

# **ANNUAL REPORT — 2014**

**OHIO VALLEY ELECTRIC CORPORATION**

and subsidiary

**INDIANA-KENTUCKY ELECTRIC CORPORATION**

# Ohio Valley Electric Corporation

GENERAL OFFICES, 3932 U.S. Route 23, Piketon, Ohio 45661

Ohio Valley Electric Corporation (OVEC) and its wholly owned subsidiary, Indiana-Kentucky Electric Corporation (IKEC), collectively, the Companies, were organized on October 1, 1952. The Companies were formed by investor-owned utilities furnishing electric service in the Ohio River Valley area and their parent holding companies for the purpose of providing the large electric power requirements projected for the uranium enrichment facilities then under construction by the Atomic Energy Commission (AEC) near Portsmouth, Ohio.

OVEC, AEC and OVEC's owners or their utility-company affiliates (called Sponsoring Companies) entered into power agreements to ensure the availability of the AEC's substantial power requirements. On October 15, 1952, OVEC and AEC executed a 25-year agreement, which was later extended through December 31, 2005 under a Department of Energy (DOE) Power Agreement. On September 29, 2000, the DOE gave OVEC notice of cancellation of the DOE Power Agreement. On April 30, 2003, the DOE Power Agreement terminated in accordance with the notice of cancellation.

OVEC and the Sponsoring Companies signed an Inter-Company Power Agreement (ICPA) on July 10, 1953, to support the DOE Power Agreement and provide for excess energy sales to the Sponsoring Companies of power not utilized by the DOE or its predecessors. Since the termination of the DOE Power Agreement on April 30, 2003, OVEC's entire generating capacity has been available to the Sponsoring Companies under the terms of the ICPA. The Sponsoring Companies and OVEC entered into an Amended and Restated ICPA, effective as of August 11, 2011, which extends its term to June 30, 2040.

OVEC's Kyger Creek Plant at Cheshire, Ohio, and IKEC's Clifty Creek Plant at Madison, Indiana, have nameplate generating capacities of 1,086,300 and 1,303,560 kilowatts, respectively. These two generating stations, both of which began operation in 1955, are connected by a network of 705 circuit miles of 345,000-volt transmission lines. These lines also interconnect with the major power transmission networks of several of the utilities serving the area.

The current Shareholders and their respective percentages of equity in OVEC are:

Allegheny Energy, Inc. <sup>1</sup> .....	3.50
American Electric Power Company, Inc.* .....	39.17
Buckeye Power Generating, LLC <sup>2</sup> .....	18.00
The Dayton Power and Light Company <sup>3</sup> .....	4.90
Duke Energy Ohio, Inc. <sup>4</sup> .....	9.00
Kentucky Utilities Company <sup>5</sup> .....	2.50
Louisville Gas and Electric Company <sup>5</sup> .....	5.63
Ohio Edison Company <sup>1</sup> .....	0.85
Ohio Power Company** <sup>6</sup> .....	4.30
Peninsula Generation Cooperative <sup>7</sup> .....	6.65
Southern Indiana Gas and Electric Company <sup>8</sup> .....	1.50
The Toledo Edison Company <sup>1</sup> .....	<u>4.00</u>
	<u>100.00</u>

These investor-owned utilities and affiliates of generation and transmission rural electric cooperatives comprise the Sponsoring Companies and currently share the OVEC power participation benefits and requirements in the following percentages:

Allegheny Energy Supply Company LLC <sup>1</sup> .....	3.01
Appalachian Power Company <sup>6</sup> .....	15.69
Buckeye Power Generating, LLC <sup>2</sup> .....	18.00
The Dayton Power and Light Company <sup>3</sup> .....	4.90
Duke Energy Ohio, Inc. <sup>4</sup> .....	9.00
FirstEnergy Solutions Corp. <sup>1</sup> .....	4.85
Indiana Michigan Power Company <sup>6</sup> .....	7.85
Kentucky Utilities Company <sup>5</sup> .....	2.50
Louisville Gas and Electric Company <sup>5</sup> .....	5.63
Monongahela Power Company <sup>1</sup> .....	0.49
Ohio Power Company <sup>6</sup> .....	19.93
Peninsula Generation Cooperative <sup>7</sup> .....	6.65
Southern Indiana Gas and Electric Company <sup>8</sup> .....	<u>1.50</u>
	<u>100.00</u>

Some of the Common Stock issued in the name of:

- \*American Gas & Electric Company
- \*\*Columbus and Southern Ohio Electric Company

Subsidiary or affiliate of:

- <sup>1</sup>FirstEnergy Corp.
- <sup>2</sup>Buckeye Power, Inc.
- <sup>3</sup>The AES Corporation
- <sup>4</sup>Duke Energy Corporation
- <sup>5</sup>PPL Corporation
- <sup>6</sup>American Electric Power Company, Inc.
- <sup>7</sup>Wolverine Power Supply Cooperative, Inc.
- <sup>8</sup>Vectren Corporation

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## A Message from the President

Ohio Valley Electric Corporation and its subsidiary, Indiana-Kentucky Electric Corporation, are making fundamental changes to the organization and the operation of the facilities to strive to be the energy provider of choice for the Sponsoring Companies. These fundamental changes include developing and using the skills, knowledge and culture improvement of our dedicated employees to elevate their performance toward first-decile goals. We expect these changes will produce the operational, financial and human performance results that will ensure OVEC-IKEC can continue to be an economical energy resource during these challenging times in our industry.

### SAFETY

OVEC and IKEC are committed to providing a safe and healthy place to work for all employees. In 2014, the Companies continued making progress on their transition to a culture that leads with safety through continued training on human performance improvement tools originally initiated in 2012. As a direct result of these efforts, OVEC and IKEC experienced their best safety performance on record in 2014. Strong leadership and the involvement of all employees and our contractors will help ensure that we ultimately achieve and sustain the desired goal of zero harm.

### ENERGY SALES

OVEC's use factor — the ratio of power scheduled by the Sponsoring Companies to power available — for the combined on- and off-peak periods averaged 86.5 percent in 2014 compared with 75.1 percent in 2013. The on-peak use factor averaged 96.2 percent in 2014 compared with 89.0 percent in 2013. The off-peak use factor averaged 74.1 percent in 2014 and 57.4 percent in 2013.

In 2014, OVEC delivered 11.2 million megawatt hours (MWh) to the Sponsoring Companies under the terms of the Inter-Company Power Agreement compared with 10.3 million MWh delivered in 2013.

### POWER COSTS

In 2014, OVEC's average power cost to the Sponsoring Companies was \$56.382 per MWh compared with \$65.183 per MWh in 2013. The total Sponsoring Company power costs were \$631 million in 2014 compared with \$672 million in 2013. The 2014 increased energy sales, due in part to lower winter temperatures and higher natural gas prices combined with significant cost control measures, resulted in the lowest average power cost since 2011.

### 2015 ENERGY SALES OUTLOOK

In 2015, the demand for energy is expected to remain at levels comparable to 2014. As a result, OVEC anticipates the combined use factor for 2015 will be approximately 81 percent, which will result in energy sales estimated at 11 million MWh and average power costs of approximately \$56 per MWh.

### COST CONTROL INITIATIVES

In 2014, OVEC and IKEC employees expanded the cost control focus to target specific functions in an effort to reduce costs and improve efficiencies through process improvements. These activities continue to improve the OVEC cost profile, the plant operation results and the physical work environment. The OVEC and IKEC employees are the driving force behind this culture change that will ensure that these continuous improvement efforts are sustainable.

### FLUE GAS DESULFURIZATION (FGD) PROJECTS AND ENVIRONMENTAL COMPLIANCE OBLIGATIONS

The two FGD scrubbers at Kyger Creek were successfully placed into service in November 2011 and February 2012. The two Clifty Creek plant FGD systems were successfully placed into service in March 2013 and May 2013. All four scrubbers have demonstrated that they can meet our environmental performance expectations. The pollution control systems installed at both plants are capable of meeting emission limitations under the

Mercury and Air Toxics Standards (MATS), which became effective in April 2015, as well as the Cross-State Air Pollution Rule (CSAPR), which went into effect on January 1, 2015.

OVEC and IKEC have a strong commitment to maintain compliance with all applicable federal, state and local environmental rules and regulations. During 2014, the Kyger Creek and Clifty Creek plants operated in compliance with their respective air emission limits. IKEC did receive one Notice of Violation for failing to adequately document fugitive dust control measures, and the issue has been resolved and appropriate corrective actions implemented. In addition, we continue to market the gypsum generated from our new scrubber operations as an agricultural soil amendment in Ohio and anticipate expanding that to Indiana in the coming year. Finally, we also initiated actions to meet boiler tuning and optimization obligations under MATS; prepared for the initiation of studies necessary to demonstrate compliance with aquatic life impingement and entrainment requirements under Clean Water Act, Section 316(b) regulations; and initiated actions necessary to prepare for Coal Combustion Residual regulations that were signed by the U.S. EPA Administrator in late 2014.

### **OVEC FERC ORDER 1000 COMPLIANCE**

The Federal Energy Regulatory Commission (FERC) Order 1000 issued in July 2011 requires transmission providers, including OVEC, to participate in regional and interregional transmission planning processes. Because OVEC is not a member of a Regional Transmission Organization (RTO) that provides such planning to its members, OVEC partnered with LG&E/KU to join the Southeast Regional Transmission Planning (SERTP) group. The SERTP had been formed in 2007 by a group of utilities led by Southern Company. Working with this group, OVEC was able to comply with Order 1000 by implementing the regional processes on June 1, 2014. On January 14, 2014, OVEC and its SERTP partners filed revisions to correct the issues identified by FERC in its July 18, 2013, order. FERC issued an order on April 13, 2015, accepting in part and denying in part the revisions submitted and directing specific changes to OVEC's and its SERTP partners' tariffs within 30 days. This filing was made on May 12, 2015. FERC also issued an order on January 23, 2015, accepting in part and denying in part the interregional portion of the filing. The SERTP jurisdictional entities filed revisions for interregional coordination with the

non-RTO seams on March 24, 2015, and simultaneously requested a 60-day extension to resolve outstanding issues with regard to the RTO seams, which was granted. Interregional filings for the RTO seams were made on May 26, 2015, for the PJM seam and will be made on June 22, 2015, for the MISO seam. A ruling on these filings is expected later this fall.

### **DOE ARRANGEMENTS WITH OVEC**

In 2014, OVEC purchased 242,638 MWh of power and energy from other electricity suppliers for delivery and use by the Department of Energy (DOE) for its Portsmouth facility. At the request of the DOE, OVEC makes these limited purchases of power and energy under the terms and conditions of an Arranged Power Agreement (APA) entered into in 2003 with the DOE.

As ordered by the FERC, the North American Electric Reliability Corporation (NERC) registered OVEC as the load-serving entity for the DOE load at the Portsmouth facility. OVEC has worked with the OVEC Operating Committee to implement procedures to mitigate any impacts, other than additional NERC compliance obligations, that could result from this NERC registration and to protect the Sponsors' rights to all of OVEC's generation.

