# EAST KENTUCKY POWER COOPERATIVE, INC.
# AND SUBSIDIARY

## CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2003 and 2002

REPORT OF INDEPENDENT AUDITORS

To the Audit Committee
East Kentucky Power Cooperative, Inc.
and Subsidiary

We have audited the accompanying consolidated balance sheets of East Kentucky Power Cooperative, Inc. and Subsidiary (the Cooperative) as of December 31, 2003 and 2002, and the related consolidated statements of revenue and expenses, changes in members' equities, and cash flows for the years then ended. These financial statements are the responsibility of the Cooperative'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. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of East Kentucky Power Cooperative, Inc. and Subsidiary as of December 31, 2003 and 2002, and their results of operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Crowe Chizek and Company LLC

Crowe Chizek and Company LLC

Lexington, Kentucky
February 20, 2004

**EAST KENTUCKY POWER COOPERATIVE, INC.**
**AND SUBSIDIARY**
**CONSOLIDATED BALANCE SHEETS**
December 31, 2003 and 2002
(Dollars in Thousands)

| | 2003 | 2002 |
|---|---|---|
| **ASSETS** | | |
| Electric plant, at original cost | | |
| In-service | $ 1,494,125 | $ 1,329,664 |
| Construction in progress | 316,086 | 229,226 |
| | 1,810,211 | 1,558,890 |
| Less accumulated depreciation | 694,529 | 684,631 |
| Electric plant, net | 1,115,682 | 874,259 |
| Long-term accounts receivable | 10,558 | 11,371 |
| Investment securities | | |
| Available for sale | 37,948 | 24,590 |
| Held to maturity | 15,423 | 8,298 |
| Current assets | | |
| Cash and cash equivalents | 42,781 | - |
| Trading securities | - | 5,572 |
| Accounts receivable | 49,344 | 45,755 |
| Fuel | 22,010 | 19,760 |
| Materials and supplies | 26,802 | 26,173 |
| Emission allowances | 739 | 4,045 |
| Other | 1,605 | 1,482 |
| Total current assets | 143,281 | 102,787 |
| Deferred charges | 1,004 | 1,088 |
| Other | 4,636 | 4,554 |
| **Total assets** | $ 1,328,532 | $ 1,026,947 |
| **LIABILITIES AND MEMBERS' EQUITIES** | | |
| Members' equities | $ 167,535 | $ 140,702 |
| Long-term debt, excluding current portion | 952,987 | 762,079 |
| Current liabilities | | |
| Current portion of long-term debt | 94,426 | 33,218 |
| Notes payable | 6,000 | 2,095 |
| Accounts payable | 49,211 | 31,707 |
| Accrued expenses | 5,094 | 4,728 |
| Total current liabilities | 154,731 | 71,748 |
| Accrued postretirement benefit cost | 43,030 | 41,280 |
| Other | 10,249 | 11,138 |
| **Total liabilities and members' equities** | $ 1,328,532 | $ 1,026,947 |

The accompanying notes are an integral part of these consolidated financial statements.

**EAST KENTUCKY POWER COOPERATIVE, INC.**
**AND SUBSIDIARY**
**CONSOLIDATED STATEMENTS OF REVENUE AND EXPENSES**
Years Ended December 31, 2003 and 2002
(Dollars in Thousands)

| | 2003 | 2002 |
|---|---|---|
| Operating revenue | $ 447,124 | $ 429,489 |
| Operating expenses | | |
| Production | | |
| Fuel | 137,103 | 146,506 |
| Other | 32,174 | 33,963 |
| Purchased power | 102,028 | 62,371 |
| Maintenance | 37,852 | 30,184 |
| Depreciation | 31,166 | 45,106 |
| Other | 44,565 | 40,777 |
| | 384,888 | 358,907 |
| Operating margins | 62,236 | 70,582 |
| Interest charges, net | | |
| Interest expense | 45,069 | 39,577 |
| Interest income on debt service, construction and related funds | (833) | (1,131) |
| | 44,236 | 38,446 |
| Net operating margin | 18,000 | 32,136 |
| Nonoperating margins | | |
| Interest income | 2,115 | 3,124 |
| Allowance for interest on borrowed funds used during construction | 8,951 | 2,072 |
| Miscellaneous | 188 | 37 |
| | 11,254 | 5,233 |
| Capital credits and patronage capital allocations | 144 | 59 |
| **Net margin** | $ 29,398 | $ 37,428 |

The accompanying notes are an integral part of these consolidated financial statements.

