



**SUNFLOWER ELECTRIC POWER CORPORATION
AND SUBSIDIARIES**

Combined Financial Statements

December 31, 2008 and 2007

(With Independent Auditors' Report Thereon)

**SUNFLOWER ELECTRIC POWER CORPORATION
AND SUBSIDIARIES**

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KPMG LLP
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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, 2008 and 2007, and the related combined statements of operations, 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 and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. 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, 2008 and 2007, and the results of their operations, member and patron deficit, and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

As discussed in note 1 to the financial statements, the Company adopted the provisions of Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, as of January 1, 2008, for fair value measurements of all financial assets and liabilities. Also, as discussed in note 1, the Company adopted the recognition, measurement date, and disclosure provisions of Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, as of December 31, 2007.

In accordance with *Government Auditing Standards*, we have also issued our reports dated April 15, 2009, on our consideration of Sunflower's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in assessing the results of our audits.

KPMG LLP

Kansas City, Missouri
April 15, 2009

**SUNFLOWER ELECTRIC POWER CORPORATION
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Combined Balance Sheets

December 31, 2008 and 2007

Assets, Pledged	2008	2007
Net utility plant, at cost	259,049,610	254,537,048
Construction work in progress	9,653,999	23,145,265
Total utility plant, net	268,703,609	277,682,313
Investments and other assets:		
Capital term certificates of the National Rural Utilities Cooperative Finance Corporation	21,069,745	21,465,578
Investments in associated organizations	4,421,361	4,153,400
Escrowed funds	8,156,068	11,196,051
Total investments and other assets	33,647,174	36,815,029
Current assets:		
Cash and cash equivalents	1,576,422	5,641,648
Accounts receivable:		
Members	9,635,454	7,141,840
Affiliates	6,956,997	4,274,045
Nonmembers	3,634,765	2,714,267
Other	1,688,758	3,208,216
	21,915,974	17,338,368
Inventories:		
Fuel	4,008,516	3,791,317
Materials and supplies	7,645,609	7,105,978
	11,654,125	10,897,295
Derivative instrument assets	1,296,034	—
Prepayments and other current assets	1,322,776	3,286,910
Total current assets	37,765,331	37,164,221
Long-term other assets	—	2,760,297
Deferred charges	30,018,690	26,062,034
Total assets	\$ 370,134,804	380,483,894

See accompanying notes to combined financial statements.

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Combined Balance Sheets

December 31, 2008 and 2007

Capitalization and Liabilities	2008	2007
Capitalization:		
Long-term obligations, less current maturities	\$ 312,839,590	336,607,663
Obligations under capital leases, less current portion	13,283,343	13,821,939
Member and patron equity (deficit):		
Memberships	890	890
Donated capital	4,852,989	4,852,989
Accumulated deficit	(41,692,954)	(55,447,268)
Accumulated other comprehensive loss	(3,356,991)	(1,501,799)
Total member and patron deficit	(40,196,066)	(52,095,188)
Total capitalization	285,926,867	298,334,414
Current liabilities:		
Current maturities of long-term obligations	27,116,865	23,908,483
Current portion of obligations under capital leases	538,596	503,067
Short-term facility borrowings	—	10,000,000
Accounts payable	6,961,826	5,146,021
Accounts payable – affiliates	136,446	3,197,669
Interest payable	320,856	432,591
Accrued liabilities:		
Taxes other than income taxes	4,057,476	3,631,284
Other	4,602,430	2,632,091
Total current liabilities	43,734,495	49,451,206
Deferred credits	34,091,341	28,564,454
Other long-term liabilities	6,382,101	4,133,820
Total capitalization and liabilities	\$ 370,134,804	380,483,894

See accompanying notes to combined financial statements.

