

**KGEN POWER CORPORATION**

**Report to Shareholders**

**for**

**Quarter Ended September 30, 2010**

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Investor Relations  
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**PART I—FINANCIAL INFORMATION**

**Number 1. Unaudited Condensed Consolidated Financial Statements and Notes**

**KGen Power Corporation**

**Condensed Consolidated Balance Sheets**

**(in thousands, except per share amounts)**

**(unaudited)**

	<u>September 30,</u> <u>2010</u>	<u>June 30,</u> <u>2010</u>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 139,028	\$ 48,177
Restricted cash and cash equivalents .....	5,616	7,167
Accounts receivable.....	21,274	26,329
Spare parts inventories.....	8,117	8,009
Prepaid expenses and other current assets .....	1,606	1,947
Assets held for sale .....	—	63,580
Total current assets .....	<u>175,641</u>	<u>155,209</u>
Property, plant, and equipment .....	637,718	637,344
Less: accumulated depreciation .....	<u>79,371</u>	<u>73,819</u>
Net property, plant, and equipment .....	558,347	563,525
Contract-based intangibles (net of \$38,818 and \$36,154 of accumulated amortization, respectively) .....	44,724	47,388
Deferred charge .....	2,127	2,575
Deferred financing fees (net of \$3,256 and \$3,032 of accumulated amortization, respectively) .....	3,008	3,232
Other noncurrent assets .....	325	325
Total assets .....	<u>\$ 784,172</u>	<u>\$ 772,254</u>
<b>Liabilities and stockholders' equity</b>		
Current liabilities:		
Accounts payable and accrued liabilities .....	\$ 17,640	\$ 20,983
Current portion of long-term debt.....	1,393	2,000
Liabilities associated with assets held for sale.....	—	784
Total current liabilities.....	<u>19,033</u>	<u>23,767</u>
Long-term debt .....	132,714	201,000
Contract-based intangibles (net of \$5,362 and \$5,039 of accumulated amortization, respectively) .....	14,806	15,129
Other noncurrent liabilities .....	2,473	2,717
Commitments and contingencies (Note 6)		
Stockholders' equity:		
Common stock (par value \$.01; 150,000 shares authorized; 55,983 and 55,974 shares issued and outstanding at September 30, 2010 and June 30, 2010, respectively).....	560	560
Additional paid in capital.....	742,872	742,477
Accumulated deficit.....	<u>(128,286)</u>	<u>(213,396)</u>
Total stockholders' equity .....	<u>615,146</u>	<u>529,641</u>
Total liabilities and stockholders' equity.....	<u>\$ 784,172</u>	<u>\$ 772,254</u>

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

**KGen Power Corporation**  
**Condensed Consolidated Statements of Operations**

(in thousands, except per share amounts)

(unaudited)

	For the Three Months Ended September 30, 2010	For the Three Months Ended September 30, 2009
<b>Revenues:</b>		
Energy sales .....	\$ 100,229	\$ 61,859
Capacity sales.....	<u>29,090</u>	<u>26,529</u>
Total revenues .....	<u>129,319</u>	<u>88,388</u>
<b>Operating expenses:</b>		
Cost of fuel.....	80,787	48,995
Operating and maintenance .....	6,900	4,022
Gas transportation .....	5,568	4,786
Selling, general, and administrative .....	3,293	2,965
Depreciation.....	5,552	6,125
Auxiliary power .....	2,577	2,290
Insurance .....	<u>735</u>	<u>925</u>
Total operating expenses.....	<u>105,412</u>	<u>70,108</u>
<b>Operating income</b> .....	<b>23,907</b>	<b>18,280</b>
<b>Other income (expenses):</b>		
Net gain on sale of assets .....	64,980	—
Interest expense.....	(2,786)	(3,599)
Taxes, other than income taxes .....	(952)	(999)
Other .....	<u>(39)</u>	<u>(69)</u>
Total other income (expenses) .....	<u>61,203</u>	<u>(4,667)</u>
<b>Net income before taxes</b> .....	<b>85,110</b>	<b>13,613</b>
Income tax expense.....	—	—
<b>Net income after taxes</b> .....	<u><b>\$ 85,110</b></u>	<u><b>\$ 13,613</b></u>
Net earnings per share—basic and diluted .....	<u>\$ 1.52</u>	<u>\$ 0.24</u>
Weighted average shares outstanding—basic .....	55,976	55,968
Weighted average shares outstanding—diluted .....	56,033	55,974

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

**KGen Power Corporation**  
**Condensed Consolidated Statements of Cash Flows**

(in thousands)

(unaudited)

	<u>For the Three Months Ended September 30, 2010</u>	<u>For the Three Months Ended September 30, 2009</u>
<b>Cash flows from operating activities</b>		
Net income .....	\$ 85,110	\$ 13,613
Adjustments to reconcile net income to net cash used in operating activities:		
Net gain on sale of assets .....	(64,980)	—
Depreciation .....	5,552	6,125
Amortization of deferred financing fees .....	224	223
Amortization of contract-based intangibles .....	2,341	2,328
Valuation of derivative instruments .....	902	1,584
Stock-based compensation .....	395	375
Payments from settlement of derivative instruments .....	(1,195)	(1,591)
Changes in operating assets and liabilities:		
Accounts receivable .....	5,055	9,307
Spare parts inventories .....	(108)	(1,165)
Prepaid expenses and other current assets .....	341	1,157
Deferred charge .....	448	(8)
Accounts payable and accrued liabilities .....	(3,143)	(6,745)
Other noncurrent liabilities .....	(2)	(1)
Net cash provided by operating activities .....	<u>30,940</u>	<u>25,202</u>
<b>Cash flows from investing activities</b>		
Purchases of property, plant, and equipment .....	(523)	(159)
Sale of assets .....	127,776	—
Use of restricted cash and cash equivalents .....	1,551	—
Net cash provided by (used in) investing activities .....	<u>128,804</u>	<u>(159)</u>
<b>Cash flows from financing activity</b>		
Repayment of debt .....	(68,893)	(500)
Net cash used in financing activity .....	<u>(68,893)</u>	<u>(500)</u>
Increase in cash and cash equivalents .....	90,851	24,543
Cash and cash equivalents at beginning of period .....	48,177	40,663
Cash and cash equivalents at end of period .....	<u>\$ 139,028</u>	<u>\$ 65,206</u>
<b>Cash paid for</b>		
Interest .....	\$ 1,661	\$ 1,810
<b>Noncash transactions</b>		
Accounts payable related to purchases of property, plant, and equipment .....	\$ 150	\$ —

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

## KGen Power Corporation

### Notes to Unaudited Condensed Consolidated Financial Statements

#### 1. Nature of Business and Significant Accounting Policies

*Operations*—KGen Power Corporation (the “Company”) was incorporated in Delaware on December 4, 2006, which is the date of its inception. The Company owns and operates electric power generation plants and sells electricity and electrical generation capacity in the United States to wholesale purchasers such as retail electric providers, power trading organizations, municipal utilities, electric power cooperatives, and other power generation companies. As of September 30, 2010, the Company’s portfolio of facilities consisted of four operational and fully permitted combined-cycle power plants (Murray I, Murray II, Hot Spring, and Hinds), or (the “Plants”), located in the southeastern United States with gas turbines having an aggregate capacity of 2,390 megawatts (“MW”). On July 9, 2010, the Company completed the sale of its Sandersville power plant, a 640 MW simple-cycle plant (See Note 12). The Plants were acquired from an affiliate of MatlinPatterson Global Advisors LLC on February 8, 2007.

