Ohio Valley Electric Corporation and Subsidiary Company

Consolidated Financial Statements as of and for the Years Ended December 31, 2016 and 2015, and Independent Auditors' Report

Deloitte.

Deloitte & Touche LLP
250 East 5th Street
Suite 1900
Cincinnati, OH 45202-5109
USA

Tel:+1 513 784 7100
Fax:+1 513 784 7204
www.deloitte.com

INDEPENDENT AUDITORS' REPORT

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, 2016 and 2015, 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 audits 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, 2016 and 2015, 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 12, 2017

OHIO VALLEY ELECTRIC CORPORATION
AND SUBSIDIARY COMPANY

CONSOLIDATED BALANCE SHEETS
AS OF DECEMBER 31, 2016 AND 2015

ASSETS	2016	2015
ELECTRIC PLANT:		
At original cost	$2,739,103,561	$2,714,054,292
Less—accumulated provisions for depreciation	1,352,933,437	1,292,775,251
	1,386,170,124	1,421,279,041
Construction in progress	14,638,632	29,848,655
Total electric plant	1,400,808,756	1,451,127,696
CURRENT ASSETS:		
Cash and cash equivalents	47,810,728	19,292,573
Accounts receivable	37,443,514	24,192,150
Fuel in storage	76,387,854	81,362,765
Emission allowances	872,920	-
Materials and supplies	34,857,142	33,060,141
Income taxes receivable	3,118,299	-
Property taxes applicable to future years	2,822,500	2,850,000
Prepaid expenses and other	1,998,372	2,112,757
Total current assets	205,311,329	162,870,386
REGULATORY ASSETS:		
Unrecognized postemployment benefits	4,273,382	2,526,541
Unrecognized pension benefits	37,128,152	27,889,880
Income taxes billable to customers	-	805,988
Total regulatory assets	41,401,534	31,222,409
DEFERRED CHARGES AND OTHER:		
Unamortized debt expense	498,536	669,463
Long-term investments	119,002,376	119,760,106
Deferred tax assets	2,700,000	-
Other	78,637	70,658
Total deferred charges and other	122,279,549	120,500,227
TOTAL	$1,769,801,168	$1,765,720,718

(Continued)

OHIO VALLEY ELECTRIC CORPORATION
AND SUBSIDIARY COMPANY

CONSOLIDATED BALANCE SHEETS
AS OF DECEMBER 31, 2016 AND 2015

CAPITALIZATION AND LIABILITIES	2016	2015
CAPITALIZATION:		
Common stock, $100 par value—authorized, 300,000 shares; outstanding, 100,000 shares in 2016 and 2015	$ 10,000,000	$ 10,000,000
Long-term debt	1,170,781,545	1,168,723,858
Line of credit borrowings	85,000,000	45,000,000
Retained earnings	8,805,462	7,866,994
Total capitalization	1,274,587,007	1,231,590,852
CURRENT LIABILITIES:		
Current portion of long-term debt	248,483,907	295,659,471
Accounts payable	33,642,452	38,614,644
Accrued other taxes	9,858,927	9,564,756
Regulatory liabilities	11,610,328	17,522,792
Accrued interest and other	25,389,872	21,954,895
Total current liabilities	328,985,486	383,316,558
COMMITMENTS AND CONTINGENCIES (Notes 3, 11, 12)		
REGULATORY LIABILITIES:		
Postretirement benefits	32,986,336	44,780,419
Income taxes refundable to customers	5,433,716	-
Decommissioning and demolition	13,507,852	11,219,680
Total regulatory liabilities	51,927,904	56,000,099
OTHER LIABILITIES:		
Pension liability	37,128,152	27,889,880
Asset retirement obligations	33,044,921	31,249,839
Postretirement benefits obligation	39,218,090	32,235,745
Postemployment benefits obligation	4,273,382	2,526,541
Other noncurrent liabilities	636,226	911,204
Total other liabilities	114,300,771	94,813,209
TOTAL	$1,769,801,168	$1,765,720,718

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, 2016 AND 2015

	2016	2015
OPERATING REVENUES—Sales of electric energy to:		
Department of Energy	$ 8,519,114	$ 10,249,126
Sponsoring Companies	577,376,640	555,079,943
Total operating revenues	585,895,754	565,329,069
OPERATING EXPENSES:		
Fuel and emission allowances consumed in operation	261,832,736	246,581,580
Purchased power	7,617,661	9,550,459
Other operation	78,388,622	78,772,695
Maintenance	81,651,038	92,750,351
Depreciation	73,882,917	53,502,810
Taxes—other than income taxes	11,983,295	11,358,562
Income taxes	345,420	286,972
Total operating expenses	515,701,689	492,803,429
OPERATING INCOME	70,194,065	72,525,640
OTHER INCOME	4,149,935	1,508,078
INCOME BEFORE INTEREST CHARGES	74,344,000	74,033,718
INTEREST CHARGES:		
Amortization of debt expense	4,618,191	4,434,468
Interest expense	68,787,341	68,763,979
Total interest charges	73,405,532	73,198,447
NET INCOME	938,468	835,271
RETAINED EARNINGS—Beginning of year	7,866,994	7,031,723
RETAINED EARNINGS—End of year	$ 8,805,462	$ 7,866,994

See notes to consolidated financial statements.

