

Big Rivers Electric Corporation

*Financial Statements as of December 31,
2006 and 2005 and for Each of the Three
Years in the Period Ended December 31,
2006, and Independent Auditors' Report*

INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Big Rivers Electric Corporation:

We have audited the accompanying balance sheets of Big Rivers Electric Corporation (the "Company") as of December 31, 2006 and 2005, and the related statements of operations, equities (deficit), and of cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these 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 audit to obtain reasonable assurance about whether the 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 the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2006 and 2005, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated March 14, 2007, on our consideration of the Company's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements. The purpose of that report 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. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.



March 14, 2007

BIG RIVERS ELECTRIC CORPORATION

BALANCE SHEETS AS OF DECEMBER 31, 2006 AND 2005 (Dollars in thousands)

	2006	2005
ASSETS		
UTILITY PLANT—Net	\$ 917,668	\$ 928,872
RESTRICTED INVESTMENTS UNDER LONG-TERM LEASE	186,690	180,650
OTHER DEPOSITS AND INVESTMENTS—At cost	3,816	3,397
CURRENT ASSETS:		
Cash and cash equivalents	96,143	67,264
Accounts receivable	17,748	16,350
Materials and supplies inventory	811	667
Prepaid expenses	3,608	91
Total current assets	118,310	84,372
DEFERRED CHARGES AND OTHER	27,905	28,689
TOTAL	<u>\$ 1,254,389</u>	<u>\$ 1,225,980</u>
EQUITIES (DEFICIT) AND LIABILITIES		
CAPITALIZATION:		
Equities (deficit)	\$ (217,371)	\$ (251,913)
Long-term debt	1,041,075	1,046,846
Obligations related to long-term lease	177,310	170,954
Other long-term obligations	45	92
Total capitalization	<u>1,001,059</u>	<u>965,979</u>
CURRENT LIABILITIES:		
Current maturities of long-term obligations	11,959	810
Voluntary prepayment of long-term debt	-	10,403
Purchased power payable	9,219	10,732
Accounts payable	3,366	2,394
Accrued expenses	2,164	2,172
Accrued interest	7,631	7,542
Total current liabilities	<u>34,339</u>	<u>34,053</u>
DEFERRED CREDITS AND OTHER:		
Deferred lease revenue	17,316	21,755
Deferred gain on sale-leaseback	56,380	59,262
Residual value payments obligation	140,744	139,710
Other	4,551	5,221
Total deferred credits and other	<u>218,991</u>	<u>225,948</u>
COMMITMENTS AND CONTINGENCIES		
TOTAL	<u>\$ 1,254,389</u>	<u>\$ 1,225,980</u>

See notes to financial statements.

BIG RIVERS ELECTRIC CORPORATION

STATEMENTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005, AND 2004 (Dollars in thousands)

	2006	2005	2004
POWER CONTRACTS REVENUE	\$ 200,692	\$ 191,280	\$ 175,777
LEASE REVENUE	<u>57,896</u>	<u>57,675</u>	<u>56,753</u>
Total operating revenue	<u>258,588</u>	<u>248,955</u>	<u>232,530</u>
OPERATING EXPENSES:			
Operations:			
Power purchased and interchanged	114,516	114,500	106,099
Transmission and other	21,684	20,309	18,674
Maintenance	3,652	3,195	2,597
Depreciation	<u>30,408</u>	<u>30,192</u>	<u>29,732</u>
Total operating expenses	<u>170,260</u>	<u>168,196</u>	<u>157,102</u>
ELECTRIC OPERATING MARGIN	<u>88,328</u>	<u>80,759</u>	<u>75,428</u>
INTEREST EXPENSE AND OTHER:			
Interest	60,754	59,639	56,923
Interest on obligations related to long-term lease	9,505	9,109	8,725
Other—net	<u>111</u>	<u>124</u>	<u>158</u>
Total interest expense and other	<u>70,370</u>	<u>68,872</u>	<u>65,806</u>
OPERATING MARGIN	<u>17,958</u>	<u>11,887</u>	<u>9,622</u>
NONOPERATING MARGIN:			
Interest income on restricted investments under long-term lease	12,069	11,670	11,278
Interest income and other	<u>4,515</u>	<u>2,786</u>	<u>1,125</u>
Total nonoperating margin	<u>16,584</u>	<u>14,456</u>	<u>12,403</u>
NET MARGIN	<u>\$ 34,542</u>	<u>\$ 26,343</u>	<u>\$ 22,025</u>

See notes to financial statements.

BIG RIVERS ELECTRIC CORPORATION

STATEMENTS OF EQUITIES (DEFICIT) FOR THE YEARS ENDED DECEMBER 31, 2006, 2005, AND 2004 (Dollars in thousands)

	Total Equities (Deficit)	Accumulated Deficit	Other Equities	
			Donated Capital and Memberships	Consumers' Contributions to Debt Service
BALANCE—January 1, 2004	\$ (300,281)	\$ (304,726)	\$ 764	\$ 3,681
Net margin	<u>22,025</u>	<u>22,025</u>	-	-
BALANCE—December 31, 2004	(278,256)	(282,701)	764	3,681
Net margin	<u>26,343</u>	<u>26,343</u>	-	-
BALANCE—December 31, 2005	(251,913)	(256,358)	764	3,681
Net margin	<u>34,542</u>	<u>34,542</u>	-	-
BALANCE—December 31, 2006	<u>\$ (217,371)</u>	<u>\$ (221,816)</u>	<u>\$ 764</u>	<u>\$ 3,681</u>

See notes to financial statements.