*Interim Financial Statements*—The accompanying condensed consolidated financial statements have been prepared in accordance with the regulations regarding interim financial reporting. Certain information and footnote disclosures normally included in the financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) have been condensed or omitted. In the opinion of management, all adjustments (consisting of normal recurring accruals, except as noted in Note 6—Commitments and Contingencies) considered necessary for a fair presentation have been included. The balance sheet as of June 30, 2010 is derived from the June 30, 2010 audited consolidated financial statements. These condensed consolidated financial statements included should be read in conjunction with the Consolidated Financial Statements and Notes included in the Company’s Annual Report for the year ended June 30, 2010.

*Use of Estimates*—The preparation of the condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Such estimates include the fair value of acquired assets, estimated asset lives, recovery of investments in long-lived assets, utilization of deferred tax assets, and fair value determination of financial instruments and share-based compensation. Actual results could differ from these estimates.

*Principles of Consolidation*—The condensed consolidated financial statements include the accounts of the Company and those of KGen Partners LLC, KGen Power Management Inc., KGen LLC, KGen Murray LLC, KGen Murray I and II LLC, KGen Hot Spring LLC, KGen Hinds LLC, and KGen Acquisition I LLC, all direct or indirect 100% owned subsidiaries of the Company as of September 30, 2010, as well as any variable interest entities for which the Company is the primary beneficiary. All significant intercompany balances and transactions have been eliminated in consolidation.

*Effects of Seasonality*—The electric power industry is highly seasonal. In the summer months, especially in the southeastern United States, demand for electricity is usually much higher as a result of increased use of air conditioning. The Company’s results of operations are subject to seasonal variations since demand for electricity, and thus production varies with weather conditions. Three of the plants operate, and historically the Sandersville power plant operated, on a merchant basis without long-term purchase agreements, and therefore are exposed to significant volatility in prices and generation demand. The Company earns the majority of its annual revenues in the five summer months, May through September. The shoulder periods, months other than the peak summer months, historically have not been profitable for the Company and are typically the months during which the Company seeks to perform scheduled maintenance-related activities.

## KGen Power Corporation

### Notes to Unaudited Condensed Consolidated Financial Statements

#### 1. Nature of Business and Significant Accounting Policies (Continued)

*Fair Value of Financial Instruments*—The Company’s financial instruments consist primarily of cash and cash equivalents, restricted cash and cash equivalents, accounts receivable, accounts payable, debt instruments, and interest rate derivatives. The carrying values of the cash and cash equivalents, restricted cash and cash equivalents, accounts receivable, and accounts payable are representative of their respective fair value due to the short-term nature of these instruments. The carrying value of interest rate derivative instruments represents the fair value, which is based on estimates using standard pricing models that take into account the present value of future cash flows as of the condensed consolidated balance sheet date. Based on the borrowing rates currently available to the Company for bank loans with similar terms and average maturities, the fair value of term debt was \$129.6 million and \$184.7 million at September 30, 2010 and June 30, 2010, respectively.

#### 2. Property, Plant, and Equipment

Property, plant, and equipment consists of the following (in thousands of dollars):

	Estimated Useful Life	September 30, 2010	June 30, 2010
Land .....	—	\$ 3,312	\$ 3,312
Buildings .....	40 years	26,394	26,382
Gas and steam turbines.....	30 years	181,974	181,733
Steam generators and auxiliaries.....	30 years	48,959	48,959
Transmission and fuel gas pipelines.....	30 years	51,038	51,038
Systems and equipment.....	5-30 years	120,296	120,210
Other plant.....	3-30 years	205,745	205,710
Total property, plant, and equipment .....		637,718	637,344
Less: accumulated depreciation .....		79,371	73,819
Net property, plant, and equipment .....		\$ 558,347	\$ 563,525

## KGen Power Corporation

### Notes to Unaudited Condensed Consolidated Financial Statements

#### 3. Contract-Based Intangibles

Contract-based intangibles consist of the following (in thousands of dollars):

	<u>Term</u>	<u>Original Cost</u>	<u>Accumulated Amortization</u>	<u>September 30, 2010</u>
<b>Assets</b>				
Murray I Georgia Power contract .....	May 31, 2012	\$ 43,265	\$(29,551)	\$ 13,714
Murray firm transportation contracts ..	Various	40,277	(9,267)	31,010
Total assets .....		<u>\$ 83,542</u>	<u>\$(38,818)</u>	<u>\$ 44,724</u>

#### Liabilities

Hinds firm transportation contract .....	March 31, 2010	\$ 669	\$ (669)	\$ —
Murray firm transportation contract ..	November 30, 2016	638	(238)	400
Hot Spring firm transportation contracts .....	Various	18,861	(4,455)	14,406
Total liabilities .....		<u>\$ 20,168</u>	<u>\$(5,362)</u>	<u>\$ 14,806</u>

	<u>Term</u>	<u>Original Cost</u>	<u>Accumulated Amortization</u>	<u>June 30, 2010</u>
<b>Assets</b>				
Murray I Georgia Power contract .....	May 31, 2012	\$ 43,265	\$(27,523)	\$ 15,742
Murray firm transportation contracts ..	Various	40,277	(8,631)	31,646
Total assets .....		<u>\$ 83,542</u>	<u>\$(36,154)</u>	<u>\$ 47,388</u>

#### Liabilities

Hinds firm transportation contract .....	March 31, 2010	\$ 669	\$ (669)	\$ —
Murray firm transportation contract ..	November 30, 2016	638	(222)	416
Hot Spring firm transportation contracts .....	Various	18,861	(4,148)	14,713
Total liabilities .....		<u>\$ 20,168</u>	<u>\$(5,039)</u>	<u>\$ 15,129</u>

For both the three months ended September 30, 2010 and 2009, amortization of contract-based power sales rights and obligations was \$2.0 million and was recorded as a reduction of energy sales on the condensed consolidated statements of operations. For both the three months ended September 30, 2010 and 2009, amortization of contract-based natural gas transportation rights and obligations was \$0.3 million and was recorded as an increase of gas transportation expenses on the condensed consolidated statements of operations.

#### 4. Long-Term Debt

Long-term debt is summarized as follows (in thousands of dollars):

	<u>Interest Rate</u>	<u>Maturity</u>	<u>September 30, 2010</u>	<u>June 30, 2010</u>
Term debt .....	Variable	February 8, 2014	\$ 134,107	\$ 193,000
Working capital facility .....	Variable	February 8, 2012	—	10,000
Total debt outstanding .....			134,107	203,000
Less: current portion .....			1,393	2,000
Total long-term debt .....			<u>\$ 132,714</u>	<u>\$ 201,000</u>



## KGen Power Corporation

### Notes to Unaudited Condensed Consolidated Financial Statements

#### 4. Long-Term Debt (Continued)

On February 8, 2007, KGen LLC, a wholly-owned subsidiary of the Company, entered into a credit agreement with Morgan Stanley (the "Credit Agreement") and related security deposit agreement (the "Security Deposit Agreement") with Union Bank, N.A., as collateral agent, and The Bank of New York, as depository agent, to provide term debt in the amount of \$200.0 million. The term debt bears interest at an adjusted rate based on the London Interbank Offered Rate ("LIBOR") plus 175 basis points, has a term of seven years, and required a \$2.0 million principal payment per year made in quarterly installments. KGen LLC's obligations and indebtedness under the Credit Agreement are secured by a security interest in all of the assets and all of the membership interests of KGen LLC and its subsidiaries. The interest rate on the term debt was 2.1% at both September 30, 2010 and June 30, 2010.

KGen LLC also entered into an \$80.0 million working capital facility for other liquidity needs and a \$120.0 million synthetic letter of credit facility to support the collateral requirements at the project level. The working capital facility charges a 200 basis point fee for outstanding letters of credit, bears interest at LIBOR plus 200 basis points for outstanding draws, and has a 50 basis point commitment fee for any unused portion. It has a five-year term expiring on February 8, 2012. KGen LLC pays a fee of 191 basis points on the \$120.0 million synthetic letter of credit facility. It has a seven-year term expiring on February 8, 2014. On March 20, 2009, KGen LLC drew \$10.0 million under the working capital facility. The proceeds of the drawdown were used for working capital purposes.

