

## Independent Auditors' Report

The Board of Directors  
Sunflower Electric Power Corporation:

We have audited the accompanying combined balance sheets of Sunflower Electric Power Corporation, Sunflower Electric Holdings, Inc., and subsidiaries (collectively, Sunflower) as of December 31, 2009 and 2008, and the related combined statements of operations and comprehensive income, member and patron deficit, and cash flows (hereinafter referred to as combined financial statements) for the years then ended. These combined financial statements are the responsibility of Sunflower's management. Our responsibility is to express an opinion on these combined 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 combined financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Sunflower's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the combined financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall combined financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the financial position of Sunflower as of December 31, 2009 and 2008, and the results of their operations, and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

**KPMG LLP**

Kansas City, Missouri  
March 15, 2010

# Notes to Combined Financial Statements

December 31, 2009 and 2008

Combined Balance Sheets

Assets, Pledged	2009	2008
Net utility plant, at cost	\$ 260,597,166	259,049,610
Construction work in progress	1,612,302	9,653,999
Total utility plant, net	<u>262,209,468</u>	<u>268,703,609</u>
Investments and other assets:		
Capital term certificates of the National Rural Utilities Cooperative Finance Corporation	20,455,275	21,069,745
Investments in associated organizations	4,557,112	4,421,361
Escrowed funds	7,939,412	8,156,068
Total investments and other assets	<u>32,951,799</u>	<u>33,647,174</u>
Current assets:		
Cash and cash equivalents	2,153,835	1,576,422
Accounts receivable:		
Member	10,087,286	9,635,454
Affiliate	4,740,885	6,956,997
Other	9,234,194	5,323,523
	<u>24,062,365</u>	<u>21,915,974</u>
Inventories:		
Fuel	5,502,947	4,008,516
Materials and supplies	7,520,762	7,645,609
	<u>13,023,709</u>	<u>11,654,125</u>
Derivative instrument assets	—	1,296,034
Prepayments and other current assets	2,050,228	1,322,776
Total current assets	<u>41,290,137</u>	<u>37,765,331</u>
Deferred charges	33,867,912	30,018,690
Total assets	<u>\$ 370,319,316</u>	<u>370,134,804</u>

# Notes to Combined Financial Statements

December 31, 2009 and 2008

Combined Balance Sheets

<b>Capitalization and Liabilities</b>	<b>2009</b>	<b>2008</b>
Capitalization:		
Long-term obligations, less current maturities	\$ 291,038,962	312,839,590
Obligations under capital leases, less current portion	14,674,453	13,283,343
Member and patron equity (deficit):		
Memberships	890	890
Donated capital	4,852,989	4,852,989
Accumulated deficit	(25,326,719)	(41,692,954)
Accumulated other comprehensive loss	(3,675,124)	(3,356,991)
Total member and patron deficit	<u>(24,147,964)</u>	<u>(40,196,066)</u>
Total capitalization	<u>281,565,451</u>	<u>285,926,867</u>
Current liabilities:		
Current maturities of long-term obligations	25,219,767	27,116,865
Current portion of obligations under capital leases	591,570	538,596
Accounts payable	6,553,432	6,961,826
Accounts payable — affiliates	860,109	136,446
Interest payable	134,820	320,856
Accrued liabilities:		
Taxes other than income taxes	4,278,302	4,057,476
Other	3,725,439	4,602,430
Total current liabilities	<u>41,363,439</u>	<u>43,734,495</u>
Deferred credits	39,628,284	34,091,341
Other long-term liabilities	7,762,142	6,382,101
Total capitalization and liabilities	<u>\$ 370,319,316</u>	<u>370,134,804</u>

See accompanying notes to combined financial statements.

# Notes to Combined Financial Statements

December 31, 2009 and 2008

## Combined Statements of Operators and Comprehensive Income

	<u>2009</u>	<u>2008</u>
Operating revenue:		
Member power sales	\$ 115,275,441	118,602,274
Nonmember power sales	33,039,494	46,083,431
Revenue from Affiliate	24,092,021	42,428,902
Other	22,808,941	25,608,131
Total operating revenue	<u>195,215,897</u>	<u>232,722,738</u>
Operating expenses:		
Operations:		
Production and other power supply	104,108,554	142,767,675
Transmission	22,363,103	22,228,309
Maintenance:		
Production	16,408,908	15,763,904
Transmission	1,513,356	1,486,835
Administrative and general	9,439,764	9,088,729
Depreciation and amortization	10,626,773	13,329,701
Other taxes	8,888	115,697
Total operating expenses	<u>164,469,346</u>	<u>204,780,850</u>
Electric operating margin	30,746,551	27,941,888
Interest expense	(16,095,453)	(17,752,191)
Other deletions, net	(487,715)	(254,914)
Operating margins	<u>14,163,383</u>	<u>9,934,783</u>
Nonoperating margins:		
Investment income	953,861	1,228,691
Other, net	1,248,991	2,590,840
Total nonoperating margins	<u>2,202,852</u>	<u>3,819,531</u>
Net margins	16,366,235	13,754,314
Other comprehensive loss - postretirement benefit plan	(318,133)	(1,855,192)
Total comprehensive income	<u>\$ 16,048,102</u>	<u>11,899,122</u>

See accompanying notes to combined financial statements.

# Notes to Combined Financial Statements

December 31, 2009 and 2008

Combined Statements of Member and Patron Deficit

	<u>Memberships</u>	<u>Donated capital</u>	<u>Accumulated deficit</u>	<u>Accumulated other comprehensive loss</u>	<u>Total</u>
Balance, December 31, 2007	\$ 890	4,852,989	(55,447,268)	(1,501,799)	(52,095,188)
Comprehensive loss:					
Net margins	—	—	13,754,314	—	13,754,314
Other comprehensive loss, net of tax postretirement benefit plan	—	—	—	(1,855,192)	(1,855,192)
Balance, December 31, 2008	890	4,852,989	(41,692,954)	(3,356,991)	(40,196,066)
Comprehensive loss:					
Net margins	—	—	16,366,235	—	16,366,235
Other comprehensive loss, net of tax postretirement benefit plan	—	—	—	(318,133)	(318,133)
Balance, December 31, 2009	\$ <u>890</u>	<u>4,852,989</u>	<u>(25,326,719)</u>	<u>(3,675,124)</u>	<u>(24,147,964)</u>

See accompanying notes to combined financial statements.

