

# **ANNUAL REPORT — 2013**

**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 (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 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, have begun a new journey competing in a volatile power market equipped with new environmental controls and new human performance improvement tools to adapt to a challenging future. We are partnering with our employees to ensure a zero harm workplace, address our challenges, operate our facilities efficiently and be the provider of choice for our owners.

### SAFETY

OVEC and IKEC are committed to providing a safe and healthy place to work for all employees. In 2013, the Companies continued making progress on their transition to a culture that leads with safety. Safety training on human performance improvement tools was initiated in 2012 and continued in 2013. Strong leadership and the involvement of all employees and our contractors will help ensure that we achieve and sustain the desired goal of zero harm.

### FLUE GAS DESULFURIZATION (FGD) PROJECTS AND FUTURE 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 continue to meet our environmental performance expectations. The pollution control systems installed at both plants are also expected to meet emission limitations under the Mercury and Air Toxics Standards (MATS) beginning in April 2015 as well as future requirements under the Cross-State Air Pollution Rule (CSAPR), which was recently upheld by the U.S. Supreme Court.

### 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 75.1 percent in 2013 compared with 69.4 percent in 2012. The on-peak use factor averaged 89.0 percent in 2013 compared with

82.9 percent in 2012. The off-peak use factor averaged 57.4 percent in 2013 and 52.4 percent in 2012.

In 2013, OVEC delivered 10.3 million MWh to the Sponsoring Companies, which is the same amount delivered in 2012.

### POWER COSTS

In 2013, OVEC's average power cost to the Sponsoring Companies was \$65.183 per MWh compared with \$62.862 per MWh in 2012. The total Sponsoring Company power costs were \$672 million in 2013 compared with \$650 million in 2012. The lack of energy sales in 2013 continued to account for the majority of the increased cost per MWh in 2013. Mild weather, low energy market prices and competitive natural gas generation were all contributing factors for lower-than-average energy sales in 2013.

### 2014 ENERGY SALES OUTLOOK

In 2014, the demand for energy improved significantly due to below average temperatures during the first quarter of 2014 and the increase in the cost of natural gas generation. OVEC projects that higher natural gas prices will have a significant impact on the Sponsors scheduling more of OVEC's power in 2014. As a result, OVEC anticipates the combined use factor for 2014 will be approximately 90 percent, which will result in increased energy sales estimated at 12 million MWh and average power costs less than \$55 per MWh.

### COST CONTROL INITIATIVES

In 2013, OVEC continued its engagement of employees in a continuous improvement initiative to control costs, improve operating performance and explore opportunities to enhance the value of the OVEC investment. These lean activities, developed and implemented by OVEC employees, are producing process improvements and sustainable savings that translate into meaningful improvements. The continuous improvement team efforts are changing the culture of our Company,

impacting our decision making and leading the way toward how we plan to do business in the future.

### **ENTERPRISE ASSET MANAGEMENT SYSTEM**

The OVEC Enterprise Asset Management (EAM) System was placed into service on August 12, 2013, after a team of OVEC employees spent over one year at the vendor's location developing and installing the system. The use of an EAM System allows the integration of core functionality within OVEC, including work management, labor entry, inventory management, purchasing and contracts management, project management and various accounting functions. Some of the benefits of the system include a transition from reactive maintenance to proactive maintenance, better data for informed decision making and standardized work practices and processes.

### **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. Because OVEC is not a member of a Regional Transmission Organization 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 submit a compliance filing to the FERC for the regional planning portion of Order 1000 in February 2013. On July 18, 2013, FERC issued a ruling on this filing accepting in part and rejecting in part certain provisions of the regional filing. Among the terms rejected were the Cost Allocation Methodology based on avoided construction costs and addressing Public Policy Requirements. On January 14, 2014, OVEC and its SERTP partners filed revisions to correct the issues identified by FERC. A ruling on this filing is expected later this summer. A ruling on the interregional filing made last July is also expected this summer.

### **DOE ARRANGEMENTS WITH OVEC**

In 2013, OVEC purchased 230,042 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 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 is working with Sponsor representatives to mitigate any impacts, other than additional NERC compliance obligations, that could result from this additional NERC registration. Discussions continue with the DOE on assuming responsibility for the remaining high-voltage substation at the facility. OVEC continues to explore other options for providing power and energy to the DOE.

### **ENVIRONMENTAL COMPLIANCE**

OVEC and IKEC have a strong commitment to maintain compliance with all applicable federal, state and local environmental rules and regulations. During 2013, the Kyger Creek and Clifty Creek plants operated in compliance with their respective air emission limits. The Companies received no enforcement actions or fines from any of the environmental agencies responsible for overseeing the status of our environmental compliance activities. In addition, we have begun marketing the gypsum generated from our new scrubber operations as an agricultural soil amendment and are preparing to meet boiler tuning and optimization obligations under MATS.

### **BOARD OF DIRECTORS AND OFFICERS CHANGES**

In August 2013, Philip R. Herrington, president, competitive generation of AES U.S. Strategic Business Unit, was elected to serve as a director of OVEC following the resignation of Dennis A. Lantzy. Mr. Lantzy had served on the OVEC board since 2012. In June 2014, William S. Doty, executive vice president – utility operations of Vectren Corporation, resigned as a director of OVEC and IKEC.

In January 2014, David E. Jones retired as vice president-operations of OVEC and IKEC. He had served as vice president-operations of both Companies since 1990.