BIG RIVERS ELECTRIC CORPORATION

STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005, AND 2004 (Dollars in thousands)

	2006	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net margin	\$ 34,542	\$ 26,343	\$ 22,025
Adjustments to reconcile net margin to net cash provided by operating activities:			
Depreciation and amortization	33,592	33,386	32,625
Increase in restricted investments under long-term lease	(6,040)	(5,955)	(5,836)
Amortization of deferred gain on sale-leaseback	(2,882)	(2,856)	(2,823)
Deferred lease revenue	(4,439)	(4,335)	(4,267)
Residual value payments obligation	(6,187)	(5,969)	(5,077)
Increase in RUS ARVP Note	5,313	5,077	4,807
Increase in New RUS Promissory Note	13,889	8,205	21,849
Increase in obligations under long-term lease	6,356	6,250	6,107
Changes in certain assets and liabilities:			
Accounts receivable	(1,398)	(741)	(261)
Materials and supplies inventory	(144)	(112)	33
Prepaid expenses	(3,517)	257	226
Deferred charges	(694)	480	(368)
Purchased power payable	(1,513)	1,528	550
Accounts payable	972	(516)	(87)
Accrued expenses	81	72	1,459
Other—net	(1,170)	351	(104)
Net cash provided by operating activities	<u>66,761</u>	<u>61,465</u>	<u>70,858</u>
CASH FLOWS FROM INVESTING ACTIVITIES:			
Capital expenditures	(13,189)	(12,904)	(12,203)
Other deposits and investments	(419)	(151)	(277)
Net cash used in investing activities	<u>(13,608)</u>	<u>(13,055)</u>	<u>(12,480)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Principal payments on long-term obligations	(24,274)	(36,037)	(9,289)
Principal payments on short-term notes payable	-	-	(10,000)
Net cash used in financing activities	<u>(24,274)</u>	<u>(36,037)</u>	<u>(19,289)</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS	28,879	12,373	39,089
CASH AND CASH EQUIVALENTS—Beginning of year	<u>67,264</u>	<u>54,891</u>	<u>15,802</u>
CASH AND CASH EQUIVALENTS—End of year	<u>\$ 96,143</u>	<u>\$ 67,264</u>	<u>\$ 54,891</u>
SUPPLEMENTAL CASH FLOW INFORMATION:			
Cash paid for interest	<u>\$ 47,277</u>	<u>\$ 46,534</u>	<u>\$ 28,485</u>
Cash paid for taxes	<u>\$ 375</u>	<u>\$ 271</u>	<u>\$ 270</u>

See notes to financial statements.

BIG RIVERS ELECTRIC CORPORATION

NOTES TO FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 2006, 2005, AND 2004 (Dollars in thousands)

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General Information—Big Rivers Electric Corporation (“Big Rivers” or the “Company”), an electric generation and transmission cooperative, supplies wholesale power to its three member distribution cooperatives (Kenergy Corp., Jackson Purchase Energy Corporation, and Meade County Rural Electric Cooperative Corporation) under all requirements contracts, excluding the power needs of two large aluminum smelters (the “Aluminum Smelters”), sells surplus power under separate contracts to Kenergy Corp. for a portion of the Aluminum Smelters load, and markets power to nonmember utilities and power marketers. The members provide electric power and energy to industrial, residential, and commercial customers located in portions of 22 western Kentucky counties. The wholesale power contracts with the members extend to January 1, 2023. Rates to Big Rivers’ members are established by the Kentucky Public Service Commission (“KPSC”) and are subject to approval by the Rural Utilities Service (“RUS”). The financial statements of Big Rivers include the provisions of Statement of Financial Accounting Standards (“SFAS”) No. 71, *Accounting for the Effects of Certain Types of Regulation*, which was adopted by the Company in 2003, and gives recognition to the ratemaking and accounting practices of these agencies.

In 1999, Big Rivers Leasing Corporation (“BRLC”) was formed as a wholly-owned subsidiary of Big Rivers. BRLC’s principal assets are the restricted investments acquired in connection with the 2000 sale-leaseback transaction discussed in Note 4.

Principles of Consolidation—The financial statements of Big Rivers include the accounts of Big Rivers and its wholly owned subsidiary, BRLC. All significant intercompany transactions have been eliminated.

Estimates—The preparation of the financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and disclosure of contingent assets and liabilities. The estimates and assumptions used in the accompanying financial statements are based upon management’s evaluation of the relevant facts and circumstances as of the date of the financial statements. Actual results may differ from those estimates.

System of Accounts—Big Rivers’ accrual basis accounting policies follow the Uniform System of Accounts as prescribed by the RUS Bulletin 1767B-1, as adopted by the KPSC. The regulatory agencies retain authority and periodically issue orders on various accounting and ratemaking matters.

Revenue Recognition—Revenues generated from the Company’s wholesale power contracts are based on month-end meter readings and are recognized as earned. In accordance with SFAS No. 13, *Accounting for Leases*, Big Rivers’ revenue from the Lease Agreement is recognized on a straight-line basis over the term of the lease. The major components of this lease revenue include the annual lease payments and the Monthly Margin Payments (described in Note 2).

In conjunction with the Lease Agreement, Big Rivers expects to realize the minimum lease revenue for the years ending December 31, as follows:

	Amount
2007	\$ 52,332
2008	52,332
2009	52,332
2010	52,332
2011	41,291
Thereafter	<u>420,908</u>
	<u>\$ 671,527</u>

Utility Plant and Depreciation—Utility plant is recorded at original cost, which includes the cost of contracted services, materials, labor, overhead, and an allowance for borrowed funds used during construction. Replacements of depreciable property units, except minor replacements, are charged to utility plant.