# Notes to Combined Financial Statements

December 31, 2009 and 2008

Combined Statements of Cash Flow

	<u>2009</u>	<u>2008</u>
Cash flows from operating activities:		
Net margins	\$ 16,366,235	13,754,314
Adjustments to reconcile net margins to net cash provided by operating activities:		
Depreciation and amortization	10,626,773	13,329,701
Amortization of capital leased assets included in rent expense	552,786	503,067
Amortization of deferred charges	1,328,065	1,328,553
Patronage credits earned from investments	(135,751)	(267,961)
Change in fair value of derivative instruments	2,225,068	(1,296,034)
Accretion of residual value notes	3,419,139	3,299,008
Changes in assets and liabilities:		
Increase in accounts receivable	(676,252)	(4,934,685)
Increase in inventories	(1,369,584)	(756,830)
(Increase) decrease in prepayments and other current assets	(727,452)	1,964,134
Decrease in long term other assets	—	2,760,297
Increase (decrease) in accounts payable	1,006,306	(1,245,418)
Decrease in interest payable	(186,036)	(111,735)
(Decrease) increase in accrued liabilities	(1,585,199)	2,396,531
Increase (decrease) in other deferred credits	546,000	(159,682)
Increase in long-term liabilities	1,061,908	393,087
Net cash provided by operating activities	<u>32,452,006</u>	<u>30,956,347</u>
Cash flows from investing activities:		
Utility plant expenditures	(5,848,760)	(10,263,023)
Proceeds from FEMA	2,638,994	6,483,482
Proceeds from investment in National Rural Utilities Cooperative Finance Corporation	614,470	395,833
Decrease in escrowed funds related to development	216,656	3,039,983
Proceeds from development projects	3,303,776	5,319,253
Payments for development costs	(5,144,268)	(5,635,335)
Net cash used in investing activities	<u>(4,219,132)</u>	<u>(659,807)</u>
Cash flows from financing activities:		
Short-term facility borrowings, net	—	(10,000,000)
Principal payments under capital lease obligations	(538,596)	(503,067)
Principal payments on long-term obligations	(27,116,865)	(23,858,699)
Net cash used in financing activities	<u>(27,655,461)</u>	<u>(34,361,766)</u>
Net increase (decrease) in cash and cash equivalents	577,413	(4,065,226)
Cash and cash equivalents, beginning of year	1,576,422	5,641,648
Cash and cash equivalents, end of year	<u>\$ 2,153,835</u>	<u>1,576,422</u>

## Supplemental information:

Sunflower paid \$16,281,488 and \$17,863,926 in cash for interest during 2009 and 2008, respectively. Sunflower entered into a new capital lease in 2009 in the amount of \$1,982,680.

See accompanying notes to combined financial statements.

# Notes to Combined Financial Statements

December 31, 2009 and 2008

## (1) Nature of Operations and Summary of Significant Accounting Policies

### (a) *Nature of Operations and Liquidity*

Sunflower Electric Power Corporation (Sunflower or the Company) is an electric generation and transmission corporation. Sunflower is responsible for the electric power requirements of its six distribution cooperative members (Members) operating within Western Kansas: Lane Scott Electric Cooperative, Inc.; Pioneer Electric Cooperative, Inc.; Prairie Land Electric Cooperative, Inc.; The Victory Electric Cooperative Association, Inc.; Western Cooperative Electric Association, Inc.; and Wheatland Electric Cooperative, Inc. Power supply rates to Sunflower's members are subject to approval by the Board of Directors and the Rural Utilities Service (RUS). Transmission rates are subject to the approval by the Kansas Corporation Commission (KCC). In accordance with this regulation, Sunflower has applied the provisions of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 980, *Regulated Operations*, formerly, FAS No. 71, *Accounting for the Effects of Certain Types of Regulation*.

Sunflower's primary resource for supplying the needs of its members is Holcomb Station. Holcomb Station is a coal-fired generating facility with a net rating of 362 megawatts. Sunflower's accredited generation with the Southwest Power Pool totals 661 megawatts, and includes all generation assets available. Sunflower purchases coal through Western Fuels Association, Inc. (Western Fuels), a not-for-profit cooperative that provides coal to consumer-owned utilities, and from DTE Coal Services. During 2009 and 2008, Sunflower purchased approximately \$39,700,000 and \$40,600,000, respectively, for coal and coal transportation. Because Western Fuels is a consumer-owned entity, representatives from Sunflower's board of directors and management are also members of Western Fuels' board of directors.

At December 31, 2009, Sunflower had negative working capital, current assets less current liabilities, of approximately \$0.1 million; however, \$7.9 million in cash is reflected in escrowed funds that can be used to make any capital purchases or pay for any development costs incurred by Sunflower on a current basis. Sunflower is dependent on cash flows from member and nonmember long-term power supply contracts to meet its current obligations.

Effective January 1, 2010, Sunflower's board of directors approved a wholesale rate increase that will be collectible from its members.

### (b) *The Financial Reporting Entity*

On November 26, 2002, Sunflower Electric Holdings, Inc. (SEHI) completed negotiations to restructure its debt and signed the *Agreement and Consent to Sunflower Restructuring, Dated as of September 30, 2002, By and Among Sunflower, SEP,*

# Notes to Combined Financial Statements

December 31, 2009 and 2008

*Holcomb Common Facilities, LLC (HCF), the Government, CFC, Co Bank, and Other Creditors* (the Consent Agreement). The Consent Agreement transferred all assets and liabilities, except for the long-term debt and certain assets discussed below, from SEHI to SEP Corporation in exchange for certain debt issued by SEP Corporation as noted in note 4. SEP Corporation legally changed its name to Sunflower Electric Power Corporation in March 2003. Sunflower is operated on a cooperative basis. The ownership of Sunflower is in the same proportion as that of SEHI. Substantially, all of Sunflower's assets, contracts, and revenue are pledged as security under the mortgage provided for in the Consent Agreement.

Sunflower has six wholly owned subsidiaries: Holcomb 2, LLC (H2); Sunflower Rail Company, LLC (Sunflower Rail); SEPC, LLC; Holcomb 3, LLC (H3); Holcomb 4, LLC (H4), and HCF (Holcomb Common Facilities, effective July 2007). Sunflower Rail, H2, H3, and H4 were created for future activities and currently do not hold any assets or liabilities. SEPC, LLC was formed to purchase and lease a communications tower in 2003. This tower is a capital lease to Sunflower as part of the operation of the generation and transmission facilities. HCF holds the common facilities located at Holcomb Station; these facilities would be common to multiple generation units that are currently being developed on the Holcomb Station site.

The accompanying combined financial statements include the combined transactions of the above entities, collectively referred to as Sunflower. Intercompany balances and transactions have been eliminated in combination.