OHIO VALLEY ELECTRIC CORPORATION
AND SUBSIDIARY COMPANY

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2016 AND 2015

	2016	2015
OPERATING ACTIVITIES:		
Net income	$ 938,468	$ 835,271
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	73,882,917	53,502,810
Amortization of debt expense	4,618,191	4,434,468
Deferred taxes/refundable taxes	3,539,704	230,280
(Gain) on marketable securities	655,288	3,149,486
Changes in assets and liabilities:		
Accounts receivable	(13,251,364)	15,809,810
Fuel in storage	4,974,911	(37,027,336)
Materials and supplies	(1,797,001)	1,439,572
Property taxes applicable to future years	27,500	(70,000)
Emissions allowances	(872,920)	-
Income tax receivable	(3,118,299)	-
Prepaid expenses and other	114,385	95,856
Other regulatory assets	(10,985,113)	3,496,376
Other noncurrent assets	(7,979)	50,219
Accounts payable	(955,698)	(16,588,072)
Accrued taxes	294,171	154,615
Accrued interest and other	3,434,977	(1,659,657)
Other liabilities	19,995,842	(13,905,092)
Other regulatory liabilities	(15,418,375)	11,704,333
Net cash provided by operating activities	66,069,605	25,652,939
INVESTING ACTIVITIES:		
Electric plant additions	(27,580,471)	(27,307,460)
Proceeds from sale of long-term investments	47,626,573	15,948,823
Purchases of long-term investments	(47,524,131)	(16,355,642)
Net cash used in investing activities	(27,478,029)	(27,714,279)
FINANCING ACTIVITIES:		
Loan maintenance costs	(3,905,669)	(3,358,557)
Repayment of Senior 2006 Notes	(18,539,255)	(17,503,483)
Repayment of Senior 2007 Notes	(13,130,063)	(12,384,167)
Repayment of Senior 2008 Notes	(13,990,154)	(13,112,545)
Proceeds from line of credit	69,000,000	102,000,000
Payments on line of credit	(29,000,000)	(77,000,000)
Principal payments under capital leases	(508,280)	(741,301)
Net cash provided by financing activities	(10,073,421)	(22,100,053)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	28,518,155	(24,161,393)
CASH AND CASH EQUIVALENTS—Beginning of year	19,292,573	43,453,966
CASH AND CASH EQUIVALENTS—End of year	$ 47,810,728	$ 19,292,573
SUPPLEMENTAL DISCLOSURES:		
Interest paid	$ 69,458,491	$ 69,326,390
Income taxes paid (received)—net	$ (76,578)	$ 56,692
Noncash electric plant additions included in accounts payable at December 31	$ 268,828	$ 4,285,322

See notes to consolidated financial statements.

1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

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

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

Prior to 2004, OVEC's primary commercial customer was the U.S. Department of Energy (DOE). The contract to provide OVEC-generated power to the DOE was terminated in 2003 and all obligations were settled at that time. Currently, OVEC has an agreement to arrange for the purchase of power (Arranged Power), under the direction of the DOE, for resale directly to the DOE. The agreement with the DOE expires on October 31, 2017. All purchase costs are billable by OVEC to the DOE.

Rate Regulation—The proceeds from the sale of power to the Sponsoring Companies are designed to be sufficient for OVEC to meet its operating expenses and fixed costs, as well as earn a return on equity before federal income taxes. In addition, the proceeds from power sales are designed to cover debt amortization and interest expense associated with financings. The Companies have continued and expect to continue to operate pursuant to the cost plus rate of return recovery provisions at least to June 30, 2040, the date of termination of the ICPA. However, during 2014, the Companies began reducing their billings under the ICPA in order to effectively forego recovery of the equity return and to pass only incurred costs on to customers through the ICPA billings. Additionally, in 2016, one of the Sponsoring Companies announced that it intended to exit its merchant business and that it may pursue restructuring or bankruptcy. The Sponsoring Company's ownership and power participating benefits and requirements are approximately 8%. However, the Companies have the ongoing ability to access the credit markets to fund ongoing liquidity needs, and the Sponsoring Companies remain obligated to fund debt service payments when due.

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 in 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.

The Companies' regulatory assets, liabilities, and amounts authorized for recovery through Sponsor billings at December 31, 2016 and 2015, were as follows:

	2016	2015
Regulatory assets:		
Other assets:		
Unrecognized postemployment benefits	$ 4,273,382	2,526,541
Unrecognized pension benefits	37,128,152	27,889,880
Income taxes billable to customers	-	805,988
Total	41,401,534	31,222,409
Total regulatory assets	$ 41,401,534	31,222,409
Regulatory liabilities:		
Current liabilities:		
Deferred credit—EPA emission allowance proceeds	$ -	103,091
Deferred revenue—advances for construction	9,722,972	15,416,432
Deferred credit—advance collection of interest	1,887,356	2,003,269
Total	11,610,328	17,522,792
Other liabilities:		
Post retirement benefits	32,986,336	44,780,419
Income taxes refundable to customers	5,433,716	-
Decommissioning and demolition	13,507,852	11,219,680
Total	51,927,904	56,000,099
Total regulatory liabilities	$ 63,538,232	73,522,891

Regulatory Assets—Regulatory assets consist primarily of pension benefit costs, postemployment benefit costs, and income taxes billable to customers. The Companies' current billing policy for pension and postemployment benefit costs is to bill its actual plan funding.

Regulatory Liabilities—The regulatory liabilities classified as current in the accompanying consolidated balance sheet as of December 31, 2016, consist primarily of interest expense collected from customers in advance of expense recognition and customer billings for construction in progress. These amounts will be credited to customer bills during 2017. Other regulatory liabilities consist primarily of postretirement benefit costs and decommissioning and demolition costs that have been billed to customers in excess of cumulative expense recognition and income taxes refundable to customers that will be credited to bills over a long-term basis.

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, 2016 and 2015, represents amounts collected in historical billings in excess of the accounting principles generally accepted in the United States of America (GAAP) net periodic benefit costs, including the DOE termination payment and incremental unfunded plan obligations recognized in the balance sheets but not yet recognizable in GAAP net periodic benefit costs. The Companies' ratemaking policy will recover postretirement benefits in an amount equal to estimated benefit accrual cost, plus amortization of unfunded liabilities, if any. As a result, related regulatory liabilities are being credited to customer bills on a long-term basis.

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

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

Fuel in Storage, Emission Allowances, and Materials and Supplies—The Companies maintain coal, reagent, and oil inventories for use in the generation of electricity 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 2016 and 2015 on securities still held at the balance sheet date were $(509,314) and $(3,066,260), respectively.

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

Unamortized Debt Expense—Unamortized debt expense relates to costs incurred in connection with obtaining revolving credit agreements. These costs are being amortized over the term of the related revolving credit agreement and are recorded as an asset in the consolidated balance sheets. Costs incurred to issue debt are recorded as a reduction to long-term debt as presented in Note 6.

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, including the impacts of the coal combustion residuals rule.

Balance—January 1, 2015	$ 29,547,185
Accretion	1,719,945
Liabilities settled	(17,291)
Balance—December 31, 2015	31,249,839
Accretion	1,832,759
Liabilities settled	(37,677)
Balance—December 31, 2016	$ 33,044,921

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 GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

New Accounting Pronouncements—In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers. The standard's core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. This standard also includes expanded disclosure requirements that result in an entity providing users of financial statements with comprehensive information about the nature, amount, timing, and uncertainty of revenue and cash flows arising from the entity's contracts with customers. In August 2015, ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, was issued deferring the effective date of ASU 2014-09 to annual reporting periods beginning after December 15, 2018. The Companies will adopt the standard and all subsequent amendments in the fiscal year ending December 31, 2019. The Companies continue to analyze the impact of the new revenue standard and related ASUs.