Allowance for borrowed funds used during construction is included on projects with an estimated total cost of \$250 or more before consideration of such allowance. The interest capitalized is determined by applying the effective rate of Big Rivers' weighted-average debt to the accumulated expenditures for qualifying projects included in construction in progress.

In accordance with the terms of the Lease Agreement, the Company generally records capital additions for Incremental Capital Costs and Nonincremental Capital Costs expenditures funded by E.ON U.S. (formerly LG&E Energy Corporation) as utility plant to which the Company maintains title. A corresponding obligation to E.ON U.S. is recorded for the estimated portion of these additions attributable to the Residual Value Payments (see Note 2). A portion of this obligation is amortized to lease revenue over the useful life of those assets during the remaining lease term. For the years ended December 31, 2006 and 2005, the Company has recorded \$7,221 and \$6,986, respectively, for such additions in utility plant. The Company has recorded \$6,187, \$5,969, and \$5,077 in 2006, 2005, and 2004, respectively, as related lease revenue in the accompanying financial statements.

In accordance with the Lease Agreement, and in addition to the capital costs funded by E.ON U.S. (see Note 2) that are recorded by the Company as utility plant and lease revenue, E.ON U.S. also incurs certain Nonincremental Capital Costs and Major Capital Improvements (as defined in the Lease Agreement) for which they forego a Residual Value Payment by Big Rivers upon lease termination. Such amounts are not recorded as utility plant or lease revenue by the Company. At December 31, 2006, the cumulative Nonincremental Capital Costs amounted to \$6,618 (unaudited).

E.ON U.S. is also in the process of constructing a scrubber (Major Capital Improvement) on Big Rivers' Coleman plant. First operation at the Coleman units occurred in February 2006, while commercial acceptance is anticipated to occur in March 2007. The project is expected to be completed in the third quarter of 2007 at a cost of \$98,000 (unaudited), none of which is expected to be recorded as utility plant or lease revenue.

Depreciation of utility plant in service is recorded using the straight-line method over the estimated remaining service lives, as approved by the RUS and KPSC. The annual composite depreciation rates used to compute depreciation expense were as follows:

Electric plant-leased	1.60%–2.47%
Transmission plant	1.76%–3.24%
General plant	1.11%–5.62%

For 2006, 2005, and 2004, the average composite depreciation rates were 1.86%, respectively. At the time plant is disposed of, the original cost plus cost of removal less salvage value of such plant is charged to accumulated depreciation, as required by the RUS.

Impairment Review of Long-Lived Assets—Long-lived assets are reviewed as facts and circumstances indicate that the carrying amount may be impaired. This review is performed in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS No. 144 establishes one accounting model for all impaired long-lived assets and long-lived assets to be disposed of by sale or otherwise. SFAS No. 144 requires the evaluation for impairment involve the comparison of an asset's carrying value to the estimated future cash flows the asset is expected to generate over its remaining life. If this evaluation were to conclude that the carrying value of the asset is impaired, an impairment charge would be recorded based on the difference between the asset's carrying amount and its fair value (less costs to sell for assets to be disposed of by sale) as a charge to operations or discontinued operations.

Restricted Investments—Investments are restricted under contractual provisions related to the sale-leaseback transaction discussed in Note 4. These investments have been classified as held-to-maturity and are carried at amortized cost.

Cash and Cash Equivalents—Big Rivers considers all short-term, highly-liquid investments with original maturities of three months or less to be cash equivalents.

Income Taxes—As a taxable cooperative, Big Rivers is entitled to exclude the amount of patronage allocations to members from taxable income. Income and expenses related to nonmember operations are taxable to Big Rivers. Big Rivers and BRLC file a consolidated Federal income tax return and Big Rivers files a separate Kentucky income tax return.

Patronage Capital—As provided in the bylaws, Big Rivers accounts for each year's patronage-sourced income, both operating and nonoperating, on a patronage basis. Notwithstanding any other provision of the bylaws, the amount to be allocated as patronage capital for a given year shall not be less than the greater of regular taxable patronage-sourced income or alternative minimum taxable patronage-sourced income. During 2006, the Company made a patronage allocation to its three member distribution cooperatives in accordance with its bylaws of \$8,602. During 2005, the Company was not required to make a patronage allocation to its three member cooperatives in accordance with its bylaws. In 2007, the Company anticipates making a patronage allocation to its members based on such calculations for tax year 2006 of approximately \$27,760.

Derivatives—Management has reviewed the requirements of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted, and has determined that all contracts meeting the definition of a derivative also qualify for the normal purchases and sales exception under SFAS No. 133. The Company has elected the Normal Purchase and Normal Sale exception for these contracts and, therefore, the contracts are not required to be recognized at fair value in the financial statements.

New Accounting Pronouncements— In June 2006, the Financial Accounting Standards Board (“FASB”) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109* (“FIN 48”). FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing the recognition threshold a tax position is required to meet before being recognized in the financial statements. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transition. The cumulative effects, if any, of applying FIN 48 will be recorded as an adjustment to retained earnings as of the beginning of the period of adoption. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the effect that the adoption of FIN 48 will have on its results of operations and financial condition but has not yet determined the impact the adoption will have on the Company.