On September 2, 2014, OVEC informed the DOE of its desire to no longer continue to provide the services outlined in the APA. OVEC advised the DOE that continuing with this arrangement is inconsistent with OVEC's goal of being the provider of choice for the Sponsors. OVEC further pointed out to the DOE that the utility industry has changed substantially since the existing arrangements were put into place and that they now had other options available to them to procure these services in a more economic manner from entities for whom such services are part of their core competencies. The DOE agreed to work with OVEC to transition away from the APA. The original goal was to have the APA terminated by May 31, 2015. Throughout this time, OVEC has been working with DOE to address details necessary to allow as seamless a transition as possible. The DOE has requested an additional 60 days to finish working on these details. OVEC has agreed to this extension, with the expectation that the APA will terminate on July 31, 2015. On April 28, 2015, both OVEC and the DOE signed an agreement to terminate the APA on July 31, 2015. On May 7, 2015, an application was filed with the Public Utilities Commission of Ohio outlining

OVEC's and DOE's mutual desire to terminate the APA effective as of midnight on July 31, 2015. This termination will also remove the load-serving entity obligation ordered by FERC in 2012.

Separate from the APA termination, OVEC has been negotiating with the DOE on an agreement to provide transmission support and other services related to NERC compliance, which OVEC had been providing as part of the APA.

Barring additional delays, on July 31, 2015, OVEC will have successfully ended its 60-plus year power supply relationship with the DOE.

### **PSEUDO-TIE OF PJM SPONSORS' SHARES OF OVEC-IKEC GENERATION**

On February 27, 2014, the OVEC Operating Committee voted to approve the pseudo-tie of the PJM Sponsors' shares of OVEC's generation into the PJM market in order to comply with new market rules instituted by PJM. This will place those shares under the dispatch control of PJM. The implementation was to be completed by June 1, 2017. On March 27, 2015, in response to other market changes in PJM, the OVEC Operating Committee agreed to advance the implementation by one year to June 1, 2016. Working through the Operating Committee, OVEC has been writing a cost development document and other procedures to enable OVEC to become the market interface for the PJM Sponsors. OVEC continues to work with its Energy Management System vendor and PJM to implement the necessary changes to meet the challenge of enabling operation of the pseudo-tie functionality by June 1, 2016, while continuing to assure delivery of the non-PJM Sponsors' shares under existing scheduling procedures.

### **BOARD OF DIRECTORS AND OFFICER CHANGES**

In July 2014, Wayne D. Games, vice president – power supply of Vectren Corporation, was elected to serve as a director of OVEC. Also in July 2014, David A. Lucas, vice president finance of Indiana Michigan Power, was elected to serve as a director of IKEC. In January 2015, John A. Verderame, managing director of power trading and dispatch of Duke Energy Corporation, was elected a director of OVEC, and in June 2015, he was appointed to the Executive Committee of OVEC. He succeeded Charles Whitlock, who had served on the OVEC board and as a member of the Executive Committee since 2006. In June 2015, Robert P. Powers, executive vice president and chief

operating officer of American Electric Power Company, Inc., was appointed to the Executive Committee of OVEC.

Also in June 2015, Justin J. Cooper was elected assistant secretary of OVEC and IKEC.



Nicholas K. Akins  
President

June 17, 2015

**OHIO VALLEY ELECTRIC CORPORATION  
AND SUBSIDIARY COMPANY**

**CONSOLIDATED BALANCE SHEETS  
AS OF DECEMBER 31, 2014 AND 2013**

	2014	2013
<b>ASSETS</b>		
ELECTRIC PLANT:		
At original cost	\$2,706,385,652	\$2,671,807,219
Less—accumulated provisions for depreciation	<u>1,245,490,373</u>	<u>1,182,491,224</u>
	1,460,895,279	1,489,315,995
Construction in progress	<u>15,329,947</u>	<u>30,583,795</u>
Total electric plant	<u>1,476,225,226</u>	<u>1,519,899,790</u>
CURRENT ASSETS:		
Cash and cash equivalents	43,453,966	70,757,710
Accounts receivable	40,001,960	35,332,653
Fuel in storage	44,335,429	43,020,394
Materials and supplies	34,499,713	32,564,435
Property taxes applicable to future years	2,780,000	2,702,905
Emission allowances	-	62,428
Deferred tax assets	4,237,801	9,980,768
Income taxes receivable	-	3,331,536
Regulatory assets	-	371,297
Prepaid expenses and other	<u>2,208,613</u>	<u>2,244,413</u>
Total current assets	<u>171,517,482</u>	<u>200,368,539</u>
REGULATORY ASSETS:		
Unrecognized postemployment benefits	1,437,151	2,078,864
Pension benefits	32,475,646	8,542,293
Income taxes billable to customers	<u>1,036,268</u>	<u>-</u>
Total regulatory assets	<u>34,949,065</u>	<u>10,621,157</u>
DEFERRED CHARGES AND OTHER:		
Unamortized debt expense	12,258,005	13,401,209
Deferred tax assets	-	19,432,479
Long-term investments	122,502,773	117,106,668
Other	<u>120,877</u>	<u>488,407</u>
Total deferred charges and other	<u>134,881,655</u>	<u>150,428,763</u>
<b>TOTAL</b>	<u><u>\$1,817,573,428</u></u>	<u><u>\$1,881,318,249</u></u>

(Continued)

**OHIO VALLEY ELECTRIC CORPORATION  
AND SUBSIDIARY COMPANY**

**CONSOLIDATED BALANCE SHEETS  
AS OF DECEMBER 31, 2014 AND 2013**

	<b>2014</b>	<b>2013</b>
<b>CAPITALIZATION AND LIABILITIES</b>		
CAPITALIZATION:		
Common stock, \$100 par value—authorized, 300,000 shares; outstanding, 100,000 shares in 2014 and 2013	\$ 10,000,000	\$ 10,000,000
Long-term debt	1,274,895,961	1,267,873,554
Line of credit borrowings	20,000,000	30,000,000
Retained earnings	<u>7,031,723</u>	<u>6,478,234</u>
Total capitalization	<u>1,311,927,684</u>	<u>1,314,351,788</u>
CURRENT LIABILITIES:		
Current portion of long-term debt	243,000,194	290,496,381
Accounts payable	54,104,896	50,131,367
Accrued other taxes	9,410,141	9,062,813
Regulatory liabilities	14,065,394	27,406,208
Accrued interest and other	<u>23,614,552</u>	<u>28,145,464</u>
Total current liabilities	<u>344,195,177</u>	<u>405,242,233</u>
COMMITMENTS AND CONTINGENCIES (Notes 3, 11, 12)		
REGULATORY LIABILITIES:		
Postretirement benefits	33,650,545	32,619,457
Decommissioning and demolition	14,102,619	19,140,730
Investment tax credits	-	3,393,146
Net antitrust settlement	-	1,823,929
Income taxes refundable to customers	<u>-</u>	<u>28,380,282</u>
Total regulatory liabilities	<u>47,753,164</u>	<u>85,357,544</u>
OTHER LIABILITIES:		
Pension liability	32,475,646	8,542,293
Deferred tax liability	4,237,801	-
Asset retirement obligations	29,547,185	22,230,109
Postretirement benefits obligation	44,875,752	42,173,401
Postemployment benefits obligation	1,437,151	2,078,864
Other noncurrent liabilities	<u>1,123,868</u>	<u>1,342,017</u>
Total other liabilities	<u>113,697,403</u>	<u>76,366,684</u>
TOTAL	<u>\$1,817,573,428</u>	<u>\$1,881,318,249</u>

See notes to consolidated financial statements.

(Concluded)

**OHIO VALLEY ELECTRIC CORPORATION  
AND SUBSIDIARY COMPANY**

**CONSOLIDATED STATEMENTS OF INCOME AND RETAINED EARNINGS  
FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013**

	<b>2014</b>	<b>2013</b>
OPERATING REVENUES—Sales of electric energy to:		
Department of Energy	\$ 11,758,386	\$ 9,281,567
Sponsoring Companies	<u>644,415,791</u>	<u>666,367,706</u>
Total operating revenues	<u>656,174,177</u>	<u>675,649,273</u>
OPERATING EXPENSES:		
Fuel and emission allowances consumed in operation	315,460,920	311,899,995
Purchased power	11,180,650	8,763,157
Other operation	92,885,913	98,197,470
Maintenance	90,766,181	83,396,811
Depreciation	65,179,764	80,172,750
Taxes—other than income taxes	12,094,519	11,421,154
Income taxes	<u>331,834</u>	<u>890,377</u>
Total operating expenses	<u>587,899,781</u>	<u>594,741,714</u>
OPERATING INCOME	68,274,396	80,907,559
OTHER INCOME	<u>9,888,500</u>	<u>530,109</u>
INCOME BEFORE INTEREST CHARGES	<u>78,162,896</u>	<u>81,437,668</u>
INTEREST CHARGES:		
Amortization of debt expense	5,075,785	5,166,736
Interest expense	<u>72,533,622</u>	<u>74,086,666</u>
Total interest charges	<u>77,609,407</u>	<u>79,253,402</u>
NET INCOME	553,489	2,184,266
RETAINED EARNINGS—Beginning of year	6,478,234	5,293,968
CASH DIVIDENDS ON COMMON STOCK	<u>-</u>	<u>(1,000,000)</u>
RETAINED EARNINGS—End of year	<u>\$ 7,031,723</u>	<u>\$ 6,478,234</u>

See notes to consolidated financial statements.



# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

	2014	2013
<b>OPERATING ACTIVITIES:</b>		
Net income	\$ 553,489	\$ 2,184,266
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	65,179,764	80,172,750
Amortization of debt expense	5,075,785	5,166,736
Deferred taxes/refundable taxes	3,328,233	890,065
(Gain) on marketable securities	(5,202,492)	4,331,444
Changes in assets and liabilities:		
Accounts receivable	(4,669,307)	1,620,172
Fuel in storage	(1,315,035)	36,529,701
Materials and supplies	(1,935,278)	(5,100,017)
Property taxes applicable to future years	(77,095)	(199,465)
Emission allowances	62,428	24,221
Income taxes receivable	-	12,501,130
Prepaid expenses and other	35,800	(76,270)
Other regulatory assets	(22,920,343)	46,467,540
Other noncurrent assets	367,530	(385,300)
Accounts payable	6,483,713	(829,201)
Accrued taxes	347,328	411,706
Accrued interest and other	(4,530,912)	2,322,890
Other liabilities	33,845,581	(59,752,402)
Other regulatory liabilities	<u>(22,564,912)</u>	<u>28,162,184</u>
Net cash provided by operating activities	<u>52,064,277</u>	<u>154,442,150</u>
<b>INVESTING ACTIVITIES:</b>		
Electric plant additions	(24,015,385)	(87,262,647)
Proceeds from sale of LT investments	18,435,960	97,023,136
Purchases of long-term investments	<u>(18,629,572)</u>	<u>(40,170,784)</u>
Net cash used in investing activities	<u>(24,208,997)</u>	<u>(30,410,295)</u>
<b>FINANCING ACTIVITIES:</b>		
Loan origination cost	(3,909,981)	(4,059,559)
Repayment of Senior 2006 Notes	(16,525,607)	(15,602,389)
Repayment of Senior 2007 Notes	(11,680,666)	(11,017,149)
Repayment of Senior 2008 Notes	(12,290,107)	(11,519,366)
Proceeds from line of credit	40,000,000	10,000,000
Payments on line of credit	(50,000,000)	(40,000,000)
Principal payments under capital leases	(752,663)	-
Dividends on common stock	-	(1,000,000)
Net cash provided by financing activities	<u>(55,159,024)</u>	<u>(73,198,463)</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(27,303,744)	50,833,392
CASH AND CASH EQUIVALENTS—Beginning of year	<u>70,757,710</u>	<u>19,924,318</u>
CASH AND CASH EQUIVALENTS—End of year	<u>\$ 43,453,966</u>	<u>\$ 70,757,710</u>
<b>SUPPLEMENTAL DISCLOSURES:</b>		
Interest paid	<u>\$ 74,387,920</u>	<u>\$ 74,902,175</u>
Income taxes paid (received)—net	<u>\$ 1,905,645</u>	<u>\$ (12,501,572)</u>
Noncash electric plant additions included in accounts payable at December 31	<u>\$ 3,187,502</u>	<u>\$ 5,697,686</u>

See notes to consolidated financial statements.

