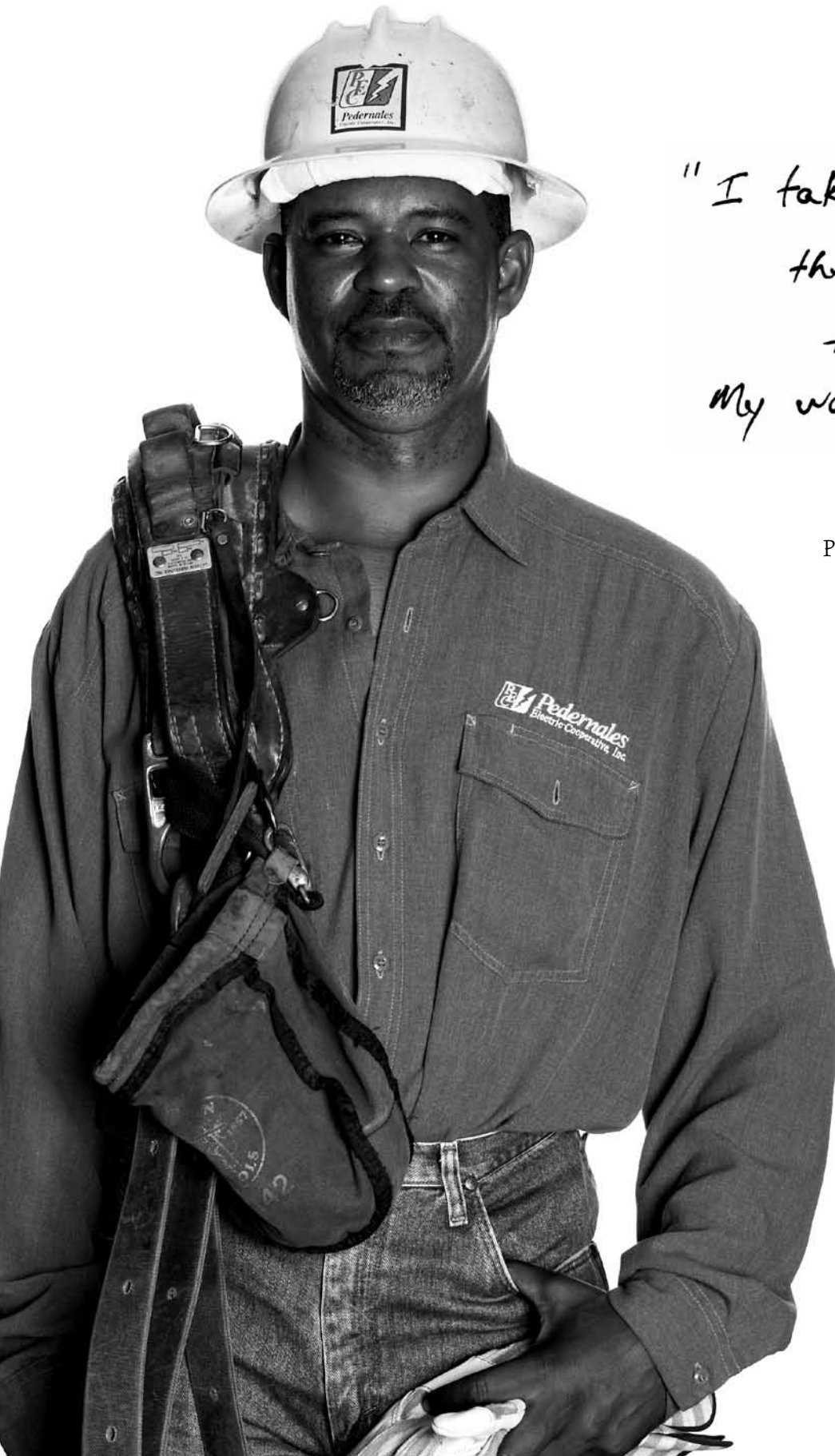


PEDERNALES ELECTRIC

2007 ANNUAL REPORT



*"I take pride in keeping
the lights on for
the members.*

My work is never done."

