

KGen Power Corporation

Report to Shareholders

for

Quarter Ended December 31, 2008

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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)

	<u>December 31,</u> 2008	<u>June 30,</u> 2008
	(unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	\$ 50,444	\$ 51,493
Restricted cash and cash equivalents	34,041	24,325
Short-term investments	1,161	2,199
Accounts receivable	3,211	36,763
Spare parts inventories	7,358	7,409
Prepaid expenses and other current assets	2,644	1,272
Total current assets	<u>98,859</u>	123,461
Property, plant, and equipment	705,399	704,343
Less: accumulated depreciation	45,446	33,229
Net property, plant, and equipment	<u>659,953</u>	671,114
Contract-based intangibles (net of \$20,170 and \$14,842 of accumulated amortization, respectively)	63,372	68,700
Deferred charge	2,697	2,101
Deferred financing fees (net of \$1,690 and \$1,243 of accumulated amortization, respectively)	4,574	5,021
Other noncurrent assets	325	325
Total assets	<u>\$ 829,780</u>	<u>\$ 870,722</u>
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 14,192	\$ 37,457
Current portion of long-term debt	2,000	2,000
Total current liabilities	<u>16,192</u>	39,457
Long-term debt	194,000	195,000
Contract-based intangibles (net of \$2,927 and \$2,243 of accumulated amortization, respectively)	17,241	17,925
Other noncurrent liabilities	7,717	2,535
Commitments and contingencies (Note 6)	—	—
Stockholders' equity:		
Common stock (par value \$.01; 150,000 shares authorized; 55,968 and 55,963 shares issued and outstanding at December 31, 2008 and June 30, 2008, respectively) . .	560	560
Additional paid in capital	739,511	738,215
Accumulated deficit	(145,441)	(122,970)
Total stockholders' equity	<u>594,630</u>	615,805
Total liabilities and stockholders' equity	<u>\$ 829,780</u>	<u>\$ 870,722</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 December 31, 2008	For the Three Months Ended December 31, 2007	For the Six Months Ended December 31, 2008	For the Six Months Ended December 31, 2007
Revenues:				
Energy sales	\$ 22,607	\$ 43,223	\$134,376	\$169,900
Capacity sales	5,645	5,631	36,494	31,725
Total revenues	<u>28,252</u>	<u>48,854</u>	<u>170,870</u>	<u>201,625</u>
Operating expenses:				
Cost of fuel	17,783	38,562	112,679	141,626
Operating and maintenance . . .	8,580	6,837	28,835	18,784
Gas transportation	3,659	3,732	8,296	8,296
Selling, general, and administrative	3,305	5,543	7,689	10,647
Acquisition contract termination loss	—	187	—	37,190
Depreciation	6,117	6,038	12,217	12,064
Auxiliary power	1,916	1,828	4,525	4,327
Insurance	962	802	1,804	1,612
Total operating expenses	<u>42,322</u>	<u>63,529</u>	<u>176,045</u>	<u>234,546</u>
Operating loss	(14,070)	(14,675)	(5,175)	(32,921)
Other income (expenses):				
Interest expense	(3,811)	(4,469)	(7,122)	(9,059)
Taxes, other than income taxes .	(907)	(756)	(2,197)	(1,501)
Interest income	42	1,240	302	1,921
Other	(7,245)	(3,468)	(8,279)	(6,584)
Total other expenses	<u>(11,921)</u>	<u>(7,453)</u>	<u>(17,296)</u>	<u>(15,223)</u>
Net loss before taxes	(25,991)	(22,128)	(22,471)	(48,144)
Income tax benefit	—	—	—	—
Net loss after taxes	<u>\$(25,991)</u>	<u>\$(22,128)</u>	<u>\$(22,471)</u>	<u>\$(48,144)</u>
Net loss per share—basic and diluted	\$ (0.46)	\$ (0.40)	\$ (0.40)	\$ (0.86)
Weighted average shares outstanding—basic and diluted .	55,967	55,949	55,967	55,947

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 Six Months Ended December 31, 2008</u>	<u>For the Six Months Ended December 31, 2007</u>
Cash flows from operating activities		
Net loss	\$(22,471)	\$(48,144)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation	12,217	12,064
Amortization of deferred financing fees	447	447
Amortization of contract-based intangibles	4,644	4,511
Change in fair value of derivative instruments	8,276	6,793
Stock-based compensation	1,296	2,277
Changes in operating assets and liabilities:		
Accounts receivable	33,552	19,108
Spare parts inventories	51	(32)
Prepaid expenses and other current assets	(1,372)	(2,038)
Deferred charge	(596)	(1,129)
Other noncurrent assets	—	690
Accounts payable and accrued liabilities	(23,767)	(7,693)
Other noncurrent liabilities	(3)	—
Net cash provided by (used in) operating activities	<u>12,274</u>	<u>(13,146)</u>
Cash flows from investing activities		
Purchases of property, plant, and equipment	(1,056)	(665)
Short-term investments	1,038	(73)
Investment in restricted cash and cash equivalents	(9,716)	(8,791)
Net cash used in investing activities	<u>(9,734)</u>	<u>(9,529)</u>
Cash flows from financing activities		
Repayment of debt	(1,000)	(1,000)
(Payments) proceeds from settlement of derivative instruments	(2,589)	478
Net cash used in financing activities	<u>(3,589)</u>	<u>(522)</u>
Decrease in cash and cash equivalents	(1,049)	(23,197)
Cash and cash equivalents at beginning of period	51,493	90,315
Cash and cash equivalents at end of period	<u>\$ 50,444</u>	<u>\$ 67,118</u>
Cash paid for		
Interest	\$ 6,673	\$ 8,707
Noncash transactions		
Grant of shares for Board fees	\$ 116	\$ —

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. The portfolio of facilities consists of five operational and fully permitted power plants (the “Plants”) located in the southeastern United States with gas turbines having an aggregate capacity of 3,030 megawatts (“MW”). The Plants include four combined-cycle plants (Murray I, Murray II, Hot Spring, and Hinds) and one simple-cycle plant (Sandersville). 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 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 at June 30, 2008 is derived from the June 30, 2008 audited consolidated financial statements. These condensed consolidated financial statements included herein 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, 2008.