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

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### 1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

**Consolidated Financial Statements** — The consolidated financial statements include the accounts of Ohio Valley Electric Corporation (OVEC) and its wholly owned subsidiary, Indiana-Kentucky Electric Corporation (IKEC), collectively, the Companies. All intercompany transactions have been eliminated in consolidation.

**Organization** — The Companies own two generating stations located in Ohio and Indiana with a combined electric production capability of approximately 2,256 megawatts. OVEC is owned by several investor-owned utilities or utility holding companies and two affiliates of generation and transmission rural electric cooperatives. These entities or their affiliates comprise the Sponsoring Companies. The Sponsoring Companies purchase power from OVEC according to the terms of the Inter-Company Power Agreement (ICPA), which has a current termination date of June 30, 2040. Approximately 26% of the Companies' employees are covered by a collective bargaining agreement that expires August 31, 2017.

Prior to 2004, OVEC's primary commercial customer was the U.S. Department of Energy (DOE). The contract to provide OVEC-generated power to the DOE was terminated in 2003 and all obligations were settled at that time. Currently, OVEC has an agreement to arrange for the purchase of power (Arranged Power), under the direction of the DOE, for resale directly to the DOE. All purchase costs are billable by OVEC to the DOE.

**Rate Regulation**—The proceeds from the sale of power to the Sponsoring Companies are designed to be sufficient for OVEC to meet its operating expenses and fixed costs, as well as earn a return on equity before federal income taxes. In addition, the proceeds from power sales are designed to cover debt amortization and interest expense associated with financings. The Companies have continued and expect to continue to operate pursuant to the cost plus rate of return recovery provisions at least to June 30, 2040, the date of termination of the ICPA. However, during 2014, the Companies began reducing their billings under the ICPA in order to effectively forego recovery of the equity return and to pass only incurred costs on to customers through the ICPA billings.

The accounting guidance for Regulated Operations provides that rate-regulated utilities account for and report assets and liabilities consistent with the economic effect of the way in which rates are established, if the rates established are designed to recover the costs of providing the regulated service and it is probable that such rates can be charged and collected. The Companies follow the accounting and reporting requirements in accordance with the guidance for Regulated Operations. Certain expenses and credits subject to utility regulation or rate determination normally reflected in income are deferred on the accompanying consolidated balance sheets and are recognized in income as the related amounts are included in service rates and recovered from or refunded to customers.

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

The Companies' regulatory assets, liabilities, and amounts authorized for recovery through Sponsor billings at December 31, 2014 and 2013, were as follows:

	2014	2013
Regulatory assets:		
Current assets:		
Lease termination costs/liquidated damages	\$ -	\$ 371,297
Unrecognized loss on coal sales	-	-
Total	<u>-</u>	<u>371,297</u>
Other assets:		
Unrecognized postemployment benefits	1,437,151	2,078,864
Pension benefits	32,475,646	8,542,293
Postretirement benefits	1,036,268	-
Total	<u>34,949,065</u>	<u>10,621,157</u>
Total regulatory assets	<u>\$ 34,949,065</u>	<u>\$ 10,992,454</u>
Regulatory liabilities:		
Current liabilities:		
Deferred credit—EPA emission allowance proceeds	\$ 226,507	\$ 275,108
Deferred revenue—voluntary severance	-	1,510,609
Deferred revenue—advances for construction	11,374,950	23,158,632
Other deferred revenue	351,534	-
Deferred credit—gain on coal sale	-	246,701
Deferred credit—advance collection of interest	2,112,403	2,215,158
Total	<u>14,065,394</u>	<u>27,406,208</u>
Other liabilities:		
Post retirement benefits	33,650,545	32,619,457
Decommissioning and demolition	14,102,619	19,140,730
Investment tax credits	-	3,393,146
Net antitrust settlement	-	1,823,929
Income taxes refundable to customers	-	28,380,282
Total	<u>47,753,164</u>	<u>85,357,544</u>
Total regulatory liabilities	<u>\$ 61,818,558</u>	<u>\$ 112,763,752</u>

**Regulatory Assets** — Regulatory assets consist primarily of pension benefit costs, postemployment benefit costs and income taxes billable to customers. The Companies' current billing policy for pension and postemployment benefit costs is to bill their actual plan funding. Income taxes billable to customers are primarily billed to customers in the period when the related deferred tax liabilities are realized. The

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

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fuel related costs, including railcar lease termination costs and liquidated damages, were billed to customers in 2014.

**Regulatory Liabilities**—The regulatory liabilities classified as current in the accompanying consolidated balance sheet as of December 31, 2014, consist primarily of interest expense collected from customers in advance of expense recognition and customer billings for construction in progress. These amounts will be credited to customer bills during 2015. In October 2013, OVEC announced a voluntary severance program for active employees who would be retirement-eligible by the end of 2014. Approved employees in the program were entitled to receive a one-time severance payment and retired on agreed-upon dates no later than January 1, 2015. Total costs related to the payments were approximately \$4.6 million for OVEC and approximately \$1.6 million for IKEC, of which \$3.5 million for OVEC and \$1.2 million for IKEC were expensed in 2013 recorded in the Other Operation under Operating Expenses. As the Companies had collected the entire expected costs from Sponsor Companies as of December 31, 2013, the remaining \$1.1 million for OVEC and \$0.4 million for IKEC were recorded as a regulatory liability at December 31, 2013 and expensed during 2014. Other regulatory liabilities consist primarily of income taxes refundable to customers, postretirement benefits, and decommissioning and demolition costs. Income taxes refundable to customers are credited to customer bills in the period when any related deferred tax assets are realized.

In 2003, the DOE terminated the DOE Power Agreement with OVEC, entitling the Sponsoring Companies to 100% of OVEC's generating capacity under the terms of the ICPA. Under the terms of the DOE Power Agreement, OVEC was entitled to receive a "termination payment" from the DOE to recover unbilled costs upon termination of the agreement. The termination payment included unbilled postretirement benefit costs. In 2003, OVEC recorded a settlement payment of \$97 million for the DOE obligation related to postretirement benefit costs. The regulatory liability for postretirement benefits recorded at December 31, 2014 and December 31, 2013, represents amounts collected in historical billings in excess of the Generally Accepted Accounting Principles (GAAP) net periodic benefit costs, including the DOE termination payment and incremental unfunded plan obligations recognized in the balance sheets but not yet recognizable in GAAP net periodic benefit costs. The Companies' ratemaking policy will recover postretirement benefits in an amount equal to estimated benefit accrual cost plus amortization of unfunded liabilities, if any. As a result, related regulatory liabilities are being credited to customer bills on a long-term basis.

**Cash and Cash Equivalents**—Cash and cash equivalents primarily consist of cash and money market funds and their carrying value approximates fair value. For purposes of these statements, the Companies consider temporary cash investments to be cash equivalents since they are readily convertible into cash and have original maturities of less than three months.

**Electric Plant**—Property additions and replacements are charged to utility plant accounts. Depreciation expense is recorded at the time property additions and replacements are billed to customers or at the date the property is placed in service if the in-service date occurs subsequent to the customer billing. Customer billings for construction in progress are recorded as deferred revenue-advances for construction. These amounts are closed to revenue at the time the related property is placed in service. Depreciation expense and accumulated depreciation are recorded when financed property additions and replacements are recovered over a period of years through customer debt retirement billing. All depreciable property will be fully billed and depreciated prior to the expiration of the ICPA. Repairs of property are charged to maintenance expense.

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

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**Fuel in Storage, Emission Allowances, and Materials and Supplies**—The Companies maintain coal, reagent, and oil inventories for use in the generation of electricity and emission allowance inventories for regulatory compliance purposes due to the generation of electricity. These inventories are valued at average cost, less reserves for obsolescence. Materials and supplies consist primarily of replacement parts necessary to maintain the generating facilities and are valued at average cost.

**Long-Term Investments**—Long-term investments consist of marketable securities that are held for the purpose of funding postretirement benefits and decommissioning and demolition costs. These securities have been classified as trading securities in accordance with the provisions of the accounting guidance for Investments—Debt and Equity Securities. Trading securities reflected in Long-Term Investments are carried at fair value with the unrealized gain or loss, reported in Other Income (Expense). The cost of securities sold is based on the specific identification cost method. The fair value of most investment securities is determined by reference to currently available market prices. Where quoted market prices are not available, we use the market price of similar types of securities that are traded in the market to estimate fair value. See Fair Value Measurements in Note 10. Due to tax limitations, the amounts held in the postretirement benefits portfolio have not yet been transferred to the Voluntary Employee Beneficiary Association (VEBA) trusts (see Note 8). Long-term investments primarily consist of municipal bonds, money market mutual fund investments, and mutual funds. Net unrealized gains (losses) recognized during 2014 and 2013 on securities still held at the balance sheet date were \$5,093,925 and \$(3,698,604), respectively.

**Fair Value Measurements of Assets and Liabilities**—The accounting guidance for Fair Value Measurements and Disclosures establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). Where observable inputs are available, pricing may be completed using comparable securities, dealer values, and general market conditions to determine fair value. Valuation models utilize various inputs that include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in inactive markets, and other observable inputs for the asset or liability.

**Unamortized Debt Expense**—Unamortized debt expense relates to loan origination costs incurred to secure financing. These costs are being amortized using the effective yield method over the life of the related loans.

**Asset Retirement Obligations and Asset Retirement Costs**—The Companies recognize the fair value of legal obligations associated with the retirement or removal of long-lived assets at the time the obligations are incurred and can be reasonably estimated. The initial recognition of this liability is accompanied by a corresponding increase in depreciable electric plant. Subsequent to the initial recognition, the liability is adjusted for any revisions to the expected value of the retirement obligation (with corresponding adjustments to electric plant) and for accretion of the liability due to the passage of time.

