Duke Energy Kentucky assesses the fair value of long-lived assets using various methods, including recent comparable third-party sales, internally developed discounted cash flow analysis and analysis from outside advisors. Triggering events to reassess cash flows may include, but are not limited to, significant changes in commodity prices, the condition of an asset or management's interest in selling the asset.

Property, Plant and Equipment

Property, plant and equipment are stated at the lower of depreciated historical cost net of any disallowances or fair value, if impaired. Duke Energy Kentucky capitalizes all construction-related direct labor and material costs, as well as indirect construction costs such as general engineering, taxes and financing costs. See "Allowance for Funds Used During Construction (AFUDC)" and "Asset Retirement Obligations (ARO)" below for further information on capitalized financing costs and legal obligations associated with the retirement of property, plant and equipment. Costs of renewals and betterments that extend the useful life of property, plant and equipment are also capitalized. The cost of repairs, replacements and major maintenance projects, which do not extend the useful life or increase the expected output of the asset, is expensed as incurred. Depreciation is generally computed over the estimated useful life of the asset using the composite straight-line method. Depreciation studies are conducted periodically to update composite rates and are approved by the KPSC and/or the FERC when required. The composite weighted average depreciation rate was 2.2 percent for the years ended December 31, 2017 and 2016.

In general, when Duke Energy Kentucky retires its regulated property, plant and equipment, original cost plus the cost of retirement, less salvage value, is charged to accumulated depreciation. However, when it becomes probable a regulated asset will be retired substantially in advance of its original expected useful life or will be abandoned, the cost of the asset and the corresponding accumulated depreciation is recognized as a separate asset. If the asset is still in operation, the net amount is classified as Generation facilities to be retired, net on the Balance Sheets. If the asset is no longer operating, the net amount is classified in Regulatory assets on the Balance Sheets. When it becomes probable that regulated mass utility assets, such as meters, will be abandoned, the cost of the assets and accumulated depreciation is reclassified to regulatory assets for the amounts recoverable in rates. The carrying value of the asset is based on historical cost if Duke Energy Kentucky is allowed to recover the remaining net book value and a return equal to at least the incremental borrowing rate. If not, an impairment is recognized to the extent the net book value of the asset exceeds the present value of future revenues discounted at the incremental borrowing rate.

When Duke Energy Kentucky sells entire regulated operating units, the original cost and accumulated depreciation and amortization balances are removed from Property, Plant and Equipment on the Balance Sheets. Any gain or loss is recorded in earnings, unless otherwise required by the applicable regulatory body.

See Note 6 for further information.

Allowance for Funds Used During Construction (AFUDC)

For regulated operations, the debt and equity costs of financing the construction of property, plant and equipment are reflected as AFUDC and capitalized as a component of the cost of property, plant and equipment. AFUDC equity is reported on the Statements of Operations as non-cash income in Other Income and Expenses, net. AFUDC debt is reported as a non-cash offset to Interest Expense. After construction is completed, Duke Energy Kentucky is permitted to recover these costs through their inclusion in rate base and the corresponding subsequent depreciation or amortization of those regulated assets.

AFUDC equity, a permanent difference for income taxes, reduces the effective tax rate when capitalized and increases the effective tax rate when depreciated or amortized.

Asset Retirement Obligations (ARO)

AROs are recognized for legal obligations associated with the retirement of property, plant and equipment. When recording an ARO the present value of the projected liability is recognized in the period in which it is incurred, if a reasonable estimate of fair value can be made, and the liability is accreted over time. For operating plants, the present value of the liability is added to the cost of the associated asset and depreciated over the remaining life of the asset. For retired plants, the present value of the liability is recorded as a regulatory asset unless determined not to be recoverable.

The present value of the initial obligation and subsequent updates are based on discounted cash flows, which include estimates regarding timing of future cash flows, selection of discount rates and cost escalation rates, among other factors. These estimates are subject to change. Depreciation expense is adjusted prospectively for any changes to the carrying amount of the associated asset. Duke Energy Kentucky receives amounts to fund the cost of the ARO from regulated revenues. As a result, the net of amounts recovered in regulated revenues, accretion expense and depreciation of the associated asset is deferred as a regulatory asset or liability.

Obligations for closure of ash basins are based upon discounted cash flows of estimated costs for site-specific plans, if known, or probability weightings of the potential closure methods if the closure plans are under development and multiple closure options are being considered and evaluated on a site-by-site basis.

See Note 5 for further information.

Comprehensive Income

Comprehensive income is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. Comprehensive income is the same as net income for all periods presented. Therefore, a separate statement of comprehensive income is not included in the accompanying financial statements.

Revenue Recognition and Unbilled Revenue

Revenues on sales of electricity and natural gas are recognized when service is provided or the product is delivered. Unbilled revenues are recognized by applying customer billing rates to the estimated volumes of energy or natural gas delivered but not yet billed. Unbilled revenues can vary significantly from period to period as a result of seasonality, weather, customer usage patterns, customer mix, average price in effect for customer classes, timing of rendering customer bills and meter reading schedules, and the impact of weather normalization or margin decoupling mechanisms.

Duke Energy Kentucky sells, on a revolving basis, nearly all of its retail accounts receivable, including receivables for unbilled revenues, to an affiliate, Cinergy Receivables Company, LLC (CRC). As discussed further in Note 11, Duke Energy Kentucky accounts for the transfers of receivables to CRC as sales. Accordingly, the receivables sold are not reflected on the Balance Sheets. Receivables for unbilled revenues related to retail accounts receivable included in the sales of accounts receivable to CRC at December 31, 2017 and 2016, were $25 million and $23 million, respectively.

Unbilled revenues, which are recorded as Receivables on the Balance Sheets and exclude receivables sold to CRC, primarily include wholesale related revenues and totaled $516 thousand and $79 thousand at December 31, 2017 and 2016, respectively.

Derivatives and Hedging

Derivative and non-derivative instruments may be used in connection with commodity price and interest rate activities, including swaps, futures, forwards and options. All derivative instruments, except those that qualify for the normal purchase/normal sale exception, are recorded on the Balance Sheets at fair value. For activity subject to regulatory accounting, gains and losses on derivative contracts are reflected as regulatory assets or liabilities and not as other comprehensive income or current period income. As a result, changes in fair value of these derivatives have no immediate earnings impact.

See Note 9 for further information.

Unamortized Debt Premium, Discount and Expense

Premiums, discounts and expenses incurred with the issuance of outstanding long-term debt are amortized over the term of the debt issue. The gain or loss on extinguishment associated with refinancing higher-cost debt obligations used to finance regulated assets is amortized. Amortization expense is recorded as Interest Expense in the Statements of Operations and is reflected as Depreciation and amortization within Net cash provided by operating activities on the Statements of Cash Flows.

Premiums, discounts and expenses are presented as an adjustment to the carrying value of the debt amount and included in Long-Term Debt on the Balance Sheets presented.

Loss Contingencies and Environmental Liabilities

Contingent losses are recorded when it is probable a loss has occurred and can be reasonably estimated. When a range of the probable loss exists and no amount within the range is a better estimate than any other amount, the minimum amount in the range is recorded. Unless otherwise required by GAAP, legal fees are expensed as incurred.

Environmental liabilities are recorded on an undiscounted basis when environmental remediation or other liabilities become probable and can be reasonably estimated. Environmental expenditures related to past operations that do not generate current or future revenues are expensed. Environmental expenditures related to operations that generate current or future revenues are expensed or capitalized, respectively. Certain environmental expenditures receive regulatory accounting treatment and are recorded as regulatory assets.

See Notes 2 and 3 for further information.

Pension and Other Post-Retirement Benefit Plans

Duke Energy maintains qualified, non-qualified and other post-retirement benefit plans. Eligible employees of Duke Energy Kentucky participate in the respective qualified, non-qualified and other post-retirement benefit plans and Duke Energy Kentucky is allocated its proportionate share of benefit costs. See Note 12 for further information.

Income Taxes

Duke Energy and its subsidiaries file a consolidated federal income tax return and other state and foreign jurisdictional returns. Duke Energy Kentucky entered into a tax-sharing agreement with Duke Energy, and income taxes recorded represent amounts Duke Energy Kentucky would incur as a separate C-Corporation. Deferred income taxes have been provided for temporary differences between GAAP and tax bases of assets and liabilities because the differences create taxable or tax-deductible amounts for future periods. Investment tax credits associated with regulated operations are deferred and amortized as a reduction of income tax expense over the estimated useful lives of the related properties.

Accumulated deferred income taxes (ADIT) are valued using the enacted tax rate expected to apply to taxable income in the periods in which the deferred tax asset or liability is expected to be settled or realized. In the event of a change in tax rates, deferred tax assets and liabilities are remeasured as of the enactment date of the new rate. To the extent that the change in the value of the deferred tax represents an obligation to customers, the impact of the remeasurement is deferred to a regulatory liability. Remaining impacts are recorded in income from continuing operations. Other impacts of the Tax Cuts and Jobs Act (Tax Act) have been recorded on a provisional basis, see Note 13, "Income Taxes," for additional information. If Duke Energy's estimate of the tax effect of reversing temporary differences is not reflective of actual outcomes, is modified to reflect new developments or interpretations of the tax law, revised to incorporate new accounting principles, or changes in the expected timing or manner of the reversal then Duke Energy's results of operations could be impacted.

Tax-related interest and penalties are recorded in Interest Expense and Other Income and Expenses, net, in the Statements of Operations.

See Note 13 for further information.

NEW ACCOUNTING STANDARDS

The new accounting standards adopted for 2017 and 2016 had no material impact on the presentation or results of operations, cash flows or financial position of Duke Energy Kentucky. The following new Accounting Standards Updates have been issued, but have not yet been adopted by Duke Energy Kentucky, as of December 31, 2017.

Revenue from Contracts with Customers. In May 2014, the Financial Accounting Standards Board (FASB) issued revised accounting guidance for revenue recognition from contracts with customers. The core principle of this guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The amendments in this update also require disclosure of sufficient information to allow users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Duke Energy Kentucky has identified material revenue streams, which served as the basis for accounting analysis and documentation of the impact of this guidance on revenue recognition. The accounting analysis included reviewing representative contracts and tariffs for each material revenue stream. Most of Duke Energy Kentucky's revenue will be in scope of the new guidance. The majority of our sales, including energy provided to residential customers, are from tariff offerings that provide natural gas or electricity without a defined contractual term ("at-will"). For such arrangements, revenue from contracts with customers will be equivalent to the electricity or natural gas supplied and billed in that period (including estimated billings). As such, there will not be a significant shift in the timing or pattern of revenue recognition for such sales.