In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements* (“SFAS No. 157”). SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measures. It applies under other accounting pronouncements that require or permit fair value measurements and does not require any new fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the effect that the adoption of SFAS No. 157 will have on its results of operations and financial condition and does not expect the adoption will have a significant impact on the Company.

In September 2006, the FASB issued FASB Statement No. 158, *Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans* (“SFAS No. 158”). SFAS No. 158 improves financial reporting by requiring an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in the funded status in the year in which the change occurs through comprehensive income of a business entity. It also requires an employer to measure the funded status of a plan as of its year-end statement of financial position, with limited exceptions. SFAS No. 158 is effective for fiscal years ending after June 15, 2007. The Company is currently evaluating the effect that the adoption of SFAS No. 158 will have on its results of operations and financial condition but cannot readily determine whether the adoption will have a significant impact on the Company.

2. LG&E LEASE AGREEMENT

On July 15, 1998 (“Effective Date”), a lease was consummated (“Lease Agreement”), whereby Big Rivers leased its generating facilities to Western Kentucky Energy Corporation (“WKEC”), a wholly owned subsidiary of E.ON U.S. Pursuant to the Lease Agreement, WKEC operates the generating facilities and maintains title to all energy produced. Throughout the lease term, in order for Big Rivers to fulfill its obligation to supply power to its members, the Company purchases substantially all of its power requirements from LG&E Energy Marketing Corporation (“LEM”), a wholly owned subsidiary of E.ON U.S., pursuant to a power purchase agreement.

Big Rivers continues to operate its transmission facilities and charges LEM tariff rates for delivery of the energy produced by WKEC and consumed by LEM’s customers. The significant terms of the Lease Agreement are as follows:

- I. WKEC leases and operates Big Rivers’ generation facilities through 2023.
- II. Big Rivers retains ownership of the generation facilities both during and at the end of the lease term.
- III. WKEC pays Big Rivers an annual lease payment of \$30,965 over the lease term, subject to certain adjustments.

- IV. On the Effective Date, Big Rivers received \$69,100 representing certain closing payments and the first two years of the annual lease payments. In accordance with SFAS No. 13, *Accounting for Leases*, the Company amortizes these payments to revenue on a straight-line basis over the life of the lease.
- V. Big Rivers continues to provide power for its members, excluding the member loads serving the Aluminum Smelters, through its power purchase agreements with LEM and the Southeastern Power Administration, based on a pre-determined maximum capacity. When economically feasible, the Company also obtains the power necessary to supply its member loads, excluding the Aluminum Smelters, in the open market. Kenergy Corp.'s retail service for the Aluminum Smelters is served by LEM and other third-party providers that may include Big Rivers. To the extent the power purchased from LEM does not reach pre-determined minimums, the Company is required to pay certain penalties. Also, to the extent additional power is available to Big Rivers under the LEM contract, Big Rivers may sell to nonmembers.
- VI. LEM will reimburse Big Rivers an additional \$75,870 for the margins expected from the Aluminum Smelters through 2011, being defined as the net cash flows that Big Rivers anticipated receiving if the Company had continued to serve the Aluminum Smelters' load, as filed in the Rate Hearing (the "Monthly Margin Payments").
- VII. WKEC is responsible for the operating costs of the generation facilities; however, Big Rivers is partially responsible for ordinary capital expenditures ("Nonincremental Capital Costs") for the generation facilities over the term of the Lease Agreement, generally up to predetermined annual amounts. This cumulative amount is not expected to exceed \$148,000 over the entire 25-1/2 year Lease Agreement. At the end of the lease term, Big Rivers is obligated to fund a "Residual Value Payment" to E.ON U.S. for such capital additions during the lease, currently estimated to be \$125,880 (see Note 1). Adjustments to the Residual Value Payment will be made based upon actual capital expenditures. Additionally, WKEC will make required capital improvements to the facilities to comply with a new law or a change to existing law ("Incremental Capital Costs") over the lease life (the Company is partially responsible for such costs: 20% through 2010) and the Company will be required to submit another Residual Value Payment to LEC for the undepreciated value of WKEC's 80% share of these costs, at the end of the lease, currently estimated to be \$15,677. The Company will have title to these assets during the lease and upon lease termination.
- VIII. Big Rivers entered into a note payable with LEM for \$19,676 (the "LEM Settlement Note") to be repaid over the term of the Lease Agreement, which bears interest at 8% per annum, in consideration for LEM's assumption of the risk related to unforeseen costs with respect to power to be supplied to the Aluminum Smelters and the increased responsibility for financing capital improvements. The Company recorded this obligation as a component of deferred charges with the related payable recorded as long-term debt in the accompanying balance sheets. This deferred charge is being amortized on a straight-line basis over the lease term.
- IX. On the Effective Date, Big Rivers paid a nonrefundable marketing payment of \$5,933 to LEM, which has been recorded as a component of deferred charges. This amount is being amortized on a straight-line basis over the lease term.
- X. During the lease term, Big Rivers will be entitled to certain "billing credits" against amounts the Company owes LEM under the power purchase agreement. Each month during the first 55 months of the lease term, Big Rivers received a credit of \$89. For the year 2011, Big Rivers will receive a credit of \$2,611 and for the years 2012 through 2023, the Company will receive a credit of \$4,111 annually.

In accordance with the power purchase agreement with LEM, the Company is allowed to purchase power in the open market rather than from LEM, incurring penalties when the power purchased from LEM does not meet certain minimum levels, and to sell excess power (power not needed to supply its jurisdictional load) in the open market (collectively referred to as “Arbitrage”). Pursuant to the New RUS Promissory Note and the RUS ARVP Note, the benefit, net of tax, as defined, derived from Arbitrage must be divided as follows: one-third, adjusted for capital expenditures, will be used to make principal payments on the New RUS Promissory Note; one-third will be used to make principal payments on the RUS ARVP Note; and the remaining value may be retained by the Company.