These asset retirement obligations are primarily related to obligations associated with future asbestos abatement at certain generating stations and certain plant closure costs.

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

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Balance—January 1, 2013	\$ 20,961,379
Accretion	1,450,943
Liabilities settled	<u>(182,213)</u>
Balance—December 31, 2013	22,230,109
Accretion	1,466,117
Liabilities settled	(35,122)
Revision to cash flows	<u>5,886,081</u>
Balance—December 31, 2014	<u>\$ 29,547,185</u>

During 2014 the Companies completed an updated study to estimate the asset retirement costs described above. The revised estimated costs are recorded in the accompanying balance sheets.

The Companies do not recognize liabilities for asset retirement obligations for which the fair value cannot be reasonably estimated. The Companies have asset retirement obligations associated with transmission assets at certain generating stations. However, the retirement date for these assets cannot be determined; therefore, the fair value of the associated liability currently cannot be estimated and no amounts are recognized in the consolidated financial statements herein.

**Income Taxes**—The Companies use the liability method of accounting for income taxes. Under the liability method, the Companies provide deferred income taxes for all temporary differences between the book and tax basis of assets and liabilities which will result in a future tax consequence. The Companies account for uncertain tax positions in accordance with the accounting guidance for Income Taxes.

**Use of Estimates**—The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**New Accounting Pronouncements**—In May 2014, the FASB issued an accounting standards update which amends the guidance for revenue recognition. This amendment contains principals that will require an entity to recognize revenue to depict the transfer of goods and services to customers at an amount that an entity expects to be entitled to in exchange for goods or services. The amendment sets forth a new revenue recognition model that requires identifying the contract, identifying the performance obligations and recognizing the revenue upon satisfaction of performance obligations. This amendment is effective for the Companies beginning January 1, 2017. At this time, the Companies have not determined the impact of this amendment to the Companies' financial statements.

In August 2014, the FASB issued guidance that requires management to evaluate whether there are conditions or events that raise substantial doubt about the entity's ability to continue as a going concern within one year from the date the financial statements are issued. The new guidance is effective for reporting periods beginning after December 15, 2016. The new guidance is effective for the Companies beginning January 1, 2017. The Companies are currently evaluating the impact that the new accounting standard will have on the financial statements.

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

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**Subsequent Events**—In preparing the accompanying financial statements and disclosures, the Companies reviewed subsequent events through April 16, 2015, which is the date the consolidated financial statements were issued.

### 2. RELATED-PARTY TRANSACTIONS

Transactions with the Sponsoring Companies during 2014 and 2013 included the sale of all generated power to them, the purchase of Arranged Power from them and other utility systems in order to meet the Department of Energy's power requirements, contract barging services, railcar services, and minor transactions for services and materials. The Companies have Power Agreements with Louisville Gas and Electric Company, Duke Energy Ohio, Inc., The Dayton Power and Light Company, Kentucky Utilities Company, Ohio Edison Company, and American Electric Power Service Corporation as agent for the American Electric Power System Companies; and Transmission Service Agreements with Louisville Gas and Electric Company, Duke Energy Ohio, Inc., The Dayton Power and Light Company, The Toledo Edison Company, Ohio Edison Company, Kentucky Utilities Company, and American Electric Power Service Corporation as agent for the American Electric Power System Companies.

At December 31, 2014 and 2013, balances due from the Sponsoring Companies are as follows:

	<b>2014</b>	<b>2013</b>
Accounts receivable	<u>\$ 34,842,796</u>	<u>\$ 31,129,486</u>

During 2014 and 2013, American Electric Power accounted for approximately 43% of operating revenues from Sponsoring Companies and Buckeye Power accounted for 18%. No other Sponsoring Company accounted for more than 10%.

American Electric Power Company, Inc. and subsidiary company owned 43.47% of the common stock of OVEC as of December 31, 2014. The following is a summary of the principal services received from the American Electric Power Service Corporation as authorized by the Companies' Boards of Directors:

	<b>2014</b>	<b>2013</b>
General services	\$ 3,009,076	\$ 3,384,509
Specific projects	<u>2,732,041</u>	<u>10,964,133</u>
Total	<u>\$ 5,741,117</u>	<u>\$ 14,348,642</u>

General services consist of regular recurring operation and maintenance services. Specific projects primarily represent nonrecurring plant construction projects and engineering studies, which are approved by the Companies' Boards of Directors. The services are provided in accordance with the service agreement dated December 15, 1956, between the Companies and the American Electric Power Service Corporation.

### 3. COAL SUPPLY

The Companies have coal supply agreements with certain nonaffiliated companies that expire at various dates from the year 2015 through 2017. Pricing for coal under these contracts is subject to contract provisions and adjustments. The Companies currently have approximately 100% of their 2015 coal requirements under contract. These contracts are based on rates in effect at the time of purchase.

**OHIO VALLEY ELECTRIC CORPORATION  
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**4. ELECTRIC PLANT**

Electric plant at December 31, 2014 and 2013, consists of the following:

	<b>2014</b>	<b>2013</b>
Steam production plant	\$ 2,615,435,925	\$ 2,582,429,102
Transmission plant	77,990,925	76,855,762
General plant	12,932,238	12,495,791
Intangible	<u>26,564</u>	<u>26,564</u>
	2,706,385,652	2,671,807,219
Less accumulated depreciation	<u>1,245,490,373</u>	<u>1,182,491,224</u>
	1,460,895,279	1,489,315,995
Construction in progress	<u>15,329,947</u>	<u>30,583,795</u>
Total electric plant	<u>\$ 1,476,225,226</u>	<u>\$ 1,519,899,790</u>

All property additions and replacements are fully depreciated on the date the property is placed in service, unless the addition or replacement relates to a financed project. As the Companies' policy is to bill in accordance with the principal billings of the debt agreements, all financed projects are being depreciated in amounts equal to the principal payments on outstanding debt.

**5. BORROWING ARRANGEMENTS AND NOTES**

OVEC has an unsecured bank revolving line of credit agreement with a borrowing limit of \$200 million as of December 31, 2014 and \$275 million as of December 31, 2013. The \$200 million line of credit has an expiration date of November 17, 2019. At December 31, 2014 and 2013, OVEC had borrowed \$20 million and \$30 million, respectively, under this line of credit. Interest expense related to line of credit borrowings was \$212,497 in 2014 and \$634,109 in 2013. During 2014 and 2013, OVEC incurred annual commitment fees of \$782,455 and \$737,792, respectively, based on the borrowing limits of the line of credit.



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**6. LONG-TERM DEBT**

The following amounts were outstanding at December 31, 2014 and 2013:

	Interest Rate	2014	2013
Senior 2006 Notes:			
2006A due February 15, 2026	5.80 %	\$ 261,689,554	\$ 277,326,804
2006B due June 15, 2040	6.40	59,530,005	60,418,362
Senior 2007 Notes:			
2007A-A due February 15, 2026	5.90	118,269,553	125,578,853
2007A-B due February 15, 2026	5.90	30,022,192	31,625,801
2007A-C due February 15, 2026	5.90	29,785,026	31,877,625
2007B-A due June 15, 2040	6.50	29,740,287	30,188,693
2007B-B due June 15, 2040	6.50	7,489,798	7,602,725
2007B-C due June 15, 2040	6.50	7,549,435	7,663,261
Senior 2008 Notes:			
2008A due February 15, 2026	5.92	36,907,905	39,185,975
2008B due February 15, 2026	6.71	74,433,137	78,865,206
2008C due February 15, 2026	6.71	76,117,755	80,487,688
2008D due June 15, 2040	6.91	43,081,900	43,681,707
2008E due June 15, 2040	6.91	43,830,471	44,440,700
Series 2009 Bonds:			
2009A due February 1, 2026	0.60	25,000,000	25,000,000
2009B due February 1, 2026	0.48	25,000,000	25,000,000
2009C due February 1, 2026	0.60	25,000,000	25,000,000
2009D due February 1, 2026	0.48	25,000,000	25,000,000
2009E due October 1, 2019	5.63	100,000,000	100,000,000
Series 2010 Bonds:			
2010A due June 29, 2017	1.44	50,000,000	50,000,000
2010B due June 29, 2016	1.44	50,000,000	50,000,000
Series 2012 Bonds:			
2012A due June 1, 2032	5.00	76,800,000	77,080,192
2012A due June 1, 2039	5.00	123,200,000	122,346,343
2012B due June 1, 2040	0.72	50,000,000	50,000,000
2012C due June 1, 2040	0.36	50,000,000	50,000,000
Series 2013 Notes:			
2013A due February 15, 2018	1.66	<u>100,000,000</u>	<u>100,000,000</u>
Total debt		1,518,447,018	1,558,369,935
Total premiums and discounts (net)		<u>(550,863)</u>	<u>-</u>
Total debt net of premiums and discounts		1,517,896,155	1,558,369,935
Current portion of long-term debt		<u>243,000,194</u>	<u>290,496,381</u>
Total long-term debt		<u>\$1,274,895,961</u>	<u>\$1,267,873,554</u>

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

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All of the OVEC amortizing unsecured senior notes have maturities scheduled for February 15, 2026, or June 15, 2040, as noted in the previous table.

During 2009, OVEC issued \$100 million variable rate non-amortizing unsecured senior notes (2009A Notes) in private placement, a series of four \$25 million variable rate non-amortizing tax exempt pollution control bonds (2009A, B, C, and D Bonds), and \$100 million fixed rate non-amortizing tax exempt pollution control bonds (2009E Bonds). The variable rates listed above reflect the interest rate in effect at December 31, 2014.

The 2009 Series A, B, C, and D Bonds are secured by irrevocable transferable direct-pay letters of credit, expiring August 12, 2016, and August 21, 2016, issued for the benefit of the owners of the bonds. The interest rate on the bonds are adjusted weekly, and bondholders may require repurchase of the bonds at the time of such interest rate adjustments. OVEC has entered into an agreement to provide for the remarketing of the bonds if such repurchase is required. The 2009A, B, C, and D Series Bonds are current, as they are redeemable at the election of the holders at any time.

In December 2010, OVEC established a borrowing facility under which OVEC borrowed, in 2011, \$100 million variable rate bonds due February 1, 2040. In June 2011, the \$100 million variable rate bonds were issued as two \$50 million non-amortizing pollution control revenue bonds (Series 2010A and 2010B) with initial interest periods of three years and five years, respectively. The Series 2010A bond was extended for another three years in June 2014 to June 29, 2017.

During 2012, OVEC issued \$200 million fixed rate tax-exempt midwestern disaster relief revenue bonds (2012A Bonds) and two series of \$50 million variable rate tax-exempt midwestern disaster relief revenue bonds (2012B and 2012C Bonds). The 2012A, 2012B, and 2012C Bonds will begin amortizing June 1, 2027, to their respective maturity dates. The variable rates listed above reflect the interest rate in effect at December 31, 2014.

The 2012B and 2012C Bonds are secured by irrevocable transferable direct-pay letters of credit, expiring June 28, 2017, and June 28, 2015, issued for the benefit of the owners of the bonds. The interest rates on the bonds are adjusted weekly, and bondholders may require repurchase of the bonds at the time of such interest rate adjustments. OVEC has entered into agreements to provide for the remarketing of the bonds if such repurchase is required. The 2012B and 2012C Bonds are current, as they are redeemable at the election of the holders at any time.

