Report of Management

Management is responsible for the preparation of all information contained in this Annual Report, including the financial statements. Management uses its best judgment to ensure that such statements reflect fairly the financial position, results of operations and cash flows of the Association. Tri-State maintains a system of internal controls that is designed to provide reasonable assurance that transactions are executed in accordance with management's authorization, that financial statements are prepared in conformity with U.S. generally accepted accounting principles and that assets are safeguarded. The Board of Directors, through its Finance Committee consisting only of directors, has responsibility for determining that management fulfills its responsibilities for the preparation of financial statements and financial control of operations. The Finance Committee meets periodically with management and the independent auditors to discuss internal control, financial reporting and auditing matters.

Report of Independent Auditors

The Board of Directors of Tri-State Generation and Transmission Association, Inc.

We have audited the accompanying consolidated statements of financial position of Tri-State Generation and Transmission Association, Inc. (the Association) as of December 31, 2008 and 2007, and the related consolidated statements of operations, equity and cash flows for each of the three years in the period ended December 31, 2008. These financial statements are the responsibility of the Association'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 and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Association's internal control over financial reporting. Our audits included 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 Association's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Association at December 31, 2008 and 2007 and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2008 in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have issued our report dated February 19, 2009 on our consideration of the Association's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Ernst + Young LLP

February 19, 2009

Consolidated Statements of Financial Position

As of December 31, (Thousands)	2008	2007
ASSETS		
Electric plant		
In service	$ 3,036,172	$ 2,960,471
Construction work in progress	143,861	107,408
	3,180,033	3,067,879
Less allowances for depreciation and amortization	(1,439,833)	(1,353,039)
	1,740,200	1,714,840
Other assets and investments		
Investments in other associations	105,917	95,202
Investments in coal mines	24,667	21,593
Deferred equity note	9,053	9,089
Prepaid lease expense	90,202	75,710
Other noncurrent assets	36,095	16,351
	265,934	217,945
Current assets		
Cash and cash equivalents	85,873	135,347
Deposits and advances	13,880	13,016
Accounts receivable—members	74,721	65,378
Other accounts receivable	29,456	30,812
Coal inventory	24,706	18,072
Materials and supplies	50,768	45,037
	279,404	307,662
Deferred charges	225,711	205,425
Total assets	$ 2,511,249	$ 2,445,872
EQUITY AND LIABILITIES		
Capitalization		
Patronage capital equity	$ 557,488	$ 471,570
Long-term debt	1,571,793	1,641,151
	2,129,281	2,112,721
Current liabilities		
Member advances	8,467	8,423
Accounts payable	77,182	63,313
Accrued expenses	47,769	40,801
Current maturities of long-term debt	135,044	124,742
	268,462	237,279
Deferred credits and other liabilities	105,774	88,576
Accumulated postretirement benefit and postemployment obligations	7,732	7,296
Commitments and contingencies	—	—
Total equity and liabilities	$ 2,511,249	$ 2,445,872

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

Consolidated Statements of Operations

For the years ended December 31, (Thousands)	2008	2007	2006
Operating revenues			
Member electric sales	$ 869,960	$ 750,838	$651,993
Non-member electric sales	257,837	244,920	186,988
Other	32,841	22,888	7,063
	1,160,638	1,018,646	846,044
Operating expenses			
Purchased power	279,132	194,979	217,654
Fuel	246,239	234,489	175,589
Production	93,769	85,119	65,120
Lease expense	64,991	56,143	27,884
Transmission	88,729	79,544	72,856
General and administrative	11,589	9,226	9,498
Generation maintenance	83,907	59,507	56,309
Transmission maintenance	17,849	16,471	16,394
Depreciation and amortization	98,936	95,158	92,438
Income taxes	1,954	2,219	—
	987,095	832,855	733,742
Operating margins	173,543	185,791	112,302
Other income			
Interest income	9,498	12,073	12,755
Allowance for equity funds used during construction	3,443	2,273	3,246
Capital credits from cooperatives	19,252	5,387	6,612
Other income	1,053	4,291	8,523
	33,246	24,024	31,136
Interest and other deductions (credits)			
Interest expense, net of amounts capitalized	97,567	104,107	103,908
Other deductions (credits)	2,773	2,701	(6,398)
	100,340	106,808	97,510
Net margins	$ 106,449	$ 103,007	$ 45,928

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

Consolidated Statements of Equity

For the years ended December 31, (Thousands)	2008	2007	2006
Balance at beginning of year	$ 471,570	$ 373,631	$332,620
Net margins	106,449	103,007	45,928
Unrealized gain (loss) on securities available for sale	(531)	(68)	83
Comprehensive income	105,918	102,939	46,011
Retirements	(20,000)	(5,000)	(5,000)
Balance at end of year	$ 557,488	$ 471,570	$373,631

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

Consolidated Statements of Cash Flows

For the years ended December 31, (Thousands)	2008	2007	2006
Operating activities			
Net margins	$ 106,449	$ 103,007	$ 45,928
Adjustments to reconcile net margins to net cash provided by operating activities:			
Depreciation and amortization	98,936	95,158	92,438
Capital credit allocations from cooperatives and income from coal mines (over) under refund distributions	(12,578)	1,172	794
Allowance for equity funds used during construction	(3,443)	(2,273)	(3,246)
Recognition of deferred revenue	—	(13,000)	—
Deferred revenue	10,000	20,000	—
Changes in operating assets and liabilities:			
Accounts receivable	(7,987)	(9,830)	(11,345)
Coal inventory	(6,634)	(4,519)	(2,385)
Prepaid lease expense	(14,492)	(74,522)	(1,226)
Accounts payable and accrued expenses	20,837	(26,280)	(5,216)
Other	5,075	1,963	(8,488)
Net cash provided by operating activities	196,163	90,876	107,254
Investing activities			
Purchases of plant, net of retirements	(116,208)	(89,600)	(186,338)
Other investing activities, primarily changes in deferred charges and other noncurrent assets	(50,417)	10,417	(138,211)
Net cash used in investing activities	(166,625)	(79,183)	(324,549)
Financing activities			
Member advances	44	(1,774)	1,168
Payments of long-term debt	(125,087)	(134,464)	(101,885)
Advance payments to RUS and funds on deposit with trustees	(25,282)	(12,301)	104,299
Retirement of patronage capital	(20,000)	(5,000)	(5,000)
Proceeds from issuance of debt	91,313	161,130	221,035
Net cash provided by (used in) financing activities	(79,012)	7,591	219,617
Net increase (decrease) in cash and cash equivalents	(49,474)	19,284	2,322
Cash and cash equivalents—beginning	135,347	116,063	113,741
Cash and cash equivalents—ending	$ 85,873	$ 135,347	$ 116,063
Supplemental information:			
Cash paid for interest	$ 102,267	$ 124,746	$ 102,528
Cash paid for income taxes	$ 2,265	$ 444	$ —

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

Notes to Consolidated Financial Statements

Note 1—Organization

Tri-State Generation and Transmission Association, Inc. (the “Association”) is a wholesale power supply cooperative. During 2008, it provided power to 44 member distribution systems that serve major parts of Colorado, Nebraska, New Mexico and Wyoming. The Association also sells a portion of its power to other utilities in the region under long-term contracts (see Note 10) and market sale arrangements. In 2008, 2007 and 2006, total megawatt-hours sold were 19.0, 18.3 and 16.6 million, respectively, of which 74, 73 and 79 percent, respectively, were sold to members. Total revenue from electric sales was $1.1 billion, $996 million and $839 million for 2008, 2007 and 2006, respectively, of which 77, 75 and 78 percent, respectively, were from member sales. Energy resources were provided by generation and purchased power, of which 68, 74 and 69 percent were from generation for 2008, 2007 and 2006, respectively.

The Association has wholesale power contracts with 42 of its members through the year 2050 and with 2 of its members through the year 2040 whereby each member is obligated to purchase at least 95 percent of its requirements from the Association and can elect to provide up to 5 percent of its requirements from generation owned or controlled by the member. Three members have made such an election. Power is provided to members at rates determined by the Board of Directors. Rates are designed to recover all costs and provide margins to increase members’ equity.