Duke Energy Kentucky has monitored the activities of the power and utilities industry revenue recognition task force including draft accounting positions released in October 2017 and the impact, if any, on Duke Energy Kentucky's specific contracts and conclusions. Potential revisions to processes, policies and controls, primarily related to evaluating supplemental disclosures required as a result of adopting this guidance, will be evaluated and implemented as necessary. Some revenue arrangements, such as alternative revenue programs and leases, are excluded from the scope of the new revenue recognition guidance and, therefore, will be accounted for and evaluated for separate presentation and disclosure under other relevant accounting guidance.

Duke Energy Kentucky intends to use the modified retrospective method of adoption effective January 1, 2018. Under the modified retrospective method of adoption, prior year reported results are not restated and a cumulative-effect adjustment, if applicable, is recorded to retained earnings at January 1, 2018, as if the standard had always been in effect. In addition, disclosures, if applicable, include a comparison to what would have been reported for 2018 under the previous revenue recognition rules to assist financial statement users in understanding how revenue recognition has changed as a result of this standard and to facilitate comparability with prior year reported results, which are not restated under the modified retrospective approach as described above. Duke Energy Kentucky will utilize certain practical expedients including applying this guidance to open contracts at the date of adoption and recognizing revenues for certain contracts under the invoice practical expedient, which allows revenue recognition to be consistent with invoiced amounts (including estimated billings) provided certain criteria are met, including consideration of whether the invoiced amounts reasonably represent the value provided to customers. While the adoption of this guidance is not expected to have a material impact on either the timing or amount of revenues recognized in Duke Energy Kentucky's financial statements, Duke Energy Kentucky anticipates additional disclosures around the nature, amount, timing and uncertainty of our revenues and cash flows arising from contracts with customers. Duke Energy Kentucky continues to evaluate what information will be most useful for users of the financial statements, including information already provided in disclosures outside of the financial statement footnotes. These additional disclosures are expected to include the disaggregation of revenues by customer class.

Financial Instruments Classification and Measurement. In January 2016, the FASB issued revised accounting guidance for the classification and measurement of financial instruments. Changes in the fair value of all equity securities will be required to be recorded in net income. Current GAAP allows some changes in fair value for available-for-sale equity securities to be recorded in accumulated other comprehensive income. Additional disclosures will be required to present separately the financial assets and financial liabilities by measurement category and form of financial asset. An entity's equity investments that are accounted for under the equity method of accounting are not included within the scope of the new guidance.

For Duke Energy Kentucky, the revised accounting guidance is effective for interim and annual periods beginning January 1, 2018, by recording a cumulative effect adjustment to retained earnings as of January 1, 2018. This guidance is expected to have minimal impact on the Statements of Operations as changes in the fair value of most of the Duke Energy Kentucky's available-for-sale equity securities are deferred as regulatory assets or liabilities pursuant to accounting guidance for regulated operations.

Leases. In February 2016, the FASB issued revised accounting guidance for leases. The core principle of this guidance is that a lessee should recognize the assets and liabilities that arise from leases on the balance sheet.

For Duke Energy Kentucky, this guidance is effective for interim and annual periods beginning January 1, 2019. The guidance is applied using a modified retrospective approach. Upon adoption, Duke Energy Kentucky expects to elect the practical expedients, which would require no reassessment of whether existing contracts are or contain leases as well as no reassessment of lease classification for existing leases. Additionally, we expect to adopt the optional transition practical expedient allowing the entity not to reassess the accounting for land easements that currently exist at the adoption of the lease standard on January 1, 2019. Duke Energy Kentucky is currently evaluating the financial statement impact of adopting this standard and is continuing to monitor industry implementation issues, including easements, pole attachments and renewable Power Purchase Agreements. Other than an expected increase in assets and liabilities, the ultimate impact of the new standard has not yet been determined. Significant system enhancements, including additional processes and controls, will be required to facilitate the identification, tracking and reporting of potential leases based upon requirements of the new lease standard. Duke Energy Kentucky has begun the implementation of a third-party software tool to help with the adoption and ongoing accounting under the new standard.

Retirement Benefits. In March 2017, the FASB issued revised accounting guidance for the presentation of net periodic costs related to benefit plans. Current GAAP permits the aggregation of all the components of net periodic costs on the Consolidated Statement of Operations and does not require the disclosure of the location of net periodic costs on the Consolidated Statement of Operations. Under the amended guidance, the service cost component of net periodic costs must be included within Operating Income within the same line as other compensation expenses. All other components of net periodic costs must be outside of Operating Income. In addition, the updated guidance permits only the service cost component of net periodic costs to be capitalized to Inventory or Property, Plant and Equipment. This represents a change from current GAAP, which permits all components of net periodic costs to be capitalized. These amendments should be applied retrospectively for the presentation of the various components of net periodic costs and prospectively for the change in eligible costs to be capitalized. The guidance allows for a practical expedient that permits a company to use amounts disclosed in prior-period financial statements as the estimation basis for applying the retrospective presentation requirements.

For Duke Energy Kentucky, this guidance is effective for interim and annual periods beginning January 1, 2018. Duke Energy Kentucky currently presents the total non-capitalized net periodic costs within Operation, maintenance and other on the Consolidated Statement of Operations. The adoption of this guidance will result in a retrospective change to reclassify the presentation of the non-service cost (benefit) components of net periodic costs to Other income and expenses. Duke Energy Kentucky intends to utilize the practical expedient for retrospective presentation. The change in net periodic costs eligible for capitalization is applicable prospectively. Since Duke Energy Kentucky's service cost component is expected to be greater than the total net periodic costs, the change will result in increased capitalization of net periodic costs, higher Operation, maintenance and other and higher Other income and expenses. The resulting impact to Duke Energy Kentucky is expected to be an immaterial increase in Net Income resulting from the limitation of eligible capitalization of net periodic costs to the service cost component, which is larger than the total net periodic costs.

2. REGULATORY MATTERS

REGULATORY ASSETS AND LIABILITIES

Duke Energy Kentucky records assets and liabilities that result from the ratemaking process. See Note 1 for further information.

The following table represents the regulatory assets and liabilities on the Balance Sheets.

(in thousands)	December 31, 2017	December 31, 2016	Recovery/Refund Period Ends
Regulatory Assets[(a)]:			
Accrued pension and other post-retirement benefits	$ 34,682	$ 31,620	(b)
East Bend deferrals	45,485	32,267	(c)
Demand side management/Energy efficiency costs	2,226	1,661	(c)(d)
Hedge costs and other deferrals	4,938	5,521	(e)
Storm cost deferrals	4,913	4,913	(c)
AROs – coal ash	16,721	11,412	(c)(g)
Vacation accrual	1,394	1,348	2018
Deferred debt expense	1,188	1,455	2036
Deferred fuel and purchased gas costs	179	3,937	2018
Carbon management research grant	1,800	1,600	(c)
Deferred gas integrity costs	2,887	2,173	(c)
Net regulatory asset related to income taxes	—	2,178	(g)
AMI	6,087	—	(c)
Other	594	—	
Total regulatory assets	123,094	100,085	
Less: current portion	4,356	7,623	
Total noncurrent regulatory assets	$ 118,738	$ 92,462	
Regulatory Liabilities[(a)]:			
Costs of removal	$ 39,707	$ 45,878	(f)
Net regulatory liability related to income taxes	132,721	—	(c)
Accrued pension and other post-retirement benefits	4,833	5,550	(b)
Hedge costs and other deferrals	33	2,502	(e)
Deferred fuel and purchased gas costs	(204)	8,456	2018
Profit sharing mechanism	1,405	1,215	2018
Other	14	450	(c)
Total regulatory liabilities	178,509	64,051	
Less: current portion	6,892	12,173	
Total noncurrent regulatory liabilities	$ 171,617	$ 51,878	

(a) Regulatory assets and liabilities are excluded from rate base unless otherwise noted.
(b) Recovered primarily over the average remaining service periods or life expectancies of employees covered by the benefit plans, which is approximately thirteen years. See Note 12 for further information.
(c) The expected recovery or refund period varies for these amounts or has not been determined.
(d) Deferred costs are recovered through a rider mechanism.
(e) Recovery varies over the life of the associated instrument.
(f) Represents funds received from customers to cover future removal of property, plant and equipment from retired or abandoned sites as property is retired. Included in rate base and recovered over the life of associated assets.
(g) Certain amounts are recovered through rates.

RATE RELATED INFORMATION

The KPSC approves rates for retail electric and natural gas services within the Commonwealth of Kentucky. The FERC approves rates for electric sales to wholesale customers served under cost-based rates, as well as sales of transmission service.

Tax Act Impacts

On December 22, 2017, President Trump signed the Tax Act into law, which, among other provisions, reduces the maximum federal corporate income tax rate from 35 percent to 21 percent, effective January 1, 2018. As a result of the Tax Act, Duke Energy Kentucky revalued its deferred tax assets and deferred tax liabilities, as of December 31, 2017, to account for the future impact of lower corporate tax rates on these deferred tax amounts. For the Duke Energy Kentucky regulated operations, where the reduction is expected to be accounted for and applied to customers' rates in future commission proceedings, including rate proceedings, the net remeasurement has been deferred as a regulatory liability. KPSC is reviewing the Tax Act to determine the potential impacts on customer rates. Beginning in January 2018, Duke Energy Kentucky will defer the estimated ongoing impacts of the Tax Act that are expected to be returned to customers. See Note 13 for additional information.

Duke Energy Kentucky Rate Case

On September 1, 2017, Duke Energy Kentucky filed a rate case with the KPSC requesting an increase in electric base rates of approximately $49 million, which represents an approximate 15 percent increase on the average customer bill. The rate increase is driven by increased investment in utility plant, increased operations and maintenance expenses and recovery of regulatory assets. The application also includes implementation of the Environmental Surcharge Mechanism to recover environmental costs not included in base rates, requests to establish a Distribution Capital Investment Rider to recover incremental costs of specific programs, requests to establish a FERC Transmission Cost Reconciliation Rider to recover escalating transmission costs and modification to the Profit Sharing Mechanism to increase customers' share of proceeds from the benefits of owning generation and to mitigate shareholder risks associated with that generation. An evidentiary hearing ended March 8, 2018. Duke Energy Kentucky anticipates that rates will go into effect in mid-April 2018. Duke Energy Kentucky cannot predict the outcome of this matter.