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, KGen Sandersville LLC, KGen Acquisition I LLC, all direct or indirect 100% owned subsidiaries, 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.

Reclassifications—Certain reclassifications have been made to the prior year financial statements to conform to the current year presentation.

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. Four of the plants currently operate 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 (Continued)

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

New Accounting Pronouncements—In September 2006, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 157, *Fair Value Measurements* (“SFAS No. 157”). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements. Rather, its application will be made pursuant to other accounting pronouncements that require or permit fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those years. The provisions of SFAS No. 157 are to be applied prospectively upon adoption, except for limited specified exceptions. SFAS No. 157 was effective for the Company on July 1, 2008. The Company evaluated the requirements of SFAS No. 157 and believes the interest rate swap derivatives (See Note 7) are valued using Level 2 fair value measurements. Under SFAS No. 157, 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.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (“SFAS No. 159”) which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS No. 159 was effective for the Company on July 1, 2008. The requirements of SFAS No. 159 did not have an impact on the Company’s consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (“SFAS No. 161”). SFAS No. 161 establishes improved financial reporting for derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity’s financial position, financial performance, and cash flows. The Company will adopt SFAS No. 161 for the quarter ended March 31, 2009, at which time the provisions of SFAS No. 161 will be applied prospectively.

2. Property, Plant, and Equipment

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

	<u>Estimated Useful Life</u>	<u>December 31, 2008</u>	<u>June 30, 2008</u>
Land	—	\$ 4,201	\$ 4,201
Buildings	40 years	28,612	28,612
Gas and steam turbines	30 years	235,985	235,985
Steam generators and auxiliaries	30 years	48,402	48,402
Transmission and fuel gas pipelines	30 years	57,191	57,191
Systems and equipment	5 - 30 years	122,611	122,611
Other plant	3 - 30 years	<u>208,397</u>	<u>207,341</u>
Total property, plant, and equipment		705,399	704,343
Less: accumulated depreciation		<u>45,446</u>	<u>33,229</u>
Net property, plant, and equipment		<u>\$659,953</u>	<u>\$671,114</u>

KGen Power Corporation
Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

3. Contract-Based Intangibles

Contract-based intangibles, net of accumulated amortization, consist of the following (in thousands of dollars):

	<u>Term</u>	<u>December 31, 2008</u>	<u>June 30, 2008</u>
Assets			
Murray I Georgia Power contract	May 31, 2012	\$27,910	\$31,965
Murray firm transportation contracts	Various	35,462	36,735
Total assets		<u>\$63,372</u>	<u>\$68,700</u>
Liabilities			
Hinds firm transportation contract	March 31, 2011	\$ 180	\$ 220
Murray firm transportation contract	November 30, 2016	514	546
Hot Spring firm transportation contracts	Various	16,547	17,159
Total liabilities		<u>\$17,241</u>	<u>\$17,925</u>

For the three and six months ended December 31, 2008 and 2007, amortization of contract-based power sales rights and obligations, in both fiscal years, was \$2.0 million and \$4.1 million, respectively, and was recorded as a reduction of energy sales on the condensed consolidated statements of operations. For the three and six months ended December 31, 2008, amortization of contract-based natural gas transportation rights and obligations was \$0.3 million and \$0.6 million, respectively, and was recorded as an increase of gas transportation expenses on the condensed consolidated statements of operations. For the three and six months ended December 31, 2007, amortization of contract-based natural gas transportation rights and obligations was \$0.3 million and \$0.5 million, respectively, 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>December 31, 2008</u>	<u>June 30, 2008</u>
Total debt outstanding	Variable	February 8, 2014	\$196,000	\$197,000
Less: current portion			2,000	2,000
Total long-term debt			<u>\$194,000</u>	<u>\$195,000</u>

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 of California, 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 requires 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 incurred on the term debt was 5.6% and 7.0% at December 31, 2008 and 2007, respectively.

KGen Power Corporation
Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

4. Long-Term Debt (Continued)

The remaining future minimum principal payments subsequent to December 31, 2008 are as follows (in thousands of dollars):

2009	\$ 1,000
2010	2,000
2011	2,000
2012	2,000
2013	2,000
Thereafter	<u>187,000</u>
Total	<u>\$196,000</u>

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 bears interest at 200 basis points with a 50 basis point commitment fee for any unused portion and has a five-year term expiring on February 8, 2012. Letters of credit have been issued under the working capital facility as of December 31, 2008 and June 30, 2008 for \$27.8 million and \$12.5 million, respectively. KGen LLC pays a fee of 191 basis points on the \$120.0 million synthetic letter of credit facility. The facility has a seven-year term expiring on February 8, 2014, and as of December 31, 2008, a \$100.0 million letter of credit had been issued under such facility.

The Credit Agreement and related financing documents contain various affirmative and negative covenants, including financial covenants, limitations on KGen LLC's ability to pay dividends and restrictions on the use of available cash for operations, except as required for debt service payments.

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 (as defined in Rule 4-04(e)(3) of Regulation S-X promulgated by the Securities and Exchange Commission) 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 \$549.9 million at December 31, 2008, of which \$38.6 million was restricted net current assets.

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 December 31, 2008 and June 30, 2008, the restricted balance, in accordance with this requirement, was \$8.0 million and \$7.0 million, respectively.

Additionally, the Security Deposit Agreement requires KGen LLC to reserve quarterly the amount of major maintenance expenditures expected to be incurred during the following 12 months. At December 31, 2008 and June 30, 2008, the restricted balance, in accordance with this requirement, was \$26.0 million and \$17.3 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. In October 2008, KGen Hinds LLC entered into a settlement agreement

KGen Power Corporation
Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

6. Commitments and Contingencies (Continued)

related to the litigation associated with amounts owed in lieu of property taxes for the 2006 and 2007 tax years. Pursuant to this settlement, the Company and the relevant taxing authorities have agreed upon property values for the 2008 through 2010 tax years.

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 8—Commitments in the Notes to Consolidated Financial Statements contained in the Annual Report for the year ended June 30, 2008.