**EAST KENTUCKY POWER COOPERATIVE, INC.**
**AND SUBSIDIARY**
**CONSOLIDATED STATEMENTS OF CHANGES IN MEMBERS' EQUITIES**
Years Ended December 31, 2003 and 2002
(Dollars in Thousands)

| | Memberships | Patronage Capital | Donated Capital | Accumulated Other Comprehensive Income (Loss) | Total Members' Equities |
|---|---|---|---|---|---|
| Balances, January 1, 2002 | $ 2 | $ 98,834 | $ 3,035 | $ 1,457 | $ 103,328 |
| Comprehensive income | | | | | |
| Net margin | - | 37,428 | - | - | 37,428 |
| Unrealized losses on investments available for sale | - | - | - | (54) | (54) |
| Total comprehensive income | | | | | 37,374 |
| Balances, December 31, 2002 | 2 | 136,262 | 3,035 | 1,403 | 140,702 |
| Comprehensive income | | | | | |
| Net margin | - | 29,398 | - | - | 29,398 |
| Unrealized losses on investments available for sale | - | - | - | (2,565) | (2,565) |
| Total comprehensive income | | | | | 26,833 |
| Balances, December 31, 2003 | $ 2 | $ 165,660 | $ 3,035 | $ (1,162) | $ 167,535 |

The accompanying notes are an integral part of these consolidated financial statements.

**EAST KENTUCKY POWER COOPERATIVE, INC.**
**AND SUBSIDIARY**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
Years Ended December 31, 2003 and 2002
(Dollars in Thousands)

| | 2003 | 2002 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Net margin | $ 29,398 | $ 37,428 |
| Adjustments to reconcile net margin to net cash from operating activities | | |
| Depreciation | 31,166 | 45,106 |
| Amortization of loan costs | 84 | 84 |
| Net gain on sales of trading securities | - | (62) |
| Changes in: | | |
| Trading securities | 5,572 | 8,882 |
| Accounts receivable | (3,589) | (3,215) |
| Fuel | (9,802) | 530 |
| Materials and supplies | (629) | 230 |
| Emission allowances | 3,306 | 141 |
| Accounts payable, trade | 46,979 | 11,170 |
| Accrued expenses | 366 | 356 |
| Accrued postretirement benefit cost | 1,750 | 1,648 |
| Other | (22,342) | 4,169 |
| Net cash from operating activities | 82,259 | 106,467 |
| **Cash flows from investing activities** | | |
| Additions to electric plant | (273,244) | (203,136) |
| Maturities and calls of securities available for sale | 601 | 12,000 |
| Purchases of securities available for sale | (16,524) | (262) |
| Purchases of securities held to maturity | (7,145) | - |
| Payments received on long-term accounts receivable | 813 | 792 |
| Net cash from investing activities | (295,499) | (190,606) |
| **Cash flows from financing activities** | | |
| Proceeds from long-term debt | 285,593 | 107,000 |
| Principal payments on long-term debt | (33,477) | (31,218) |
| Advances on notes payable | 317,644 | 2,095 |
| Payment on notes payable | (313,739) | - |
| Net cash from financing activities | 256,021 | 77,877 |
| Net change in cash and cash equivalents | 42,781 | (6,262) |
| Cash and cash equivalents at beginning of year | - | 6,262 |
| **Cash and cash equivalents at end of year** | $ 42,781 | $ - |

The accompanying notes are an integral part of these consolidated financial statements.

**EAST KENTUCKY POWER COOPERATIVE, INC.**
**AND SUBSIDIARY**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
Years Ended December 31, 2003 and 2002
(Dollars in Thousands)

| | 2003 | 2002 |
|---|---|---|
| Supplemental disclosure of cash flow information | | |
| Cash paid (received) for | | |
| Interest | $ 44,916 | $ 39,685 |
| Income taxes | - | (512) |
| | | |
| Non-cash operating transaction | | |
| Fuel included in accounts payable | $ 7,552 | $ 8,015 |
| | | |
| Non-cash investing transaction | | |
| Additions to electric plant included in accounts payable | $ 21,923 | $ 11,832 |
| Unrealized losses on securities available for sale | (2,565) | (54) |

The accompanying notes are an integral part of these consolidated financial statements.

## NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations: The Cooperative is engaged in generating and transmitting electrical power primarily to its sixteen member cooperatives throughout central and eastern Kentucky. The financial statements are prepared in accordance with policies prescribed or permitted by the Kentucky Public Service Commission (KPSC) and the United States Department of Agriculture, Rural Utilities Service (RUS), which conform with accounting principles generally accepted in the United States of America as applied to regulated enterprises.