ROBERT JONES

PEC Lineman, 14 years



This has been an evolutionary year for Pedernales Electric Cooperative, highlighted by significant governance changes and new initiatives. Our unwavering commitment to members, however, remained steadfast while we instituted meaningful revisions in policy and welcomed new leadership.

Our membership requested revisions in the way we elect our Board of Directors, which the PEC Board accomplished by initiating a nomination-by-petition procedure that enables members to seek a position on the Board by collecting 25 member signatures. Petition materials were made available to members on the PEC web site and at each PEC office. Further, the Board replaced the proxy voting system formerly in place with a ballot voting system to be overseen by an independent election services provider that allows members to vote for the candidates of their choice in person, by mail, or online.

The Board also decided to limit Board officers to serving two consecutive one-year terms for the same office, and they agreed to reevaluate Director compensation. In addition, the Board voted to periodically hold Board meetings at locations throughout our service area to make it easier for members living in different areas to attend the meetings.

A policy of annual patronage capital distribution was initiated in November. Capital credits will be distributed to members on a 30-year rotating basis, beginning with the earliest allocated credits. The first allotment of patronage capital, totaling \$7,304,265 and involving 61,805 current and former members, was distributed in December to members of record through 1976.

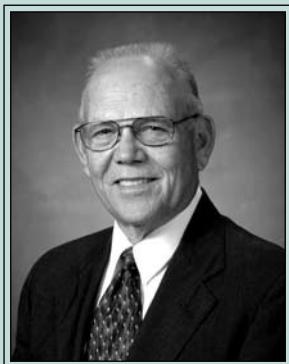
We also had significant changes at the top of the organization, filling vacancies created by the retirement of both the General Manager and Board President. Juan Garza, former General Manager of Austin Energy, joined PEC as General Manager. Former Board President W. W. “Bud” Burnett’s retirement left his Director term unexpired, which the Board voted to fill with a candidate nominated by petition in 2008, rather than appointing a new director.

To communicate these changes and future business decisions to members and the media, our web site was revised to include a *Corporate Profile* section

and provide greater member access to business and governance information, including: PEC Board biographies, the IRS Form 990, our annual report, and information for members regarding capital credits. In addition, notices of the Board's meetings and meeting agendas are now placed on our web site before each regular meeting.

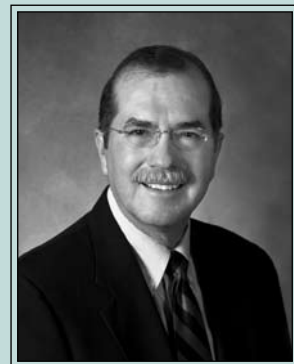
Our newest district office opened in Oak Hill in late November. This office serves the ever-expanding membership between South Austin and Dripping Springs, which includes more than 33,000 PEC members. We now have 16 business offices to provide personal, convenient support for our membership and to provide more timely access for our service vehicles throughout our 8,100-square-mile service area.

We are excited about these changes and the new perspectives they bring to PEC, and we will continue to review policies and procedures to best serve our members. Pedernales Electric has a long and proud history, and we're dedicated to marking 2008, our 70th year of operation, by working with our members to move the Cooperative forward into a new, progressive era while maintaining our customer service focus, strong financial standing, and system reliability.



A handwritten signature in cursive script, reading "E. B. Price".

E. B. Price
Board President



A handwritten signature in cursive script, reading "Juan Garza".

Juan Garza
General Manager



*"We don't talk to members—
we have a conversation
with them."*

MICHELLE CLOUD

PEC Customer Care Representative, 8 years

PEC's first full year as a billion-dollar corporation began with the most significant ice storm our system endured in ten years. Continual light drizzle and sub-freezing temperatures in mid-January led to frozen power lines and road surfaces causing many members to be without power for extended periods. Our employees met this challenge by working around the clock to answer member calls and repair damage to lines and poles. Our proactive tree-trimming program also helped lessen the damage.

