

Ohio Valley Electric Corporation and Subsidiary Company

Consolidating Financial Statements as of and for the
Years Ended December 31, 2008 and 2007, and
Independent Auditors' Report

INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Ohio Valley Electric Corporation:

We have audited the accompanying consolidating balance sheets of Ohio Valley Electric Corporation and its subsidiary company, Indiana-Kentucky Electric Corporation (the Companies), as of December 31, 2008 and 2007, and the related consolidating statements of income and retained earnings and cash flows for the years then ended. These consolidating financial statements are the responsibility of the Companies' management. Our responsibility is to express an opinion on these consolidating 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 audit to obtain reasonable assurance about whether the consolidating 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 Companies' 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 consolidating 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, such consolidating financial statements present fairly, in all material respects, the financial position of the Companies as of December 31, 2008 and 2007, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 9 to the consolidating financial statements, the Companies changed their method of accounting for defined benefit pension and other postretirement plans effective December 31, 2007.

Deloitte + Touche LLP

March 27, 2009

OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

CONSOLIDATING BALANCE SHEETS AS OF DECEMBER 31, 2008 AND 2007

	2008				2007			
	Consolidated	Eliminations (Deduct)	Ohio Valley Electric Corporation	Indiana- Kentucky Electric Corporation	Consolidated	Eliminations (Deduct)	Ohio Valley Electric Corporation	Indiana- Kentucky Electric Corporation
ASSETS								
ELECTRIC PLANT:								
At original cost	\$ 1,237,629,673	\$ -	\$ 593,482,569	\$ 644,147,104	\$ 1,212,196,875	\$ -	\$ 581,116,307	\$ 631,080,568
Less — accumulated provisions for depreciation	907,307,285	-	393,319,793	513,987,492	865,927,293	-	372,034,376	493,892,917
	330,322,388	-	200,162,776	130,159,612	346,269,582	-	209,081,931	137,187,651
Construction in progress	767,848,855	-	444,061,731	323,787,124	316,560,056	-	214,414,070	102,145,986
Total electric plant	<u>1,098,171,243</u>	<u>-</u>	<u>644,224,507</u>	<u>453,946,736</u>	<u>662,829,638</u>	<u>-</u>	<u>423,496,001</u>	<u>239,333,637</u>
INVESTMENTS AND OTHER:								
Investment in subsidiary company	-	(3,400,000)	3,400,000	-	-	(3,400,000)	3,400,000	-
Advances to subsidiary — construction	-	(139,956,336)	139,956,336	-	-	(148,069,747)	148,069,747	-
Total investments and other	<u>-</u>	<u>(143,356,336)</u>	<u>143,356,336</u>	<u>-</u>	<u>-</u>	<u>(151,469,747)</u>	<u>151,469,747</u>	<u>-</u>
CURRENT ASSETS:								
Cash and cash equivalents	45,176,266	-	45,140,413	35,853	107,694,495	-	107,684,288	10,207
Accounts receivable	35,586,985	-	31,849,129	3,737,856	28,979,038	-	24,563,471	4,415,567
Intercompany receivable	-	(251,267,276)	251,267,276	-	-	(71,422,670)	71,422,670	-
Fuel in storage — at average cost	52,220,614	-	21,233,373	30,987,241	63,913,331	-	30,151,099	33,762,232
Materials and supplies — at average cost	19,223,210	-	9,598,080	9,625,130	16,863,327	-	8,299,128	8,564,199
Property taxes applicable to future years	2,348,400	-	2,348,400	-	2,227,920	-	2,227,920	-
Emission allowances	2,244,126	-	2,244,126	-	11,787,964	-	11,787,964	-
Refundable state income taxes	-	-	-	-	849,123	-	-	849,123
Deferred tax assets	10,982,423	-	4,931,530	6,050,893	-	-	-	-
Regulatory assets	1,034,148	-	-	1,034,148	-	-	-	-
Prepaid expenses and other	1,937,142	-	1,059,356	877,786	1,705,135	-	829,378	875,757
Total current assets	<u>170,753,314</u>	<u>(251,267,276)</u>	<u>369,671,683</u>	<u>52,348,907</u>	<u>234,020,333</u>	<u>(71,422,670)</u>	<u>256,965,918</u>	<u>48,477,085</u>
REGULATORY ASSETS:								
Asset retirement costs	14,642,782	-	2,163,613	12,479,169	16,102,473	-	2,722,771	13,379,702
Unrecognized postemployment benefits	2,236,997	-	936,047	1,300,950	2,222,600	-	889,553	1,333,047
Deferred depreciation	27,047,875	-	13,525,524	13,522,351	38,643,429	-	24,444,960	14,198,469
Pension benefits	27,261,510	-	14,593,086	12,668,424	-	-	-	-
Postretirement benefits	-	(985,463)	-	985,463	-	-	-	-
Total regulatory assets	<u>71,189,164</u>	<u>(985,463)</u>	<u>31,218,270</u>	<u>40,956,357</u>	<u>56,968,502</u>	<u>-</u>	<u>28,057,284</u>	<u>28,911,218</u>
DEFERRED CHARGES AND OTHER:								
Unamortized debt expense	9,549,916	-	9,549,916	-	6,831,081	-	6,831,081	-
Deferred tax assets	37,524,839	-	25,468,128	12,056,711	50,635,428	-	39,418,189	11,217,239
Pension asset	-	-	-	-	16,050,249	-	8,623,799	7,426,450
Long-term investments	53,609,545	-	53,609,545	-	-	-	-	-
Other	141,090	-	137,015	4,075	9,601	-	9,601	-
Total deferred charges and other	<u>100,825,390</u>	<u>-</u>	<u>88,764,604</u>	<u>12,060,786</u>	<u>73,526,359</u>	<u>-</u>	<u>54,882,670</u>	<u>18,643,689</u>
TOTAL	<u>\$ 1,440,939,111</u>	<u>\$(395,609,075)</u>	<u>\$ 1,277,235,400</u>	<u>\$ 559,312,786</u>	<u>\$ 1,027,344,832</u>	<u>\$(222,892,417)</u>	<u>\$ 914,871,620</u>	<u>\$ 335,365,629</u>

OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

CONSOLIDATING BALANCE SHEETS AS OF DECEMBER 31, 2008 AND 2007

	2008				2007			
	Consolidated	Eliminations (Deduct)	Ohio Valley Electric Corporation	Indiana- Kentucky Electric Corporation	Consolidated	Eliminations (Deduct)	Ohio Valley Electric Corporation	Indiana- Kentucky Electric Corporation
CAPITALIZATION AND LIABILITIES								
CAPITALIZATION:								
Common stock, \$100 par value — authorized, 300,000 shares; outstanding, 100,000 shares in 2008 and 2007	\$ 10,000,000	\$ -	\$ 10,000,000	\$ -	\$ 10,000,000	\$ -	\$ 10,000,000	\$ -
Common stock, without par value, stated at \$200 per share — authorized, 100,000 shares; outstanding, 17,000 shares in 2008 and 2007	-	(3,400,000)	-	3,400,000	-	(3,400,000)	-	3,400,000
Long-term debt	1,009,864,781	-	1,009,864,781	-	700,151,995	-	700,151,995	-
Line of credit borrowings	50,000,000	-	50,000,000	-	-	-	-	-
Retained earnings	2,506,811	-	2,506,811	-	2,915,642	-	2,915,642	-
Total capitalization	<u>1,072,371,592</u>	<u>(3,400,000)</u>	<u>1,072,371,592</u>	<u>3,400,000</u>	<u>713,067,637</u>	<u>(3,400,000)</u>	<u>713,067,637</u>	<u>3,400,000</u>
CURRENT LIABILITIES:								
Current portion of long-term debt	35,453,528	-	35,453,528	-	22,809,408	-	22,809,408	-
Accounts payable	99,405,252	-	36,778,769	62,626,483	77,031,015	-	47,591,564	29,439,451
Intercompany payable	-	(251,267,276)	-	251,267,276	-	(71,422,670)	-	71,422,670
Deferred revenue — advances for construction	26,670,003	-	10,296,658	16,373,345	24,589,022	-	11,148,711	13,440,311
Accrued other taxes	9,822,786	-	6,168,455	3,654,331	7,679,638	-	4,950,180	2,729,458
Regulatory liabilities	4,230,400	-	3,378,491	851,909	5,114,333	-	2,311,861	2,802,472
Accrued interest and other	20,837,485	-	17,363,123	3,474,362	16,783,248	-	13,820,547	2,962,701
Total current liabilities	<u>196,419,454</u>	<u>(251,267,276)</u>	<u>109,439,024</u>	<u>338,247,706</u>	<u>154,006,664</u>	<u>(71,422,670)</u>	<u>102,632,271</u>	<u>122,797,063</u>
COMMITMENTS AND CONTINGENCIES (Note 13)								
REGULATORY LIABILITIES:								
Postretirement benefits	13,670,062	(985,463)	14,655,525	-	18,947,629	-	18,947,629	-
Pension benefits	-	-	-	-	16,050,249	-	8,623,799	7,426,450
Investment tax credits	3,393,146	-	3,393,146	-	3,393,146	-	3,393,146	-
Net antitrust settlement	1,823,929	-	673,070	1,150,859	1,823,929	-	673,070	1,150,859
Income taxes refundable to customers	47,070,877	-	28,601,321	18,469,556	48,834,534	-	37,617,295	11,217,239
Total regulatory liabilities	<u>65,958,014</u>	<u>(985,463)</u>	<u>47,323,062</u>	<u>19,620,415</u>	<u>89,049,487</u>	<u>-</u>	<u>69,254,939</u>	<u>19,794,548</u>
OTHER LIABILITIES:								
Pension liability	27,261,510	-	14,593,086	12,668,424	-	-	-	-
Asset retirement obligations	34,162,393	-	10,379,998	23,782,395	32,223,528	-	9,790,888	22,432,640
Postretirement benefits obligation	42,529,151	-	22,192,591	20,336,560	36,774,916	-	19,236,332	17,538,584
Postemployment benefits obligation	2,236,997	-	936,047	1,300,950	2,222,600	-	889,553	1,333,047
Parent advances for construction	-	(139,956,336)	-	139,956,336	-	(148,069,747)	-	148,069,747
Total other liabilities	<u>106,190,051</u>	<u>(139,956,336)</u>	<u>48,101,722</u>	<u>198,044,665</u>	<u>71,221,044</u>	<u>(148,069,747)</u>	<u>29,916,773</u>	<u>189,374,018</u>
TOTAL	<u>\$1,440,939,111</u>	<u>\$(395,609,075)</u>	<u>\$1,277,235,400</u>	<u>\$559,312,786</u>	<u>\$1,027,344,832</u>	<u>\$(222,892,417)</u>	<u>\$914,871,620</u>	<u>\$335,365,629</u>

See notes to consolidating financial statements.

(Concluded)

OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

CONSOLIDATING STATEMENTS OF INCOME AND RETAINED EARNINGS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

	2008				2007			
	Consolidated	Eliminations (Deduct)	Ohio Valley Electric Corporation	Indiana- Kentucky Electric Corporation	Consolidated	Eliminations (Deduct)	Ohio Valley Electric Corporation	Indiana- Kentucky Electric Corporation
OPERATING REVENUES:								
Sales of electric energy to:								
Department of Energy	\$ 18,539,153	\$ -	\$ 18,539,153	\$ -	\$ 14,605,075	\$ -	\$ 14,605,075	\$ -
Ohio Valley Electric Corporation	-	(292,864,776)	-	292,864,776	-	(254,069,947)	-	254,069,947
Sponsoring Companies	603,273,999	-	603,273,999	-	516,757,146	-	516,757,146	-
Total operating revenues	621,813,152	(292,864,776)	621,813,152	292,864,776	531,362,221	(254,069,947)	531,362,221	254,069,947
OPERATING EXPENSES:								
Fuel and emission allowances consumed in operation	340,212,739	-	148,492,131	191,720,608	300,666,274	-	140,691,797	159,974,477
Purchased power	17,903,608	(292,864,776)	310,768,384	-	14,106,371	(254,069,947)	268,176,318	-
Other operation	69,414,118	-	38,568,612	30,845,506	68,471,855	-	38,710,011	29,761,844
Maintenance	71,513,450	-	29,195,268	42,318,182	69,945,403	-	32,329,137	37,616,266
Depreciation	56,946,744	-	33,558,811	23,387,933	31,720,198	-	9,131,505	22,588,693
Taxes — other than income taxes	9,784,455	-	5,140,848	4,643,607	8,990,186	-	4,687,208	4,302,978
Income taxes	1,023,381	-	1,023,381	-	907,416	-	907,416	-
Total operating expenses	566,798,495	(292,864,776)	566,747,435	292,915,836	494,807,703	(254,069,947)	494,633,392	254,244,258
OPERATING INCOME	55,014,657	-	55,065,717	(51,060)	36,554,518	-	36,728,829	(174,311)
OTHER INCOME	4,714,761	-	4,663,697	51,064	5,252,583	-	5,078,254	174,329
INCOME BEFORE INTEREST CHARGES	59,729,418	-	59,729,414	4	41,807,101	-	41,807,083	18
INTEREST CHARGES:								
Amortization of debt expense	532,119	-	532,119	-	404,083	-	404,083	-
Interest expense	54,106,130	-	54,106,126	4	36,261,637	-	36,261,619	18
Total interest charges	54,638,249	-	54,638,245	4	36,665,720	-	36,665,702	18
NET INCOME	5,091,169	-	5,091,169	-	5,141,381	-	5,141,381	-
RETAINED EARNINGS — Beginning of year	2,915,642	-	2,915,642	-	2,274,261	-	2,274,261	-
CASH DIVIDENDS ON COMMON STOCK	(5,500,000)	-	(5,500,000)	-	(4,500,000)	-	(4,500,000)	-
RETAINED EARNINGS — End of year	\$ 2,506,811	\$ -	\$ 2,506,811	\$ -	\$ 2,915,642	\$ -	\$ 2,915,642	\$ -

See notes to consolidating financial statements.

OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

CONSOLIDATING STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

	2008				2007			
	Consolidated	Eliminations (Deduct)	Ohio Valley Electric Corporation	Indiana- Kentucky Electric Corporation	Consolidated	Eliminations (Deduct)	Ohio Valley Electric Corporation	Indiana- Kentucky Electric Corporation
OPERATING ACTIVITIES:								
Net income	\$ 5,091,169	\$ -	\$ 5,091,169	\$ -	\$ 5,141,381	\$ -	\$ 5,141,381	\$ -
Adjustments to reconcile net income to net cash provided by (used in) operating activities:								
Depreciation	56,946,744	-	33,558,811	23,387,933	31,720,198	-	9,131,505	22,588,693
Amortization of debt expense	532,119	-	532,119	-	404,083	-	404,083	-
Deferred taxes	364,509	-	2,557	361,952	783,148	-	783,148	-
Gain on disposal of assets	(300,000)	-	(300,000)	-	(300,000)	-	(300,000)	-
Gain on marketable securities	(638,007)	-	(638,007)	-	-	-	-	-
Changes in assets and liabilities:								
Accounts receivable	(6,607,947)	-	(7,285,658)	677,711	(7,470,340)	-	(3,322,270)	(4,148,070)
Fuel in storage	11,692,717	-	8,917,726	2,774,991	(29,248,030)	-	(12,592,441)	(16,655,589)
Materials and supplies	(2,359,883)	-	(1,298,952)	(1,060,931)	(1,167,437)	-	(601,364)	(566,073)
Property taxes applicable to subsequent years	(120,480)	-	(120,480)	-	(255,120)	-	(255,120)	-
Emission allowances	9,543,838	-	9,543,838	-	22,275,022	-	22,275,022	-
Refundable federal income taxes	-	-	-	-	681	-	681	-
Refundable state income taxes	849,123	-	-	849,123	107,851	-	107,851	-
Prepaid expenses and other	(232,007)	-	(229,978)	(2,029)	(52,036)	-	(122,680)	70,644
Other assets	15,532,270	-	8,109,895	7,422,375	(15,647,863)	-	(8,376,656)	(7,271,207)
Regulatory assets	(27,835,827)	-	(14,080,422)	(13,755,405)	2,574,798	-	1,573,792	1,001,006
Accounts payable	(22,535,520)	-	(18,993,939)	(3,541,581)	10,700,986	-	2,784,789	7,916,197
Deferred revenue	2,080,981	-	(852,053)	2,933,034	11,044,690	-	6,092,087	4,952,603
Accrued taxes	2,143,148	-	1,218,275	924,873	652,983	-	662,928	(9,945)
Accrued interest and other	4,054,237	-	3,542,576	511,661	443,272	-	309,709	133,563
Regulatory liabilities	(21,226,286)	-	(11,849,273)	(9,377,013)	23,772,209	-	13,543,287	10,228,922
Other liabilities	34,969,007	-	18,184,949	16,784,058	(1,433,900)	-	(1,498,943)	65,043
Net cash provided by operating activities	61,943,905	-	33,053,153	28,890,752	54,046,576	-	35,740,789	18,305,787

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OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

CONSOLIDATING STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

	2008				2007			
	Consolidated	Eliminations (Deduct)	Ohio Valley Electric Corporation	Indiana- Kentucky Electric Corporation	Consolidated	Eliminations (Deduct)	Ohio Valley Electric Corporation	Indiana- Kentucky Electric Corporation
INVESTING ACTIVITIES:								
Advances to subsidiary	\$ -	\$ 171,731,195	\$(171,731,195)	\$ -	\$ -	\$ 65,939,462	\$ (65,939,462)	\$ -
Electric plant additions	(435,783,038)	-	(235,186,737)	(200,596,301)	(232,025,190)	-	(147,776,987)	(84,248,203)
Proceeds from sale of marketable securities	24,286,124	-	24,286,124	-	-	-	-	-
Purchases of marketable securities	(76,871,172)	-	(76,871,172)	-	-	-	-	-
Proceeds from sale of transformers	300,000	-	300,000	-	300,000	-	300,000	-
Net cash (used in) provided by investing activities	<u>(488,068,086)</u>	<u>171,731,195</u>	<u>(459,202,980)</u>	<u>(200,596,301)</u>	<u>(231,725,190)</u>	<u>65,939,462</u>	<u>(213,416,449)</u>	<u>(84,248,203)</u>
FINANCING ACTIVITIES:								
Advances from parent	-	(171,731,195)	-	171,731,195	-	(65,939,462)	-	65,939,462
Issuance of Senior 2007 Notes	-	-	-	-	300,000,000	-	300,000,000	-
Issuance of Senior 2008 Notes	350,000,000	-	350,000,000	-	-	-	-	-
Loan origination costs	(3,250,954)	-	(3,250,954)	-	(2,763,237)	-	(2,763,237)	-
Repayment of Senior 2006 Notes	(13,345,479)	-	(13,345,479)	-	-	-	-	-
Repayment of Senior 2007 Notes	(9,463,928)	-	(9,463,928)	-	(12,603,856)	-	(12,603,856)	-
Repayment of Senior 2008 Notes	(4,833,687)	-	(4,833,687)	-	(3,397,953)	-	(3,397,953)	-
Proceeds from line of credit	100,000,000	-	100,000,000	-	160,000,000	-	160,000,000	-
Payments on line of credit	(50,000,000)	-	(50,000,000)	-	(210,000,000)	-	(210,000,000)	-
Dividends on common stock	(5,500,000)	-	(5,500,000)	-	(4,500,000)	-	(4,500,000)	-
Net cash provided by (used in) financing activities	<u>363,605,952</u>	<u>(171,731,195)</u>	<u>363,605,952</u>	<u>171,731,195</u>	<u>226,734,954</u>	<u>(65,939,462)</u>	<u>226,734,954</u>	<u>65,939,462</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	<u>(62,518,229)</u>	<u>-</u>	<u>(62,543,875)</u>	<u>25,646</u>	<u>49,056,340</u>	<u>-</u>	<u>49,059,294</u>	<u>(2,954)</u>
CASH AND CASH EQUIVALENTS — Beginning of year	<u>107,694,495</u>	<u>-</u>	<u>107,684,288</u>	<u>10,207</u>	<u>58,638,155</u>	<u>-</u>	<u>58,624,994</u>	<u>13,161</u>
CASH AND CASH EQUIVALENTS — End of year	<u>\$ 45,176,266</u>	<u>\$ -</u>	<u>\$ 45,140,413</u>	<u>\$ 35,853</u>	<u>\$ 107,694,495</u>	<u>\$ -</u>	<u>\$ 107,684,288</u>	<u>\$ 10,207</u>
SUPPLEMENTAL DISCLOSURES:								
Interest paid	<u>\$ 49,379,338</u>	<u>\$ -</u>	<u>\$ 49,379,338</u>	<u>\$ 4</u>	<u>\$ 35,392,737</u>	<u>\$ -</u>	<u>\$ 35,392,719</u>	<u>\$ 18</u>
Income taxes paid (received) — net	<u>\$ (710,829)</u>	<u>\$ -</u>	<u>\$ 138,294</u>	<u>\$ (849,123)</u>	<u>\$ 79,671</u>	<u>\$ -</u>	<u>\$ 79,671</u>	<u>\$ -</u>
Non-cash electric plant additions included in accounts payable at December 31	<u>\$ 63,225,054</u>	<u>\$ -</u>	<u>\$ 22,663,772</u>	<u>\$ 40,561,282</u>	<u>\$ 20,261,593</u>	<u>\$ -</u>	<u>\$ 14,482,628</u>	<u>\$ 5,778,965</u>

See notes to consolidating financial statements.

(Concluded)

OHIO VALLEY ELECTRIC CORPORATION AND SUBSIDIARY COMPANY

NOTES TO CONSOLIDATING FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Consolidating Financial Statements — The consolidating financial statements include the accounts of Ohio Valley Electric Corporation (OVEC) and its wholly owned subsidiary, Indiana-Kentucky Electric Corporation (IKEC), collectively, the “Companies.” All intercompany transactions have been eliminated in consolidation.

Organization — The Companies own two generating stations located in Ohio and Indiana with a combined electric production capability of approximately 2,256 megawatts. OVEC is owned by several investor-owned utilities or utility holding companies and an affiliate of a generation and transmission rural electric cooperative. These entities and their affiliates comprise the Sponsoring Companies. The Sponsoring Companies purchase power from OVEC according to the terms of the Inter-Company Power Agreement (ICPA), which in 2004 was extended for an additional 20 years from March 13, 2006 to March 13, 2026. Approximately 30% of the Companies’ employees are covered by a collective bargaining agreement that expires August 31, 2011.

Rate Regulation — The proceeds from the sale of power to the Sponsoring Companies are designed to be sufficient for OVEC to meet its operating expenses and fixed costs, as well as earn a return on equity before federal income taxes. In addition, the proceeds from power sales are designed to cover debt amortization and interest expense associated with financings. The Companies have continued and expect to continue to operate pursuant to the cost plus rate of return recovery provisions at least to March 13, 2026, the date of termination of the ICPA.