Nicholas K. Akins  
President

June 30, 2014

**OHIO VALLEY ELECTRIC CORPORATION  
AND SUBSIDIARY COMPANY**

**CONSOLIDATED BALANCE SHEETS  
AS OF DECEMBER 31, 2013 AND 2012**

	<b>2013</b>	<b>2012</b>
<b>ASSETS</b>		
<b>ELECTRIC PLANT:</b>		
At original cost	\$ 2,671,807,219	\$ 1,985,645,118
Less — accumulated provisions for depreciation	<u>1,182,491,224</u>	<u>1,115,363,691</u>
	1,489,315,995	870,281,427
Construction in progress	<u>30,583,795</u>	<u>645,484,896</u>
Total electric plant	<u>1,519,899,790</u>	<u>1,515,766,323</u>
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	70,757,710	19,924,318
Accounts receivable	35,332,653	36,952,825
Fuel in storage	43,020,394	79,550,095
Materials and supplies	32,564,435	27,464,418
Property taxes applicable to future years	2,702,905	2,503,440
Emission allowances	62,428	86,649
Deferred tax assets	9,980,768	18,302,793
Income taxes receivable	3,331,536	15,832,666
Regulatory assets	371,297	8,277,357
Prepaid expenses and other	<u>2,244,413</u>	<u>2,168,143</u>
Total current assets	<u>200,368,539</u>	<u>211,062,704</u>
<b>REGULATORY ASSETS:</b>		
Unrecognized postemployment benefits	2,078,864	2,498,759
Pension benefits	8,542,293	30,561,325
Postretirement benefits	<u>-</u>	<u>1,324,775</u>
Total regulatory assets	<u>10,621,157</u>	<u>34,384,859</u>
<b>DEFERRED CHARGES AND OTHER:</b>		
Unamortized debt expense	13,401,209	14,485,787
Deferred tax assets	19,432,479	22,265,884
Long-term investments	117,106,668	120,351,712
Special deposits — restricted	-	57,938,752
Other	<u>488,407</u>	<u>103,107</u>
Total deferred charges and other	<u>150,428,763</u>	<u>215,145,242</u>
<b>TOTAL</b>	<u>\$ 1,881,318,249</u>	<u>\$ 1,976,359,128</u>

(Continued)

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## CONSOLIDATED BALANCE SHEETS AS OF DECEMBER 31, 2013 AND 2012

	2013	2012
<b>CAPITALIZATION AND LIABILITIES</b>		
CAPITALIZATION:		
Common stock, \$100 par value — authorized, 300,000 shares; outstanding, 100,000 shares in 2013 and 2012	\$ 10,000,000	\$ 10,000,000
Long-term debt	1,267,873,554	1,358,347,337
Line of credit borrowings	30,000,000	60,000,000
Retained earnings	<u>6,478,234</u>	<u>5,293,968</u>
Total capitalization	<u>1,314,351,788</u>	<u>1,433,641,305</u>
CURRENT LIABILITIES:		
Current portion of long-term debt	290,496,381	238,138,903
Accounts payable	50,131,367	53,916,997
Accrued other taxes	9,062,813	8,651,108
Regulatory liabilities	27,406,208	21,975,974
Accrued interest and other	<u>28,145,464</u>	<u>25,822,574</u>
Total current liabilities	<u>405,242,233</u>	<u>348,505,556</u>
COMMITMENTS AND CONTINGENCIES (Notes 3, 11, 12)		
REGULATORY LIABILITIES:		
Postretirement benefits	32,619,457	-
Decommissioning and demolition	19,140,730	14,230,459
Investment tax credits	3,393,146	3,393,146
Net antitrust settlement	1,823,929	1,823,929
Income taxes refundable to customers	<u>28,380,282</u>	<u>38,645,647</u>
Total regulatory liabilities	<u>85,357,544</u>	<u>58,093,181</u>
OTHER LIABILITIES:		
Pension liability	8,542,293	30,561,325
Asset retirement obligations	22,230,109	20,961,379
Postretirement benefits obligation	42,173,401	82,097,623
Postemployment benefits obligation	2,078,864	2,498,759
Other non-current liabilities	<u>1,342,017</u>	<u>-</u>
Total other liabilities	<u>76,366,684</u>	<u>136,119,086</u>
TOTAL	<u>\$1,881,318,249</u>	<u>\$1,976,359,128</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, 2013 AND 2012**

	<b>2013</b>	<b>2012</b>
OPERATING REVENUES — Sales of electric energy to:		
Department of Energy	\$ 9,281,567	\$ 9,097,306
Sponsoring Companies	<u>666,367,706</u>	<u>661,721,951</u>
Total operating revenues	<u>675,649,273</u>	<u>670,819,257</u>
OPERATING EXPENSES:		
Fuel and emission allowances consumed in operation	311,899,995	302,925,697
Purchased power	8,763,157	8,552,565
Other operation	98,197,470	101,967,242
Maintenance	83,396,811	89,645,354
Depreciation	80,172,750	85,140,820
Taxes — other than income taxes	11,421,154	10,765,327
Income taxes	<u>890,377</u>	<u>893,533</u>
Total operating expenses	<u>594,741,714</u>	<u>599,890,538</u>
OPERATING INCOME	80,907,559	70,928,719
OTHER INCOME	<u>530,109</u>	<u>10,920,111</u>
INCOME BEFORE INTEREST CHARGES	<u>81,437,668</u>	<u>81,848,830</u>
INTEREST CHARGES:		
Amortization of debt expense	5,166,736	4,606,617
Interest expense	<u>74,086,666</u>	<u>74,985,523</u>
Total interest charges	<u>79,253,402</u>	<u>79,592,140</u>
NET INCOME	2,184,266	2,256,690
RETAINED EARNINGS — Beginning of year	5,293,968	4,037,278
CASH DIVIDENDS ON COMMON STOCK	<u>(1,000,000)</u>	<u>(1,000,000)</u>
RETAINED EARNINGS — End of year	<u>\$ 6,478,234</u>	<u>\$ 5,293,968</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, 2013 AND 2012