Our outstanding customer care representatives worked hard during the ice storm and throughout the year to retain the top national customer service ranking in J.D. Power and Associates' 2007 Electric Utility Residential Customer Satisfaction StudySM, released in August. Our customer service score put us at the top of the 76 electric utilities included in the study, indicating our members' satisfaction in our ability to serve their needs. We also ranked in the top five utilities in overall customer satisfaction.

Our top-ranked CCRs helped serve a still-growing membership, which added 9,336 new members in 2007 to bring our membership total to 221,276 at year's end.

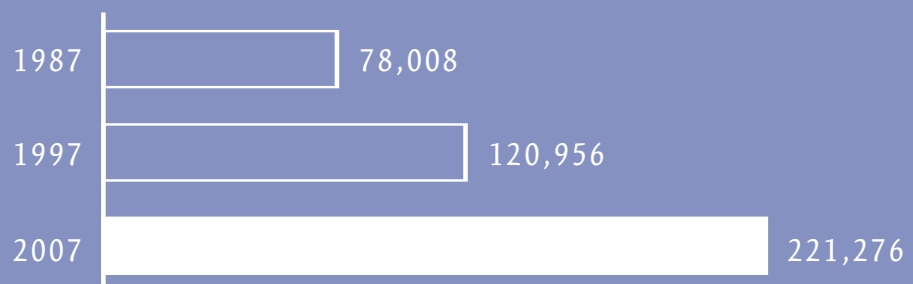
Interestingly enough, even with a 4.4 percent increase in members, our call center fielded 7.8 percent fewer calls. This may be attributed to the fact that our web site, www.pec.coop, experienced significant growth, recording 673,194 visits, representing a 77 percent increase in traffic compared with 2006. Members made 164,114 payments on our web site in 2007, totaling \$28,177,755—up almost \$10 million from a year ago.

Our engineers responded to growth patterns in large part by upgrading six existing substations, beginning construction on three new substations near our high-growth areas around Austin, and making plans to build another new substation near Marble Falls. These new substations are all scheduled to be energized by June 2009, joining the other 56 active substations in our network.

Our Green Works environmental initiative, launched in April, represents the evolution of our commitment to environmental stewardship. Central to the initiative is our Board's decision to agree to a long-term contract with American Electric Power to purchase wind-generated electricity. The wind power will come from the South Trent Wind Farm, which is located in West Texas and is scheduled to begin commercial operation in December 2009.

continued

Total Members



The PEC Home Energy Center was added to our web site in April as a part of the Green Works launch. This exciting feature is designed to help members conserve electricity, lower their monthly bills, and reduce carbon dioxide emissions. Members using the Home Energy Center key in detailed information about their homes and receive specific ideas for reducing electric use.

We also provided 1,500 compact fluorescent lightbulbs (CFLs) at our annual meeting and have given away more than 80,000 additional CFLs at our offices and other events since Green Works began. On average, CFLs use 75 percent less electricity, produce 75 percent less heat, and last up to 10 times longer than standard incandescent bulbs.

We help members and their businesses save money on heating, cooling, and lighting costs with our rebate programs. Through our HVAC Rebate Program, we provide rebates of up to \$1,000 to members upgrading to more efficient heating, venting, and air conditioning systems. We paid more than \$548,000 in HVAC rebates to members who took advantage of this program in 2007.

