

KGen Power Corporation

**Report to Shareholders
for
Quarter Ended December 31, 2009**

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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> 2009 <u>(unaudited)</u> | <u>June 30,</u> 2009 |
|--|---|-------------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 59,772 | \$ 40,663 |
| Restricted cash and cash equivalents | 32,943 | 32,943 |
| Accounts receivable | 4,997 | 22,815 |
| Spare parts inventories | 8,514 | 7,232 |
| Prepaid expenses and other current assets | 3,320 | 1,336 |
| Total current assets | <u>109,546</u> | 104,989 |
| Property, plant, and equipment | 707,143 | 705,711 |
| Less: accumulated depreciation | 69,721 | 57,501 |
| Net property, plant, and equipment | <u>637,422</u> | 648,210 |
| Contract-based intangibles (net of \$30,826 and \$25,498 of accumulated amortization, respectively) | 52,716 | 58,044 |
| Deferred charge | 2,818 | 2,769 |
| Deferred financing fees (net of \$2,585 and \$2,138 of accumulated amortization, respectively) | 3,679 | 4,126 |
| Other noncurrent assets | 325 | 325 |
| Total assets | <u>\$ 806,506</u> | <u>\$ 818,463</u> |
| Liabilities and stockholders' equity | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | \$ 14,403 | \$ 19,078 |
| Current portion of long-term debt | 2,000 | 2,000 |
| Total current liabilities | <u>16,403</u> | 21,078 |
| Long-term debt | 202,000 | 203,000 |
| Contract-based intangibles (net of \$4,275 and \$3,604 of accumulated amortization, respectively) | 15,893 | 16,564 |
| Other noncurrent liabilities | 3,090 | 4,119 |
| Commitments and contingencies (Note 6) | — | — |
| Stockholders' equity: | | |
| Common stock (par value \$.01; 150,000 shares authorized; 55,968 shares issued and outstanding at both December 31, 2009 and June 30, 2009) | 560 | 560 |
| Additional paid in capital | 742,358 | 741,602 |
| Accumulated deficit | (173,798) | (168,460) |
| Total stockholders' equity | <u>569,120</u> | <u>573,702</u> |
| Total liabilities and stockholders' equity | <u>\$ 806,506</u> | <u>\$ 818,463</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, 2009 | For the Three Months Ended December 31, 2008 | For the Six Months Ended December 31, 2009 | For the Six Months Ended December 31, 2008 |
|---|--|--|--|--|
| Revenues: | | | | |
| Energy sales | \$ 15,556 | \$ 22,607 | \$ 77,415 | \$134,376 |
| Capacity sales | 5,849 | 5,645 | 32,378 | 36,494 |
| Total revenues | <u>21,405</u> | 28,252 | <u>109,793</u> | 170,870 |
| Operating expenses: | | | | |
| Cost of fuel | 14,174 | 17,783 | 63,169 | 112,679 |
| Operating and maintenance | 7,069 | 8,580 | 11,091 | 28,835 |
| Gas transportation | 3,649 | 3,659 | 8,434 | 8,296 |
| Selling, general, and administrative | 2,983 | 3,305 | 5,946 | 7,689 |
| Depreciation | 6,130 | 6,117 | 12,255 | 12,217 |
| Auxiliary power | 1,892 | 1,916 | 4,183 | 4,525 |
| Insurance | 856 | 962 | 1,782 | 1,804 |
| Total operating expenses | <u>36,753</u> | 42,322 | <u>106,860</u> | 176,045 |
| Operating income (expense) | (15,348) | (14,070) | 2,933 | (5,175) |
| Other income (expenses): | | | | |
| Interest expense | (2,589) | (3,811) | (6,188) | (7,122) |
| Taxes, other than income taxes | (964) | (907) | (1,963) | (2,197) |
| Net interest income | — | 42 | — | 302 |
| Other | (51) | (7,245) | (120) | (8,279) |
| Total other expenses | <u>(3,604)</u> | (11,921) | <u>(8,271)</u> | (17,296) |
| Net loss before taxes | (18,952) | (25,991) | (5,338) | (22,471) |
| Income tax benefit | — | — | — | — |
| Net loss after taxes | <u>\$(18,952)</u> | <u>\$(25,991)</u> | <u>\$ (5,338)</u> | <u>\$(22,471)</u> |
| Net loss per share—basic and diluted | \$ (0.34) | \$ (0.46) | \$ (0.10) | \$ (0.40) |
| Weighted average shares outstanding—basic and diluted | 55,968 | 55,967 | 55,968 | 55,967 |

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, 2009</u> | <u>For the Six Months Ended December 31, 2008</u> |
|---|---|---|
| Cash flows from operating activities | | |
| Net loss | \$ (5,338) | \$(22,471) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation | 12,255 | 12,217 |
| Amortization of deferred financing fees | 447 | 447 |
| Amortization of contract-based intangibles | 4,657 | 4,644 |
| Valuation of derivative instruments | 2,192 | 8,276 |
| Stock-based compensation | 756 | 1,296 |
| Payments from settlement of derivative instruments | (3,197) | (2,589) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 17,818 | 33,552 |
| Spare parts inventories | (1,282) | 51 |
| Prepaid expenses and other current assets | (1,984) | (1,372) |
| Deferred charge | (49) | (596) |
| Accounts payable and accrued liabilities | (5,367) | (23,767) |
| Other noncurrent liabilities | (4) | (3) |
| Net cash provided by operating activities | <u>20,904</u> | <u>9,685</u> |
| Cash flows from investing activities | | |
| Purchases of property, plant, and equipment | (795) | (1,056) |
| Short-term investments | — | 1,038 |
| Use of restricted cash and cash equivalents | — | (9,716) |
| Net cash used in investing activities | <u>(795)</u> | <u>(9,734)</u> |
| Cash flows from financing activity | | |
| Repayment of debt | (1,000) | (1,000) |
| Net cash used in financing activity | <u>(1,000)</u> | <u>(1,000)</u> |
| Increase (decrease) in cash and cash equivalents | 19,109 | (1,049) |
| Cash and cash equivalents at beginning of period | 40,663 | 51,493 |
| Cash and cash equivalents at end of period | <u>\$59,772</u> | <u>\$ 50,444</u> |
| Cash paid for | | |
| Interest | \$ 3,574 | \$ 6,673 |
| 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, 2009 is derived from the June 30, 2009 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, 2009.

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.

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.

Recently Issued Accounting Standards—In August 2009, FASB ASC 820-10 *Fair Value Measurements and Disclosures* was issued, effective for the Company for interim periods ending December 2009. In

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

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

January 2010, an update to FASB ASC 820-10 was issued. FASB ASC 820-10 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The Company does not expect the adoption of this guidance to have a material impact on either its financial position or results of operations.

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, 2009</u> | <u>June 30, 2009</u> |
|--|----------------------------------|--------------------------|----------------------|
| Land | — | \$ 4,201 | \$ 4,201 |
| Buildings | 40 years | 29,382 | 28,612 |
| Gas and steam turbines | 30 years | 236,286 | 235,985 |
| Steam generators and auxiliaries | 30 years | 48,954 | 48,402 |
| Transmission and fuel gas pipelines | 30 years | 57,390 | 57,191 |
| Systems and equipment | 5 - 30 years | 124,648 | 122,616 |
| Other plant | 3 - 30 years | <u>206,282</u> | <u>208,704</u> |
| Total property, plant, and equipment | | 707,143 | 705,711 |
| Less: accumulated depreciation | | <u>69,721</u> | <u>57,501</u> |
| Net property, plant, and equipment | | <u>\$637,422</u> | <u>\$648,210</u> |

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, 2009</u> | <u>June 30, 2009</u> |
|--|-------------------|--------------------------|----------------------|
| Assets | | | |
| Murray I Georgia Power contract | May 31, 2012 | \$19,798 | \$23,854 |
| Murray firm transportation contracts | Various | <u>32,918</u> | <u>34,190</u> |
| Total assets | | <u>\$52,716</u> | <u>\$58,044</u> |
| Liabilities | | | |
| Hinds firm transportation contract | March 31, 2012 | \$ 120 | \$ 147 |
| Murray firm transportation contract | November 30, 2016 | 449 | 481 |
| Hot Spring firm transportation contracts | Various | <u>15,324</u> | <u>15,936</u> |
| Total liabilities | | <u>\$15,893</u> | <u>\$16,564</u> |

For the three months ended December 31, 2009 and 2008, amortization of contract-based power sales rights and obligations was \$2.0 million. For the six months ended December 31, 2009 and 2008, amortization of contract-based power sales rights and obligations was \$4.1 million. These amortization amounts were recorded as a reduction of energy sales on the condensed consolidated statements of operations.