In 2013, the \$100 million 2009A Notes were retired on February 15, 2013, with funding from the issuance of \$100 million 2013A variable rate non-amortizing unsecured senior notes (2013A Notes). The 2013A Notes mature on February 15, 2018.

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The annual maturities of long-term debt as of December 31, 2014, are as follows:

2015	\$ 243,000,194
2016	95,536,872
2017	48,461,307
2018	51,460,006
2019	154,647,515
2020–2040	<u>925,341,124</u>
Total	<u>\$1,518,447,018</u>

Note that the 2015 current maturities of long-term debt include \$200 million of remarketable variable-rate bonds. The Companies expect cash maturities of only \$43,000,194 to the extent the remarketing agents are successful in their ongoing efforts to remarket the bonds through the contractual maturity dates in February 2026 and June 2040.

### 7. INCOME TAXES

OVEC and IKEC file a consolidated federal income tax return. The effective tax rate varied from the statutory federal income tax rate due to differences between the book and tax treatment of various transactions as follows:

	2014	2013
Income tax expense at 35% statutory rate	\$ 309,862	\$ 1,076,125
State income taxes—net of federal benefit	203,769	-
Temporary differences flowed through to customer bills	(200,141)	(212,144)
Permanent differences and other	<u>18,344</u>	<u>26,396</u>
Income tax provision	<u>\$ 331,834</u>	<u>\$ 890,377</u>

Components of the income tax provision were as follows:

	2014	2013
Current income tax (benefit)/expense	\$ 313,490	\$ -
Deferred income tax expense/(benefit)	<u>18,344</u>	<u>890,377</u>
Total income tax provision	<u>\$ 331,834</u>	<u>\$ 890,377</u>

OVEC and IKEC record deferred tax assets and liabilities based on differences between book and tax basis of assets and liabilities measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. Deferred tax assets and liabilities are adjusted for changes in tax rates.

To the extent that the Companies have not reflected credits in customer billings for deferred tax assets, they have recorded a regulatory liability representing income taxes refundable to customers under the applicable agreements among the parties. The regulatory liability was \$0 and \$28,380,282 at December 31, 2014 and 2013, respectively.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

Deferred income tax assets (liabilities) at December 31, 2014 and 2013, consisted of the following:

	2014	2013
Deferred tax assets:		
Deferred revenue—advances for construction	\$ 4,108,103	\$ 8,110,780
AMT credit carryforwards	12,030,465	2,574,572
Federal net operating loss carryforwards	68,603,277	61,312,280
Postretirement benefit obligation	15,721,185	14,770,267
Pension liability	9,835,656	1,684,610
Postemployment benefit obligation	503,473	728,074
Asset retirement obligations	10,351,175	7,785,586
Miscellaneous accruals	2,705,995	2,131,262
Regulatory liability—other	30,927	1,288,943
Regulatory liability—investment tax credits	-	1,188,372
Regulatory liability—net antitrust settlement	-	638,789
Regulatory liability—asset retirement costs	4,951,051	6,703,602
Regulatory liability—postretirement benefits	10,587,096	10,283,147
Regulatory liability—income taxes refundable to customers	-	-
	<u>15,575,898</u>	<u>13,856,458</u>
Total deferred tax assets	<u>155,004,301</u>	<u>133,056,742</u>
Deferred tax liabilities:		
Prepaid expenses	(660,931)	(679,165)
Electric plant	(92,761,349)	(85,468,227)
Unrealized gain/loss on marketable securities	(5,281,413)	(3,580,925)
Regulatory asset—postretirement benefits	-	-
Regulatory asset—pension benefits	(11,377,094)	(2,991,742)
Regulatory asset—unrecognized postemployment benefits	<u>(503,473)</u>	<u>(728,074)</u>
Total deferred tax liabilities	<u>(110,584,260)</u>	<u>(93,448,133)</u>
Valuation allowance	<u>(44,420,041)</u>	<u>(10,195,362)</u>
Deferred income tax assets	<u>\$ -</u>	<u>\$ 29,413,247</u>
Current deferred income taxes	\$ 4,237,801	\$ 9,980,768
Noncurrent deferred income taxes	(4,237,801)	19,432,479

As discussed in Note 1, OVEC indefinitely changed its billing practices in 2014 to effectively suspend billings for its authorized equity return. As a result, the Companies' long-term expectation is that taxable income will be breakeven for the foreseeable future. Accordingly, the Companies have recorded a valuation allowance as of December 31, 2014.

The accounting guidance for Income Taxes addresses the determination of whether the tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under this guidance, the Companies may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

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position are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. The Companies have not identified any uncertain tax positions as of December 31, 2014 and 2013, and accordingly, no liabilities for uncertain tax positions have been recognized.

The Companies file income tax returns with the Internal Revenue Service and the states of Ohio, Indiana, and the Commonwealth of Kentucky. The Companies are no longer subject to federal tax examinations for tax years 2010 and earlier. The Companies completed an audit by the Internal Revenue Service for the tax years ended December 31, 2008 through December 31, 2012. The Companies are no longer subject to State of Indiana tax examinations for tax years 2010 and earlier. The Companies are no longer subject to Ohio and the Commonwealth of Kentucky examinations for tax years 2009 and earlier.

### **8. PENSION PLAN, OTHER POSTRETIREMENT AND POSTEMPLOYMENT BENEFITS**

The Companies have a noncontributory qualified defined benefit pension plan (the Pension Plan) covering substantially all of their employees. The benefits are based on years of service and each employee's highest consecutive 36-month compensation period. Employees are vested in the Pension Plan after five years of service with the Companies.

Funding for the Pension Plan is based on actuarially determined contributions, the maximum of which is generally the amount deductible for income tax purposes and the minimum being that required by the Employee Retirement Income Security Act of 1974 (ERISA), as amended.

In addition to the Pension Plan, the Companies provide certain health care and life insurance benefits (Other Postretirement Benefits) for retired employees. Substantially all of the Companies' employees become eligible for these benefits if they reach retirement age while working for the Companies. These and similar benefits for active employees are provided through employer funding and insurance policies. In December 2004, the Companies established Voluntary Employee Beneficiary Association (VEBA) trusts. In January 2011, the Companies established an IRC Section 401(h) account under the Pension Plan.

The full cost of the pension benefits and other postretirement benefits has been allocated to OVEC and IKEC in the accompanying consolidated financial statements. The allocated amounts represent approximately a 56% and 44% split between OVEC and IKEC, respectively, as of December 31, 2014, and approximately a 57% and 43% split between OVEC and IKEC, respectively, as of December 31, 2013.

The Pension Plan's assets as of December 31, 2014, consist of investments in equity and debt securities.

All of the trust funds' investments for the pension and postemployment benefit plans are diversified and managed in compliance with all laws and regulations. Management regularly reviews the actual asset allocation and periodically rebalances the investments to targeted allocation when appropriate. The investments are reported at fair value under the Fair Value Measurements and Disclosures accounting guidance.

All benefit plan assets are invested in accordance with each plan's investment policy. The investment policy outlines the investment objectives, strategies, and target asset allocations by plan. Benefit plan assets are reviewed on a formal basis each quarter by the OVEC/IKEC Qualified Plan Trust Committee.

The investment philosophies for the benefit plans support the allocation of assets to minimize risks and optimize net returns.

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Investment strategies include:

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

The target asset allocation for each portfolio is as follows:

<b>Pension Plan Assets</b>	<b>Target</b>
Domestic equity	15.0 %
International and global equity	15.0
Fixed income	70.0
<b>VEBA Plan Assets</b>	<b>Target</b>
Domestic equity	20.0 %
International and global equity	20.0
Fixed income	57.0
Cash	3.0

Each benefit plan contains various investment limitations. These limitations are described in the investment policy statement and detailed in customized investment guidelines. These investment guidelines require appropriate portfolio diversification and define security concentration limits. Each investment manager's portfolio is compared to an appropriate diversified benchmark index.

Equity investment limitations:

- No security in excess of 5% of all equities.
- Cash equivalents must be less than 10% of each investment manager's equity portfolio.
- Individual securities must be less than 15% of each manager's equity portfolio.
- No investment in excess of 5% of an outstanding class of any company.
- No securities may be bought or sold on margin or other use of leverage.

**Fixed Income Limitations**—As of December 31, 2014, the Pension Plan fixed income allocation consists of managed accounts composed of U.S. Government, corporate, and municipal obligations. The VEBA benefit plans' fixed income allocation is composed of a variety of fixed income securities and mutual funds. Investment limitations for these fixed income funds are defined by manager prospectus.

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

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

Projected Pension Plan and Other Postretirement Benefits obligations and funded status as of December 31, 2014 and 2013, are as follows:

	Pension Plan		Other Postretirement Benefits	
	2014	2013	2014	2013
Change in projected benefit obligation:				
Projected benefit obligation—beginning of year	\$ 179,046,962	\$ 195,007,159	\$ 162,744,143	\$ 190,323,891
Service cost	5,652,257	6,825,230	5,887,965	7,375,556
Interest cost	9,156,641	8,357,208	8,358,022	8,180,654
Plan participants' contributions	-	-	1,108,208	979,846
Benefits paid	(8,355,638)	(4,289,481)	(4,938,909)	(5,067,595)
Net actuarial (gain)/loss	40,681,544	(23,604,558)	21,209,006	(39,654,091)
Medicare subsidy	-	-	150,041	300,508
Plan amendments	(3,274,589)	(3,173,345)	(22,744,039)	305,374
Expenses paid from assets	(83,288)	(75,251)	-	-
Projected benefit obligation—end of year	<u>222,823,889</u>	<u>179,046,962</u>	<u>171,774,437</u>	<u>162,744,143</u>
Change in fair value of plan assets:				
Fair value of plan assets—beginning of year	170,504,669	164,445,834	120,570,742	108,226,268
Actual return on plan assets	21,682,500	4,000,880	5,275,212	9,279,474
Expenses paid from assets	(83,288)	(75,251)	-	-
Employer contributions	6,600,000	6,422,687	4,733,391	6,852,241
Plan participants' contributions	-	-	1,108,208	979,846
Medicare subsidy	-	-	150,041	300,508
Benefits paid	(8,355,638)	(4,289,481)	(4,938,909)	(5,067,595)
Fair value of plan assets—end of year	<u>190,348,243</u>	<u>170,504,669</u>	<u>126,898,685</u>	<u>120,570,742</u>
(Underfunded) status—end of year	<u>\$ (32,475,646)</u>	<u>\$ (8,542,293)</u>	<u>\$ (44,875,752)</u>	<u>\$ (42,173,401)</u>

See Note 1 for information regarding regulatory assets related to the Pension Plan and Other Postretirement Benefits plan. During 2014, the Companies amended their Other Postretirement Benefits plan to require additional employee cost sharing for certain groups of employees resulting in a \$22.7 million reduction in PBO for 2014, as detailed in the above table.