Our Commercial Lighting Rebate Program offers incentives to help members install energy-efficient lighting in new or existing

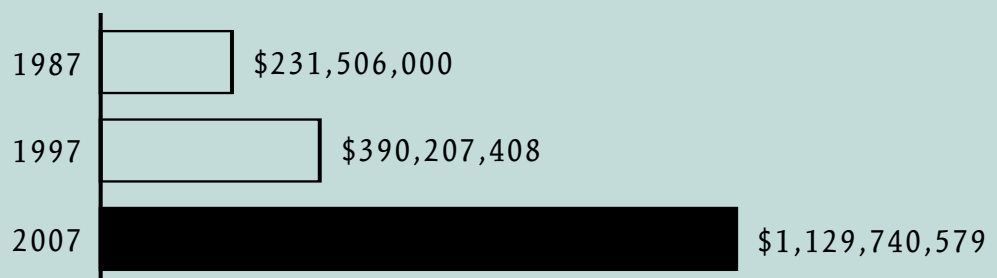
commercial buildings. Rebate amounts are \$150 per kilowatt reduced for new construction and \$300 per kilowatt reduced in existing buildings. Lighting accounts for more than 40 percent of commercial electricity consumption in the United States.

Another essential component of Green Works involves minimizing the environmental impact of our business practices. We've extended our recycling efforts and use recycled paper where possible, limit the types and uses of herbicides at PEC facilities, and use organic fertilizer on PEC property. We're also replacing aging vehicles in our fleet with hybrid vehicles whenever possible to reduce emissions.

We take pride in supporting the communities in which our members and employees live. This year we continued our support for area students through our scholarship fund and Project Graduation donations, and we were able to assist 14 local education foundations with our Partners in Learning program. Our sponsorship of the eight-month Lyndon Baines Johnson Library and Museum exhibit, *Power to the People: The Electrification of Rural Texas*, ended in May after helping educate 209,365 visitors about rural electrification in Texas.

continued

Total Assets



*"We're here 24/7
to make sure the
power stays on."*

MANDO TREVINO

PEC SCADA Operator, 15 years



"The thing I like most
about my job is that it
takes me to the member's
kitchen table."

CHRIS DENISON

PEC Conservation Representative, 14 years



Charitable organizations benefit from our United Charities and Light the Way programs, and we provide support to builders and new homeowners working with Habitat for Humanity®.

Our Community Assistance Program helps members unable to pay their electric bills. Each year, the PEC Board authorizes funds for this program, which uses local agencies to qualify applicants for assistance based on financial need. Members also fund a portion of this initiative through their final bills after disconnecting service, in which credit amounts less than \$15 are transferred to the Community Assistance Program unless a refund is requested.

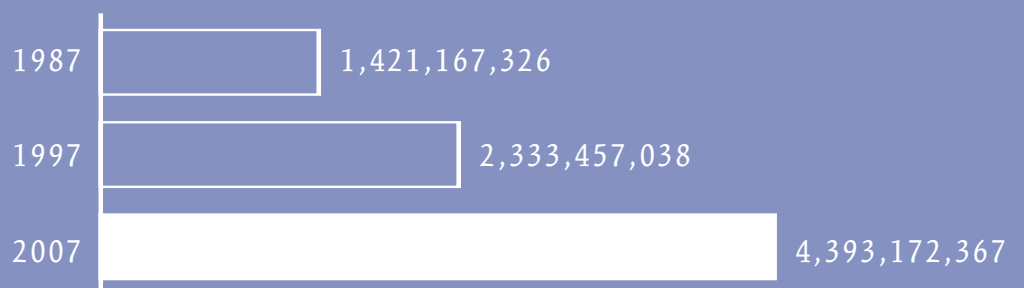
Electrical safety awareness is one of our top priorities for both employees and members. All of our employees attend quarterly safety training courses, and our field employees participate in weekly safety meetings. For our members and other community residents, our Speakers Bureau promotes safety awareness through free presentations such as “WOW! Watch Out for Wires!” and “Electrical Awareness in Emergencies.” We also help prevent potential electrical hazards for excavators by assisting the Texas Excavation Safety System in identifying underground electric lines.

We’re also helping to keep our communities safer by participating in the Rural Crime Watch program and the Texas Amber Alert Network. Our participation is ideal because our vehicles are equipped with two-way radio units that allow prompt communication with law enforcement or emergency medical services.