Statement of Financial Accounting Standards (SFAS) No. 71, *Accounting for the Effects of Certain Types of Regulation*, provides that rate-regulated utilities account for and report assets and liabilities consistent with the economic effect of the way in which rates are established, if the rates established are designed to recover the costs of providing the regulated service and it is probable that such rates can be charged and collected. The Companies follow the accounting and reporting requirements of SFAS No. 71. Certain expenses and credits subject to utility regulation or rate determination normally reflected in income are deferred on the accompanying consolidating balance sheets and are recognized in income as the related amounts are included in service rates and recovered from or refunded to customers.

The Companies' regulatory assets, liabilities, and amounts authorized for recovery through Sponsor billings at December 31, 2008 and 2007, were as follows:

	2008		2007	
	OVEC	IKEC	OVEC	IKEC
Regulatory assets:				
Current assets — income taxes billable to customers	\$ -	\$ 1,034,148	\$ -	\$ -
Total	-	1,034,148	-	-
Other assets:				
Asset retirement costs	2,163,613	12,479,169	2,722,771	13,379,702
Unrecognized postemployment benefits	936,047	1,300,950	889,553	1,333,047
Deferred depreciation	13,525,524	13,522,351	24,444,960	14,198,469
Pension benefits	14,593,086	12,668,424	-	-
Postretirement benefits	-	985,463	-	-
Total	31,218,270	40,956,357	28,057,284	28,911,218
Total regulatory assets	<u>\$31,218,270</u>	<u>\$41,990,505</u>	<u>\$28,057,284</u>	<u>\$28,911,218</u>
Regulatory liabilities:				
Current liabilities:				
Deferred credit — EPA emission allowance proceeds	\$ 725,522	\$ 851,909	\$ 426,959	\$ 466,811
Advance collection of interest	2,652,969	-	1,884,902	-
Fuel related settlement	-	-	-	2,335,661
Total	3,378,491	851,909	2,311,861	2,802,472
Other liabilities:				
Postretirement benefits	14,655,525	-	18,947,629	-
Pension benefits	-	-	8,623,799	7,426,450
Investment tax credits	3,393,146	-	3,393,146	-
Net antitrust settlement	673,070	1,150,859	673,070	1,150,859
Income taxes refundable to customers	28,601,321	18,469,556	37,617,295	11,217,239
Total	47,323,062	19,620,415	69,254,939	19,794,548
Total regulatory liabilities	<u>\$50,701,553</u>	<u>\$20,472,324</u>	<u>\$71,566,800</u>	<u>\$22,597,020</u>

Regulatory Assets — Regulatory assets consist primarily of deferred depreciation, asset retirement cost, and pension benefits. Deferred depreciation is recovered over the life of the debt that was used to fund the related plant additions. The Companies follow the sinking fund depreciation method for ratemaking purposes, and the difference between straight-line depreciation and the debt principal payments billed to customers is recorded as deferred depreciation. With the exception of income taxes billable to customers, which will be recovered during 2009, other regulatory assets are being recovered on a long-term basis.

Regulatory Liabilities — The regulatory liabilities classified as current in the accompanying consolidating balance sheets represent emission allowance auction proceeds, a gain on a fuel related settlement, and interest expense collected from customers in advance of expense recognition. These amounts outstanding will be credited to customer bills during 2009. Other regulatory liabilities consist primarily of income taxes refundable to customers, postretirement benefits, and pension benefits. Income taxes refundable to customers are credited to customer bills in the period when the related deferred tax assets are realized. The Companies' current ratemaking policy recovers pension expense in an amount equal to plan contributions and postretirement benefits in an amount equal to service cost. As a result, related regulatory liabilities are being credited to customer bills on a long-term basis. The remaining regulatory liabilities are awaiting credit to customer bills in a future period that is yet to be determined.

Cash and Cash Equivalents — For purposes of these statements, the Companies consider temporary cash investments to be cash equivalents since they are readily convertible into cash and have original maturities of less than three months.

Electric Plant — Property additions and replacements are charged to utility plant accounts. Depreciation expense is recorded at the time property additions and replacements are billed to customers or at the date the property is placed in service if the in-service date occurs subsequent to the customer billing. Customer billings for construction in progress are recorded as deferred revenue-advances for construction. These amounts are closed to revenue at the time the related property is placed in service. Deferred depreciation, depreciation expense, and accumulated depreciation are recorded when financed property additions and replacements are recovered over a period of years through customer debt retirement billing. All depreciable property will be fully billed and depreciated prior to the expiration of the ICPA. Repairs of property are charged to maintenance expense.

Fuel in Storage, Emission Allowances, and Materials and Supplies — The Companies maintain coal, reagent, and oil inventories for use in the generation of electricity and emission allowance inventories for regulatory compliance purposes due to the generation of electricity. These inventories are valued at average cost. Materials and supplies consist primarily of replacement parts necessary to maintain the generating facilities and are valued at average cost.

Long-Term Investments — Long-term investments consist of marketable securities that are held for the purpose of funding postretirement benefits. These securities have been classified as trading securities. Due to tax limitations, the amounts held in this portfolio have not yet been transferred to the Voluntary Employee Beneficiary Association trusts (see Note 9). Long-term investments primarily consist of municipal bonds and money market mutual fund investments. Net unrealized gains recognized during 2008 on securities still held at the balance sheet date were \$638,007.

Unamortized Debt Expense — Unamortized debt expense relates to loan origination costs incurred to secure financing. These costs are being amortized over the life of the related loans.

Asset Retirement Obligations and Asset Retirement Costs — The Companies recognize the fair value of legal obligations associated with the retirement or removal of long-lived assets at the time the obligations are incurred and can be reasonably estimated. The initial recognition of this liability is accompanied by a corresponding increase in depreciable electric plant. Subsequent to the initial recognition, the liability is adjusted for any revisions to the expected value of the retirement obligation (with corresponding adjustments to electric plant) and for accretion of the liability due to the passage of time.

These asset retirement obligations are primarily related to obligations associated with future asbestos abatement at certain generating stations and certain plant closure costs. As of December 31, 2008 and 2007, the Companies had a regulatory asset of \$14.6 million and \$16.1 million, respectively, related to asset retirement obligations.

	OVEC	IKEC	Consolidated
Balance — December 31, 2006	\$ 9,236,687	\$21,162,868	\$30,399,555
Accretion	<u>554,201</u>	<u>1,269,772</u>	<u>1,823,973</u>
Balance — December 31, 2007	9,790,888	22,432,640	32,223,528
Accretion	<u>589,110</u>	<u>1,349,755</u>	<u>1,938,865</u>
Balance — December 31, 2008	<u>\$10,379,998</u>	<u>\$23,782,395</u>	<u>\$34,162,393</u>

The Companies do not recognize liabilities for asset retirement obligations for which the fair value cannot be reasonably estimated. The Companies have asset retirement obligations associated with transmission assets and river structures at certain generating stations. However, the retirement date for these assets cannot be determined; therefore, the fair value of the associated liability currently cannot be estimated and no amounts are recognized in the consolidating financial statements herein.

Use of Estimates — The preparation of consolidating 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 consolidating financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. RELATED-PARTY TRANSACTIONS

Transactions with the Sponsoring Companies during 2008 and 2007 included the sale of all generated power to them, the purchase of Arranged Power from them and other utility systems in order to meet the Department of Energy's power requirements, contract barging services, railcar services, and minor transactions for services and materials. The Companies have Power Agreements with Louisville Gas and Electric Company, Duke Energy Ohio, Inc., The Dayton Power and Light Company, Kentucky Utilities Company, Ohio Edison Company, and American Electric Power Service Corporation as agent for the American Electric Power System Companies; and Transmission Service Agreements with Louisville Gas and Electric Company, Duke Energy Ohio, Inc., The Dayton Power and Light Company, The Toledo Edison Company, Ohio Edison Company, Kentucky Utilities Company, and American Electric Power Service Corporation as agent for the American Electric Power System Companies.