On August 18, 2010, the Company prepaid \$58.5 million of its outstanding term debt and \$10.0 million of its outstanding working capital facility using a portion of the proceeds received from the sale of 100% of the ownership interests in KGen Sandersville LLC, the entity that owned the Sandersville power generation facility (See Note 12). In connection with this prepayment, the Company reduced its principal payment requirement of \$2.0 million per year to \$1.4 million per year with quarterly installments beginning September 30, 2010. In addition, there were \$0.5 million of outstanding letters of credit issued under the working capital facility and \$14.4 million of outstanding letters of credit issued under the synthetic letter of credit facility that related to Sandersville and were cancelled following the sale of 100% of the ownership interests in KGen Sandersville LLC.

There were \$17.5 million and \$14.0 million of outstanding letters of credit issued under the working capital facility as of September 30, 2010 and June 30, 2010, respectively. At both September 30, 2010 and June 30, 2010, a letter of credit, supporting the power sales contract with GPC, in the amount of \$80.0 million was outstanding under the synthetic letter of credit facility. There were \$5.5 million and \$19.9 million of other outstanding letters of credit under the synthetic letter of credit facility as of September 30, 2010 and June 30, 2010, respectively.

The remaining future minimum principal payments under the term debt and the working capital facility subsequent to September 30, 2010 are as follows (in thousands of dollars):

2011.....	\$ 1,045
2012.....	1,393
2013.....	1,393
2014.....	130,275
Total .....	<u>\$ 134,107</u>

The Credit Agreement and related financing documents contain various affirmative and negative covenants, including (a) financial covenants, (b) limitations on KGen LLC's ability to pay dividends, (c) restrictions on the use of available cash for operations, except as required for debt service payments and (d) an event of default in the event of a change in control of KGen. At September 30, 2010, KGen LLC was in compliance with these covenants.

Under the terms of the Credit Agreement, KGen LLC is restricted from making dividend payments, loans or advances to the Company. These restrictions resulted in restricted net assets of the Company's subsidiaries exceeding 25% of the consolidated net assets of the Company and its subsidiaries. The amount of restricted net assets was \$556.9 million at September 30, 2010, of which \$99.1 million was restricted net current assets.

## **KGen Power Corporation**

### **Notes to Unaudited Condensed Consolidated Financial Statements**

#### **5. Restricted Cash and Cash Equivalents**

The Credit Agreement requires KGen LLC to maintain six months of principal and interest payments reserve in cash. At September 30, 2010 and June 30, 2010, the restricted balance, in accordance with this requirement, was \$4.3 million and \$4.7 million, respectively.

Additionally, the Security Deposit Agreement requires KGen LLC to reserve, on a quarterly basis, the amount of major maintenance expenditures expected to be incurred during the following 12 months. At September 30, 2010 and June 30, 2010, the restricted balance, in accordance with this requirement, was \$1.3 million and \$2.5 million, respectively.

#### **6. Commitments and Contingencies**

*Litigation*—The Company is party to various legal and regulatory actions arising in the normal course of business. Matters that are probable of unfavorable outcome to the Company and which can be reasonably estimated are accrued.

*Commitments*—The Company enters into long-term contractual arrangements for power purchases and capacity sales and to procure fuel and transportation services. There have not been significant changes to these commitments as discussed in Note 6—Commitments in the Notes to Consolidated Financial Statements contained in the Annual Report for the year ended June 30, 2010.

#### **7. Industrial Development Revenue Bonds**

This footnote should be read in conjunction with Note 7—Industrial Development Revenue Bonds of the Notes to the Consolidated Financial Statements contained in the Annual Report for the year ended June 30, 2010. Construction of the Hot Spring, Murray, and Sandersville facilities was financed by various development authorities through the issuance of Industrial Development Revenue Bonds (the “Bonds”).

Following the sale of 100% of the ownership interests in KGen Sandersville LLC, the entity that owns the Sandersville power generation facility (See Note 12), the Industrial Development Revenue Bond related to Sandersville was no longer held by the Company. At September 30, 2010, \$510.0 million of the Bonds remained outstanding related to the Hot Spring and Murray projects. At June 30, 2010, \$775.4 million of the Bonds remained outstanding related to the Hot Spring, Sandersville, and Murray projects.

#### **8. Derivatives**

The Company recognizes all derivatives as either assets or liabilities on the balance sheet and measures those instruments at fair value. The ongoing effects are dependent on future market conditions.

On May 4, 2007, KGen LLC entered into six interest rate swap agreements (“Swaps”) for the purpose of reducing exposure to interest rate fluctuations as required under Credit Agreement terms. Each of the six individual swap agreements has a notional amount of \$33.0 million and has a term that expires in each consecutive year, beginning on March 31, 2008 continuing through March 31, 2013. The average interest rate payable by KGen LLC was 5.0% at September 30, 2010.

The short-term portion of the Swaps as of both September 30, 2010 and June 30, 2010 was \$3.6 million and was recorded in accounts payable and accrued liabilities. The long-term portion of the Swaps as of September 30, 2010 and June 30, 2010 was \$2.5 million and \$2.7 million, respectively, and was recorded in other noncurrent liabilities.

## KGen Power Corporation

### Notes to Unaudited Condensed Consolidated Financial Statements

#### 8. Derivatives (Continued)

The Swaps are not accounted for utilizing hedge accounting; they are marked to market with gains and losses shown on the condensed consolidated statements of operations as follows (in thousands of dollars):

	Location of Gain (Loss) on Derivatives	Gain (Loss) on Derivatives
For the three months ended September 30, 2010 ....	Interest expense	\$ (902)
For the three months ended September 30, 2009 ....	Interest expense	\$(1,584)

The Company evaluated the requirements of FASB ASC 820, *Fair Value Measurement and Disclosures* (“FASB ASC 820”) and believes the Swaps are valued using Level 2 fair value measurements. Under FASB ASC 820, instruments valued using Level 2 measurements are valued based on either quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and/or model-based valuations whose inputs are observable or whose significant value drivers are observable.

The three levels of the fair value hierarchy are:

Level 1—Unadjusted quoted prices in active markets that are accessible at the measurement date for identical assets and liabilities;

Level 2—Pricing inputs include quoted prices for similar assets and liabilities in active markets and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument; and

Level 3—Prices or valuations that require inputs that are both significant to the fair value measurements and unobservable.

#### 9. Net Earnings per Share

Basic earnings per share is calculated by dividing net income by the weighted average number of shares of common stock outstanding during the period. For the three months ended September 30, 2010 and 2009, diluted earnings per share was calculated by adjusting the weighted average number of shares of common stock outstanding by the dilutive effect of incremental shares attributable to restricted stock awards in the amounts of 56,279 and 6,457 shares, respectively. There were no unexercised in-the-money stock options to purchase shares of common stock for the three months ended September 30, 2010 and 2009. Unexercised out-of-the-money stock options to purchase a weighted average of 796,297 shares and 2,495,224 shares of common stock for the three months ended September 30, 2010 and 2009, respectively, were not considered in the earnings per share calculation as the impact of such inclusion would have been anti-dilutive. Amounts shown below are in thousands, except per share amounts.

	For the Three Months Ended September 30, 2010	For the Three Months Ended September 30, 2010
<b>Numerator:</b>		
Net income .....	\$ 85,110	\$ 13,613
<b>Denominator:</b>		
Weighted average shares outstanding—basic .....	55,976	55,968
Weighted average shares outstanding—diluted .....	56,033	55,974
Net income per share—basic and diluted.....	\$ 1.52	\$ 0.24

## KGen Power Corporation

### Notes to Unaudited Condensed Consolidated Financial Statements

#### 10. Share-Based Payments

This footnote should be read in conjunction with Note 9—Share-Based Payments of the Notes to the Consolidated Financial Statements contained in the Annual Report for the year ended June 30, 2010.