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

3. Contract-Based Intangibles (Continued)

For the three months ended December 31, 2009 and 2008, amortization of contract-based natural gas transportation rights and obligations was \$0.3 million. For the six months ended December 31, 2009 and 2008, amortization of contract-based natural gas transportation rights and obligations was \$0.6 million. These amortization amounts were 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, 2009</u> | <u>June 30, 2009</u> |
|------------------------------------|----------------------|------------------|--------------------------|----------------------|
| Term debt | Variable | February 8, 2014 | \$194,000 | \$195,000 |
| Working capital facility | Variable | February 8, 2012 | <u>10,000</u> | <u>10,000</u> |
| Total debt outstanding | | | 204,000 | 205,000 |
| Less: current portion | | | <u>2,000</u> | <u>2,000</u> |
| Total long-term debt | | | <u>\$202,000</u> | <u>\$203,000</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 2.0% and 2.1% at December 31, 2009 and June 30, 2009, respectively.

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. On March 20, 2009, KGen LLC drew \$10.0 million under the working capital facility. The proceeds of the drawdown continue to be used for working capital purposes. There were \$8.0 million of outstanding letters of credit issued under the working capital facility as of December 31, 2009 and June 30, 2009. KGen LLC pays a fee of 191 basis points on the \$120.0 million synthetic letter of credit facility. The synthetic letter of credit facility has a seven-year term expiring on February 8, 2014. At both December 31, 2009 and June 30, 2009, a letter of credit, supporting the power sales contract with GPC, with a current outstanding amount of \$100.0 million, and \$19.9 million of other letters of credit were outstanding under the synthetic letter of credit facility.

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

4. Long-Term Debt (Continued)

The remaining future minimum principal payments under the term debt and the working capital facility subsequent to December 31, 2009 are as follows (in thousands of dollars):

| | |
|------------------|------------------|
| 2010 | 1,000 |
| 2011 | 2,000 |
| 2012 | 12,000 |
| 2013 | 2,000 |
| Thereafter | 187,000 |
| Total | <u>\$204,000</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 December 31, 2009, 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 \$528.3 million at December 31, 2009, of which \$52.9 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 both December 31, 2009 and June 30, 2009, the restricted balance, in accordance with this requirement, was \$5.8 million.

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 both December 31, 2009 and June 30, 2009, the restricted balance, in accordance with this requirement, was \$27.1 million.

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, 2009.

Sublease—The Company entered into an agreement on September 29, 2009 to sublease approximately 6,318 square feet of corporate office space in exchange for monthly payments of \$15,775. The

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

6. Commitments and Contingencies (Continued)

commencement date of the sublease was December 17, 2009. Sublease payments will begin on February 17, 2010.

Operating and Maintenance Service Provider—On October 16, 2009, the Company notified Duke Energy Generation Services (“DEGS”) that it was exercising its rights to terminate the operating and maintenance agreements between DEGS and KGen Hinds LLC, KGen Hot Spring LLC, and KGen Sandersville LLC, the 100% owned subsidiaries of the Company that, respectively, own the Hinds, Hot Spring, and Sandersville plants. The termination was effective for the Sandersville plant on February 1, 2010 and will be effective for the Hinds and Hot Spring plants on February 15, 2010. The Company will be required to pay DEGS approximately \$420,000, in the aggregate, in connection with the termination of all of the agreements. KGen Hinds LLC, KGen Hot Spring LLC, and KGen Sandersville LLC executed new operating agreements with NAES Corporation (“NAES”), a third party operations and maintenance provider that will replace DEGS as the service provider for such facilities.

NERC Violation—On September 23, 2009, KGen Hot Spring LLC, a 100% owned subsidiary of the Company, self-reported to the SERC Reliability Corporation (“SERC”), that it failed to document certain maintenance and testing items which may constitute a violation of a North American Electric Reliability Corporation (“NERC”) reliability standard. Subsequent to this reporting, SERC conducted its regularly scheduled audit of all of the Company’s facilities and found two separate possible violations by KGen Hot Spring LLC of the reliability standards. On December 7, 2009, SERC notified KGen Hot Spring LLC that insufficient basis exists to allege a violation or noncompliance of the standard in connection with the September 23, 2009 self-reported event. SERC’s investigation of the two other possible violations continues. In the event that it is determined that there has been a violation of the reliability standards, KGen Hot Spring LLC may be subject to penalties. The ultimate outcome of these matters remains uncertain, but the Company does not believe an unfavorable outcome would result in a material impact to its consolidated financial statements. No loss contingency is accrued, however such financial penalties should be imposed on us, it is our estimate any such penalties would be in the range of \$0 to \$250,000.

7. 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 Swaps 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 December 31, 2009. During the year ended June 30, 2009, the Company and its counterparty amended the Swaps to reduce the Company’s fixed rate payments component and change the basis of the counterparty’s floating rate payments.

The short-term portion of the Swaps as of December 31, 2009 and June 30, 2009 was \$4.0 million and \$3.9 million, respectively, and was recorded in accounts payable and accrued liabilities. The long-term portion of the Swaps as of December 31, 2009 and June 30, 2009 was \$3.1 million and \$4.1 million, respectively, and was recorded in other noncurrent liabilities.

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

7. 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):

| | <u>Location of Gain (Loss) in Statement of Operations</u> | <u>Gain (Loss) on Derivatives</u> |
|--|---|---------------------------------------|
| For the three months ended December 31, 2009 | Interest expense | \$ (608) |
| For the three months ended December 31, 2008 | Other income (expenses) | \$(7,243) |
| For the six months ended December 31, 2009 | Interest expense | \$(2,192) |
| For the six months ended December 31, 2008 | Other income (expenses) | \$(8,276) |

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 quote 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.

The Company also considered the effect of its nonperformance risk in determining the fair value of its liabilities, as required under FASB ASC 820. The consideration of nonperformance risk resulted in an adjustment of \$0.5 million for the three months ended December 31, 2009. The adjustment reduced the fair value of the Company’s Swap liabilities on the condensed consolidated balance sheets and decreased the loss on derivatives on the condensed consolidated statements of operations.

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. For both the three and six months ended December 31, 2009 and 2008, diluted loss per share was computed on the same basis as basic loss per share as the inclusion of any other potential shares outstanding would be anti-dilutive. Unexercised in-the-money stock options to purchase a weighted average of zero and 42,016 shares of common stock for the three months ended December 31, 2009 and 2008, respectively, and zero and 73,224 shares of common stock for the six months ended December 31, 2009 and 2008, respectively, were not considered in the loss per share calculation as

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

8. Net Loss per Share (Continued)

such inclusion would have been anti-dilutive. Amounts shown below are in thousands, except per share amounts.

| | For the Three Months Ended December 31, 2009 | For the Three Months Ended December 31, 2008 | For the Six Months Ended December 31, 2009 | For the Six Months Ended December 31, 2008 |
|---|--|--|--|--|
| Numerator: | | | | |
| Net loss | <u>\$(18,952)</u> | <u>\$(25,991)</u> | <u>\$(5,338)</u> | <u>\$(22,471)</u> |
| Denominator: | | | | |
| Weighted average shares outstanding—basic and diluted | <u>55,968</u> | <u>55,967</u> | <u>55,968</u> | <u>55,967</u> |
| Net loss per share—basic and diluted | <u>\$ (0.34)</u> | <u>\$ (0.46)</u> | <u>\$ (0.10)</u> | <u>\$ (0.40)</u> |

9. Share-Based Payments

This footnote should be read in conjunction with Note 9—Share-Based Payments of the Notes to Consolidated Financial Statements contained in the Annual Report for the year ended June 30, 2009.