	2013	2012
OPERATING ACTIVITIES:		
Net income	\$ 2,184,266	\$ 2,256,690
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	80,172,750	85,140,820
Amortization of debt expense	5,166,736	4,606,617
Deferred taxes/refundable taxes	890,065	2,908,239
(Gain) on marketable securities	4,331,444	(6,345,075)
Changes in assets and liabilities:		
Accounts receivable	1,620,172	3,948,625
Fuel in storage	36,529,701	(7,853,097)
Materials and supplies	(5,100,017)	341,497
Property taxes applicable to future years	(199,465)	18,480
Emission allowances	24,221	(58,130)
Income taxes receivable	12,501,130	(14,391,215)
Prepaid expenses and other	(76,270)	(260,491)
Other regulatory assets	46,467,540	11,638,471
Other assets	-	-
Other noncurrent assets	(385,300)	119,375
Accounts payable	(829,201)	2,571,729
Deferred revenue — advances for construction	-	(11,694,904)
Accrued taxes	411,706	(160,864)
Accrued interest and other	2,322,890	2,912,675
Other liabilities	(59,752,402)	(13,943,822)
Other regulatory liabilities	28,162,184	5,248,035
	<u>154,442,150</u>	<u>67,003,655</u>
Net cash provided by operating activities		
INVESTING ACTIVITIES:		
Electric plant additions	(87,262,647)	(203,169,352)
Proceeds from sale of LT investments	97,023,136	20,342,154
Purchases of long-term investments	(40,170,784)	(86,110,337)
	<u>(30,410,295)</u>	<u>(268,937,535)</u>
Net cash used in investing activities		
FINANCING ACTIVITIES:		
Issuance of Senior 2012 Bonds	-	299,403,938
Issuance of Senior 2010 Bonds	-	-
Loan origination cost	(4,059,559)	(5,377,779)
Repayment of Senior 2006 Notes	(15,602,389)	(14,730,774)
Repayment of Senior 2007 Notes	(11,017,149)	(10,392,343)
Repayment of Senior 2008 Notes	(11,519,366)	(10,797,067)
Proceeds from line of credit	10,000,000	160,000,000
Payments on line of credit	(40,000,000)	(200,000,000)
Dividends on common stock	(1,000,000)	(1,000,000)
	<u>(73,198,463)</u>	<u>217,105,975</u>
Net cash provided by financing activities		
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	50,833,392	15,172,095
CASH AND CASH EQUIVALENTS — Beginning of year	19,924,318	4,752,223
CASH AND CASH EQUIVALENTS — End of year	<u>\$ 70,757,710</u>	<u>\$ 19,924,318</u>
SUPPLEMENTAL DISCLOSURES:		
Interest paid	<u>\$ 74,902,175</u>	<u>\$ 74,160,307</u>
Income taxes paid (received) — net	<u>\$ (12,501,572)</u>	<u>\$ 12,504,500</u>
Non-cash electric plant additions included in accounts payable at December 31	<u>\$ 5,697,686</u>	<u>\$ 8,654,116</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, 2013 AND 2012

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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 27% of the Companies' employees are covered by a collective bargaining agreement that expires August 31, 2014.

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.

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, 2013 AND 2012

The Companies' regulatory assets, liabilities, and amounts authorized for recovery through Sponsor billings at December 31, 2013 and 2012, were as follows:

	2013	2012
Regulatory assets:		
Current assets:		
Lease termination costs/liquidated damages	\$ 371,297	\$ 5,225,467
Unrecognized loss on coal sales	<u>-</u>	<u>3,051,890</u>
Total	<u>371,297</u>	<u>8,277,357</u>
Other assets:		
Unrecognized postemployment benefits	2,078,864	2,498,759
Pension benefits	8,542,293	30,561,325
Postretirement benefits	<u>-</u>	<u>1,324,775</u>
Total	<u>10,621,157</u>	<u>34,384,859</u>
Total regulatory assets	<u>\$ 10,992,454</u>	<u>\$ 42,662,216</u>
Regulatory liabilities:		
Current liabilities:		
Deferred credit — EPA emission allowance proceeds	\$ 275,108	\$ 274,687
Deferred revenue — voluntary severance	1,510,609	-
Deferred revenue — advances for construction	23,158,632	19,389,380
Deferred credit — gain on coal sale	246,701	-
Deferred credit — advance collection of interest	<u>2,215,158</u>	<u>2,311,907</u>
Total	<u>27,406,208</u>	<u>21,975,974</u>
Other liabilities:		
Post retirement benefits	32,619,457	-
Decommissioning and demolition	19,140,730	14,230,459
Investment tax credits	3,393,146	3,393,146
Net antitrust settlement	1,823,929	1,823,929
Income taxes refundable to customers	<u>28,380,282</u>	<u>38,645,647</u>
Total	<u>85,357,544</u>	<u>58,093,181</u>
Total regulatory liabilities	<u>\$ 112,763,752</u>	<u>\$ 80,069,155</u>

**Regulatory Assets** — Regulatory assets consist primarily of pension benefit costs, postretirement benefit costs and income taxes billable to customers. Income taxes billable to customers are billed to customers in the period when the related deferred tax liabilities are realized. The fuel related costs, including railcar lease termination costs and liquidated damages, will be billed to customers in 2014. All other regulatory assets are being recovered on a long-term basis.