The Company recorded compensation expense of zero and \$0.4 million for the three months ended September 30, 2010 and 2009, respectively, related to stock options outstanding. As of September 30, 2010, all options were vested and there was no unrecognized compensation expense remaining on the options. As of September 30, 2009, there was \$0.5 million of total unrecognized compensation expense related to unvested options. For the three months ended September 30, 2010 and 2009, no options were granted or exercised.

On August 13, 2010, the Board of Directors granted a total of 237,268 restricted stock units (“RSUs”) to senior employees and the Chairman of the Board of Directors pursuant to the KGen Power Corporation 2006 Equity Incentive Plan. Each RSU will entitle its holder to receive, upon vesting of the RSU, one share of common stock of the Company. Under the terms of the RSU awards, 35,592 RSUs vested immediately upon grant due to the completed sale of 100% of the ownership interests in KGen Sandersville LLC, the entity that owns the Sandersville power generation facility. Of the remaining unvested RSUs, 106,769 will vest upon the consummation of a sale of the Murray I and II power generation facilities; 47,454 will vest upon the consummation of a sale of the Hot Spring power generation facility; and 47,453 will vest upon the consummation of a sale of the Hinds power generation facility. All unvested RSUs will vest upon the consummation of a change in control of the Company. Stock compensation expense related to these RSUs began during the three months ended September 30, 2010.

The Company recorded compensation expense of \$0.4 million and \$18.0 thousand for the three months ended September 30, 2010 and 2009, respectively, related to outstanding RSUs. As of September 30, 2010 and 2009, there was \$1.3 million and \$0.1 million of total unrecognized compensation expense related to unvested RSUs.

#### 11. Income Taxes

For both the three months ended September 30, 2010 and 2009, there were no current or deferred income tax provision (benefits) included in the net income.

The Company’s provision for income taxes differed from that determined by applying the federal income tax rate (statutory rate) to income before income taxes, as follows (in thousands of dollars):

	<b>For the Three Months Ended September 30, 2010</b>	<b>For the Three Months Ended September 30, 2009</b>
Statutory rate .....	35%	35%
Tax at statutory rate.....	\$ 29,788	\$ 4,765
Increase (decrease) due to:		
Nondeductible meals and entertainment .....	1	2
State tax expense .....	3,251	515
Adjustment to valuation allowance .....	(33,040)	(5,282)
Total provision .....	\$ —	\$ —

## KGen Power Corporation

### Notes to Unaudited Condensed Consolidated Financial Statements

#### 11. Income Taxes (Continued)

Temporary differences and carryforwards which gave rise to deferred tax assets and liabilities were as follows (in thousands of dollars):

	September 30, 2010	June 30, 2010
Deferred tax assets:		
Interest rate derivatives.....	\$ 2,358	\$ 2,472
Contract-based intangible assets.....	16,054	15,109
Nonqualified stock options expense .....	5,528	5,375
Accrued expenses .....	21	21
Net operating loss .....	46,105	81,113
Contribution carryforward.....	18	16
Net deferred tax assets.....	70,084	104,106
Deferred tax liabilities:		
Property, plant, and equipment.....	18,583	19,346
Prepaid expenses .....	270	613
Contract-based intangible liabilities .....	4,168	4,043
Net deferred tax liability.....	23,021	24,002
Valuation allowance .....	47,063	80,104
Deferred tax asset (liabilities), net.....	\$ —	\$ —

At September 30, 2010, the Company had a federal net operating loss carryforward of \$119.1 million which will expire between 2027 and 2031. The amount of taxable income that the Company can offset with this carryforward is subject to limitations under Section 382 of the Internal Revenue Code, which is applicable to corporations in certain instances following an ownership change (as such term is defined for income tax purposes).

Based on management's projections of book and taxable income for the year ended June 30, 2011, it was deemed appropriate to release a \$33.0 million valuation allowance equal to the projected taxable income for the three months ended September 30, 2010, as a portion of the net operating loss carryforward can now be utilized against such income. There were no unrecognized tax benefits that if recognized would affect the tax rate. No interest or penalties were recognized as of September 30, 2010.

The Company filed income tax returns in the United States federal jurisdiction and in various U.S. states. In all material respects, the Company will not be subject to United States federal, state, and local income tax examination by tax authorities for fiscal years ended before 2005.

#### 12. Net Gain on Sale of Asset

This footnote should be read in conjunction with Note 12—Assets Held for Sale of the Notes to the Consolidated Financial Statements contained in the Annual Report for the year ended June 30, 2010.

The transaction between the Company and AL Sandersville Holdings, LLC, an entity formed by ArcLight Energy Partners Fund III, LP, to purchase 100% of the ownership interests in KGen Sandersville LLC, the entity that owns the Sandersville power generation facility closed on July 9, 2010. A subsidiary of ArcLight Energy Partners Fund IV, LLP, is a shareholder who owns approximately 12% of the Company. The Company received \$129.3 million in cash sales proceeds which represents a \$130.0 million purchase price less a working capital adjustment. The net gain on the sale was \$65.0 million and the Company prepaid \$58.5 million of its outstanding term debt and \$10.0 million of its outstanding working capital facility using a portion of the proceeds of this sale. In addition, KGen LLC distributed \$19.5 million of the cash sales proceeds received to its parent, KGen Power

## **KGen Power Corporation**

### **Notes to Unaudited Condensed Consolidated Financial Statements**

#### **12. Net Gain on Sale of Asset (Continued)**

Corporation. The Company expects to use a portion of its existing tax net operating loss to offset all of the taxable gain resulting from the sale.

#### **13. Subsequent Events**

On October 5, 2010, the Board of Directors granted 15,000 RSUs to the CEO of the company pursuant to the KGen Power Corporation 2006 Stock Incentive Plan. Each RSU will entitle the CEO to receive, upon vesting of the RSU, one share of common stock of the Company. Under the terms of the RSU awards, all 15,000 shares vest immediately upon grant. Stock compensation expense related to these RSUs will be expensed during the three months ended December 31, 2010.

Subsequent events were analyzed and considered through November 12, 2010, the date this report was available for issuance.

## **Number 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **Business Overview**

We own and operate electric power generation plants and sell electricity and electrical generation capacity in the United States. We sell power and related products to wholesale purchasers such as retail electric providers, power trading organizations, municipal utilities, electric power cooperatives, and other power generation companies. Our portfolio of facilities consists of four operational and fully permitted combined-cycle power plants (Murray I, Murray II, Hot Spring and Hinds), located in the southeastern United States with General Electric (GE) 7FA gas turbines. Our combined-cycle Plants have an aggregate capacity of 2,390 MW. On July 9, 2010, we completed the sale of our Sandersville power plant, a 640 MW simple-cycle plant, for which we received \$129.3 million in sales proceeds. We acquired our Plants from an affiliate of MatlinPatterson Global Advisors LLC on February 8, 2007.

Three of our four Plants currently operate, and historically the Sandersville power plant operated, as merchant power providers. The remaining plant, the Murray I combined-cycle plant, benefits from a fixed-price long-term power purchase agreement, or the GPC PPA, for all of its 630 MW of capacity with Georgia Power, a subsidiary of Southern Company. The GPC PPA, which continues through May 2012, provides for fixed capacity payments that provide stable cash flow. The Company recognized \$26.3 million and \$26.2 million related to capacity sales on the GPC PPA for the three months ended September 30, 2010 and 2009, respectively.

As part of our strategy, we continue to explore and review credible alternatives that may become available to us to enhance shareholder value. Our management team's compensation package includes incentives payable upon successful facility sales or a change in control transaction.