**(c) *Basis of Presentation***

The accompanying combined financial statements have been prepared using the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. The Company has evaluated subsequent events through March 15, 2010 for inclusion in this report.

**(d) *Use of Estimates***

The preparation of combined 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 combined financial statements and the reported amounts of operating revenue, expenses, and other items during the reporting period. Significant items subject to such estimates and assumptions include the useful lives of fixed assets, recoverability of deferred tax assets, derivatives, asset retirement obligations, and key inputs to actuarial calculations of postretirement obligations. Actual results could differ significantly from those estimates. The current economic environment has increased the degree of uncertainty in

# Notes to Combined Financial Statements

December 31, 2009 and 2008

these estimates and assumptions.

**(e) *Application of Accounting Standards***

On January 1, 2009, the Company adopted the standard for accounting for uncertainty in income taxes. See note 1(n) below for a description of changes that resulted with the adoption of this new standard.

**(f) *Utility Plant***

Utility plant is stated at cost and expenditures for replacement of property units are recorded as utility plant. The cost of units replaced or retired, including cost of removal, net of any salvage value, is charged to accumulated depreciation. The cost of maintenance and repairs, including renewals of minor items, is charged to operating expenses.

The costs of homogeneous units of property, plant, and equipment are aggregated to form groups of assets that are depreciated on a straight-line basis over the estimated remaining useful life established for each specific group. Estimates and assumptions used in establishing the depreciation rates associated with each group are based on management's best estimate of useful lives considering input from external studies. Generally, changes in depreciation rates are effected through changes in the remaining depreciable lives of the applicable group assets and are considered a change in accounting estimate.

On August 13, 2009, Sunflower submitted a depreciation study to RUS requesting the approval of new depreciation rates to be effective as of January 1, 2009. Until approval is received from RUS, Sunflower will continue to use the approved depreciation rates from the depreciation study dated March 3, 2003. As of the date of this report, RUS has not approved the new depreciation rates. See note 3 for more information.

The average annual depreciation rates from the depreciation study dated March 3, 2003 and in effect for 2009 are as follows:

Steam production plant	2.40%
Other production plant	3.02
Transmission plant	2.45
General plant	1.90

**(g) *Long-Lived Assets***

Long-lived assets, such as property, plant, and equipment, and purchased intangible assets subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If circumstances require a long-lived asset or asset group be tested for possible impairment, Sunflower first compares undiscounted cash flows expected to be

# Notes to Combined Financial Statements

December 31, 2009 and 2008

generated by that asset or asset group to its carrying value. If the carrying value of the long-lived asset or asset group is not recoverable on an undiscounted cash flow basis, an impairment is recognized to the extent that the carrying value exceeds its fair value. Fair value is determined through various valuation techniques including discounted cash flow models, quoted market values, and third-party independent appraisals, as considered necessary. For the years ended December 31, 2009 and 2008, there has been no impairment of Sunflower's long-lived assets.

**(h) Investments**

Investments in associated organizations are stated at cost plus Sunflower's share of patronage capital credits allocated and reduced by distributions received. Sunflower's ownership percentage in these associated organizations is less than 20%.

Capital term certificates and escrowed funds are carried at cost. Cost is estimated to approximate fair value due to the nature of the certificates and the underlying short-term investments held in escrow.

**(i) Cash and Cash Equivalents**

Cash and cash equivalents include cash deposits in banks and short-term investments with original maturities of three months or less. Included in short-term investments are overnight repurchase agreements and commercial paper.

**(j) Inventories**

Inventories are recorded at the lower of cost or market and are recognized on an average-cost basis.

**(k) Derivative Instruments**

The Company recognizes all derivative instruments as either assets or liabilities in the balance sheets at their respective fair values. The Company's coal purchase contracts generally meet the definition of a derivative; however, most of the Company's coal contracts are designated as normal purchases, and as such are not recorded in the combined financial statements at fair value. In 2009, the Company recognized a derivative liability recorded in other accrued liabilities relating to its high-grade coal sales and purchases that no longer qualified as normal purchase and sale, with an offset to a regulatory asset that was classified as other current assets on the combined financial statements. In 2008, the Company recognized a derivative asset relating to its high-grade coal sales and purchases that no longer qualified as normal purchase and sale, with an offset to a regulatory liability that was classified as other accrued liabilities on the combined financial statements. The Company entered into the derivative activities in order to minimize volatility of fuel cost.

# Notes to Combined Financial Statements

December 31, 2009 and 2008

**(l) Deferred Charges**

As of December 31, 2009 and 2008, deferred charges consist of:

	2009		2008	
	Gross carrying amount	Accumulated amortization	Gross carrying amount	Accumulated amortization
Deferred financing costs	\$ 2,267,414	1,016,815	2,267,414	838,298
Major maintenance costs	11,495,479	4,023,417	11,495,479	2,873,870
Deferred development costs	25,145,251	—	19,967,965	—
	\$ 38,908,144	5,040,232	33,730,858	3,712,168

Deferred financing costs include legal and filing fees incurred to refinance Secured “A” notes, as defined in note 4, *Long-term Debt*, in 2004. These charges are amortized over the life of the refinanced notes.

The major maintenance costs are repair and maintenance charges incurred in connection with periodic, planned, major maintenance activities that benefit future periods greater than 12 months. These operations require shutdown of the entire facility to perform planned, major repair, and maintenance activities on the generating unit. The frequency of such repair and maintenance activities is predictable and scheduled and typically ranges from 10 to 15 years. In order to recognize the repair and maintenance activities in the period benefited from the maintenance activities, Sunflower capitalizes the actual cost of the major maintenance and amortizes those costs to the next overhaul. The 2006 Holcomb Station extended maintenance outage was completed in July 2006 and those costs are being amortized over a ten-year period.

Deferred development costs include legal and engineering fees incurred by Sunflower for the potential construction of new electric power generating stations to be adjacent to Holcomb Station and are being capitalized as project costs associated with the acquisition, development, and construction of a real estate. All charges relating to the construction of new electric generating stations are expected to be recovered through payments from entities participating in the development, except for the development costs related to the proportional share of the units that Sunflower will own, which will be capitalized as part of the cost of the generating station. See further information on associated deferred credits in note 1(o).

**(m) Member and Patron Deficit**

All net margins are required to first offset any losses incurred during the current or any prior fiscal year. Remaining net margins, if any, are allocated to members based on energy purchases. At December 31, 2009 and 2008, no portion of equity had been allocated or assigned.