In September 2006, the Companies sold two transformers and associated equipment to Duke Energy Ohio, Inc. for a total maximum purchase price of \$3 million, which subject to the terms of the asset purchase agreement, is payable in equal annual installments over ten years. The purchase price is contingent on the performance of the transformers, and as such, no receivable has been recognized in the accompanying consolidating balance sheets. In 2008, the Companies were informed that one of the transformers failed, and as such, no further payments from Duke Energy Ohio, Inc. are anticipated.

At December 31, 2008 and 2007, balances due from or to the Sponsoring Companies are as follows:

	2008	2007
Accounts receivable	\$31,668,608	\$23,136,138
Accounts payable	-	1,352,250

American Electric Power Company, Inc. and a subsidiary company owned 43.47% of the common stock of OVEC as of December 31, 2008. The following is a summary of the principal services received from the American Electric Power Service Corporation as authorized by the Companies' Boards of Directors:

	2008	2007
General services	\$ 2,198,238	\$ 2,473,834
Specific projects	<u>21,274,966</u>	<u>10,623,656</u>
Total	<u>\$23,473,204</u>	<u>\$13,097,490</u>

General services consist of regular recurring operation and maintenance services. Specific projects primarily represent nonrecurring plant construction projects and engineering studies, which are approved by the Companies' Boards of Directors. The services are provided in accordance with the service agreement dated December 15, 1956, between the Companies and the American Electric Power Service Corporation.

3. COAL SUPPLY

The Companies have coal supply agreements with certain nonaffiliated companies that expire at various dates from the year 2009 through 2017. Pricing for coal under these contracts is subject to contract provisions and adjustments. The Companies currently have approximately 100% of their 2009 coal requirements under long-term agreements of one year or greater.

4. INVENTORIES

Inventories, net of reserves, at December 31, 2008 and 2007, consist of the following:

	2008	2007
Fuel in storage — at average cost	\$52,220,614	\$63,913,331
Materials and supplies — at average cost	19,223,210	16,863,327
Emission allowances	<u>2,244,126</u>	<u>11,787,964</u>
Total inventories	<u>\$73,687,950</u>	<u>\$92,564,622</u>

5. ELECTRIC PLANT

Electric plant at December 31, 2008 and 2007, consists of the following:

	2008		2007	
	OVEC	IKEC	OVEC	IKEC
Intangible	\$ 18,924	\$ 7,640	\$ 18,924	\$ 7,640
Steam production plant	535,762,721	616,694,861	527,006,731	603,715,430
Transmission plant	33,793,422	26,398,065	46,022,703	26,189,185
General plant	<u>23,907,502</u>	<u>1,046,538</u>	<u>8,067,949</u>	<u>1,168,313</u>
	593,482,569	644,147,104	581,116,307	631,080,568
Less accumulated depreciation	<u>393,319,793</u>	<u>513,987,492</u>	<u>372,034,376</u>	<u>493,892,917</u>
	200,162,776	130,159,612	209,081,931	137,187,651
Construction in progress	<u>444,061,731</u>	<u>323,787,124</u>	<u>214,414,070</u>	<u>102,145,986</u>
Total electric plant	<u>\$ 644,224,507</u>	<u>\$ 453,946,736</u>	<u>\$ 423,496,001</u>	<u>\$ 239,333,637</u>

6. BORROWING ARRANGEMENTS AND NOTES

OVEC has an unsecured bank revolving line of credit agreement with a borrowing limit of \$200 million as of December 31, 2008. The \$200 million line of credit has an expiration date of August 4, 2010. At December 31, 2008 and 2007, OVEC had borrowed \$50 and \$0 million, respectively, under this line of credit. Interest expense related to line of credit borrowings was \$255,699 in 2008 and \$3,051,247 in 2007. During 2008 and 2007, OVEC incurred annual commitment fees of \$343,729 and \$288,736, respectively, based on the borrowing limits of the line of credit.

7. LONG-TERM DEBT

The following amounts were outstanding at December 31, 2008 and 2007:

	Interest Rate	2008	2007
Senior 2006 Notes due February 15, 2026	5.80 %	\$ 413,013,876	\$ 426,359,355
Senior 2007 Notes:			
Tranche A due February 15, 2026	5.90	190,703,342	196,990,760
Tranche B due February 15, 2026	5.90	48,027,572	49,611,288
Tranche C due February 15, 2026	5.90	48,407,206	50,000,000
Senior 2008 Notes:			
Tranche A due February 15, 2026	5.92	48,780,045	-
Tranche B due February 15, 2026	6.71	147,157,899	-
Tranche C due February 15, 2026	6.71	<u>149,228,369</u>	<u>-</u>
Total debt		1,045,318,309	722,961,403
Current portion of long-term debt		<u>35,453,528</u>	<u>22,809,408</u>
Total long-term debt		<u>\$1,009,864,781</u>	<u>\$700,151,995</u>

During 2007, OVEC issued \$300 million unsecured senior notes (Senior 2007 Notes) in private placements in three tranches. The \$200 million Tranche A notes were issued in June 2007, the \$50 million Tranche B notes were issued in September 2007, and the \$50 million Tranche C notes were issued in December 2007.

During 2008, OVEC issued \$350 million unsecured senior notes (Senior 2008 Notes) in private placements in three tranches. The \$50 million Tranche A notes were issued in March 2008, the \$150 million Tranche B notes were issued in June 2008, and the \$150 million Tranche C notes were issued in August 2008.

The annual maturities of long-term debt as of December 31, 2008, are as follows:

2009	\$ 35,453,528
2010	37,642,055
2011	39,966,243
2012	42,404,535
2013	45,055,902
2014–2026	<u>844,796,046</u>
Total	<u>\$1,045,318,309</u>

8. INCOME TAXES

OVEC and IKEC file a consolidated federal income tax return. The effective tax rate varied from the statutory federal income tax rate due to differences between the book and tax treatment of various transactions as follows:

	2008	2007
Income tax expense at 35% statutory rate	\$ 2,140,093	\$ 2,117,079
State income taxes net of federal benefit	66,042	53,707
Temporary differences flowed through to customer bills	(1,218,762)	(1,274,392)
Permanent differences	<u>36,008</u>	<u>11,022</u>
Income tax provision	<u>\$ 1,023,381</u>	<u>\$ 907,416</u>
Effective tax rate	<u>16.7 %</u>	<u>15.0 %</u>

Components of the income tax provision were as follows:

	2008	2007
Current income tax expense	\$ 977,761	\$ 125,036
Deferred income tax expense	<u>45,620</u>	<u>782,380</u>
Total income tax provision	<u>\$1,023,381</u>	<u>\$907,416</u>

OVEC and IKEC record deferred tax assets and liabilities based on differences between book and tax basis of assets and liabilities measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. Deferred tax assets and liabilities are adjusted for changes in tax rates. The deferred tax assets recorded in the accompanying consolidated balance sheets consist primarily of the net deferred taxes on depreciation, postretirement benefits obligation, net operating loss carryforwards, asset retirement obligations, regulatory assets and regulatory liabilities.

To the extent that the Companies have not reflected credits in customer billings for deferred tax assets, they have recorded a regulatory liability representing income taxes refundable to customers under the applicable agreements among the parties. The liability was \$47,070,877 at December 31, 2008, and \$48,834,534 at December 31, 2007.