Management is of the opinion that the Company is in compliance with all covenants of the Lease Agreement.

3. UTILITY PLANT

At December 31, 2006 and 2005, utility plant is summarized as follows:

	2006	2005
Classified plant in service:		
Electric plant—leased	\$ 1,506,822	\$ 1,497,039
Transmission plant	208,760	202,925
General plant	15,581	14,819
Other	<u>67</u>	<u>67</u>
	1,731,230	1,714,850
Less accumulated depreciation	<u>826,647</u>	<u>798,684</u>
	904,583	916,166
Construction in progress	<u>13,085</u>	<u>12,706</u>
Utility plant—net	<u>\$ 917,668</u>	<u>\$ 928,872</u>

Interest capitalized for the years ended December 31, 2006, 2005, and 2004 was \$236, \$160, and \$221, respectively.

The Company has not identified any material legal obligations, as defined in SFAS No. 143, *Accounting for Asset Retirement Obligations*, which was further interpreted by FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*. In accordance with regulatory treatment, the Company records an estimated net cost of removal of its utility plant through normal depreciation. As of December 31, 2006 and 2005, the Company had a regulatory liability of approximately \$26,670 and \$23,619, respectively, related to nonlegal removal costs included in accumulated depreciation.

4. SALE-LEASEBACK

On April 18, 2000, the Company completed a sale-leaseback of two of its utility plants, including the related facilities and equipment. The sale-leaseback provides Big Rivers a \$1,089,000 fixed price purchase option, at the end of each lease term (25 and 27 years), which, together with future contractual interest receipts, will be fully funded.

This transaction has been recorded as a financing for financial reporting purposes and a sale for Federal income tax purposes. In connection therewith, Big Rivers received \$866,676 of proceeds and incurred \$791,626 of related obligations. Pursuant to a payment undertaking agreement with a financial

institution, Big Rivers effectively extinguished \$656,029 of these obligations with an equivalent portion of the proceeds. The Company also purchased investments with an initial value of \$146,647 to fund the remaining \$135,597 of the obligations. These amounts are reflected as restricted investments under long-term lease and obligations related to long-term lease in the accompanying balance sheets. Interest received and paid will be recorded to these accounts over the life of the lease. Currently, the Company is paying 7.57% interest on its obligations related to long-term lease and receiving 6.89% on its related investments. The Company made a \$64,000 principal payment on the New RUS Promissory Note with the remaining proceeds. The \$75,050 gain was deferred and will be amortized over the respective lease terms, of which the Company recognized \$2,881, \$2,856, and \$2,824, in 2006, 2005, and 2004, respectively. Principal payments begin in 2009.

Amounts recognized in the statement of financial position related to the sale-leaseback as of December 31, 2006 and 2005, are as follows:

	2006	2005
Restricted investments under long-term lease	\$ 186,690	\$ 180,650
Obligations related to long-term lease	177,310	170,954
Deferred gain on sale-leaseback	56,380	59,262

Amounts recognized in the statement of operations related to the sale-leaseback for the years ended December 31, 2006, 2005, and 2004, are as follows:

	2006	2005	2004
Power contracts revenue (revenue discount adjustment—see Note 6)	\$ (3,680)	\$ (3,680)	\$ (3,680)
Interest on obligations related to long-term lease:			
Interest expense	12,386	11,965	11,548
Amortize gain on sale-leaseback	<u>(2,881)</u>	<u>(2,856)</u>	<u>(2,823)</u>
Net interest on obligations related to long-term lease	<u>9,505</u>	<u>9,109</u>	<u>8,725</u>
Interest income on restricted investments under long-term lease	12,069	11,670	11,278
Interest income and other (CoBank patronage allocation)	777	772	661

5. DEBT AND OTHER LONG-TERM OBLIGATIONS

A detail of long-term debt at December 31, 2006 and 2005, is as follows:

	2006	2005
New RUS Promissory Note, stated amount of, \$803,601, stated interest rate of 5.75%, with an interest rate of 5.81%, maturing July 2021	\$ 799,789	\$ 808,094
RUS ARVP Note, stated amount of \$251,215, no stated interest rate, with interest imputed at 5.81%, maturing December 2023	94,391	90,347
LEM Settlement Note, interest rate of 8.0%, payable in monthly installments through July 2023	16,707	17,173
County of Ohio, Kentucky, promissory note, variable interest rate (average interest rate of 3.49% and 2.46% in 2006 and 2005, respectively), maturing in October 2022	83,300	83,300
County of Ohio, Kentucky, promissory note, variable interest rate (average interest rate of 3.49% and 2.46% in 2006 and 2005, respectively), maturing in June 2013	<u>58,800</u>	<u>58,800</u>
Total long-term debt	1,052,987	1,057,714
Current maturities	11,912	465
Voluntary prepayment	<u>-</u>	<u>10,403</u>
Total long-term debt—net of current maturities and prepayment	<u>\$ 1,041,075</u>	<u>\$ 1,046,846</u>

The following are scheduled maturities of long-term debt at December 31:

Year	Amount
2007	\$ 11,912
2008	39,178
2009	39,230
2010	41,286
2011	47,345
Thereafter	<u>874,036</u>
Total	<u>\$ 1,052,987</u>

RUS Notes—On July 15, 1998, Big Rivers recorded the New RUS Promissory Note and the RUS ARVP Note at fair value using the applicable market rate of 5.81%. The RUS Notes are collateralized by substantially all assets of the Company.