In February 2016, the FASB issued ASU No. 2016-02, Leases, which represents a wholesale change to lease accounting. The standard introduces a lessee model that brings most leases into the balance sheet as well as aligns certain underlying principles of the new lessor model with those in Accounting Standards Codification (ASC) 606, Revenue From Contracts With Customers. The new standard is effective for entities with fiscal years beginning after December 15, 2019, and lessees and lessors are required to use a modified retrospective transition method for existing leases. The Companies are in the process of evaluating the impact of adoption of this ASU on the Companies' consolidated financial statements.

The FASB issued ASU No. 2014-15, Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern, in August 2014. This standard update provides guidance about the Companies' responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. The standard is effective for the fiscal year ended December 31, 2016. The adoption of this pronouncement did not have an impact on the Companies' consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, Simplifying the Presentation of Debt Issuance Costs, which changes the presentation of debt issuance costs in the financial statements. Specifically, this amendment requires that costs associated with the issuance of debt be presented in the balance sheet as a direct deduction from the related debt liability. The Companies retrospectively adopted the amended standard effective January 1, 2016. The adoption resulted in a prior-period adjustment due to a change in accounting principle. The consolidated balance sheet as of December 31, 2015, has been restated to reflect this change in accounting principle. Debt issuance costs of $10.5 million were reclassed from "Unamortized debt expense" to "Long-term debt." On the effective date of ASU No. 2015-03, the Companies made a onetime policy election to record costs incurred in connection with obtaining revolving credit agreements as an asset and to amortize these costs ratably over the term of the agreement. This accounting treatment is consistent with how deferred financing costs were accounted for prior to adoption of ASU No. 2015-03. Note 6 has been updated to reflect the adjustment.

In November 2015, the FASB issued ASU No. 2015-17, Balance Sheet Classification of Deferred Taxes, which amends rules regarding the classification of current and noncurrent deferred tax liabilities and assets. Specifically, this amendment requires that, for a particular tax-paying component of an entity and within a particular tax jurisdiction, all deferred tax liabilities and assets shall be offset and presented as a single noncurrent amount. The Companies retrospectively adopted the amended standard effective December 31, 2015. Adoption of ASU No. 2015-17 did not affect operating income (loss) or retained earnings in the presented periods.

Subsequent Events—In preparing the accompanying financial statements and disclosures, the Companies reviewed subsequent events through April 12, 2017, which is the date the consolidated financial statements were issued.

2. RELATED-PARTY TRANSACTIONS

Transactions with the Sponsoring Companies during 2016 and 2015 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 DOE'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, 2016 and 2015, balances due from the Sponsoring Companies are as follows:

	2016	2015
Accounts receivable	$36,035,316	$19,061,773

During 2016 and 2015, American Electric Power accounted for approximately 43% of operating revenues from Sponsoring Companies and Buckeye Power accounted for 18%. No other Sponsoring Company accounted for more than 10%.

American Electric Power Company, Inc. and subsidiary company owned 43.47% of the common stock of OVEC as of December 31, 2016. 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:

	2016	2015
General services	$3,978,358	$3,292,439
Specific projects	1,562,412	2,258,624
Total	$5,540,770	$5,551,063

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 2017 through 2021. Pricing for coal under these contracts is subject to contract provisions and adjustments. The Companies currently have approximately 73% of their 2017 coal requirements under contract. These contracts are based on rates in effect at the time of contract execution.

4. ELECTRIC PLANT

Electric plant at December 31, 2016 and 2015, consists of the following:

	2016	2015
Steam production plant	$2,645,647,687	$2,623,003,141
Transmission plant	80,459,171	78,044,293
General plant	12,970,139	12,980,294
Intangible	26,564	26,564
	2,739,103,561	2,714,054,292
Less accumulated depreciation	1,352,933,437	1,292,775,251
	1,386,170,124	1,421,279,041
Construction in progress	14,638,632	29,848,655
Total electric plant	$1,400,808,756	$1,451,127,696

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

5. BORROWING ARRANGEMENTS AND NOTES

OVEC has an unsecured bank revolving line of credit agreement with a borrowing limit of $200 million as of December 31, 2016 and 2015. The $200 million line of credit has an expiration date of November 14, 2019. At December 31, 2016 and 2015, OVEC had borrowed $85 million and $45 million, respectively, under this line of credit. Interest expense related to line of credit borrowings was $1,692,301 in 2016 and $414,105 in 2015. During 2016 and 2015, OVEC incurred annual commitment fees of $335,376 and $505,526, respectively, based on the borrowing limits of the line of credit.

6. LONG-TERM DEBT

The following amounts were outstanding at December 31, 2016 and 2015:

	Interest Rate	2016	2015
Senior 2006 Notes:			
2006A due February 15, 2026	5.80 %	$ 227,600,578	$ 245,132,192
2006B due June 15, 2040	6.40	57,576,242	58,583,884
Senior 2007 Notes:			
2007A-A due February 15, 2026	5.90	102,311,927	110,522,644
2007A-B due February 15, 2026	5.90	25,766,254	28,055,674
2007A-C due February 15, 2026	5.90	25,971,422	27,834,043
2007B-A due June 15, 2040	6.50	28,752,657	29,262,260
2007B-B due June 15, 2040	6.50	7,241,073	7,369,412
2007B-C due June 15, 2040	6.50	7,298,730	7,428,091
Senior 2008 Notes:			
2008A due February 15, 2026	5.92	31,932,971	34,492,978
2008B due February 15, 2026	6.71	64,641,227	69,698,688
2008C due February 15, 2026	6.71	66,463,125	71,449,681
2008D due June 15, 2040	6.91	41,752,834	42,439,930
2008E due June 15, 2040	6.91	42,478,312	43,177,347
Series 2009 Bonds:			
2009A due February 1, 2026	0.67	25,000,000	25,000,000
2009B due February 1, 2026	2.29	25,000,000	25,000,000
2009C due February 1, 2026	2.29	25,000,000	25,000,000
2009D due February 1, 2026	0.67	25,000,000	25,000,000
2009E due October 1, 2019	5.63	100,000,000	100,000,000
Series 2010 Bonds:			
2010A due February 1, 2040	1.86	50,000,000	50,000,000
2010B due February 1, 2040	2.29	50,000,000	50,000,000
Series 2012 Bonds:			
2012A due June 1, 2032	5.00	76,800,000	76,800,000
2012A due June 1, 2039	5.00	123,200,000	123,200,000
2012B due June 1, 2040	0.42	50,000,000	50,000,000
2012C due June 1, 2040	0.42	50,000,000	50,000,000
Series 2013 Notes:			
2013A due February 15, 2018	2.27	100,000,000	100,000,000
Total debt		1,429,787,352	1,475,446,824
Total premiums and discounts (net)		(505,664)	(528,264)
Less unamortized debt expense		(10,016,236)	(10,535,231)
Total debt net of premiums and discounts		1,419,265,452	1,464,383,329
Current portion of long-term debt		248,483,907	295,659,471
Total long-term debt		$1,170,781,545	$1,168,723,858

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 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, 2016.