Woodsdale Station Fuel System Filing

On June 9, 2015, the FERC ruled in favor of PJM Interconnection, LLC (PJM) on a revised Tariff and Reliability Assurance Agreement including implementation of a Capacity Performance (CP) proposal and to amend sections of the Operating Agreement related to generation non-performance. The CP proposal includes performance-based penalties for non-compliance. Duke Energy Kentucky is a Fixed Resource Requirement (FRR) entity, and therefore is subject to the compliance standards through its FRR plans. A partial CP obligation will apply to Duke Energy Kentucky in the delivery year beginning June 1, 2019, with full compliance beginning June 1, 2020. Duke Energy Kentucky has developed strategies for CP compliance investments. On December 21, 2017, the KPSC issued an order approving Duke Energy Kentucky's request for a certificate of public convenience and necessity (CPCN) to construct an ultra-low sulfur diesel backup fuel system for the Woodsdale Station. The backup fuel system is projected to cost approximately $55 million and is anticipated to be in service prior to the CP compliance deadline of April 2019.

East Bend Coal Ash Basin Filings

On December 2, 2016, Duke Energy Kentucky filed with the KPSC a request for a CPCN for construction projects necessary to close and repurpose an ash basin at the East Bend Station as a result of current and proposed U.S. Environmental Protection Agency (EPA) regulations. Duke Energy Kentucky estimated a total cost of approximately $93 million in the filing and expects in-service date by the first quarter of 2021. On June 6, 2017, the KPSC approved the CPCN request.

Dry Bottom Ash Conversion

On July 28, 2016, Duke Energy Kentucky filed with the KPSC a request for approval of a CPCN to convert to dry bottom ash at the East Bend station. The project is necessary to comply with various environmental law requirements. The project is estimated to cost approximately $25 million. On February 23, 2017, the KPSC granted a CPCN for the project.

Advanced Metering Infrastructure (AMI)

On April 25, 2016, Duke Energy Kentucky filed with the KPSC an application for approval of a CPCN for the construction of AMI. Duke Energy Kentucky estimates the $49 million project will take two years to complete. Duke Energy Kentucky also requested approval to establish a regulatory asset for the remaining book value of existing meter equipment and inventory to be replaced. Duke Energy Kentucky and the Kentucky attorney general entered into a stipulation to settle matters related to the application. On May 25, 2017, the KPSC issued an order to approve the stipulation with certain modifications. On June 1, 2017, Duke Energy Kentucky filed its acceptance of the modifications. The deployment of AMI meters began in third quarter 2017 and is expected to be completed in early 2019. Duke Energy Kentucky has approximately $6 million included in Regulatory assets on its Consolidated Balance Sheets at December 31, 2017, for the book value of existing meter equipment.

Regional Transmission Organization (RTO) Realignment

Duke Energy Ohio and Duke Energy Kentucky transferred control of their transmission assets to effect a RTO realignment from Midcontinent Independent System Operator, Inc. (MISO) to PJM, effective December 31, 2011.

On December 22, 2010, the KPSC approved Duke Energy Kentucky's request to effect the RTO realignment, subject to a commitment not to seek double-recovery in a future rate case of the transmission expansion fees that may be charged by MISO and PJM in the same period or overlapping periods. Duke Energy Kentucky is not currently recovering PJM or MISO transmission expansion fees through current base rates.

Upon its exit from MISO on December 31, 2011, Duke Energy Kentucky recorded a liability and expense for its exit obligation and share of MISO Transmission Expansion Planning costs, excluding Multi Value Projects (MVP). This liability was recorded within Other in Current Liabilities and Other in Noncurrent Liabilities on the Balance Sheets.

The following table provides a reconciliation of the beginning and ending balance of recorded obligations related to the withdrawal from MISO.

(in thousands)	December 31, 2016	Provision / Adjustments	Cash Reductions	December 31, 2017
MISO withdrawal liability	$ 19,452	$ (2,111)	$ (975)	$ 16,366

MVP

MISO approved 17 MVP proposals prior to Duke Energy Ohio and Duke Energy Kentucky's exit from MISO on December 31, 2011. Construction of these projects is expected to continue through 2020. Costs of these projects, including operating and maintenance costs, property and income taxes, depreciation and an allowed return, are allocated and billed to MISO transmission owners.

On December 29, 2011, MISO filed a tariff with the FERC providing for the allocation of MVP costs to a withdrawing owner based on monthly energy usage. The FERC set for hearing (i) whether MISO's proposed cost allocation methodology to transmission owners who withdrew from MISO prior to January 1, 2012 is consistent with the tariff at the time of their withdrawal from MISO and, (ii) if not, what the amount of and methodology for calculating any MVP cost responsibility should be. In 2012, MISO estimated Duke Energy Kentucky's MVP obligation over the period from 2012 to 2071 at $450 million, on an undiscounted basis. On July 16, 2013, a FERC Administrative Law Judge (ALJ) issued an initial decision. Under this initial decision, Duke Energy Ohio and Duke Energy Kentucky would be liable for MVP costs. Duke Energy Ohio and Duke Energy Kentucky filed exceptions to the initial decision, requesting the FERC overturn the ALJ's decision.

On October 29, 2015, the FERC issued an order reversing the ALJ's decision. The FERC ruled the cost allocation methodology is not consistent with the MISO tariff and that Duke Energy Ohio and Duke Energy Kentucky have no liability for MVP costs after withdrawal from MISO. On May 19, 2016, the FERC denied the request for rehearing filed by MISO and the MISO Transmission Owners. On July 15, 2016, the MISO Transmission Owners filed a petition for review with the U.S. Court of Appeals for the Sixth Circuit. On June 21, 2017, a three-judge panel affirmed FERC's 2015 decision holding that Duke Energy Kentucky has no liability for the cost of the MVP projects constructed after Duke Energy Kentucky's withdrawal from MISO. MISO did not file further petitions for review and this matter is now final.

3. COMMITMENTS AND CONTINGENCIES

GENERAL INSURANCE

Duke Energy Kentucky has insurance and/or reinsurance coverage either directly or through indemnification from Duke Energy's captive insurance company, Bison Insurance Company Limited, and its affiliates, consistent with companies engaged in similar commercial operations with similar type properties. Duke Energy Kentucky's coverage includes (i) commercial general liability coverage for liabilities arising to third parties for bodily injury and property damage; (ii) workers' compensation; (iii) automobile liability coverage; and (iv) property coverage for all real and personal property damage. Real and personal property damage coverage excludes electric transmission and distribution lines, but includes damages arising from boiler and machinery breakdowns, earthquakes, flood damage and extra expense, but not outage or replacement power coverage. All coverage is subject to certain deductibles or retentions, sublimits, exclusions, terms and conditions that are common for companies with similar types of operations. Duke Energy Kentucky self-insures its electric transmission and distribution lines against loss due to storm damage and other natural disasters.

The cost of Duke Energy Kentucky's coverage can fluctuate year to year reflecting claims history and conditions of the insurance and reinsurance markets.

In the event of a loss, terms and amounts of insurance and reinsurance available might not be adequate to cover claims and other expenses incurred. Uninsured losses and other expenses, to the extent not recovered by other sources, could have a material effect on Duke Energy Kentucky's results of operations, cash flows or financial position. Duke Energy Kentucky is responsible to the extent losses may exceed limits of the coverage available.

ENVIRONMENTAL

Duke Energy Kentucky is subject to federal, state, and local regulations regarding air and water quality, hazardous and solid waste disposal, and other environmental matters. These regulations can be changed from time to time, imposing new obligations on Duke Energy Kentucky.

Remediation Activities

In addition to the AROs discussed in Note 5, Duke Energy Kentucky is responsible for environmental remediation at various sites. These include some properties that are part of ongoing operations and sites formerly owned or used by Duke Energy Kentucky. These sites are in various stages of investigation, remediation and monitoring. Managed in conjunction with relevant federal, state and local agencies, remediation activities vary based upon site condition and location, remediation requirements, complexity and sharing of responsibility. If remediation activities involve joint and several liability provisions, strict liability, or cost recovery or contribution actions, Duke Energy Kentucky could potentially be held responsible for environmental impacts caused by other potentially responsible parties, and may also benefit from insurance policies or contractual indemnities that cover some or all cleanup costs. Liabilities are recorded when losses become probable and are reasonably estimable. The total costs that may be incurred cannot be estimated because the extent of environmental impact, allocation among potentially responsible parties, remediation alternatives and/or regulatory decisions have not yet been determined. Additional costs associated with remediation activities are likely to be incurred in the future and could be significant. Costs are typically expensed as Operation, maintenance and other in the Statements of Operations unless regulatory recovery of the costs is deemed probable.

Duke Energy Kentucky has accrued approximately $670 thousand of probable and estimable costs related to its various environmental sites in Other within Other Noncurrent Liabilities on the Balance Sheets as of December 31, 2017 and 2016. Additional losses in excess of recorded reserves are expected to be immaterial for the stages of investigation, remediation and monitoring for the environmental sites that have been evaluated. The maximum amount of the range for all stages of Duke Energy Kentucky's environmental sites cannot be determined at this time.

Clean Power Plan (CPP)

On October 23, 2015, the EPA published in the Federal Register the CPP rule for regulating carbon dioxide (CO_2) emissions from existing fossil fuel-fired electric generating units. The CPP establishes CO_2 emission rates and mass cap goals that apply to fossil fuel-fired generation. Petitions challenging the CPP have been filed by several groups and on February 9, 2016, the Supreme Court issued a stay of the final CPP rule, halting implementation of the CPP until legal challenges are resolved. Kentucky has suspended work on the CPP in response to the stay. Oral arguments before 10 of the 11 judges on the D.C. Circuit Court were heard on September 27, 2016. The court has not issued its opinion in the case.

On March 28, 2017, President Trump signed an executive order directing EPA to review the CPP and determine whether to suspend, revise or rescind the rule. On the same day, the Department of Justice filed a motion with the D.C. Circuit Court requesting that the court stay the litigation of the rule while it is reviewed by EPA. On April 28, 2017, the court issued an order to suspend the litigation for 60 days. On August 8, 2017, the court, on its own motion, extended the suspension of the litigation for an additional 60 days. On October 16, 2017, EPA issued a Notice of Proposed Rulemaking (NPR) to repeal the CPP based on a change to EPA's legal interpretation of the section of the Clean Air Act on which the CPP was based. In the proposal, EPA indicates that it has not determined whether it will issue a rule to replace the CPP, and if it will do so, when and what form that rule will take. The comment period on EPA's NPR ends April 26, 2018. On December 28, 2017, EPA issued an Advance Notice of Proposed Rulemaking (ANPRM) in which it seeks public comment on various aspects of a potential CPP replacement rule. The comment period on the ANPRM ended February 26, 2018. If EPA decides to move forward with a CPP replacement rule, it will need to issue a formal proposal for public comment. Litigation of the CPP remains on hold in the D.C. Circuit Court and the February 2016 U.S. Supreme Court stay of the CPP remains in effect. Duke Energy Kentucky cannot predict the outcome of these matters.