Deferred income tax assets (liabilities) consisted of the following at December 31, 2008 and 2007:

	2008	2007
Deferred tax assets:		
Deferred revenue — advances for construction	\$ 9,619,159	\$ 8,942,781
Federal net operating loss carryforwards	4,456,189	22,341,256
State net operating loss carryforwards	39,212	273,971
AMT credit carryforwards	2,532,919	1,505,920
Postretirement benefit obligation	20,445,933	13,374,669
Pension liability	9,832,499	10,113,109
Postemployment benefit obligation	806,825	808,337
Asset retirement obligations	12,321,464	11,719,375
Miscellaneous accruals	2,649,351	2,834,718
Regulatory liability — postretirement benefits	4,930,427	6,891,063
Regulatory liability — investment tax credits	1,223,817	1,234,053
Regulatory liability — net antitrust settlement	657,843	663,345
Regulatory liability — income taxes refundable to customers	<u>16,977,211</u>	<u>17,621,791</u>
 Total deferred tax assets	 <u>86,492,849</u>	 <u>98,324,388</u>
Deferred tax liabilities:		
Regulatory asset — income taxes billable to customers	(361,952)	-
Prepaid expenses	(582,702)	(576,140)
Electric plant	(21,120,348)	(34,610,360)
Regulatory asset — pension benefits	(9,832,499)	(5,837,815)
Regulatory asset — unrecognized postemployment benefits	(806,825)	(808,337)
Regulatory asset — asset retirement costs	<u>(5,281,261)</u>	<u>(5,856,308)</u>
 Total deferred tax liabilities	 <u>(37,985,587)</u>	 <u>(47,688,960)</u>
 Deferred income tax assets (liabilities)	 <u>\$ 48,507,262</u>	 <u>\$ 50,635,428</u>

The Companies had federal income tax net operating loss carryforwards (NOLs) of \$12.7 million as of December 31, 2008. These federal income tax NOLs result in part from accelerated depreciation methods for property, plant and equipment for income tax reporting purposes. The Companies also have alternative minimum tax (AMT) credit carryforwards of approximately \$2.5 million, which are not limited by expiration dates. Management periodically assesses the need for a valuation allowance on deferred tax assets. As of December 31, 2008 and 2007, management believes that realization of the Companies' deferred tax assets is more likely than not.

In July 2006, the Financial Accounting Standards Board issued Interpretation No. 48 to clarify the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement No. 109. Interpretation No. 48 addresses the determination of whether the tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under Interpretation No. 48, the Companies may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. Upon adoption of FIN 48, the Companies have not identified any uncertain tax positions.

The Companies file income tax returns with the Internal Revenue Service and the states of Ohio, Indiana and the Commonwealth of Kentucky. The Companies are no longer subject to federal tax examinations for tax years 2004 and earlier. The Companies are no longer subject to states of Ohio and Indiana tax examinations for tax years 2004 and earlier. The Companies are no longer subject to the Commonwealth of Kentucky examinations for tax years 2003 and earlier.

9. PENSION PLAN, OTHER POSTRETIREMENT AND POSTEMPLOYMENT BENEFITS

The Companies have a noncontributory qualified defined benefit pension plan (the Pension Plan) covering substantially all of their employees. The benefits are based on years of service and each employee's highest consecutive 36-month compensation period. Employees are vested in the Pension Plan after five years of service with the Companies.

Funding for the Pension Plan is based on actuarially determined contributions, the maximum of which is generally the amount deductible for income tax purposes and the minimum being that required by the Employee Retirement Income Security Act of 1974 (ERISA), as amended. The full cost of the pension benefits and related obligations has been allocated to OVEC and IKEC in the accompanying consolidating financial statements. The allocated amounts represent approximately a 54% and 46% split for OVEC and IKEC, respectively, as of December 31, 2008 and 2007. The Pension Plan's assets consist of an insurance contract and investments in equity and debt securities. In the following disclosures, the insurance contract is treated as a debt security because its long-term yield is tied to the debt markets.

In addition to the Pension Plan, the Companies provide certain health care and life insurance benefits (Other Postretirement Benefits) for retired employees. Substantially all of the Companies' employees become eligible for these benefits if they reach retirement age while working for the Companies. These and similar benefits for active employees are provided through employer funding and insurance policies. In December 2004, the Companies established Voluntary Employee Beneficiary Association (VEBA) trusts. The main objectives of the VEBA trusts are to maintain the purchasing power of the current assets and all future contributions, to have the ability to pay all benefits and expense obligations when due and to achieve a "funding cushion" to maximize return within prudent levels of risk. The investment horizon for the Pension Plan and VEBA trusts is greater than five years and the strategic asset allocation is based on a long-term perspective.

Projected Pension Plan and Other Postretirement Benefits obligations and funded status as of December 31, 2008 and 2007:

	Pension Plan		Other Postretirement Benefits	
	2008	2007	2008	2007
Change in projected benefit obligation:				
Projected benefit obligation — beginning of year	\$ 153,972,014	\$ 161,065,647	\$ 97,431,448	\$ 102,541,624
Service cost	3,899,052	4,221,650	2,781,098	3,219,492
Interest cost	9,799,772	9,243,320	6,173,680	5,855,237
Plan participants' contributions	-	-	613,383	585,570
Benefits paid	(7,755,609)	(7,499,086)	(3,286,320)	(3,279,279)
Net actuarial (gain) loss	9,056,558	(13,018,717)	1,242,881	(11,761,744)
Medicare subsidy	-	-	-	270,548
Expenses paid from assets	(45,200)	(40,800)	-	-
Projected benefit obligation — end of year	<u>168,926,587</u>	<u>153,972,014</u>	<u>104,956,170</u>	<u>97,431,448</u>
Change in fair value of plan assets:				
Fair value of plan assets — beginning of year	170,022,263	169,811,906	60,656,532	55,395,876
Actual return on plan assets	(26,056,377)	1,750,243	(728,513)	2,760,656
Expenses paid from assets	(45,200)	(40,800)	-	-
Employer contributions	5,500,000	6,000,000	5,171,937	4,923,161
Plan participants' contributions	-	-	613,383	585,570
Medicare subsidy	-	-	-	270,548
Benefits paid	(7,755,609)	(7,499,086)	(3,286,320)	(3,279,279)
Fair value of plan assets — end of year	<u>141,665,077</u>	<u>170,022,263</u>	<u>62,427,019</u>	<u>60,656,532</u>
Funded (underfunded) status — end of year	<u>\$ (27,261,510)</u>	<u>\$ 16,050,249</u>	<u>\$ (42,529,151)</u>	<u>\$ (36,774,916)</u>

On December 8, 2003, the President of the United States of America signed into law the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act). The Act introduced a prescription drug benefit to retirees as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a prescription drug benefit that is actuarially equivalent to the benefit provided by Medicare. The Companies believe that the coverage for prescription drugs is at least actuarially equivalent to the benefits provided by Medicare for most current retirees because the benefits for that group substantially exceed the benefits provided by Medicare, thereby allowing the Companies to qualify for the subsidy. The Companies' employer contributions for Other Postretirement Benefits in the above table are net of subsidies received of \$0 and \$270,548 for 2008 and 2007, respectively. The Companies have accounted for the subsidy as a reduction of the benefit obligation detailed in the above table. The benefit obligation was reduced by approximately \$14.2 and \$11.3 million as of December 31, 2008 and 2007.

The accumulated benefit obligation for the Pension Plan was \$144,698,788 and \$131,992,635 at December 31, 2008 and 2007, respectively.

Components of Net Periodic Benefit Cost — The Companies record the expected cost of Other Postretirement Benefits over the service period during which such benefits are earned.

Pension expense is recognized as amounts are contributed to the Pension Plan and billed to customers. The accumulated difference between recorded pension expense and the yearly net periodic pension expense as calculated under SFAS No. 87, *Employers' Accounting for Pensions*, is billable as a cost of operations under the ICPA when contributed to the pension fund. This accumulated difference has been recorded as a regulatory asset in the accompanying consolidating balance sheets.