**SUNFLOWER ELECTRIC POWER CORPORATION
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Combined Statements of Operations

Years ended December 31, 2008 and 2007

	<u>2008</u>	<u>2007</u>
Operating revenue:		
Member power sales	\$ 118,602,274	96,427,864
Nonmember power sales	46,083,431	52,852,884
Revenue from Affiliates	42,428,902	22,951,927
Other	25,608,131	10,571,952
Total operating revenue	<u>232,722,738</u>	<u>182,804,627</u>
Operating expenses:		
Operations:		
Production and other power supply	142,767,675	106,819,956
Transmission	22,228,309	12,220,619
Maintenance:		
Production	15,763,904	9,601,512
Transmission	1,486,835	1,905,917
Administrative and general	9,088,729	7,084,265
Depreciation and amortization	13,329,701	12,673,166
Other taxes	115,697	285,833
Total operating expenses	<u>204,780,850</u>	<u>150,591,268</u>
Electric operating margin	27,941,888	32,213,359
Interest expense	(17,752,191)	(19,036,115)
Other deletions, net	(254,914)	(544,852)
Operating margins	<u>9,934,783</u>	<u>12,632,392</u>
Nonoperating margins:		
Investment income	1,228,691	1,474,938
Other, net	2,590,840	1,724,384
Total nonoperating margins	<u>3,819,531</u>	<u>3,199,322</u>
Net margins	<u>\$ 13,754,314</u>	<u>15,831,714</u>

See accompanying notes to combined financial statements.

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Combined Statements of Member and Patron Deficit

Years ended December 31, 2008 and 2007

	<u>Memberships</u>	<u>Donated capital</u>	<u>Accumulated deficit</u>	<u>Accumulated other comprehensive loss</u>	<u>Total</u>
Balance, December 31, 2006	890	4,852,989	(71,278,982)	—	(66,425,103)
Net margins	—	—	15,831,714	—	15,831,714
Adjustment to initially apply SFAS No. 158	—	—	—	(1,501,799)	(1,501,799)
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	\$ <u>890</u>	<u>4,852,989</u>	<u>(41,692,954)</u>	<u>(3,356,991)</u>	<u>(40,196,066)</u>

See accompanying notes to combined financial statements.

SUNFLOWER ELECTRIC POWER CORPORATION AND SUBSIDIARIES

Combined Statements of Cash Flows
Years ended December 31, 2008 and 2007

	<u>2008</u>	<u>2007</u>
Cash flows from operating activities:		
Net margins	\$ 13,754,314	15,831,714
Adjustments to reconcile net margins to net cash provided by operating activities:		
Depreciation and amortization	13,329,701	12,673,166
Amortization of capital leased assets included in rent expense	503,067	468,024
Amortization of deferred charges	1,328,553	1,328,065
Patronage credits earned from investments	(267,961)	(455,999)
Change in fair value of derivative instrument asset	(1,296,034)	—
Accretion of residual value notes	3,299,008	3,183,097
Changes in assets and liabilities:		
Increase in accounts receivable	(4,934,685)	(4,588,179)
Increase in inventories	(756,830)	(1,284,633)
Decrease (increase) in prepayments and other current assets	1,964,134	(2,246,118)
Increase (decrease) in accounts payable	(1,245,418)	2,095,946
Decrease in long term other assets	2,760,297	—
Decrease in interest payable	(111,735)	(174,195)
Increase in accrued liabilities	2,396,531	446,155
Increase (decrease) in other deferred credits	(159,682)	159,682
Increase in long-term liabilities	393,087	1,569,446
Net cash provided by operating activities	<u>30,956,347</u>	<u>29,006,171</u>
Cash flows from investing activities:		
Utility plant expenditures	(10,263,023)	(14,222,919)
Proceeds from FEMA	6,483,482	1,808,622
Proceeds from investment in National Rural Utilities Cooperative Finance Corporation	395,833	205,776
Decrease (increase) in escrowed funds related to development	3,039,983	(10,634,050)
Proceeds from development costs	5,319,253	27,450,770
Payments for development costs	(5,635,335)	(7,212,480)
Net cash used in investing activities	<u>(659,807)</u>	<u>(2,604,281)</u>
Cash flows from financing activities:		
Short-term facility borrowings, net	(10,000,000)	1,200,000
Principal payments under capital lease obligations	(503,067)	(480,550)
Principal payments on long-term obligations	(23,858,699)	(22,104,495)
Net cash used in financing activities	<u>(34,361,766)</u>	<u>(21,385,045)</u>
Net increase (decrease) in cash and cash equivalents	(4,065,226)	5,016,845
Cash and cash equivalents, beginning of year	<u>5,641,648</u>	<u>624,803</u>
Cash and cash equivalents, end of year	<u>\$ 1,576,422</u>	<u>5,641,648</u>

Supplemental information:

Sunflower paid \$17,863,926 and \$19,210,247 in cash for interest during 2008 and 2007, respectively.