The Company recorded compensation expense of \$0.4 million and \$0.8 million for the three and six months ended December 31, 2009, respectively, and \$0.6 million and \$1.2 million for the three and six months ended December 31, 2008, respectively, related to stock options and awards outstanding. As of December 31, 2009 and 2008, there was \$0.2 million and \$2.2 million, respectively, of total unrecognized compensation expense related to unvested options. For both the three and six months ended December 31, 2009 and 2008, no options were granted or exercised.

10. Income Taxes

For the three and six months ended December 31, 2009 and 2008, there were no current or deferred income tax provision (benefits) 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 loss before income taxes, as follows (in thousands of dollars):

| | For the Three Months Ended December 31, 2009 | For the Three Months Ended December 31, 2008 | For the Six Months Ended December 31, 2009 | For the Six Months Ended December 31, 2008 |
|---|--|--|--|--|
| Statutory rate | 35% | 35% | 35% | 35% |
| Tax at statutory rate | \$(6,633) | \$(9,097) | \$(1,868) | \$(7,865) |
| Increase (decrease) due to: | | | | |
| Nondeductible meals and entertainment | 3 | 3 | 5 | 3 |
| State tax expense (benefit) | (694) | (1,324) | (179) | (1,183) |
| Return to provision | | | | |
| Adjustment to valuation allowance | 7,324 | 10,418 | 2,042 | 9,045 |
| 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, 2009</u> | <u>At June 30, 2009</u> |
|---|---------------------------------|-----------------------------|
| Deferred tax assets: | | |
| Interest rate derivatives | \$ 2,734 | \$ 3,124 |
| Contract-based intangible assets | 13,220 | 11,329 |
| Nonqualified stock options expense | 5,329 | 5,036 |
| Accrued expenses | 111 | 258 |
| Net operating loss | <u>64,643</u> | <u>60,493</u> |
| Net deferred tax assets | <u>86,037</u> | <u>80,240</u> |
| Deferred tax liabilities: | | |
| Property, plant, and equipment | 16,484 | 13,886 |
| Prepaid expenses | 1,189 | 294 |
| Contract-based intangible liabilities | <u>3,748</u> | <u>3,488</u> |
| Net deferred tax liability | 21,421 | 17,668 |
| Valuation allowance | <u>64,616</u> | <u>62,572</u> |
| Deferred tax asset (liabilities), net | <u>\$ —</u> | <u>\$ —</u> |

At December 31, 2009, the Company had a federal net operating loss carryforward of \$167.2 million which will expire between 2027 and 2029. 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).

Management has determined that valuation allowances are necessary as of December 31, 2009 and June 30, 2009, 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, 2009.

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.

11. Subsequent Events

Subsequent events were analyzed and considered through February 12, 2010, the issuance date of the report. There were no subsequent events requiring disclosure.

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 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, 2009. 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, 2009 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 7FA 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 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 \$5.7 million and \$31.9 million related to capacity sales on the GPC PPA for the three and six months ended December 31, 2009. The Company recognized \$5.6 million and \$31.8 million related to capacity sales on the GPC PPA for the three and six months ended December 31, 2008. 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.

As part of our strategy, we continue to explore and review credible alternatives that may become available to us to enhance shareholder value.

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, 2009 compared to the Three Months Ended December 31, 2008.

The following table sets forth our results of operations for the three months ended December 31, 2009 and 2008, expressed in thousands of dollars:

| | For the Three Months Ended December 31, 2009 | For the Three Months Ended December 31, 2008 | Favorable/ (Unfavorable) | |
|--|--|--|-----------------------------|----------|
| | | | Change | % Change |
| Revenues: | | | | |
| Energy sales | \$ 15,556 | \$ 22,607 | \$(7,051) | (31)% |
| Capacity sales | 5,849 | 5,645 | 204 | 4% |
| Total revenues | 21,405 | 28,252 | (6,847) | (24)% |
| Operating expenses: | | | | |
| Cost of fuel | 14,174 | 17,783 | 3,609 | 20% |
| Operating and maintenance | 7,069 | 8,580 | 1,511 | 18% |
| Gas transportation | 3,649 | 3,659 | 10 | 0% |
| Selling, general, and administrative | 2,983 | 3,305 | 322 | 10% |
| Depreciation | 6,130 | 6,117 | (13) | (0)% |
| Auxiliary power | 1,892 | 1,916 | 24 | 1% |
| Insurance | 856 | 962 | 106 | 11% |
| Total operating expenses | 36,753 | 42,322 | 5,569 | 13% |
| Operating loss | (15,348) | (14,070) | (1,278) | (9)% |
| Other income (expenses): | | | | |
| Interest expense | (2,589) | (3,811) | 1,222 | 32% |
| Taxes, other than income taxes | (964) | (907) | (57) | (6)% |
| Net interest income | — | 42 | (42) | 100% |
| Other | (51) | (7,245) | 7,194 | 99% |
| Total other expenses | (3,604) | (11,921) | 8,317 | 70% |
| Net loss before taxes | (18,952) | (25,991) | 7,039 | 27% |
| Income tax benefit | — | — | — | 0% |
| Net loss after taxes | <u>\$(18,952)</u> | <u>\$(25,991)</u> | <u>\$ 7,039</u> | 27% |

Operating and Business Metrics We Use to Analyze the Company's Performance for the Three Months Ended December 31, 2009 and December 31, 2008

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 December 31, 2009 and 2008, to the most directly comparable GAAP measures for those periods. See the reconciliation of net loss to adjusted EBITDA on page 20. This presentation may not include all of the disclosure that SEC regulations would require of a company that files periodic reports with the SEC, 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 currently consider Hinds, Hot Spring, Murray II and Sandersville to be merchant plants because they are currently not selling their energy output and capacity pursuant to long-term sales agreements.

| | For the Three Months Ended December 31, 2009 | For the Three Months Ended December 31, 2008 |
|--|--|--|
| Energy sales | \$ 15,556 | \$ 22,607 |
| <i>Less:</i> Cost of fuel | (14,174) | (17,783) |
| <i>Less:</i> Contracted energy sales | (257) | 1,545 |
| <i>Add:</i> Contracted cost of fuel | 1,883 | (30) |
| Merchant energy margin | 3,008 | 6,339 |
| Capacity sales | 5,849 | 5,645 |
| <i>Less:</i> Contracted capacity sales | (5,659) | (5,645) |
| Merchant capacity sales | \$ 190 | \$ — |
| Merchant margin | \$ 3,198 | \$ 6,339 |

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.

| | For the Three Months Ended December 31, 2009 | For the Three Months Ended December 31, 2008 |
|--|--|--|
| Energy sales | \$ 15,556 | \$ 22,607 |
| <i>Less:</i> Merchant sales | (15,299) | (24,152) |
| Contracted energy sales | 257 | (1,545) |
| <i>Less:</i> Contracted cost of fuel | (1,883) | 30 |
| <i>Add:</i> Power sales rights and obligations amortization | 2,028 | 2,028 |
| Adjusted contracted energy margin | 402 | 513 |
| Contracted capacity sales | 5,659 | 5,645 |
| <i>Less:</i> Noncash deferred capacity revenue . . | (41) | (138) |
| Adjusted contracted capacity sales | \$ 5,618 | \$ 5,507 |
| Adjusted contracted margin | \$ 6,020 | \$ 6,020 |