Principles of Consolidation: The consolidated financial statements include the accounts of East Kentucky Power Cooperative, Inc. and its subsidiary, Charleston Bottoms Rural Electric Cooperative Corporation (CBRECC). All significant intercompany accounts and transactions have been eliminated.

Estimates in the Financial Statements: The preparation of 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 financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Electric Plant: Electric plant is stated at original cost, which is the cost when first dedicated to public service, including applicable labor and overhead cost and an allowance for interest on borrowed funds used during construction.

The cost of maintenance and repairs, including renewals of minor items of property, is charged to operating expense. The cost of replacement of depreciable property units, as distinguished from minor items, is charged to utility plant. The cost of units replaced or retired, including cost of removal, net of any salvage value, is charged to accumulated depreciation.

Provision for depreciation has been made on the basis of estimated useful lives at straight-line composite rates generally as follows:

| | |
|---|---|
| Production plant | 3.30% |
| Transmission plant | 2.75% - 8.00% |
| General plant | 2.00% - 16.67% |

Long-Term Assets: Electric plant and other long-term assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value. No impairment has been recognized on long-term assets for the years ended December 31, 2003 or 2002.

(Continued)

**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Allowance for Interest on Borrowed Funds Used During Construction: In accordance with practices permitted by the prescribed system of accounts, the Cooperative provides an allowance for interest on borrowed funds used during construction. The allowance represents the calculated net interest cost of funds borrowed for construction of major projects which take longer than one year and cost in excess of $100,000.

Investment Securities: Investment securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Investment securities are classified as available for sale when they might be sold before maturity. Investment securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income. Trading securities are carried at fair value, with changes in unrealized holding gains and losses included in income.

Interest income includes amortization of purchase premium or discount. Gains and losses on sales are based on the amortized cost of the security sold. Investment securities are written down to fair value when a decline in fair value is not temporary.

Revenue and Fuel Costs: Revenue is recorded monthly based on meter readings made at month-end.

The state regulatory authority has adopted a uniform fuel adjustment clause for all electric utilities within its jurisdiction. Under this clause, fuel cost above or below a stated amount per kWh is charged or credited to the member cooperatives for all energy sales.

The Cooperative's sales are primarily to its member cooperatives and amounted to approximately $441,053,000 and $412,323,000 for 2003 and 2002, respectively. Accounts receivable at December 31, 2003 and 2002 were primarily from member cooperatives. At December 31, 2003 and 2002, individual account balances that exceeded 10 percent of total accounts receivable are as follows:

| | 2003 | 2002 |
|---|---|---|
| Owen Electric Cooperative | $ 7,091,000 | $ 5,600,000 |
| South Kentucky RECC | 5,064,000 | - |
| Farmers RECC | - | 5,200,000 |

Cash and Cash Equivalents: For purposes of the consolidated financial statements, the Cooperative considers temporary investments having a maturity of three months or less when purchased to be cash equivalents.

(Continued)

**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

At December 31, 2003 and 2002, respectively, the Cooperative had $2,818,724 and $838,816 of cash on deposit at one bank, which is in excess of federally insured limits.

Fuel and Materials and Supplies: Inventories of fuels and materials and supplies are stated at the lower of average cost or market.

Emission Allowances: Title IV of the Clean Air Act Amendments of 1990 provides for the issuance of allowances as a means to limit the emissions of certain airborne pollutants. Allowances are stated at cost. Issuances of allowances are stated using a monthly weighted-average method of cost determination. Gains and losses are recorded upon the disposition of allowances.

Members' Equities: Memberships represent contributions to the Cooperative made by members. Should the Cooperative cease business, these amounts, if available, will be returned to the members. In addition, any available capital credits will also be allocated to members on a contribution-to-gross margins basis.

A provision in the Cooperative's bylaws prohibits the return of capital contributed by patrons unless, after any proposed retirement, the total capital of the Cooperative equals or exceeds 40 percent of total assets. In addition, provisions of certain loan agreements prohibit the retirement of capital until stipulated requirements as to liquid assets (cash and U.S. Government obligations) are met. Accordingly, at December 31, 2003, no patronage capital was available for refunds or retirement.

Comprehensive Income: Comprehensive income includes both net margin and other comprehensive income. Other comprehensive income represents the change in unrealized gains and losses on securities available for sale.