The 2009 Series D Bonds are secured by irrevocable transferable direct-pay letters of credit, expiring on November 14, 2019, issued for the benefit of the owners of the bonds. The interest rate on the bonds are adjusted weekly, and bondholders may require repurchase of the bonds at the time of such interest rate adjustments. OVEC has entered into an agreement to provide for the remarketing of the bonds if such repurchase is required. The 2009D Series Bonds are current, as they are redeemable at the election of the holders at any time. The 2009 Series B and C Bonds were remarketed in August 2016 for a five year interest period that extends to August 25, 2021. The 2009A Bonds were secured by an irrevocable transferable direct-pay letter of credit at December 31, 2016, but were repurchased by OVEC on February 6, 2017. The 2009A Bonds are classified as current at December 31, 2016.

In December 2010, OVEC established a borrowing facility under which OVEC borrowed, in 2011, $100 million remarketable variable-rate bonds due on February 1, 2040. In June 2011, the $100 million variable-rate bonds were issued as two $50 million non-amortizing pollution control revenue bonds (Series 2010A and 2010B) with initial interest periods of three years and five years, respectively. The Series 2010A Bond was remarketed in June 2014 for another three-year interest period that extends to June 29, 2017. As such, the Series 2010A Bond is classified as current at December 31, 2016. The Series 2010B Bond was remarketed in August 2016 for another five-year interest period that extends to August 25, 2021.

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 on June 1, 2027, to their respective maturity dates. The variable rates listed above reflect the interest rate in effect at December 31, 2016.

The 2012B and 2012C Bonds are secured by irrevocable transferable direct-pay letters of credit, expiring June 28, 2017, and June 28, 2018, issued for the benefit of the owners of the bonds. The interest rates on the bonds are adjusted weekly, and bondholders may require repurchase of the bonds at the time of such interest rate adjustments. OVEC has entered into agreements to provide for the remarketing of the bonds if such repurchase is required. The 2012B and 2012C Bonds are current, as they are redeemable at the election of the holders at any time.

In 2013, OVEC issued $100 million 2013A variable-rate non-amortizing unsecured senior notes (2013A Notes) to refinance and retire a 2009 series of notes. The 2013A Notes mature on February 15, 2018.

The annual maturities of long-term debt as of December 31, 2016, are as follows:

2017	$ 248,483,907
2018	151,483,806
2019	154,670,115
2020	58,054,470
2021	161,649,237
2022–2042	655,445,817
Total	$1,429,787,352

Note that the 2017 current maturities of long-term debt include $200 million of remarketable variable rate bonds. The Companies expect cash maturities of as little as $48,483,907 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 and to the extent that OVEC elects not to repurchase the bonds.

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:

	2016	2015
Income tax expense at 35% statutory rate	$ 449,361	$ 372,943
State income taxes—net of federal benefit	-	56,692
Temporary differences flowed through to customer bills	(115,669)	(149,935)
Permanent differences and other	11,728	7,272
Income tax provision	$ 345,420	$ 286,972

Components of the income tax provision were as follows:

	2016	2015
Current income tax (benefit)/expense federal	$ 345,420	$ 230,280
Current income tax (benefit)/expense state	-	56,692
Deferred income tax expense/(benefit) federal	-	-
Total income tax provision	$ 345,420	$ 286,972

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

To the extent that the Companies have not reflected credits in customer billings for deferred tax assets, they have recorded a regulatory liability representing income taxes refundable to customers under the applicable agreements among the parties. The regulatory liability was $5,433,716 at December 31, 2016 and $0 at December 31, 2015.

Deferred income tax assets (liabilities) at December 31, 2016 and 2015, consisted of the following:

	2016	2015
Deferred tax assets:		
Deferred revenue—advances for construction	$ 3,404,026	$ 5,397,379
AMT credit carryforwards	8,837,712	12,030,465
Federal net operating loss carryforwards	104,723,266	88,071,534
Postretirement benefit obligation	13,683,150	11,285,916
Pension liability	11,721,810	8,457,343
Postemployment benefit obligation	1,535,562	884,556
Asset retirement obligations	11,569,073	10,940,744
Miscellaneous accruals	2,819,512	2,701,010
Regulatory liability—other	-	171,113
Regulatory liability—asset retirement costs	4,729,118	3,928,073
Regulatory liability—postretirement benefits	9,670,762	12,515,434
Regulatory liability—income taxes refundable to customers	15,096,997	15,393,198
Total deferred tax assets	187,790,988	171,776,765
Deferred tax liabilities:		
Prepaid expenses	(602,424)	(626,595)
Electric plant	(128,994,396)	(112,357,167)
Unrealized gain/loss on marketable securities	(3,694,091)	(4,220,517)
Regulatory asset—pension benefits	(12,998,618)	(9,764,404)
Regulatory asset—unrecognized postemployment benefits	(1,535,562)	(884,556)
Total deferred tax liabilities	(147,825,091)	(127,853,239)
Valuation allowance	(37,265,897)	(43,923,526)
Deferred income tax assets	$ 2,700,000	$ -

As discussed in Note 1, OVEC indefinitely changed its billing practices in 2014 to effectively suspend billings for its authorized equity return. As a result, the Companies' long-term expectation is that taxable income will be breakeven for the foreseeable future. Accordingly, the Companies have recorded a valuation allowance as of December 31, 2016 and 2015. During 2016, due to a change in federal tax law, the Companies reduced the recorded valuation allowance to reflect certain Alternative Minimum Tax (AMT) credit carryforwards that the Companies expect to claim as refundable credits in its 2016-2019 federal income tax returns. The favorable impact of releasing the valuation allowance has been recorded as a regulatory liability that will be refunded to Sponsor Companies over a long-term basis.

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 50% likelihood of being realized upon ultimate settlement. The Companies have not identified any uncertain tax positions as of December 31, 2016 and 2015, and accordingly, no liabilities for uncertain tax positions have been recognized.

The Companies file income tax returns with the Internal Revenue Service and the states of Ohio, Indiana, and the Commonwealth of Kentucky. The Companies are no longer subject to federal tax examinations for tax years 2012 and earlier. The Companies are no longer subject to State of Indiana tax examinations for tax years 2012 and earlier. The Companies are no longer subject to Ohio and the Commonwealth of Kentucky examinations for tax years 2011 and earlier. The Companies have $299,209,332 of Federal Net Operating Loss carryovers that begin to expire in 2031.