In addition, to help facilitate economic development in local communities, we provide free grant writing and research assistance to local governments and non-profit groups. We helped these organizations obtain \$782,323 in grant funds in 2007.

We are ever cognizant of our many obligations to our owners, the Pedernales Electric membership. Our overriding mission has always been to provide reasonably priced, reliable electricity and outstanding customer service to members. We will also work diligently to incorporate member feedback into business decisions, conduct our business in an open and transparent fashion, and work to be a strong corporate supporter of our communities and steward to our environment. We will forever remain dedicated to meeting the needs of our membership, and we look forward to serving our members with renewed enthusiasm.

Kilowatt-Hour Sales



BOARD OF DIRECTORS



E. B. PRICE
PRESIDENT



O. C. HARMON
SECRETARY-TREASURER



BARRY ADAIR
DIRECTOR



VI CLOUD
DIRECTOR



R. B. FELPS
DIRECTOR



VAL SMITH
DIRECTOR



RUSTY ALLEN
ADVISORY DIRECTOR



OLA ARMSTRONG
ADVISORY DIRECTOR



DR. STUART M. NUNNALLY
ADVISORY DIRECTOR



ROBERT A. REED JR.
ADVISORY DIRECTOR



D. L. RUFF
ADVISORY DIRECTOR



BARBARA A. SHAFFER
ADVISORY DIRECTOR



BLAS TENORIO
ADVISORY DIRECTOR



KENNETH W. KENNEDY
ADVISORY DIRECTOR-AT-LARGE



LIBBY A. LINEBARGER
ADVISORY DIRECTOR-AT-LARGE



LAMONT RAMAGE
ADVISORY DIRECTOR-AT-LARGE



PEDERNALES ELECTRIC COOPERATIVE, INC.

Consolidated Financial Statements

December 31, 2007 and 2006

(With Independent Auditors' Report Thereon)

PEDERNALES ELECTRIC COOPERATIVE, INC.

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KPMG LLP
Suite 1200
300 Convent
San Antonio, TX 78205

Independent Auditors' Report

The Board of Directors
Pedernales Electric Cooperative, Inc.:

We have audited the accompanying consolidated balance sheets of Pedernales Electric Cooperative, Inc. and its subsidiaries (the Cooperative) as of December 31, 2007 and 2006, and the related consolidated statements of revenues, expenses and patronage capital and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Cooperative's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Cooperative's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pedernales Electric Cooperative, Inc. and its subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

As discussed in note 1 to the consolidated financial statements, the Cooperative changed its classification method for contributed facilities in 2007. Also, as discussed in the notes 1 and 7 to the consolidated financial statements, the Cooperative adopted the provisions of SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, and changed its method of recognizing the funded status of its defined benefit postretirement plans.

KPMG LLP

April 1, 2009

PEDERNALES ELECTRIC COOPERATIVE, INC.

Consolidated Balance Sheets

December 31, 2007 and 2006

Assets	2007	2006
		(As adjusted)
Utility plant:		
Transmission	\$ 65,587,505	57,241,635
Distribution	834,227,351	749,868,043
General	<u>100,212,037</u>	<u>92,216,778</u>
Total utility plant in service	1,000,026,893	899,326,456
Construction work in progress	<u>26,950,840</u>	<u>11,154,120</u>
Total utility plant	1,026,977,733	910,480,576
Less accumulated depreciation	<u>179,500,361</u>	<u>162,913,008</u>
Utility plant, net	<u>847,477,372</u>	<u>747,567,568</u>
Subscription and long-term capital certificates and other investments	<u>7,682,963</u>	<u>6,876,382</u>
Current assets:		
Cash and cash equivalents	4,326,942	5,455,804
Short-term investments	6,400,000	23,623,000
Short-term investments – reserve fund	35,000,000	33,000,000
Short-term investments – contingency fund	10,500,000	10,500,000
Accounts receivable:		
Members	23,043,855	25,453,750
Other	4,801,391	2,435,929
Allowance for uncollectible accounts	(1,021,042)	(1,114,907)
Accrued unbilled revenues	17,432,583	17,741,438
Materials and supplies	12,216,183	11,245,402
Prepayments and other current assets	<u>953,876</u>	<u>977,936</u>
Total current assets	<u>113,653,788</u>	<u>129,318,352</u>
Deferred charges and other assets:		
Prepaid retirement benefit	—	15,982,724
Deferred charges and other assets	<u>9,606,288</u>	<u>11,053,457</u>
Total deferred charges and other assets	<u>9,606,288</u>	<u>27,036,181</u>
Total assets	<u>\$ 978,420,411</u>	<u>910,798,483</u>

