

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

Associated Electric Cooperative, Inc. (Associated) is pleased to present the enclosed interim financial statements, which include balance sheets, statements of revenues and expenses, and statements of cash flows as of, or for the periods ended September 30, 2009 and 2008. The discussion below is not meant to be comprehensive but rather to identify significant aspects in the current quarter and year-to-date performance of Associated.

### **Overview**

Associated's earnings for the nine month and twelve month periods ended September 30, 2009 were \$80.3 million and \$67.8 million, an increase of \$10.0 million and \$1.1 million, respectively, as compared to the same periods a year earlier. The increase in earnings for these periods is the result of the net of increased member revenue, decreased nonmember revenue and lower generation and purchased power costs driven primarily by the significant decrease in natural gas prices. These factors are discussed in more detail in the paragraphs below.

### **Operating Revenues**

Revenue from members for the nine and twelve month periods increased 11.1% and 12.7% respectively as compared to the same periods. Member revenue increased for the twelve months ending September 30, 2009 by \$92.9 million due to rate increases in April 2008 and 2009. The volume of energy sales to members decreased during both the nine and twelve month periods, 3.8% and 1.5% respectively. These decreases are driven by the loss of a municipal load, the affects of energy efficiency programs, mild weather, and the overall economic conditions.

Revenue from nonmembers decreased 48.3% for the nine month period and decreased 40.2% for the twelve month period ended September 30, 2009, when compared to the same periods a year earlier. The nine month ended period decrease in nonmember sales was due to a 50.0% decrease in average market price and a decrease of 3.4% in sales volume. The decrease for the twelve month period was due to a 55.5% decrease in the average market price which was partially offset by a 0.3% increase in sales volume. Market prices for energy sold to nonmembers have been affected by the significant drop in natural gas fuel prices.

### **Generation Operation**

Generation operations expense decreased 17.3% for the nine month period and decreased 5.7% for the twelve month period ended September 30, 2009, when compared to the same periods a year earlier. The decrease in the nine month period was the result of several factors including lower production volumes and lower natural gas prices. Generation operation expenses decreased for the twelve month period due primarily to a significant decrease in natural gas prices in 2009.

### **Purchased Power**

Purchased power expense decreased 45.8% for the nine month period and 37.7% for the twelve month period ended September 30, 2009, when compared to the same periods a year earlier. The decrease in purchased power expense for both periods was largely the result of significantly lower market prices. Purchases are made only if they result in a savings relative to Associated's owned or contracted generation assets

### **Generation maintenance**

Generation maintenance expense increased by 30.6% for the nine month period and 25.9% for the twelve month period ended September 30, 2009, when compared to the same periods a year earlier. The increase in maintenance expense for both periods is due to increased preventive maintenance at Associated's aging coal power plants.

### **Depreciation and amortization**

Depreciation and amortization expense increased by 22.7% for the nine month period and 16.6% for the twelve month period ended September 30, 2009, when compared to the same periods a year earlier. The increase is due to the depreciation of environmental controls that were placed in service in December of 2008.

### **Non Operating Income**

Interest and dividend income decreased 18.3% for the nine month period and 26.7% for the twelve month period ended September 30, 2009, when compared to the same periods a year earlier because of lower interest rates.

### **Financial Position:**

Significant changes in the balance sheet at September 30, 2009 as compared to September 30, 2008 include the following:

- Utility plant increased \$228.7 million due primarily to the addition of environmental control equipment at Thomas Hill Energy Center, the construction of Chouteau 2, and turbine projects at the New Madrid Energy Center.
- Fuel inventory increased \$20.5 million due to larger coal stockpiles and an increase in the price of coal.
- Restricted short-term investments decreased by \$35.9 million due to the transfer of restricted funds from the money market investments to the RUS cushion of credit.
- Other restricted and designated assets increased due to the increase in funds in the RUS cushion of credit.

- Deferred debits increased \$49.6 million due to increases in deferred costs of an interest rate swap agreement, increases in the deferral of certain eligible maintenance costs and energy efficiency program costs, and for contributions in aid of construction for the Chouteau 2 pipeline.
- Patronage capital and other equities increased \$67.9 million as a net result of a \$67.8 million net margin during the twelve months ended September 30, 2009, the retirement of \$7.1 million of patronage capital and a \$7.2 million increase in accumulated other comprehensive income related to post-retirement benefit obligations and gains on hedging activities.
- Long term debt increased \$194.1 million primarily due to financing of new generation and environmental control equipment, net of scheduled principal payments.
- Other deferred liabilities increased \$27.0 million due primarily to the deferral of the gain on a sale-leaseback transaction related to some of Associated's rail cars and adjustments made to the liability associated with an interest rate swap agreement.