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

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**Regulatory Liabilities** — The regulatory liabilities classified as current in the accompanying consolidated balance sheet as of December 31, 2013, consist primarily of interest expense collected from customers in advance of expense recognition, customer billings for construction in progress, and voluntary severance payments collected in advance of expense recognition. These amounts will be credited to customer bills during 2014. 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 are entitled to receive a one-time severance payment and would retire on an agreed-upon date after they are retirement-eligible, but not later than January 1, 2015. Total expected costs related to the one-time payments are \$4.6 million for OVEC and \$1.6 million for IKEC, of which \$3.5 million for OVEC and \$1.2 million for IKEC has been expensed in 2013 recorded in the Other Operation under Operating Expenses. As the Companies have 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 to be expensed during 2014 has been recorded as a current regulatory liability at December 31, 2013. 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 the related deferred tax assets are realized. 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. The remaining regulatory liabilities are awaiting credit to customer bills in a future period that is yet to be determined.

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, 2013 and December 31, 2012, 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.

**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, 2013 AND 2012

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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 2013 and 2012 on securities still held at the balance sheets date were \$(3,698,604) and \$6,250,092, respectively.

**Special Deposits** — Special deposits at December 31, 2012 consisted of money market mutual funds held by trustees restricted for use in specific construction projects. The fair value of special deposits was \$0 and \$57,938,752 at December 31, 2013 and December 31, 2012, respectively.

Money market mutual funds reflected in special deposits were carried at fair value with the related investment income reported in Other Income. The cost of securities sold is based on the specific identification method. The fair value of money market mutual funds is determined by reference to currently available market prices and, as such, is considered Level 1. There were no unrealized gains or losses recognized on this portfolio during 2013 or 2012. These funds were used for construction in 2013.

**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.

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

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**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.

Balance — January 1, 2012	\$ 19,809,316
Accretion	1,429,394
Liabilities settled	<u>(277,331)</u>
Balance — December 31, 2012	20,961,379
Accretion	1,450,943
Liabilities settled	<u>(182,213)</u>
Balance — December 31, 2013	<u>\$ 22,230,109</u>

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.

**Subsequent Events** — In preparing the accompanying financial statements and disclosures, the Companies reviewed subsequent events through April 16, 2014, which is the date the consolidated financial statements were issued.

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

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### 2. RELATED-PARTY TRANSACTIONS

Transactions with the Sponsoring Companies during 2013 and 2012 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, 2013 and 2012, balances due from the Sponsoring Companies are as follows:

	<b>2013</b>	<b>2012</b>
Accounts receivable	<u>\$31,129,486</u>	<u>\$34,343,741</u>

During 2013 and 2012, American Electric Power accounted for approximately 43% of operating revenues from Sponsoring Companies and Buckeye Power accounted for approximately 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, 2013. 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>2013</b>	<b>2012</b>
General services	\$ 3,384,509	\$ 3,216,482
Specific projects	<u>10,964,133</u>	<u>12,746,357</u>
Total	<u>\$14,348,642</u>	<u>\$15,962,839</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 2014 through 2017. Pricing for coal under these contracts is subject to contract provisions and adjustments. The Companies currently have approximately 90% of their 2014 coal requirements under contract. These contracts are based on rates in effect at the time of purchase.

**OHIO VALLEY ELECTRIC CORPORATION  
AND SUBSIDIARY COMPANY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012**

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**4. ELECTRIC PLANT**

Electric plant at December 31, 2013 and 2012, consists of the following:

	<b>2013</b>	<b>2012</b>
Steam production plant	\$2,582,429,102	\$1,898,140,562
Transmission plant	76,855,762	74,777,994
General plant	12,495,791	12,699,998
Intangible	<u>26,564</u>	<u>26,564</u>
	2,671,807,219	1,985,645,118
Less accumulated depreciation	<u>1,182,491,224</u>	<u>1,115,363,691</u>
	1,489,315,995	870,281,427
Construction in progress	<u>30,583,795</u>	<u>645,484,896</u>
Total electric plant	<u>\$1,519,899,790</u>	<u>\$1,515,766,323</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. The majority of financed projects placed in service over the past 5 years have been recorded to steam production plant with depreciable lives ranging from 32 to 45 years. However, as the Companies' policy is to bill in accordance with the principal billings of the debt agreements, all financed projects are being depreciated in line with 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 \$275 million as of December 31, 2013 and December 31, 2012. The \$275 million line of credit has an expiration date of June 18, 2015. At December 31, 2013 and 2012, OVEC had borrowed \$30 million and \$60 million, respectively, under this line of credit. Interest expense related to line of credit borrowings was \$634,109 in 2013 and \$3,139,158 in 2012. During 2013 and 2012, OVEC incurred annual commitment fees of \$737,792 and \$412,458, respectively, based on the borrowing limits of the line of credit.

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

### 6. LONG-TERM DEBT

The following amounts were outstanding at December 31, 2013 and 2012:

	Interest Rate	2013	2012
Senior 2006 Notes:			
2006A due February 15, 2026	5.80 %	\$ 277,326,804	\$ 292,095,074
2006B due June 15, 2040	6.40	60,418,362	61,252,481
Senior 2007 Notes:			
2007A-A due February 15, 2026	5.90	125,578,853	132,475,263
2007A-B due February 15, 2026	5.90	31,625,801	33,362,594
2007A-C due February 15, 2026	5.90	31,877,625	33,628,247
2007B-A due June 15, 2040	6.50	30,188,693	30,609,314
2007B-B due June 15, 2040	6.50	7,602,725	7,708,654
2007B-C due June 15, 2040	6.50	7,663,261	7,770,034
Senior 2008 Notes:			
2008A due February 15, 2026	5.92	39,185,975	41,334,943
2008B due February 15, 2026	6.71	78,865,206	83,014,206
2008C due February 15, 2026	6.71	80,487,688	84,578,521
2008D due June 15, 2040	6.91	43,681,707	44,242,121
2008E due June 15, 2040	6.91	44,440,700	45,010,851
Series 2009 Notes:			
2009A due February 15, 2013	1.96	-	100,000,000
Series 2009 Bonds:			
2009A due February 1, 2026	0.48	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	0.60	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, 2014	2.16	50,000,000	50,000,000
2010B due June 29, 2016	2.16	50,000,000	50,000,000
Series 2012 Bonds:			
2012A due June 1, 2032 (a)	5.00	77,080,192	77,091,234
2012A due June 1, 2039 (a)	5.00	122,346,343	122,312,703
2012B due June 1, 2040	0.60	50,000,000	50,000,000
2012C due June 1, 2040	0.60	50,000,000	50,000,000
Series 2013 Notes:			
2013A due February 15, 2018	1.67	<u>100,000,000</u>	<u>-</u>
Total debt		1,558,369,935	1,596,486,240
Current portion of long-term debt		<u>290,496,381</u>	<u>238,138,903</u>
Total long-term debt		<u>\$ 1,267,873,554</u>	<u>\$ 1,358,347,337</u>

(a) 2012A Bonds are net of unamortized discount of \$573,465 at December 31, 2013 and \$596,063 at December 31, 2012



# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

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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, 2013.

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 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 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 callable 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.

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, 2013.

The 2012B and 2012C Bonds are secured by irrevocable transferable direct-pay letters of credit, expiring June 28, 2014, 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 callable 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.

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

The annual maturities of long-term debt as of December 31, 2013, are as follows:

2014	\$ 290,496,381
2015	42,977,594
2016	95,536,872
2017	48,461,307
2018	51,460,006
2019–2040	<u>1,029,437,775</u>
Total	<u>\$ 1,558,369,935</u>

Note that the 2014 current maturities of long-term debt include \$200 million of remarketable variable-rate bonds. The Companies expect cash maturities of only \$40,496,382 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:

	2013	2012
Income tax expense at 35% statutory rate	\$ 1,076,125	\$ 1,102,283
State income taxes — net of federal benefit	-	549
Temporary differences flowed through to customer bills	(212,144)	(224,609)
Permanent differences and other	<u>26,396</u>	<u>15,310</u>
Income tax provision	<u>\$ 890,377</u>	<u>\$ 893,533</u>

Components of the income tax provision were as follows:

	2013	2012
Current income tax (benefit)/expense	\$ -	\$ (9,609,247)
Deferred income tax expense/(benefit)	<u>890,377</u>	<u>10,502,780</u>
Total income tax provision	<u>\$ 890,377</u>	<u>\$ 893,533</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. The deferred tax assets recorded in the accompanying consolidated balance sheets consist primarily of the net deferred taxes on depreciation, postretirement benefits obligation, asset retirement obligations, regulatory assets, and regulatory liabilities.

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

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 \$28,380,282 and \$38,645,647 at December 31, 2013 and 2012, respectively.

Deferred income tax assets (liabilities) at December 31, 2012 and 2011, consisted of the following:

	2013	2012
Deferred tax assets:		
Deferred revenue — advances for construction	\$ 8,110,780	\$ 6,789,730
AMT credit carryforwards	2,574,572	2,574,572
Federal net operating loss	61,312,280	9,392,878
Postretirement benefit obligation	14,770,267	28,748,763
Pension liability	1,684,610	9,207,805
Postemployment benefit obligation	728,074	875,010
Asset retirement obligations	7,785,586	7,340,209
Miscellaneous accruals	2,131,262	2,742,592
Regulatory liability — other	1,288,943	-
Regulatory liability — investment tax credits	1,188,372	1,188,204
Regulatory liability — net antitrust settlement	638,789	638,700
Regulatory liability — asset retirement costs	6,703,602	4,983,191
Regulatory liability — postretirement benefits	10,283,147	-
Regulatory liability — income taxes refundable to customers	<u>13,856,458</u>	<u>13,844,317</u>
Total deferred tax assets	<u>133,056,742</u>	<u>88,325,971</u>
Deferred tax liabilities:		
Prepaid expenses	(679,165)	(622,408)
Electric plant	(85,468,227)	(29,477,415)
Unrealized gain/loss on marketable securities	(3,580,925)	(5,616,658)
Regulatory asset — postretirement benefits	-	(463,906)
Regulatory asset — pension benefits	(2,991,742)	(10,701,897)
Regulatory asset — unrecognized postemployment benefits	<u>(728,074)</u>	<u>(875,010)</u>
Total deferred tax liabilities	<u>(93,448,133)</u>	<u>(47,757,294)</u>
Valuation allowance	<u>(10,195,362)</u>	<u>-</u>
Deferred income tax assets	<u>\$ 29,413,247</u>	<u>\$ 40,568,677</u>
Current deferred income taxes	\$ 9,980,768	\$ 18,302,793
Non-current deferred income taxes	19,432,479	22,265,884

During 2013, due to trends in market factors surrounding U.S. coal-fired generation and wholesale power prices, the Companies recorded a valuation allowance in order to recognize only those deferred tax assets that are more likely than not of realization through the end of the ICPA contract term in 2040.

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

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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 position are measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. The Companies have not identified any uncertain tax positions as of December 31, 2013 and 2012, and accordingly, no liabilities for uncertain tax positions have been recognized.

On March 23, 2010, President Obama signed into law the Patient Protection and Affordable Care Act (the PPAC Act). The PPAC Act is a comprehensive health care reform bill that includes revenue-raising provisions of nearly \$400 billion over 10 years through tax increases on high-income individuals, excise taxes on high-cost group health plans, and new fees on selected health-care-related industries. In addition, on March 30, 2010, President Obama signed into law the reconciliation measure, which modifies certain provisions of the PPAC Act.