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 hired prior to January 1, 2015. The benefits are based on years of service and each employee's highest consecutive 36-month compensation period. Employees are vested in the Pension Plan after five years of service with the Companies.

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

In addition to the Pension Plan, the Companies provide certain health care and life insurance benefits (Other Postretirement Benefits) for retired employees. Substantially, all of the Companies' employees hired prior to January 1, 2015, 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 VEBA trusts. In January 2011, the Companies established an Internal Revenue Code Section 401(h) account under the Pension Plan.

The full cost of the pension benefits and other postretirement benefits has been allocated to OVEC and IKEC in the accompanying consolidated financial statements. The allocated amounts represent approximately a 56% and 44% split between OVEC and IKEC, respectively, as of December 31, 2016, and approximately a 55% and 45% split between OVEC and IKEC, respectively, as of December 31, 2015.

The Pension Plan's assets as of December 31, 2016, consist of investments in equity and debt securities. All of the trust funds' investments for the pension and postemployment benefit plans are diversified and managed in compliance with all laws and regulations. Management regularly reviews the actual asset allocation and periodically rebalances the investments to targeted allocation when appropriate. The investments are reported at fair value under the Fair Value Measurements and Disclosures accounting guidance.

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

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

Investment strategies include:

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

The target asset allocation for each portfolio is as follows:

Pension Plan Assets	**Target**
Domestic equity	15 %
International and global equity	15 %
Fixed income	70 %

VEBA Plan Assets	**Target**
Domestic equity	20 %
International and global equity	20 %
Fixed income	57 %
Cash	3 %

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, 2016, the Pension Plan fixed income allocation consists of managed accounts composed of U.S. Government, corporate, and municipal obligations. The VEBA benefit plans' fixed income allocation is composed of a variety of fixed income securities and mutual funds. Investment limitations for these fixed income funds are defined by manager prospectus.

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

Projected Pension Plan and Other Postretirement Benefits obligations and funded status as of December 31, 2016 and 2015, are as follows:

	Pension Plan		Other Postretirement Benefits	
	2016	2015	2016	2015
Change in projected benefit obligation:				
Projected benefit obligation—beginning of year	$ 210,230,403	$ 222,823,889	$ 159,175,000	$ 171,774,437
Service cost	6,100,517	6,989,504	4,668,640	5,327,376
Interest cost	10,010,361	9,407,555	7,490,213	7,254,699
Plan participants' contributions	-	-	1,242,428	1,205,258
Benefits paid	(8,968,048)	(7,946,163)	(5,477,750)	(4,725,510)
Net actuarial (gain)/loss	15,674,831	(20,959,580)	7,239,951	(21,661,260)
Expenses paid from assets	(49,905)	(84,802)	-	-
Projected benefit obligation—end of year	232,998,159	210,230,403	174,338,482	159,175,000
Change in fair value of plan assets:				
Fair value of plan assets—beginning of year	182,340,523	190,348,243	126,939,255	126,898,685
Actual return on plan assets	16,380,770	(5,110,088)	7,972,778	(1,050,162)
Expenses paid from assets	(49,905)	(84,802)	-	-
Employer contributions	6,166,667	5,133,333	4,443,681	4,610,984
Plan participants' contributions	-	-	1,242,428	1,205,258
Benefits paid	(8,968,048)	(7,946,163)	(5,477,750)	(4,725,510)
Fair value of plan assets—end of year	195,870,007	182,340,523	135,120,392	126,939,255
(Underfunded) status—end of year	$ (37,128,152)	$ (27,889,880)	$ (39,218,090)	$ (32,235,745)

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

The accumulated benefit obligation for the Pension Plan was $208,284,000 and $186,842,491 at December 31, 2016 and 2015, 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	
	2016	2015	2016	2015
Service cost	$ 6,100,517	$ 6,989,504	$ 4,668,640	$ 5,327,376
Interest cost	10,010,361	9,407,555	7,490,213	7,254,699
Expected return on plan assets	(10,904,733)	(11,363,279)	(6,719,397)	(6,857,348)
Amortization of prior service cost	(416,565)	(416,565)	(1,763,901)	(1,763,901)
Recognized actuarial loss	643,503	882,076	(75,802)	(12,653)
Total benefit cost	$ 5,433,083	$ 5,499,291	$ 3,599,753	$ 3,948,173
Pension and other postretirement benefits expense recognized in the consolidated statements of income and retained earnings and billed to Sponsoring Companies under the ICPA	$ 6,166,667	$ 5,133,333	$ -	$ -

The following table presents the classification of Pension Plan assets within the fair value hierarchy at December 31, 2016 and 2015:

	Fair Value Measurements at Reporting Date Using			
2016	**Quoted Prices in Active Market for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**2016 Total**
Domestic equity mutual funds	$ 16,007,602	$ -	$ -	$ 16,007,602
Common stock—domestic	8,501,931	-	-	8,501,931
Common stock—foreign	554,648	-	-	554,648
International and global equity mutual funds	24,249,523	-	-	24,249,523
Cash equivalents	6,727,436	-	-	6,727,436
U.S. Treasury securities	-	8,886,917	-	8,886,917
Corporate debt securities	-	109,890,354	-	109,890,354
Municipal debt securities	-	8,933,969	-	8,933,969
Subtotal Benefit Plan Assets	$ 56,041,140	$ 127,711,240	$ -	183,752,380
Investments measured at net asset value (NAV)				12,117,627
Total Benefit Plan Assets				$ 195,870,007
2015				
Domestic equity mutual funds	$ 14,335,609	$ -	$ -	$ 14,335,609
Common stock—domestic	7,055,019	-	-	7,055,019
Common stock—foreign	-	-	-	-
International and global equity mutual funds	22,176,739	-	-	22,176,739
Cash equivalents	4,504,117	-	-	4,504,117
U.S. Treasury securities	-	6,685,068	-	6,685,068
Corporate debt securities	-	107,733,562	-	107,733,562
Municipal debt securities	-	8,607,765	-	8,607,765
Subtotal Benefit Plan Assets	$ 48,071,484	$ 123,026,395	$ -	171,097,879
Investments measured at net asset value (NAV)				11,242,644
Total Benefit Plan Assets				$ 182,340,523

The following table presents the classification of VEBA and 401(h) account assets within the fair value hierarchy at December 31, 2016 and 2015:

	Fair Value Measurements at Reporting Date Using			
2016	**Quoted Prices in Active Market for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**2016 Total**
Domestic equity mutual funds	$ 45,270,259	$ -	$ -	$ 45,270,259
International and global equity mutual funds	23,375,504	-	-	23,375,504
Fixed-income mutual funds	41,750,065	-	-	41,750,065
Fixed-income securities	-	18,611,238	-	18,611,238
Cash equivalents	728,483	-	-	728,483
Benefit Plan Assets	$ 111,124,311	$ 18,611,238	$ -	129,735,549
Uncleared cash disbursements from benefits paid				(1,601,641)
Investments measured at net asset value (NAV)				6,986,484
Total Benefit Plan Assets				$ 135,120,392
2015				
Domestic equity mutual funds	$ 41,553,682	$ -	$ -	$ 41,553,682
International and global equity mutual funds	20,442,372	-	-	20,442,372
Fixed-income mutual funds	39,627,128	-	-	39,627,128
Fixed-income securities	-	18,407,810	-	18,407,810
Cash equivalents	257,086	-	-	257,086
Benefit Plan Assets	$ 101,880,268	$ 18,407,810	$ -	120,288,078
Investments measured at net asset value (NAV)				6,651,177
Total Benefit Plan Assets				$ 126,939,255

Investments that were measured at net asset value (NAV) per share (or its equivalent) as a practical expedient have not been classified in the fair value hierarchy. These investments represent holdings in a single private investment fund that are redeemable at the election of the holder upon no more than 30 days' notice. The values reported above are based on information provided by the fund manager.

Pension Plan and Other Postretirement Benefit Assumptions—Actuarial assumptions used to determine benefit obligations at December 31, 2016 and 2015, were as follows:

	Pension Plan		Other Postretirement Benefits			
	2016	2015	2016		2015	
			Medical	Life	Medical	Life
Discount rate	4.31 %	4.82 %	4.31 %	4.31 %	4.80 %	4.80 %
Rate of compensation increase	3.00	3.00	N/A	3.00	N/A	3.00

Actuarial assumptions used to determine net periodic benefit cost for the years ended December 31, 2016 and 2015, were as follows:

	Pension Plan		Other Postretirement Benefits			
	2016	2015	2016		2015	
			Medical	Life	Medical	Life
Discount rate	4.82 %	4.28 %	4.80 %	4.80 %	4.33 %	4.33 %
Expected long-term return on plan assets	6.00	6.00	5.29	6.00	5.29	6.00
Rate of compensation increase	3.00	3.00	N/A	3.00	N/A	3.00

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

Assumed health care cost trend rates at December 31, 2016 and 2015, were as follows:

	2016	2015
Health care trend rate assumed for next year—participants under 65	7.00 %	7.00 %
Health care trend rate assumed for next year—participants over 65	7.00	7.00
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	2022	2022

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:

	One-Percentage Point Increase	One-Percentage Point Decrease
Effect on total service and interest cost	$ 2,353,599	$ (1,869,850)
Effect on postretirement benefit obligation	29,092,165	(22,937,519)

Pension Plan and Other Postretirement Benefit Assets—The asset allocation for the Pension Plan and VEBA trusts at December 31, 2016 and 2015, by asset category was as follows:

	Pension Plan		VEBA Trusts	
	2016	2015	2016	2015
Asset category:				
Equity securities	31 %	30 %	40 %	38 %
Debt securities	69	70	60	62

Pension Plan and Other Postretirement Benefit Contributions—The Companies expect to contribute $6,000,000 to their Pension Plan and $5,166,759 to their Other Postretirement Benefits plan in 2017.

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
2017	$ 7,987,611	$ 6,730,248
2018	8,626,513	7,159,952
2019	9,532,649	7,689,832
2020	10,365,968	8,213,128
2021	11,241,424	8,668,791
Five years thereafter	67,777,423	51,882,547

Postemployment Benefits—The Companies follow the accounting guidance in FASB ASC 712, 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 59% and 41% split between OVEC and IKEC, respectively, as of December 31, 2016, and approximately a 36% and 64% split between OVEC and IKEC, respectively, as of December 31, 2015. 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 $4,273,362 and $2,526,541 at December 31, 2016 and 2015, 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' pay contributed. In addition, the Companies provide contributions to eligible employees, hired on or after January 1, 2015, of 3% to 5% of pay based on age and service. 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 2016 and 2015 were $1,985,582 and $2,047,129, respectively.

9. ENVIRONMENTAL MATTERS

Title IV of the 1990 Clean Air Act Amendments (CAAAs) required the Companies to reduce sulfur dioxide (SO_2) 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_2 allowances. Historically, the cost of these purchased allowances has been inventoried and included on an average cost basis in the cost of fuel consumed when used.

Title IV of the 1990 CAAAs also required the Companies to comply with a nitrogen oxides (NO_x) emission rate limit of 0.84 lb/mmBtu in 2000. The Companies installed overfire air systems on all 11 units at the plants to comply with this limit. The total capital cost of the 11 overfire air systems was approximately $8.2 million.

During 2002 and 2003, Ohio and Indiana finalized respective NO_x State Implementation Plan (SIP) Call regulations that required further significant NO_x emission reductions for coal-burning power plants during the ozone control period. The Companies installed selective catalytic reduction (SCR) systems on 10 of their 11 units to comply with these rules. The total capital cost of the 10 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_2 and NO_x 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_x; 2010 and 2015 for SO_2; 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 (MATS) rule. The rule became final on April 16, 2012, and OVEC-IKEC had to demonstrate compliance with MATS emission limits on April 16, 2015. In June 2015, the U.S. Supreme Court issued a ruling on outstanding MATS litigation that the U.S. EPA had failed to take costs into consideration when they made a determination that it was appropriate and necessary to regulate mercury emissions from steam electric utilities; however, the rule remains in effect and it was remanded back to the D.C. Circuit Court for further action. That Court sent the rule back to the U.S. EPA to remedy the flaws identified in the Supreme Court decision. A final determination on whether the U.S. EPA has adequately considered costs as part of the rulemaking process is still pending. Regardless of that outcome, MATS is now in effect, and the controls OVEC-IKEC has installed have proven to be adequate to meet the emissions requirements outlined in the MATS rule.