See accompanying notes to combined financial statements.

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December 31, 2008 and 2007

(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. Rates to Sunflower's members are subject to approval by the Kansas Corporation Commission (KCC) and the Rural Utilities Service (RUS or the Government). In accordance with this regulation, Sunflower applies the provisions of Statement of Financial Accounting Standards (SFAS) No. 71, *Accounting for the Effects of Certain Types of Regulation* (SFAS 71).

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 360 megawatts. Sunflower's accredited generation with the Southwest Power Pool totals 652 megawatts, and includes all generation assets available. Sunflower purchases coal from Western Fuels Association, Inc. (Western Fuels), a not-for-profit cooperative that provides coal to consumer owned utilities, and DTE Coal Services. During 2008 and 2007, Sunflower purchased approximately \$40,600,000 and \$36,000,000, 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, 2008, Sunflower had negative working capital, current assets less current liabilities, of approximately \$6.0 million; however, \$8.2 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.

(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, 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.

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As part of the November 2002 transaction, HCF was created as a wholly owned subsidiary of SEHI for the purpose of holding specific assets located at Holcomb Station Unit No. 1 Power Plant (Holcomb Station). These assets were capital leased to Sunflower through July 2007. In July 2007, Sunflower reached agreement with the Rural Utility Service (RUS) on additional development of the Holcomb Station site. The agreement effectively transferred the HCF membership certificate to Sunflower; in addition, Sunflower issued Holcomb 2, Holcomb 3-B, and Holcomb 4 notes to the RUS and Holcomb 2 Notes to CoBank and National Rural Utilities Cooperative Finance Bank (CFC). The capital lease of the facilities held by HCF ended in July 2007.

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 (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.

(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.

(e) *Application of Accounting Standards*

Effective December 31, 2007, the Company adopted the recognition, measurement date, and disclosure provisions of SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plan* (SFAS 158). SFAS 158 requires companies to recognize the funded status of defined benefit pension and other postretirement plans as a net asset or liability and to recognize changes in that funded status in the year in which the changes occur through other comprehensive

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income to the extent those changes are not included in the net periodic cost. The adoption of the recognition provisions of SFAS 158 did not impact the Company's compliance with debt covenants, results of operations, or its cash position.

On January 1, 2008, the Company adopted the provisions of SFAS No. 157, *Fair Value Measurement* (SFAS 157), for fair value measurements of financial assets and liabilities and for fair value measurements of nonfinancial items that are recognized or disclosed at fair value in the financial statements on a recurring basis. SFAS 157 defines fair value as the price 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. SFAS 157 also establishes a framework for measuring fair value and expands disclosures about fair value measurements. FASB Staff Position 157-2 (FSP 157-2), *Effective Date of FASB Statement No. 157*, delays the effective date of SFAS 157 until fiscal years beginning after November 15, 2008 for all nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. The Company is in the process of evaluating the impact, if any, of applying the provisions, FSP 157-2, on its financial position and results of operations.

(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.

Depreciation is provided on the composite straight-line method over the estimated useful lives of the assets. The average annual depreciation rates are:

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

(g) Long-Lived Assets

In accordance with FASB Statement No. 144, *Accounting for the Impairment or Disposal of 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 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

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the years ended December 31, 2008 and 2007, management believes 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 accounts for derivative activities in accordance with SFAS Statement No. 133, *Accounting for Derivative Instruments and Certain Hedging Activities* (SFAS 133), as amended, which requires entities to recognize all derivative instruments as either assets or liabilities in the balance sheet at their respective fair values. As defined by SFAS 133, the Company's coal purchases contracts generally meet the definition of a derivative. Most of the Company's coal contracts are designated as normal purchases, and as such are not recorded in the financial statements at fair value. 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 recorded in the other accrued liabilities line item. The Company entered into the derivative activities in order to minimize fuel cost.