An undivided interest in the jointly owned facilities of the Yampa Project, the Missouri Basin Power Project (“MBPP”), and the San Juan Project (“San Juan”) are owned by the Association. Each participant in these facilities provides its own financing. The Association receives a portion of the total output of the generating stations, which approximates its percentage ownership. The operating agent for each of these projects allocates to the Association its share of fuel and other operating costs.

The Association employs 1,137 people, of which 330 are subject to collective bargaining agreements.

Note 2—Summary of Significant Accounting Policies

Basis of Consolidation:

The consolidated financial statements include the accounts of the Association and its 99 percent interest in Western Fuels-Colorado, a limited liability company organized for the purpose of acquiring coal reserves and supplying coal to the Association. The consolidated financial statements also include, on a pro rata basis, the Association’s undivided interest in jointly owned facilities (see Note 1). All significant intercompany balances and transactions have been eliminated in consolidation. The accompanying consolidated statements have been prepared in accordance with generally accepted accounting principles (“GAAP”) as applied to regulated enterprises and as prescribed by the Rural Utilities Service (“RUS”).

Use of Estimates:

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, 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 may differ from those estimates.

Electric Plant and Depreciation:

Electric plant is stated at cost. The cost of internally constructed assets includes payroll, allowance for equity funds used during construction, overhead costs and interest charged during construction. The amount of interest capitalized during construction was $3.6 and $2.7 million and $0 during 2008, 2007 and 2006, respectively. At the time that units of electric plant are retired, original cost and cost of removal, net of the salvage value, are charged to the allowance for depreciation. Replacements of electric plant that involve less than a designated unit value are charged to maintenance expense when incurred.

Leases:

The accounting for lease transactions is in compliance with the provisions of Statement of Financial Accounting Standards (“SFAS”) No. 13, *Accounting for Leases*, as well as other accounting pronouncements issued by the Financial Accounting Standards Board (“FASB”) and the Emerging Issues Task Force (“EITF”) that provide specific guidance and additional requirements related to accounting for various leasing arrangements and for identifying arrangements as leases. In accounting for leases, management makes various assumptions, including the discount rate, the fair market value of the leased assets and the estimated useful life, in order to determine whether a lease should be classified as operating or capital.

Beginning in 2007, the Association has certain power sales arrangements that are required to be accounted for as operating leases since the arrangements are in substance leases because they convey the right to use power generating equipment for a stated period of time. The contracts under which sales were made to Public Service Company of Colorado ("PSCO") out of the Association's Knutson and Limon Generating Stations were modified in June 2007. This resulted in the arrangements being accounted for as operating leases and the related revenues being treated as lease revenues beginning in June 2007. Under these contracts, PSCO directs the use of both of the two Knutson generating units and one of the two Limon generating units over the terms of the contracts under tolling arrangements whereby PSCO provides its own natural gas for generation of electricity. A similar tolling arrangement involving a 40 megawatt unit at the Association's Pyramid Generating Station began in 2007 and this is accounted for as an operating lease. The Limon contract will be suspended for a period of four years beginning in 2009 and the Knutson contract will be suspended for a period of three years beginning in 2010 to allow the Association to utilize the output of the turbines. Both turbine contracts resume with PSCO under the original tolling arrangements for the period May 1, 2013 to April 30, 2016. The revenues from these operating leases of $24.4 and $15.3 million for 2008 and 2007, respectively, are accounted for as lease revenue and are reflected in other operating revenue on the statements of operations. The generating units used in these gas tolling arrangements have a total cost and accumulated depreciation as of December 31, 2008 of $135.4 and $27.2 million, respectively. The minimum future lease revenues under these gas tolling arrangements at December 31, 2008 are as follows (thousands):

2009	$17,087
2010	5,337
2011	600
2012	600
2013	14,159
Thereafter	49,521
	$87,304

Beginning in 2008, the Association entered into power purchase arrangements that are required to be accounted for as operating leases since the arrangements are in substance leases because they convey to the Association the right to use power generating equipment for a stated period of time. Such an agreement began in June 2008 for the use of generating equipment at the Rawhide Generating Station (owned by Platte River Power Authority). Additionally, two agreements begin in 2009 that give the Association the use of generating equipment at the Ft. Lupton Generating Station (owned by Thermo Cogeneration Partnership) and Brush Generating Station (owned by Brush Cogeneration Partners). Under these contracts, the Association directs the use of the contracted generating equipment over the terms of the contracts under tolling arrangements whereby the Association provides its own natural gas for generation of electricity. These tolling arrangements are discussed further in Note 7.

Investments in Other Associations:

Investments in other associations primarily include the Association's investment in the patronage capital of other cooperatives. Allocations of capital credits from other cooperatives are based on the Association's patronage with the cooperatives. Cash retirements of capital credits from other cooperatives reduce the investment balances.

Investments in Coal Mines:

The Association and certain participants in the Yampa Project are members of Trapper Mining, Inc. ("Trapper Mining") which is organized as a cooperative and is the owner and operator of the Trapper Mine near Craig, Colorado. The Association also owns 99 percent of Western Fuels-Colorado which is the owner and operator of the New Horizon Mine near Nucla, Colorado. In addition, the Association has partial ownership in Western Fuels Association ("WFA"), which, through its ownership in Western Fuels-Wyoming, is the owner and operator of the Dry Fork Mine near Gillette, Wyoming. The Association also owns a 50 percent undivided ownership in the land and the rights to mine the property known as Fort Union Mine which is located adjacent to the Dry Fork Mine.

Notes to Consolidated Financial Statements

Deferred Equity Note:

During 1981 and 1982, the Association sold certain tax benefits under the safe harbor leasing provision of the Internal Revenue Code. The initial proceeds were recorded in deferred credits and are being amortized into income at $715,000 per year through 2024. The unamortized balance at December 31, 2008 and 2007 was $11.2 and $11.9 million, respectively. The 1981 lease included a $34.7 million deferred equity note, payable annually, that has been recorded on a discounted basis at 10 percent, which approximates its fair value of $9.0 and $9.1 million at December 31, 2008 and 2007, respectively.

Cash and Cash Equivalents:

The Association considers highly liquid investments with an original maturity of three months or less to be cash equivalents.

Marketable Securities:

The Association's investment in fixed maturity securities is classified as either held-to-maturity, available-for-sale or trading. If the Association had investments in debt securities that the Association had both the positive intent and ability to hold to maturity the investments would be carried at amortized cost. The Association does not have any such investments. Investments in debt securities that the Association does not have the positive intent and ability to hold to maturity are classified as available-for-sale or trading and are carried at fair value. Classification of debt securities is made at the time of purchase and, prospectively, that classification is reevaluated as of each balance sheet date. Unrealized holding gains and losses on securities classified as available-for-sale are carried as a separate component of members' equity. Unrealized holding gains and losses on securities classified as trading are reported in margins. Realized gains and losses on sales of investments, and declines in value judged to be other-than-temporary, are recognized on the specific identification basis and are also included in margins.

Marketable securities held by the Association are related to the directors' and executives' elective deferred compensation plans and consist of investments in stock funds, bond funds and money market funds. At December 31, 2008, the cost and estimated fair value of the investments based upon their active market value were $1.4 and $0.9 million, respectively, with a net unrealized loss balance of $478,000. At December 31, 2007, the cost and estimated fair value of the investments were $1.3 and $1.4 million, respectively, with a net unrealized gain balance of $53,000. The estimated fair value of the investments is included in other noncurrent assets on the statements of financial position. The change in the net unrealized gain or loss is reported separately as a component of comprehensive income as shown on the statements of equity.