	Pension Plan		Other Postretirement Benefits	
	2008	2007	2008	2007
Service cost	\$ 3,899,052	\$ 4,221,650	\$ 2,781,098	\$ 3,219,492
Interest cost	9,799,772	9,243,320	6,173,680	5,855,237
Expected return on plan assets	(11,049,029)	(11,668,332)	(2,880,712)	(2,631,976)
Amortization of prior service cost	531,437	531,437	(379,000)	(379,000)
Recognized actuarial loss	-	-	(263,945)	126,175
Net periodic benefit cost	<u>\$ 3,181,232</u>	<u>\$ 2,328,075</u>	<u>\$ 5,431,121</u>	<u>\$ 6,189,928</u>
Pension and Other Postretirement Benefits expense recognized in the consolidating statement of income and retained earnings and billed to sponsoring companies under the ICPA	<u>\$ 5,500,000</u>	<u>\$ 6,000,000</u>	<u>\$ 3,260,000</u>	<u>\$ 3,219,492</u>

Pension Plan and Other Postretirement Benefit Assumptions — Actuarial assumptions used to determine benefit obligations at December 31, 2008 and 2007, were as follows:

	Pension Plan		Other Postretirement Benefits	
	2008	2007	2008	2007
Discount rate	6.10 %	6.50 %	5.90 %	6.50 %
Rate of compensation increase	4.00	4.00	4.00	4.00

Actuarial assumptions used to determine net periodic benefit cost for the years ended December 31, 2008 and 2007, were as follows:

	Pension Plan		Other Postretirement Benefits	
	2008	2007	2008	2007
Discount rate	6.50 %	5.90 %	6.50 %	5.90 %
Expected long-term return on plan assets	6.50	7.00	4.70	4.70
Rate of compensation increase	4.00	4.00	4.00	4.00

In selecting the expected long-term rate of return on assets, the Companies considered the average rate of earnings expected on the funds invested or to be invested to provide for plan benefits. This included considering the Pension Plan and VEBA trusts' asset allocation, as well as the target asset allocations for the future, and the expected returns likely to be earned over the life of the Pension Plan and the VEBAs.

Assumed health care cost trend rates at December 31, 2008 and 2007, were as follows:

	2008	2007
Health care trend rate assumed for next year — participants under 65	8.00 %	9.00 %
Health care trend rate assumed for next year — participants over 65	9.50	11.29
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate) — participants under 65	5.00	5.00
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate) — participants over 65	5.00	5.00
Year that the rate reaches the ultimate trend rate	2015	2012

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects:

	One-Percentage Point Increase	One-Percentage Point Decrease
Effect on total service and interest cost	\$ 1,553,985	\$ (1,222,418)
Effect on postretirement benefit obligation	16,334,303	(13,014,742)

Pension Plan and Other Postretirement Benefit Assets — The asset allocation for the Pension Plan and VEBA trusts at December 31, 2008 and 2007, by asset category was as follows:

	Pension Plan		VEBA Trusts	
	2008	2007	2008	2007
Asset category:				
Equity securities	24 %	31 %	24 %	- %
Debt securities	76	69	76	100

The target asset allocation for the Pension Plan is 30% equity securities and 70% debt securities and for the VEBA trust is 40% equity securities and 60% debt securities.

Pension Plan and Other Postretirement Benefit Contributions — The Companies expect to contribute \$5,700,000 to their Pension Plan and \$6,227,701 to their Other Postretirement Benefits plan in 2009.

Estimated Future Benefit Payments — The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

Years Ending December 31	Pension Plan	Other Postretirement Benefits	
		With Medicare Subsidy	Without Medicare Subsidy
2009	\$ 8,190,118	\$ 4,042,701	\$ 4,388,179
2010	8,563,310	4,454,986	4,833,964
2011	8,860,448	4,797,783	5,211,111
2012	9,258,537	5,136,259	5,587,667
2013	9,646,383	5,403,058	5,892,674
Five years thereafter	57,038,752	32,929,845	35,939,277

Postemployment Benefits — The Companies follow SFAS No. 112, *Employers' Accounting for Postemployment Benefits*, and accrue the estimated cost of benefits provided to former or inactive employees after employment but before retirement. Such benefits include, but are not limited to, salary continuations, supplemental unemployment, severance, disability (including workers' compensation), job training, counseling, and continuation of benefits, such as health care and life insurance coverage. The cost of such benefits and related obligations has been allocated to OVEC and IKEC in the accompanying consolidating financial statements. The allocated amounts represent approximately a 42% and 58% split between OVEC and IKEC, respectively, as of December 31, 2008, and approximately a 40% and 60% split between OVEC and IKEC, respectively, as of December 31, 2007. The liability is offset with a corresponding regulatory asset and represents unrecognized postemployment benefits billable in the future to customers. The accrued cost of such benefits was \$2,236,997 and \$2,222,600 at December 31, 2008 and 2007, respectively.

Defined Contribution Plan — The Companies have a trustee-defined contribution supplemental pension and savings plan that includes 401(k) features and is available to employees who have met eligibility requirements. In 2007, the Companies' contributions to the savings plan were made in amounts equal to 50% of the employee-participants' contributions up to 6% of total compensation. In January 2008, the Companies' contributions to the savings plan were changed to amounts equal to 100% of the first 1% and 50% of the next 5% of employee-participants' contributions based upon total compensation. Benefits to participating employees are based solely upon amounts contributed to the participants' accounts and investment earnings. By its nature, the plan is fully funded at all times. The employer contributions for 2008 and 2007 were \$1,634,334 and \$1,278,249, respectively.

Adoption of SFAS No. 158 — Pension and Other Postretirement Benefits — The Companies adopted SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, effective December 31, 2007. SFAS No. 158 requires employers to fully recognize the obligations associated with defined benefit pension plans and other postretirement plans, which include retiree healthcare, in their balance sheets. Previous standards required an employer to disclose the complete funded status of its plan only in the notes to the financial statements and provided that an employer delay recognition of certain changes in plan assets and obligations that affected the costs of providing benefits resulting in an asset or liability that often differed from the plan's funded status. SFAS No. 158 requires a defined benefit pension or postretirement plan sponsor to recognize in its statement of financial position an asset for a plan's overfunded status or a liability for the plan's underfunded status. The effects of the Companies' adoption of SFAS No. 158 were as follows:

	Before Application of SFAS No. 158	Adjustments	After Application of SFAS No. 158
Pension asset	\$ 3,671,925	\$12,378,324	\$ 16,050,249
Postretirement benefits obligation	(40,299,341)	3,524,425	(36,774,916)

The adjustments detailed in the above table represent the unrecognized actuarial gains and unrecognized prior service cost for the plans as of December 31, 2007. These amounts were recorded as additions to regulatory liabilities (see Note 1).

10. ENVIRONMENTAL MATTERS

Title IV of the 1990 Clean Air Act Amendments required the Companies to reduce sulfur dioxide (SO₂) emissions in two phases: Phase I in 1995 and Phase II in 2000. The Companies selected a fuel switching strategy to comply with the emission reduction requirements. The Companies also purchased additional

SO₂ allowances. The cost of these purchased allowances was inventoried and included on an average cost basis in the cost of fuel consumed when used. The cost of unused allowances at December 31, 2008 and 2007, was \$2,244,126 and \$11,787,964, respectively.

Title IV of the 1990 Clean Air Act Amendments also required the Companies to comply with a nitrogen oxides (NO_x) emission rate limit of 0.84 lb/mmBtu in 2000. The Companies installed overfire air systems on all eleven units at the plants to comply with this limit. The total capital cost of the eleven overfire air systems was approximately \$8.2 million.

During 2002 and 2003, Ohio and Indiana finalized respective NO_x State Implementation Plan (SIP) Call regulations that required further significant NO_x emission reductions for coal-burning power plants during the ozone control period (May through September). The Companies installed selective catalytic reduction (SCR) systems on ten of its eleven units to comply with these rules. The total capital cost of the ten SCR systems was approximately \$355 million.