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(l) Deferred Charges

As of December 31, 2008 and 2007, deferred charges consist of:

	2008		2007	
	Gross carrying amount	Accumulated amortization	Gross carrying amount	Accumulated amortization
Deferred financing costs	\$ 2,267,414	838,298	2,267,414	659,291
Major maintenance costs	11,495,479	2,873,870	11,495,479	1,724,322
Deferred development costs	19,967,965	—	14,682,754	—
	<u>\$ 33,730,858</u>	<u>3,712,168</u>	<u>28,445,647</u>	<u>2,383,613</u>

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.

In accordance with FASB issued FSP AUG AIR-1, *Accounting for Planned Major Maintenance Activities*, 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 10-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 under the provisions of SFAS No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*. 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, 2008 and 2007, no portion of equity had been allocated or assigned.

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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 SFAS No. 109, *Accounting for Income Taxes*. Under the asset and liability method of SFAS No. 109, 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. 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. Under SFAS No. 109, the effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date.

(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:

	2008	2007
Holcomb development	\$ 32,787,341	27,100,770
Capacity agreements	1,304,000	1,463,684
	\$ 34,091,341	28,564,454

During 2007, Sunflower received \$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 balance sheet. During 2008, Sunflower received an additional \$5.3 million 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 \$7.1 million held in this escrowed fund account on December 31, 2008 is available for future years cash needs.

The payments received are shown as a deferred credit on Sunflower's balance sheet. 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 becomes more certain.

(p) Other Long-Term Liabilities

Other long-term liabilities consist of accrued postretirement benefit obligations recorded in accordance with the provisions of SFAS No. 106, *Employers' Accounting for Postretirement Benefit Other Than Pensions* (SFAS 106), and SFAS 158, and asset retirement obligations recorded in

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accordance with the provisions of SFAS No. 143, *Accounting for Asset Retirement Obligations* (SFAS 143) and FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* (FIN 47).

(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 in accordance with SFAS 106. 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 beginning in 2007 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.

Effective December 31, 2007, the Company adopted the recognition, measurement date, and disclosure provisions of SFAS 158, which requires the company to recognize the funded status of the postretirement plan as a net asset or liability and to recognize changes in that funded status in the year in which the changes occur through other comprehensive income to the extent those changes are not included in the net periodic cost. The adoption of the recognition provisions of SFAS 158 did not impact the Company's compliance with debt covenants or its cash position. The incremental effect of applying the recognition provisions of SFAS 158 on the Company's financial position as of December 31, 2007 was as follows:

	Before application of SFAS 158	Adjustments	After application of SFAS 158
Accumulated benefit obligation	2,109,976	1,501,799	3,611,775
Total liabilities	431,077,283	1,501,799	432,579,082
Accumulated other comprehensive income, net of tax	—	(1,501,799)	(1,501,799)
Total member and parton deficit	(50,593,389)	(1,501,799)	(52,095,188)

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The recognition provisions of SFAS 158 had no effect on the statements of income for the periods presented. The Company has a measurement for benefit obligations of December 31 for each fiscal year.

(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.

(s) Recently Issued Accounting Standards

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133* (SFAS 161). SFAS 161 requires entities that utilize derivative instruments to provide qualitative disclosures about their objectives and strategies for using such instruments, as well as any details of credit-risk-related contingent features contained within derivatives. SFAS 161 also requires entities to disclose additional information about the amounts and location of derivatives located within the financial statements, how the provisions of Statement 133 have been applied, and the impact that hedges have on an entity's financial position, financial performance, and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008. The Company is currently evaluating the impact of SFAS 161 on the disclosures about its hedging activities and use of derivatives.

(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 by a third party 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 2008 and 2007, Sunflower allocated indirect costs of approximately \$9 million of expenses to Mid-Kansas. In 2008 and 2007, Sunflower sold approximately \$42 million and \$23 million, respectively, of power to Mid-Kansas and purchased approximately \$15 million and \$12 million of power from Mid-Kansas respectively.