In July 2008, the D.C. Circuit Court of Appeals issued a decision that vacated the federal CAIR and remanded the rule to the U.S. EPA. In September 2008, the U.S. EPA, a group of electric utilities and other parties filed petitions for rehearing. In December 2008, the D.C. Circuit Court of Appeals granted the U.S. EPA's petition and remanded the rule to the U.S. EPA without vacatur, allowing the federal CAIR to remain in effect while a new rule was developed and promulgated. Following the remand, the U.S. EPA promulgated a replacement rule to CAIR. This new rule is called the Cross-State Air Pollution Rule (CSAPR) and it was issued on July 6, 2011, and it was scheduled to go into effect on January 1, 2012. However, on December 30, 2011, the D.C. Circuit Court issued an indefinite stay of the CSAPR rule until the Court considered the numerous state, trade association, and industry petitions filed to have the rule either stayed or reviewed. The Court also instructed the U.S. EPA to keep CAIR in place while they considered the numerous petitions. On August 21, 2012, in a 2-1 decision, the D.C. Circuit Court vacated the CSAPR rule and ordered the U.S. EPA to keep CAIR in effect until a CSAPR replacement rule is promulgated. The U.S. EPA and other parties filed a petition seeking rehearing before the entire 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 2013, and the Supreme Court granted that petition in June 2013. Oral arguments were presented before the Supreme Court in December 2013. On April 29, 2014, the U.S. Supreme Court issued a decision reversing the D.C. Circuit Court's 2013 CSAPR vacatur and remanded the CSAPR rule back to that Court for further deliberation. On October 23, 2014, the D.C. Circuit Court issued a motion lifting the stay on the CSAPR rules and then U.S. EPA issued a ministerial rule on November 21, 2014, that allowed CSAPR to become effective on January 1, 2015. On July 28, 2015, the U.S. Supreme Court remanded portions of the CSAPR rule back to the D.C. Circuit Court for additional review and subsequent action by the U.S. EPA. The remaining issues included overstated ozone season budgets for nine states, including Ohio. As a result, on November 16, 2015, the U.S. EPA proposed a CSAPR update rule that incorporated the 2008 ozone National Ambient Air Quality Standards (NAAQS) to update these states' allocation budgets to address interstate transport, as well as addressing some of the other remaining issues from the original CSAPR. This proposed CSAPR Update rule became final on September 7, 2016, and is scheduled to go into effect beginning with the May 2017 Ozone Season. OVEC-IKEC is evaluating the final rule and is preparing our compliance strategy for meeting this rule beginning on May 1, 2017.

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_2 allowances in 2016 to cover actual emissions; however, there was a need to purchase a limited quantity of NO_x Ozone Season allowances in 2016. Depending on a variety of operational and economic factors, management may also elect to strategically purchase CSAPR Annual and Ozone Season NO_x allowances in 2017 and beyond.

Now that all FGD systems are fully operational, OVEC-IKEC continues to expect to have adequate SO_2 allowances available without having to rely on market purchases to comply with the CSAPR rules in their current form; however, the purchase of additional NO_x allowances and the improvement and optimization of current NO_x control systems are being conducted. In addition, we are evaluating the need for additional NO_x controls and/or changes in unit dispatch criteria for Clifty Creek Unit 6 as well as other OVEC-IKEC units under the current CSAPR regulations as well as any future NO_x regulations.

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 were operational. 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 2013.

CCR Rule

In 2010, the U.S. EPA published a proposed rule to regulate the disposal and beneficial reuse of coal combustion residuals (CCRs), including fly ash and boiler slag generated at coal-fired electric generating units as well as FGD gypsum generated at some coal-fired plants. The proposed rule contained two alternative proposals. One proposal would impose federal hazardous waste disposal and management standards on these materials and another would allow states to retain primary authority to regulate the beneficial reuse and disposal of these materials under state solid waste management standards, including minimum federal standards for disposal and management. Both proposals would impose stringent requirements for the construction of new coal ash landfills and existing unlined surface impoundments.

Various environmental organizations and industry groups filed a petition seeking to establish deadlines for a final rule. To comply with a court-ordered deadline, the U.S. EPA issued a prepublication copy of its final rule in December 2014. The rule was published in the Federal Register in April 2015 and became effective in October 2015.

In the final rule, the U.S. EPA elected to regulate CCR as a non-hazardous solid waste and issued new minimum federal solid waste management standards. The rule applies to new and existing active CCR landfills and CCR surface impoundments at operating electric utility or independent power production facilities. The rule imposes new and additional construction and operating obligations, including location restrictions, liner criteria, structural integrity requirements for impoundments, operating criteria, and additional groundwater monitoring requirements. The rule is self-implementing and currently does not require state action. As a result of this self-implementing feature, the rule contains extensive recordkeeping, notice, and Internet posting requirements. OVEC-IKEC has been systematically implementing applicable provisions of the CCR rule. OVEC-IKEC has completed all compliance obligations associated with the rule to date and has begun evaluating what, if any, impacts groundwater quality will have on its CCR units. Preliminary background results indicate that there is a potential for groundwater quality issues with the boiler slag ponds at each plant and both landfills. This information is still being collected and evaluated, so no final determination has been made to date. Alternative Source Demonstrations (ASD) are being completed in parallel to the background data collection. OVEC-IKEC is confident in being able to demonstrate that an ASD is the cause of the preliminary groundwater quality issues being observed in the Kyger Creek landfill and boiler slag ponds. Additional information will be available in early 2018.

In February 2014, the U.S. EPA completed a risk evaluation of the beneficial uses of coal fly ash in concrete and FGD gypsum in wallboard and concluded that the U.S. EPA supports these beneficial uses. Currently, approximately 5% of the coal ash and other residual products from our generating facilities are reused in the production of cement and wallboard, as structural fill or soil amendments, as abrasives or road treatment materials, and for other beneficial uses.

NAAQS Compliance for SO_2

On June 22, 2010, the U.S. EPA revised the Clean Air Act by developing and publishing a new one-hour SO_2 NAAQS of 75 parts per billion, which replaced the previously existing 24-hour and annual standards, and became effective on August 23, 2010. States with areas failing to meet the new standard are required to develop SIPs to expeditiously attain and maintain the standard.

On August 15, 2013, the U.S. EPA published its initial non-attainment area designations for the new one-hour SO_2, which did not include the areas around Kyger Creek or Clifty Creek. However, the amended rule does establish that at a minimum sources that emit 2,000 tons SO_2 or more per year be characterized by their respective states using either modeling of actual source emissions or through appropriately sited ambient air quality monitors.

In addition, U.S. EPA entered into a settle agreement with Sierra Club/NRDC in the U.S. District Court for the Northern District of California requiring U.S. EPA to take certain actions, including completing area designation by July 2, 2016, for areas with either monitored violations based on 2013-15 air quality monitoring or sources not announced for retirement that emitted more than 16,000 tons SO_2 or more than 2,600 tons with a 0.45 SO_2/mmBtu emission rate in 2012.

Both Kyger Creek and Clifty Creek, either directly or indirectly, triggered one of these criteria and have been evaluated by our respective state regulatory agencies through modeling. The modeling results showed Clifty Creek could meet the new one-hour SO_2 limit using their current scrubber systems without any additional investment or modifications. Kyger Creek's modeling data was rejected by U.S. EPA as inconclusive. As a result, Kyger Creek installed a SO_2 monitoring network around the plant and will be required to monitor ambient air quality for at least the next three years, beginning on January 1, 2017. U.S. EPA will then use the results of the monitoring network data to make a determination of our compliance status with the SO_2 NAAQS by no later than December 31, 2020. Based on initial data from that network, OVEC expects to show compliance with the new one-hour standard, and we expect to avoid additional scrubber investments or modifications.