**Associated Electric Cooperative, Inc.**  
**Balance Sheets**  
**September 30, 2009 and September 30, 2008**  
*(in thousands of dollars)*

	2009	2008
<b>Assets</b>		
Utility plant:		
Electric plant in service	\$ 2,779,670	\$ 2,309,322
Construction work in progress	210,942	392,965
	<u>2,990,613</u>	<u>2,702,287</u>
Less accumulated depreciation	(1,212,911)	(1,153,311)
	<u>1,777,702</u>	<u>1,548,976</u>
Mining property and equipment:		
Land	9,533	9,909
Equipment	20,343	20,343
	<u>29,876</u>	<u>30,252</u>
Less accumulated depreciation and depletion	(19,974)	(19,892)
	<u>9,902</u>	<u>10,360</u>
Other property and investments:		
Nonutility property	7,782	5,181
Net investment in direct financing leases	5,511	5,647
Advanced construction funds	16,067	14,385
Long-term investments	1,442	2,327
	<u>30,802</u>	<u>27,541</u>
Restricted and designated long-term assets:		
Investments in associated organizations, at cost	27,008	27,421
Restricted long-term investments	17,520	1,946
Other Restricted and designated assets	74,835	17,795
	<u>119,363</u>	<u>47,162</u>
Current assets:		
Cash and cash equivalents	47,038	61,733
Restricted short-term investments, at fair value	88,631	124,578
Short-term investments	773	10,388
Accounts receivable, net	99,475	78,652
Fuel inventory	54,423	33,973
Materials and supplies inventory	47,736	44,021
Other current assets	11,245	18,178
	<u>349,321</u>	<u>371,523</u>
Deferred debits	<u>103,973</u>	<u>54,384</u>
	<u>2,391,062</u>	<u>2,059,947</u>
Total assets	\$ 2,391,062	\$ 2,059,947

The interim financial statements for September 30, 2009, and 2008 are unaudited. In the opinion of management all adjustments (which are normal recurring accruals) necessary for a fair presentation of results for interim periods have been included. The interim financial statements should be read in conjunction with the Notes to the Financial Statements included in the 2008 Annual Report

**Associated Electric Cooperative, Inc.**  
**Balance Sheets**  
**September 30, 2009 and September 30, 2008**  
*(in thousands of dollars)*

	2009	2008
<b>Capitalization and Liabilities</b>		
Patronage capital and other equities:		
Memberships	\$ 12	\$ 12
Patronage capital	382,564	321,883
Other equities	55,540	55,540
Accumulated other comprehensive income (expense)	(224)	(7,392)
	<u>437,892</u>	<u>370,042</u>
Long-term debt, excluding current maturities:		
Federal Financing Bank	673,824	722,928
CoBank	398,495	301,904
National Rural Utilities Cooperative Finance Corporation	129,740	76,549
State Environmental Improvement and Energy Resources Authority (Missouri)	71,550	71,550
Other Long Term Debt	153,480	59,749
Rural Utilities Service	33	323
	<u>1,427,121</u>	<u>1,233,002</u>
Asset Retirement Obligation	15,389	14,858
Accumulated provision for postretirement benefits	<u>29,030</u>	<u>28,896</u>
Current liabilities:		
Payable to member cooperatives	32,600	40,148
Accounts payable	92,216	64,610
Other current and accrued liabilities	29,356	27,914
Current maturities of long-term debt	73,389	64,160
Current portion of Asset Retirement Obligation	1,323	210
	<u>228,884</u>	<u>197,042</u>
Deferred regulatory credits	216,166	206,501
Other deferred liabilities	36,580	9,605
	<u>252,746</u>	<u>216,105</u>
Total capitalization and liabilities	<u>\$ 2,391,062</u>	<u>\$ 2,059,947</u>

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**Associated Electric Cooperative, Inc.**  
**Statements of Revenue and Expenses**  
**For the Quarters and Years Ended September 30, 2009 and 2008**