Pollution Control Bonds—The County of Ohio, Kentucky, issued \$83,300 of Pollution Control Periodic Auction Rate Securities, Series 2001, the proceeds of which are supported by a promissory note from Big Rivers, which bears the same interest rate. These bonds bear interest at a variable rate and mature in October 2022.

The County of Ohio, Kentucky, issued \$58,800 of Pollution Control Variable Rate Demand Bonds, Series 1983, the proceeds of which are supported by a promissory note from Big Rivers, which bears the same interest rate as the bonds. These bonds bear interest at a variable rate and mature in June 2013.

The Series 1983 bonds are supported by a liquidity facility issued by Credit Suisse First Boston, which was assigned to Dexia Credit in 2006. Both Series are supported by municipal bond insurance and surety policies issued by Ambac Assurance Corporation. Big Rivers has agreed to reimburse Ambac Assurance Corporation for any payments under the municipal bond insurance policies or the surety policies.

LEM Settlement Note—On the Effective Date, Big Rivers executed the Settlement Note with LEM. The Settlement Note requires Big Rivers to pay to LEM \$19,676, plus interest at 8% per annum over the lease term. The principal and interest payment is approximately \$1,822 annually. This payment is consideration for LEM's assumption of the risk related to unforeseen costs with respect to power to be supplied to the Aluminum Smelters and the increased responsibility for financing capital improvements.

Other Long-Term Obligations—During 1997, Big Rivers terminated two unfavorable coal contracts. In connection with that settlement, the Company paid \$345, \$351, and \$351 during 2006, 2005, and 2004, respectively. At December 31, 2006, the Company has a remaining liability of \$92 payable over the next two years, of which \$47 is included in current maturities of long-term obligations.

Notes Payable—Notes payable represent the Company's borrowing on its line of credit with the National Rural Utilities Cooperative Finance Corporation. The maximum borrowing capacity on the line of credit is \$15,000. There were no amounts outstanding on the line of credit at December 31, 2006. The line of credit bears interest at a variable rate. Each advance on the line of credit is payable within one year.

6. RATE MATTERS

The rates charged to Big Rivers' members consist of a demand charge per kW and an energy charge per kWh consumed as approved by the KPSC. The rates include specific rate designs for its members' two classes of customers, the large industrial customers and the rural customers under its jurisdiction. For the large industrial customers, the demand charge is generally based on each customer's maximum demand during the current month. The remaining customers demand charge is based upon the maximum coincident demand of each member's delivery points. The demand and energy charges are not subject to adjustments for increases or decreases in fuel or environmental costs. Big Rivers' current rates will remain in effect until changed by the KPSC.

Effective since September 1, 2000, the KPSC has approved Big Rivers' request for a \$3,680 annual revenue discount adjustment for its members through August 31, 2006, effectively passing the benefit of the sale-leaseback transaction (see Note 4) to them. The extent to which Big Rivers requests KPSC approval to continue the adjustment depends upon its planned environmental compliance costs and its overall financial condition. In March 2007, Big Rivers plans to request the KPSC's approval to extend the adjustment through August 31, 2008.

7. INCOME TAXES

The components of the net deferred tax assets as of December 31, 2006 and 2005, were as follows:

	2006	2005
Deferred tax assets:		
Net operating loss carryforward	\$ 68,696	\$ 80,769
Alternative minimum tax credit carryforwards	4,790	4,283
Sale-leaseback	136,598	130,568
Other accruals	<u>2,465</u>	<u>2,066</u>
Total deferred tax assets	<u>212,549</u>	<u>217,686</u>
Deferred tax liabilities:		
Lease agreement	(21,270)	(15,395)
Fixed asset basis difference	<u>(827)</u>	<u>(10,178)</u>
Total deferred tax liabilities	<u>(22,097)</u>	<u>(25,573)</u>
Net deferred tax asset (pre-valuation allowance)	190,452	192,113
Valuation allowance	<u>(185,662)</u>	<u>(187,830)</u>
Net deferred tax asset	<u>\$ 4,790</u>	<u>\$ 4,283</u>

Big Rivers was formed as a tax-exempt cooperative organization described in Internal Revenue Code Section 501(c)(12). To retain tax-exempt status under this section, at least 85% of the Big Rivers' receipts must be generated from transactions with the Company's members. In 1983, sales to nonmembers resulted in Big Rivers failing to meet the 85% requirement. Until Big Rivers can meet the 85% member income requirement, the Company is a taxable cooperative. Big Rivers is also subject to Kentucky income tax.

Under the provisions of SFAS No. 109, *Accounting for Income Taxes*, Big Rivers is required to record deferred tax assets and liabilities for temporary differences between amounts reported for financial reporting purposes and amounts reported for income tax purposes. The Company has not recorded any income tax expense for the years ended December 31, 2006, 2005 and 2004 as the Company has utilized federal net operating losses to offset any taxable income during those years. Had the Company not had the benefit of a net operating loss carryforward, the Company would have recorded \$10,599, \$7,995, and \$6,759 in current tax expense for the years ended December 31, 2006, 2005 and 2004, respectively. Deferred tax assets and liabilities are determined based upon these temporary differences using enacted tax rates for the year in which these differences are expected to reverse. Deferred income tax expense or benefit is based on the change in assets and liabilities from period to period, subject to an ongoing assessment of realization.