LITIGATION

Duke Energy Kentucky is involved in other legal, tax and regulatory proceedings arising in the ordinary course of business, some of which involve significant amounts. Duke Energy Kentucky believes the final disposition of these proceedings will not have a material effect on its results of operations, cash flows or financial position. Duke Energy Kentucky expenses legal costs related to the defense of loss contingencies as incurred.

OTHER COMMITMENTS AND CONTINGENCIES

General

As part of its normal business, Duke Energy Kentucky is party to various financial guarantees, performance guarantees and other contractual commitments to extend guarantees of credit and other assistance to various third parties. These guarantees involve elements of performance and credit risk which are not included on the Balance Sheets. The possibility of Duke Energy Kentucky having to honor its contingencies is largely dependent upon future operations of various third parties or the occurrence of certain future events.

Operating and Capital Lease Commitments

Duke Energy Kentucky leases vehicles, computer equipment and other property and equipment with various terms and expiration dates. Capitalized lease obligations are classified as Long-Term Debt on the Balance Sheets. Amortization of assets recorded under capital leases is included in Depreciation and amortization on the Statements of Operations.

Rental expense for operating leases, which is included in Operation, maintenance and other on the Statements of Operations, was $2 million and $3 million for the years ended December 31, 2017 and 2016, respectively.

The following table presents future minimum lease payments under operating leases, which at inception had a non-cancelable term of more than one year, and capital leases as of December 31, 2017.

(in thousands)	Operating Leases	Capital Leases
2018	$ 2,649	$ 975
2019	1,332	461
2020	1,118	236
2021	929	—
2022	676	—
Thereafter	587	—
Minimum annual payments	7,291	1,672
Less: amount representing interest	—	(206)
Total	$ 7,291	$ 1,466

4. DEBT AND CREDIT FACILITIES

SUMMARY OF DEBT AND RELATED TERMS

The following table summarizes outstanding debt.

			December 31,	
(in thousands)	Weighted Average Interest Rate	Year Due	2017	2016
Unsecured debt	4.56%	2019 - 2057	$ 350,000	$ 260,000
Capital leases	6.16%	2018 - 2020	1,466	2,152
Tax-exempt bonds[(a)(b)]	1.74%	2027	76,720	76,720
Money pool borrowings[(b)(c)]	1.66%		25,000	44,656
Unamortized debt discount and premium, net			(288)	(338)
Unamortized debt issuance costs			(1,718)	(1,488)
Total debt	3.93%		$ 451,180	$ 381,702
Short-term money pool borrowings			—	(19,656)
Current maturities of long-term debt			(885)	(686)
Total long-term debt			$ 450,295	$ 361,360

(a) Includes $27 million that is secured by a bilateral letter of credit agreement.
(b) Floating-rate debt. At December 31, 2016, the weighted average interest rate was 1.05% for tax-exempt bonds.
(c) Includes $25 million classified as Long-Term Debt Payable to Affiliated Companies on the Balance Sheets.

MATURITIES AND CALL OPTIONS

The following table shows the annual maturities of long-term debt for the next five years and thereafter.

(in thousands)	December 31, 2017
2018	$ 885
2019	100,210
2020	55
2021	49,873
2022	24,873
Thereafter	275,284
Total long-term debt, including current maturities	$ 451,180

Duke Energy Kentucky has the ability under certain debt facilities to call and repay the obligation prior to its scheduled maturity. Therefore, the actual timing of future cash repayments could be materially different than as presented above.

SHORT-TERM OBLIGATIONS CLASSIFIED AS LONG-TERM DEBT

Tax-exempt bonds that may be put to Duke Energy Kentucky at the option of the holder and money pool borrowings, which are short-term obligations by nature, are classified as long-term due to Duke Energy Kentucky's intent and ability to utilize such borrowings as long-term financing. As Duke Energy's Master Credit Facility and Duke Energy Kentucky's other bilateral letter of credit agreements have non-cancelable terms in excess of one year as of the balance sheet date, Duke Energy Kentucky has the ability to refinance these short-term obligations on a long-term basis. See "Available Credit Facilities" below for additional information.

At December 31, 2017 and 2016, $27 million of tax-exempt bonds and $25 million of money pool borrowings were classified as Long-Term Debt and Long-Term Debt Payable to Affiliated Companies, respectively, on the Balance Sheets.

SIGNIFICANT DEBT ISSUANCES

In September 2017, Duke Energy Kentucky issued $90 million of unsecured debentures, of which $30 million carry a fixed interest rate of 3.35 percent and mature September 2029, $30 million carry a fixed interest rate of 4.11 percent and mature September 2047 and $30 million carry a fixed interest rate of 4.26 percent and mature September 2057. The debt was issued for capital expenditures, to refinance short-term debt and for general corporate purposes.

In January 2016, Duke Energy Kentucky issued $95 million of unsecured debentures, of which $45 million carry a fixed interest rate of 3.42 percent and mature January 15, 2026, and $50 million carry a fixed interest rate of 4.45 percent and mature January 15, 2046. Proceeds were used to refinance existing debt, including money pool borrowings, capital expenditures and for general corporate purposes.

AVAILABLE CREDIT FACILITIES

In March 2017, Duke Energy amended its Master Credit Facility to increase its capacity from $7.5 billion to $8 billion, and to extend the termination date of the facility from January 30, 2020, to March 16, 2022. In January 2018, Duke Energy further amended its Master Credit Facility with consenting lenders to extend $7.65 billion of the existing $8 billion Master Credit Facility by one year to March 16, 2023. Duke Energy Kentucky has borrowing capacity under the Master Credit Facility up to a specified sublimit. Duke Energy has the unilateral ability at any time to increase or decrease Duke Energy Kentucky's borrowing sublimit, subject to a maximum sublimit. The amount available to Duke Energy Kentucky under the Master Credit Facility may be reduced to backstop issuances of commercial paper, certain letters of credit and variable-rate demand tax-exempt bonds that may be put to Duke Energy Kentucky at the option of the holder. At December 31, 2017, Duke Energy Kentucky had a borrowing sublimit of $150 million and available capacity of $125 million under the Master Credit Facility.

Duke Energy Kentucky and Duke Energy Indiana, LLC (Duke Energy Indiana), a wholly owned subsidiary of Duke Energy, collectively have a $156 million bilateral letter of credit agreement. In February 2018, Duke Energy Kentucky and Duke Energy Indiana amended the bilateral letter of credit agreement to extend the termination date from February 2019 to February 2023. Duke Energy Kentucky and Duke Energy Indiana may request the issuance of letters of credit up to $27 million and $129 million, respectively, on their behalf to support various series of tax-exempt bonds. This credit facility may not be used for any purpose other than to support the tax-exempt bonds.

OTHER DEBT MATTERS

Money Pool

Duke Energy Kentucky receives support for its short-term borrowing needs through participation with Duke Energy and certain of its subsidiaries in a money pool arrangement. Under this arrangement, those companies with short-term funds may provide short-term loans to affiliates participating under this arrangement. The money pool is structured such that Duke Energy Kentucky separately manages its cash needs and working capital requirements. Accordingly, there is no net settlement of receivables and payables related to the money pool between the money pool participants.

Money pool receivable balances are reflected within Notes receivable from affiliated companies in the Balance Sheets. The change in receivables is reflected within Investing Activities on the Statements of Cash Flows. Money pool payable balances are reflected within either Notes payable to affiliated companies or Long-Term Debt Payable to Affiliated Companies on the Balance Sheets. The change in payables are reflected within Financing Activities on the Statements of Cash Flows.

Restrictive Debt Covenants

Duke Energy Kentucky's debt and credit agreements contain various financial and other covenants. Failure to meet those covenants beyond applicable grace periods could result in accelerated due dates and/or termination of the agreements. As of December 31, 2017, Duke Energy Kentucky was in compliance with all covenants related to its debt agreements. In addition, some credit agreements may allow for acceleration of payments or termination of the agreements due to nonpayment, or the acceleration of other significant indebtedness of the borrower or some of its subsidiaries. None of the debt or credit agreements contain material adverse change clauses.

5. ASSET RETIREMENT OBLIGATIONS

Duke Energy Kentucky records an ARO when it has a legal obligation to incur retirement costs associated with the retirement of a long-lived asset and the obligation can be reasonably estimated. Certain assets have an indeterminate life, and thus the fair value of the retirement obligation is not reasonably estimable. A liability for these AROs will be recorded when a fair value is determinable.

Duke Energy Kentucky's regulated electric and regulated natural gas operations accrue costs of removal for property that does not have an associated legal retirement obligation based on regulatory orders from the KPSC. These costs of removal are recorded as a regulatory liability in accordance with regulatory accounting treatment. See Note 2 for the estimated cost of removal for assets without an associated legal retirement obligation, which are included in Regulatory liabilities on the Balance Sheets as of December 31, 2017 and 2016.

In April 2015, the EPA published a rule to regulate the disposal of Coal Combustion Residuals (CCR) from electric utilities as solid waste. The EPA CCR rule establishes requirements regarding landfill design, structural integrity design and assessment criteria for surface impoundments, groundwater monitoring and protection procedures and other operational and reporting procedures to ensure the safe disposal and management of CCR. The EPA CCR rule has certain requirements which if not met could initiate impoundment closure and require closure completion within five years. The EPA CCR rule includes extension requirements, which if met could allow the extension of closure completion by up to 10 years. On March 1, 2018, the EPA proposed significant changes to the federal CCR rule, including revisions that were required as part of a CCR litigation settlement, as well as changes that the agency considers warranted due to the passage of the Water Infrastructure Improvements for the Nation Act, which provides statutory authority for state and federal permit programs. Duke Energy Kentucky does not expect any significant changes to our closure plans as we continue to safely close ash basins across the various sites. In addition to the requirements of the federal CCR regulation, CCR landfills and surface impoundments are also independently regulated by the state of Kentucky.