Derivatives:

The Association enters into contracts to manage its energy resource portfolio and to manage its exposure to price risks, such as changes in commodity prices. These contracts are evaluated in accordance with the accounting requirements of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted. SFAS No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities. To the extent that these contracts are considered derivatives, the Association assesses whether or not the normal purchase or normal sales exception applies. For contracts in which this exclusion cannot be applied, SFAS No. 133 requires that an entity recognize these derivatives as either assets or liabilities on the statements of financial position and measure those instruments at fair value. Furthermore, changes in the fair value of those instruments are to be recorded in current earnings or deferred in accumulated other comprehensive income (loss), depending on whether a derivative is designated as, and is effective as, a hedge and depending on the type of hedge transaction. Beginning in 2008, the Association entered into certain forward purchase agreements for natural gas in order to assure an adequate supply of natural gas at a price certain for the generation of electricity. These natural gas agreements are considered derivative instruments and are recorded at fair value. Hedge accounting treatment has not been elected for the natural gas agreements. Therefore, the changes in the fair value of these derivatives are required to be recognized in the related revenue or expense shown on the statements of operations. At December 31, 2008, the derivatives that required mark to market accounting consisted of fixed-price, fixed-quantity physical contracts to purchase anticipated future gas needed for the Association's generation. As of this date, these derivative instruments had a current loss in fair market value of $6.3 million. This mark to market loss would have ordinarily been recorded as a $6.3 million fuel expense in 2008. However, the current recognition of the mark to market loss was deferred under SFAS No. 71, *Accounting for Certain Types of*

Regulation, and the $6.3 million deferred loss is accounted for as a regulatory asset. The process of marking the derivatives to market and deferring the recognition of the change in market value will continue until each derivative purchase contract is settled. At the time of the delivery/settlement of each derivative contract, the balance of the deferral relating to the settled contract will be recognized as fuel expense. This will result in the total fuel expense recognized at delivery/settlement under each contract being equal to the total amount owed under the contract at delivery/settlement. In essence, this regulatory treatment of mark to market gains and losses will result in each of the derivative purchases being recognized as an expense at delivery/settlement. This regulatory approach thus results in the matching of the expenses and the cost recovery included in the Association's rates.

Inventories:

Coal inventories of $16.4 and $12.5 million at December 31, 2008 and 2007, respectively, are stated at LIFO (last-in, first-out) cost. The remaining coal inventories, other fuel, and materials and supplies inventories are stated at average cost.

Memberships:

Fifty $5 memberships are authorized of which 44 are outstanding at December 31, 2008 and 2007.

Patronage Capital:

Net margins of the Association are treated as advances of capital by the members. In 2008 and prior to the merger with Plains Electric Generation and Transmission Cooperative, Inc. ("Plains") in June 2000, the net margins have been allocated to the members on the basis of their electricity purchases from the Association. Subsequent to the merger in 2000 through 2007, the net margins were accounted for on the basis of allocation units and the net margins of each allocation unit were allocated to the members thereof based on their electricity purchases from the Association. One allocation unit consisted of the members of the Association before the merger and another allocation unit consisted of the former members of Plains that became members of the Association. Net losses are not allocated to members, but are offset by future margins.

Accumulated Postretirement Benefit and Postemployment Obligations:

The Association sponsors a medical plan for all employees of the Association. The plan provides postretirement medical benefits to all full-time employees and retirees (who have attained age 55) that elect to participate, and postemployment medical benefits to employees on long-term disability. The plan was unfunded at December 31, 2008, is contributory (with retiree premium contributions equivalent to the employee's premium, adjusted annually) and contains other cost-sharing features such as deductibles. In 2006, the Association adopted SFAS No. 158, *Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106 and 132(R)*. The full underfunded status of the postretirement medical benefit at December 31, 2006 was determined per an actuarial study performed during 2006 and was recorded in the December 31, 2006 liability. The postretirement medical benefit liability balances of $6.8 and $6.3 million at December 31, 2008 and 2007, respectively, are included in accumulated postretirement benefit and postemployment obligations. The postemployment medical benefit liability balance was $971,000 at December 31, 2008 and 2007 and is included in accumulated postretirement benefit and postemployment obligations.

Electric Sales Revenue:

Revenue from electric energy deliveries is recognized when delivered.

Other Operating Revenue:

Other operating revenue consists primarily of wheeling revenue and lease revenue. Wheeling revenue is received when the Association charges other energy companies for transmitting electricity over the Association's transmission lines. The lease revenue is primarily from certain power sales arrangements that are required to be accounted for as operating leases since the arrangements are in substance leases because they convey to others the right to use power generating equipment for a stated period of time. The lease accounting treatment began in June 2007 for the contracts under which sales were made to PSCO out of the Association's Knutson and Limon generating stations. The modification of the contracts, effective in June 2007, resulted in the arrangements being accounted for as operating leases and the related revenue being treated as lease revenue beginning in June 2007. Prior to the June 2007 contract modifications, the contracts were accounted for as power sales and the resulting revenues were included in non-member electric sales revenue on the statements of operations. PSCO directs the use of both of the two Knutson generating units and one of the two Limon generating units over the term of the contract under tolling arrangements whereby PSCO provides its own natural gas for generation of electricity. A similar tolling arrangement involving a 40-megawatt unit at the Association's Pyramid Generating Station began in June 2007 and this is accounted for as an operating lease. The revenue from these operating leases is accounted for as lease revenue and is reflected in other operating revenue on the statements of operations.

Deferred Revenues:

The Association has recognized the benefit of certain deferred revenues assumed from Plains in connection with the merger in 2000. Prior to the merger, twelve former Plains members made payments totaling $47.6 million to Plains for the prepayment of purchased power and one former Plains member made an $11.8 million payment to Plains in order to buy out of its relationship with Plains. Plains recorded the amounts as deferred revenues. The Association assumed the deferred revenues upon merging with Plains and has included them in deferred credits and other liabilities. During 2008, 2007 and 2006, none of the member prepayment was recognized in member electric sales revenue and none of the buyout payment was recognized in non-member electric sales revenue. The balances in the deferred revenue accounts for the member prepayment and buyout payment were $4.8 and $0.8 million, respectively, at both December 31, 2008 and December 31, 2007. These deferred revenues will be recognized in revenue prior to 2011.

During 2007, the Association deferred the recognition of $20 million of non-member electric sales revenue earned during 2007 in accordance with regulatory accounting requirements and the approval of RUS. The $20 million deferred revenue is included in deferred credits and other liabilities. This deferred revenue will be recognized in non-member electric sales revenue prior to 2013. Also, during 2007, the Association recognized $13 million of previously deferred non-member electric sales revenue that was deferred in 2003. The net result of the $20 million deferral and the $13 million recognition was a $7 million reduction in non-member electric sales revenue recognized in 2007 and a $7 million increase in deferred revenues during 2007.

During 2008, the Association deferred the recognition of $10 million of non-member electric sales revenue earned during 2008 in accordance with regulatory accounting requirements and the approval of RUS. The $10 million deferred revenue is included in deferred credits and other liabilities. This deferred revenue will be recognized in non-member electric sales revenue prior to 2014.

The total of these deferred revenues is $35.6 and $25.6 million at December 31, 2008 and 2007, respectively, and is included in deferred credits and other liabilities. The accounting for deferred revenues is discussed further in Accounting for Rate Regulation.

Income Taxes:

The Association is a non-exempt cooperative subject to federal and state taxation and, as a cooperative, is allowed a tax exclusion for margins allocated as patronage capital. The liability method of accounting for income taxes is utilized, whereby changes in deferred tax assets or liabilities result in the establishment of a regulatory asset or liability. A regulatory asset or liability associated with deferred income taxes generally represents the future increase or decrease in income taxes payable that will be received or settled through future rate revenues.

Accounting for Rate Regulation:

The Association is subject to the accounting requirements of SFAS No. 71, *Accounting for Certain Types of Regulation*. In accordance with SFAS No. 71, some revenues and expenses have been deferred at the discretion of the Association's Board of Directors (which has budgetary and rate-setting authority) and with the approval of RUS. Regulatory assets are included in deferred charges. Regulatory liabilities are included in deferred credits and other liabilities. The regulatory assets and liabilities are recognized as expenses and income in future periods at the discretion of the Board of Directors.