On March 10, 2005, the U.S. EPA signed the Clean Air Interstate Rule (CAIR) that will require significant further reductions of SO₂ and NO_x emissions from coal-burning power plants. On March 15, 2005, the U.S. EPA also signed the Clean Air Mercury Rule (CAMR) that will require significant mercury emission reductions for coal-burning power plants. These emission reductions will be required in two phases: 2009 and 2015 for NO_x; 2010 and 2015 for SO₂; and 2010 and 2018 for mercury. Ohio and Indiana also subsequently finalized their respective versions of CAIR and CAMR. In response, the Companies determined that it would be necessary to install flue gas desulfurization (FGD) systems at both plants to comply with these new rules and have since been conducting the necessary engineering, permitting, and construction to install these new FGD systems.

In February 2008, the D.C. Circuit Court of Appeals issued a decision which vacated the federal CAMR and remanded the rule to the U.S. EPA with a determination that the rule be rewritten under the maximum achievable control technologies (MACT) provision of Section 112(d) of the Clean Air Act. A group of electric utilities and the U.S. EPA requested a rehearing of the decision, which was denied by the court. Following those denials, both the group of electric utilities and the U.S. EPA requested that the U.S. Supreme Court hear the case. However, in February 2009, the U.S. EPA withdrew its request and the group of utilities' request was denied. These actions left the original court decision in place, which vacated the federal CAMR and remanded the rule to the U.S. EPA with a determination that the rule be rewritten under the MACT provision of Section 112(d) of the Clean Air Act.

In July 2008, the D.C. Circuit Court of Appeals issued a decision that vacated the federal CAIR and remanded the rule to the U.S. EPA. In September 2008, the U.S. EPA, a group of electric utilities and other parties filed petitions for rehearing. In December 2008, the D.C. Circuit Court of Appeals granted the U.S. EPA's petition and remanded the rule to the U.S. EPA without vacatur, allowing the federal CAIR to remain in effect while a new rule is developed and promulgated.

In December 2008, the Companies Boards of Directors authorized a delay in construction of the FGD at the Clifty Creek Plant of at least 18 months due to economic uncertainty in the capital markets.

In March 2009, the Board of Directors of OVEC authorized a delay in the anticipated tie-in of the first three generating units to the Kyger Creek Plant's FGD system pending an investigation into the structural integrity of the two newly constructed jet bubbling reactors, which are major components of the FGD system. Additional SO₂ allowances will be purchased to operate the Clifty Creek and Kyger Creek generating units to comply with the current environmental emission rules during the delays. The current cost to complete the new Kyger Creek and Clifty Creek FGD systems and the associated landfills is estimated not to exceed \$1.33 billion.

11. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*, requires disclosure of the fair value of certain financial instruments. The estimates of fair value under SFAS No. 107 require the application of broad assumptions and estimates. Accordingly, any actual exchange of such financial instruments could occur at values significantly different from the amounts disclosed. As cash and cash equivalents, current receivables, current payables, and line of credit borrowings are all short term in nature, their carrying amounts approximate fair value. The fair values of the Senior Notes were estimated using discounted cash flow analyses based on current incremental borrowing rates for similar types of borrowing arrangements.

The fair values and recorded values of the Senior Notes as of December 31, 2008 and 2007, are as follows:

	2008		2007	
	Fair Value	Recorded Value	Fair Value	Recorded Value
Senior 2006 Notes	\$ 365,930,295	\$ 413,013,876	\$ 420,070,000	\$ 426,359,355
Senior 2007 Notes	256,988,617	287,138,120	288,450,000	296,602,048
Senior 2008 Notes	<u>324,385,533</u>	<u>345,166,313</u>	<u>-</u>	<u>-</u>
Total	<u>\$ 947,304,445</u>	<u>\$ 1,045,318,309</u>	<u>\$ 708,520,000</u>	<u>\$ 722,961,403</u>

12. OPERATING LEASES

OVEC has entered into operating leases to secure railcars for the transportation of coal in connection with the fuel switching modifications at the OVEC and the IKEC generating stations. OVEC has railcar lease agreements that extend to as long as December 31, 2025, with options to exit the leases under certain conditions.

Future minimum lease payments for operating leases at December 31, 2008, are as follows:

Years Ending December 31	
2009	\$ 4,726,988
2010	4,758,188
2011	3,356,810
2012	3,266,568
2013	3,254,088
Thereafter	<u>25,886,781</u>
Total future minimum lease payments	<u>\$ 45,249,423</u>

The annual lease cost incurred was \$4,761,224 and \$4,767,379 for 2008 and 2007, respectively.

13. COMMITMENTS AND CONTINGENCIES

The Companies are party in or may be affected by various matters under litigation. Management believes that the ultimate outcome of these matters will not have a significant adverse effect on either the Companies' future results of operation or financial position.

14. FAIR VALUE MEASUREMENTS

Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157), clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. The Companies have adopted SFAS 157 and FASB Staff Position FAS No. 157-2 — *Effective Date of FASB Statement No. 157*, effective January 1, 2008. The adoption of SFAS 157 for financial instruments as required at January 1, 2008 did not have a material effect on the Companies' consolidating financial statements; however, the Companies are required to provide additional disclosure as part of the Companies' consolidating financial statements. As of December 31, 2008, the Companies have not adopted SFAS 157 for non-financial assets and non-financial liabilities. However, the provisions associated with non-financial assets and non-financial liabilities will be included in the disclosures in the Companies' 2009 consolidating financial statements, as required, and will not have a material effect on the Companies' consolidating financial statements.

On October 10, 2008, the FASB issued Staff Position FAS No. 157-3, *Fair Value Measurements* (FSP FAS 157-3), which clarifies the application of SFAS 157 in an inactive market and provides an example to demonstrate how the fair value of a financial asset is determined when the market for that financial asset is inactive. FSP FAS 157-3 was effective upon issuance, including prior periods for which financial statements had not been issued. The adoption of this standard as of December 31, 2008 did not have a material impact on the Companies' consolidated financial statements.

SFAS 157 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

As of December 31, 2008, the Companies held certain assets that are required to be measured at fair value on a recurring basis. These consist of investments recorded within cash and cash equivalents. The investments consist of money market mutual funds and debt securities. Changes in the observed trading prices and liquidity of money market funds are monitored as additional support for determining fair value, and losses are recorded in earnings if fair value falls below recorded cost.

Assets measured at fair value on a recurring basis subject to the disclosure requirements of SFAS 157 at December 31, 2008, were as follows:

	Fair Value Measurements at Reporting Date Using		
	Quoted Prices in Active for Market Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	\$ -	\$45,118,305	\$ -
Marketable securities	\$ -	\$53,609,545	\$ -

15. NEW ACCOUNTING STANDARDS

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115*. This statement permits entities to choose to measure many financial instruments and certain other items at fair value. The election is made on an instrument-by-instrument basis and is irrevocable. If the fair value option is elected for an instrument, SFAS 159 specifies that all subsequent changes in fair value for that instrument shall be reported in earnings. The objective of the pronouncement is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, and was adopted by the Companies on January 1, 2008. There was no impact on the Companies' financial position and results of operations, because the Companies made no fair value elections upon adoption.

On December 30, 2008, the FASB issued FSP FAS 132(R)-1, which amends Statement of Financial Accounting Standards No. 132(R), *Employers' Disclosures About Pensions and Other Postretirement Benefits — an amendment of FASB Statements No. 87, 88, and 106*, to require more detailed disclosures about employers' plan assets, including employers' investment strategies, major categories of plan assets, concentrations of risk within plan assets, and valuation techniques used to measure the fair value of plan assets. The disclosure requirements of FSP FAS 132(R)-1 will be effective for the Companies for the year ended December 31, 2009.

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