# Notes to Combined Financial Statements

December 31, 2009 and 2008

Under provisions of the mortgage with RUS, patronage capital cannot be distributed without approval from certain long-term creditors. Sunflower allocates patronage capital on a tax basis.

**(n) Income Taxes**

Sunflower is a taxable cooperative. Income taxes generally apply to Sunflower to the extent that income or losses are allocated to nonpatron activity. Sunflower accounts for income taxes attributable to nonpatron activity under the asset and liability method of accounting for income taxes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the combined financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income from nonpatron sales in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date.

Beginning with the adoption of the new standard on accounting for uncertainty in income taxes as of January 1, 2009, the Company recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs. Prior to the adoption of accounting for uncertainty in income taxes, the Company recognized the effect of income tax positions only if such positions were probable of being sustained.

**(o) Deferred Credits**

Deferred credits consist of unearned revenue from contracts with power customers and funds received for participation in the development of the Holcomb site as follows:

	<u>2009</u>	<u>2008</u>
Holcomb development	\$ 37,778,284	32,787,341
Capacity agreements	<u>1,850,000</u>	<u>1,304,000</u>
	<u>\$ 39,628,284</u>	<u>34,091,341</u>

During 2007, Sunflower recorded option payments of \$27.1 million from three companies interested in participating in the development of new electric power generating stations on the Holcomb Station site. Sunflower deposited \$25 million into a restricted cash account reflected in escrowed funds on the combined balance sheets.

# Notes to Combined Financial Statements

December 31, 2009 and 2008

During 2009 and 2008, Sunflower received option payments of \$5.0 million and \$5.3 million, respectively, from two of the same companies. With RUS approval, this cash is available to pay for current capital improvements and Holcomb site development costs incurred by Sunflower as well as other specifically identified needs. The \$6.7 million held in this escrowed fund account on December 31, 2009 is available for future years cash needs.

The payments received are shown as a deferred credit on Sunflower's combined balance sheets. Although Sunflower has no obligation to pay back the cash received from the participating companies regardless of the outcome of the project development, neither the income nor expense will be recognized until the plans to develop additional units become more certain.

**(p) Other Long-Term Liabilities**

Other long-term liabilities consist of accrued postretirement benefit obligations, measured at each fiscal year-end, and asset retirement obligations for the estimated costs for legally required removal of the underlying assets.

**(q) Postretirement Plans**

Sunflower allows eligible retirees to purchase medical insurance from the multiple employer plan in which Sunflower participates. The premium payments are calculated on an average of both active and retiree participants. Sunflower will incur additional costs as the premium payments of active participants paid by Sunflower will increase due to the retirees' participation in the plan. This obligation represents a liability to Sunflower. Sunflower retains the right, subject to existing agreements, to change or eliminate these benefits. In order for retirees to be eligible for healthcare benefits, the participant must pay the premium cost associated with the coverage.

The Company records annual amounts relating to its postretirement plans based on calculations that incorporate various actuarial and other assumptions, including discount rates, mortality, turnover rates, and healthcare cost trend rates. The Company reviews its assumptions on an annual basis and makes modifications to the assumptions based on current rates and trends when it is appropriate. The effect of modifications to those assumptions is recorded in accumulated other comprehensive income and amortized to net periodic cost over future periods using the corridor method. The net periodic costs are recognized as employees render the services necessary to earn the postretirement benefits. The Company believes that the assumptions utilized in recording its obligations under its plans are reasonable based on its experience and market conditions.

The Company recognizes the funded status of the postretirement plan as a net asset or liability, and the changes in that funded status in the year in which the changes occur

# Notes to Combined Financial Statements

December 31, 2009 and 2008

through other comprehensive income to the extent those changes are not included in the net periodic cost.

**(r) Revenue and Fuel Expense Recognition**

Electric energy sales and the related fuel expenses are recorded at the time electric energy is generated and delivered.

**(2) Related Parties**

In 2005, Sunflower's members formed Mid-Kansas Electric Company, LLC (Mid-Kansas) to purchase all of the Kansas electric assets and operations of Aquila, Inc. Mid-Kansas is owned by the same Members that own Sunflower but in different ownership percentages. Upon Mid-Kansas closing the acquisition on April 1, 2007, Sunflower was contracted by Mid-Kansas to operate the generation and transmission assets of Mid-Kansas. The distribution assets of Mid-Kansas are operated by the members. Sunflower has no ownership interest in Mid-Kansas. In addition to the relationship between Mid-Kansas' members and Sunflower's members, L. Earl Watkins serves as the Chief Executive Officer of both entities.

Sunflower bills to Mid-Kansas all direct and indirect operating costs as well as a portion of Sunflower's administrative and general costs as agreed upon in the *Service and Operation Agreement* between Mid-Kansas and Sunflower. These allocation methodologies are reviewed annually and approved by the Mid-Kansas and Sunflower boards. In addition to the expense allocation and reimbursement arrangement, Sunflower has been directed by the Mid-Kansas and Sunflower boards to jointly dispatch the generation resources of Mid-Kansas and Sunflower in the most efficient and cost effective manner. To do this, a joint dispatch model was developed and utilized on a monthly basis to allocate power costs between the two entities. This model is designed to prevent Sunflower from absorbing any additional costs from this dispatch arrangement yet recognizing that in most months, there are benefits that are allocated to each entity, thus lowering the cost of operating each entities' generation resources separately. In 2009 and 2008, Sunflower allocated indirect costs of expenses to Mid-Kansas of approximately \$10 million and \$9 million, respectively. In 2009 and 2008, Sunflower sold approximately \$24 million and \$42 million, respectively, of power to Mid-Kansas and purchased approximately \$9 million and \$15 million of power from Mid-Kansas, respectively.

Sunflower's financial interest in Mid-Kansas' operations is limited solely to the items described above. Mid-Kansas is a separate legal entity, and Sunflower does not guarantee any debt of Mid-Kansas. Consequently, Sunflower does not consolidate Mid-Kansas.

As of December 31, 2009 and 2008, Sunflower had accounts receivable from Mid-Kansas of \$4,740,885 and \$6,956,997, respectively. Additionally, Sunflower owed Mid-Kansas \$860,109 and \$136,446 as of December 31, 2009 and 2008, respectively.