PEDERNALES ELECTRIC COOPERATIVE, INC.

Consolidated Balance Sheets

December 31, 2007 and 2006

Membership Equity and Liabilities	2007	2006
		(As adjusted)
Membership equity:		
Membership certificates	\$ 11,437,944	10,821,647
Nonowner changes in equity	(30,920,594)	—
Patronage capital	216,442,740	226,359,576
Total membership equity	<u>196,960,090</u>	<u>237,181,223</u>
Long-term debt, net of current maturities	<u>556,024,000</u>	<u>572,081,000</u>
Current liabilities:		
Line of credit	54,000,000	—
Current maturities of long-term debt	16,057,000	15,190,000
Accounts payable	50,084,119	30,646,303
Accrued taxes	4,621,901	5,151,269
Accrued interest	4,684,634	4,754,280
Other	17,062,679	6,999,577
Total current liabilities	<u>146,510,333</u>	<u>62,741,429</u>
Deferred credits and other noncurrent liabilities:		
Postretirement benefits obligation	59,585,133	37,171,580
Other deferred credits	19,340,855	1,623,251
Total deferred credits and other noncurrent liabilities	<u>78,925,988</u>	<u>38,794,831</u>
Total membership equity and liabilities	<u>\$ 978,420,411</u>	<u>910,798,483</u>

See accompanying notes to consolidated financial statements.

PEDERNALES ELECTRIC COOPERATIVE, INC.

Consolidated Statements of Revenues, Expenses and Patronage Capital

Years Ended December 31, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Operating revenues	\$ 457,012,187	495,996,272
Operating expenses:		
Purchased power	263,545,140	274,258,870
Operations	13,552,495	10,339,435
Maintenance	15,963,791	10,483,572
Administrative and general	67,920,847	61,440,063
Depreciation and amortization	32,123,822	31,899,509
Property and other taxes	10,006,037	10,744,136
Total operating expenses	<u>403,112,132</u>	<u>399,165,585</u>
Operating income before interest expense	<u>53,900,055</u>	<u>96,830,687</u>
Interest expense:		
Interest on long-term debt	37,925,860	38,748,269
Interest charged to construction	(1,775,220)	(1,023,494)
Other interest	531,864	852
Interest expense, net	<u>36,682,504</u>	<u>37,725,627</u>
Operating income	<u>17,217,551</u>	<u>59,105,060</u>
Other income (expense):		
Interest income	3,341,591	4,193,592
Capital credits and patronage dividends	902,909	66,513
Other	(1,033,473)	(1,398,076)
Other income, net	<u>3,211,027</u>	<u>2,862,029</u>
Excess of revenues over expenses	20,428,578	61,967,089
Patronage capital, beginning of year	226,359,576	164,392,487
Authorized retirement – patronage capital credits	(30,345,414)	—
Patronage capital, end of year	\$ <u><u>216,442,740</u></u>	<u><u>226,359,576</u></u>

See accompanying notes to consolidated financial statements.

PEDERNALES ELECTRIC COOPERATIVE, INC.