The 2005 conversion to ownership accounting for the Association's 78 percent ownership in the Craig Generating Station Unit 3 lease essentially terminated the lease accounting for the 78 percent portion accounted for as owned property. Upon termination of 78 percent of the lease, the Association would ordinarily have been required to recognize 78 percent of the prepaid lease expense balance, $62.9 million, as an expense in 2005. The use of ownership accounting for the additional 22 percent ownership acquired in 2006 essentially terminated the remaining 22 percent of the lease. The Association would ordinarily have been required to recognize 22 percent of the prepaid lease balance, $22.5 million, as an expense in 2006. However, the current recognition of the prepaid lease expense in both 2005 and 2006 was deferred under SFAS No. 71 and the amount of the deferrals is accounted for as a regulatory asset. The regulatory asset for the deferred prepaid lease expense is being amortized into expense each year beginning January 1, 2005 for the 78 percent portion and beginning in 2006 for the 22 percent portion, through the remaining original life of the lease ending in 2018. In 2008, 2007 and 2006, prepaid lease amortization expense of $6.5, $6.5 and $6.3 million, respectively, is included in depreciation and amortization. The deferred prepaid lease balance was $61.5 and $68.0 million at December 31, 2008 and 2007, respectively, and is included in deferred charges.

The regulatory asset related to deferred income tax expense is discussed further in Income Taxes. The regulatory asset related to deferred derivative mark to market expense is discussed further in Derivatives. The regulatory liability related to deferred revenues is discussed further in Deferred Revenues.

Regulatory assets and liabilities are as follows (thousands):

	2008	2007
Regulatory assets		
Deferred income tax expense	$ 25,750	$ 27,337
Deferred derivative mark to market expense	6,280	—
Deferred prepaid lease expense	61,496	67,969
	93,526	95,306
Regulatory liabilities		
Deferred revenues	(35,599)	(25,599)
Net regulatory asset	$ 57,927	$ 69,707

Interchange Power:

The Association occasionally engages in interchanges, or non-cash swapping, of energy. Based on the assumption that all energy interchanged will eventually be received or delivered in-kind, interchanged energy is generally valued at the average cost of fuel to generate power. Additionally, portions of the energy interchanged are valued per contract with the utility involved in the interchange. When the Association is in a net energy advance position, the advanced energy balance is recorded as an asset. If the Association owes energy, the energy balance owed to others is recorded as a liability. The net activity for the year is included in purchased power expense. The interchange liability of $2.0 million at December 31, 2008 is included in accounts payable and the interchange asset of $421,000 at December 31, 2007 is included in deposits and advances. The net interchange activity recorded in purchased power expense was $2.4, $(4.7) and $(7.1) million in 2008, 2007 and 2006, respectively.

Allowance for Equity Funds Used During Construction ("AFUDC"):

AFUDC represents the cost of internal capital used for construction purposes. AFUDC is capitalized as part of the cost of plant and is credited to income. Interest rates of 6.3, 6.4 and 6.5 percent were used for 2008, 2007 and 2006, respectively.

SO_2 Emission Allowances:

The Association has received an annual allocation of SO_2 (sulfur dioxide) emission allowances from the Environmental Protection Agency as part of a nationwide program to limit SO_2 emissions. An allowance provides authority to emit one ton of SO_2. Under this program, the Association has received more SO_2 allowances than it has utilized. The unutilized SO_2 allowances have no cost basis and are therefore not recorded on the balance sheet. The Association recorded gains from the sales of SO_2 allowances of $0, $1.2 and $5.6 million in 2008, 2007 and 2006, respectively, which are included in other income.

Asset Retirement Obligations:

The Association accounts for obligations associated with the retirement of tangible long-lived assets and the related asset retirement costs.

Coal Mines: The Association has asset retirement obligations for the final reclamation costs and post-reclamation monitoring related to the New Horizon Mine and the Fort Union Mine.

Notes to Consolidated Financial Statements

Fossil Steam Generation: The Association, including its undivided interest in jointly-owned facilities, has asset retirement obligations related to equipment, dams, ponds, ground water, wells and underground storage tanks at the fossil steam generating stations.

Aggregate carrying amounts of asset retirement obligations are as follows (thousands):

	2008	2007
Asset retirement obligation at beginning of year	$4,814	$4,868
Liabilities incurred	1,469	—
Liabilities settled	(318)	(264)
Accretion expense	282	210
Asset retirement obligation at end of year	$6,247	$4,814

The Association also has asset retirement obligations with indeterminate settlement dates. These are made up primarily of obligations attached to transmission and other easements that are considered by the Association to be operated in perpetuity and therefore the Association does not have sufficient information to reasonably estimate the fair value of the obligation. A liability will be recognized in the period in which sufficient information exists to estimate a range of potential settlement dates as is needed to employ a present value technique to estimate fair value.

New Accounting Pronouncements:

In September 2006, the FASB released SFAS No. 157, *Fair Value Measurements*, effective for fiscal years beginning after November 15, 2007. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. In November 2007, the FASB agreed to a one-year deferral of the effective date for non-financial assets and liabilities that are recognized or disclosed at fair value on a nonrecurring basis. The Association adopted SFAS No. 157 for financial assets and liabilities in 2008 and it did not have a material impact on its financial position or results of operations. The Association will adopt SFAS No. 157 for non-financial assets and liabilities in 2009 but does not believe that it will have a material impact on its financial position or results of operations.

In February 2007, the FASB released SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, effective for fiscal years beginning after November 15, 2007. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective 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. The Association adopted SFAS No. 159 in 2008 and it did not have a material impact on its financial position or results of operations.

In July 2006, the FASB issued Interpretation No. (“FIN”) 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109*, effective for fiscal years beginning after December 15, 2006. The objective of the interpretation is to clarify the accounting for uncertain tax positions. Generally, financial statement recognition of a tax position is allowed if the likelihood of sustaining the position is more-likely-than-not (greater than 50 percent). Individual tax positions that fail to meet the more-likely-than-not threshold will generally result in either (a) a reduction in the deferred tax asset or an increase in a deferred tax liability or (b) an increase in a liability for income taxes payable or the reduction of an income tax refund receivable. On February 1, 2008, the FASB posted FASB Staff Position No. FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, which deferred the effective date of FIN 48 for nonpublic enterprises until fiscal years beginning after December 15, 2007. On December 30, 2008, the FASB issued FASB Staff Position No. 48-3, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, which extended the deferral of implementing FIN 48 for nonpublic enterprises until fiscal years beginning after December 15, 2008. The Association meets the definition of a nonpublic enterprise and therefore has elected to defer implementing FIN 48 until 2009. The Association believes that it does not currently have any uncertain tax positions and therefore it does not believe that FIN 48 will have a material impact on its financial position or results of operations.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, effective for fiscal years beginning after November 15, 2008, with early adoption encouraged. SFAS No. 161, an amendment of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, requires enhanced disclosures regarding the objectives and strategies for using derivatives, how derivative instruments and related hedge items are accounted for under SFAS No. 133 and its related interpretations, and how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. The Association will adopt SFAS No. 161 in 2009 but does not believe that it will have a material impact on its financial position or results of operations.

In June 2008, the FASB released FASB Exposure Draft, *Disclosure of Certain Loss Contingencies*, which would replace and enhance the disclosure requirements in SFAS No. 5, *Accounting for Contingencies*. Under SFAS No. 5, a loss is required to be accrued as a charge to income if the loss is probable of occurring and the amount of the loss can reasonably be estimated. If no accrual is made for a loss contingency because one or both of the conditions are not met, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss may have occurred. The Exposure Draft would, if adopted, require that all loss contingencies be disclosed unless the likelihood of it to occur was more than remote. The proposed Statement was originally proposed to be effective for annual financial statements issued for fiscal years ending after December 15, 2008. However, the proposed effective date has now been delayed to fiscal years ending after December 15, 2009. The Association anticipates adoption of a final Statement in 2009 but does not believe that it will have a material impact on its financial position or results of operations.

Reclassifications:

Certain reclassifications have been made to the prior year financial statements to conform to the 2008 presentations.