At December 31, 2006 and 2005, Big Rivers had a nonpatron net operating loss carryforward of approximately \$167,551 and \$196,998, respectively, for tax reporting purposes expiring through 2013, and an alternative minimum tax credit carryforward at December 31, 2006 and 2005, of approximately \$4,790 and \$4,283, respectively, which carries forward indefinitely.

Big Rivers has a net deferred tax asset, against which a valuation allowance has been provided, in part, based upon the fact that it is presently uncertain whether such asset will be realized. The resulting net deferred tax asset at December 31, 2006 and 2005, is approximately \$4,790 and \$4,283, respectively, which represents the alternative minimum tax credit carryforward, against which no allowance has been provided.

8. POWER PURCHASED

In accordance with the Lease Agreement, Big Rivers supplies all of the members' requirements for power to serve their customers, other than the Aluminum Smelters. Contract limits were established in the Lease Agreement and include minimum and maximum hourly and annual power purchase amounts. Big Rivers cannot reduce the contract limits by more than 12 MW in any year or by more than a total of 72 MW over the lease term. In the event Big Rivers fails to take the minimum requirement during any hour or year, Big Rivers is liable to LEM for a certain percentage of the difference between the amount of power actually taken and the applicable minimum requirement.

Although Big Rivers will be required by the Lease Agreement to purchase minimum hourly and annual amounts of power from LEM, the lease does not prevent Big Rivers from paying the associated penalty in certain hours to purchase lower cost power, if available, in the open market or reselling a portion of its purchased power to a third party. The power purchases made under this agreement for the years ended December 31, 2006, 2005, and 2004, were \$97,999, \$96,795, and \$89,696, respectively, and are included in power purchased and interchanged on the statement of operations.

9. PENSION PLANS

Big Rivers has noncontributory defined benefit pension plans covering substantially all employees who meet minimum age and service requirements. The plans provide benefits based on the participants' years of service and the five highest consecutive years' compensation during the last ten years of employment. Big Rivers' policy is to fund such plans in accordance with the requirements of the Employee Retirement Income Security Act of 1974. The plans are measured as of December 31, 2006 and 2005.

At December 31, 2006 and 2005, the following is an assessment of the Company's noncontributory defined benefit pension plans:

	2006	2005
Projected benefit obligation	\$ (17,464)	\$ (16,550)
Fair value of plan assets	<u>16,416</u>	<u>11,868</u>
Funded status	<u>\$ (1,048)</u>	<u>\$ (4,682)</u>

The accumulated benefit obligation for all defined benefit pension plans was \$12,421 and \$11,426 at December 31, 2006 and 2005, respectively.

At December 31, 2006 and 2005, amounts recognized in the statement of financial position are as follows:

	2006	2005
Prepaid benefit cost	\$ 3,520	\$ 110
Accrued benefit liability	<u>-</u>	<u>(108)</u>
Net amount recognized	<u>\$ 3,520</u>	<u>\$ 2</u>

Net periodic pension costs, which are calculated based on actuarial assumptions at January 1, for the years ended December 31, 2006, 2005, and 2004, were as follows:

	2006	2005	2004
Benefit cost	\$ 1,167	\$ 1,158	\$ 954
Employer contribution	4,684	921	843
Benefits paid or transferred	852	1,757	103

Assumptions used to develop the projected benefit obligation were as follows:

	2006	2005	2004
Discount rates	5.75 %	5.75 %	5.75 %
Rates of increase in compensation levels	4.00	4.00	4.00
Expected long-term rate of return on assets	7.25	7.25	7.50

The expected long-term rate of return on plan assets for determining net periodic pension cost for each fiscal year is chosen by the Company from a best estimate range determined by applying anticipated long-term returns and long-term volatility for various asset categories to the target asset allocation of the plans, as well as taking into account historical returns.

Using the asset allocation policy adopted by the Company noted in the paragraph below, we determined the expected rate of return at a 50% probability of achievement level based on (a) forward-looking rate of return expectations for passively-managed asset categories over a 20-year time horizon and (b) historical rates of return for passively-managed asset categories. Applying an approximately 80%/20% weighting to the rates determined in (a) and (b), respectively, produced an expected rate of return of 7.28%, which was rounded to 7.25%.

The general investment objectives are to invest in a diversified portfolio, comprised of both equity and fixed income investments, which are further diversified among various asset classes. The diversification is designed to minimize the risk of large losses while maximizing total return within reasonable and prudent levels of risk. The investment objectives specify a targeted investment allocation for the pension plans of up to 55% equities. The remaining 45% may be allocated among fixed income or cash equivalent investments. Objectives do not target a specific return by asset class. These investment objectives are long-term in nature. As of December 31, 2006 and 2005, the investment allocation was 0% and 56%, respectively, in equities and 100% and 44%, respectively, in fixed income. This temporary departure from the above investment objectives reflects the process of transferring to a new investment advisor.

Expected retiree pension benefit payments projected to be required during the years following 2006 are as follows:

Years Ending December 31	Amount
2007	\$ 488
2008	1,104
2009	803
2010	1,346
2011	1,220
2012–2016	<u>12,343</u>
Total	<u>\$ 17,304</u>

In 2007, the Company expects to contribute \$1,111 to its pension plan trusts.

10. FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying value of cash and cash equivalents, accounts receivable, and accounts payable approximate fair value due to their short maturity.