Consolidated Statements of Cash Flows

Years Ended December 31, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Cash flows from operating activities:		
Excess of revenues over expenses	\$ 20,428,578	61,967,089
Adjustments to reconcile excess of revenues over expenses to net cash provided by operating activities:		
Provision for uncollectible accounts	2,026,604	2,386,801
Depreciation and amortization	32,711,943	32,492,471
Nonoperating income from investment in patronage capital	(902,909)	(66,513)
Deferred charges for postretirement medical benefits	3,449,418	4,413,264
Changes in assets and liabilities:		
Increase in accounts receivable	(2,076,036)	(2,356,480)
Decrease in accrued unbilled revenues	308,855	5,391,562
Increase in materials and supplies	(970,781)	(985,870)
Decrease (increase) in prepayments and other current assets	24,060	(66,119)
Decrease in deferred charges and other assets	16,841,772	4,543,162
Increase (decrease) in accounts payable	19,437,816	(5,874,713)
Decrease in accrued taxes	(529,368)	(402,838)
Decrease in accrued interest	(69,646)	(102,002)
Increase in other current liabilities	10,063,102	5,401,631
Increase in other deferred credits and liabilities	5,761,145	3,453,523
Net cash provided by operating activities	<u>106,504,553</u>	<u>110,194,968</u>
Cash flows from investing activities:		
Net additions to utility plant	(132,033,626)	(99,439,715)
Proceeds from short-term investments	258,622,000	521,625,908
Purchases of short-term investments	(241,399,000)	(516,336,075)
Purchase of short-term investments – contingency fund	—	(1,500,000)
Purchase of short-term investments – reserve fund	(2,000,000)	—
Proceeds from capital term certificates and other	96,328	1,460,273
Net cash used in investing activities	<u>(116,714,298)</u>	<u>(94,189,609)</u>
Cash flows from financing activities:		
Net borrowings under line of credit	54,000,000	—
Payments on long-term debt	(15,190,000)	(14,359,000)
Authorized retirement of patronage capital	(30,345,414)	—
Net increase in membership certificates	616,297	260,368
Net cash provided by (used in) financing activities	<u>9,080,883</u>	<u>(14,098,632)</u>
Net (decrease) increase in cash and cash equivalents	(1,128,862)	1,906,727
Cash and cash equivalents at beginning of year	<u>5,455,804</u>	<u>3,549,077</u>
Cash and cash equivalents at end of year	<u>\$ 4,326,942</u>	<u>5,455,804</u>

See accompanying notes to consolidated financial statements.

PEDERNALES ELECTRIC COOPERATIVE, INC.

Notes to Consolidated Financial Statements

December 31, 2007 and 2006

(1) Summary of Significant Accounting Policies

(a) Description of Business

Pedernales Electric Cooperative, Inc. (PEC) is a not-for-profit electric cooperative corporation owned by the members it serves. As of December 31, 2007, PEC served approximately 221,000 members. PEC purchases its electrical power from generating source suppliers and delivers service to consumers through its transmission and distribution systems. PEC's service area extends into twenty-four counties in the Central Texas region.

As of September 1, 1999, PEC's accounting policies and rates are no longer regulated by the Public Utility Commission of Texas (PUC) due to the passage of Senate Bill No. 7 which restructured the powers and duties of the PUC. However, PEC continues to maintain its general ledger in accordance with the uniform system of accounts prescribed by the Federal Energy Regulatory Commission (FERC) as originally adopted by the PUC.

The rates charged by PEC are determined by the board of directors. PEC reviews its rates and fees annually for recovery of costs. Recommended changes are reviewed and approved by the Board as needed. Additional changes are made in the rates to account for changes in purchased power throughout the year.