Note 3—Electric Plant

The Association's investment in electric plant and the related annual rates of depreciation or amortization calculated using the straight-line method are as follows (thousands):

	Annual Depreciation Rate	2008	2007
Generation plant	2.2% to 3.10%	$ 1,906,687	$ 1,894,269
Transmission plant	2.0% to 2.88%	756,716	713,035
General plant	3.0% to 30.00%	248,322	231,186
Other	2.8% to 5.60%	124,447	121,981
Electric plant in service (at cost)		3,036,172	2,960,471
Construction work in progress		143,861	107,408
Less allowances for depreciation and amortization		(1,439,833)	(1,353,039)
Electric plant		$ 1,740,200	$ 1,714,840

At December 31, 2008, the Association had $25.2 million of commitments to complete construction projects of which approximately $25.1 million and $90,000 are expected to be incurred in 2009 and 2010, respectively.

The Purchase Option and Development Agreement was executed on July 26, 2007 between the Association and Sunflower Electric Power Corporation and other Sunflower parties. The agreement calls for the Association to make option payments totaling $55 million to Sunflower and/or the other Sunflower parties in exchange for the development rights to develop one or two new coal-fired generating units at Sunflower's existing single-unit Holcomb Station in western Kansas. Upon execution $25 million was paid. In 2008, $5 million was paid and the remainder will be paid on the purchase date. The purchase date will be designated by the Association, Sunflower and the other parties to the Purchase Option and Development Agreement after the Association exercises its option to acquire the development rights. The purchase date cannot currently be estimated due to the fact that the necessary air permit for developing the additional units at Holcomb Station has not been obtained. The air permit application was denied by the Kansas Department of Health and Environment in October 2007 and the Association and Sunflower have appealed the denial to the Kansas courts. Excluding the cost of land and water rights, the cost of developing the units incurred by the Association as of December 31, 2008 is $45.8 million. The Association is unable to project the ultimate outcome of this matter, but it intends to pursue the appeals process to conclusion. The Association is unable to project when the appeals process may conclude.

Notes to Consolidated Financial Statements

Note 4—Long-Term Debt

The mortgage notes payable and pollution control revenue bonds are secured on a parity basis by a Master First Mortgage Indenture, Deed of Trust and Security Agreement. Substantially all the assets, rents, revenues and margins of the Association are pledged as collateral. The mortgage notes payable contain certain restrictive financial covenants and consist of the following (thousands):

	2008	2007
Mortgage notes payable		
2% RUS, due through 2017	$ 815	$ 1,382
5% RUS, due through 2026	20,350	25,654
2.66% to 13.39% FFB, 5.81% average for 2008, due through 2037	1,173,726	1,180,997
5.75% to 9.05% CFC, 7.71% average for 2008, due through 2022	203,300	218,064
6.17% to 7.24% CoBank, ACB, 6.40% average for 2008, due through 2036	85,053	88,589
Variable rate CFC, as determined by CFC, 5.44% average for 2008, due through 2026	930	961
Variable rate Grantor Trust Obligations, as determined by CFC, 2.95% average for 2008, due 2017	32,660	34,840
Variable rate CoBank, ACB, based on LIBOR, 4.29% average for 2008, due through 2010	6,500	6,500
Variable rate, Credit Agreement, LIBOR based revolving credit, 3.82% average for 2008, due 2012	102,200	78,000
Pollution control revenue bonds		
Platte County, WY Daily Adjustable Rate Series 1984, 1.96% average for 2008, due 2014	48,000	48,000
City of Gallup, NM, 5.0%, Series 2005, due through 2017	43,624	47,650
Moffat County, CO Weekly Adjustable Rate Series 1984, 5.79% average for 2008, due 2010	46,800	67,050
Other	1,536	1,582
Less advance payments to RUS	(57,972)	(32,677)
	1,707,522	1,766,592
Less funds on deposit with trustees	(685)	(699)
Total debt	1,706,837	1,765,893
Less current maturities	(135,044)	(124,742)
Long-term debt	$1,571,793	$1,641,151

In January 2007, the Association entered into an agreement (the “Credit Agreement”) with Credit Suisse Cayman Islands Branch as Administrative Agent, and with Credit Suisse Securities (USA) LLC and Lehman Brothers Inc. (“Lehman”) as Joint Lead Arrangers for an unsecured revolving credit facility with a total commitment of $250 million for a term of five years. Later in 2007, the Association secured the Credit Agreement. In September 2008, Lehman filed for bankruptcy and defaulted on a requested advance. The total commitment from Lehman was $50 million. At the time of the default, the Association had $95 million advanced under the Credit Agreement, of which $19 million was from Lehman. Lehman’s default impacts the remaining $31 million of Lehman’s commitment which results in a credit facility with a total commitment of $219 million. In January 2009, the Association received an advance of an additional $52 million under the Credit Agreement bringing the outstanding balance to $154.2 million. The Association is subject to a number of customary covenants under the Credit Agreement and was in compliance with all of them as of the date of the last advance.

RUS allows borrowers to make advance payments that will be used to pay future debt. These advances are irrevocable and can only be used to pay RUS or Federal Financing Bank ("FFB") debt. The advance payments earn interest at a 5 percent rate.

The Platte County bonds may be "put" back for remarketing at any time and may be converted to a long-term fixed rate at the option of the Association. A $49.1 million letter of credit with National Rural Utilities Cooperative Finance Corporation ("CFC") secures payment of these bonds and as of December 31, 2008 had an expiration date of November 2009. Subsequent to year end, CFC extended the letter of credit to November 2010.

At December 31, 2008, the Association had $150 million of unused committed lines of credit. The lines of credit had expiration dates of $75 million in 2009, $50 million in 2010 and $25 million in 2011. Subsequent to year end, $50 million of the $75 million expiring in 2009 was extended to January 2010. All other lines of credit are expected to be renewed upon expiration.

Due to the 2005 conversion to ownership accounting for its 78 percent equity ownership in the Craig Generating Station Unit 3 lease ("Craig 3 lease"), the Association recorded 78 percent of the Moffat County pollution control revenue bonds as the Association's debt in 2005. During 2006, the Association acquired the remaining 22 percent equity ownership in the lease, thereby giving it a 100 percent equity ownership. Therefore, 100 percent of the Moffat County pollution control revenue bonds was recorded as the Association's debt at December 31, 2006. In May 2007, the Association and other parties to the Craig 3 lease agreed to terminate the lease structure. This resulted in the Association obtaining direct ownership of Craig 3 and the assumption of the Moffat County pollution control revenue bonds. The bonds are shown in the debt table above as Moffat County, CO Weekly Adjustable Rate Series 1984 with balances at December 31, 2008 and 2007 of $46.8 and $67.1 million, respectively. The bonds mature in 2010 and bear interest at a variable rate, adjusted weekly. During 2008, the average interest rate on this issue was 5.79 percent. The guarantee of the payment of principal and interest on these bonds is provided by a combination of bond insurance provided by AMBAC Indemnity Corporation ("AMBAC") and a liquidity facility with JPMorgan Chase Bank. The liquidity facility is scheduled to expire July 2010 which coincides with the expiration of the bonds.

During 2008, the credit ratings of AMBAC were downgraded due to ongoing problems in the subprime mortgage market. This rating action resulted in an increase in the interest rates paid by the Association on the Moffat County bonds. Liquidation or bankruptcy of AMBAC would have resulted in an event of default on the bonds. This event could also have resulted in potential cross defaults under other loan agreements. In addition, should AMBAC's ratings have been lowered below investment grade by Standard & Poor's and by Moody's and the Association was unable to replace AMBAC, the liquidity facility could have been terminated. In order to eliminate the impact of the increased interest rates and the potential cross defaults, as an interim step, the Association elected to purchase back the bonds during 2008 as they were tendered on the market and at December 31, 2008 held bonds totaling $20.9 million. The Association evaluated the replacement of AMBAC under the current structure, but AMBAC would not terminate the insurance policy without 100% bondholders' consent. To avoid a potential event of default due to AMBAC's financial situation, the Association decided to redeem and reissue the Moffat County bonds. This was finalized when the Association issued the $46.8 million Moffat County, Colorado, Variable Rate Demand Pollution Control Revenue Refunding Bonds, Series 2009 with a direct pay letter of credit provided by Bank of America, N.A. on February 4, 2009 and the Association redeemed the Moffat County, CO Weekly Adjustable Rate Series 1984 bonds in the amount of $46.8 million on February 19, 2009. Redemption of the bonds resulted in the Association receiving $20.9 million for the redeemed bonds it held as of the redemption date. The letter of credit from Bank of America, N.A. will expire on February 3, 2010 unless renewed or extended.