An employer offering retiree prescription drug coverage that is at least as valuable as Medicare Part D coverage is currently entitled to a federal retiree drug subsidy. Employers can currently claim a deduction for the entire cost of providing the prescription drug coverage even though a portion of the cost is offset by the subsidy they receive. However, the PPAC Act repealed the current rule permitting a deduction of the portion of the drug coverage expense that is offset by the Medicare Part D subsidy. This provision of the PPAC Act as modified by the reconciliation measure is effective for taxable years beginning after December 31, 2012. As the law has been in effect for 2013, there is no additional adjustment in 2013 or going forward.

During 2013 and 2012, the passage of the PPAC Act resulted in a reduction of the postemployment benefits deferred tax asset of approximately \$0 and \$80,000 and a reduction to the related regulatory liability (income taxes refundable to customers) of approximately \$0 and \$80,000, respectively.

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 2007 and earlier. The Companies are currently under 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 2007 and earlier. The Companies are no longer subject to Ohio and the Commonwealth of Kentucky examinations for tax years 2006 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

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

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Employee Retirement Income Security Act of 1974 (ERISA), as amended. The full cost of the pension benefits and related obligations has been allocated to OVEC and IKEC in the accompanying consolidated financial statements. The allocated amounts represent approximately a 57% and 43% split between OVEC and IKEC, respectively, as of December 31, 2013, and approximately a 57% and 43% split between OVEC and IKEC, respectively, as of December 31, 2012. The Pension Plan's assets as of December 31, 2013, consist of investments in equity and debt securities.

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.

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.

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.

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

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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, 2013, 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 managed accounts and mutual funds. Investment limitations for these fixed income funds are defined by manager prospectus.

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

**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. Projected Pension Plan and Other Postretirement Benefits obligations and funded status as of December 31, 2013 and 2012, are as follows:

	Pension Plan		Other Postretirement Benefits	
	2013	2012	2013	2012
Change in projected benefit obligation:				
Projected benefit obligation — beginning of year	\$ 195,007,159	\$ 192,294,158	\$ 190,323,891	\$ 171,866,123
Service cost	6,825,230	7,050,298	7,375,556	6,411,493
Interest cost	8,357,208	8,383,604	8,180,654	7,442,065
Plan participants' contributions	-	-	979,846	908,758
Benefits paid	(4,289,481)	(3,536,952)	(5,067,595)	(4,449,852)
Net actuarial (gain)/loss	(23,604,558)	(9,114,566)	(39,654,091)	7,821,460
Medicare subsidy	-	-	300,508	323,844
Plan amendments	(3,173,345)	-	305,374	-
Expenses paid from assets	(75,251)	(69,383)	-	-
Projected benefit obligation — end of year	179,046,962	195,007,159	162,744,143	190,323,891
Change in fair value of plan assets:				
Fair value of plan assets — beginning of year	164,445,834	141,371,363	108,226,268	94,948,011
Actual return on plan assets	4,000,880	21,180,806	9,279,474	10,538,257
Expenses paid from assets	(75,251)	(69,383)	-	-
Employer contributions	6,422,687	5,500,000	6,852,241	5,957,250
Plan participants' contributions	-	-	979,846	908,758
Medicare subsidy	-	-	300,508	323,844
Benefits paid	(4,289,481)	(3,536,952)	(5,067,595)	(4,449,852)
Fair value of plan assets — end of year	170,504,669	164,445,834	120,570,742	108,226,268
(Underfunded) status — end of year	\$ (8,542,293)	\$ (30,561,325)	\$ (42,173,401)	\$ (82,097,623)

See Note 1 for information regarding regulatory assets related to the Pension Plan and Other Postretirement Benefits plan.

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 above table are net of subsidies received of \$300,508 and \$323,844 for 2013 and 2012, respectively. The Companies have

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

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accounted for the subsidy as a reduction of the benefit obligation detailed in the above table. In June 2013, the Companies converted the prescription drug program for retirees over the age of 65 to a group-based company sponsored Medicare Part D program, or Employer Group Waiver Plan, or 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 \$156,748,676 and \$167,595,378 at December 31, 2013 and 2012, 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	
	2013	2012	2013	2012
Service cost	\$ 6,825,230	\$ 7,050,298	\$ 7,375,556	\$ 6,411,493
Interest cost	8,357,208	8,383,604	8,180,654	7,442,065
Expected return on plan assets	(9,088,934)	(8,522,609)	(5,562,089)	(5,516,937)
Amortization of prior service cost	189,437	189,437	(385,000)	(379,000)
Recognized actuarial loss	428,567	2,086,365	1,828,893	1,577,730
Total benefit cost	\$ 6,711,508	\$ 9,187,095	\$11,438,014	\$ 9,535,351
Pension and other postretirement benefits expense recognized in the consolidated statements of income and retained earnings and billed to Sponsoring Companies under the ICPA	\$ 6,422,687	\$ 5,500,000	\$ 5,400,000	\$ 5,500,000



**OHIO VALLEY ELECTRIC CORPORATION  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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The following table presents the classification of Pension Plan assets within the fair value hierarchy at December 31, 2013 and 2012:

	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>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	-	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	-
Total fair value	<u>\$ 54,822,901</u>	<u>\$ 115,681,768</u>	<u>\$ -</u>
<b>2012</b>			
Domestic equity	\$ 23,558,247	\$ -	\$ -
International and global equity	17,292,251	8,550,837	-
Cash equivalents	4,924,712	-	-
U.S. Treasury securities	-	6,804,928	-
Corporate debt securities	-	92,091,492	-
Municipal debt securities	-	11,223,367	-
Total fair value	<u>\$ 45,775,210</u>	<u>\$ 118,670,624</u>	<u>\$ -</u>