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

| | <u>For the Three Months Ended December 31, 2009</u> | <u>For the Three Months Ended December 31, 2008</u> |
|--|---|---|
| Merchant margin | \$3,198 | \$ 6,339 |
| Adjusted contracted margin | <u>6,020</u> | <u>6,020</u> |
| Total adjusted margin | <u><u>\$9,218</u></u> | <u><u>\$12,359</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) any nonrecurring items such as an acquisition contract termination loss, (f) depreciation, (g) director and officer insurance expense captured in adjusted corporate expenses (defined below); and 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 December 31, 2009</u> | <u>For the Three Months Ended December 31, 2008</u> |
|--|---|---|
| Total operating expenses | \$ 36,753 | \$ 42,322 |
| Less: Cost of fuel | (14,174) | (17,783) |
| Less: Major maintenance expense | 593 | (2,986) |
| Less: Gas transportation noncash amortization | (301) | (294) |
| Less: Selling, general and administrative expense | (2,983) | (3,305) |
| Less: Depreciation | (6,130) | (6,117) |
| Less: D&O insurance expense | (46) | (101) |
| Add: Taxes, other than income taxes | <u>964</u> | <u>907</u> |
| Adjusted plant expenses | <u><u>\$ 14,676</u></u> | <u><u>\$ 12,643</u></u> |

Adjusted corporate expenses is defined as selling, general, and administrative expense adjusted for (a) the removal of noncash employee options/awards expense and reorganization items such as employee severance and (b) the addition of director and officer insurance expense.

| | <u>For the Three Months Ended December 31, 2009</u> | <u>For the Three Months Ended December 31, 2008</u> |
|--|---|---|
| Selling, general and administrative expense . . | \$2,983 | \$3,305 |
| Less: Noncash employee options/awards expense | (381) | (607) |
| Less: Employee severance expense | — | 10 |
| Add: D&O insurance expense | <u>46</u> | <u>101</u> |
| Adjusted corporate expenses | <u><u>\$2,648</u></u> | <u><u>\$2,809</u></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.

| | For the Three Months Ended December 31, 2009 | For the Three Months Ended December 31, 2008 | Favorable/ (Unfavorable) | |
|--|--|--|-----------------------------|----------------------|
| | | | Change | % Change |
| Merchant energy margin | \$ 3,008 | \$ 6,339 | \$(3,331) | (53)% |
| Merchant capacity sales | 190 | — | 190 | 100% |
| Merchant margin | 3,198 | 6,339 | (3,141) | (50)% |
| Adjusted contracted energy margin | 402 | 513 | (111) | (22)% |
| Adjusted contracted capacity sales | 5,618 | 5,507 | 111 | 2% |
| Adjusted contracted margin | 6,020 | 6,020 | — | 0% |
| Total adjusted margin | 9,218 | 12,359 | (3,141) | (25)% |
| Adjusted plant expenses | 14,676 | 12,643 | (2,033) | (16)% |
| Adjusted plant EBITDA | (5,458) | (284) | (5,174) | (1,822)% |
| Adjusted corporate expenses | 2,648 | 2,809 | 161 | 6% |
| Adjusted EBITDA | <u>\$(8,106)</u> | <u>\$(3,093)</u> | <u>\$(5,013)</u> | <u>(162)%</u> |

Selected Operating and Business Metrics

| | For the Three Months Ended December 31, 2009 | For the Three Months Ended December 31, 2008 | Favorable/ (Unfavorable) | |
|---|--|--|-----------------------------|----------|
| | | | Change | % Change |
| Selected Financial and Operating Data | | | | |
| Total generation (GWh) | 476 | 484 | (8) | (2)% |
| Merchant generation (GWh) | 420 | 484 | (64) | (13)% |
| Merchant margin/merchant generation (\$/MWh) | \$7.61 | \$13.10 | \$(5.49) | (42)% |

Selected Market and Weather Data

| | For the Three Months Ended December 31, 2009 | For the Three Months Ended December 31, 2008 | Change | % Change |
|--|--|--|-----------|----------|
| Selected Market Data(1) | | | | |
| Average on-peak market power price— | | | | |
| Entergy (\$/MWh) | \$34.08 | \$44.94 | \$(10.86) | (24)% |
| Average on-peak market power price— | | | | |
| Southern (\$/MWh) | \$36.75 | \$49.54 | \$(12.79) | (26)% |
| Average Henry Hub gas price (\$/MMbtu) . | \$ 4.26 | \$ 6.38 | \$ (2.12) | (33)% |
| Selected Weather Data | | | | |
| Actual CDDs(2) | 119 | 201 | (82) | (41)% |
| Normal CDDs | 62 | 62 | — | 0% |
| Actual HDDs(3) | 3,067 | 3,059 | 8 | 0% |
| Normal HDDs | 3,087 | 3,087 | — | 0% |

Notes:

- (1) Data from Platt's Megawatt Daily and Gas Daily publications.
- (2) 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. The cumulative cooling degree days are calculated using current weather data obtained from online weather data services such as Weather Channel and Accuweather compared to the 30 year NOAA National Weather Service archive database.
- (3) 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. The cumulative heating degree days are calculated using current weather data obtained from online weather data services such as Weather Channel and Accuweather compared to the 30 year NOAA National Weather Service archive database.

Historical Results of Operations of KGen for the Three Months Ended December 31, 2009 compared to the Three Month Ended December 31, 2008.

Total adjusted margin decreased \$3.1 million, or 25%, to \$9.2 million for the three months ended December 31, 2009 compared to the same period in the previous year as a result of a \$3.1 million decrease in merchant margin. The \$9.2 million in total adjusted margin was comprised of \$3.2 million in merchant margin and \$6.0 million in adjusted contracted margin.

Merchant margin decreased \$3.1 million, or 50%, to \$3.2 million for the three months ended December 31, 2009. The \$3.1 million decrease was made up of a \$3.3 million decrease in merchant energy margin, offset by a \$0.2 million increase in merchant capacity sales. The \$3.3 million decrease in merchant energy margin was principally related to a decrease in merchant revenues from Hot Spring. Hot Spring's sales for the three months ended December 31, 2008, benefited from favorable gas basis differentials. Pipeline operational constraints in 2009 have limited Hot Spring to selling longer schedules which generally have lower financial value. There was a decrease in merchant generation of 13% from 484 GWh to 420 GWh. This volatility in generation is not uncommon in the shoulder months when our total generation is relatively low compared to our summer months. The \$0.2 million increase in merchant capacity sales was attributable to capacity sales at the Hinds plant in October 2009. When compared to the previous year, the implied merchant spark spread, or merchant margin divided by merchant generation, decreased from \$13.10 per MWh to \$7.61 per MWh for the three months ended December 31, 2009, largely due to the effects of generally lower market gas prices and the absence of favorable gas basis differentials at Hot Spring in the 2009 period compared to 2008.

Adjusted contracted margin remained the same for the three months ended December 31, 2009 and 2008 due to a \$0.1 million decrease in adjusted contracted energy margin offset by a \$0.1 million increase in adjusted contracted capacity sales.

Adjusted plant expenses increased by \$2.0 million, or 16%, to \$14.7 million for the three months ended December 31, 2009. The increase was primarily related to a \$2.1 million increase in operating and maintenance expenses for the three months ended December 31, 2009 compared to the same period in the previous year. The increase can be primarily attributed to performance of certain non-critical maintenance during the three months ended December 31, 2009 that was deferred from the three months ended December 31, 2008.

As a result of the foregoing changes in total adjusted margin and adjusted plant expenses, adjusted plant EBITDA decreased by \$5.2 million to a \$5.5 million loss for the three months ended December 31, 2009.

Adjusted corporate expenses decreased by \$0.2 million, or 6%, to \$2.6 million for the three months ended December 31, 2009.

As a result of the foregoing, adjusted EBITDA decreased by \$5.0 million to an \$8.1 million loss for the three months ended December 31, 2009.