At December 31, 2008, the Association had FFB commitments to advance additional construction funds of $217 million.

Annual maturities of long-term debt at December 31, 2008 are as follows (thousands):

2009	$ 135,044
2010	115,866
2011	111,585
2012	134,305
2013	112,358
Thereafter	1,098,364
	$1,707,522

Notes to Consolidated Financial Statements

Note 5—Fair Values of Financial Instruments

Certain methods and assumptions were used by the Association in estimating its fair value disclosure. The fair values of long-term debt were estimated using discounted cash flow analyses based on the Association's current incremental borrowing rates for similar types of borrowing arrangements. Fair values of marketable securities are presented in Note 2. The carrying amounts and fair values of the Association's long-term debt are as follows (thousands):

	2008		2007	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
RUS	$ 21,165	$ 22,204	$ 27,036	$ 27,373
FFB	1,173,726	1,491,566	1,180,997	1,293,962
CFC	204,230	240,589	219,025	233,908
Pollution control revenue bonds	138,424	131,712	162,700	149,562
Credit Facility	102,200	123,647	78,000	83,178
Grantor Trust Obligations	32,660	32,883	34,840	32,402
CoBank, ACB	91,553	109,072	95,089	89,853
Other	1,536	1,325	1,582	1,117
	1,765,494	2,152,998	1,799,269	1,911,355
Less: Advance payments to RUS	(57,972)	(57,972)	(32,677)	(32,677)
Funds on deposit with trustees	(685)	(685)	(699)	(699)
	$1,706,837	$2,094,341	$1,765,893	$1,877,979

Note 6—Income Taxes

Under the liability method, deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and for income tax purposes. Components of the Association's net deferred tax liability are as follows (thousands):

	2008	2007
Deferred tax benefits		
Safe harbor lease receivables	$ 47,597	$ 48,730
Net operating loss carryforwards	5,403	9,298
Deferred debt charges	5,992	7,042
Deferred revenues	13,396	9,633
Interchange	1,169	1,443
Other	17,118	14,827
	90,675	90,973
Deferred tax liabilities		
Asset basis differences including safe harbor assets	74,278	80,232
Depreciation	20,527	21,247
Capital credits from other associations	21,620	16,831
	116,425	118,310
Net deferred tax liability	$ (25,750)	$ (27,337)

The $1.5 million decrease in the net deferred tax liability from $27.3 million at December 31, 2007 to $25.8 million at December 31, 2008 is not recognized as a tax benefit in 2008 due to the Association's regulatory accounting treatment of deferred taxes. Instead, the tax benefit is deferred and reflected as a decrease in the regulatory asset established for deferred income tax expense. This regulatory asset account therefore has a $25.8 and $27.3 million balance for deferred income tax expense at December 31, 2008 and 2007, respectively. The accounting for regulatory assets is discussed further in Accounting for Rate Regulation.

At December 31, 2008, the Association had net operating loss carryforwards of $14.3 million, which, if not utilized, will expire between 2022 and 2026. The future reversal of existing temporary differences will more-likely-than-not enable realization of the net operating loss carryforwards.

The income tax expense for 2008, 2007 and 2006 was $2.0 million, $2.2 million, and $0, respectively. Included in other deferred tax benefits at December 31, 2008, the Association had $6.2 million of alternative minimum tax credit carryforwards to offset future regular taxes payable.

Note 7—Leases

Springerville Generating Station Unit 3:

In October 2003, the Association entered into a series of agreements to develop a 418-megawatt, coal-fired generating facility near Springerville, Arizona, called Springerville Generating Station Unit 3. In accordance with the agreements, the Association acted as the construction agent, for the benefit of the owner lessor, to oversee the construction of the Springerville project. Construction was completed and the lease commenced on July 28, 2006. Pursuant to the Facility Lease Agreement, the Association is committed to lease the facility for 34 years.

Construction funding for the Springerville project was acquired solely by the owner lessor. The two primary sources of these construction proceeds were the issuance of a $760 million bond issue and the infusion of owner equity. The bond proceeds are comprised of two series which were issued October 21, 2003. The first issue was in the amount of $355 million with a coupon rate of 6.04 percent and will amortize over a period maturing on January 31, 2018. The second issue was in the amount of $405 million with a coupon rate of 7.144 percent and will amortize over a period maturing on July 31, 2033. During construction, unused bond funds were invested under the direction of the Association, acting as construction agent, to offset accumulated interest charges associated with each of the issues.

Equity proceeds were also drawn during the construction period. Each equity draw represented not less than 10 percent of the amount of total construction funds necessary at the time of the individual draw. Cumulative equity draws bore an effective interest rate of approximately 7.30 percent during construction. The total equity funds drawn for project completion were $176 million.

The Association is committed to make semiannual lease payments for the 34-year lease term extending through July 2040. The semiannual lease payments are fundamentally comprised of amounts equal to the long and short-term bond commitments as well as the repayment of equity funds to the owner lessor. In turn, the owner lessor is obliged to pay principal and interest on the issued bonds with the lease payment proceeds received from the Association. The Association's operating lease commitments for Springerville Unit 3 at December 31, 2008 are as follows (thousands):

2009	$ 70,345
2010	70,345
2011	70,345
2012	70,345
2013	70,345
Thereafter	1,321,479
	$1,673,204

Lease expense for the Springerville Unit 3 operating lease is recorded on a straight-line basis over the term of the lease based on total scheduled lease payments to be paid over the life of the lease. Amounts paid in excess of or below recorded lease expense are recorded as prepaid lease expense and are recognized as lease expense over the remaining term of the lease. The Association incurred lease expense of $55.9 million in 2008 and 2007. The prepaid lease expense balance as of December 31, 2008 and 2007 is $90.2 and $75.7 million, respectively.

In the 29th year of the lease and at the end of the 34-year lease term, the Association will have an option to acquire the leased facility for a fair market value price determined in October 2003 as of each of those dates. Alternatively, at the end of the 34-year lease term, the Association will have an option to renew the lease for a term of up to 42 months and a second option to extend the lease for an additional term of up to 54 months.

The owner lessor qualifies as the owner of the facility and the lease qualifies as an operating lease. The lease is therefore accounted for as an operating lease by the Association and the costs of construction of the facility are recorded as assets of the owner lessor and not of the Association. The owner lessor is a variable interest entity but the Association is not the primary beneficiary of the owner lessor. Therefore, the Association does not consolidate the assets, liabilities and results of operations of the owner lessor in the Association's consolidated financial statements.