### **Results of Operations**

Our results of operations are subject to seasonal variations since demand for electricity, and thus, production capacity, varies with weather conditions. For our merchant plants, we earn the majority of our revenues in the months of May through September. Months other than the peak summer months historically have not been profitable for KGen and are the months during which we typically seek to perform scheduled maintenance-related activities. The discussion below includes the results from our Sandersville plant, which we sold on July 9, 2010. For the three months ended September 30, 2010, KGen Sandersville LLC's adjusted EBITDA, a non-GAAP financial measure, was a loss of \$0.1 million. Accordingly, these results may not be indicative of future results of the Company.

**Consolidated Results of Operations of KGen for the Three Months Ended September 30, 2010 compared to the Three Months Ended September 30, 2009.**

The following table sets forth our results of operations for the three months ended September 30, 2010 and 2009, expressed in thousands of dollars.

	For the Three Months Ended September 30, 2010	For the Three Months Ended September 30, 2009	Favorable/(Unfavorable) Change      % Change	
<b>Revenues:</b>				
Energy sales .....	\$ 100,229	\$ 61,859	\$ 38,370	62%
Capacity sales .....	29,090	26,259	2,561	10%
Total revenues.....	129,319	88,388	40,931	46%
<b>Operating expenses:</b>				
Cost of fuel .....	80,787	48,995	(31,792)	(65%)
Operating and maintenance .....	6,900	4,022	(2,878)	(72%)
Gas transportation .....	5,568	4,786	(782)	(16%)
Selling, general, and administrative .....	3,293	2,965	(328)	(11%)
Depreciation.....	5,552	6,125	573	9%
Auxiliary power .....	2,577	2,290	(287)	(13%)
Insurance.....	735	925	190	21%
Total operating expenses .....	105,412	70,108	(35,304)	(50%)
<b>Operating income</b> .....	23,907	18,280	5,627	31%
<b>Other income (expenses):</b>				
Net gain on sale of assets	64,980	—	64,980	100%
Interest expense .....	(2,786)	(3,599)	813	23%
Taxes, other than income taxes .....	(952)	(999)	47	5%
Other .....	(39)	(69)	30	43%
Total other income (expenses) .....	61,203	(4,667)	65,870	1411%
<b>Net income before taxes</b> .....	85,110	13,613	71,497	525%
Income tax expense.....	—	—	—	0%
<b>Net income after taxes</b> .....	<u>\$ 85,110</u>	<u>\$ 13,613</u>	<u>\$ 71,497</u>	525%

**Operating and Business Metrics We Use to Analyze the Company's Performance for the Three Months Ended September 30, 2010 and September 30, 2009**

In addition to the foregoing results of operations presented in accordance with GAAP, we utilize various non-GAAP operating and business metrics to analyze the Company's performance. We believe these metrics provide useful insight into the Company's performance, assist us in identifying trends in our business, and better allow us to compare our performance to others in our industry. We describe below these various non-GAAP metrics and provide a reconciliation of these metrics for the three months ended September 30, 2010 and 2009, to the most directly comparable GAAP measures for those periods. See the reconciliation of net income to adjusted EBITDA on page 20. This presentation may not include all of the disclosure that SEC regulations would require a company that files periodic reports with the SEC to make, with respect to non-GAAP financial measures.

*Merchant Margin, Adjusted Contracted Margin, and Total Adjusted Margin*

We separate merchant margin and adjusted contracted margin because the distinction helps us analyze the certainty of future cash flows of the Company and the underlying commodity value of the Company's assets.

Merchant margin is equal to the sum of merchant energy margin and merchant capacity sales. Merchant energy margin is defined as energy sales less the related cost of fuel pursuant to arrangements having an original delivery term of less than one year. Merchant capacity sales is defined as capacity sales pursuant to arrangements having an original delivery term of less than one year. We consider our Hinds, Hot Spring, and Murray II plants and considered our former Sandersville plant to be merchant plants because they are not selling their energy output and capacity pursuant to long-term sales agreements.



	<b>For the Three Months Ended September 30, 2010</b>	<b>For the Three Months Ended September 30, 2009</b>
Energy sales .....	\$ 100,229	\$ 61,859
<i>Less: Cost of fuel</i> .....	(80,787)	(48,995)
<i>Less: Contracted energy sales</i> .....	(23,979)	(12,914)
<i>Add: Contracted cost of fuel</i> .....	22,497	11,234
<b>Merchant energy margin</b> .....	<u>17,960</u>	<u>11,184</u>
Capacity sales .....	29,090	26,529
<i>Less: Contracted capacity sales</i> .....	(26,290)	(26,223)
<b>Merchant capacity sales</b> .....	<u>\$ 2,800</u>	<u>\$ 306</u>
<b>Merchant margin</b> .....	<u>\$ 20,760</u>	<u>\$ 11,490</u>

Adjusted contracted margin is equal to the sum of adjusted contracted energy margin and adjusted contracted capacity sales. Adjusted contracted energy margin is defined as energy sales less the related cost of fuel pursuant to arrangements having an original delivery term of one year or greater adjusted to remove the income effects of noncash amortization of contract-based intangibles. Adjusted contracted capacity sales is defined as capacity sales pursuant to arrangements having an original delivery term of one year or greater adjusted to remove the income effects of noncash deferred capacity revenue to levelize the capacity sales over the term of the agreement as required by GAAP. We believe that the foregoing adjustments are helpful in understanding the commercial results of our contractual arrangements without the impact of noncash accounting adjustments. We currently consider Murray I to be contracted, because it is selling its energy output and capacity pursuant to the long-term GPC PPA.

	<b>For the Three Months Ended September 30, 2010</b>	<b>For the Three Months Ended September 30, 2009</b>
Energy sales .....	\$ 100,229	\$ 61,859
<i>Less: Merchant sales</i> .....	(76,250)	(48,945)
<b>Contracted energy sales</b> .....	<u>23,979</u>	<u>12,914</u>
<i>Less: Contracted cost of fuel</i> .....	(22,497)	(11,234)
<i>Add: Power sales rights and obligations amortization</i> .....	2,028	2,028
<b>Adjusted contracted energy margin</b> .....	<u>3,510</u>	<u>3,708</u>
Contracted capacity sales .....	26,290	26,223
<i>Add (Less): Noncash deferred capacity revenue</i> .....	448	(8)
<b>Adjusted contracted capacity sales</b> .....	<u>\$ 26,738</u>	<u>\$ 26,215</u>
<b>Adjusted contracted margin</b> .....	<u>\$ 30,248</u>	<u>\$ 29,923</u>

Total adjusted margin is equal to the sum of merchant margin and adjusted contracted margin.

	<b>For the Three Months Ended September 30, 2010</b>	<b>For the Three Months Ended September 30, 2009</b>
Merchant margin .....	\$ 20,760	\$ 11,490
Adjusted contracted margin .....	<u>30,248</u>	<u>29,923</u>
<b>Total adjusted margin</b> .....	<u><u>\$ 51,008</u></u>	<u><u>\$ 41,413</u></u>

#### *Adjusted Plant Expense and Adjusted Corporate Expense*

Adjusted plant expenses is defined as total operating expenses adjusted for the removal of (a) cost of fuel captured in merchant energy margin and adjusted contracted energy margin, (b) major maintenance expense, (c) the income effects of noncash amortization of contract-based intangibles of gas transportation expense, (d) all selling, general, and administrative expense, part of which is captured in adjusted corporate expenses (defined below), (e) depreciation, (f) director and officer insurance expense captured in adjusted corporate expenses (defined below); and (g) the addition of taxes, other than income taxes, as it largely represents plant property taxes and payments in lieu of taxes.