The ARO amount recorded on the Balance Sheets is based upon estimated closure costs for impacted ash impoundments. The amount recorded represents the discounted cash flows for estimated closure costs based upon either specific closure plans or the probability weightings of the potential closure methods as evaluated on a site-by-site basis. Actual costs to be incurred will be dependent upon factors that vary from site to site. The most significant factors are the method and time frame of closure at the individual sites. Closure methods considered include removing the water from the basins, consolidating material as necessary and capping the ash with a synthetic barrier, excavating and relocating the ash to a lined structural fill or lined landfill, or recycling the ash for concrete or some other beneficial use. The ultimate method and timetable for closure will be in compliance with standards set by federal and state regulations. The ARO amount will be adjusted as additional information is gained through the closure and post-closure process, including acceptance and approval of compliance approaches which may change management assumptions, and may result in a material change to the balance. See ARO Liability Rollforward section below for information on revisions made to the coal ash liability during 2017 and 2016.

Asset retirement costs associated with coal ash AROs at the East Bend Station are included within Property, Plant and Equipment on the Balance Sheets.

The following table presents the changes in the liability associated with AROs.

	Years Ended December 31,	
(in thousands)	2017	2016
Balance at beginning of period	$ 52,822	$ 103,500
Accretion expense	2,044	4,034
Liabilities settled[(a)]	(7,435)	(4,757)
Liabilities incurred in the current year[(b)]	7,089	—
Revisions to estimates of cash flows[(c)]	62	(49,955)
Balance at end of period	$ 54,582	$ 52,822

(a) Settlement of liabilities primarily relate to ash basin closure costs at the East Bend Station.
(b) Additional liabilities incurred primarily relate to landfill closure costs at the East Bend Station.
(c) 2016 amount primarily related to ash basin closure costs based on additional site-specific information about related costs, methods and timing of work to be performed.

Cost recovery related to ash basin and landfill closures will be pursued through the normal ratemaking process with the KPSC which permits recovery of necessary and prudently incurred costs associated with Duke Energy Kentucky's regulated operations.

6. PROPERTY, PLANT AND EQUIPMENT

The following table summarizes property, plant and equipment.

	Estimated Useful Life	December 31,	
(in thousands)	(Years)	2017	2016
Land		$ 24,616	$ 26,007
Plant[(a)]			
Electric generation, distribution and transmission	8 – 100	1,585,904	1,496,729
Natural gas transmission and distribution	12 – 50	488,871	459,165
Other buildings and improvements	15 – 100	11,958	11,554
Equipment	5 – 25	19,167	17,549
Construction in process		109,722	63,833
Other	5 – 10	51,847	41,382
Total property, plant and equipment		2,292,085	2,116,219
Accumulated depreciation and amortization[(b)]		(977,244)	(948,144)
Net property, plant and equipment[(c)]		$ 1,314,841	$ 1,168,075

(a) Includes capitalized lease amounts of $26.2 million and $27.6 million at December 31, 2017 and 2016, respectively.
(b) Includes accumulated amortization of capitalized leases of $6.8 million and $7.1 million at December 31, 2017 and 2016, respectively.
(c) The debt component of AFUDC totaled $1.3 million and $0.5 million at December 31, 2017 and 2016, respectively.

7. OTHER INCOME AND EXPENSES, NET

The components of Other Income and Expenses, net on the Statements of Operations are as follows.

	Years Ended December 31,	
(in thousands)	2017	2016
Income/(Expense):		
Interest income	$ 1,236	$ 990
AFUDC equity	3,358	1,332
Other	5	(1)
Other Income and Expenses, net	$ 4,599	$ 2,321

8. RELATED PARTY TRANSACTIONS

Duke Energy Kentucky engages in related party transactions, which are generally performed at cost and in accordance with KPSC and FERC regulations. Material amounts related to transactions with related parties included in the Statements of Operations are presented in the following table.

	Years Ended December 31,	
(in thousands)	**2017**	**2016**
Corporate governance and shared service expenses[a]	$ 81,815	$ 83,100

(a) Duke Energy Kentucky is charged its proportionate share of costs, primarily related to human resources, employee benefits, legal and accounting fees, as well as other third party costs, from an unconsolidated affiliate that is a consolidated affiliate of Duke Energy. These amounts are recorded in Operation, maintenance and other within Operating Expenses on the Statements of Operations.

In addition to the amounts presented above, Duke Energy Kentucky records the impact on net income of other affiliate transactions, including rental of office space, participation in a money pool arrangement with Duke Energy and certain of its subsidiaries, other operational transactions and its proportionate share of certain charged expenses. The net impact of these transactions was not material for each of the years ended December 31, 2017 and 2016.

Certain trade receivables have been sold by Duke Energy Kentucky to CRC, an unconsolidated entity formed by a subsidiary of Duke Energy. The proceeds obtained from the sales of receivables are largely cash but do include a subordinated note from CRC for a portion of the purchase price. See Notes 1 and 11 for further information related to the sales of these receivables.

See the Balance Sheets for amounts due to or due from related parties.

Intercompany Income Taxes

Duke Energy and its subsidiaries file a consolidated federal income tax return and other state and jurisdictional returns. Duke Energy Kentucky has a tax sharing agreement with Duke Energy for the allocation of consolidated tax liabilities and benefits. Income taxes recorded represent amounts Duke Energy Kentucky would incur as a separate C-Corporation. Duke Energy Kentucky had an intercompany tax payable balance of $2 million at December 31, 2017, and an immaterial intercompany tax payable balance at December 31, 2016.

9. DERIVATIVES AND HEDGING

COMMODITY PRICE RISK

Duke Energy Kentucky has limited exposure to market price changes of fuel and emission allowance costs incurred for its retail customers due to the use of cost tracking and recovery mechanisms. Duke Energy Kentucky does have exposure to the impact of market fluctuations in the prices of electricity, fuel and emission allowances associated with its generation output not utilized to serve retail operations or committed load (off-system, wholesale power sales). Duke Energy Kentucky's outstanding commodity derivatives are financial transmission rights.

See Note 10 for additional information on the fair value of commodity derivatives.

INTEREST RATE RISK

Duke Energy Kentucky is exposed to changes in interest rates as a result of its issuance or anticipated issuance of variable-rate and fixed-rate debt. Interest rate risk is managed by limiting variable-rate exposure to a percentage of total debt and by monitoring changes in interest rates. To manage risk associated with changes in interest rates, Duke Energy Kentucky may enter into financial contracts including interest rate swaps and U.S. Treasury lock agreements. The notional amount of interest rate swaps outstanding was $26.7 million at December 31, 2017 and December 31, 2016. Financial contracts entered into by Duke Energy Kentucky are not designated as a hedge because they are accounted for under regulatory accounting. With regulatory accounting, the mark-to-market gains or losses are deferred as regulatory liabilities or assets. Regulatory assets and liabilities are amortized consistent with the treatment of related costs in the ratemaking process. The accrual of interest on swaps is recorded as Interest Expense on the Statements of Operations.

See Note 10 for additional information on the fair value of interest rate derivatives.

CREDIT RISK

Duke Energy Kentucky analyzes the financial condition of counterparties prior to entering into agreements and establishes credit limits and monitors the appropriateness of those limits on an ongoing basis. Credit limits and collateral requirements for retail electric customers are established by the KPSC.

Duke Energy Kentucky's industry has historically operated under negotiated credit lines for physical delivery contracts. Duke Energy Kentucky may use master collateral agreements to mitigate certain credit exposures. The collateral agreements require certain counterparties to post cash or letters of credit for the amount of exposure in excess of an established threshold. The threshold amount represents an unsecured credit limit determined in accordance with the corporate credit policy. Collateral agreements also provide that the inability to post collateral is sufficient cause to terminate contracts and liquidate all positions.

Duke Energy Kentucky also obtains cash or letters of credit from customers to provide credit support outside of collateral agreements, where appropriate, based on its financial analysis of the customer and the regulatory or contractual terms and conditions applicable to each transaction.

10. FAIR VALUE MEASUREMENTS

Fair value is the exchange price in an orderly transaction between market participants to sell an asset or transfer a liability at the measurement date. The fair value definition focuses on an exit price versus the acquisition cost. Fair value measurements use market data or assumptions market participants would use in pricing the asset or liability, including assumptions about risk and the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, corroborated by market data or generally unobservable. Valuation techniques maximize the use of observable inputs and minimize the use of unobservable inputs. A midmarket pricing convention (the midpoint price between bid and ask prices) is permitted for use as a practical expedient.

Fair value measurements are classified in three levels based on the fair value hierarchy:

Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity can access at the measurement date. An active market is one in which transactions for an asset or liability occur with sufficient frequency and volume to provide ongoing pricing information.

Level 2 – A fair value measurement utilizing inputs other than quoted prices included in Level 1 that are observable, either directly or indirectly, for an asset or liability. Inputs include (i) quoted prices for similar assets or liabilities in active markets, (ii) quoted prices for identical or similar assets or liabilities in markets that are not active, and (iii) inputs other than quoted market prices that are observable for the asset or liability, such as interest rate curves and yield curves observable at commonly quoted intervals, volatilities, and credit spreads. A Level 2 measurement cannot have more than an insignificant portion of its valuation based on unobservable inputs. Instruments in this category include non-exchange-traded derivatives, such as over-the-counter forwards, swaps and options; certain marketable debt securities; and financial instruments traded in less than active markets.

Level 3 – Any fair value measurement which includes unobservable inputs for more than an insignificant portion of the valuation. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value. Level 3 measurements may include longer-term instruments that extend into periods in which observable inputs are not available.

Fair value accounting guidance permits entities to elect to measure certain financial instruments that are not required to be accounted for at fair value, such as equity method investments or the company's own debt, at fair value. Duke Energy Kentucky has not elected to record any of these items at fair value.

Transfers between levels represent assets or liabilities that were previously (i) categorized at a higher level for which the inputs to the estimate became less observable or (ii) classified at a lower level for which the inputs became more observable during the period. Duke Energy Kentucky's policy is to recognize transfers between levels of the fair value hierarchy at the end of the period. There were no transfers between levels 1, 2 or 3 during the years ended December 31, 2017 and 2016.

Interest rate derivatives

Most over-the-counter interest rate contract derivatives are valued using financial models which utilize observable inputs for similar instruments and are classified as Level 2. Inputs include forward interest rate curves, notional amounts, interest rates and credit quality of the counterparties.

QUANTITATIVE DISCLOSURES

The following tables provide recorded balances for assets and liabilities measured at fair value on a recurring basis on the Balance Sheets. Derivative amounts in the table below exclude cash collateral.