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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, 2008 and 2007, Sunflower had accounts receivable from Mid-Kansas of \$6,956,997 and \$4,274,045, respectively. Additionally, Sunflower owed Mid-Kansas \$136,446 and \$3,197,669 as of December 31, 2008 and 2007, respectively.

(3) Utility Plant

Utility plant balances by major class of asset are as follows at December 31, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Steam production plant	\$ 481,146,628	479,695,167
Other production plant	16,795,569	14,504,748
Transmission plant	125,918,641	126,321,096
General plant	29,362,516	21,649,539
	<u>653,223,354</u>	<u>642,170,550</u>
Total utility plant	653,223,354	642,170,550
Less accumulated depreciation	<u>(397,367,587)</u>	<u>(390,827,345)</u>
Net utility plant	255,855,767	251,343,205
Land held for future use	3,193,843	3,193,843
Construction work in progress	<u>9,653,999</u>	<u>23,145,265</u>
Total utility plant, net	<u>\$ 268,703,609</u>	<u>277,682,313</u>

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(4) Long-Term Debt

(a) Outstanding Notes Payable

The outstanding note balances are as follows as of December 31, 2008 and 2007:

	2008	2007
Secured "A-1" Notes, 4.28% interest, due in semiannual principal and interest installments through 2011	\$ 25,900,000	39,200,000
Secured "A-2" Notes, interest ranging from 2.80% to 5.50%, due in quarterly principal and interest installments through 2016	129,317,801	133,017,801
Unsecured "A" Participation Notes, 8.00% interest, due in quarterly principal and interest installments through 2016	41,384,141	45,075,128
Secured "B" Notes, bearing no stated interest rate, quarterly installments applied 2 for 1, effective interest rate of 3.80% through 2016	21,660,236	23,935,864
Residual Value Notes, bearing no stated interest rate, lump-sum payment due December 31, 2016, effective interest rate of 3.59%	93,894,909	90,595,902
Unsecured "B" Notes, bearing no stated interest rate, due in quarterly installments through 2027, effective interest rate of 5.30%	9,319,854	9,683,207
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	18,479,514	19,008,244
	339,956,455	360,516,146
Less current maturities of long-term obligations	(27,116,865)	(23,908,483)
Long-term obligations, less current maturities	\$ 312,839,590	336,607,663

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

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installments. 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 \$25,217,632 as of December 31, 2008. 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 \$21,660,236 and \$23,935,864 as of December 31, 2008 and 2007, 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 \$9,319,854 and \$9,683,207 as of December 31, 2008 and 2007, respectively.

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

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“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, 2008, scheduled maturities of the long-term debt are as follows:

Year ending December 31:	
2009	\$ 27,116,865
2010	25,219,767
2011	24,283,320
2012	29,694,417
2013	32,323,992
Thereafter	<u>201,318,094</u>
	<u>\$ 339,956,455</u>

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, 2008, Sunflower had outstanding letters of credit to Southwest Power Pool (SPP) and Midwest Independent System Operator (MISO) for approximately \$3.0 million. These securities 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 \$11,787,509 as of December 31, 2008. 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.

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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 have 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 2008, is \$157,250. 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.

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 2008 is \$2.6 million, \$1.15 million and \$0.8 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 cancelled.

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, 2008; 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.

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(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, 2008 and 2007 are presented below:

	2008	2007
Deferred tax assets:		
Property and equipment, principally due to safe harbor leasing transactions	\$ 12,243,052	12,228,771
Property and equipment, principally due to differences in depreciation	5,157,054	5,439,253
Accrued vacation	263,728	218,716
Investment in SEHI notes	952,340	885,026
Investment in Holcomb 2, LLC	1,571,917	1,548,432
Net operating loss carryforwards	94,481,310	94,616,455
Total gross deferred tax assets	114,669,401	114,936,653
Less valuation allowance	(81,021,239)	(81,978,929)
Deferred tax assets, less allowance	33,648,162	32,957,724
Deferred tax liabilities:		
Debt, principally due to differences in effective interest rates	32,848,142	32,190,044
Other	800,020	767,680
Total gross deferred tax liabilities	33,648,162	32,957,724
Net deferred tax assets	\$ —	—

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, 2008, Sunflower has approximately \$6,000,000 and SEHI has approximately \$236,000,000 of net operating loss carryforwards for regular and alternative minimum tax purposes that, if not utilized, begin to expire after 2018 through 2027.