Employee Matters—The employment of Gerald Lindner, the former Chairman and Chief Executive Officer and Donald Boyd, the former Chief Operating Officer and Executive Vice President, was terminated on May 6, 2008 and May 23, 2008, respectively. Each was a party to an employment and severance agreement that provided for certain termination payments. The Company negotiated separation agreements with each of Mr. Lindner and Mr. Boyd providing for payments and benefits in full settlement of the Company's obligations under their respective employment agreements. Mr. Lindner received a cash payment of approximately \$2.7 million in November 2008 pursuant to his separation agreement. Mr. Boyd received a payment of approximately \$0.5 million in November 2008 and an additional payment of approximately \$0.5 million in January 2009 pursuant to his separation agreement. Mr. Boyd will also receive health benefits for 18 months. In accordance with their employment agreements, all unvested options held by them vested upon their respective termination. Under the settlement agreement terms, these options will remain exercisable until November 2009.

7. Derivatives

The Company accounts for derivative instruments in accordance with the provisions of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended. SFAS No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. The statement requires an entity to recognize all derivatives as either assets or liabilities on the balance sheet and measure 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 purposes 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 5.1% at December 31, 2008. The change in the fair value of the contracts and all related amounts in connection with settlement were recorded in the other line item in the other income and expense category. The short-term portion of the Swaps as of December 31, 2008 and June 30, 2008 was \$4.5 million and \$2.9 million, respectively, and was recorded in accounts payable and accrued liabilities. The long-term portion of the Swaps as of December 31, 2008 and June 30, 2008 was \$7.7 million and \$2.5 million, respectively, and was recorded in other noncurrent liabilities.

The Company evaluated the requirements of SFAS No. 157, *Fair Value Measurements* ("SFAS No. 157") and believes the Swaps are valued using Level 2 fair value measurements. Under SFAS No. 157, 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

KGen Power Corporation
Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

7. Derivatives (Continued)

active, and/or model-based valuations whose inputs are observable or whose significant value drivers are observable.

8. Net Loss per Share

Basic loss per share is calculated by dividing net loss by the weighted average number of shares of common stock outstanding during the period. Fully diluted loss per share is computed on the same basis as basic loss per share as the inclusion of any other potential shares outstanding would be anti-dilutive. Amounts shown below are in thousands, except per share amounts.

	<u>For the Three Months Ended December 31, 2008</u>	<u>For the Three Months Ended December 31, 2007</u>	<u>For the Six Months Ended December 31, 2008</u>	<u>For the Six Months Ended December 31, 2007</u>
Numerator:				
Net loss	\$(25,991)	\$(22,128)	\$(22,471)	\$(48,144)
Denominator:				
Weighted average shares outstanding—basic and diluted	<u>55,967</u>	<u>55,949</u>	<u>55,967</u>	<u>55,947</u>
Net loss per share—basic and diluted	<u>\$ (0.46)</u>	<u>\$ (0.40)</u>	<u>\$ (0.40)</u>	<u>\$ (0.86)</u>

9. Share-Based Payments

This footnote should be read in conjunction with Note 11—Share-Based Payments of the Notes to Consolidated Financial Statements contained in the Annual Report for the year ended June 30, 2008.

The Company recorded compensation expense of \$0.6 million and \$1.2 million for the three and six months ended December 31, 2008, respectively, and \$1.1 million and \$2.2 million for the three and six months ended December 31, 2007, respectively, related to stock options outstanding. As of December 31, 2008 and 2007, there was \$2.2 million and \$9.0 million, respectively, of total unrecognized compensation expense related to unvested options. For the three and six months ended December 31, 2008 and 2007, no options were granted or exercised.

10. Income Taxes

For the three and six months ended December 31, 2008 and 2007, there were no current or deferred income tax provision (credits) included in the net loss.

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

	<u>For the Three Months Ended December 31, 2008</u>	<u>For the Three Months Ended December 31, 2007</u>	<u>For the Six Months Ended December 31, 2008</u>	<u>For the Six Months Ended December 31, 2007</u>
Statutory rate	35%	35%	35%	35%
Tax at statutory rate	\$(9,097)	\$(7,745)	\$(7,865)	\$(16,851)
Increase (decrease) due to:				
Nondeductible meals and entertainment	3	9	3	12
State tax expense (benefit) .	(1,324)	(68)	(1,183)	(68)
Adjustment to valuation allowance	<u>10,418</u>	<u>7,804</u>	<u>9,045</u>	<u>16,907</u>
Total provision	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

KGen Power Corporation
Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

10. Income Taxes (Continued)

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

	<u>At December 31, 2008</u>	<u>At June 30, 2008</u>
Deferred tax assets:		
Interest rate derivatives	\$ 5,118	\$ 2,271
Contract-based intangible assets	9,087	6,180
Nonqualified stock options expense	4,225	3,400
Accrued expenses	186	1,367
Net operating loss	49,419	41,467
Net deferred tax assets	<u>68,035</u>	<u>54,685</u>
Deferred tax liabilities:		
Property, plant, and equipment	10,613	6,707
Prepaid expenses	323	291
Contract-based intangible liabilities	3,464	3,102
Net deferred tax liability	14,400	10,100
Valuation allowance	53,635	44,585
Deferred tax asset (liabilities), net	<u>\$ —</u>	<u>\$ —</u>

At December 31, 2008, the Company had a federal net operating loss carryforward of \$127.8 million which will expire between 2027 and 2029. A wholly-owned subsidiary of the Company had an estimated net operating loss carryforward of approximately \$0.1 million, which will expire between 2025 and 2026. The amount of taxable income that the Company can offset with this carryforward is subject to an annual limitation 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).

Management has determined that valuation allowances are necessary as of December 31, 2008 and June 30, 2008, as the future tax benefits relating to all deferred income tax assets are not expected to be fully realized when measured against a more likely than not standard. There were no unrecognized tax benefits that if recognized would affect the tax rate. No interest or penalties were recognized as of December 31, 2008.

The Company filed income tax returns in the United States federal jurisdiction and in various 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.