	December 31, 2017		
(in thousands)	**Total Fair Value**	**Level 2**	**Level 3**
Derivative assets[(a)]	**$ 1,444**	**$ —**	**$ 1,444**
Derivative liabilities[(b)]	**(5,367)**	**(5,367)**	**—**
Net (liabilities) assets	**$ (3,923)**	**$ (5,367)**	**$ 1,444**

	December 31, 2016		
(in thousands)	**Total Fair Value**	**Level 2**	**Level 3**
Derivative assets[(a)]	$ 4,916	$ —	$ 4,916
Derivative liabilities[(b)]	(5,944)	(5,944)	—
Net (liabilities) assets	$ (1,028)	$ (5,944)	$ 4,916

(a) Included in Other within Current Assets and Other within Other Noncurrent Assets on the Balance Sheets. The amounts classified as Level 3 relate to financial transmission rights.

(b) Included in Other within Current Liabilities and Other within Other Noncurrent Liabilities on the Balance Sheets. The amounts classified as Level 2 relate to interest rate swaps.

The following table provides a reconciliation of beginning and ending balances of assets and liabilities measured at fair value on a recurring basis where the determination of fair value includes significant unobservable inputs (Level 3).

	Derivatives (net)	
	Years Ended December 31,	
(in thousands)	2017	2016
Balance at beginning of period	$ 4,916	$ 2,913
Purchases, sales, issuances and settlements:		
Purchases	3,343	4,921
Settlements	(4,135)	(4,441)
Total (losses) gains included on the Balance Sheets as regulatory assets or liabilities	(2,680)	1,523
Balance at end of period	$ 1,444	$ 4,916

OTHER FAIR VALUE DISCLOSURES

The fair value of long-term debt, including current maturities, is summarized in the following table. Judgment is required in interpreting market data to develop the estimates of fair value. Accordingly, the estimates determined are not necessarily indicative of the amounts Duke Energy Kentucky could have settled in current markets. The fair value of long-term debt is determined using Level 2 measurements.

	December 31, 2017		December 31, 2016	
(in thousands)	Book value	Fair value	Book value	Fair value
Long-Term debt, including current maturities	$ 451,180	$ 475,973	$ 362,046	$ 380,386

At both December 31, 2017 and December 31, 2016, the fair value of cash and cash equivalents, accounts and notes receivable, and accounts and notes payable are not materially different from their carrying amounts because of the short-term nature of these instruments and/or because the stated rates approximate market rates.

11. VARIABLE INTEREST ENTITIES

A variable interest entity (VIE) is an entity that is evaluated for consolidation using more than a simple analysis of voting control. The analysis to determine whether an entity is a VIE considers contracts with an entity, credit support for an entity, the adequacy of the equity investment of an entity, and the relationship of voting power to the amount of equity invested in an entity. This analysis is performed either upon the creation of a legal entity or upon the occurrence of an event requiring reevaluation, such as a significant change in an entity's assets or activities. A qualitative analysis of control determines the party that consolidates a VIE. This assessment is based on (i) what party has the power to direct the most significant activities of the VIE that impact its economic performance and (ii) what party has rights to receive benefits or is obligated to absorb losses that are significant to the VIE. The analysis of the party that consolidates a VIE is a continual reassessment.

Cinergy Receivables Company

CRC is a bankruptcy remote, special purpose entity that is an affiliate of Duke Energy Kentucky. As discussed below, Duke Energy Kentucky does not consolidate CRC as it is not the primary beneficiary. On a revolving basis, CRC buys certain accounts receivable arising from the sale of electricity, natural gas and related services from Duke Energy Kentucky. CRC borrows amounts under a credit facility to buy the receivables from Duke Energy Kentucky. Borrowing availability from the credit facility is limited to the amount of qualified receivables sold to CRC. The sole source of funds to satisfy the related debt obligation is cash collections from the receivables. Depending on experience with collections, additional equity infusions to CRC may be required by Duke Energy to maintain a minimum equity balance of $3 million. There were no infusions to CRC during the years ended December 31, 2017 and 2016.

The proceeds Duke Energy Kentucky receives from the sale of receivables to CRC are typically 75 percent cash and 25 percent in the form of a subordinated note from CRC. The subordinated note is a retained interest in the receivables sold. Duke Energy Kentucky had receivables of $19.7 million and $18.4 million from CRC at December 31, 2017 and December 31, 2016, respectively. These balances are included in Receivables from affiliated companies on the Balance Sheets.

CRC is considered a VIE because (i) equity capitalization is insufficient to support its operations, (ii) power to direct the activities that most significantly impact economic performance of the entity are not performed by the equity holder and (iii) deficiencies in net worth of CRC are funded by Duke Energy. The most significant activities that impact the economic performance of CRC are decisions made to manage delinquent receivables. Duke Energy consolidates CRC as it makes these decisions. Duke Energy Kentucky does not consolidate CRC. No financial support was provided to this non-consolidated VIE during the years ended December 31, 2017 or 2016, or is expected to be provided in the future, that was not previously contractually required.

The subordinated note held by Duke Energy Kentucky is stated at fair value. Carrying values of retained interests are determined by allocating carrying value of the receivables between assets sold and interests retained based on relative fair value. The allocated basis of the subordinated notes are not materially different than their face value because (i) the receivables generally turnover in less than two months, (ii) credit losses are reasonably predictable due to the broad customer base and lack of significant concentration and (iii) the equity in CRC is subordinate to all retained interests and thus would absorb losses first. The hypothetical effect on fair value of the retained interests assuming both a 10 percent and a 20 percent unfavorable variation in credit losses or discount rates is not material due to the short turnover of receivables and historically low credit loss history. Interest accrues to Duke Energy Kentucky on the retained interests using the acceptable yield method. This method generally approximates the stated rate on the notes since the allocated basis and the face value are nearly equivalent. An impairment charge is recorded against the carrying value of both retained interests and purchased beneficial interest whenever it is determined that an other-than-temporary impairment has occurred. Duke Energy Kentucky's maximum exposure to loss does not exceed the carrying value.

Key assumptions used in estimating fair value in 2017 and 2016 are detailed in the following table.

	2017	2016
Anticipated credit loss ratio	0.5%	0.5%
Discount rate	2.1%	1.5%
Receivables turnover rate	11.4%	11.5%

The following table presents gross and net receivables sold.

(in thousands)	December 31, 2017	December 31, 2016
Receivables sold	$ 59,074	$ 58,903
Less: Retained interests	19,736	18,390
Net receivables sold	$ 39,338	$ 40,513

The following table presents sales and cash flows related to receivables sold.

	Years Ended December 31,	
(in thousands)	2017	2016
Sales:		
Receivables sold	$ 417,779	$ 438,249
Loss recognized on sale	1,704	1,627
Cash flows:		
Cash proceeds from receivables sold	$ 414,729	$ 428,369
Collection fees received	209	219
Return received on retained interests	783	647

Cash flows from the sale of receivables are reflected within Operating Activities on the Statements of Cash Flows.

Collection fees received in connection with the servicing of transferred accounts receivable are included in Operation, maintenance, and other on the Statements of Operations. The loss recognized on the sale of receivables is calculated monthly by multiplying the receivables sold during the month by the required discount. The required discount is derived monthly utilizing a three-year weighted average formula that considers charge-off history, late charge history and turnover history on the sold receivables, as well as a component for the time value of money. The discount rate, or component for the time value of money, is calculated monthly by summing the prior month-end London Interbank Offered Rate (LIBOR) plus a fixed rate of 1.00 percent.

12. EMPLOYEE BENEFIT PLANS

DEFINED BENEFIT RETIREMENT PLANS

Duke Energy Kentucky participates in qualified and non-qualified defined benefit retirement plans and other post-retirement benefit plans sponsored by Duke Energy. Duke Energy allocates pension and other post-retirement obligations and costs related to these plans to Duke Energy Kentucky. The plans cover most employees using a cash balance formula. Under a cash balance formula, a plan participant accumulates a retirement benefit consisting of pay credits based upon a percentage of current eligible earnings based on age and/or years of service and interest credits. Certain employees are covered under plans that use a final average earnings formula. Under these average earnings formulas, a plan participant accumulates a retirement benefit equal to the sum of percentages of their (i) highest three-year or four-year average earnings, (ii) highest three-year or four-year average earnings in excess of covered compensation per year of participation (maximum of 35 years), and/or (iii) highest three-year average earnings times years of participation in excess of 35 years. Duke Energy also maintains, and Duke Energy Kentucky participates in, non-qualified, non-contributory defined benefit retirement plans which cover certain executives. As of January 1, 2014, the qualified and non-qualified non-contributory defined benefit plans are closed to new participants.

Duke Energy approved plan amendments to restructure its qualified non-contributory defined benefit retirement plans, effective January 1, 2018. The restructuring involved (i) the spin-off of the majority of inactive participants from two plans into a separate inactive plan and (ii) the merger of the active participant portions of such plans. Benefits offered to the plan participants remain unchanged. Actuarial gains and losses associated with the inactive plan will be amortized over the remaining life expectancy of the inactive participants.

Duke Energy uses a December 31 measurement date for its defined benefit retirement plan assets and obligations.

Duke Energy's policy is to fund amounts on an actuarial basis to provide assets sufficient to meet benefit payments to be paid to plan participants. Actual contributions for Duke Energy Kentucky were $1,324 thousand and $1,443 thousand for the years ended December 31, 2017 and 2016, respectively. A contribution of $72 thousand for Duke Energy Kentucky was made on January 2, 2018; no further contributions are anticipated in 2018.

Net periodic benefit costs disclosed in the tables below represent the cost of the respective plan for the periods presented. However, portions of the net periodic benefit cost disclosed in the tables have been capitalized as a component of property, plant and equipment. Amounts presented in the tables below represent the amounts of pension and other post-retirement benefit cost allocated by Duke Energy for employees of Duke Energy Kentucky. Additionally, Duke Energy Kentucky is allocated its proportionate share of pension and other post-retirement benefit cost for employees of Duke Energy's shared services affiliate that provides support to Duke Energy Kentucky. These allocated amounts are included in the governance and shared services costs discussed in Note 8.