Income Taxes: The Cooperative is exempt under section 501(c)(12) of the Internal Revenue Code from federal income tax for any year in which at least 85 percent of its gross income is derived from members but is responsible for income taxes on certain unrelated business income.

Reclassifications: Certain 2002 amounts have been reclassified in these consolidated financial statements to conform to the 2003 presentation. Such reclassifications had no effect on net margin or members' equities as previously reported.

(Continued)

**NOTE 2 – ELECTRIC PLANT**

Electric plant in-service consisted of the following:

| | 2003 | 2002 |
|---|---|---|
| | (in thousands) | |
| Production plant | $ 1,051,186 | $ 855,768 |
| Transmission plant | 357,515 | 343,779 |
| General plant | 47,110 | 46,608 |
| Completed construction, not classified | 38,314 | 83,509 |
| Electric plant in service | $ 1,494,125 | $ 1,329,664 |

Depreciation expense was $31,166,000 and $45,106,000 for 2003 and 2002, respectively.

During 2003, as a result of a depreciation study, the Cooperative extended the useful life of both the Cooper and Spurlock Power Stations. This change in the estimated useful lives of these plants reduced 2003 depreciation expense by approximately $12,650,000.

**NOTE 3 – LONG-TERM ACCOUNTS RECEIVABLE**

Long-term receivables include modifications to Spurlock Power Station in order to provide steam to a paper mill that recycles container board. The paper mill is reimbursing the Cooperative for the cost of the modifications through a monthly facilities charge over the 20-year life of the contract. Long-term receivables also include interest-bearing notes from joint ventures owned by the Cooperative and four of the Cooperative's member systems for the buyout of a propane company. The joint ventures of the member systems will make five years of interest-only (prime rate minus one-half of one percent, adjust annually) payments, with principal and interest payments beginning in 2005. The notes will be payable in full in 2015.

(Continued)

## NOTE 4 – INVESTMENT SECURITIES

Amortized cost and estimated fair value of investment securities available for sale at December 31 are as follows (in thousands):

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| 2003 | | | | |
| National Rural Utilities Cooperative Finance Corporation Promissory Note | $ 48 | $ - | $ - | $ 48 |
| U.S. Treasury bill | 34,128 | 4 | (1,881) | 32,251 |
| Zero Coupon Bond | 3,874 | 723 | - | 4,597 |
| Other | 1,060 | - | (8) | 1,052 |
| | $ 39,110 | $ 727 | $ (1,889) | $ 37,948 |

Investment securities available for sale with unrealized losses at December 31, 2003 not recognized in net margin are as follows:

| | Unrealized Loss Less than 12 months | | Unrealized Loss 12 Months or More | |
|---|---|---|---|---|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| U.S. Treasury bill | $ 32,251 | $ (1,881) | - | - |
| Other | 1,052 | (8) | - | - |
| | $ 33,303 | $ (1,889) | - | - |

These unrealized losses are considered temporary as the treasury bill has a 2004 maturity date and for other securities, unrealized losses are considered temporary as they result from the current interest rate environment.

(Continued)

**NOTE 4 – INVESTMENT SECURITIES** (Continued)

2002

| | | | | |
|---|---|---|---|---|
| National Rural Utilities Cooperative Finance Corporation Promissory Note | $ 28 | $ - | $ - | $ 28 |
| U.S. Treasury note | 18,088 | 506 | - | 18,594 |
| Zero Coupon Bond | 4,012 | 856 | - | 4,868 |
| Other | 1,059 | 41 | - | 1,100 |
| | $ 23,187 | $ 1,403 | $ - | $ 24,590 |

Proceeds from maturities and calls of securities were $601,000 and $12,000,000 in 2003 and 2002, respectively. There were no realized gains or losses on those calls.

Amortized cost and estimated fair value of investment securities held to maturity at December 31 are as follows (in thousands):

| 2003 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| National Rural Utilities Cooperative Finance Corporation | | | | |
| 3-5% capital term certificates | $ 7,655 | $ - | $ (2,056) | $ 5,599 |
| 6.5875% subordinated term certificate | 500 | 92 | - | 592 |
| 2.72% equity term certificate | 7,145 | 70 | - | 7,215 |
| 0% subordinated term certificate | 123 | - | (36) | 87 |
| | $ 15,423 | $ 162 | $ (2,092) | $ 13,493 |

(Continued)

**NOTE 4 – INVESTMENT SECURITIES** (Continued)

Investment securities held to maturity with unrealized losses at December 31, 2003 not recognized in net margins are as follows:

| | Unrealized Loss Less than 12 months | | Unrealized Loss 12 Months or More | |
|---|---|---|---|---|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| 3-5% capital term certificates | - | - | $ 5,599 | $ (2,056) |
| 0% subordinated term certificate | - | - | 87 | (36) |
| | - | - | $ 5,686 | $ (2,092) |

The maturity dates on the above securities range from 2019 to 2080 and have no available trading market. However, it is management's intent to hold these securities until maturity, at which time management expects to recover full value.