The fair value of restricted investments is determined based upon quoted market prices and rates. The carrying value of the investments is recorded at accreted value and the terms of the investment are within Note 4. The estimated fair values of the restricted investments are as follows:

	2006		2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Restricted investments	\$ 186,690	\$ 233,418	\$ 180,650	\$ 236,571

It was not practical to estimate the fair value of patronage capital included within other deposits and investments due to these being untraded companies.

It was not practical to estimate the fair value of long-term debt due to Big Rivers' inability to obtain long-term debt from outside parties.

11. POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

Big Rivers provides certain postretirement medical benefits for retired employees and their spouses. As of July 1, 2001, Big Rivers pays 85% of the cost from age 62 to 65 for all retirees. For salaried employees who retired prior to December 31, 1993, Big Rivers pays 100% of Medicare supplemental costs. For salaried employees who retire after December 31, 1993, Big Rivers pays 25% plus \$25 per month of the Medicare supplemental costs.

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Medicare Act") was enacted. The Medicare Act created Medicare Part D, a new prescription drug benefit that is available to all Medicare-eligible individuals, effective January 1, 2006. National Rural Electric Cooperative Association ("NRECA"), the provider of Big Rivers' health plan coverage through the NRECA Group Benefits Trust, chose to become a Medicare Part D provider. Effective January 1, 2006, Part D coverage is the only drug coverage available to Big Rivers' Medicare-eligible retirees.

The discount rate used in computing the postretirement obligation was 5.75% for 2006 and 2005. A health care cost trend rate of 9% in 2006 declining to 5.5% in 2011 was utilized.

An assessment of the Company's postretirement plan at December 31, 2006 and 2005, is as follows:

	2006	2005
Total benefit obligation	\$ (2,695)	\$ (3,339)
Unfunded accrued postretirement cost	(3,787)	(3,755)

The components of net periodic postretirement benefit costs for the years ended December 31, 2006, 2005, and 2004, which are calculated based on actuarial assumptions at January 1, were as follows:

	2006	2005	2004
Benefit cost	\$ 241	\$ 286	\$ 310
Benefits paid	171	216	188

Expected retiree benefit payments projected to be required during the years following 2006 are as follows:

Year	Amount
2007	\$ 153
2008	142
2009	162
2010	184
2011	199
2012–2016	<u>1,246</u>
Total	<u>\$ 2,086</u>

In addition to the postretirement plan discussed above, in 1992 Big Rivers began a postretirement benefit plan which vests a portion of accrued sick leave benefits to salaried employees upon retirement or death. To the extent an employee's sick leave hour balance exceeds 480 hours such excess hours are paid at 20% of the employee's base hourly rate at the time of retirement or death. The accumulated obligation recorded for the postretirement sick leave benefit is \$294 and \$270 at December 31, 2006 and 2005, respectively. The postretirement expense recorded was \$44, \$27, and \$28 for 2006, 2005, and 2004, respectively, and the benefits paid were \$20, \$16, and \$-0- for 2006, 2005, and 2004, respectively.

12. BENEFIT PLAN—401(k)

Big Rivers has two defined contribution retirement plans covering bargaining and salaried employees. Big Rivers matches up to 60% of the first 6% of eligible employees' wages contributed. Employees generally become vested in Company matching contributions based upon years of service as follows:

Years of Vesting Service	Vested Percentage
1	20 %
2	40
3	60
4	80
5 or more	100

Employees are also permitted to make pre-tax contributions of up to 75% of eligible wages. Big Rivers' expense under this plan was \$193, \$178, and \$168 for the years ended December 31, 2006, 2005, and 2004, respectively.

13. RELATED-PARTIES

For the years ended December 31, 2006, 2005, and 2004 Big Rivers had tariff sales to its members of \$108,737, \$109,439, and \$105,004, respectively. In addition, for the years ended December 31, 2006, 2005, and 2004, Big Rivers had certain sales to Kenergy for the Aluminum Smelters and Weyerhaeuser loads of \$57,374, \$46,372, and \$43,017, respectively.

At December 31, 2006 and 2005, Big Rivers had accounts receivable from its members of \$13,015 and \$12,872, respectively.

In October 2005, Big Rivers made a lump sum payment of \$221 to Kenergy for the lease of office space in a building owned by Kenergy. The charge for the lump sum payment was deferred and is being amortized over the life of the agreement.

14. COMMITMENTS AND CONTINGENCIES

Big Rivers is involved in litigation arising in the normal course of business. While the results of such litigation cannot be predicted with certainty, management, based upon advice of counsel, believes that the final outcome will not have a material adverse effect on the financial statements.

15. SUBSEQUENT EVENT

The Big Rivers board of directors adopted resolutions on February 23, 2007, authorizing management, among other things, to execute a Transaction Termination Agreement Among Big Rivers Electric Corporation, LG&E Energy Marketing Inc., and Western Kentucky Energy Corp. (the "Termination Agreement"). The Termination Agreement establishes the terms on which Big Rivers, on the one hand, and LG&E Energy Marketing Inc. and Western Kentucky Energy Corp. on the other hand, agree to terminate a series of contractual relationships established in 1998 under which, among other things, LG&E Energy Marketing Inc. and Western Kentucky Energy Corp. currently lease and operate the generating units owned or previously operated by Big Rivers, and sell power to Big Rivers to use in meeting the requirements of its system. Those resolutions additionally authorize management to sign various agreements under which Big Rivers agrees to sell its member, Kenergy Corp., 850 MW in the aggregate for resale to Alcan Primary Products Corporation and Century Aluminum of Kentucky General Partnership, contingent upon the closing of the transaction contemplated in the Termination Agreement.

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