11. Registration of Shares with the Securities and Exchange Commission

On November 9, 2007, the Company filed a registration statement on Form S-1 with the Securities and Exchange Commission, and subsequently amended such statement. The registration statement has not been declared effective. On February 21, 2008, the Company's Board of Directors suspended the process for completion of the registration statement.

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

The following discussion is intended to assist you in understanding our business and the results of operations together with our present financial condition. This section should be read in conjunction with our Condensed Consolidated Financial Statements and the accompanying notes included in this Quarterly Report, as well as our Annual Report for the fiscal year ended June 30, 2008. Unless the context otherwise requires or indicates, references to "KGen," "Company," "we," "our," and "us" refer to KGen Power Corporation and its subsidiaries. Statements in our discussion may be forward-looking. These forward-looking statements involve risk and uncertainties. We caution that a number of factors could cause future results to differ materially from our expectations. Please see "Number 1A. *Risk Factors*" of Part I of our Annual Report for the fiscal year ended June 30, 2008 and "Number 1A. *Risk Factors and Forward-Looking Statements*" of Part II of this Quarterly Report regarding certain risk factors related to the Company.

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 five operational and fully permitted power plants, or the Plants, located in the southeastern United States with General Electric 7EA and 7EA gas turbines. The Plants have an aggregate capacity of 3,030 megawatts, or MW. The Plants include four combined-cycle plants (Murray I, Murray II, Hot Spring and Hinds) and one simple-cycle plant (Sandersville). We acquired the Plants from an affiliate of MatlinPatterson Global Advisors LLC, or MatlinPatterson, on February 8, 2007.

Four of the Plants currently operate 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 \$5.6 million related to capacity sales on the GPC PPA for both of the quarters ended December 31, 2008 and 2007, and \$31.8 million and \$31.7 million for the six months ended December 31, 2008 and 2007, respectively. On June 6, 2008, the Sandersville simple-cycle plant entered into a power purchase agreement, or the Sandersville PPA, for a unit contingent 250 to 280 MW of capacity and associated energy with Southern Power Company. The Sandersville PPA commences on June 1, 2011 and continues through December 31, 2015.

Recent Events

Exploration of Strategic Alternatives

On April 11, 2008, the Board of Directors of the Company announced that it had retained Credit Suisse to evaluate all of the Company's options for enhancing shareholder value, including the sale of the Company, sale of individual power generation facilities, potential business combinations and continuing to enhance the value of our existing assets. On May 6, 2008, the Board of Directors announced that it was committed to exploring any and all strategic alternatives to maximize the value of the Company.

On October 17, 2008, the Board of Directors announced that the directors and management of the Company, with the assistance of an experienced team at Credit Suisse, had engaged in an extensive process of exploring various strategic alternatives for the Company, with the ultimate goal of maximizing the value of the Company for our shareholders. As part of this process, the Company and Credit Suisse approached many industry participants and financial sponsors regarding their potential interest in a range of transactions, including a purchase of the Company as a whole and an acquisition of one or a combination of our power generating facilities. Despite the difficult mergers and acquisitions and credit markets, the Company received multiple indicative proposals for both the acquisition of the entire Company and

acquisitions of individual assets from a combination of strategic and financial bidders. Although the Board was generally pleased with the results of the solicitation, it believes that the Company and its shareholders would realize even greater value, with more certainty of closing, in a more stable financial market in which potential acquirers would have greater, and more certain, access to capital and financing instruments. Accordingly, the Board determined not to bring the sale process to a conclusion at this time.

The Company will continue to explore and review credible transaction proposals, to the extent that they increase shareholder value, as they are received. The Company incurred \$0.5 million in expenses related to the strategic review process during the six months ended December 31, 2008.

Employee Matters

The employment of Gerald Lindner, the former Chairman and Chief Executive Officer and Donald Boyd, the former Chief Operating Officer and Executive Vice President, was terminated on May 6, 2008 and May 23, 2008, respectively. Each was a party to an employment and severance agreement that provided for certain termination payments. The Company negotiated separation agreements with each of Mr. Lindner and Mr. Boyd providing for payments and benefits in full settlement of the Company's obligations under their respective employment agreements. Mr. Lindner received a cash payment of approximately \$2.7 million in November 2008 pursuant to his separation agreement. Mr. Boyd received a payment of approximately \$0.5 million in November 2008 and an additional payment of approximately \$0.5 million in January 2009 pursuant to his separation agreement. Mr. Boyd will also receive health benefits for 18 months. In accordance with their employment agreements, all unvested options held by them vested upon their respective termination. Under the settlement agreement terms, these options will remain exercisable until November 2009.

Changes to the Board

Jeffrey S. Stein resigned from the Board of Directors effective November 26, 2008. Mr. Stein cited personal time constraints as the reason for his decision. Mr. Stein continues to hold a significant investment in the Company. A successor has not been appointed.

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.

Consolidated Results of Operations of KGen for the Three Months Ended December 31, 2008 compared to the Three Months Ended December 31, 2007.

The following table sets forth our results of operations for the three months ended December 31, 2008 and 2007, expressed in thousands of dollars.

	<u>For the Three Months Ended December 31, 2008</u>	<u>For the Three Months Ended December 31, 2007</u>	<u>Change</u>	<u>% Change</u>
Revenues:				
Energy sales	\$ 22,607	\$ 43,223	\$(20,616)	- 48%
Capacity sales	5,645	5,631	14	0%
Total revenues	<u>28,252</u>	<u>48,854</u>	<u>(20,602)</u>	<u>- 42%</u>
Operating expenses:				
Cost of fuel	17,783	38,562	(20,779)	- 54%
Operating and maintenance	8,580	6,837	1,743	25%
Gas transportation	3,659	3,732	(73)	- 2%
Selling, general, and administrative	3,305	5,543	(2,238)	- 40%
Acquisition contract termination loss	—	187	(187)	- 100%
Depreciation	6,117	6,038	79	1%
Auxiliary power	1,916	1,828	88	5%
Insurance	962	802	160	20%
Total operating expenses	<u>42,322</u>	<u>63,529</u>	<u>(21,207)</u>	<u>- 33%</u>
Operating loss	<u>(14,070)</u>	<u>(14,675)</u>	<u>605</u>	<u>- 4%</u>
Other income (expenses):				
Interest expense	(3,811)	(4,469)	658	- 15%
Taxes, other than income taxes	(907)	(756)	(151)	20%
Interest income	42	1,240	(1,198)	- 97%
Other	(7,245)	(3,468)	(3,777)	109%
Total other expenses	<u>(11,921)</u>	<u>(7,453)</u>	<u>(4,468)</u>	<u>60%</u>
Net loss before taxes	<u>(25,991)</u>	<u>(22,128)</u>	<u>(3,863)</u>	<u>17%</u>
Income tax benefit	—	—	—	0%
Net loss after taxes	<u><u>\$(25,991)</u></u>	<u><u>\$(22,128)</u></u>	<u><u>\$ (3,863)</u></u>	<u><u>17%</u></u>