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 has elected to defer the adoption of FASB FIN 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB No. 109* under the guidance of FSP No. 48-3 (FSP 48-3), *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*. The Company's policy is to evaluate uncertain tax positions under the guidance of FAS 5, *Accounting for Contingencies*, which requires recognition of loss contingencies when it is probable that a liability has been incurred, and the amount of loss is reasonably estimated.

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(6) Leases

Sunflower is obligated under various leases for transmission plant that are accounted for as capital leases. At December 31, 2008 and 2007, the net amount of plant and equipment under capital leases was \$13,821,939 and \$14,325,006, respectively.

Amortization of assets held under capital leases is included within the operations-transmission expense line item. Rental expense incurred for capital leases amounted to \$1,667,320 and \$1,682,801 for the years ended December 31, 2008 and 2007, respectively. Interest costs associated with capital leases amounted to \$1,164,253 and \$1,202,251 for the years ended December 31, 2008 and 2007, respectively. Amortization of leased assets in association with capital leases amounted to \$503,067 and \$480,550 for the years ended December 31, 2008 and 2007, 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 \$5,842,630 and \$5,581,376 for the years ended December 31, 2008 and 2007, respectively.

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Future minimum lease payments under noncancelable operating leases and future minimum capital lease payments as of December 31, 2008 are as follows:

	Capital leases	Operating leases
Year ending December 31:		
2009	\$ 1,665,068	5,294,944
2010	1,634,225	4,791,285
2011	1,616,938	4,440,658
2012	1,498,034	4,440,658
2013	1,498,034	3,982,321
Thereafter	21,033,488	39,236,042
	28,945,787	\$ 62,185,908
Less amount representing interest	15,123,848	
Present value of minimum lease payments	13,821,939	
Less current portion	538,596	
Long-term obligations under capital leases	\$ 13,283,343	

(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 multiemployer 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, 2008 and 2007 was approximately \$4,098,011 and \$3,565,189, 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.

In April 2007, in conjunction with the transaction discussed in note 2, Sunflower and its members hired several former Aquila, Inc. employees and they were allowed immediate eligibility in Sunflower's pension plan. Due to funding of these employees obligations previously made by Aquila, Inc., Sunflower recorded a prepaid pension for the amount of \$2,760,297 as long-term other assets and an associated payable to Mid-Kansas included within accounts payable – affiliates at December 31, 2007. This amount represents credits with the NRECA that the Company utilized in fiscal year 2008 to reduce pension funding obligations. As of December 31, 2008, the Company has \$436,845 remaining, which is recorded in prepayments and other current assets.

(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

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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 in accordance with SFAS 106. Sunflower retains the right, subject to existing agreements, to change or eliminate these benefits.

As discussed in note 1(q), the Company adopted the recognition, measurement date, and disclosure provisions and the measurement date provisions of SFAS 158 effective December 31, 2007 and 2008, respectively. SFAS 158 requires companies to recognize 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 balance sheet at December 31, 2008 and 2007:

	Postretirement benefits	
	December 31, 2008	December 31, 2007
Current liabilities	\$ 71,000	62,205
Noncurrent liabilities	5,822,990	3,549,570
Total liability recognized	<u>\$ 5,893,990</u>	<u>3,611,775</u>

The accumulated benefit obligation for the plan was \$5,893,990 and \$3,611,775 at December 31, 2008 and 2007, respectively. The postretirement benefit obligation is unfunded. Net periodic postretirement benefit cost for December 31, 2008 and 2007, was \$635,886 and \$1,047,400. As of December 31, 2008, the unrecognized actuarial loss was \$3,206,791 and the unrecognized transitional obligation was \$150,200.