# Notes to Combined Financial Statements

December 31, 2009 and 2008

## (3) Utility Plant

Utility plant balances by major class of asset are as follows at December 31, 2009 and 2008:

	<u>2009</u>	<u>2008</u>
Steam production plant	\$ 481,890,253	481,146,628
Other production plant	16,795,569	16,795,569
Transmission plant	129,863,256	125,918,641
General plant	<u>33,097,882</u>	<u>29,362,516</u>
Total utility plant	661,646,960	653,223,354
Less accumulated depreciation	<u>(404,243,637)</u>	<u>(397,367,587)</u>
Net utility plant	257,403,323	255,855,767
Land held for future use	3,193,843	3,193,843
Construction work in progress	<u>1,612,302</u>	<u>9,653,999</u>
Total utility plant, net	<u>\$ 262,209,468</u>	<u>268,703,609</u>

On December 16, 2008, the Kansas Corporation Commission (KCC) ordered Sunflower to use depreciation rates presented in Docket No. 08 SEPE 257 DRS, Exhibit TBD-2 for rate recovery purposes. The KCC depreciation rates differ from the March 3, 2003 depreciation study rates approved by RUS. This difference in rates results in a regulatory asset of \$3,092,489, which is reported as a reduction of accumulated depreciation and depreciation expense in the combined financial statements.

# Notes to Combined Financial Statements

December 31, 2009 and 2008

## (4) Long-Term Debt

### (a) *Outstanding Notes Payable*

The outstanding note balances are as follows as of December 31, 2009 and 2008:

	<u>2009</u>	<u>2008</u>
Secured "A-1" Notes, 4.28% interest, due in semiannual principal and interest installments through 2011	\$ 12,600,000	25,900,000
Secured "A-2" Notes, interest ranging from 2.80% to 5.50%, due in quarterly principal and interest installments through 2016	123,217,801	129,317,801
Unsecured "A" Participation Notes, 8.00% interest, due in quarterly principal and interest installments through 2016	37,285,225	41,384,141
Secured "B" Notes, bearing no stated interest rate, quarterly installments applied 2 for 1, effective interest rate of 3.80% through 2016	19,296,977	21,660,236
Residual Value Notes, bearing no stated interest rate, lump-sum payment due December 31, 2016, effective interest rate of 3.59%	97,314,049	93,894,909
Unsecured "B" Notes, bearing no stated interest rate, due in quarterly installments through 2027, effective interest rate of 5.30%	8,936,854	9,319,854
National Rural Utilities Cooperative Finance Corporation Loan Capital Term Certificate (LCTC) Notes, interest ranging from 2.80% to 5.50%, due in quarterly principal and interest installments through 2016	<u>17,607,823</u>	<u>18,479,514</u>
	316,258,729	339,956,455
Less current maturities of long-term obligations	<u>(25,219,767)</u>	<u>(27,116,865)</u>
Long-term obligations, less current maturities	<u>\$ 291,038,962</u>	<u>312,839,590</u>

On April 22, 2004, Sunflower completed a refinancing of the original outstanding Secured "A" Notes, primarily to reduce the interest rate. The Secured "A" Note debt was refinanced with the proceeds from the issuance of the Secured "A-1" and Secured "A-2" Notes. Upon the refinancing, all outstanding Secured "A" Note debt was extinguished. No gain or loss was recorded on the extinguishment given the carrying amount of the extinguished debt was equivalent to the reacquisition price.

Prior to April 22, 2004, all Secured "A" Notes had interest rates ranging from 2% to 10%, with principal and interest payable quarterly through 2016. Subsequent to the refinancing, the Secured "A-1" Notes, issued in the amount of \$75,000,000, bear interest at 4.28%, payable in semiannual installments.

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The Secured "A-2" Notes, issued in the amount of \$138,277,800, consist of 13 separate notes, with one note due each year beginning March 31, 2005 through March 31, 2016. The last note is due on December 31, 2016. The Secured "A-2" Notes bear interest ranging from 2.8% to 5.5%.

The Unsecured "A" Participation Notes were issued in November 2002 in the amount of \$60,514,505 bearing 8% interest with principal and interest payments payable quarterly through 2016.

The Secured "B" Notes were issued in November 2002, in the amount of \$89,888,660, without a stated interest rate. The quarterly principal payments are applied to reduce the outstanding note balance on A-2 for 1 basis; for every \$1 paid, the outstanding note balance is reduced by \$2, resulting in expected future cash outflows of \$22,065,428 as of December 31, 2009. For financial statement reporting purposes, the expected future quarterly payments have been discounted assuming an effective interest rate of 3.8%, resulting in carrying amounts of \$19,296,977 and \$21,660,236 as of December 31, 2009 and 2008, respectively.

The Residual Value Notes were issued for the greater of \$125,000,000, or 43%, of the fair value of Holcomb Station on December 31, 2016, without a stated interest rate, payable in one lump sum amount on December 31, 2016. The Consent Agreement provides the terms for determining the fair value of 43% of Holcomb Station upon the December 31, 2016 appraisal date. The Residual Value Notes contain a prepayment provision that is to be used upon prepayment of the notes or upon the sale of the Holcomb Unit 1 facility. Under the prepayment provision, the \$125,000,000 could increase to as much as \$148,181,482. For financial statement reporting purposes, the note is reflected at an accreted carrying amount originally equivalent to the beginning Stipulated Value of \$75,760,193, fully accreting to \$125,000,000 as of December 31, 2016. This results in interest at an effective interest rate of 3.59% per year. Any amount that might be paid on this note in excess of \$125,000,000 has been treated as a contingent amount and, as such, is not currently recognized due to the uncertainties of prepayment, sale of the Holcomb Unit 1 facility, or appraised fair value of Holcomb Station as of December 31, 2016.

Unsecured "B" Notes were issued in November 2002, totaling \$17,997,972, without a stated interest rate, payable in quarterly installments through June 30, 2027. For financial statement reporting purposes, the expected future quarterly payments have been discounted assuming an effective interest rate of 5.3%, resulting in carrying amounts of \$8,936,854 and \$9,319,854 as of December 31, 2009 and 2008, respectively.

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The LCTC Notes were issued in the amount of \$19,759,898, or 14.29%, of the Secured “A-2” Notes, as part of the 2004 refinancing to the CFC. Like the Secured “A-2” Notes, there are 13 separate notes, with one note due each year beginning March 31, 2005 through March 31, 2016. The last note is due on December 31, 2016. The LCTC Notes bear interest ranging from 2.8% to 5.5%. Required as part of CFC loan policy, Sunflower purchased an equity interest in CFC. The proceeds from these notes were used solely to purchase CFC capital term certificates in an amount originally equivalent to the LCTC Note balance. The equity term certificates are reflected as capital term certificates of the National Rural Utilities Cooperative Finance Corporation on Sunflower’s combined balance sheets.