On December 8, 2003, the President of the United States of America signed into law the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act). The Act introduced a prescription drug benefit to retirees as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a prescription drug benefit that is actuarially equivalent to the benefit provided by Medicare. The Companies believe that the coverage for prescription drugs is at least actuarially equivalent to the benefits provided by Medicare for most current retirees because the benefits for that group substantially exceed the benefits provided by Medicare, thereby allowing the Companies to qualify for the subsidy. The Companies' employer contributions for Other Postretirement Benefits in the previous table are net of subsidies received of \$150,041 and \$300,508 for 2014 and 2013, respectively. The Companies have accounted for the subsidy as a reduction of the benefit obligation detailed in the previous table. In June 2013, the Companies converted the prescription drug program for retirees over the age of 65 to a

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

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group-based company sponsored Medicare Part D program, or Employer Group Waiver Plan (EGWP). Beginning in June 2013, the Companies use the Part D subsidies delivered through the EGWP each year to reduce net company retiree medical costs. Accordingly, the Companies no longer receive subsidies directly from the Medicare program and no subsidies have been included in the benefit obligation.

The accumulated benefit obligation for the Pension Plan was \$195,776,660 and \$156,748,676 at December 31, 2014 and 2013, respectively.

**Components of Net Periodic Benefit Cost**—The Companies record the expected cost of Other Postretirement Benefits over the service period during which such benefits are earned.

Pension expense is recognized as amounts are contributed to the Pension Plan and billed to customers. The accumulated difference between recorded pension expense and the yearly net periodic pension expense, as calculated under the accounting guidance for Compensation—Retirement Benefits, is billable as a cost of operations under the ICPA when contributed to the pension fund. This accumulated difference has been recorded as a regulatory asset in the accompanying consolidated balance sheets.

	Pension Plan		Other Postretirement Benefits	
	2014	2013	2014	2013
Service cost	\$ 5,652,257	\$ 6,825,230	\$ 5,887,965	\$ 7,375,556
Interest cost	9,156,641	8,357,208	8,358,022	8,180,654
Expected return on plan assets	(10,233,418)	(9,088,934)	(6,482,601)	(5,562,089)
Amortization of prior service cost	(180,575)	189,437	24,041	(385,000)
Recognized actuarial loss	-	428,567	(234,171)	1,828,893
Total benefit cost	\$ 4,394,905	\$ 6,711,508	\$ 7,553,256	\$ 11,438,014
Pension and other postretirement benefits expense recognized in the consolidating statements of income and retained earnings and billed to Sponsoring Companies under the ICPA	\$ 6,600,000	\$ 6,422,687	\$ -	\$ 5,400,000



**OHIO VALLEY ELECTRIC CORPORATION  
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The following table presents the classification of Pension Plan assets within the fair value hierarchy at December 31, 2014 and 2013:

	Fair Value Measurements at Reporting Date Using		
	Quoted Prices in Active Market for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>2014</b>			
Domestic equity mutual funds	\$ 14,850,107	\$ -	\$ -
Common stock—domestic	7,600,351	-	-
International and global equity mutual funds	20,792,451	-	-
International and global private investment funds (equities)	-	11,078,646	-
Cash equivalents	4,451,721	-	-
U.S. Treasury securities	-	6,264,602	-
Corporate debt securities	-	116,102,015	-
Municipal debt securities	-	9,208,350	-
	<u>-</u>	<u>-</u>	<u>-</u>
Total fair value	<u>\$ 47,694,630</u>	<u>\$ 142,653,613</u>	<u>\$ -</u>
<b>2013</b>			
Domestic equity mutual funds	\$ 16,572,985	\$ -	\$ -
Common stock—domestic	8,480,137	-	-
International and global equity mutual funds	24,557,818	-	-
International and global private investment funds (equities)	-	5,102,504	-
Cash equivalents	5,211,961	-	-
U.S. Treasury securities	-	7,505,362	-
Corporate debt securities	-	94,537,258	-
Municipal debt securities	-	8,536,644	-
	<u>-</u>	<u>-</u>	<u>-</u>
Total fair value	<u>\$ 54,822,901</u>	<u>\$ 115,681,768</u>	<u>\$ -</u>

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

The following table presents the classification of VEBA and 401(h) account assets within the fair value hierarchy at December 31, 2014 and 2013:

	Fair Value Measurements at Reporting Date Using		
	Quoted Prices in Active Market for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>2014</b>			
Domestic equity mutual funds	\$ 41,122,698	\$ -	\$ -
International and global equity mutual funds	20,812,612	-	-
International and global private investment funds	-	6,731,149	-
Fixed income mutual funds	38,452,331	-	-
Fixed income securities	-	17,426,355	-
Cash equivalents	2,353,540	-	-
Total fair value	<u>\$ 102,741,181</u>	<u>\$ 24,157,504</u>	<u>\$ -</u>
<b>2013</b>			
Domestic equity mutual funds	\$ 40,105,729	\$ -	\$ -
International and global equity mutual funds	22,737,909	-	-
International and global private investment funds	-	4,267,427	-
Fixed income mutual funds	33,485,886	-	-
Fixed income securities	-	13,940,290	-
Cash equivalents	6,033,501	-	-
Total fair value	<u>\$ 102,363,025</u>	<u>\$ 18,207,717</u>	<u>\$ -</u>

The private investment fund detailed in the above tables is redeemable at the election of the holder upon no more than 30 days' notice and, as such, this fund has been classified as a Level 2 fair value measure.

**Pension Plan and Other Postretirement Benefit Assumptions**—Actuarial assumptions used to determine benefit obligations at December 31, 2014 and 2013, were as follows:

	Pension Plan		Other Postretirement Benefits			
	2014	2013	2014		2013	
			Medical	Life	Medical	Life
Discount rate	4.28 %	5.15 %	4.33 %	4.33 %	5.20 %	5.20 %
Rate of compensation increase	3.00	3.00	N/A	3.00	N/A	3.00

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

Actuarial assumptions used to determine net periodic benefit cost for the years ended December 31, 2014 and 2013, were as follows:

	<u>Pension Plan</u>		<u>Other Postretirement Benefits</u>			
	<u>2014</u>	<u>2013</u>	<u>2014</u>		<u>2013</u>	
			<u>Medical</u>	<u>Life</u>	<u>Medical</u>	<u>Life</u>
Discount rate	5.15 %	4.29 %	5.20 %	5.20 %	4.40 %	4.30 %
Expected long-term return on plan assets	6.00	5.50	5.29	6.00	4.95	5.75
Rate of compensation increase	3.00	3.00	N/A	3.00	N/A	3.00

In selecting the expected long-term rate of return on assets, the Companies considered the average rate of earnings expected on the funds invested to provide for plan benefits. This included considering the Pension Plan and VEBA trusts' asset allocation, and the expected returns likely to be earned over the life of the Pension Plan and the VEBAs.

Assumed health care cost trend rates at December 31, 2014 and 2013, were as follows:

	<b>2014</b>	<b>2013</b>
Health care trend rate assumed for next year—participants under 65	7.00 %	7.50 %
Health care trend rate assumed for next year—participants over 65	7.00	7.50
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)—participants under 65	5.00	5.00
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)—participants over 65	5.00	5.00
Year that the rate reaches the ultimate trend rate	2019	2019

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects:

	<b>One-Percentage Point Increase</b>	<b>One-Percentage Point Decrease</b>
Effect on total service and interest cost	\$ 3,156,652	\$ (2,398,815)
Effect on postretirement benefit obligation	31,503,493	(24,403,704)

**Pension Plan and Other Postretirement Benefit Assets**—The asset allocation for the Pension Plan and VEBA trusts at December 31, 2014 and 2013, by asset category was as follows:

Asset category:	<u>Pension Plan</u>		<u>VEBA Trusts</u>	
	<u>2014</u>	<u>2013</u>	<u>2014</u>	<u>2013</u>
Equity securities	29 %	32 %	39 %	42 %
Debt securities	71	68	61	58

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

**Pension Plan and Other Postretirement Benefit Contributions**—The Companies expect to contribute \$5,600,000 to their Pension Plan and \$5,355,051 to their Other Postretirement Benefits plan in 2015.

**Estimated Future Benefit Payments**—The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

Years Ending December 31	Pension Plan	Other Postretirement Benefits
2015	\$6,384,692	\$5,894,867
2016	7,153,692	6,323,071
2017	8,182,919	6,758,905
2018	8,789,634	7,198,179
2019	9,799,896	7,720,128
Five years thereafter	62,127,081	46,175,651

**Postemployment Benefits**—The Companies follow the accounting guidance in Compensation—Non-Retirement Postemployment Benefits and accrue the estimated cost of benefits provided to former or inactive employees after employment but before retirement. Such benefits include, but are not limited to, salary continuations, supplemental unemployment, severance, disability (including workers' compensation), job training, counseling, and continuation of benefits, such as health care and life insurance coverage. The cost of such benefits and related obligations has been allocated to OVEC and IKEC in the accompanying consolidated financial statements. The allocated amounts represent approximately a 27% and 73% split between OVEC and IKEC, respectively, as of December 31, 2014, and approximately a 56% and 44% split between OVEC and IKEC, respectively, as of December 31, 2013. The liability is offset with a corresponding regulatory asset and represents unrecognized postemployment benefits billable in the future to customers. The accrued cost of such benefits was \$1,437,151 and \$2,078,864 at December 31, 2014 and 2013, respectively.

**Defined Contribution Plan**—The Companies have a trustee-defined contribution supplemental pension and savings plan that includes 401(k) features and is available to employees who have met eligibility requirements. The Companies' contributions to the savings plan equal 100% of the first 1% and 50% of the next 5% of employee-participants' contributions. Benefits to participating employees are based solely upon amounts contributed to the participants' accounts and investment earnings. By its nature, the plan is fully funded at all times. The employer contributions for 2014 and 2013 were \$1,939,829 and \$1,956,546, respectively.

## 9. ENVIRONMENTAL MATTERS

Title IV of the 1990 Clean Air Act Amendments (CAAAAs) required the Companies to reduce sulfur dioxide (SO<sub>2</sub>) emissions in two phases: Phase I in 1995 and Phase II in 2000. The Companies selected a fuel switching strategy to comply with the emission reduction requirements. The Companies also purchased additional SO<sub>2</sub> allowances. Historically, the cost of these purchased allowances has been inventoried and included on an average cost basis in the cost of fuel consumed when used.

Title IV of the 1990 CAAAs also required the Companies to comply with a nitrogen oxides (NO<sub>x</sub>) emission rate limit of 0.84 lb/mmBtu in 2000. The Companies installed overfire air systems on all eleven

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

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units at the plants to comply with this limit. The total capital cost of the eleven overfire air systems was approximately \$8.2 million.

During 2002 and 2003, Ohio and Indiana finalized respective NO<sub>x</sub> State Implementation Plan (SIP) Call regulations that required further significant NO<sub>x</sub> emission reductions for coal-burning power plants during the ozone control period. The Companies installed selective catalytic reduction (SCR) systems on ten of their eleven units to comply with these rules. The total capital cost of the ten SCR systems was approximately \$355 million.