The benefit cost as of December 31, 2008 and 2007 includes the following:

	2008	2007
New employees	\$ —	845,000
Service cost	293,102	75,781
Interest cost	251,795	95,363
Amortization of transitional obligation	25,000	25,000
Recognized net actuarial loss	65,989	6,256
Total benefit cost	<u>\$ 635,886</u>	<u>1,047,400</u>

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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 \$185,000 and \$25,000, respectively. Weighted average assumptions used to determine benefit obligations and cost for 2008 and 2007 were as follows:

	Postretirement benefits	
	2008	2007
Discount rate – obligation	5.05%	6.50%
Discount rate – cost	6.50%	6.00%
Healthcare cost trend rate	8.5% – 5.0%	10.0% – 5.0%

For measurement purposes at December 31, 2008, a 8.5% annual rate of increase in the per capita cost of covered healthcare benefits was assumed for 2008. The rate was assumed to decrease gradually to 5.0% for 2016 and remain at that level thereafter. If the annual rate changed by 1%, the effect would be insignificant.

The following table summarizes benefits paid during 2008 and 2007:

	2008	2007
Gross benefits paid	\$ 364,612	581,604
Retiree contributions	(155,748)	(232,910)
Net benefits paid	208,864	348,694

The benefits expected to be paid, net of retiree contributions, from the postretirement benefit plan in each year 2009 – 2013 are \$71,000, \$102,000, \$148,000, \$178,000, and \$93,000, respectively. The aggregate benefits expected to be paid, net of retiree contributions, in the five years from 2014 through to 2018 are \$616,000. 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.

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(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, 2008 and 2007. 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.

	<u>2008</u>		<u>2007</u>	
	<u>Carrying amount</u>	<u>Fair value</u>	<u>Carrying amount</u>	<u>Fair value</u>
Financial assets:				
Investments in associated organizations	\$ 4,421,361	4,421,361	4,153,400	4,153,400
Capital term certificates in NRUCF	21,069,745	21,069,745	21,465,578	21,465,578
Financial liabilities:				
Long-term debt	\$ 339,956,455	309,406,781	360,516,146	328,445,560

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, 2008 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, 2007 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 Cooperative for the debt of the same maturity.

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(b) Fair Value Hierarchy

The Company adopted Statement 157 on January 1, 2008 for fair value measurements of financial assets and liabilities. Statement 157 establishes 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, 2008:

	<u>December 31,</u> <u>2008</u>	<u>Fair value measurements at reporting date using</u>		
		<u>Quoted prices</u> <u>in active</u> <u>markets for</u> <u>identical</u> <u>assets</u> <u>(Level 1)</u>	<u>Significant</u> <u>other</u> <u>observable</u> <u>inputs</u> <u>(Level 2)</u>	<u>Significant</u> <u>unobservable</u> <u>inputs</u> <u>(Level 3)</u>
Assets:				
Derivative				
instrument assets	\$ 1,296,034	—	1,296,034	—
Total	\$ 1,296,034	—	1,296,034	—

The derivative instrument assets 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 \$22 million in fiscal year 2009, \$15.6 million in 2010, \$11 million in 2011, and \$7.1 million in 2012 and thereafter.

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In mid-January 2007, Sunflower requested and received necessary approvals from RUS and CFC for an additional \$18,000,000 line-of-credit facility to fund the costs to repair the damage to its transmission lines that resulted from an ice storm that affected the service area on December 30 and 31, 2006. Damage estimates to the system range from \$18 to \$23 million and will be reimbursed in large part by the Federal Emergency Management Agency (FEMA). The damaged areas were declared a federal disaster; management expects approximately 85% of the costs will be reimbursed. This emergency line-of-credit was in place through December 31, 2008. The facility has been paid to zero at December 31, 2008 and is no longer in effect.

During 2008 and 2007, Sunflower incurred construction costs of \$3.6 million and \$8.8 million and received FEMA reimbursement of \$6.5 million and \$1.8 million. 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 \$7.9 million in 2009.

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, 2008.

As part of a tax benefit transfer transaction entered into in the early 1980's, 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, 2008, the maximum amount that could be drawn upon the letter of credit was \$11,787,509. As of December 31, 2008, 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 is currently working with various Kansas state entities to resolve this issue. 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 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. Sunflower intends to contest the case vigorously.

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.