CFC repays the capital term certificates to Sunflower as Sunflower’s outstanding Secured “A-2” Notes and LCTC Notes are repaid. Quarterly payments on the LCTC Notes, like the original borrowing, are equivalent to 14.29% of the quarterly payments made on the Secured “A-2” Notes.

At December 31, 2009, scheduled maturities of the long-term debt are as follows:

Year ending December 31:	
2010	\$ 25,219,767
2011	24,283,320
2012	29,694,417
2013	32,323,992
2014	33,370,779
Thereafter	<u>171,366,455</u>
	<u>\$ 316,258,730</u>

Financial covenants require the Company to maintain a times interest earned ratio (TIER) of 1.25 on an annual calendar basis until Series A-1 Refinancing Notes are paid off. After the Series A-1 Refinancing Notes are paid off, covenants require an average of 1.25 TIER in two of the last three most recent calendar years. Financial covenants also require an average debt service coverage ratio (DSC) of 1.10 in two out of the three most recent calendar years. As of December 31, 2009 and 2008, the Company was in compliance with these financial covenants.

Sunflower currently maintains a \$20,000,000 hybrid facility with CFC for purposes of managing seasonal fluctuations in cash flow and to issue various letters of credit necessary in the normal operations of the Company. The facility may be used for any combination of letters of credit or cash so long as the total does not exceed \$20,000,000. As of December 31, 2009, Sunflower had outstanding letters of credit to Southwest Power Pool (SPP), Midwest Independent System Operator (MISO), and Omaha Public Power District (OPPD) for approximately \$3.1 million. These securities

# Notes to Combined Financial Statements

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were issued to the power pools in the ordinary course of business. Sunflower is current with regard to all purchases within the power pools, and accordingly, no draw was or has been made on those letters of credit. The hybrid facility expires June 30, 2010. Sunflower also has a letter of credit agreement with CoBank in the amount of \$10,848,265 as of December 31, 2009. This letter expires on September 8, 2013.

**(b) Contingent Notes**

The November 26, 2002 Consent Agreement modified the Sunflower reporting entity. The Consent Agreement transferred assets and liabilities, except for Sunflower Electric Holdings, Inc. (SEHI) long-term debt and the legal title to the Holcomb Common Facilities (Common Facilities) and Retained Infrastructure, to SEP Corporation in exchange for debt issued by Sunflower. The Common Facilities and Retained Infrastructure included property necessary to operate one or more additional units if built on the Holcomb Station site. If additional generation units are constructed, rental payments for use of the Common Facilities and Retained Infrastructure were to be paid to HCF. Under terms of the 1988 credit agreement outstanding for SEHI, the proceeds would then flow to the creditors of SEHI since HCF was a wholly owned subsidiary of SEHI.

By transferring HCF to Sunflower, Sunflower will now be the recipient of any rental payments for use of the Common Facilities and Retained Infrastructure used by any additional generating units. Management estimates annual rental payments of \$10,000,000 from the owners of the three planned generating units over a minimum of 19 years.

An Unsecured "B" Contingent Note was issued by Sunflower to one creditor in connection with the November 26, 2002 transaction. The note is payable upon receipt by Sunflower of cash flows from the lease of property that would be used to build additional generating units on the Holcomb Station site if the site is ever to be developed. The amount of the lease payments has not been established; thus the amount of the note is contingent upon determining an agreed upon lease payment.

Holcomb 3 Contingent Notes, totaling \$3,145,000, were issued in connection with the November 26, 2002 transaction. These are contingent notes bearing no interest through January 1, 2008, and accruing interest at 5% thereafter until paid. Interest attributable to these notes as of December 2009, is \$314,500. The principal and accrued interest are payable in full upon the commercial operation date of a third unit (Holcomb Unit 3) located on the Holcomb Station site. If commercial operation does not commence prior to December 31, 2021, or if Sunflower is not an owner or operator of Holcomb Unit 3, the notes, including accrued interest, are canceled.

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In July 2007, Sunflower reached agreement with the RUS regarding Holcomb site development. The agreement transferred the membership certificate of HCF from SEHI to Sunflower. Sunflower issued contingent notes Holcomb 2, Holcomb 3-B, and Holcomb 4 for \$52 million, \$23 million, and \$16 million, respectively. These are contingent notes bearing 5% interest beginning January 1, 2008 through the payment date. Interest attributable to these notes as of December 2009 is \$5.2 million, \$2.3 million and \$1.6 million. The principal and accrued interest are payable upon commercial operation of the respective units; as such the amounts are not considered a liability until financial close of the respective unit. If commercial operation does not commence prior to December 31, 2021, the notes and interest are canceled.

In July 2007, Sunflower issued contingent Holcomb 2 notes to CoBank and CFC. These contingent notes bear no interest. Annual payment amounts are \$12,525 and \$49,980, respectively. The principal is payable on the last business day of December beginning with the first year of commercial operation of the Holcomb 2 unit; as such the amounts are not considered a liability until financial close of the respective unit. If commercial operation does not commence prior to December 31, 2021, the notes are canceled.

Although discussions continue in an effort to develop the plant site, no construction agreements were effected and no construction activities for additional generating units have begun as of December 31, 2009; thus, Sunflower's contingent long-term debt agreements discussed above are not considered probable as to payment and, accordingly, are not reflected in the accompanying combined financial statements.

## **(5) Income Taxes**

Sunflower is a taxable cooperative. Income taxes generally apply to Sunflower to the extent that income or losses are allocated to nonpatron activity. The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities at December 31, 2009 and 2008 are presented in the following table:

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	<u>2009</u>	<u>2008</u>
Deferred tax assets:		
Property and equipment, principally due to safe harbor leasing transactions	\$ 12,053,073	12,243,052
Property and equipment, principally due to differences in depreciation	4,213,372	5,157,054
Accrued vacation and other	476,865	263,728
Investment in SEHI notes	1,009,277	952,340
Investment in Holcomb 2, LLC	1,572,801	1,571,917
Net operating loss carryforwards	<u>96,929,574</u>	<u>94,481,310</u>
Total gross deferred tax assets	116,254,962	114,669,401
Less valuation allowance	<u>(81,915,836)</u>	<u>(81,021,239)</u>
Deferred tax assets, less allowance	<u>34,339,126</u>	<u>33,648,162</u>
Deferred tax liabilities:		
Debt, principally due to differences in effective interest rates	33,415,926	32,848,142
Other	<u>923,200</u>	<u>800,020</u>
Total gross deferred tax liabilities	<u>34,339,126</u>	<u>33,648,162</u>
Net deferred tax assets	<u>\$ —</u>	<u>—</u>

Although the table above presents the deferred tax assets and liabilities on a combined basis, SEHI and Sunflower each file separate income tax returns. As of December 31, 2009, Sunflower has approximately \$13 million and SEHI has approximately \$236 million of net operating loss carryforwards for regular and alternative minimum tax purposes that, if not utilized, begin to expire after 2018 through 2030.