On March 10, 2005, the United States Environmental Protection Agency (the U.S. EPA) issued the Clean Air Interstate Rule (CAIR) that required further significant reductions of SO<sub>2</sub> and NO<sub>x</sub> emissions from coal-burning power plants. On March 15, 2005, the U.S. EPA also issued the Clean Air Mercury Rule (CAMR) that required significant mercury emission reductions for coal-burning power plants. These emission reductions were required in two phases: 2009 and 2015 for NO<sub>x</sub>; 2010 and 2015 for SO<sub>2</sub>; and 2010 and 2018 for mercury. Ohio and Indiana subsequently finalized their respective versions of CAIR and CAMR. In response, the Companies determined that it would be necessary to install flue gas desulfurization (FGD) systems at both plants to comply with these new rules. Following completion of the necessary engineering and permitting, construction was started on the new FGD systems.

In February 2008, the D.C. Circuit Court of Appeals issued a decision which vacated the federal CAMR and remanded the rule to the U.S. EPA with a determination that the rule be rewritten under the maximum achievable control technologies (MACT) provision of Section 112(d) of the Clean Air Act. A group of electric utilities and the U.S. EPA requested a rehearing of the decision, which was denied by the Court. Following those denials, both the group of electric utilities and the U.S. EPA requested that the U.S. Supreme Court hear the case. However, in February 2009, the U.S. EPA withdrew its request and the group of utilities' request was denied. These actions left the original court decision in place, which vacated the federal CAMR and remanded the rule to the U.S. EPA with a determination that the rule be rewritten under the MACT provision of Section 112(d) of the Clean Air Act. The U.S. EPA has subsequently written a replacement rule for the regulation of coal-fired utility emissions of mercury and other hazardous air pollutants. This replacement rule was published in the Federal Register on February 16, 2012, and it is referred to as the Mercury and Air Toxics Standards (or MATS) rule. The rule became final on April 16, 2012, and OVEC-IKEC must be in compliance with MATS emission limits by April 16, 2015. Management expects that, with the SCRs and FGD systems fully functional, OVEC-IKEC will be able to meet the emissions requirements outlined in the MATS rule.

In July 2008, the D.C. Circuit Court of Appeals issued a decision that vacated the federal CAIR and remanded the rule to the U.S. EPA. In September 2008, the U.S. EPA, a group of electric utilities and other parties filed petitions for rehearing. In December 2008, the D.C. Circuit Court of Appeals granted the U.S. EPA's petition and remanded the rule to the U.S. EPA without vacatur, allowing the federal CAIR to remain in effect while a new rule was developed and promulgated. Following the remand, the U.S. EPA promulgated a replacement rule to CAIR. This new rule is called the Cross-State Air Pollution Rule (CSAPR) and it was issued on July 6, 2011, and it was scheduled to go into effect on January 1, 2012. However, on December 30, 2011, the D.C. Circuit Court issued an indefinite "stay" of the CSAPR rule until the Court considered the numerous state, trade association, and industry petitions filed to have the rule either stayed or reviewed. The Court also instructed the U.S. EPA to keep CAIR in place while they considered the numerous petitions. On August 21, 2012, in a 2-1 decision, the D.C. Circuit Court vacated the CSAPR rule and ordered the U.S. EPA to keep CAIR in effect until a CSAPR replacement rule is promulgated. The U.S. EPA and other parties filed a petition seeking rehearing before the entire

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

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D.C. Circuit Court on October 5, 2012. That petition was denied by the D.C. Circuit Court on January 24, 2013; however, the U.S. Solicitor General petitioned the U.S. Supreme Court to review the D.C. Circuit Court's decision on CSAPR in March of 2013, and the Supreme Court granted that petition in June of 2013. Oral arguments were presented before the Supreme Court in December of 2013. On April 29, 2014, the U.S. Supreme Court issued a decision reversing the D.C. Circuit Court's 2013 CSAPR vacatur and remanded the CSAPR rule back to that court for further deliberation. On October 23, 2014, the D.C. Circuit Court issued a motion lifting the stay on the CSAPR rules and then U.S. EPA issued a ministerial rule on November 21, 2014 that allowed CSAPR to become effective on January 1, 2015. There are remaining issues with the CSAPR rule that are before the D.C. Circuit Court, and the court is expected to issue a ruling on them by the summer of 2015. In the interim, OVEC-IKEC expects to be able to comply with CSAPR, as currently written.

With the Kyger Creek FGD and the Clifty Creek FGD systems now fully operational, and with the 10 SCR systems operational at both plants, management did not need to purchase additional SO<sub>2</sub> allowances in 2014; however, there was a need to purchase a limited quantity of NO<sub>x</sub> allowances in 2014. Depending on a variety of operational and economic factors, management may also elect to strategically purchase CSAPR NO<sub>x</sub> allowances in 2015 and beyond.

Now that all FGD systems are fully operational, OVEC-IKEC expects to have adequate SO<sub>2</sub> allowances available without having to rely on market purchases to comply with the CSAPR rules in their current form; however, the purchase of additional NO<sub>x</sub> allowances or the installation of additional NO<sub>x</sub> controls may be necessary for Clifty Creek Unit 6 either under the CSAPR rule or any future NO<sub>x</sub> regulations. During the 2013 compliance period and prior to the FGD systems becoming fully operational, OVEC purchased SO<sub>2</sub> and NO<sub>x</sub> allowances to operate the Clifty Creek generating units in compliance with the CAIR environmental emission rules.

On November 6, 2009, the Companies received a Section 114 Information Request from the U.S. EPA. The stated purpose of the information request was for the U.S. EPA to obtain the necessary information to determine if the Kyger Creek and Clifty Creek plants have been operating in compliance with the Federal Clean Air Act. Attorneys for the Companies subsequently contacted the U.S. EPA and established a schedule for submission of the requested information. Based on this schedule, all requested information was submitted to the U.S. EPA by March 8, 2010.

In late December 2011, OVEC-IKEC received a letter dated December 21, 2011, from the U.S. EPA requesting follow-up information. Specifically, the U.S. EPA asked for an update on the status of the FGD scrubber projects at both plants as well as additional information on any other new emissions controls that either have been installed or are planned for installation since the last submittal we filed on March 8, 2012. This information was prepared and filed with the U.S. EPA in late January 2012. In the fall of 2012, following an on-site visit, the U.S. EPA made an informal request that OVEC-IKEC provide the agency with a monthly email progress report on the Clifty Creek FGD project until both FGD systems are operational in 2013. As of this date, the only communication OVEC-IKEC has had with the U.S. EPA related to either the original Section 114 data submittal or the supplemental data filing made in 2011 are the monthly email progress reports. Those monthly email progress reports were discontinued once the second of the two FGD scrubbers at Clifty Creek was placed into service in May of 2013.

### **Coal Combustion Residual Rule**

In 2010, the Federal EPA published a proposed rule to regulate the disposal and beneficial re-use of coal combustion residuals (CCR), including fly ash and bottom ash generated at coal-fired electric generating

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

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units and also FGD gypsum generated at some coal-fired plants. The proposed rule contained two alternative proposals. One proposal would impose federal hazardous waste disposal and management standards on these materials and another would allow states to retain primary authority to regulate the beneficial re-use and disposal of these materials under state solid waste management standards, including minimum federal standards for disposal and management. Both proposals would impose stringent requirements for the construction of new coal ash landfills and existing unlined surface impoundments.

Various environmental organizations and industry groups filed a petition seeking to establish deadlines for a final rule. To comply with a court-ordered deadline, the Federal EPA issued a prepublication copy of its final rule in December 2014. The rule is expected to be published in the Federal Register during 2015 and become effective six months following publication.

In the final rule, the Federal EPA elected to regulate CCR as a non-hazardous solid waste and issued new minimum federal solid waste management standards. On the effective date, the rule applies to new and existing active CCR landfills and CCR surface impoundments at operating electric utility or independent power production facilities. The rule imposes new and additional construction and operating obligations, including location restrictions, liner criteria, structural integrity requirements for impoundments, operating criteria, and additional groundwater monitoring requirements. The rule does not apply to inactive CCR landfills and inactive surface impoundments at retired generating stations or the beneficial use of CCR. The rule is self-implementing so state action is not required. Because of this self-implementing feature, the rule contains extensive record keeping, notice, and internet posting requirements. Because OVEC-IKEC currently uses surface impoundments and landfills to manage CCR materials at our generating facilities, OVEC-IKEC may incur costs to modify, upgrade or close, and replace these existing facilities at some point in the future as the new rule is implemented. OVEC-IKEC continue to review the new rule and evaluate its costs and impacts to our operations, including ongoing monitoring requirements.

In February 2014, the Federal EPA completed a risk evaluation of the beneficial uses of coal fly ash in concrete and FGD gypsum in wallboard and concluded that the Federal EPA supports these beneficial uses. Currently, approximately 5% of the coal ash and other residual products from our generating facilities are re-used in the production of cement and wallboard, as structural fill or soil amendments, as abrasives or road treatment materials, and for other beneficial uses. Encapsulated beneficial uses are not materially impacted by the new rule, but additional demonstrations may be required to continue land applications in significant amounts except in road construction projects.

### **10. FAIR VALUE MEASUREMENTS**

The accounting guidance for Financial Instruments requires disclosure of the fair value of certain financial instruments. The estimates of fair value under this guidance require the application of broad assumptions and estimates. Accordingly, any actual exchange of such financial instruments could occur at values significantly different from the amounts disclosed.

OVEC utilizes its trustee's external pricing service in its estimate of the fair value of the underlying investments held in the benefit plan trusts and investment portfolios. The Companies' management reviews and validates the prices utilized by the trustee to determine fair value. Equities and fixed income securities are classified as Level 1 holdings if they are actively traded on exchanges. In addition, mutual funds are classified as Level 1 holdings because they are actively traded at quoted market prices. Certain fixed income securities do not trade on an exchange and do not have an official closing price. Pricing vendors calculate bond valuations using financial models and matrices. Fixed income securities are typically classified as Level 2 holdings because their valuation inputs are based on observable market

# **OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY**

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data. Observable inputs used for valuing fixed income securities are benchmark yields, reported trades, broker/dealer quotes, issuer spreads, bids, offers, and economic events. Other securities with model-derived valuation inputs that are observable are also classified as Level 2 investments. Investments with unobservable valuation inputs are classified as Level 3 investments.

As of December 31, 2014 and 2013, the Companies held certain assets that are required to be measured at fair value on a recurring basis. These consist of investments recorded within long-term investments. The investments consist of money market mutual funds, equity mutual funds, and fixed income municipal securities. Changes in the observed trading prices and liquidity of money market funds are monitored as additional support for determining fair value, and unrealized gains and losses are recorded in earnings.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Companies believe their valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

As cash and cash equivalents, current receivables, current payables, and line of credit borrowings are all short term in nature, their carrying amounts approximate fair value.