QUALIFIED PENSION PLANS

Components of Net Periodic Pension Costs

	Years Ended December 31,	
(in thousands)	**2017**	**2016**
Service cost	**$ 1,360**	$ 1,459
Interest cost on projected benefit obligation	**4,274**	4,368
Expected return on plan assets	**(6,290)**	(6,156)
Amortization of prior service cost	**(95)**	4
Amortization of loss	**1,912**	1,677
Other	**91**	91
Net periodic pension costs	**$ 1,252**	$ 1,443

Amounts Recognized in Regulatory Assets

	December 31,	
(in thousands)	**2017**	**2016**
Regulatory assets, net increase	**$ 3,340**	$ 3,636

Reconciliation of Funded Status to Net Amount Recognized

	Years Ended December 31,	
(in thousands)	**2017**	**2016**
Change in Projected Benefit Obligation:		
Obligation at prior measurement date	$ 106,067	$ 100,829
Service cost	1,360	1,459
Interest cost	4,274	4,368
Actuarial losses	10,369	6,203
Transfers [(a)]	1,586	2,003
Plan amendments	—	(450)
Benefits paid	(6,679)	(8,345)
Obligation at measurement date	$ 116,977	$ 106,067
Accumulated Benefit Obligation	$ 113,557	$ 102,223
Change in Fair Value of Plan Assets:		
Plan assets at prior measurement date	$ 98,252	$ 96,373
Actual return on plan assets	11,674	6,778
Benefits paid	(6,679)	(8,345)
Employer contributions	1,324	1,443
Transfers [(a)]	1,586	2,003
Plan assets at measurement date	$ 106,157	$ 98,252

(a) Transfers represents net amounts associated with plan participants that have moved to/from other Duke Energy subsidiaries.

Amounts Recognized in the Balance Sheets

	December 31,	
(in thousands)	**2017**	**2016**
Prefunded pension[(a)]	$ 1,184	$ 1,716
Noncurrent pension liability[(b)]	12,004	9,531
Net liability recognized	$ (10,820)	$ (7,815)
Regulatory assets	$ 32,299	$ 28,959
Amounts to be reported in net periodic pension expense in the next year:		
Unrecognized net actuarial loss	$ 1,664	$ 1,407
Unrecognized prior service credit	(100)	62

(a) Included in Other within Investments and Other Assets on the Balance Sheets.
(b) Included in Accrued pension and other post-retirement benefit costs on the Balance Sheets.

Information for Plans with Accumulated Benefit Obligation in Excess of Plan Assets

	December 31,	
(in thousands)	**2017**	**2016**
Projected benefit obligation	$ 102,755	$ 92,663
Accumulated benefit obligation	99,335	88,820
Fair Value of plan assets	90,750	83,132

Assumptions Used for Pension Benefits Accounting

	December 31,	
	2017	2016
Benefit Obligations:		
Discount rate	3.60%	4.10%
Salary increase	3.50%	4.40%
Net Periodic Benefit Cost:		
Discount rate	4.10%	4.40%
Salary increase	4.40%	4.40%
Expected long-term rate of return on plan assets	6.50%	6.50%

The discount rate used to determine the current year pension obligation and following year's pension expense is based on a bond selection-settlement portfolio approach. This approach develops a discount rate by selecting a portfolio of high quality corporate bonds that generate sufficient cash flow to provide for the projected benefit payments of the plan. The selected bond portfolio is derived from a universe of non-callable corporate bonds rated Aa quality or higher. After the bond portfolio is selected, a single interest rate is determined that equates the present value of the plan's projected benefit payments discounted at this rate with the market value of the bonds selected.

NON-QUALIFIED PENSION PLANS

Components of Net Periodic Pension Costs

	Years Ended December 31,	
(in thousands)	2017	2016
Interest cost on projected benefit obligation	$ 6	$ 6
Amortization of actuarial loss	4	5
Net periodic pension costs	$ 10	$ 11

Amounts Recognized in Regulatory Assets

	December 31,	
(in thousands)	2017	2016
Regulatory assets, net increase	$ 1	$ —

Reconciliation of Funded Status to Net Amount Recognized

	Years Ended December 31,	
(in thousands)	2017	2016
Change in Projected Benefit Obligation:		
Obligation at prior measurement date	$ 140	$ 141
Interest cost	6	6
Actuarial losses	6	4
Benefits paid	(11)	(11)
Obligation at measurement date	$ 141	$ 140
Accumulated Benefit Obligation	$ 141	$ 140
Change in Fair Value of Plan Assets:		
Plan assets at prior measurement date	$ —	$ —
Benefits paid	(11)	(11)
Employer contributions	11	11
Plan assets at measurement date	$ —	$ —

Amounts Recognized in the Balance Sheets

	December 31,	
(in thousands)	**2017**	**2016**
Current pension liability[(a)]	**$ 10**	$ 10
Noncurrent pension liability[(b)]	**131**	130
Total accrued pension liability	**$ 141**	$ 140
Regulatory assets	**$ 52**	$ 51
Amounts to be recognized in net periodic pension expense in the next year:		
Unrecognized net actuarial loss	**$ 4**	4

(a) Included in Other within Current Liabilities on the Balance Sheets.
(b) Included in Accrued pension and other post-retirement benefit costs on the Balance Sheets.

Information for Plans with Accumulated Benefit Obligation in Excess of Plan Assets

	December 31,	
(in thousands)	**2017**	**2016**
Projected benefit obligation	**$ 141**	$ 140
Accumulated benefit obligation	**141**	140

Assumptions Used for Pension Benefits Accounting

	December 31,	
	2017	**2016**
Benefit Obligations:		
Discount rate	**3.60%**	4.10%
Salary increase	**3.50%**	4.40%
Net Periodic Benefit Cost:		
Discount rate	**4.10%**	4.40%
Salary increase	**4.40%**	4.40%

The discount rate used to determine the current year pension obligation and following year's pension expense is based on a bond selection-settlement portfolio approach. This approach develops a discount rate by selecting a portfolio of high quality corporate bonds that generate sufficient cash flow to provide for the projected benefit payments of the plan. The selected bond portfolio is derived from a universe of non-callable corporate bonds rated Aa quality or higher. After the bond portfolio is selected, a single interest rate is determined that equates the present value of the plan's projected benefit payments discounted at this rate with the market value of the bonds selected.

OTHER POST-RETIREMENT BENEFIT PLANS

Duke Energy provides, and Duke Energy Kentucky participates in, some health care and life insurance benefits for retired employees on a contributory and non-contributory basis. Employees are eligible for these benefits if they have met age and service requirements at retirement, as defined in the plans. The health care benefits include medical, dental, and prescription drug coverage and are subject to certain limitations, such as deductibles and co-payments.

Duke Energy did not make any pre-funding contributions to its other post-retirement benefit plans during the years ended December 31, 2017 and 2016.

Components of Net Periodic Other Post-Retirement Benefit Costs

	Years Ended December 31,	
(in thousands)	**2017**	**2016**
Service cost	**$ 82**	$ 91
Interest cost on projected benefit obligation	**254**	288
Expected return on plan assets	**(78)**	(61)
Amortization of prior service (credit) cost	**(184)**	175
Amortization of gain	**(144)**	(420)
Curtailment credit	**(614)**	—
Net periodic pension costs	**$ (684)**	$ 73

Amounts Recognized in Regulatory Assets and Regulatory Liabilities

	December 31,	
(in thousands)	**2017**	**2016**
Regulatory assets, net decrease	**$ (280)**	$ (305)
Regulatory liabilities, net (decrease) increase	**(717)**	612

Reconciliation of Funded Status to Accrued Other Post-Retirement Benefit Costs

	Years Ended December 31,	
(in thousands)	**2017**	**2016**
Change in Projected Benefit Obligation:		
Accumulated post-retirement benefit obligation at prior measurement date	**$ 6,556**	$ 6,845
Service cost	**82**	91
Interest cost	**254**	288
Plan participants' contributions	**193**	189
Actuarial losses (gains)	**197**	(107)
Transfers [(a)]	**85**	242
Plan amendments	**(642)**	(377)
Benefits paid	**(673)**	(615)
Accumulated post-retirement benefit obligation at measurement date	**$ 6,052**	$ 6,556
Change in Fair Value of Plan Assets:		
Plan assets at prior measurement date	**$ 1,519**	$ 1,198
Actual return on plan assets	**160**	86
Plan participants' contributions	**193**	189
Benefits paid	**(673)**	(615)
Transfers [(a)]	**36**	240
Employer contributions	**198**	421
Plan assets at measurement date	**$ 1,433**	$ 1,519

(a) Transfers represents net amounts associated with plan participants that have moved to/from other Duke Energy subsidiaries.

Amounts Recognized in the Balance Sheets

	December 31,	
(in thousands)	**2017**	**2016**
Current post-retirement liability[(a)]	**$ 159**	$ 165
Noncurrent post-retirement liability[(b)]	**4,460**	4,872
Total accrued post-retirement liability	**$ 4,619**	$ 5,037
Regulatory assets	**$ 2,330**	$ 2,610
Regulatory liabilities	**$ 4,833**	$ 5,550
Amounts to be recognized in net periodic pension expense in the next year:		
Unrecognized net actuarial loss	**$ 31**	$ (424)
Unrecognized prior service credit	**$ (236)**	$ (184)

(a) Included in Other within Current Liabilities on the Balance Sheets.
(b) Included in Accrued pension and other post-retirement benefit costs on the Balance Sheets.

Assumptions Used for Other Post-Retirement Benefits Accounting

	December 31,	
	2017	**2016**
Benefit Obligations:		
Discount rate	**3.60%**	4.10%
Net Periodic Benefit Cost:		
Discount rate	**4.10%**	4.40%
Expected long-term rate of return on plan assets	**6.50%**	6.50%

The discount rate used to determine the current year other post-retirement benefits obligation and following year's other post-retirement benefits expense is based on a bond selection-settlement portfolio approach. This approach develops a discount rate by selecting a portfolio of high quality corporate bonds that generate sufficient cash flow to provide for the projected benefit payments of the plan. The selected bond portfolio is derived from a universe of non-callable corporate bonds rated Aa quality or higher. After the bond portfolio is selected, a single interest rate is determined that equates the present value of the plan's projected benefit payments discounted at this rate with the market value of the bonds selected.

Assumed Health Care Cost Trend Rate

	December 31,	
	2017	**2016**
Health care cost trend rate assumed for next year	**7.00%**	7.00%
Rate to which the cost trend is assumed to decline (the ultimate trend rate)	**4.75%**	4.75%
Year that the rate reaches the ultimate trend rate	**2024**	2023

Expected Benefit Payments

The following table presents Duke Energy's expected benefit payments to participants on behalf of Duke Energy Kentucky in its qualified, non-qualified and other post-retirement benefit plans over the next 10 years. These benefit payments reflect expected future service, as appropriate.