Selected Operating and Business Metrics

	For the Three Months Ended December 31, 2008	For the Three Months Ended December 31, 2007	Change	% Change
Selected Financial and Operating Data				
Total generation (GWh)	484	743	(259)	- 35%
Merchant generation (GWh)	484	637	(153)	- 24%
Merchant energy gross margin (in thousands)	\$6,399	\$5,753	\$ 646	11%
Merchant capacity sales (in thousands)	\$ —	\$ —	\$ —	0%
Merchant gross margin (in thousands)	\$6,399	\$5,753	\$ 646	11%
Merchant energy gross margin/merchant generation (\$/MWh)	\$13.22	\$ 9.03	\$ 4.19	46%
Selected Market Data				
Average on-peak market power price— Entergy (\$/MWh)	\$44.94	\$52.31	\$(7.37)	- 14%
Average on-peak market power price— Southern (\$/MWh)	\$49.54	\$52.17	\$(2.63)	- 5%
Average Henry Hub gas price (\$/MMbtu) . . .	\$ 6.38	\$ 6.92	\$(0.54)	- 8%
Selected Weather Data				
Actual CDDs(1)	201	431	(230)	- 53%
Normal CDDs	62	62	—	0%
Actual HDDs(2)	3,059	2,495	564	23%
Normal HDDs	3,087	3,087	—	0%

Notes:

- (1) CDD, or cooling degree days, represents the number of degrees that the mean temperature for a particular day is above 65 degrees Fahrenheit. The CDDs are then accumulated for a given period.
- (2) HDD, or heating degree days, represents the number of degrees that the mean temperature for a particular day is below 65 degrees Fahrenheit. The HDDs are then accumulated for a given period.

GAAP to Non-GAAP Reconciliations

	For the Three Months Ended December 31, 2008	For the Three Months Ended December 31, 2007
	(in thousands)	
Energy sales	\$22,607	\$43,223
Cost of fuel	17,783	38,562
Energy gross margin	<u>4,824</u>	<u>4,661</u>
<i>Less:</i> Murray I energy sales	(1,545)	5,080
<i>Add:</i> Murray I fuel	<u>30</u>	<u>6,172</u>
Merchant energy gross margin	<u>\$ 6,399</u>	<u>\$ 5,753</u>
Capacity sales	\$ 5,645	\$ 5,631
<i>Less:</i> Murray I capacity sales	5,645	5,631
Merchant capacity sales	<u>\$ —</u>	<u>\$ —</u>
Energy gross margin	\$ 4,824	\$ 4,661
<i>Add:</i> Capacity sales	<u>5,645</u>	<u>5,631</u>
Total gross margin	10,469	10,292
<i>Less:</i> Murray I gross margin	<u>4,070</u>	<u>4,539</u>
Merchant gross margin	<u>\$ 6,399</u>	<u>\$ 5,753</u>

Historical Results of Operations of KGen for the Three Months Ended December 31, 2008 compared to the Three Months Ended December 31, 2007.

We analyze our results of operations by focusing on gross margin, a non-GAAP measure which is made up of energy gross margin and capacity sales. We define energy gross margin as energy sales less the related cost of fuel. This metric is one measure of our efficiency in converting natural gas expense into revenues. We consider our merchant plants to be Hinds, Hot Spring, Murray II and Sandersville because they are currently not selling their output pursuant to long-term sales agreements. Our Murray I plant is selling its output pursuant to the long-term GPC PPA.

Gross margin increased \$0.2 million to \$10.5 million for the three months ended December 31, 2008 compared to the same period in the previous year due to a \$0.7 million increase in merchant energy gross margin offset by a \$0.5 million decrease in energy gross margin from our Murray I plant. The \$0.7 million merchant energy gross margin increase resulted from decreased merchant generation at a higher spark spread. Merchant generation decreased by 153 GWh, or 24%, to 484 GWh for the quarter ended December 31, 2008 and implied merchant spark spread increased by \$4.19/MWh, or 46%, to \$13.22/MWh for the quarter ended December 31, 2008. The increase in implied merchant spark spread was principally from Hot Spring, representing \$5.4 million of the \$6.4 million merchant energy gross margin for the three months ended December 31, 2008. Hot Spring's daily sales benefitted from favorable gas prices throughout October and during the first half of November. Both Murray I and II undertook planned outages during October and November 2008, which reduced their generation compared to the same time period last year. Cooler than normal weather in October also led to reduced generation output from Hinds. The \$0.5 million decrease in energy gross margin from the Murray I plant resulted from decreased Murray I generation of 106 GWh, or 100%, to 0 GWh for the three months ended December 31, 2008, largely due to the extended outage.

Operating expenses, excluding cost of fuel, for the three months ended December 31, 2008 were \$24.5 million, compared to \$25.0 million for the three months ended December 31, 2007. This \$0.5 million

decrease includes, but is not solely derived from, a \$2.2 million decrease in selling, general, and administrative expenses, offset by a \$1.7 million increase in operating and maintenance expenses. The decrease in selling, general, and administrative expenses for the three months ended December 31, 2008 primarily related to a \$0.5 million decrease in noncash options expense, a \$1.0 million decrease in payroll expenses, and a \$0.7 million decrease in legal and professional services. The reductions in noncash options expense and payroll were both due to employee terminations in May 2008. The decrease in legal and professional expenses was due to the services rendered in connection with the Form S-1 filing in November 2007. The operating and maintenance expense increase was primarily related to \$1.3 million in unanticipated steam turbine generator maintenance expenses at Murray I and \$0.7 million in connection with the fall 2008 scheduled major maintenance outage at Murray II.