*(in thousands of dollars)*

	Nine months ended		Twelve months ended	
	September 30		September 30	
	2009	2008	2009	2008
Operating revenues:				
Members	\$ 638,650	\$ 574,749	\$ 823,102	\$ 730,175
Nonmembers	140,959	272,490	194,039	324,349
	<u>779,609</u>	<u>847,239</u>	<u>1,017,141</u>	<u>1,054,524</u>
Operating expenses:				
Generation operation	265,420	320,964	350,252	371,521
Contracted generation	139,708	146,029	189,143	188,050
Power purchased	60,561	111,822	98,525	158,068
Generation maintenance	49,313	37,749	72,024	57,231
Transmission	44,932	40,087	60,042	55,269
Administrative and general	32,229	27,890	42,894	36,992
Depreciation and amortization	60,425	49,249	76,840	65,927
Taxes	1,963	1,592	2,729	2,044
Accretion of asset retirement obligations	648	508	1,060	732
	<u>655,199</u>	<u>735,889</u>	<u>893,509</u>	<u>935,837</u>
Operating margin before interest expense	<u>124,411</u>	<u>111,349</u>	<u>123,632</u>	<u>118,688</u>
Interest expense:				
Interest on long-term debt	60,266	51,743	84,377	68,874
Less interest capitalized	(5,074)	(7,977)	(15,271)	(10,139)
	<u>55,191</u>	<u>43,767</u>	<u>69,107</u>	<u>58,735</u>
Operating margin	<u>69,219</u>	<u>67,583</u>	<u>54,525</u>	<u>59,953</u>
Nonoperating:				
Interest and dividend income	11,249	13,769	13,714	18,674
Interest expense	(129)	(1,174)	(438)	(2,018)
Loss on termination of power plant project	-	(9,918)	-	(9,918)
Total nonoperating	<u>11,120</u>	<u>2,677</u>	<u>13,276</u>	<u>6,738</u>
Net margin (loss)	<u>\$ 80,338</u>	<u>\$ 70,260</u>	<u>\$ 67,801</u>	<u>\$ 66,691</u>

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**Associated Electric Cooperative Inc.**  
**Statements of Cash Flows**  
**For the Quarters and Years Ended September 30, 2009 and 2008**

*(dollars in thousands)*

	Nine months ended		Twelve months ended	
	September 30		September 30	
	2009	2008	2009	2008
Cash flows from operating activities:				
Net margin(loss)	\$ 80,338	\$ 70,260	\$ 67,801	\$ 66,691
Reconciliation of net margin to net cash provided by operating activities:				
Depreciation and amortization	60,425	49,249	76,840	65,927
Amortization of loan expenses and other	1,117	1,384	1,777	391
Increase (decrease) in deferred debits, net	(26,421)	(7,355)	(51,365)	(13,664)
Change in asset retirement obligation	271	212	532	(4,060)
Increase (decrease) in deferred regulatory credits	(7,649)	(17,976)	9,665	(48,158)
Changes in current assets and liabilities:				
Accounts receivable, net	(12,347)	(5,165)	(20,823)	34,583
Fuel inventories	(2,510)	4,075	(20,450)	(957)
Materials and supplies inventories	(3,180)	(4,890)	(3,715)	(5,868)
Accounts payable	(46,809)	(69,451)	27,607	(28,575)
Decrease in mine separation	-	-	-	(27)
Other current and accrued liabilities	10,343	9,167	2,554	(11,207)
Other operating activities net	(11,926)	(3,640)	34,043	7,866
Net cash provided (used) by operating activities	<u>41,653</u>	<u>25,870</u>	<u>124,465</u>	<u>62,941</u>
Cash flows from investing activities:				
Construction/capital expenditures, net	(157,648)	(126,121)	(329,858)	(235,390)
Proceeds from sale of property, plant, and equipment	404	1,240	24,374	1,240
Sale (purchase) of mine P&E	197	378	376	378
Sale (Purchase) of investments	(8,749)	27,691	(31,750)	51,918
Investments in associated organizations , net	207	(7,399)	413	(6,960)
Direct financing lease proceeds	103	95	136	126
Other investing activities, net	8,695	2,641	8,468	(7,526)
Net cash used in investing activities	<u>(156,791)</u>	<u>(101,476)</u>	<u>(327,841)</u>	<u>(196,215)</u>
Cash flows from financing activities:				
Net investments from member cooperatives	(1,284)	(13,226)	(7,548)	(45,292)
Issuance and retirement of long-term debt, net	98,490	69,476	203,348	132,144
Retirement of patronage capital	(7,119)	(6,067)	(7,119)	(6,067)
Net cash provided by (used in) financing activities	<u>90,087</u>	<u>50,183</u>	<u>188,681</u>	<u>80,785</u>
Net increase (decrease) in cash and cash equivalents	<u>\$ (25,050)</u>	<u>\$ (25,423)</u>	<u>\$ (14,695)</u>	<u>\$ (52,488)</u>
Cash and cash equivalents, beginning of period	<u>\$ 72,088</u>	<u>\$ 87,158</u>	<u>\$ 61,733</u>	<u>\$ 114,222</u>
Cash and cash equivalents, end of period	<u>\$ 47,038</u>	<u>\$ 61,733</u>	<u>\$ 47,038</u>	<u>\$ 61,733</u>

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