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 non-recurring expenses). Adjusted plant EBITDA is equal to total adjusted EBITDA less certain corporate expenses.

| | For the Three Months Ended December 31, 2009 | For the Three Months Ended December 31, 2008 |
|--|--|--|
| Net loss after taxes | \$(18,952) | \$(25,991) |
| <i>Add:</i> Interest expense | 2,589 | 3,811 |
| <i>Less:</i> Net interest income | — | (42) |
| <i>Add:</i> Depreciation | 6,130 | 6,117 |
| <i>Add:</i> Power sales rights and obligations amortization | 2,028 | 2,028 |
| <i>Add:</i> Gas transportation noncash amortization | 301 | 294 |
| <i>Less:</i> Noncash deferred capacity revenue . . | (41) | (138) |
| <i>Add:</i> Other expenses | 51 | 7,245 |
| EBITDA | <u>(7,894)</u> | <u>(6,676)</u> |
| <i>Add:</i> Major maintenance expense | (593) | 2,986 |
| <i>Add:</i> Noncash employee options/awards expense | 381 | 607 |
| <i>Add:</i> Employee severance expense | — | (10) |
| Adjusted EBITDA | <u>(8,106)</u> | <u>(3,093)</u> |
| <i>Add:</i> Selling, general and administrative expense | 2,983 | 3,305 |
| <i>Less:</i> Noncash employee options/awards expense | (381) | (607) |
| <i>Less:</i> Employee severance expense | — | 10 |
| <i>Add:</i> D&O insurance expense | 46 | 101 |
| Adjusted plant EBITDA | <u>\$ (5,458)</u> | <u>\$ (284)</u> |

The following describes changes to specified financial measures of our performance. As indicated above, in calculating our adjusted EBITDA, we make adjustments to our net loss after taxes using these financial measures for the three months ended December 31, 2009 compared to the three months ended December 31, 2008.

- Interest expense for the three months ended December 31, 2009 was \$2.6 million compared to \$3.8 million for the same period in 2008. In order to more accurately reflect our financing costs for the three months ended December 31, 2009, we have elected to move gains and losses on derivatives from the other expense line and reflect them in the interest expense line of our condensed consolidated statement of operations. The \$1.2 million decrease was made up of a \$1.8 million decrease in interest expense due to a reduction in interest rates and outstanding debt compared to the same period in the previous year, offset by \$0.6 million in losses on derivatives associated with our interest rate hedging and cash payments on our Swaps.
- Interest income was offset by banking fees for the three months ended December 31, 2009 and was \$42,000 for the three months ended December 31, 2008. The decrease in interest income was related to lower interest rates for the three months ended December 31, 2009, when compared to the same period in the previous year.
- Depreciation was \$6.1 million for both three month periods.
- 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 approximately \$41,000 and \$0.1 million was recorded as capacity sales for the three months ended December 31, 2009 and 2008, respectively.
- Other expense for the three months ended December 31, 2009 and 2008 was \$0.1 million and \$7.2 million, respectively. The \$0.1 million related to various financing fees and the \$7.2 million related to losses on derivatives associated with our interest rate hedging due to cash payments on and a change in valuation of our Swaps. For the three months ended December 31, 2009, the losses on derivatives were moved to the interest expense line of our condensed consolidated statement of operations.
- Major maintenance expense for the three months ended December 31, 2009 and 2008 consisted of income of \$0.6 million and expense of \$3.0 million, respectively. The \$0.6 million income related to a credit from GE for repair work at Murray I. The \$3.0 million expense in the prior year primarily related to \$1.9 million of major maintenance expenses at both Murray facilities and \$0.8 million in connection with the fall 2008 scheduled major maintenance outage at Murray II.
- Noncash employee options/awards expense for the three months ended December 31, 2009 and 2008 was \$0.4 million and \$0.6 million, respectively, and was recorded as an increase of selling, general, and administrative expense.
- Selling, general, and administrative expense was \$3.0 million and \$3.3 million for the three months ended December 31, 2009 and 2008, respectively.

Consolidated Results of Operations of KGen for the Six Months Ended December 31, 2009 compared to the Six Months Ended December 31, 2008.

The following table sets forth our results of operations for the six months ended December 31, 2009 and 2008, expressed in thousands of dollars:

| | For the Six Months Ended December 31, 2009 | For the Six Months Ended December 31, 2008 | Favorable/ (Unfavorable) | |
|--|--|--|-----------------------------|----------|
| | | | Change | % Change |
| Revenues: | | | | |
| Energy sales | \$ 77,415 | \$134,376 | \$(56,961) | (42)% |
| Capacity sales | 32,378 | 36,494 | (4,116) | (11)% |
| Total revenues | 109,793 | 170,870 | (61,077) | (36)% |
| Operating expenses: | | | | |
| Cost of fuel | 63,169 | 112,679 | 49,510 | 44% |
| Operating and maintenance | 11,091 | 28,835 | 17,744 | 62% |
| Gas transportation | 8,434 | 8,296 | (138) | (2)% |
| Selling, general, and administrative | 5,946 | 7,689 | 1,743 | 23% |
| Depreciation | 12,255 | 12,217 | (38) | (0)% |
| Auxiliary power | 4,183 | 4,525 | 342 | 8% |
| Insurance | 1,782 | 1,804 | 22 | 1% |
| Total operating expenses | 106,860 | 176,045 | 69,185 | 39% |
| Operating income (loss) | 2,933 | (5,175) | 8,108 | 157% |
| Other income (expenses): | | | | |
| Interest expense | (6,188) | (7,122) | 934 | 13% |
| Taxes, other than income taxes | (1,963) | (2,197) | 234 | 11% |
| Net interest income | — | 302 | (302) | (100)% |
| Other | (120) | (8,279) | 8,159 | 99% |
| Total other expenses | (8,271) | (17,296) | 9,025 | 52% |
| Net loss before taxes | (5,338) | (22,471) | 17,133 | 76% |
| Income tax benefit | — | — | — | 0% |
| Net loss after taxes | \$ (5,338) | \$ (22,471) | \$ 17,133 | 76% |

Operating and Business Metrics We Use to Analyze the Company's Performance for the Six Months Ended December 31, 2009 and December 31, 2008

As indicated above, 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 six months ended December 31, 2009 and 2008, to the most directly comparable GAAP measures for those periods. See the reconciliation of net loss to adjusted EBITDA on page 27. This presentation may not include all of the disclosure that SEC regulations would require with respect to non-GAAP financial measures of a company that files periodic reports with the SEC.

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 currently consider Hinds, Hot Spring, Murray II and Sandersville to be merchant plants because they are currently not selling their energy output and capacity pursuant to long-term sales agreements.

| | <u>For the Six Months Ended December 31, 2009</u> | <u>For the Six Months Ended December 31, 2008</u> |
|--|---|---|
| Energy sales | \$ 77,415 | \$ 134,376 |
| <i>Less:</i> Cost of fuel | (63,169) | (112,679) |
| <i>Less:</i> Contracted energy sales | (13,171) | (28,943) |
| <i>Add:</i> Contracted cost of fuel | 13,116 | 27,611 |
| Merchant energy margin | <u>14,191</u> | <u>20,365</u> |
| Capacity sales | 32,378 | 36,494 |
| <i>Less:</i> Contracted capacity sales | (31,882) | (31,803) |
| Merchant capacity sales | <u>\$ 496</u> | <u>\$ 4,691</u> |
| Merchant margin | <u>\$ 14,687</u> | <u>\$ 25,056</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.

| | <u>For the Six Months Ended December 31, 2009</u> | <u>For the Six Months Ended December 31, 2008</u> |
|--|---|---|
| Energy sales | \$ 77,415 | \$ 134,376 |
| <i>Less:</i> Merchant sales | (64,244) | (105,433) |
| Contracted energy sales | 13,171 | 28,943 |
| <i>Less:</i> Contracted cost of fuel | (13,116) | (27,611) |
| <i>Add:</i> Power sales rights and obligations amortization | 4,056 | 4,056 |
| Adjusted contracted energy margin | <u>4,111</u> | <u>5,388</u> |
| Contracted capacity sales | 31,882 | 31,803 |
| <i>Less:</i> Noncash deferred capacity revenue | (49) | (596) |
| Adjusted contracted capacity sales | <u>\$ 31,833</u> | <u>\$ 31,207</u> |
| Adjusted contracted margin | <u>\$ 35,944</u> | <u>\$ 36,595</u> |