	<u>For the Three Months Ended September 30, 2010</u>	<u>For the Three Months Ended September 30, 2009</u>
Total operating expenses .....	\$ 105,412	\$ 70,108
Less: Cost of fuel.....	(80,787)	(48,995)
Less: Major maintenance expense.....	(1,690)	402
Less: Gas transportation noncash amortization .....	(314)	(301)
Less: Selling, general, and administrative expense .....	(3,293)	(2,965)
Less: Depreciation.....	(5,552)	(6,125)
Less: D&O insurance expense.....	(42)	(46)
Add: Taxes, other than income taxes.....	952	999
<b>Adjusted plant expenses</b> .....	<u>\$ 14,686</u>	<u>\$ 13,077</u>

Adjusted corporate expenses is defined as selling, general, and administrative expense adjusted for (a) the removal of noncash stock compensation expense and reorganization items such as employee severance, (b) any nonrecurring items such as expenses associated with plant sales and (c) the addition of director and officer insurance expense.

	<u>For the Three Months Ended September 30, 2010</u>	<u>For the Three Months Ended September 30, 2009</u>
Selling, general, and administrative expense .....	\$ 3,293	\$ 2,965
Less: Noncash employee options/awards expense .....	(395)	(375)
Less: Employee severance expense.....	—	(1)
Less: Sale of plant expense .....	(5)	—
Add: D&O insurance expense.....	42	46
<b>Adjusted corporate expenses</b> .....	<u>\$ 2,935</u>	<u>\$ 2,635</u>

*Adjusted Plant EBITDA and Adjusted EBITDA:*

Adjusted plant EBITDA is defined as total adjusted margin less adjusted plant expenses. Adjusted EBITDA is defined as adjusted plant EBITDA less adjusted corporate expenses.

	<u>For the Three Months Ended September 30, 2010</u>	<u>For the Three Months Ended September 30, 2009</u>	<u>Favorable/(Unfavorable)</u>	
			<u>Change</u>	<u>% Change</u>
Merchant energy margin .....	\$ 17,960	\$ 11,184	\$ 6,776	61%
Merchant capacity sales.....	2,800	306	2,494	815%
<b>Merchant margin</b> .....	20,760	11,490	9,270	81%
Adjusted contracted energy margin.....	3,510	3,708	(198)	(5%)
Adjusted contracted capacity sales .....	26,738	26,215	523	2%
<b>Adjusted contracted margin</b> .....	30,248	29,923	325	1%
<b>Total adjusted margin</b> .....	51,008	41,413	9,595	23%
Adjusted plant expenses .....	14,686	13,077	(1,609)	(12%)
<b>Adjusted plant EBITDA</b> .....	36,322	28,336	7,986	28%
Adjusted corporate expenses .....	2,935	2,635	(300)	(11%)
<b>Adjusted EBITDA</b> .....	<u>\$ 33,387</u>	<u>\$ 25,701</u>	<u>\$ 7,686</u>	<u>30%</u>

### *Selected Operating and Business Metrics*

	For the	For the	Favorable/(Unfavorable)	
	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Change	% Change
<b>Selected Financial and Operating Data</b>				
Total generation (GWh) .....	2,282	1,880	402	21%
Merchant generation (GWh) .....	1,667	1,491	176	12%
Merchant margin/merchant generation (\$/MWh) .....	\$ 12.45	\$ 7.71	\$ 4.74	61%

### *Selected Market and Weather Data*

	For the	For the	Change	% Change
	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009		
<b>Selected Market Data(1)</b>				
Average on-peak market power price—Entergy (\$/MWh).....	\$ 43.68	\$ 28.78	\$ 14.90	52%
Average on-peak market power price—Southern (\$/MWh).....	\$ 45.91	\$ 31.34	\$ 14.57	46%
Average Henry Hub gas price (\$/MMbtu) .....	\$ 4.29	\$ 3.15	\$ 1.14	36%
<b>Selected Weather Data</b>				
Actual CDDs(2).....	4,709	3,592	1,117	31%
Normal CDDs .....	3,698	3,699	(1)	(0%)

Notes:

- (1) Data from Platt's Megawatt Daily and Gas Daily publications.
- (2) CDD, or cooling degree days, represents the number of degrees during April through October that the mean temperature for a particular day is above 65 degrees Fahrenheit. The CDDs are then accumulated for a given period.

### *Historical Results of Operations of KGen for the Three Months Ended September 30, 2010 compared to the Three Months Ended September 30, 2009.*

Total adjusted margin increased \$9.6 million, or 23%, to \$51.0 million for the three months ended September 30, 2010 compared to the same period in the previous year as a result of a \$9.3 million increase in merchant margin and a \$0.3 million increase in adjusted contracted margin. The \$51.0 million in total adjusted margin was comprised of \$20.8 million in merchant margin and \$30.2 million in adjusted contracted margin.

Merchant margin increased \$9.3 million, or 81%, to \$20.8 million for the three months ended September 30, 2010. The \$9.3 million increase was made up of a \$6.8 million increase in merchant energy margin and a \$2.5 million increase in merchant capacity sales. The \$6.8 million increase in merchant energy margin related primarily to warmer weather and an increase in natural gas prices, as evidenced by a 31% increase in CDDs and a 36% increase in the average Henry Hub gas price from \$3.15 per MMBtu to \$4.29 per MMBtu for the three months ended September 30, 2010 as compared to the previous year. Merchant generation increased by 12% from 1,491 GWh to 1,667 GWh for the three months ended September 30, 2010 as compared to the previous year. The \$2.5 million increase in merchant capacity sales was attributable to \$2.8 million in merchant capacity sales from the Hinds plant offset in part by \$0.3 million in merchant capacity sales from the Hinds plant in the prior year. The implied merchant spark spread, or merchant margin divided by merchant generation, increased from \$7.71 per MWh to \$12.45 per MWh, largely due to the increase in merchant capacity sales, warmer weather, and the effects of higher market gas prices. Merchant margin was also impacted by operational issues associated with the Hot Spring facility's inlet chiller system. These issues are scheduled to be repaired at the facility's spring 2011 outage and we expect to file an insurance claim in connection herewith.

Adjusted contracted margin increased \$0.3 million, or 1%, to \$30.2 million for the three months ended September 30, 2010, which was comprised of \$3.5 million in adjusted contracted energy margin and \$26.7 million in adjusted contracted capacity sales. The \$0.3 million increase was made up of a \$0.5 million increase in the adjusted contracted capacity sales offset by a \$0.2 million decrease in the adjusted contracted energy margin. The \$0.5 million increase in adjusted contracted capacity sales was a result of the escalation of the pricing in the GPC PPA.

Adjusted plant expenses increased by \$1.6 million, or 12%, to \$14.7 million for the three months ended September 30, 2010. The increase primarily related a \$0.8 million increase in operating and maintenance expenses caused by increased generation for the three months ended September 30, 2010 compared to the three months ended September 30, 2009, and a \$0.9 million increase in fixed gas transportation at the Hot Spring plant due to the costs associated with enhanced firm transportation purchased for July through September 2010.

As a result of the foregoing changes in total adjusted margin and adjusted plant expenses, adjusted plant EBITDA increased by \$8.0 million to \$36.3 million for the three months ended September 30, 2010.

Adjusted corporate expenses increased by \$0.3 million, or 11%, to \$3.0 million for the three months ended September 30, 2010. The increase was primarily related to a \$0.4 million increase in commercial marketing fees associated with an increase in merchant sales for the three months ended September 30, 2010 compared to the three months ended September 30, 2009.

As a result of the foregoing, adjusted EBITDA increased by \$7.7 million to \$33.4 million for the three months ended September 30, 2010.

#### GAAP to Non-GAAP Adjusted EBITDA Reconciliation

Following is an alternative calculation of adjusted EBITDA and adjusted plant EBITDA starting from net loss after taxes. EBITDA is equal to net loss after taxes adjusted for interest expenses, income taxes, depreciation, and amortization. Adjusted EBITDA is equal to EBITDA minus certain other items (such as major maintenance and other nonrecurring expenses). Adjusted plant EBITDA is equal to total adjusted EBITDA less certain corporate expenses.