2002

| | | | | |
|---|---|---|---|---|
| National Rural Utilities Cooperative Finance Corporation | | | | |
| 3-5% capital term certificates | $ 7,655 | $ - | $ (1,970) | $ 5,685 |
| 6.5875% subordinated term certificate | 515 | 118 | - | 633 |
| 0% subordinated term certificate | 128 | - | (38) | 90 |
| | $ 8,298 | $ 118 | $ (2,008) | $ 6,408 |

**NOTE 4 – INVESTMENT SECURITIES** (Continued)

The amortized cost and fair value of securities at December 31, 2003, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | Amortized Cost | Fair Value |
|---|---|---|
| | (in thousands) | |
| Available for sale | | |
| Due in one year or less | $ 36,161 | $ 34,326 |
| Due after one year through five years | 1,889 | 2,570 |
| Due after ten years | 1,060 | 1,052 |
| | $ 39,110 | $ 37,948 |
| Held to maturity | | |
| Due in one year or less | $ 7,145 | $ 7,215 |
| Due after ten years | 8,278 | 6,278 |
| | $ 15,423 | $ 13,493 |

**NOTE 5 – NOTES PAYABLE**

The Cooperative has a line of credit with National Rural Utilities Cooperative Finance Corporation (CFC) for $50,000,000 which matures in March 2005. Interest rates may not exceed the prime rate (as defined) plus 1 percent (2.80% at December 31, 2003). The Cooperative had $0 and $2,095,000 (payable on demand) outstanding on this line of credit at December 31, 2003 and 2002, respectively.

The Cooperative has an unsecured promissory note from one of its members in the amount of $6,000,000 at December 31, 2003. The interest rate is fixed at 3.10%, and principal is due on or before September 30, 2004.

(Continued)

## NOTE 6 – LONG-TERM DEBT

Long-term debt outstanding at December 31, 2003 and 2002 consisted of the following (in thousands):

| | 2003 | 2002 |
|---|---|---|
| First mortgage notes: | | |
| 4.241% - 10.657%, payable quarterly to Federal Financing Bank (FFB) in varying amounts through 2030 | $ 754,204 | $ 544,460 |
| 2%, 5%, and 5.125% payable quarterly to RUS in varying amounts through 2024 | 64,635 | 70,021 |
| 4.1%, payable quarterly to CFC in varying amounts through 2014 | 7,149 | 7,700 |
| 4.1% payable quarterly to CFC in varying amounts through 2024 | 17,125 | 17,731 |
| Fixed rate loan, 7.7%, payable semiannually in varying amounts to National Cooperative Services Corporation through 2012 | 11,600 | 12,600 |
| Promissory notes: | | |
| 2.55% variable rate note payable to CFC in 2004 | 50,000 | - |
| 3.40% fixed rate note payable to CFC in 2004 | 7,145 | - |
| Pollution control bonds: | | |
| Series 1984B, variable rate bonds, due October 15, 2014, 1.45% at December 31, 2003 and 1.80% at December 31, 2002 | 99,750 | 104,550 |
| Series 1984J, variable rate bonds, due October 15, 2014, 1.00% at December 31, 2003 and 1.70% at December 31, 2002 | 26,105 | 28,235 |

(Continued)

**NOTE 6 – LONG-TERM DEBT** (Continued)

| | | |
|---|---|---|
| Solid waste disposal revenue bonds, Series 1993B, variable rate bonds, due August 15, 2023, interest rate 1.10% at December 31, 2003 and 1.80% at December 31, 2002 | 9,700 | 10,000 |
| | 1,047,413 | 795,297 |
| Less current portion of long-term debt | 94,426 | 33,218 |
| | $ 952,987 | $ 762,079 |

In March 1996, RUS approved a loan application in the amount of $32,910,000 to finance the construction of transmission facilities. In July 2000, RUS approved a loan application in the amount of $85,600,000 to finance the construction of transmission facilities. In August 2001, RUS approved a loan application for the construction of the fourth and fifth combustion turbines and associated transmission facilities in the amount of $92,300,000. Advances on these loans are subject to certain conditions outlined by RUS and the non-governmental portions of such loans are subject to authorization from the KPSC. At December 31, 2003, $51,690,000 of these amounts remained to be advanced.