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

| | <u>For the Six Months Ended December 31, 2009</u> | <u>For the Six Months Ended December 31, 2008</u> |
|--|---|---|
| Merchant margin | \$14,687 | \$25,056 |
| Adjusted contracted margin | <u>35,944</u> | <u>36,595</u> |
| Total adjusted margin | <u>\$50,631</u> | <u>\$61,651</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) any nonrecurring items such as an acquisition contract termination loss, (f) depreciation, (g) director and officer insurance expense captured in adjusted corporate expenses (defined below); and the addition of taxes, other than income taxes, as it largely represents plant property taxes and payments in lieu of taxes.

| | <u>For the Six Months Ended December 31, 2009</u> | <u>For the Six Months Ended December 31, 2008</u> |
|---|---|---|
| Total operating expenses | \$106,860 | \$ 176,045 |
| <i>Less:</i> Cost of fuel | (63,169) | (112,679) |
| <i>Less:</i> Major maintenance expense | 995 | (18,613) |
| <i>Less:</i> Gas transportation noncash amortization | (601) | (588) |
| <i>Less:</i> Selling, general and administrative expense | (5,946) | (7,689) |
| <i>Less:</i> Depreciation | (12,255) | (12,217) |
| <i>Less:</i> D&O insurance expense | (92) | (203) |
| <i>Add:</i> Taxes, other than income taxes | <u>1,963</u> | <u>2,197</u> |
| Adjusted plant expenses | <u>\$ 27,755</u> | <u>\$ 26,253</u> |

Adjusted corporate expenses is defined as selling, general, and administrative expense adjusted for (a) the removal of noncash employee options/awards expense and reorganization items such as employee severance and (b) the addition of director and officer insurance expense.

| | <u>For the Six Months Ended December 31, 2009</u> | <u>For the Six Months Ended December 31, 2008</u> |
|---|---|---|
| Selling, general and administrative expense | \$5,946 | \$ 7,689 |
| <i>Less:</i> Noncash employee options/awards expense | (756) | (1,180) |
| <i>Less:</i> Employee severance expense | (1) | 10 |
| <i>Add:</i> D&O insurance expense | <u>92</u> | <u>203</u> |
| Adjusted corporate expenses | <u>\$5,281</u> | <u>\$ 6,722</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.

| | For the Six Months Ended December 31, 2009 | For the Six Months Ended December 31, 2008 | Favorable/ (Unfavorable) | |
|--|--|--|-----------------------------|--------------|
| | | | Change | % Change |
| Merchant energy margin | \$14,191 | \$20,365 | \$ (6,174) | (30)% |
| Merchant capacity sales | 496 | 4,691 | (4,195) | (89)% |
| Merchant margin | 14,687 | 25,056 | (10,369) | (41)% |
| Adjusted contracted energy margin | 4,111 | 5,388 | (1,277) | (24)% |
| Adjusted contracted capacity sales | 31,833 | 31,207 | 626 | 2% |
| Adjusted contracted margin | 35,944 | 36,595 | (651) | (2)% |
| Total adjusted margin | 50,631 | 61,651 | (11,020) | (18)% |
| Adjusted plant expenses | 27,755 | 26,253 | (1,502) | (6)% |
| Adjusted plant EBITDA | 22,876 | 35,398 | (12,522) | (35)% |
| Adjusted corporate expenses | 5,281 | 6,722 | 1,441 | 21% |
| Adjusted EBITDA | \$17,595 | \$28,676 | \$(11,081) | (39)% |

Selected Operating and Business Metrics

| | For the Six Months Ended December 31, 2009 | For the Six Months Ended December 31, 2008 | Favorable/ (Unfavorable) | |
|---|--|--|-----------------------------|----------|
| | | | Change | % Change |
| Selected Financial and Operating Data | | | | |
| Total generation (GWh) | 2,356 | 1,750 | 606 | 35% |
| Merchant generation (GWh) | 1,911 | 1,397 | 514 | 37% |
| Merchant margin/merchant generation (\$/MWh) | \$ 7.69 | \$17.94 | \$(10.25) | (57)% |

Selected Market and Weather Data

| | For the Six Months Ended December 31, 2009 | For the Six Months Ended December 31, 2008 | Change | % Change |
|--|---|---|---------------|-----------------|
| Selected Market Data(1) | | | | |
| Average on-peak market power price— | | | | |
| Entergy (\$/MWh) | \$31.43 | \$58.27 | \$(26.84) | (46)% |
| Average on-peak market power price— | | | | |
| Southern (\$/MWh) | \$34.04 | \$63.77 | \$(29.73) | (47)% |
| Average Henry Hub gas price (\$/MMbtu) | \$ 3.71 | \$ 7.77 | \$ (4.06) | (52)% |
| Selected Weather Data | | | | |
| Actual CDDs(2) | 3,710 | 3,974 | (264) | (7)% |
| Normal CDDs | 3,761 | 3,761 | — | 0% |
| Actual HDDs(3) | 3,067 | 3,059 | 8 | 0% |
| Normal HDDs | 3,087 | 3,087 | — | 0% |

Notes:

- (1) Data from Platt's Megawatt Daily and Gas Daily publications.
- (2) 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. The cumulative cooling degree days are calculated using current weather data obtained from online weather data services such as Weather Channel and Accuweather compared to the 30 year NOAA National Weather Service archive database.
- (3) 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. The cumulative heating degree days are calculated using current weather data obtained from online weather data services such as Weather Channel and Accuweather compared to the 30 year NOAA National Weather Service archive database.

Historical Results of Operations of KGen for the Six Months Ended December 31, 2009 compared to the Six Month Ended December 31, 2008.

Total adjusted margin decreased \$11.0 million, or 18%, to \$50.6 million for the six months ended December 31, 2009 compared to the same period in the previous year as a result of a \$10.4 million decrease in merchant margin and a \$0.7 million decrease in adjusted contracted margin. The \$50.6 million in total adjusted margin was comprised of \$14.7 million in merchant margin and \$35.9 million in adjusted contracted margin.

Merchant margin decreased \$10.4 million, or 41%, to \$14.7 million for the six months ended December 31, 2009. The \$10.4 million decrease was made up of a \$6.2 million decrease in merchant energy margin and a \$4.2 million decrease in merchant capacity sales. The \$6.2 million decrease in merchant energy margin related primarily to the significant decrease in natural gas prices, as evidenced by the 52% decrease in the average Henry Hub gas price from \$7.77 per MMBtu to \$3.71 per MMBtu for the six months ended December 31, 2009 as compared to the previous year, the absence of favorable gas basis differentials at Hot Spring in the 2009 period compared to 2008, and the pipeline operational constraints that developed in 2009 that have limited Hot Spring to selling longer schedules which generally have lower financial value. In our markets, merchant energy margins are in part a function of natural gas prices and the market heat rates. Thus, lower gas prices at the same level of market heat rates will yield lower merchant energy margins. There was an increase in merchant generation of 37% from 1,397 GWh to

1,911 GWh which was a result of additional “must run” and 24 hour monthly block sales as compared to the six months ended December 31, 2008. We believe that lower natural gas prices were in part a factor in the increased monthly sales opportunities for our plants and that such prices enabled our combined cycle plants to displace more expensive generation sources in the market. The \$4.2 million decrease in merchant capacity sales was attributable to \$4.7 million in merchant capacity sales from a portion of the Murray II plant in the prior year, offset by merchant capacity sales from the Hinds plant in the current year in the amount of \$0.5 million. The implied merchant spark spread, or merchant margin divided by merchant generation, decreased from \$17.94 per MWh to \$7.69 per MWh, largely due to the decrease in merchant capacity sales, the effects of generally lower market gas prices and the absence of favorable gas basis differentials at Hot Spring in the 2009 period compared to 2008.