Management believes that it is more likely than not that the deferred tax assets will not be utilized; accordingly, it has provided a valuation allowance to reduce the net deferred tax assets to zero.

The Company adopted the provisions of accounting for uncertainty in income taxes on January 1, 2009. Adoption of this provision had no impact on the combined financial statements of the Company. There are no unrecognized tax benefits to be disclosed, and thus, no interest and penalties to accrue thereon.

## (6) Leases

Sunflower is obligated under various leases for transmission plant that are accounted for as capital leases. At December 31, 2009 and 2008, the net amount of plant and equipment under capital leases was \$15,266,024 and \$13,821,939, respectively.

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Amortization of assets held under capital leases is included within the operations-transmission expense line item. Rental expense incurred for capital leases amounted to \$1,724,388 and \$1,667,320 for the years ended December 31, 2009 and 2008, respectively. Interest costs associated with capital leases amounted to \$1,171,602 and \$1,164,253 for the years ended December 31, 2009 and 2008, respectively. Amortization of leased assets in association with capital leases amounted to \$552,786 and \$503,067 for the years ended December 31, 2009 and 2008, respectively.

Sunflower has several types of operating leases, including leases of transmission lines from several of Sunflower's member systems and lease with Western Fuels for the use of steel railcars. Western Fuels (WFA) has leased to Sunflower one 134-car set, which expires in June 2010. One 128-car set is leased by Western Fuels to Sunflower, the Board of Public Utilities of Kansas City, Sikeston Board of Municipal Utilities, and Southern Minnesota Municipal Power Agency on a shared basis, is referred to as the "Pool" train, and expires in May 2026. Sunflower is invoiced by Western Fuels at a per car, per day rate of \$18.556 for the use of these two train sets. To ensure that Sunflower and Western Fuels tender to BNSF for delivery the tonnage that has been declared by Sunflower, Sunflower, and Western Fuels will utilize additional BNSF and Western Fuels train sets on an as-needed basis, the utilization for which does not fall within any long-term lease agreement but rather falls within the parameters of our existing all-requirements coal supply contract with Western Fuels.

Minimum rent payments under operating leases are recognized on a straight-line basis over the term of the lease including any periods of free rent. Total expense associated with operating leases was \$5,549,287 and \$5,842,630 for the years ended December 31, 2009 and 2008, respectively.

Future minimum lease payments under noncancelable operating leases and future minimum capital lease payments as of December 31, 2009 are as follows:

	<u>Capital leases</u>	<u>Operating leases</u>
Year ending December 31:		
2010	\$ 1,812,184	4,791,285
2011	1,794,897	4,440,658
2012	1,675,993	4,440,658
2013	1,675,993	3,982,321
2014	1,627,991	3,940,654
Thereafter	<u>23,026,929</u>	<u>35,295,388</u>
	31,613,987	\$ <u>56,890,964</u>
Less amount representing interest	<u>16,347,964</u>	
Present value of minimum lease payments	15,266,023	
Less current portion	<u>591,570</u>	
Long-term obligations under capital leases	<u>\$ 14,674,453</u>	

# Notes to Combined Financial Statements

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## (7) Pension Plan

All Sunflower employees are covered by a defined benefit pension plan that is funded through participation in the National Rural Electric Cooperative Association (NRECA) Retirement and Security Program, a multi-employer plan. Employees vest in the plan after one year of service. Information on the accumulated benefits and plan assets are not determined or allocated by employer. Pension expense for the years ended December 31, 2009 and 2008 was approximately \$5,039,621 and \$4,098,011, respectively. A portion of these costs were allocated to Mid-Kansas as part of the agreed upon allocation and reimbursement of costs. See note 2 for an explanation of the allocation and reimbursement agreement.

## (8) Postretirement Benefit Obligations

Sunflower allows eligible retirees to purchase medical insurance from the multiple employer plan in which Sunflower participates. In order for retirees to be eligible for healthcare benefits, the retiree must pay the premium cost associated with the coverage. Sunflower pays a portion of current employees' premiums and is reimbursed by retirees for their premium cost. The premium payments are calculated on an average of both active and retiree participants. As such, Sunflower will incur additional costs for the premium payments of active participants due to the retirees' participation in the plan. This obligation represents a liability to Sunflower. Sunflower retains the right, subject to existing agreements, to change or eliminate these benefits.

The Company recognizes the funded status of the postretirement plan as a net asset or liability on its balance sheet. Actuarial gains and losses are generally amortized subject to the corridor method, over the average remaining service life of the Company's active employees.

The Company measured its benefit obligations as of December 31 of each year. The following table sets forth the plan's benefit obligations recognized in the combined balance sheets at December 31, 2009 and 2008:

	<b>Postretirement benefits</b>	
	<b>December 31</b>	
	<b>2009</b>	<b>2008</b>
Current liabilities	\$ 147,000	71,000
Noncurrent liabilities	7,016,334	5,822,990
Total liability recognized	<u>\$ 7,163,334</u>	<u>5,893,990</u>

The accumulated benefit obligation for the plan was \$7,163,334 and \$5,893,990 at December 31, 2009 and 2008, respectively. The postretirement benefit obligation is unfunded. Net periodic postretirement benefit cost for December 31, 2009 and 2008 was \$1,062,294 and \$635,886, respectively. As of December 31, 2009, the unrecognized actuarial loss was \$3,549,924 and the unrecognized transitional obligation was \$125,200.

# Notes to Combined Financial Statements

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The benefit cost as of December 31, 2009 and 2008 includes the following:

	<u>2009</u>	<u>2008</u>
Service cost	\$ 374,224	293,102
Interest cost	323,750	251,795
Amortization of transitional obligation	25,000	25,000
Recognized net actuarial loss	<u>339,320</u>	<u>65,989</u>
Total benefit cost	<u>\$ 1,062,294</u>	<u>635,886</u>

The net loss and transitional obligation for the postretirement plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year are \$247,000 and \$25,000, respectively. Weighted average assumptions used to determine benefit obligations and cost for 2009 and 2008 were as follows:

	<u>Postretirement benefits</u>	
	<u>2009</u>	<u>2008</u>
Discount rate – obligation	6.11%	5.05%
Discount rate – cost	5.05%	6.50%
Healthcare cost trend rate	8.5% – 5.0%	8.5% – 5.0%

For measurement purposes at December 31, 2009, an 8.5% annual rate of increase in the per capita cost of covered healthcare benefits was assumed for 2009. The rate was assumed to decrease gradually to 5.0% for 2017 and remain at that level thereafter. If the annual rate increased (decreased) by one percentage point, the effect on the accumulated benefit obligation would be \$1,658,699 (\$1,278,730).