**OHIO VALLEY ELECTRIC CORPORATION  
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The following table presents the classification of VEBA and 401(h) account assets within the fair value hierarchy at December 31, 2013 and 2012:

	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>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	<u>6,033,501</u>	<u>-</u>	<u>-</u>
Total fair value	<u>\$ 102,363,025</u>	<u>\$ 18,207,717</u>	<u>\$ -</u>
<b>2012</b>			
Domestic equity mutual funds	\$ 21,360,870	\$ -	\$ -
International and global equity	22,601,305	-	-
Fixed income mutual funds	48,177,536	-	-
Fixed income securities	-	13,581,890	-
Cash equivalents	<u>2,504,667</u>	<u>-</u>	<u>-</u>
Total fair value	<u>\$ 94,644,378</u>	<u>\$ 13,581,890</u>	<u>\$ -</u>

**Pension Plan and Other Postretirement Benefit Assumptions** — Actuarial assumptions used to determine benefit obligations at December 31, 2013 and 2012, were as follows:

	Pension Plan		Other Postretirement Benefits			
	2013	2012	2013		2012	
			Medical	Life	Medical	Life
Discount rate	5.15 %	4.29 %	5.20 %	5.20 %	4.40 %	4.30 %
Rate of compensation increase	3.00	3.00	N/A	3.00	N/A	3.00

**OHIO VALLEY ELECTRIC CORPORATION  
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Actuarial assumptions used to determine net periodic benefit cost for the years ended December 31, 2013 and 2012, were as follows:

	<b>Pension Plan</b>		<b>Other Postretirement Benefits</b>			
	<b>2013</b>	<b>2012</b>	<b>2013</b>		<b>2012</b>	
			<b>Medical</b>	<b>Life</b>	<b>Medical</b>	<b>Life</b>
Discount rate	4.29 %	4.40 %	4.40 %	4.30 %	4.40 %	4.40 %
Expected long-term return on plan assets	5.50	6.00	4.95	5.75	5.60	6.50
Rate of compensation increase	3.00	4.00	N/A	3.00	N/A	4.00

In selecting the expected long-term rate of return on assets, the Companies considered the average rate of earnings expected on the funds invested or to be invested to provide for plan benefits. This included considering the Pension Plan and VEBA trusts' asset allocation, as well as the target asset allocations for the future, 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, 2013 and 2012, were as follows.

	<b>2013</b>	<b>2012</b>
Health care trend rate assumed for next year — participants under 65	7.50 %	8.00 %
Health care trend rate assumed for next year — participants over 65	7.50	8.00
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	\$ 3,631,271	\$ (2,784,708)
Effect on postretirement benefit obligation	28,284,656	(22,171,247)

**Pension Plan and Other Postretirement Benefit Assets** — The asset allocation for the Pension Plan and VEBA trusts at December 31, 2013 and 2012, by asset category was as follows:

Asset category:	<b>Pension Plan</b>		<b>VEBA Trusts</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Equity securities	32 %	30 %	42 %	41 %
Debt securities	68	70	58	59

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

**Pension Plan and Other Postretirement Benefit Contributions** — The Companies expect to contribute \$6,600,000 to their Pension Plan and \$7,759,496 to their Other Postretirement Benefits plan in 2014.

**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
2014	\$5,416,910	\$5,923,496
2015	6,126,992	6,300,880
2016	7,042,389	6,852,055
2017	7,848,396	7,425,451
2018	8,664,325	7,890,713
Five years thereafter	56,948,180	47,510,450

**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 56% and 44% split between OVEC and IKEC, respectively, as of December 31, 2013, and approximately a 45% and 55% split between OVEC and IKEC, respectively, as of December 31, 2012. 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 \$2,078,864 and \$2,498,759 at December 31, 2013 and 2012, 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 2013 and 2012 were \$1,956,546 and \$1,942,045, 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.

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

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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 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 15, 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 Mercury and Air Toxics Standards (MATS) rule by the April 15, 2015, compliance deadline.

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

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

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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 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, and we now await a decision from the Supreme Court. That decision is expected to be issued in the summer of 2014. In the interim, CAIR will remain in effect.

The first Kyger Creek plant FGD system became fully operational in November 2011 and the second FGD system began operation in February 2012. Clifty Creek's two FGD scrubbers were placed into service in March and May of 2013. As a result, OVEC-IKEC is positioned to meet the anticipated reductions in SO<sub>2</sub> and NO<sub>x</sub> emissions that are required under the CSAPR rule if the U.S. EPA ultimately prevails on its appeal and the rule is reinstated. Alternatively, OVEC-IKEC is also positioned to meet comparable emissions reductions that may be required by an equivalent replacement rule if the D.C. Circuit Court decision is ultimately upheld and the U.S. EPA is required to develop a replacement rule.

Additional SO<sub>2</sub> and NO<sub>x</sub> allowances were purchased to operate the Clifty Creek generating units to comply with the reinstated CAIR environmental emission rules during the 2012 compliance period. 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 2013; however, there were limited NO<sub>x</sub> purchases and there may be a need to purchase limited NO<sub>x</sub> allowances in 2014 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 if the CSAPR rules are upheld in their current form; however, additional NO<sub>x</sub> allowances or additional NO<sub>x</sub> controls may be necessary for Clifty Creek Unit 6 either under a reinstated CSAPR rule or any promulgated replacement rule.

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

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

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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.