(in thousands)	Qualified Plans	Non-Qualified Plans	Other Post-Retirement Plans	Total
Years ending December 31,				
2018	$ 7,106	$ 11	$ 864	$ 7,981
2019	7,417	11	742	8,170
2020	8,188	11	633	8,832
2021	9,449	10	631	10,090
2022	8,489	10	616	9,115
2023–2027	40,475	50	2,526	43,051

MASTER RETIREMENT TRUST (MASTER TRUST)

The assets for the Duke Energy Kentucky plans discussed above are derived from the Master Trust that is held by Duke Energy and, as such, Duke Energy Kentucky is allocated its proportionate share of assets discussed below. Assets for both the qualified pension and other post-retirement benefits are maintained in the Master Trust. Duke Energy also invests other post-retirement assets in Voluntary Employees' Beneficiary Association trusts. The investment objective is to achieve sufficient returns, subject to a prudent level of portfolio risk, for the purpose of promoting the security of plan benefits for participants. Duke Energy assumes pension and other post-retirement plan assets will generate a long-term rate of return of 6.50 percent. The expected long-term rate of return was developed using a weighted average calculation of expected returns based primarily on future expected returns across asset classes considering the use of active asset managers, where applicable. The asset allocation targets were set after considering the investment objective and the risk profile. Equity securities are held for their high expected return. Debt securities are primarily held to hedge the qualified pension plan liability. Hedge funds, real estate and other global securities are held for diversification. Investments within asset classes are diversified to achieve broad market participation and reduce the impact of individual managers or investments.

Duke Energy has a de-risking investment strategy for the Duke Energy Master Trust. As the funded status of the pension plans increase, the targeted allocation to return seeking assets may be reduced and the targeted allocation to fixed-income assets will be increased to better manage Duke Energy's pension liability and reduce funded status volatility. Duke Energy regularly reviews its actual asset allocation and periodically rebalances its investments to the targeted allocation when considered appropriate.

The following table presents target and actual asset allocations for the Master Trust at December 31, 2017 and 2016.

Asset Category	Target Allocation	Actual Allocation at December 31, 2017	2016
U.S. equity securities	10%	11%	11%
Non-U.S. equity securities	8%	8%	8%
Global equity securities	10%	10%	10%
Global private equity securities	3%	2%	2%
Debt securities	63%	63%	63%
Hedge funds	2%	2%	2%
Real estate and cash	2%	2%	2%
Other global securities	2%	2%	2%
Total	100%	100%	100%

EMPLOYEE SAVINGS PLAN

Duke Energy Kentucky also participates in employee savings plans sponsored by Duke Energy. Most employees participate in a matching contribution formula where Duke Energy provides a matching contribution generally equal to 100 percent of employee before-tax and Roth 401(k) contributions and, as applicable, after-tax contributions of up to 6 percent of eligible pay per period.

As of January 1, 2014, for new and rehired non-union and certain unionized employees who are not eligible to participate in Duke Energy's defined benefit plans, an additional employer contribution of 4 percent of eligible pay per pay period, which is subject to a three-year vesting schedule, is provided to the employee's savings plan account.

Duke Energy Kentucky's expense related to its proportionate share of pretax employer contributions and the additional 4 percent employer contribution was $1,035 thousand and $720 thousand for the years ended December 31, 2017 and 2016, respectively.

13. INCOME TAXES

Tax Act

On December 22, 2017, President Trump signed the Tax Act into law. Among other provisions, the Tax Act lowers the corporate federal income tax rate from 35 percent to 21 percent and eliminates bonus depreciation for regulated utilities, effective January 1, 2018. The Tax Act also could be amended or subject to technical correction, which could change the financial impacts that were recorded at December 31, 2017, or are expected to be recorded in future periods. The FERC and KSPC will determine the regulatory treatment of the impacts of the Tax Act for Duke Energy Kentucky. Duke Energy Kentucky' future results of operations, financial condition and cash flows could be adversely impacted by the Tax Act, subsequent amendments or corrections or the actions of the FERC, KSPC or credit rating agencies related to the Tax Act. Duke Energy Kentucky is reviewing orders to address the rate treatment of the Tax Act by KSPC. See Note 2 for additional information. Beginning in January 2018, Duke Energy Kentucky will defer the estimated ongoing impacts of the Tax Act that are expected to be returned to customers.

As a result of the Tax Act, Duke Energy Kentucky revalued its existing deferred tax assets and deferred tax liabilities as of December 31, 2017, to account for the estimated future impact of lower corporate tax rates on these deferred tax amounts. For Duke Energy Kentucky's regulated operations, where the reduction in the net ADIT liability is expected to be returned to customers in future rates, the net remeasurement has been deferred as a regulatory liability. The regulatory liability for income taxes includes the effect of the reduction of the net deferred tax liability including the tax gross-up of the excess ADIT liabilities and the effect of the new tax rate on the previous regulatory asset for income taxes. Excess ADITs are generally classified as either "protected" or "unprotected" under Internal Revenue Service (IRS) rules. Protected excess ADIT, resulting from accumulated tax depreciation of public utility property, are required to utilize the average rate assumption method under the IRS normalization rules for determining the timing of the return to customers. The majority of the excess ADIT is related to protected amounts associated with public utility property. See Note 2 for additional information on the Tax Act's impact to the regulatory asset and liability accounts.

On December 22, 2017, the Securities and Exchange Commission staff issued Staff Accounting Bulletin No. 118, Income Tax Accounting Implications of the Tax Cuts and Jobs Act (SAB 118), which provides guidance on accounting for the Tax Act's impact. SAB 118 provides a measurement period, which in no case should extend beyond one year from the Tax Act enactment date, during which a company acting in good faith may complete the accounting for the impacts of the Tax Act under Accounting Standards Codification (ASC) Topic 740. In accordance with SAB 118, a company must reflect the income tax effects of the Tax Act in the reporting period in which the accounting under ASC Topic 740 is complete. To the extent that a company's accounting for certain income tax effects of the Tax Act is incomplete, a company can determine a reasonable estimate for those effects and record a provisional estimate in the financial statements in the first reporting period in which a reasonable estimate can be determined.

Duke Energy Kentucky recorded a provisional net tax benefit of $21.3 million related to the Tax Act in the period ending December 31, 2017. This net benefit primarily due to the remeasurement of deferred tax accounts to reflect the corporate rate reduction impact to net deferred tax balances. The majority of Duke Energy Kentucky's operations are regulated and it is expected that the savings associated with the amount representing the remeasurement of deferred tax balances related to regulated operations will ultimately be passed on to customers. Duke Energy Kentucky recorded a regulatory liability of $133.3 million, representing the revaluation of those deferred tax balances. Duke Energy Kentucky will continue to respond to requests from KSPC to determine the timing and magnitude of savings they will pass on to customers.

The net provisional charge from deferred tax remeasurement and assessment of valuation allowance is based on currently available information and interpretations which are continuing to evolve. Duke Energy Kentucky continues to analyze additional information and guidance related to certain aspects of the Tax Act, such as conformity or decoupling by state legislatures in response to the Tax Act and the final determination of the net deferred tax liabilities subject to the remeasurement. The prospects of supplemental legislation or regulatory processes to address questions that arise because of the Tax Act, or evolving technical interpretations of the tax law, may also cause the final impact from the Tax Act to differ from the estimated amounts. Duke Energy Kentucky continues to appropriately refine such amounts within the measurement period allowed by SAB 118, which will be completed no later than the fourth quarter of 2018.

INCOME TAX EXPENSE

Components of Income Tax (Benefit) Expense

	Years Ended December 31,	
(in thousands)	**2017**	**2016**
Current income taxes:		
Federal	**$ (13,442)**	$ (580)
State	**(87)**	(361)
Total current income taxes	**(13,529)**	(941)
Deferred income taxes:		
Federal	**9,746**	15,181
State	**2,709**	2,939
Total deferred income taxes	**12,455**	18,120
Investment tax credit amortization	**(87)**	(132)
Total income tax (benefit) expense included in Statements of Operations	**$ (1,161)**	$ 17,047

Statutory Rate Reconciliation

The following table presents a reconciliation of income tax expense at the U.S. federal statutory tax rate to actual tax expense.

	Years Ended December 31,	
(in thousands)	**2017**	**2016**
Income tax expense, computed at the statutory rate of 35 percent	**$ 20,383**	$ 20,871
State income tax, net of federal income tax effect	**1,705**	1,676
Federal true-up	**(1,079)**	(5,269)
Tax Act	**(21,276)**	—
Other items, net	**(894)**	(231)
Total income tax (benefit) expense	**$ (1,161)**	$ 17,047
Effective tax rates[(a)]	**(2.0)%**	28.6%

(a) The decrease in the effective tax rate was primarily due to the revaluation of deferred tax assets and liabilities as a result of the Tax Act.

DEFERRED TAXES

Net Deferred Income Tax Liability Components

	Years Ended December 31,	
(in thousands)	**2017**	**2016**
Deferred credits and other liabilities	**$ 38**	$ 50
Tax credits and net operating loss carryforwards	**4,059**	3,668
Pension, postretirement and other employee benefits	**4,970**	6,436
Regulatory liabilities and deferred credits	**7,104**	—
Other	**581**	359
Investments and other liabilities	**718**	1,468
Total deferred income tax assets	**17,470**	11,981
Accelerated depreciation rates	**(203,907)**	(298,205)
Regulatory assets and deferred debits, net	**—**	(25,412)
Total deferred income tax liabilities	**(203,907)**	(323,617)
Net deferred income tax liabilities	**$ (186,437)**	$ (311,636)

As noted above, as a result of the Tax Act, Duke Energy Kentucky revalued its existing deferred tax assets and liabilities as of December 31, 2017, to account for the estimated future impact of lower corporate tax rates on these deferred amounts. Duke Energy Kentucky's net deferred income tax liabilities decreased $156.7 million as a result of this revaluation.

UNRECOGNIZED TAX BENEFITS

The following table presents changes to unrecognized tax benefits.

	Years Ended December 31,	
(in thousands)	**2017**	**2016**
Unrecognized tax benefits – January 1	**$ —**	$ 52
Unrecognized tax benefits increases (decreases):		
Gross increases – tax positions in prior periods	**143**	4
Decreases due to settlements	**—**	(56)
Total changes	**143**	(52)
Unrecognized tax benefits – December 31	**$ 143**	$ —

OTHER TAX MATTERS

The following table includes interest recognized in the Statements of Operations and the Balance Sheets.

	As of December 31,	
(in thousands)	**2017**	**2016**
Net interest income recognized related to income taxes	**$ —**	$ 8

Duke Energy Kentucky is no longer subject to U.S. federal examination for years before 2015. With few exceptions, Duke Energy Kentucky is no longer subject to state, local or non-U.S. income tax examinations by tax authorities for years before 2014.

14. SUBSEQUENT EVENTS

For information on subsequent events related to regulatory matters, commitments and contingencies, debt and credit facilities, asset retirement obligations, employee benefit plans and income taxes, see Notes 2, 3, 4, 5, 12 and 13.