The following table summarizes benefits paid during 2009 and 2008:

	<u>2009</u>	<u>2008</u>
Gross benefits paid	\$ 278,351	364,612
Retiree contributions	<u>(167,268)</u>	<u>(155,748)</u>
Net benefits paid	<u>\$ 111,083</u>	<u>208,864</u>

The benefits expected to be paid, net of retiree contributions, from the postretirement benefit plan in each year 2010 – 2014 are \$147,000, \$203,000, \$222,000, \$131,000, and \$147,000, respectively. The aggregate benefits expected to be paid, net of retiree contributions, in the five years from 2015 through to 2019 are \$1,056,000. The expected benefits are based on the same assumptions used to measure the Company's benefit obligation at December 31 and include estimated future employee service.

# Notes to Combined Financial Statements

December 31, 2009 and 2008

## (9) Fair Value Measurements and Fair Value Option

### (a) Fair Value of Financial Instruments

The following table presents the carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2009 and 2008. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

	2009		2008	
	Carrying amount	Fair value	Carrying amount	Fair value
Financial assets:				
Investments in associated organizations	\$ 4,557,112	4,557,112	4,421,361	4,421,361
Capital term certificates in NRUCF	20,455,275	20,455,275	21,069,745	21,069,745
Financial liabilities:				
Debt	\$ 316,258,730	292,791,577	339,956,455	309,406,781

The carrying amounts shown in the table are included in the combined balance sheets under the indicated captions.

The fair values of the financial instruments shown in the above table as of December 31, 2009 represent management's best estimates of the amounts that would be received to sell those assets or that would be paid to transfer those liabilities in an orderly transaction between market participants at that date. Those fair value measurements maximize the use of observable inputs. However, in situations where there is little, if any, market activity for the asset or liability at the measurement date, the fair value measurement reflects the Company's own judgments about the assumptions that market participants would use in pricing the asset or liability. Those judgments are developed by the Company based on the best information available in the circumstances.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

Cash and cash equivalents, accounts receivable, investments, escrowed funds, and accounts payable approximate the fair value as December 31, 2009 and 2008. The method used to estimate the fair value of the Company's long-term debt is based on quoted market prices for the same or similar issues or on the current rates offered to the Company for the debt of the same maturity.

# Notes to Combined Financial Statements

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**(b) Fair Value Hierarchy**

The Company has adopted standards for fair value measurements of financial assets and liabilities that establish a fair value hierarchy that prioritizes the inputs to valuation techniques 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 measurements involving significant unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 inputs are unobservable inputs for the asset or liability.

The level in the fair value hierarchy within which a fair measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

The following table presents assets and liabilities that are measured at fair value on a recurring basis at December 31, 2009.

	December 31, 2009	Fair value measurements at reporting date using		
		Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Liabilities:				
Derivative liabilities	\$ 929,034	—	929,034	—
Total	\$ 929,034	—	929,034	—

The derivative instrument reflected in the Level 2 of the valuation hierarchy relates to certain high grade coal contracts and is determined using active broker quotes from similar coal mines.

**(10) Commitments and Contingencies**

Sunflower has multiyear contracts through December 31, 2010 to acquire and transport coal for Holcomb Station.

Sunflower has entered into various contracts with third parties to purchase coal. Under these contracts, the Company has agreed to pay \$18.7 million in 2010, \$17.1 million in 2011, and \$19.7 million in 2012 and thereafter.

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During 2009 and 2008, Sunflower incurred construction costs of \$107,000 and \$3.6 million and received FEMA reimbursement of \$2.6 million and \$6.5 million, respectively. These amounts are reflected in construction work in progress and will be moved to utility plant once all projects are completed and reimbursements received. Sunflower anticipates spending an additional \$12 million in 2010 for costs relating to assets damaged by storm.

As part of the 2004 refinancing, RUS required Sunflower to issue a \$3,100,000 letter of credit for its benefit, through the earlier of January 15, 2017 or the date upon which Sunflower satisfies its Secured "B" Note obligation to the government. Sunflower is in compliance with the terms of the government's note, and no amounts have been drawn on the letter of credit as of December 31, 2009.

As part of a tax benefit transfer transaction entered into in the early 1980s, Sunflower was required to maintain a letter of credit for the benefit of the tax lessor in the unlikely event that Sunflower's actions might give rise to the potential loss of benefits sold. On December 31, 2009, the maximum amount that could be drawn upon the letter of credit was \$10,848,265. As of December 31, 2009, events have not occurred that might give rise to the potential loss of benefits sold, and accordingly, no draw was or has been made on the letter of credit.

In relation to the Holcomb site development, in 2007, the Kansas Department of Health and Environment denied Sunflower the right to receive the air permits that are necessary for the proposed plants. Sunflower reached a compromise with the Kansas Governor's office, which required Sunflower to resubmit the air permit request with updated information to the Kansas Department of Health and Environment. This request is currently under review. While this issue remains uncertain, management believes that the Company will be successful in acquiring the needed permits and continuing with development of the proposed plants.

Sierra Club has challenged RUS' approval of certain Sunflower transactions. These transactions include the 2004 refinancing of certain RUS obligations and the 2007 sale of an option to Tri-State for development of up to two coal-fired units at Sunflower's Holcomb Station. Sierra Club's requested relief is to invalidate the prior approvals until such time as the RUS has complied with the National Environmental Policy Act (NEPA) and prepared an Environmental Impact Statement (EIS). NEPA is procedural in nature; if RUS is found to have violated NEPA, RUS can remedy the violation by completion of an EIS and then issuing the same approvals previously granted. Potential exposure is limited to the costs of completing an EIS, which could range from \$500,000 to \$600,000. The court has heard arguments in the case, and a decision is expected in the first half of 2010. Sunflower intends to contest the case vigorously.

The National Rural Electric Cooperative Association (NRECA) has informed Sunflower that base contribution rates for the retirement security plan will increase by an average of 35% for 2010. Sunflower estimates that the additional contribution will be between \$2.0 and \$2.5 million.



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Sunflower is a defendant in other litigation matters and a party to various claims arising from its normal activities. In management's opinion, based on advice from legal counsel, these actions will not result in a material adverse effect on the financial position, results of operations, or liquidity of Sunflower.