In September 2002, RUS approved a loan application in the amount of $223,500,000 for the design, purchase, and installation of NOx reduction equipment and electrostatic precipitators, including plant modifications and related expenditures on Spurlock Power Station Units No. 1 and 2. Advances on these loans are subject to certain conditions outlined by RUS, and the non-governmental portions of such loans are subject to authorization from the KPSC. At December 31, 2003, $21,700,000 of these amounts remained to be advanced.

On September 14, 2001, the Cooperative submitted to RUS a loan application for the construction of the Gilbert Unit at the Spurlock Power Station, including engineering services, preliminary structural design, and related transmission facilities in the amount of $410,000,000. In September 2003, this loan application was approved in the amount of $433,863,000, but has not been cleared for advances. Since this loan application has not been cleared for advances and construction has begun, the Cooperative sought alternative financing in the form of bridge financing from the National Rural Utilities Cooperative Finance Corporation (CFC) in the amount of $100,000,000, of which $50,000,000 remains to be advanced.

(Continued)

**NOTE 6 – LONG-TERM DEBT** (Continued)

The interest rate on the Series 1984B Pollution Control Bonds is subject to change weekly and the interest rate on the Series 1984J Pollution Control Bonds and the Series 1993B Solid Waste Disposal Revenue Bonds are subject to change semiannually. The interest rate adjustment period on any series of the above-mentioned variable rate bonds may be converted to a weekly, semiannual, annual or three-year basis or to a fixed-rate basis, at the option of the Cooperative.

Long-term pollution control and solid waste disposal revenue bonds require that debt service reserve funds be on deposit with a trustee throughout the term of the bonds. Debt service reserve requirements are as follows: Series 1984B - $12,717,000; Series1984J - $5,368,500; and Series 1993B - $1,062,000. In addition, mandatory sinking fund payments are required for each series as follows: Series 1984B – payments range from $5,300,000 in 2004 to $13,150,000 in 2013; Series 1984J – payments range from $2,355,000 in 2004 to $4,325,000 in 2010; and Series 1993B – payments range from $300,000 in 2004 to $700,000 in 2023. Debt service reserve and construction funds are held by trustees and are invested primarily in U.S. Government securities and CFC promissory notes. These funds are included in investment securities available for sale and have a fair value of approximately $19,200,000 at December 31, 2003.

Estimated maturities of long-term debt for the five years subsequent to December 31, 2003 are as follows: 2004 - $94,426,000; 2005 - $43,567,000; 2006 - $46,628,000; 2007 - $49,617,000; 2008 - $52,083,000; and thereafter - $761,092,000.

Under the terms of the loan agreements with RUS, CFC and institutional investors, the Cooperative is required to maintain certain levels of interest coverage and debt service coverage, both of which have been met at December 31, 2003.

Substantially all assets are pledged as collateral for first mortgage notes payable to the United States of America (RUS and FFB) and CFC.

**NOTE 7 – RETIREMENT BENEFITS**

Pension Plan: Pension benefits for substantially all employees are provided through participation in the National Rural Electric Cooperative Association's Retirement and Security Program, a multi-employer defined benefit plan. The Cooperative's required contributions were approximately $5,583,000 and $5,368,000 for 2003 and 2002, respectively.

(Continued)

**NOTE 7 – RETIREMENT BENEFITS** (Continued)

Retirement Savings Plan: The Cooperative has a Retirement Savings Plan for all employees who are eligible to participate in the Cooperative's benefit programs. The plan allows participants to make contributions by salary reduction, pursuant to Section 401(k) of the Internal Revenue Code. The Cooperative makes matching contributions to the account of each participant up to 2 percent of the participant's compensation. The Cooperative contributed approximately $669,000 and $673,000 to the plan in 2003 and 2002, respectively. Employees vest immediately in their contributions and the contributions of the Cooperative.

Supplemental Death Benefit Plan: The Cooperative provides a Supplemental Death Benefit Plan to all employees eligible to participate in the pension plan. The supplemental death benefit is payable to a deceased employee's beneficiary if the lump sum value of a 100% survivor benefit under the pension plan exceeds the pension plan benefits plus the Cooperative's group life insurance proceeds. Management believes that any liability related to this plan will not have a material effect on the consolidated financial statements.