As a result of the foregoing, we incurred an operating loss of \$14.1 million for the three months ended December 31, 2008 compared to an operating loss of \$14.7 million for the three months ended December 31, 2007.

Other expenses were \$11.9 million and \$7.5 million for the three months ended December 31, 2008 and 2007, respectively. The primary components of other expenses were as follows:

- Interest expense for the three months ended December 31, 2008 was \$3.8 million compared to \$4.5 million for the same period in 2007. The decrease in interest expense related to a reduction in interest rates and outstanding debt compared to the same period in the previous year.
- Interest income for the three months ended December 31, 2008 and 2007 was approximately \$42,000 and \$1.2 million, respectively. The decrease in interest income related to lower interest rates and lower average cash balances compared to the same period in the previous year.
- Other expense for the three months ended December 31, 2008 and 2007 was \$7.2 million and \$3.5 million, respectively, and primarily related to losses on derivatives associated with our interest rate hedging due to the change of the fair value and the cash settlements on our Swaps.

As a result of the foregoing, we had a net loss of \$26.0 million for the three months ended December 31, 2008 compared to a net loss of \$22.1 million for the three months ended December 31, 2007.

Consolidated Results of Operations of KGen for the Six Months Ended December 31, 2008 compared to the Six Months Ended December 31, 2007.

The following table sets forth our results of operations for the six months ended December 31, 2008 and 2007, expressed in thousands of dollars.

	<u>For the Six Months Ended December 31, 2008</u>	<u>For the Six Months Ended December 31, 2007</u>	<u>Change</u>	<u>% Change</u>
Revenues:				
Energy sales	\$134,376	\$169,900	\$(35,524)	- 21%
Capacity sales	36,494	31,725	4,769	15%
Total revenues	<u>170,870</u>	<u>201,625</u>	<u>(30,755)</u>	<u>- 15%</u>
Operating expenses:				
Cost of fuel	112,679	141,626	(28,947)	- 20%
Operating and maintenance	28,835	18,784	10,051	54%
Gas transportation	8,296	8,296	—	0%
Selling, general, and administrative	7,689	10,647	(2,958)	- 28%
Acquisition contract termination loss	—	37,190	(37,190)	- 100%
Depreciation	12,217	12,064	153	1%
Auxiliary power	4,525	4,327	198	5%
Insurance	1,804	1,612	192	12%
Total operating expenses	<u>176,045</u>	<u>234,546</u>	<u>(58,501)</u>	<u>- 25%</u>
Operating loss	(5,175)	(32,921)	27,746	- 84%
Other income (expenses):				
Interest expense	(7,122)	(9,059)	1,937	- 21%
Taxes, other than income taxes	(2,197)	(1,501)	(696)	46%
Interest income	302	1,921	(1,619)	- 84%
Other	(8,279)	(6,584)	(1,695)	26%
Total other expenses	<u>(17,296)</u>	<u>(15,223)</u>	<u>(2,073)</u>	<u>14%</u>
Net loss before taxes	(22,471)	(48,144)	25,673	- 53%
Income tax benefit	—	—	—	0%
Net loss after taxes	<u>\$(22,471)</u>	<u>\$(48,144)</u>	<u>\$ 25,673</u>	<u>- 53%</u>

Selected Operating and Business Metrics

	For the Six Months Ended December 31, 2008	For the Six Months Ended December 31, 2007	Change	% Change
Selected Financial and Operating Data				
Total generation (GWh)	1,750	2,747	(997)	-36%
Merchant generation (GWh)	1,397	2,064	(667)	-32%
Merchant energy gross margin (in thousands) . .	\$20,425	\$28,182	\$(7,757)	-28%
Merchant capacity sales (in thousands)	\$ 4,691	\$ —	\$ 4,691	0%
Merchant gross margin (in thousands)	\$25,116	\$28,182	\$(3,066)	-11%
Merchant energy gross margin/merchant generation (\$/MWh)	\$ 14.62	\$ 13.65	\$ 0.97	7%
Selected Market Data				
Average on-peak market power price— Entergy (\$/MWh)	\$ 58.27	\$ 54.71	\$ 3.56	7%
Average on-peak market power price— Southern (\$/MWh)	\$ 63.77	\$ 56.27	\$ 7.50	13%
Average Henry Hub gas price (\$/MMbtu)	\$ 7.77	\$ 6.54	\$ 1.23	19%
Selected Weather Data				
Actual CDDs(1)	3,974	4,760	(786)	-17%
Normal CDDs	3,761	3,761	—	0%
Actual HDDs(2)	3,059	2,495	564	23%
Normal HDDs	3,087	3,087	—	0%

Notes:

- (1) CDD, or cooling degree days, represents the number of degrees that the mean temperature for a particular day is above 65 degrees Fahrenheit. The CDDs are then accumulated for a given period.
- (2) HDD, or heating degree days, represents the number of degrees that the mean temperature for a particular day is below 65 degrees Fahrenheit. The HDDs are then accumulated for a given period.

GAAP to Non-GAAP Reconciliations

	For the Six Months Ended December 31, 2008	For the Six Months Ended December 31, 2007
	(in thousands)	
Energy sales	\$134,376	\$169,900
Cost of fuel	112,679	141,626
Energy gross margin	<u>21,697</u>	<u>28,274</u>
Less: Murray I energy sales	28,943	37,612
Add: Murray I fuel	<u>27,671</u>	<u>37,520</u>
Merchant energy gross margin	<u>\$ 20,425</u>	<u>\$ 28,182</u>
Capacity sales	\$ 36,494	\$ 31,725
Less: Murray I capacity sales	31,803	31,725
Merchant capacity sales	<u>\$ 4,691</u>	<u>\$ —</u>
Energy gross margin	\$ 21,697	\$ 28,274
Add: Capacity sales	<u>36,494</u>	<u>31,725</u>
Total gross margin	58,191	59,999
Less: Murray I gross margin	<u>33,075</u>	<u>31,817</u>
Merchant gross margin	<u>\$ 25,116</u>	<u>\$ 28,182</u>

Historical Results of Operations of KGen for the Six Months Ended December 31, 2008 compared to the Six Months Ended December 31, 2007.