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**Long-Term Investments**—Assets measured at fair value on a recurring basis at December 31, 2014 and 2013, were as follows:

	Fair Value Measurements at Reporting Date Using		
	Quoted Prices in Active Market for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>2014</b>			
Equity mutual funds	\$ 25,372,238	-	-
Fixed income municipal securities	-	91,600,666	-
Cash equivalents	<u>5,529,869</u>	<u>-</u>	<u>-</u>
Total fair value	<u>\$ 30,902,107</u>	<u>\$ 91,600,666</u>	<u>-</u>
<b>2013</b>			
Equity mutual funds	\$ 24,795,074	\$ -	\$ -
Fixed income municipal securities	-	88,696,555	-
Cash equivalents	<u>3,615,039</u>	<u>-</u>	<u>-</u>
Total fair value	<u>\$ 28,410,113</u>	<u>\$ 88,696,555</u>	<u>\$ -</u>

**Long-Term Debt**— The fair values of the senior notes and fixed rate bonds were estimated using discounted cash flow analyses based on current incremental borrowing rates for similar types of borrowing arrangements. These fair values are not reflected in the balance sheets.

The fair values and recorded values of the senior notes and fixed and variable rate bonds as of December 31, 2014 and 2013, are as follows:

	2014		2013	
	Fair Value	Recorded Value	Fair Value	Recorded Value
Total	<u>\$ 1,702,226,733</u>	<u>\$ 1,517,896,155</u>	<u>\$ 1,684,165,978</u>	<u>\$ 1,558,369,935</u>

**11. LEASES**

OVEC has railcar lease agreements that extend to January 1, 2016. OVEC also has various other operating leases for the use of other property and equipment. During 2013, OVEC terminated certain railcar lease agreements for the transportation of coal in conjunction with the fuel switching strategy that had been employed by the Companies' generating stations prior to the in-service date of the FGD's discussed in Note 9. This resulted in lease termination costs of \$3,497,300 billed to Sponsor Companies during 2014 and 2013 of \$371,297 and \$3,126,003, respectively.

**OHIO VALLEY ELECTRIC CORPORATION  
AND SUBSIDIARY COMPANY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013**

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The amount in property under capital leases is \$3,100,767 and \$2,793,119 with accumulated depreciation of \$1,441,030 and \$905,642 as of December 31, 2014 and 2013, respectively.

Future minimum lease payments for capital and operating leases at December 31, 2014, are as follows:

<b>Years Ending December 31</b>	<b>Operating</b>	<b>Capital</b>
2015	\$ 822,863	\$ 672,589
2016	24,465	417,385
2017	2,846	321,461
2018	-	192,347
2019	-	107,722
Thereafter	-	428,410
	<u>\$ 850,174</u>	<u>2,139,914</u>
Total future minimum lease payments		
		<u>463,050</u>
Less estimated interest element		
		<u>\$ 1,676,864</u>
Estimated present value of future minimum lease payments		

The annual operating lease cost incurred was \$1,079,950 and \$1,862,319 for 2014 and 2013, respectively, and the annual capital lease cost incurred was \$752,663 and \$593,456 for 2014 and 2013, respectively.

**12. COMMITMENTS AND CONTINGENCIES**

The Companies are party to or may be affected by various matters under litigation. Management believes that the ultimate outcome of these matters will not have a significant adverse effect on either the Companies' future results of operation or financial position.

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# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## INDEPENDENT AUDITORS' REPORT

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To the Board of Directors of  
Ohio Valley Electric Corporation:

We have audited the accompanying consolidated financial statements of Ohio Valley Electric Corporation and its subsidiary company, Indiana-Kentucky Electric Corporation (the "Companies"), which comprise the consolidated balance sheets as of December 31, 2014 and 2013, and the related consolidated statements of income and retained earnings and cash flows for the years then ended, and the related notes to the consolidated financial statements.

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

Management is responsible for the preparation and fair presentation of these consolidated 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 consolidated 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 consolidated 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 consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Companies' preparation and fair presentation of the consolidated 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 Companies' 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 consolidated 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Companies as of December 31, 2014 and 2013, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

/s/ Deloitte & Touche LLP

Cincinnati, Ohio  
April 16, 2015

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## OVEC PERFORMANCE—A 5-YEAR COMPARISON

	2014	2013	2012	2011	2010
Net Generation (MWh)	<b>11,410,006</b>	10,471,693	10,514,762	14,468,168	14,634,079
Energy Delivered (MWh) to:					
DOE <sup>(1)</sup>	<b>211,337</b>	195,470	207,692	253,157	249,139
Sponsors	<b>11,193,643</b>	10,304,107	10,340,568	14,199,025	14,421,180
Maximum Scheduled (MW) by:					
DOE <sup>(1)</sup>	<b>42</b>	33	36	39	39
Sponsors	<b>2,162</b>	2,160	2,165	2,247	2,223
Power Costs to:					
DOE <sup>(1)</sup>	<b>\$11,758,000</b>	\$9,282,000	\$9,097,000	\$11,643,000	\$11,207,000
Sponsors	<b>\$631,120,000</b>	\$671,648,000	\$650,027,000	\$722,153,000	\$671,671,000
Average Price (MWh):					
DOE <sup>(1)</sup>	<b>\$55.636</b>	\$47.483	\$43.802	\$45.993	\$44.984
Sponsors	<b>\$56.382</b>	\$65.183	\$62.862	\$50.859	\$46.575
Operating Revenues	<b>\$656,174,000</b>	\$675,649,000	\$670,819,000	\$716,938,000	\$690,687,000
Operating Expenses	<b>\$587,900,000</b>	\$594,742,000	\$599,891,000	\$653,696,000	\$618,790,000
Cost of Fuel Consumed	<b>\$315,461,000</b>	\$311,900,000	\$302,926,000	\$397,543,000	\$358,507,000
Taxes (federal, state, and local)	<b>\$12,426,000</b>	\$12,312,000	\$11,659,000	\$12,059,000	\$11,208,000
Payroll	<b>\$62,275,000</b>	\$63,175,000	\$61,907,000	\$57,141,000	\$55,609,000
Fuel Burned (tons)	<b>5,183,311</b>	4,958,872	5,290,009	7,310,107	7,506,530
Heat Rate (Btu per kWh, net generation)	<b>10,483</b>	10,715	10,581	10,467	10,310
Unit Cost of Fuel Burned (per mmBtu)	<b>\$2.64</b>	\$2.78	\$2.72	\$2.63	\$2.38
Equivalent Availability (percent)	<b>69.8</b>	73.9	78.9	83.0	81.0
Power Use Factor (percent)	<b>86.48</b>	75.05	69.40	89.61	92.82
Employees (year-end)	<b>775</b>	781	828	810	783

<sup>(1)</sup> OVEC purchases power from third party generators and provides certain services for the Department of Energy (DOE) at its Portsmouth facility under the terms and conditions of an Arranged Power Agreement (APA) dated May 1, 2003. On April 28, 2015, DOE and OVEC signed an agreement to terminate the APA effective July 31, 2015.

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## DIRECTORS

### Ohio Valley Electric Corporation

- <sup>1,2</sup> **ANTHONY J. AHERN**, Columbus, Ohio  
*President and Chief Executive Officer*  
*Buckeye Power Generating, LLC*
- <sup>1</sup> **NICHOLAS K. AKINS**, Columbus, Ohio  
*Chairman, President and Chief Executive Officer*  
*American Electric Power Company, Inc.*
- ERIC D. BAKER**, Cadillac, Michigan  
*President and Chief Executive Officer*  
*Wolverine Power Supply Cooperative, Inc.*
- WAYNE D. GAMES**, Evansville, Indiana  
*Vice President – Power Supply*  
*Vectren Corporation*
- JAMES R. HANEY**, Akron, Ohio  
*Vice President, Compliance & Regulated Services*  
*and Chief FERC Compliance Officer*  
*FirstEnergy Corp.*
- PHILIP R. HERRINGTON**, Dayton, Ohio  
*President, Competitive Generation*  
*AES U.S. Strategic Business Unit*
- <sup>2</sup> **LANA L. HILLEBRAND**, Columbus, Ohio  
*Senior Vice President and Chief Administrative Officer*  
*American Electric Power Company, Inc.*
- <sup>1</sup> **CHARLES D. LASKY**, Akron, Ohio  
*Vice President, Fossil Operations and Engineering*  
*FirstEnergy Generation, LLC*
- <sup>2</sup> **MARK C. McCULLOUGH**, Columbus, Ohio  
*Executive Vice President - Generation*  
*American Electric Power Company, Inc.*
- STEVEN K. NELSON**, Coshocton, Ohio  
*Chairman, Buckeye Power Board of Trustees*  
*The Frontier Power Company*
- PATRICK W. O'LOUGHLIN**, Columbus, Ohio  
*Senior Vice President and Chief Operating Officer*  
*Buckeye Power Generating, LLC*
- <sup>1</sup> **ROBERT P. POWERS**, Columbus, Ohio  
*Executive Vice President and Chief Operating Officer*  
*American Electric Power Company, Inc.*
- <sup>2</sup> **PAUL W. THOMPSON**, Louisville, Kentucky  
*Chief Operating Officer*  
*LG&E and KU Energy LLC*
- <sup>1</sup> **JOHN A. VERDERAME**, Charlotte, North Carolina  
*Managing Director, Power Trading & Dispatch*  
*Duke Energy Corporation*
- <sup>1</sup> **JOHN N. VOYLES, JR.**, Louisville, Kentucky  
*Vice President, Transmission and Generation Services*  
*LG&E and KU Energy LLC*

### Indiana-Kentucky Electric Corporation

- <sup>1</sup> **ANTHONY J. AHERN**, Columbus, Ohio  
*President and Chief Executive Officer*  
*Buckeye Power Generating, LLC*
- <sup>1</sup> **NICHOLAS K. AKINS**, Columbus, Ohio  
*Chairman, President and Chief Executive Officer*  
*American Electric Power Company, Inc.*
- PAUL CHODAK**, Fort Wayne, Indiana  
*President and Chief Operating Officer*  
*Indiana Michigan Power*
- WAYNE D. GAMES**, Evansville, Indiana  
*Vice President – Power Supply*  
*Vectren Corporation*
- <sup>1</sup> **CHARLES D. LASKY**, Akron, Ohio  
*Vice President, Fossil Operations and Engineering*  
*FirstEnergy Generation, LLC*
- MARC E. LEWIS**, Fort Wayne, Indiana  
*Vice President, External Relations*  
*Indiana Michigan Power*
- DAVID A. LUCAS**, Fort Wayne, Indiana  
*Vice President Finance*  
*Indiana Michigan Power*

## OFFICERS—OVEC AND IKEC

**NICHOLAS K. AKINS**  
*President*

**MARK A. PEIFER**  
*Vice President and*  
*Chief Operating Officer*

**JOHN D. BRODT**  
*Chief Financial Officer,*  
*Secretary and Treasurer*

**RONALD D. COOK**  
*Assistant Secretary, Assistant*  
*Treasurer and Supply Chain Director*

**JULIE SLOAT**  
*Assistant Secretary and*  
*Assistant Treasurer*

**JUSTIN J. COOPER**  
*Assistant Secretary and*  
*Budget and Finance Manager*

<sup>1</sup>Member of Executive Committee.

<sup>2</sup>Member of Human Resources Committee.