In accordance with the Facility Lease Agreement and other related agreements, the Association has provided guarantees to the owner lessor for certain events. These include guarantees that, as of the lease commencement date, the Association retain its investment grade credit ratings from the rating agencies and that there have been no changes in the lease accounting rules, income tax law, regulatory law or other applicable law that would have a detrimental impact on the assumed consequences to the owner lessor of entering into the Facility Lease Agreement. In addition, the Association has provided guarantees to the owner lessor that extend through the term of the lease. These include customary general and tax indemnities as well as protection for the owner lessor against changes in regulatory law that would have a detrimental impact on the lease assumptions. These guarantees are within the scope of FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, which requires that a liability be recorded by the guarantor equal to the fair value of the guarantees provided. This liability is intended to represent the cost of a premium that would be required by a guarantor to issue the same guarantee in a standalone arm's-length transaction with an unrelated party. In the absence of observable transactions for identical or similar guarantees (as was the case with this lease), the liability is determined using expected present value measurement techniques. Using these measurement techniques, the Association originally estimated the expected present value of the guarantees to be approximately $14.5 million. The $14.5 million lease guarantee liability was recorded as of October 2003 in deferred credits and other liabilities and an offsetting $14.5 million lease guarantee asset was recorded and was being expensed over the estimated term of the guarantees. As of the July 28, 2006 lease commencement date, the total expense recorded for the guarantees was $10.1 million. Since no guaranteed events had occurred as of the July 28, 2006 lease commencement date, the lease guarantee liability and the lease guarantee asset were adjusted based upon the same measurement techniques previously used. The Association estimated the expected present value of the lease term guarantees to be approximately $1.0 million for the guarantees that extend through the term of the lease. The $1.0 million lease term guarantee liability was recorded as of July 2006 in deferred credits and other liabilities and an offsetting $1.0 million lease guarantee asset was recorded and is being expensed over the 34-year lease term beginning July 28, 2006. The maximum potential amount of possible payments under these guarantees is estimated to be $798 million. During 2008, 2007 and 2006, an expense (credit) of $28,000, $28,000 and $(8.2) million, respectively, was included in other deductions (credits). The balance of the lease guarantee asset of $891,000 and $919,000 at December 31, 2008 and 2007, respectively, is included in other noncurrent assets.

Generating Stations With Gas Tolling Arrangements:

Beginning in 2008, the Association entered into power purchase arrangements that are required to be accounted for as operating leases since the arrangements are in substance leases because they convey to the Association the right to use power generating equipment for a stated period of time. Such an agreement began in June 2008 for the use of the Rawhide Generating Station (owned by Platte River Power Authority). This agreement allows the Association to toll natural gas for 100 megawatts of power from the combustion turbines beginning in 2008 that declines to 50 megawatts in 2012. Additionally, the Association has 10-year agreements with Thermo Cogeneration Partnership to toll natural gas at the Ft. Lupton Generating Station for 150 megawatts effective July 1, 2009 and with Brush Cogeneration Partners to toll natural gas at the Brush Generating Station for 72 megawatts effective October 1, 2009. Under these agreements, the Association directs the use of the contracted generating equipment over the terms of the contracts under tolling arrangements whereby the Association provides its own natural gas for generation of electricity. These agreements are therefore in substance leases and are accounted for as operating leases. The Association's operating lease commitments for these gas tolling arrangements at December 31, 2008 are as follows (thousands):

2009	$ 12,359
2010	20,052
2011	19,210
2012	16,865
2013	15,686
Thereafter	94,338
	$178,510

Craig Generating Station Unit 3:

The Association was the lessee under five individual lease agreements of Craig Generating Station Unit 3 with a lease term through 2018. All the costs of operating and maintaining the facilities were the responsibility of the Association.

The lessors were obliged to pay the principal and interest on non-recourse debt from the proceeds of the lease payments made by the Association. Semiannual lease payments made by the Association were for an amount at least equal to the non-recourse debt service payments. Lease payments in excess of the debt payments were distributed to the lessors as equity proceeds. The non-recourse debt associated with this lease consisted of pollution control revenue bonds that were issued by Moffat County, Colorado to finance costs of certain pollution control equipment installed at Craig 3.

Beginning in 2002, the Association began acquiring the equity ownership interests in the five separate leases. As of December 31, 2005, the Association had acquired 78 percent of the equity ownership interests in three of the five separate leases that make up the Craig 3 lease and the Association had no ownership in the other two leases. During 2006, the Association acquired the remaining 22 percent of the equity ownership interests in two separate transactions (20 percent in January and 2 percent in October). Therefore, as of December 31, 2006, the Association had acquired 100 percent of the equity ownership interests in the Craig 3 lease.

The high levels of equity ownership in the lease put the Association in an economic position that was virtually equivalent to direct ownership of Craig 3. For this reason, effective January 1, 2005, the accounting for the 78 percent equity ownership in the Craig 3 lease was converted to a direct ownership of 78 percent of Craig 3. This ownership accounting resulted in the Association recording 78 percent, $79.6 million, of the Moffat County pollution control revenue bonds as the Association's debt which thereby increased the cost of the electric plant cost relating to Craig 3 by the same amount. The purchases of the equity ownership interests had been recorded in electric plant in the year of each of the acquisitions. In 2006, the Association acquired the remaining 22 percent of the equity ownership interests and accounted for these ownership interests consistent with 2005. Therefore, the Association recorded the remaining 22 percent, $20.5 million, of the Moffat County pollution control revenue bonds as the Association's debt. The electric plant cost relating to this 22 percent of Craig 3 was increased in 2006 by the total of the purchase prices for the 22 percent interests, and by the $20.5 million increase in the recorded Moffat County pollution control revenue bond debt. The electric plant costs are being depreciated over the life of the plant.

The conversion to ownership accounting at January 1, 2005 essentially terminated the lease accounting for the 78 percent portion accounted for as owned property. As of the termination of 78 percent of the lease, the Association would ordinarily have been required to recognize 78 percent of the prepaid lease expense balance, $62.9 million, as an expense in 2005. The use of ownership accounting for the additional 22 percent ownership acquired in 2006 essentially terminated the remaining 22 percent of the lease. The Association would ordinarily have been required to recognize 22 percent of the prepaid lease balance, $22.5 million, as an expense in 2006. However, the current recognition of the prepaid lease expense in both 2005 and 2006 was deferred under SFAS No. 71, *Accounting for Certain Types of Regulation*, and the amount of the deferrals is accounted for as a regulatory asset. The regulatory asset for the deferred prepaid lease expense is being amortized into expense each year beginning January 1, 2005 for the 78 percent portion, and beginning in 2006 for the 22 percent portion, through the remaining original life of the lease ending in 2018. In 2008, 2007 and 2006, prepaid lease amortization expense of $6.5, $6.5 and $6.3 million, respectively, is included in depreciation and amortization.

Lease expense for the portions of the Craig 3 lease for which no equity ownership interests were owned (22 percent in 2005 and 2 percent from January to October 2006) has been recorded on a straight-line basis over the term of the lease based on total scheduled lease payments to be paid over the life of the lease. Amounts paid in excess of or below recorded lease expense were recorded as prepaid lease expense and were recognized as lease expense over the remaining term of the lease or non-recourse debt, as applicable. The Craig 3 lease expense for 2008, 2007 and 2006 was $0, $0 and $0.5 million, respectively.

In May 2007, the Association and other parties to the Craig 3 lease terminated the lease structure. Upon termination the Association obtained direct ownership of Craig 3 and assumed the Moffat County pollution control bonds. This direct ownership and debt assumption did not result in any changes from the ownership accounting that was already in effect. The bonds are described further in Note 4 where they are shown in the debt table as Moffat County, CO Weekly Adjustable Rate Series 1984. In February 2009, the Moffat County, CO Weekly Adjustable Rate Series 1984 bonds were redeemed and reissued as the $46.8 million Moffat County, Colorado, Variable Rate Demand Pollution Control Revenue Bonds, Series 2009.

Note 8—Related Parties

Yampa Project:

The Association acts as the operating agent for participants of the Yampa Project and related common facilities.

Basin Electric Power Cooperative ("BEPC"):

BEPC is a wholesale power supply cooperative of which the Association is a member. The Association purchased power from BEPC at a cost of $65.5, $57.8 and $61.8 million in 2008, 2007 and 2006, respectively. The Association's investment in BEPC was $52.6 and $42.1 million at December 31, 2008 and 2007, respectively, and is included in investments in other associations. The Association's share of BEPC capital credit allocations was $13.4, $1.2 and $3.5 million in 2008, 2007 and 2006, respectively, and is included in capital credits from cooperatives.

National Rural Utilities Cooperative Finance Corporation:

Investments in other associations included a $45.7 and $46.8 million investment in CFC as of December 31, 2008 and 2007, respectively. At December 31, 2008 and 2007, the total outstanding debt owed to CFC was $204 and $219 million, respectively. The Association's share of CFC capital credit allocations for 2008, 2007 and 2006 was $1.9, $2.0 and $2.2 million, respectively, and is included in capital credits from cooperatives.