We analyze our results of operations by focusing on gross margin, a non-GAAP measure which is made up of energy gross margin and capacity sales. We define energy gross margin as energy sales less the related cost of fuel. This metric is one measure of our efficiency in converting natural gas expense into revenues. We consider our merchant plants to be Hinds, Hot Spring, Murray II and Sandersville because they are currently not selling their output pursuant to long-term sales agreements. Our Murray I plant is selling its output pursuant to the long-term GPC PPA.

Gross margin decreased by \$1.8 million to \$58.2 million for the six months ended December 31, 2008 compared to the same period in the previous year as a result of a \$3.1 million decrease in merchant gross margin offset by a \$1.3 million increase in gross margin related to Murray I.

The \$3.1 million decrease in merchant gross margin was comprised of a \$7.8 million decrease in merchant energy gross margin offset by a \$4.7 million increase in merchant capacity sales from a portion of the Murray II plant. There were no merchant capacity sales during the six months ended December 31, 2007. The decrease in merchant energy gross margin related to cooler weather during the summer months, as evidenced by a 17% decrease in cooling degree days, when compared to the previous year. There was also a corresponding decrease in merchant generation of 32% during the six months ended December 31, 2008.

Gross margin for Murray I increased by \$1.3 million, to \$33.1 million, for the six months ended December 31, 2008, which was comprised of \$31.8 million in capacity sales and \$1.3 million in energy gross margin. Excluding \$4.1 million in noncash intangibles amortization expense, energy gross margin would have been \$5.4 million and \$4.1 million for Murray I for the six months ended December 31, 2008 and 2007, respectively. A \$1.2 million increase in energy gross margin for Murray I was largely attributable to a reduction in replacement energy during the six months ended December 31, 2008, when compared to the

previous year. From time to time, KGen has replaced energy scheduled from Murray I under the GPC PPA with energy from Murray II, Sandersville, or third-party sources. The cost of such replacement energy is accounted for as a reduction of energy sales at Murray I. When KGen utilizes replacement energy from Murray II or Sandersville, such replacement energy is also accounted for as energy sales at market prices for such Plant.

Operating expenses, excluding cost of fuel, for the six months ended December 31, 2008 were \$63.4 million, compared to \$92.9 million for the six months ended December 31, 2007. This \$29.5 million decrease includes, but is not solely derived from, a \$37.2 million decrease in expenses associated with the termination of the proposed acquisition of Complete Energy Holdings, LLC recorded during the three months ended September 30, 2007, a \$3.0 million decrease in selling, general, and administrative expenses, partially offset by a \$10.1 million increase in operating and maintenance expenses. The decrease in selling, general, and administrative expenses for the six months ended December 31, 2008 primarily related to a \$1.0 million decrease in noncash options expense, a \$1.4 million decrease in payroll expenses, and a \$0.7 million decrease in legal and professional services. The reductions in noncash options expense and payroll were both due to employee terminations in May 2008. The decrease in legal and professional expenses was due to the services rendered in connection with the Form S-1 filing in November 2007. The operating and maintenance expense increase was primarily related to a \$9.3 million increase in major maintenance expense and \$1.3 million of expenses related to unanticipated steam turbine generator maintenance at Murray I. Major maintenance expenses during the six months ended December 31, 2008 were \$16.4 million for the Murray II scheduled major maintenance. Major maintenance expenses during the six months ended December 31, 2007 were \$7.1 million for the Hot Spring scheduled major maintenance.

As a result of the foregoing, we incurred an operating loss of \$5.2 million for the six months ended December 31, 2008 compared to an operating loss of \$32.9 million for the six months ended December 31, 2007.

Other expenses were \$17.3 million and \$15.2 million for the six months ended December 31, 2008 and 2007, respectively. The primary components of other expenses were as follows:

- Interest expense for the six months ended December 31, 2008 was \$7.1 million compared to \$9.1 million for the same period in 2007. The decrease in interest expense related to a reduction in interest rates and outstanding debt compared to the same period in the previous year.
- Interest income for the six months ended December 31, 2008 and 2007 was \$0.3 million and \$1.9 million, respectively. The decrease in interest income related to lower interest rates and lower average cash balances compared to the same period in the previous year.
- Other expense for the six months ended December 31, 2008 and 2007 was \$8.3 million and \$6.6 million, respectively and primarily related to losses on derivatives associated with our interest rate hedging due to the change of the fair value and the cash settlements on our Swaps.

As a result of the foregoing, we had a net loss of \$22.5 million for the six months ended December 31, 2008 compared to a net loss of \$48.1 million for the six months ended December 31, 2007.

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 December 31, 2008 (in thousands of dollars):

Unrestricted cash and cash equivalents	\$ 50,444
Working capital revolver and synthetic letter of credit facility (net of letters of credit issued thereunder)	<u>72,156</u>
Total	<u>\$122,600</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 December 31, 2008, we had approximately \$72.2 million available under our Credit Facility, of which \$52.2 million was under the working capital revolver and \$20.0 million was under the synthetic letter of credit facility, for activities related to our plants. We had cash on hand of \$50.4 million, of which \$34.7 million was not subject to the lien of the Credit Agreement. Management believes that cash on hand, amounts available under our Credit Facility, and cash flows from operations will be adequate to finance capital expenditures and other liquidity commitments.

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 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.

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 3. *Quantitative and Qualitative Disclosures About Market Risk.*” The \$80.0 million Working Capital Facility bears interest at 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 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 \$34.7 million at December 31, 2008 that was held at our parent company level.

The Credit Facility and related financing documents contain various affirmative and negative covenants, including financial covenants, limitations on KGen LLC’s ability to pay dividends and restrictions on the use of available cash for operations, except as required for debt service payments and an

event of default in the event of a change in control of KGen. At December 31, 2008, we were in compliance with the covenants contained within our Credit Facility.