Adjusted contracted margin decreased \$0.7 million, or 2%, to \$35.9 million for the six months ended December 31, 2009, which was comprised of \$4.1 million in adjusted contracted energy margin and \$31.8 million in adjusted contracted capacity sales. The \$0.7 million decrease was made up of a \$1.3 million decrease in adjusted contracted energy margin offset by a \$0.6 million increase in adjusted contracted capacity sales. The \$1.3 million decrease in adjusted contracted energy margin was largely attributable to lower revenues from the GPC PPA as a result of lower natural gas prices and was also offset by the reduction of costs of replacement power purchased in connection with the GPC PPA for the six months ended December 31, 2009 as compared to the previous year. The \$0.6 million increase in adjusted contracted capacity sales was a result of the escalation of the pricing under the GPC PPA.

Adjusted plant expenses increased by \$1.5 million, or 6%, to \$27.8 million for the six months ended December 31, 2009. The increase was primarily related to a \$1.9 million increase in operating and maintenance expenses offset in part by a \$0.3 million decrease in auxiliary power for the six months ended December 31, 2009 compared to the same period in the previous year. The operating and maintenance increase can be primarily attributed to performance of certain non-critical maintenance during the three months ended December 31, 2009 that was deferred from the three months ended December 31, 2008. As a result of the foregoing changes in total adjusted margin and adjusted plant expenses, adjusted plant EBITDA decreased by \$12.5 million to \$22.9 million for the six months ended December 31, 2009.

Adjusted corporate expenses decreased by \$1.4 million, or 21%, to \$5.3 million for the six months ended December 31, 2009. This decrease was primarily related to a \$0.6 million decrease in commercial marketing fees, a \$0.5 million decrease in legal and professional service expenses, and a \$0.4 million decrease in payroll expenses.

As a result of the foregoing, adjusted EBITDA decreased by \$11.1 million to \$17.6 million for the six months ended December 31, 2009.

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 non-recurring expenses). Adjusted plant EBITDA is equal to total adjusted EBITDA less certain corporate expenses.

| | <u>For the Six Months Ended December 31, 2009</u> | <u>For the Six Months Ended December 31, 2008</u> |
|---|---|---|
| Net loss after taxes | \$(5,338) | \$(22,471) |
| Add: Interest expense | 6,188 | 7,122 |
| Less: Net interest income | — | (302) |
| Add: Depreciation | 12,255 | 12,217 |
| Add: Power sales rights and obligations amortization | 4,056 | 4,056 |
| Add: Gas transportation noncash amortization . | 601 | 588 |
| Less: Noncash deferred capacity revenue | (49) | (596) |
| Add: Other expenses | 120 | 8,279 |
| EBITDA | <u>17,833</u> | <u>8,893</u> |
| Add: Major maintenance expense | (995) | 18,613 |
| Add: Noncash employee options/awards expense | 756 | 1,180 |
| Add: Employee severance expense | 1 | (10) |
| Adjusted EBITDA | <u>17,595</u> | <u>28,676</u> |
| Add: Selling, general and administrative expense | 5,946 | 7,689 |
| Less: Noncash employee options/awards expense | (756) | (1,180) |
| Less: Employee severance expense | (1) | 10 |
| Add: D&O insurance expense | 92 | 203 |
| Adjusted plant EBITDA | <u><u>\$22,876</u></u> | <u><u>\$ 35,398</u></u> |

The following describes changes to specified financial measures of our performance. As indicated above, in calculating our adjusted EBITDA, we make adjustments to our net loss after taxes using these financial measures for the six months ended December 31, 2009 compared to the six months ended December 31, 2008.

- Interest expense for the six months ended December 31, 2009 was \$6.2 million compared to \$7.1 million for the same period in 2008. In order to more accurately reflect our financing costs for the six months ended December 31, 2009, we have elected to move gains and losses on derivatives from the other expense line and reflect them in the interest expense line of our condensed consolidated statement of operations. The \$0.9 million decrease was made up of a \$3.1 million decrease in interest expense due to a reduction in interest rates and outstanding debt compared to the same period in the previous year, offset by \$2.2 million in losses on derivatives associated with our interest rate hedging and cash payments on our Swaps.
- Interest income was offset by banking fees for the six months ended December 31, 2009 and was \$0.3 million for the six months ended December 31, 2008. The decrease in interest income was related to lower interest rates when compared to the same period in the previous year.
- Depreciation was \$12.2 million for both six month periods.
- Amortization of contract-based power sales rights and obligations, for both six month periods, was \$4.1 million and was recorded as a reduction of energy sales.

- Amortization of contract-based natural gas transportation rights and obligations, for both six month periods, was \$0.6 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 approximately \$49,000 and \$0.6 million was recorded as capacity sales for the six months ended December 31, 2009 and 2008, respectively.
- Other expense for the six months ended December 31, 2009 and 2008 was \$0.1 million and \$8.3 million, respectively. The \$8.3 million in prior year related to losses on derivatives associated with our interest rate hedging due to cash payments on and a change in valuation of our Swaps. For the six months ended December 31, 2009, the losses on derivatives were moved to the interest expense line of our condensed consolidated statement of operations.
- Major maintenance expense for the six months ended December 31, 2009 and 2008 was income of \$1.0 million and expense of \$18.6 million, respectively. The \$1.0 million income related to a credit from GE for repair work at Murray I. The \$18.6 million expense primarily related to \$16.4 million in connection with the fall 2008 hot gas path inspection performed at Murray II and \$1.9 million in other major maintenance expenses at both Murray facilities.
- Noncash employee options/awards expense for the six months ended December 31, 2009 and 2008 was \$0.8 million and \$1.2 million, respectively, and was recorded as an increase of selling, general, and administrative expense.
- Selling, general, and administrative expense was \$5.9 million and \$7.7 million for the six months ended December 31, 2009 and 2008, respectively. This decrease was primarily related to a \$0.6 million decrease in commercial marketing fees, a \$0.5 million decrease in legal and professional service expenses, a \$0.4 million decrease in payroll expenses, and \$0.4 million decrease in noncash employee options/awards expense.

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, 2009 (in thousands of dollars):

| | |
|--|------------------|
| Unrestricted cash and cash equivalents | \$ 59,772 |
| Working capital revolver and synthetic letter of credit facility (net of letters of credit issued and cash draws thereunder) | <u>62,126</u> |
| Total | <u>\$121,898</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, 2009, we had \$62.1 million available under our Credit Facility, of which \$62.0 million was under the working capital revolver and \$0.1 million was under the synthetic letter of credit facility, for activities related to our plants. We had cash on hand of \$59.8 million, of which \$30.1 million was cash at the parent level and not subject to the lien of the Credit Agreement at December 31, 2009. Similarly, \$32.0 million was the balance at the parent level not subject to the credit agreement at June 30, 2009. 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 over the next 12 months.

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. The proceeds of the drawdown continue to be used for working capital purposes. Total letters of credits outstanding under the Working Capital Facility were \$8.0 million as of December 31, 2009. Total letters of credit outstanding under the Collateral Credit Facility were \$119.9 million as of December 31, 2009.

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.*” 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 \$30.1 million at December 31, 2009 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 December 31, 2009, we were in compliance with the covenants contained within our Credit Facility.

Capital Expenditures and Major Maintenance

Total capital expenditures for the three and six months ended December 31, 2009 were \$0.4 million and \$1.4 million, respectively. Total capital expenditures for the three and six months ended December 31, 2008 were \$0.7 million and \$1.1 million, respectively.