Postretirement Medical Benefits: The Cooperative sponsors a defined benefit plan that provides medical and life insurance coverage to retirees and their dependents. Participating retirees and dependents contribute 50 percent of the projected cost of coverage. For purposes of the liability estimates, the substantive plan is assumed to be the same as the extant written plan. The plan is not funded.

The following table sets forth the plan's status reconciled with the amount shown in the Cooperative's balance sheets at December 31, 2003 and 2002 (dollars in thousands):

| | 2003 | 2002 |
|---|---|---|
| Change in plan assets: | | |
| Fair value of plan assets at beginning of year | $ - | $ - |
| Employer contribution | 539 | 378 |
| Plan participants' contribution | 539 | 377 |
| Benefits paid | (1,078) | (755) |
| Actual return on plan assets | - | - |
| Fair value of plan assets at end of year | - | - |

(Continued)

**NOTE 7 – RETIREMENT BENEFITS** (Continued)

| | 2003 | 2002 |
|---|---|---|
| Change in benefit obligation: | | |
| Benefit obligation at beginning of year | 28,601 | 26,309 |
| Service cost-benefits attributed to service during the period | 1,006 | 1,056 |
| Interest cost on accumulated postretirement benefit obligation | 1,888 | 1,681 |
| Benefits paid | (1,078) | (755) |
| Plan participants' contribution | 539 | 377 |
| Actuarial (gain) loss | 3,843 | (67) |
| Benefit obligation at end of year | 34,799 | 28,601 |
| Funded status | $ (34,799) | $ (28,601) |
| Unrecognized actuarial gain | (8,231) | (12,679) |
| Accrued benefit cost | $ (43,030) | $ (41,280) |

The discount rate used in determining the accumulated postretirement benefit obligation for 2003 and 2002 was 6% and 6.5%, respectively.

| | 2003 | 2002 |
|---|---|---|
| Components of net periodic postretirement benefit cost (dollars in thousands): | | |
| Service cost-benefits attributed to service during the period | $ 1,006 | $ 1,056 |
| Interest cost on accumulated postretirement benefit obligation | 1,888 | 1,681 |
| Amortization of unrecognized actuarial gain | (605) | (711) |
| Net periodic benefit cost | $ 2,289 | $ 2,026 |

For measurement purposes, a 10.25 percent annual rate of increase in the per capita cost of covered health care benefits was used for the year ended December 31, 2003. The rate is assumed to decline to 5% after seven years.

The health care cost trend rate assumption has a significant effect on the amounts reported.

(Continued)

**NOTE 7 – RETIREMENT BENEFITS** (Continued)

| | 2003 | 2002 |
|---|---|---|
| Effect on total of service cost and interest cost components (dollars in thousands) | | |
| 1-percentage-point increase | $ 613 | $ 631 |
| 1-percentage-point decrease | (469) | (484) |
| Effect on postretirement benefit obligation (dollars in thousands) | | |
| 1-percentage-point increase | $ 6,781 | $ 5,863 |
| 1-percentage-point decrease | (5,283) | (4,571) |

The Cooperative offers prescription drug benefits to its postretirement health care plan, and has deferred implementing FASB Staff Position (FSP) 106-1. The benefit obligation and net periodic benefit cost do not reflect the effects of this FSP on the plan.

**NOTE 8 – COMMITMENTS, EXPENDITURES AND CONTINGENCIES**

The Cooperative has entered into long-term power purchase agreements having minimum payment obligations for the five years subsequent to December 31, 2003 as follows (dollars in thousands):

| | |
|---|---|
| 2004 | $ 11,607 |
| 2005 | 7,180 |
| 2006 | 4,553 |
| 2007 | 4,553 |
| 2008 | 4,553 |

The Cooperative is committed to purchase coal for its generating plants under long-term contracts having minimum purchase obligations as follows (dollars in thousands):

| | |
|---|---|
| 2004 | $ 93,976 |
| 2005 | 49,496 |
| 2006 | 40,817 |
| 2007 | 23,904 |

The minimum cost of the coal purchases, based on the latest contractual prices, is subject to escalation clauses that are generally based on government-published indices and market price re-openers.

(Continued)

**NOTE 8 – COMMITMENTS, EXPENDITURES AND CONTINGENCIES** (Continued)

In July 2001, the Board approved the construction of a 268-megawatt coal-fired unit at Spurlock Power Station. The cost of construction of the generating unit, including related transmission facilities, will approximate $410,000,000.