	<b>For the Three Months Ended September 30, 2010</b>	<b>For the Three Months Ended September 30, 2009</b>
Net income after taxes.....	\$ 85,110	\$ 13,613
Add: Interest expense.....	2,786	3,599
Add: Depreciation.....	5,552	6,125
Add: Power sales rights and obligations amortization.....	2,028	2,028
Add: Gas transportation noncash amortization.....	314	301
Add (Less): Noncash deferred capacity revenue.....	448	(8)
Add: Other expense .....	39	69
<b>EBITDA</b> .....	<u>96,277</u>	<u>25,727</u>
Less: Net gain on sale of assets .....	(64,980)	—
Add: Major maintenance expense .....	1,690	(402)
Add: Noncash employee options/awards expense .....	395	375
Add: Employee severance expense.....	—	1
Add: Sale of plant expense .....	5	—
<b>Adjusted EBITDA</b> .....	<u>33,387</u>	<u>25,701</u>
Add: Selling, general, and administrative expense.....	3,293	2,965
Less: Noncash employee options/awards expense .....	(395)	(375)
Less: Employee severance expense.....	—	(1)
Less: Sale of plant expense.....	(5)	—
Add: D&O insurance expense .....	42	46
<b>Adjusted plant EBITDA</b> .....	<u>\$ 36,322</u>	<u>\$ 28,336</u>

The following describes changes to specified financial measures of our performance. As indicated above, in calculating our adjusted EBITDA, we made adjustments to our net loss after taxes using these financial measures for the three months ended September 30, 2010 compared to the three months ended September 30, 2009.

- Interest expense for the three months ended September 30, 2010 was \$2.8 million compared to \$3.6 million for the same period in 2009. The \$0.8 million decrease was primarily made up of a \$0.1 million decrease due to lower outstanding debt amounts offset slightly by higher interest rates compared to the same period in the previous year, and \$0.7 million in losses on derivatives associated with our interest rate hedging and cash payments on our Swaps.
- Depreciation was \$5.6 million and \$6.1 million for the three months ended September 30, 2010 and 2009, respectively.
- Amortization of contract-based power sales rights and obligations, for both three month periods, was \$2.0 million and was recorded as a reduction of energy sales.
- Amortization of contract-based natural gas transportation rights and obligations, for both three month periods, was \$0.3 million and was recorded as an increase of gas transportation expense.
- Noncash deferred capacity revenue, which represents the levelization of capacity sales over the GPC PPA term, of \$0.4 million of expense and \$8.0 thousand of revenue for the three months ended September 30, 2010 and 2009, respectively, was recorded as capacity sales.
- Other expense for the three months ended September 30, 2010 and 2009 was \$39.0 thousand and \$0.1 million, respectively.
- Net gain on sale of assets was \$65.0 million and zero for the three months ended September 30, 2010 and 2009, respectively. The net gain on sale of assets is related to the sale of the Sandersville facility on July 9, 2010.
- Major maintenance expense consisted of \$1.7 million of expense and \$0.4 million of income for the three months ended September 30, 2010 and 2009, respectively. The \$1.7 million expense primarily represented a payment to GE as a result of restructuring the long-term service agreements with GE. The \$0.4 million of income for the three months ended September 30, 2009 related to a credit from GE for repair work at Murray I.
- Noncash employee options/awards expense for both three month periods was \$0.4 million and was recorded as an increase of selling, general, and administrative expense.
- Sale of plant expenses for the three months ended September 30, 2010 and 2009 were \$5.0 thousand and zero, respectively, and were recorded as an increase of selling, general, and administrative expense.
- Selling, general, and administrative expense was \$3.3 million and \$3.0 million for the three months ended September 30, 2010 and 2009, respectively. The increase was primarily related to \$0.4 million in commercial marketing fees associated with an increase in merchant sales.

## Liquidity and Capital Resources

### Liquidity Position

We expect that cash on hand, cash flow provided by operations, and cash available under our Credit Facility will satisfy our short-term liquidity needs with respect to our current portfolio of working capital assets over the next 12 months. Our liquidity was comprised of the following at September 30, 2010 (in thousands of dollars):

Unrestricted cash and cash equivalents .....	\$ 139,028
Working capital revolver and synthetic letter of credit facility (net of letters of credit issued thereunder) .....	<u>97,036</u>
Total .....	<u>\$ 236,064</u>

Our principal sources of funds are cash flows from operations and borrowings under our Credit Facility. Our principal use of funds consists of operating expenditures, payments of principal and interest on our Credit Facility, and capital expenditures. On September 30, 2010, we had \$97.0 million available under our Credit Facility, of which \$62.5 million was under the working capital revolver and \$34.5 million was under the synthetic letter of credit facility, for activities related to our plants. We had unrestricted cash on hand of \$139.0 million, of which \$47.1 million was cash at the parent level and not subject to the lien of the Credit Agreement at September 30, 2010. Similarly, \$27.9 million was the balance at the parent level not subject to the Credit Agreement at June 30, 2010. The increase at the parent level relates to a \$19.5 million cash distribution made by KGen LLC to its parent KGen Power Corporation upon receipt of the Sandersville cash sales proceeds.

### ***Debt and Credit Facility***

Our only debt for borrowed money is evidenced by our Credit Facility, which consists of:

- a \$200.0 million term loan facility, or the Term Loan Facility;
- an \$80.0 million working capital facility for letters of credit and other liquidity needs, or the Working Capital Facility; and
- a \$120.0 million synthetic letter of credit facility to support the collateral requirements under the project documents related to the facilities, or the Collateral Credit Facility.

Borrowings under the Term Loan Facility were made in 2007 by KGen LLC, our subsidiary, and were used to refinance existing indebtedness of KGen LLC, pay fees and expenses relating to the Credit Facility, and fund required reserves. Future borrowings under the Credit Facility are subject to the satisfaction of customary conditions.

On March 20, 2009, KGen LLC drew \$10.0 million under the Working Capital Facility to be used for working capital purposes.

On August 18, 2010, the Company prepaid \$58.5 million of its outstanding term debt and \$10.0 million of its outstanding working capital facility using a portion of the proceeds received from the sale of 100% of the ownership interests in KGen Sandersville LLC, the entity that owned the Sandersville power generation facility (See Note 12). In connection with this prepayment, the Company reduced its principal payment requirement of \$2.0 million per year to \$1.4 million per year with quarterly installments beginning September 30, 2010. KGen LLC distributed \$19.5 million of the cash sales proceeds received to its parent, KGen Power Corporation. In addition, there were \$0.5 million of outstanding letters of credit issued under the working capital facility and \$14.4 million of outstanding letters of credit issued under the Collateral Credit Facility that related to Sandersville and were cancelled following the sale of 100% of the ownership interests in KGen Sandersville LLC.

Total letters of credit outstanding under the Working Capital Facility were \$17.5 million as of September 30, 2010. Total letters of credit issued under the Collateral Credit Facility were \$85.5 million as of September 30, 2010.

***Interest Rate.*** Borrowings under the Credit Facility bear interest at a spread above LIBOR-based loans. The \$200.0 million Term Loan Facility bears interest at LIBOR plus 175 basis points. Please refer to “Number 7. *Quantitative and Qualitative Disclosures About Market Risk.*” Amounts borrowed under the \$80.0 million Working Capital Facility bear interest at LIBOR plus 200 basis points.

***Fees.*** We pay a 50 basis point fee on the unused portion of commitments and all undrawn letters of credit under the Working Capital Facility, a 200 basis point fee on drawn letters of credit under the Working Capital Facility, and a 191 basis point fee on the \$120.0 million of the Collateral Credit Facility.