On December 2, 2008, Moody's Investors Service downgraded KGen's debt rating to Ba3 citing continuing weakness in the merchant energy markets. On December 8, 2008, Standard & Poor's Rating Services reaffirmed its current rating of our debt of BB citing stable cash flows from the Georgia Power PPA and a low debt-per-kW debt burden. We do not believe that the Moody's rating reduction will have a material adverse financial impact on us.

Capital Expenditures and Major Maintenance

Total capital expenditures for the three and six months ended December 31, 2008 were \$0.7 million and \$1.1 million, respectively. Total capital expenditures for the three and six months ended December 31, 2007 were \$0.6 million and \$0.7 million, respectively.

We incur costs for major maintenance on the Plants which is expensed in the period incurred. We do not expect to incur additional major maintenance expenditures for the remainder of fiscal 2009.

Cash Flow Analysis

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

	<u>For the Six Months Ended December 31, 2008</u>	<u>For the Six Months Ended December 31, 2007</u>
Statement of Cash Flow Data:		
Cash flows provided by (used in):		
Operating activities	\$12,274	\$(13,146)
Investing activities	(9,734)	(9,529)
Financing activities	<u>(3,589)</u>	<u>(522)</u>
Decrease in cash and cash equivalents	(1,049)	(23,197)
Cash and cash equivalents at beginning of period	<u>51,493</u>	<u>90,315</u>
Cash and cash equivalents at end of period	<u>\$50,444</u>	<u>\$ 67,118</u>

Cash Flows from Operating Activities. Our cash flows from operations were \$12.3 million for the six months ended December 31, 2008, primarily related to collections of accounts receivable of \$33.6 million, depreciation expense of \$12.2 million, change in fair value of derivative instruments of \$8.3 million, and amortization expense of \$4.6 million, which was offset primarily by a net loss of \$22.5 million and a decrease in accounts payable of \$23.8 million. We also incurred \$6.7 million of cash interest during the period under our outstanding Credit Facility.

Cash Flows from Investing Activities. Our cash flows used in investing activities for the six months ended December 31, 2008 were \$9.7 million and primarily related to the investment in restricted cash requirements for major maintenance.

Cash Flows from Financing Activities. Our cash flows used in financing activities for the six months ended December 31, 2008 were \$3.6 million and represented \$1.0 million in quarterly principal payments of long-term debt as required by the Credit Facility and cash settlements on our Swaps of \$2.6 million.

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. The terms of our Credit Facility require us to maintain interest hedge arrangements to reduce our exposure to market risk from changes in the interest rate. As a result, we have entered into interest rate swaps in order to mitigate the risk associated with the variable rate borrowings.

KGen LLC has five current interest rate swap agreements, or Swaps. These Swaps are intended to hedge the risk associated with variable interest rates. For each of the interest rate 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 three-month LIBOR rate calculated on the same notional value. These payments are made on a quarterly 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 is \$165.0 million with an average interest rate payable by KGen LLC of 5.1%. The following is a summary of the Swaps:

	<u>Maturity Date</u>	<u>Notional Amount</u>	<u>Fair Value at December 31, 2008</u>	<u>Fixed Rate</u>
		(in millions)	(in thousands)	
Contract #1	Expired	\$ —	\$ —	—
Contract #2	3-31-2009	\$33.0	\$ (305)	5.2%
Contract #3	3-31-2010	\$33.0	\$(1,369)	5.1%
Contract #4	3-31-2011	\$33.0	\$(2,619)	5.1%
Contract #5	3-31-2012	\$33.0	\$(3,523)	5.1%
Contract #6	3-31-2013	\$33.0	\$(4,331)	5.2%

As of December 31, 2008, 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

The following risk factors below update Part I. “Number 1A. *Risk Factors*” of our Annual Report for the year ended June 30, 2008.

Demand for electricity from our plants may decline due to difficult economic conditions in the southeastern United States.

A sustained decline in economic conditions in the southeastern United States where our Plants are located may lead to sustained lower demand for electricity from our merchant facilities, which may have a material adverse effect on our financial condition and results of operations.

Fortis, our energy management service provider, was recently nationalized by the Belgian government as a result of recent credit market turmoil and as a result, our contractual relationship could suffer and we could be subject to a material adverse effect on our financial condition and results of operations.

Fortis’ energy marketing and trading operation is our energy management service provider. We utilize Fortis’ credit through back-to-back sales of merchant power and capacity to our ultimate customers which are netted against the corresponding gas purchases.

As credit markets deteriorated globally in September and October 2008, the Belgian government nationalized Fortis and agreed to sell most of its operations, including the energy marketing operations that service us, to BNP Paribas. The sale of these operations to BNP Paribas was rejected by a shareholder vote in February 2009. We continue to monitor the status of this transaction. As of this date, our business relations with Fortis have not been materially and adversely impacted. Fortis has the right to terminate its agreements with us at its convenience in accordance with the terms of our agreements with Fortis. If our contractual relationships with Fortis were to change significantly or terminate as a result of a Fortis sale or for any other reason, it may have a material and adverse impact on our financial condition and results of operations. However, based upon discussion with potential alternative providers, we believe that multiple options for a replacement energy management service provider are available to KGen, if required.

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 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, the volatility of our stock price, 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-Looking Statements” and Part I. “Number 1A. *Risk Factors*” in our Annual Report for the fiscal year ended June 30, 2008.

Number 2. Submission of Matters to a Vote of Security Holders

On December 10, 2008, we held our annual meeting of shareholders. At the meeting, the following proposals were voted upon and approved:

Election of Directors

<u>Nominees</u>	<u>For</u>	<u>Withheld</u>
Daniel T. Hudson	43,557,992	1,060
James P. Jenkins	43,507,522	51,500
Gerald J. Stalun	43,507,522	51,500
Thomas B. White	43,507,522	51,500

Other Matters

	<u>For</u>	<u>Against</u>	<u>Abstain</u>	<u>Broker Non-Votes</u>
Approve Amendment to Certificate of Incorporation	39,224,123	4,334,929	—	—
Approve Amendment to the Company's Bylaws	43,514,052	45,000		
Ratify Ernst & Young LLP as the Independent, Registered Public Accountants	43,559,052	—	—	—