Major maintenance was income of \$0.6 million and expense of \$3.0 million for the three months ended December 31, 2009 and 2008, respectively. The \$0.6 million income related to a credit from GE for repair work at Murray I. The \$3.0 million expense in the prior year primarily related to \$1.9 million of major maintenance expenses at both Murray facilities and \$0.8 million in connection with the fall 2008 scheduled major maintenance outage at Murray II. Major maintenance expense was income of \$1.0 million and expense of \$18.6 million for the six months ended December 31, 2009 and 2008, respectively. The

\$1.0 million income related to a credit from GE for repair work at Murray I. The \$18.6 million expense primarily related to \$16.4 million in connection with the fall 2008 hot gas path inspection performed at Murray II and \$1.9 million in other major maintenance expenses at both Murray facilities.

We incur costs for major maintenance on the Plants which is expensed in the period incurred. We expect to incur major maintenance expense of \$18.5 million for the remainder of fiscal 2010.

Cash Flow Analysis

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

| | <u>For the Six Months Ended December 31, 2009</u> | <u>For the Six Months Ended December 31, 2008</u> |
|--|---|---|
| Statement of Cash Flow Data: | | |
| Cash flows provided by (used in): | | |
| Operating activities | \$20,904 | \$ 9,685 |
| Investing activities | (795) | (9,734) |
| Financing activity | <u>(1,000)</u> | <u>(1,000)</u> |
| Increase in cash and cash equivalents | 19,109 | (1,049) |
| Cash and cash equivalents at beginning of period | <u>40,663</u> | <u>51,493</u> |
| Cash and cash equivalents at end of period | <u>\$59,772</u> | <u>\$50,444</u> |

Cash Flows from Operating Activities. Our cash flows from operations were \$20.9 million for the six months ended December 31, 2009, primarily related to depreciation expense of \$12.2 million, amortization expense of \$4.7 million, valuation of derivative instruments of \$2.2 million, and collections of accounts receivable of \$17.8 million, which was offset primarily by a net loss of \$5.3 million, payments from settlement of derivatives instruments of \$3.2 million, a decrease in spare parts inventories of \$1.3 million, a decrease in prepaid expenses and other current assets of \$2.0 million and a decrease in accounts payable and accrued liabilities of \$5.4 million. We also incurred \$3.6 million of cash interest expense 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, 2009 were \$0.8 million and related primarily to purchases of property, plant, and equipment.

Cash Flows from Financing Activity. Our cash flows used in financing activity for the six months ended December 31, 2009 were \$1.0 million and represented \$1.0 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. The terms of our Credit Facility require us to maintain interest hedge arrangements through the third anniversary of the closing date of our Credit Facility 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 have entered into interest rate swaps in order to mitigate the risk associated with the variable rate borrowings.

KGen LLC has four 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 has historically paid its counterparty the equivalent of a fixed interest payment on a predetermined notional value, and we

received the equivalent of a floating interest payment based on three-month LIBOR rate calculated on the same notional value. These payments were made on a quarterly basis. During the year ended June 30, 2009, the Company and its counterparty amended the Swaps to reduce the Company's fixed rate payment component and change the basis of the counterparty's floating rate payments. We now 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 December 31, 2009 was \$132.0 million with an average interest rate payable by KGen LLC of 5.0%. The following is a summary of the Swaps:

| | <u>Maturity Date</u> | <u>Notional Amount</u> (in millions) | <u>December 31, 2009</u> | | <u>June 30, 2009</u> | |
|-----------------------|----------------------|---|-------------------------------------|-------------------|-------------------------------------|-------------------|
| | | | <u>Fair Value</u> (in thousands) | <u>Fixed Rate</u> | <u>Fair Value</u> (in thousands) | <u>Fixed Rate</u> |
| Contract #1 | Expired | \$ — | \$ — | | \$ — | |
| Contract #2 | Expired | \$ — | \$ — | | \$ — | |
| Contract #3 | 3-31-2010 | \$33.0 | \$ (352) | 4.9% | \$ (922) | 4.9% |
| Contract #4 | 3-31-2011 | \$33.0 | \$(1,454) | 5.0% | \$(1,869) | 5.0% |
| Contract #5 | 3-31-2012 | \$33.0 | \$(2,378) | 5.0% | \$(2,455) | 5.0% |
| Contract #6 | 3-31-2013 | \$33.0 | \$(2,840) | 5.1% | \$(2,778) | 5.1% |

As of December 31, 2009, the majority of our exposure to variation in interest costs associated with our debt due to changes in the LIBOR rate has been hedged 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.

PART II—OTHER INFORMATION

Number 1A. Risk Factors and Forward-Looking Statements

Risk Factors

The following risk factor below updates Part I. “Number 1A. *Risk Factors*” of our Annual Report for the year ended June 30, 2009 as a result of executing new agreements with NAES.

We rely extensively on third party service providers for the operation and maintenance of the Plants and for certain marketing of our electricity, and if such service providers cease to perform such services or fail to perform such services adequately or on the same terms, it could adversely affect our results of operations and cash flows.

We currently have few employees of our own and are dependent on contractual arrangements with third parties for the operation and maintenance of our Plants. Currently all of our Plants are operated by DEGS under operating and maintenance agreements. Upon termination of the applicable agreements with DEGS, NAES will operate our Hinds, Hot Spring and Sandersville Plants. In addition, GEI provides maintenance services to our combined-cycle plants under LTSAs. BNP Paribas Energy Trading GP, or BNP, formerly Fortis Energy Marketing & Trading GP, acts as commercial marketer for the power produced by four of the Plants other than the Murray I plant. Procurement of fuel for the Plants, except for sales under the GPC PPA for Murray I and natural gas supply from Sequent for Murray I, is provided by BNP. Currently, BNP and Sequent provide significant credit to us which allows us to transact without providing additional financial collateral. In the event that their credit policies toward us change or these agreements terminate, we may be unable to obtain an agreement with another energy service provider on similarly favorable terms and this could have a significant impact on our ability to procure fuel and meet our power generation targets. While we believe that such contractual arrangements allow us to leverage our management team and have allowed us to operate more effectively and efficiently, in the event we have a significant disagreement with DEGS, NAES, GEI, Sequent or BNP that interrupts one of their services or one of these providers experiences financial difficulties that adversely affect their ability to provide services, our results of operations, financial condition and cash flows may be adversely affected. In this regard, DEGS and BNP both have the right to terminate their agreements with us at their convenience. In addition, although we seek to align our interests contractually, there may be conflicts of interest and one of these parties may take actions that are not in our best interests. We do not have the internal operating capability to perform the services that we outsource, and to develop such capabilities would be time consuming and expensive. However, based upon discussions with potential alternative providers, we believe that multiple options for a replacement energy management service provider and a replacement operations and maintenance service provider are available to KGen. However, we cannot be certain that these providers will deliver their services to us on the same terms as our current providers.

It is our intent that BNP passes through the actual price of power and costs of fuel that it receives from its counterparties through mirroring back-to-back transactions and not make any additional revenues by inserting an additional margin on these transactions. However, not all transactions are totally transparent (particularly when sales or purchases are made to and from BNP’s own trading book), and although we have the ultimate authority for all transactions, the possibility exists that our future sales margins may be materially reduced by BNP’s pricing.

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, 2009.

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

On December 10, 2009, 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>Against</u> | <u>Abstain</u> |
|----------------------------|------------|----------------|----------------|
| Daniel T. Hudson | 48,027,591 | 12,623 | — |
| James P. Jenkins | 46,739,978 | 1,300,235 | — |
| Gerald J. Stalun | 47,672,039 | 368,174 | — |
| Thomas B. White | 47,670,979 | 369,234 | — |

Other Matters

| | <u>For</u> | <u>Against</u> | <u>Abstain</u> | <u>Broker Non-Votes</u> |
|---|------------|----------------|----------------|-----------------------------|
| Ratify Deloitte & Touche LLP as the Independent, Registered Public Accountants | 47,729,662 | 310,551 | — | — |
| Approve Stockholders Rights Plan | 29,201,366 | 8,886,680 | 7,266,568 | 2,685,600 |