Steam Electric ELGs

On September 30, 2015, the U.S. EPA signed a new final rule governing Effluent Limitations Guidelines (ELGs) for the wastewater discharges from steam electric power generating plants. The rule, which was formally published in the Federal Register on November 3, 2015, will affect future wastewater discharges from both the Kyger Creek and Clifty Creek Stations.

The rule will require OVEC-IKEC to modify the way it handles a number of wastewater processes at both power plants. Specifically, the new ELG standards will affect the following wastewater processes in three ways:

1. Kyger Creek will need to convert to dry fly ash handling by no later than December 31, 2023. The Clifty Creek Station already has a dry fly ash handling system in place, so this provision of the rule will not impact Clifty Creek's operations.

2. The new ELGs will prohibit the discharge of bottom ash sluice water from boiler slag/bottom ash wastewater treatment systems. For Clifty Creek and Kyger Creek, this will most likely mean conversion of each plant's boiler slag ponds to either a closed-loop sluicing system or a dry handling system for boiler slag. OVEC-IKEC conducted a Phase I engineering study in 2016 to determine options and costs associated with retrofitting the plants' boiler slag treatment systems. The study results are being refined and we expect to make a final selection of proposed control technologies in 2017. Engineering, design, construction, installation, and successful operation of all controls will also need to be completed by no later than December 31, 2023.

3. The new ELG rules also establish new internal limitations for the FGD system wastewater discharges. Specifically, there will be new internal limits for arsenic, mercury, selenium, and nitrate/nitrite nitrogen from the FGD chlorides purge stream wastewater treatment plant at each plant. For both Clifty Creek and Kyger Creek Stations, we are expecting to be able to meet the

mercury and arsenic limitations with the current wastewater treatment technology; however, we are expecting to add some form of biological (or equivalent non-biological) treatment system on the back end of each Station's existing FGD wastewater treatment plant to meet the new nitrate/nitrite nitrogen and selenium limitations.

U.S. EPA is requiring compliance with these new limits "as soon as possible" after November 1, 2018, but no later than December 31, 2023. The new limits will be implemented through each Station's wastewater discharge permit which is typically renewed on a five-year basis. The final compliance dates will be facility-specific and negotiated with our state permit agencies based on the time needed to plan, secure funding, design, procure, and install necessary control technologies. OVEC-IKEC has initiated the process of investigating various technologies to meet the compliance requirements of the ELG rule, and we have preliminary technologies and associate cost estimates developed. The cost estimates and technology evaluations will be refined over the coming year.

316(b) Compliance

The 316(b) rule was published as a final rule in the Federal Register on August 15, 2014, and impacts facilities that use cooling water intakes structures designed to withdraw at least 2 million gallons per day from waters of the U.S. and who also have an NPDES permit. The rule requires such facilities to choose one of seven options specified by the rule to reduce impingement to fish and other aquatic organisms. Additionally, facilities that withdraw 125 million gallons or more per day must conduct entrainment studies to assist state permitting authorities in determining what site-specific controls are required to reduce the number of aquatic organisms entrained by each respective cooling water system.

OVEC-IKEC has completed the required two-year fish entrainment studies. Additional analysis is being performed in compliance with the rule, and comprehensive reports are being developed for submittal to each plant's respective state agency for review.

Currently, OVEC-IKEC expects to provide the results of the comprehensive 316(b) studies and our control technology recommendations to our state regulatory agencies in 2018. The timeline for when we will be required to retrofit the cooling water systems at Clifty Creek and Kyger Creek, as well as the type of retrofit required, will then be negotiated with each state regulatory agency.

10. FAIR VALUE MEASUREMENTS

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

OVEC utilizes its trustee's external pricing service in its estimate of the fair value of the underlying investments held in the benefit plan trusts and investment portfolios. The Companies' management reviews and validates the prices utilized by the trustee to determine fair value. Equities and fixed-income securities are classified as Level 1 holdings if they are actively traded on exchanges. In addition, mutual funds are classified as Level 1 holdings because they are actively traded at quoted market prices. Certain fixed-income securities do not trade on an exchange and do not have an official closing price. Pricing vendors calculate bond valuations using financial models and matrices. Fixed-income securities are typically classified as Level 2 holdings because their valuation inputs are based on observable market 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, 2016 and 2015, the Companies held certain assets that are required to be measured at fair value on a recurring basis. These consist of investments recorded within long-term investments. The investments consist of money market mutual funds, equity mutual funds, and fixed-income municipal securities. Changes in the observed trading prices and liquidity of money market funds are monitored as additional support for determining fair value, and unrealized gains and losses are recorded in earnings.

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

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

Long-Term Investments—Assets measured at fair value on a recurring basis at December 31, 2016 and 2015, were as follows:

	Fair Value Measurements at Reporting Date Using		
2016	**Quoted Prices in Active Market for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Equity mutual funds	$28,106,968	$ -	$ -
Fixed income municipal securities	-	87,163,674	-
Cash equivalents	3,731,735	-	-
Total fair value	$31,838,703	$87,163,674	$ -
2015			
Equity mutual funds	$23,811,678	$ -	$ -
Fixed income municipal securities	-	90,587,635	-
Cash equivalents	5,360,793	-	-
Total fair value	$29,172,471	$90,587,635	$ -

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, 2016 and 2015, are as follows:

	2016		2015	
	Fair Value	**Recorded Value**	**Fair Value**	**Recorded Value**
Total	$1,548,416,122	$1,429,281,688	$1,626,945,340	$1,474,918,560

11. LEASES

OVEC has various operating leases for the use of other property and equipment.

The amount in property under capital leases is $1,866,796 and $2,084,462 with accumulated depreciation of $949,520 and $812,724 as of December 31, 2016 and 2015, respectively.

Future minimum lease payments for capital and operating leases at December 31, 2016, are as follows:

Years Ending December 31	**Operating**	**Capital**
2017	$ 31,531	$ 353,342
2018	19,123	217,340
2019	-	114,294
2020	-	78,293
2021	-	23,625
Thereafter	-	278,722
Total future minimum lease payments	$ 50,654	1,065,616
Less estimated interest element		279,202
Estimated present value of future minimum lease payments		$ 786,414

The annual operating lease cost incurred was $41,198 and $834,815 for 2016 and 2015, 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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