In 1999, the Cooperative agreed to lease a portion of land at Smith to an independent power producer (IPP) who proposes to build a 540-megawatt integrated gasification combined cycle plant. The Cooperative executed a 20-year power purchase agreement (PPA) with the independent power producer to purchase 100 percent of the power plant output. During 2001, the IPP informed the Cooperative that it could not meet the financial closing deadline of June 30, 2001, nor could it commit to any future date for financial closure. The Cooperative notified the IPP in September 2002 that it intended to give a notice of termination of the PPA on January 31, 2003, but has subsequently agreed to withhold such notice of termination due to the pendency of the IPP's case before the Kentucky State Board for Electric Generation and Transmission Siting ("the Siting Board"). The KPSC initiated a review of its approval of the PPA on January 30, 2003, and that review is still pending. The Siting Board has approved the IPP's construction, on the condition that the IPP complies with local planning and zoning requirements. This condition has not yet been satisfied by the IPP. Should the Cooperative issue the notice of termination for failure to obtain financing, after completion of the Siting Board's review, the IPP would have 60 days to obtain project financing, based on existing PPA terms and pricing, after such a notice by the Cooperative of termination for failure of financing. The IPP will not have rights to lease the proposed site if the PPA is eventually terminated.

The Cooperative has received permission from the KPSC to construct two 80-megawatt gas-fired combustion turbines and related transmission facilities to be located at the Cooperative's J.K. Smith Power Station. The combustion turbines are expected to cost approximately $50 million. These combustion turbines are scheduled to be operational in December 2004.

There are pending claims in litigation against the Cooperative. Under the Cooperative's general liability insurance program, it is responsible for a deductible amount up to $1,000,000 for each occurrence. Neither the probable outcome nor ultimate liability resulting from any claims and litigation can be readily determined at this time. Accruals have been made when appropriate and management believes that any liability for such matters will, in any case, not have a material effect on the consolidated financial statements.

On January 28, 2004, the federal Environmental Protection Agency (EPA) sued the Cooperative alleging that physical or operating changes to three coal-fired generators resulted in simultaneous violations of the Prevention of Significant Deterioration provision of the Clean Air Act; the New Source Performance Standards of the Clean Air Act; and the State Implementation Plan for Kentucky, as approved by EPA.

(Continued)

**NOTE 8 – COMMITMENTS, EXPENDITURES AND CONTINGENCIES** (Continued)

The lawsuit seeks injunctive relief, and civil penalties of up to $25,000 a day before January 31, 1997, and $27,500 a day since then. The Cooperative denies the alleged violations, and maintains that it has complied with both federal and state requirements. This is the first significant violation cited by the government in the history of the organization. The Cooperative believes that when all the evidence is presented, the facts will bear out that the Cooperative complied with the requirements, and acted in good faith.

**NOTE 9 – FAIR VALUE OF FINANCIAL INSTRUMENTS**

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

<u>Cash and Cash Equivalents</u>: The carrying amount approximates fair value because of the short maturity of these instruments.

<u>Investment Securities</u>: The fair values of investment securities are estimated based on quoted market prices for the same or similar investments.

<u>Long-Term Accounts Receivable</u>: The fair values of long-term accounts receivable are estimated based on quoted interest rates for similar maturities.

<u>Notes Payable</u>: The carrying amount approximates fair value because of the variable rate and payable on demand terms of the financial instrument.

<u>Long-Term Debt</u>: The fair value of the Cooperative's long-term debt that is practicable to estimate, is estimated based on the quoted market prices for the same or similar issues or on the current rates available to the Cooperative for debt of the same remaining maturities, including the appropriate redemption premium, if any.

(Continued)

**NOTE 9 – FAIR VALUE OF FINANCIAL INSTRUMENTS** (Continued)

The estimated fair values of the Cooperative's financial instruments are as follows (in thousands):

| | 2003 | | 2002 | |
|---|---|---|---|---|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial assets | | | | |
| Cash and cash equivalents | $ 42,781 | $ 42,781 | $ - | $ - |
| Trading securities | - | - | 5,572 | 5,572 |
| Investment securities | | | | |
| Available for sale | 37,948 | 37,948 | 24,590 | 24,590 |
| Held to maturity | 15,423 | 13,493 | 8,298 | 6,408 |
| Long-term accounts receivable | 10,558 | 10,411 | 11,371 | 11,397 |
| Financial liabilities | | | | |
| Notes payable | $ 6,000 | $ 6,000 | $ 2,095 | $ 2,095 |
| Long-term debt | 1,047,413 | 1,068,485 | 795,297 | 853,225 |