### 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. 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.

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 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, 2013 and 2012, the Companies held certain assets that are required to be measured at fair value on a recurring basis. These consist of investments recorded within special deposits and long-term investments. The special deposits consist of money market mutual funds restricted for use on certain projects. 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.

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

**Long-Term Investments** — Assets measured at fair value on a recurring basis at December 31, 2013 and 2012, 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>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>
<b>2012</b>			
Equity mutual funds	\$ 21,192,480	\$ -	\$ -
Fixed income municipal securities	-	96,088,024	-
Cash equivalents	<u>61,009,960</u>	<u>-</u>	<u>-</u>
Total fair value	<u>\$ 82,202,440</u>	<u>\$ 96,088,024</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, 2013 and 2012, are as follows:

	2013		2012	
	Fair Value	Recorded Value	Fair Value	Recorded Value
Total	<u>\$ 1,684,165,978</u>	<u>\$ 1,558,369,935</u>	<u>\$ 1,848,202,504</u>	<u>\$ 1,596,486,240</u>

### 11. LEASES

OVEC has entered into operating leases to secure railcars for the transportation of coal in connection with the fuel switching modifications at the OVEC and the IKEC generating stations. OVEC has railcar lease agreements that extend to as long as December 31, 2025, with options to exit the leases under certain conditions. OVEC also has various other operating leases with other property and equipment. During 2013, OVEC terminated certain railcar lease agreements, which resulted in lease termination costs of \$3,497,300. As of December 31, 2013, OVEC had billed Sponsor Companies \$3,126,003 resulting in a balance of \$371,297 that will be recovered from the Sponsor Companies within the next 12 months. This amount is recorded in current regulatory assets (see Note 1) and is not included in the lease payments below.



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The amount in property under capital leases is \$2,793,119 with accumulated depreciation of \$905,642 and \$460,693 as of December 31, 2013 and 2012, respectively.

Future minimum lease payments for capital and operating leases at December 31, 2013, are as follows:

<b>Years Ending December 31</b>	<b>Operating</b>	<b>Capital</b>
2014	\$ 1,072,266	\$ 677,352
2015	814,895	528,896
2016	13,081	264,693
2017	-	216,247
2018	-	137,643
Thereafter	<u>-</u>	<u>499,596</u>
Total future minimum lease payments	<u>\$ 1,900,242</u>	2,324,427
Less estimated interest element		<u>549,901</u>
Estimated present value of future minimum lease payments		<u>\$ 1,774,526</u>

The annual operating lease cost incurred was \$1,862,319 and \$3,310,227 for 2013 and 2012, respectively, and the annual capital lease cost incurred (depreciation expense) was \$593,456 and \$437,084 for 2013 and 2012, 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, 2013 and 2012, 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.

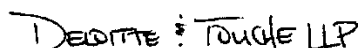
An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, 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, 2013 and 2012, 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.

DELOITTE & TOUCHE LLP



April 16, 2014

# OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

## OVEC PERFORMANCE—A 5-YEAR COMPARISON

	2013	2012	2011	2010	2009
Net Generation (MWh)	<b>10,471,693</b>	10,514,762	14,468,168	14,634,079	15,260,922
Energy Delivered (MWh) to:					
DOE	<b>195,470</b>	207,692	253,157	249,139	264,664
Sponsors	<b>10,304,107</b>	10,340,568	14,199,025	14,421,180	15,069,699
Maximum Scheduled (MW) by:					
DOE	<b>33</b>	36	39	39	39
Sponsors	<b>2,160</b>	2,165	2,247	2,223	2,212
Power Costs to:					
DOE	<b>\$9,282,000</b>	\$9,097,000	\$11,643,000	\$11,207,000	\$11,451,000
Sponsors	<b>\$671,648,000</b>	\$650,027,000	\$722,153,000	\$671,671,000	\$632,506,000
Average Price (MWh):					
DOE	<b>\$47.483</b>	\$43.802	\$45.993	\$44.984	\$43.266
Sponsors	<b>\$65.183</b>	\$62.862	\$50.859	\$46.575	\$41.972
Operating Revenues	<b>\$675,649,000</b>	\$670,819,000	\$716,938,000	\$690,687,000	\$648,593,000
Operating Expenses	<b>\$594,742,000</b>	\$599,891,000	\$653,696,000	\$618,790,000	\$584,881,000
Cost of Fuel Consumed	<b>\$311,900,000</b>	\$302,926,000	\$397,543,000	\$358,507,000	\$329,448,000
Taxes (federal, state, and local)	<b>\$12,312,000</b>	\$11,659,000	\$12,059,000	\$11,208,000	\$12,298,000
Payroll	<b>\$63,175,000</b>	\$61,907,000	\$57,141,000	\$55,609,000	\$56,589,000
Fuel Burned (tons)	<b>4,958,872</b>	5,290,009	7,310,107	7,506,530	7,900,894
Heat Rate (Btu per kWh, net generation)	<b>10,715</b>	10,581	10,467	10,310	10,299
Unit Cost of Fuel Burned (per mmBtu)	<b>\$2.78</b>	\$2.72	\$2.63	\$2.38	\$2.10
Equivalent Availability (percent)	<b>73.9</b>	78.9	83.0	81.0	81.6
Power Use Factor (percent)	<b>75.05</b>	69.40	89.61	92.82	96.29
Employees (year-end)	<b>781</b>	828	810	783	809

# 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.*
- 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*
- 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 N. VOYLES, JR.**, Louisville, Kentucky  
*Vice President, Transmission and Generation Services*  
*LG&E and KU Energy LLC*
- <sup>1</sup> **CHARLES WHITLOCK**, Cincinnati, Ohio  
*President, Commercial Asset Management & Operations*  
*Duke Energy Corporation*

### 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*

## 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*

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

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