***Maturity Date.*** The maturity date of the Credit Facility is February 8, 2014, except that the maturity date of the Working Capital Facility is February 8, 2012.

***Security.*** Borrowings under the Credit Facility are secured by substantially all of the assets of our subsidiaries, which constitute all of our operating assets and generate substantially all of our operating cash flows. Our only significant asset not subject to the lien of the Credit Agreement was a cash balance of \$47.1 million at September 30, 2010 that was held at our parent company level.

The Credit Facility and related financing documents contain various affirmative and negative covenants, including (a) financial covenants, (b) limitations on KGen LLC's ability to pay dividends, (c) restrictions on the use of available cash for operations, except as required for debt service payments and, (d) an event of default in the event of a change in control of KGen. At September 30, 2010, we were in compliance with the covenants contained within our Credit Facility.

On May 14, 2010, Standard & Poor's Rating Service affirmed a BB- rating on our Credit Facility with a negative outlook. On July 21, 2010, Moody's Investors Service affirmed a B1 rating on our Credit Facility and revised the outlook to stable.

### **Capital Expenditures and Major Maintenance**

Total capital expenditures for the three months ended September 30, 2010 and 2009 were \$0.4 million and \$1.1 million, respectively.

Major maintenance expense was \$1.7 million and income of \$0.4 million for the three months ended September 30, 2010 and 2009, respectively. The \$1.7 million expense primarily represented a payment to GE as a result of restructuring the long-term service agreements with GE. The \$0.4 million of income for the three months ended September 30, 2009 related to a credit from GE for repair work at Murray I.

The timing of major maintenance expenditures is uncertain and can be delayed or accelerated depending on many factors including plant utilization, unexpected plant shut-downs for other reasons, and unanticipated dispatch schedules. We budget anticipated major maintenance costs by using our estimate of future anticipated run time at each facility. This schedule can change based upon changes to actual run time.

We incur costs for major maintenance on the Plants which are expensed in the period incurred. We expect to incur major maintenance expenses of \$4.0 million for the remainder of fiscal 2011 and expect to increase the balance of the restricted cash and cash equivalents account for major maintenance by \$2.7 million for expenses identified after September 30, 2010.

### **Cash Flow Analysis**

The following table summarizes our changes in cash (in thousands of dollars):

	<b>For the Three Months Ended September 30, 2010</b>	<b>For the Three Months Ended September 30, 2009</b>
<b>Statements of Cash Flows Data:</b>		
Cash flows provided by (used in):		
Operating activities .....	\$ 30,940	\$ 25,202
Investing activities.....	128,804	(159)
Financing activity .....	<u>(68,893)</u>	<u>(500)</u>
Increase in cash and cash equivalents .....	90,851	24,543
Cash and cash equivalents at beginning of period.....	<u>48,177</u>	<u>40,663</u>
Cash and cash equivalents at end of period.....	<u>\$ 139,028</u>	<u>\$ 65,206</u>

*Cash Flows from Operating Activities.* Our cash flows provided by operations were \$30.9 million for the three months ended September 30, 2010, primarily related to a net income of \$85.1 million, depreciation expense of \$5.6 million, amortization expense of \$2.6 million, valuation of derivative instruments of \$0.9 million, stock-based compensation of \$0.4 million, an increase in accounts receivable of \$5.1 million, an increase in prepaid expenses and other current assets of \$0.3 million, and an increase in deferred charge of \$0.4 million, which was offset primarily by a net gain on sale of assets of \$65.0 million, payments from settlement of derivative instruments of \$1.2 million, a \$0.1 million decrease in spare parts inventories, and a decrease in accounts payable and accrued liabilities of \$3.1 million. We also incurred \$1.7 million of cash interest during the period under our outstanding Credit Facility.

*Cash Flows from Investing Activities.* Our cash flows provided by investing activities for the three months ended September 30, 2010 were \$128.8 million and related to a sale of assets of \$127.8 million and a \$1.5 million use of restricted cash and cash equivalents, offset by \$0.5 million in purchases of property, plant, and equipment.

*Cash Flows from Financing Activity.* Our cash flows used in financing activity for the three months ended September 30, 2010 were \$68.9 million and represented a prepayment of \$58.5 million of the outstanding term debt and \$10.0 million of the outstanding working capital facility as well as \$0.3 million in principal payments of long-term debt as required by the Credit Facility.

### Number 3. Quantitative and Qualitative Disclosures about Market Risk

#### *Interest Rate Risks*

Our primary market risk is the potential impact of changes in interest rates on our variable rate borrowings. Prior to February 7, 2010, the terms of our Credit Facility required us to maintain interest hedge arrangements on at least fifty percent of our outstanding term debt balance to reduce our exposure to market risk from changes in the interest rate. As a result, we entered into interest rate swaps in order to mitigate the risk associated with the variable rate borrowings.

KGen LLC has three current interest rate swap agreements, or Swaps. These Swaps are intended to hedge the risk associated with variable interest rates. For each of the Swaps, the Company pays its counterparty the equivalent of a fixed interest payment on a predetermined notional value, and we receive the equivalent of a floating interest payment based on a one-month LIBOR rate calculated on the same notional value. These payments are made on a monthly basis. While the notional value of each of the Swaps does not vary over time, the Swaps are designed to mature sequentially. The total notional amount of the Swaps as of September 30, 2010 was \$99.0 million with an average interest rate payable by KGen LLC of 5.0%. The following is a summary of the Swaps:

	Maturity Date	Notional Amount (in millions)	September 30, 2010		September 30, 2009	
			Fair Value (in thousands)	Fixed Rate	Fair Value (in thousands)	Fixed Rate
Contract #1 .....	Expired	\$ —	\$ —	—	\$ —	—
Contract #2 .....	Expired	—	—	—	—	—
Contract #3 .....	Expired	—	—	—	—	—
Contract #4 .....	3-31-2011	33.0	(730)	5.0%	(998)	5.0%
Contract #5 .....	3-31-2012	33.0	(2,081)	5.0%	(2,212)	5.0%
Contract #6 .....	3-31-2013	\$ 33.0	\$ (3,239)	5.1%	\$ (3,135)	5.1%

As of September 30, 2010, the majority of our outstanding variable rate debt has been converted to a fixed rate through the Swaps. We are exposed to credit related losses in the event of non-performance by the counterparty to the Swaps, however our counterparty is a major financial institution and we consider such risk of loss to be minimal. We will continue to monitor the creditworthiness of our counterparty in light of the current unfavorable financial markets.

## PART II-OTHER INFORMATION

### Number 1A. Risk Factors and Forward-Looking Statements

#### *Risk Factors*

Please refer to Number 1A of our Annual Report for the year ended June 30, 2010.

#### *Forward-Looking Statements*

The discussion in this report contains certain forward looking statements that involve risks and uncertainties. We have based these forward looking statements on our current expectations and assumptions about future events. In some cases, you can identify forward looking statements by terminology, such as “may,” “should,” “could,” “predict,” “potential,” “continue,” “expect,” “anticipate,” “future,” “intend,” “plan,” “believe,” “estimate,”



“forecast” and similar expressions (or the negative of such expressions). Forward looking statements include statements concerning known and unknown risks, uncertainties and other important factors that could cause actual results, performance or achievements of KGen Power Corporation and its subsidiaries to differ materially from any future results, performance or achievements expressed or implied by such forward looking statements. Forward looking statements are based on our beliefs as well as assumptions based on information currently available to us, including financial and operational information, current competitive conditions, and anticipated demand for electricity. As a result, these statements are subject to various risks and uncertainties. For a discussion of material risks and uncertainties that the Company faces, see the discussion above, and the “Cautionary Statement concerning Forward Statements” and Part I. “Number 1A. Risk Factors” in our Annual Report for the fiscal year ended June 30, 2010.