Trapper Mining:

The Association and certain participants in the Yampa Project own Trapper Mining. Organized as a cooperative, Trapper Mining is the Yampa Project's primary coal supplier. The Association's membership interest in Trapper Mining of $8.7 and $6.8 million at December 31, 2008 and 2007, respectively, is accounted for as an investment in coal mines. The Association's share of coal purchases from Trapper Mining was $15.2, $13.6 and $12.3 million in 2008, 2007 and 2006, respectively. The Association's investment in Trapper Mining is recorded using the equity method. In 2008, 2007 and 2006, gains (loss) of $1.9 million, $(27,000) and $179,000, respectively, are included in capital credits from cooperatives.

Western Fuels Association:

WFA is a non-profit membership corporation organized for the purpose of acquiring and supplying fuel resources to its members, which include the Association and BEPC. WFA supplies fuel to MBPP through contracts with coal companies and through its ownership in Western Fuels-Wyoming, which owns and operates the Dry Fork Mine. The Association also receives coal supplies directly from WFA for the Escalante Generating Station in New Mexico and spot coal for the Springerville Generating Station in Arizona. The Association's share of coal purchases from WFA was $73.5, $66.9 and $54.7 million in 2008, 2007 and 2006, respectively.

The Association advanced funds to WFA, through MBPP, for mine and equipment purchases and mine development costs. The fund advance balance of $5.2 and $6.3 million at December 31, 2008 and 2007, respectively, is included in investments in coal mines. The Association's membership interest in WFA, including interest through MBPP in WFA, totals $2.1 and $1.6 million at December 31, 2008 and 2007, respectively, and is included in investments in other associations. The Association's investment in WFA is recorded using the equity method. The 2008, 2007 and 2006 gains of $463,000, $673,000 and $27,000, respectively, are included in capital credits from cooperatives.

Note 9—Pension Plan

All employees of the Association participate in the National Rural Electric Cooperative Association Retirement and Security Program which is fully funded. The Association's contributions totaled $13.1, $11.9 and $10.7 million in 2008, 2007 and 2006, respectively. In this master multiemployer defined benefit plan, the accumulated benefits and plan assets are not identified separately by individual employer.

Note 10—Commitments and Contingencies

Sales:

The Association has delivery obligations under resource-contingent firm power sales contracts with PSCO totaling 225 megawatts in the summer season and 275 megawatts in the winter season. These contracts expire in 2011, 2016 and 2017. Also with PSCO, the output of the two gas turbines at Knutson Generating Station and one gas turbine at the Limon Generating Station has been sold under two contracts for a total of 210 megawatts in tolling capacity sales that expire in 2016. The tolling arrangements at Knutson and Limon are accounted for as operating leases and the lease revenues are reflected in other operating revenue on the statements of operations. The Limon turbine contract will be suspended for a period of four years beginning in 2009 and the Knutson turbine contract will be suspended for a period of three years beginning in 2010 to allow the Association to utilize the output of the turbines. Both turbine contracts resume with PSCO under the original tolling arrangements for the period May 1, 2013 to April 30, 2016.

In addition, the Association has (1) a resource-contingent firm power sales contract of 100 megawatts to Salt River Project through August 31, 2036, (2) a firm power sales contract of 50 MW to Public Service Company of New Mexico through June 30, 2010, (3) a firm power sales contract committing up to 13 megawatts to BEPC through 2025, (4) a resource-contingent firm power sales contract with PacifiCorp committing 35 megawatts in 2008 and 2009, 30 megawatts in 2010, and 25 megawatts from 2011 through 2020, (5) a resource-contingent firm power sales contract with Shell Energy North America of 50 megawatts through September 30, 2014 and (6) a resource-contingent tolling power sales contract with Shell Energy North America of 40 megawatts from the Pyramid Generating Station through September 30, 2014. The tolling contract at Pyramid is accounted for as an operating lease and the lease revenue is reflected in other operating revenue on the statements of operations.

Purchase Requirements:

The Association is committed to purchase coal for its generating plants under long-term contracts that expire between 2014 and 2034. These contracts require the Association to purchase a minimum quantity of coal at prices that are subject to escalation clauses that reflect cost increases incurred by the suppliers and market conditions. The projection of contractually committed purchases are based upon estimated prices. At December 31, 2008, the annual minimum coal purchases under these contracts are as follows (thousands):

2009	$ 120,225
2010	120,225
2011	120,225
2012	120,788
2013	120,788
Thereafter	411,548
	$1,013,799

Notes to Consolidated Financial Statements

Indemnities:

The Association agreed to indemnify certain lessors and purchasers of the tax benefits under the safe harbor leases (see Note 2) should certain disqualifying events occur, the most significant being the failure of the Association to maintain its status as a taxable entity. Certain other safe harbor leases, not acquired by the Association, also contain indemnity responsibilities that were assumed in 1992. Should a disqualifying event occur related to 2008 or prior, specified payments must be made to the lessors and purchasers of $17.1 million, decreasing ratably through expiration in 2024.

Environmental:

The Association's electric generation facilities are subject to various operating permits and must operate within guidelines imposed by numerous environmental regulations. The Association believes these facilities are currently in compliance with such regulatory and operating permit requirements.

Deregulation:

The operating environment of the electric utility industry is moving toward partially regulated competition with the passage of the 1992 Energy Policy Act and Federal Energy Regulatory Commission Orders 888 and 889 that deregulate sales among power resellers. As a result, end-user deregulation was left to the states, and the Association is actively monitoring proposed legislation. The effects of potential legislation on the financial position or results of operations of the Association are not known at this time.

Legal:

Southwest Tire Processors, Inc. ("Southwest"), v. Socorro Electric Cooperative, Inc. ("Socorro") and Tri-State Generation and Transmission Association, Inc.: Southwest filed suit in November 2001 alleging that the Association and Socorro were negligent in the maintenance and operation of their electric lines and that the negligence resulted in a fire at the Southwest tire disposal site. The Association's insurance carrier is providing defense. In January 2005, the carrier notified the Association that it was reserving its right to assert that its policy did not cover damages related to the discharge of pollutants that may have occurred during the fire. In 2008, settlements of the litigation and coverage issue were reached and no additional losses were recorded since the losses had previously been accrued.

Tri-State/Member System Consolidated Financial Data

(Unaudited)

(Thousands)	Total Assets	Equity	Net Margins	Equity as % of Assets
2008				
Members	$2,934,692	$1,302,436	$ 138,924	44.4
Tri-State	2,511,249	557,488	106,449	22.2
Less eliminations	(640,569)	(557,488)	(106,449)	
System consolidation	$4,805,372	$1,302,436	$ 138,924	27.1
2007	4,630,006	1,200,219	143,862	25.9
2006	4,447,066	1,086,235	92,798	24.4
2005	4,059,780	1,013,756	80,380	25.0
2004	3,905,503	952,805	85,177	24.4

Members Only (Thousands)	2008	2007	2006	2005	2004
Revenues	$1,290,934	$1,148,722	$1,022,645	$ 934,487	$ 835,908
Operating margins	36,664	37,914	36,167	30,412	34,082
Net margins	138,924	143,862	92,798	80,380	85,177
Plant in service (net)	1,958,336	1,840,024	1,727,015	1,618,446	1,530,132
Total assets	2,934,692	2,729,313	2,511,866	2,329,162	2,190,160
Long-term debt	1,275,200	1,201,665	1,145,829	1,070,520	1,008,013
Equity	1,302,436	1,200,219	1,086,235	1,013,756	952,805
Equity as a % of assets	44.4	44.0	43.2	43.5	43.5
Average retail rate (mills/kWh)	95.9	89.8	82.4	79.8	73.5
Times Interest Earned Ratio	3.12	3.28	2.59	2.53	2.86
Debt Service Coverage Ratio	2.54	2.51	2.28	1.92	2.36

Source: 2008 Members' Form 7s.

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TRI-STATE

Generation and Transmission
Association, Inc.

A Touchstone Energy® Cooperative