(b) Change in Accounting Principle

Effective December 31, 2007, PEC elected a change in accounting principle to recognize contributed facilities as a contra-asset. Prior to the change, the PEC recognized these transactions in the consolidated financial statements as a component of membership equity. The Cooperative concluded that classification of contributed facilities as a contra-asset was preferable as this method more closely aligns with the methodology utilized by other utilities. In accordance with Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*, this change in accounting principle has been applied retrospectively to the Cooperative's consolidated financial statements for all prior periods. This change in accounting principle had no effect on previously reported operating income, excess of revenues over expenses, patronage capital or cash flows. The effect on the consolidated balance sheet was to reduce total assets and equity by \$133,513,158 as of December 31, 2006 and \$117,195,787 as of January 1, 2006. There are no indirect effects of the change in accounting principle that require recognition.

(c) Principles of Consolidation

The consolidated financial statements include the accounts of PEC and its wholly owned subsidiaries, Envision Utility Software Corporation (Envision) and Wild Texas Blue, Inc. (Texas Skies), collectively referred to as the Cooperative. All significant intercompany transactions and balances have been eliminated in consolidation.

(d) Utility Plant

Utility plant is stated at original cost, which is the cost when the plant and any subsequent additions are first dedicated to member service. Such cost includes labor, materials, applicable overhead, payroll related costs, and interest on borrowed funds charged to construction.

PEDERNALES ELECTRIC COOPERATIVE, INC.

Notes to Consolidated Financial Statements

December 31, 2007 and 2006

Underground facilities constructed by real estate developers and conveyed to PEC are capitalized based on the number of feet contributed at a rate per foot obtained from a third-party engineering firm.

Maintenance and repairs of plant and replacement of items determined to be less than units of property are charged to expense as incurred. Replacements and betterments of items considered to be units of property are charged to utility plant. When a disposition of transmission or distribution plant is made, the original cost plus cost of removal less salvage value as well as any gain or loss on the transaction of such plant is charged to accumulated depreciation. When a disposition of general plant is made, any difference between the remaining net book value and proceeds received, if any, is recognized as a nonoperating gain or loss in the accompanying consolidated statements of revenues, expenses and patronage capital.

(e) Depreciation

Depreciation is computed using the straight-line method over the estimated service lives of the assets. Average depreciation rates by plant function for the years ended December 31, 2007 and 2006 are as follows:

	<u>2007</u>	<u>2006</u>
Transmission	2.75%	2.75%
Distribution	3.07	3.10
General	10.11	11.63

(f) Interest Charged to Construction

Interest is capitalized on construction work in progress using a capitalization rate based on the Cooperative's weighted average borrowing rate on long-term debt. This rate is applied to the current month's average cumulative balance of work in progress and materials.

(g) Asset Retirement Obligation

On January 1, 2003, the Cooperative adopted Financial Accounting Standards Board (FASB) Statement No. 143, *Accounting for Asset Retirement Obligations*, which requires the Cooperative to record the fair value of an asset retirement obligation as a liability in the period in which it incurs a legal obligation associated with the retirement of tangible long-lived assets that results from the acquisition, construction, development, and/or normal use of the assets. The Cooperative would also record a corresponding asset that is depreciated over the life of the asset. Subsequent to the initial measurement of the asset retirement obligation, the obligation would be adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows underlying the obligation.

PEDERNALES ELECTRIC COOPERATIVE, INC.

Notes to Consolidated Financial Statements

December 31, 2007 and 2006

In 2005, the Cooperative adopted FASB Interpretation No. 47 (FIN 47), *Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143*. FIN 47 clarifies that an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability's fair value can be reasonably estimated. The Cooperative determined that they do not have any asset retirement obligations.

(h) Investment Securities

PEC's investment securities are classified in one of two categories: available-for-sale or held-to-maturity. Held-to-maturity securities are those securities that the Cooperative has the ability and intent to hold until maturity. All securities not included in held-to-maturity are classified as available-for-sale.

Available-for-sale securities are recorded at fair value (see note 2). Held-to-maturity securities are recorded at amortized cost, adjusted for the amortization or accretion of premiums or discounts. Realized gains and losses from the sale of available-for-sale securities are determined on a specific identification basis.

(i) Cash and Cash Equivalents

For purposes of reporting cash flows, cash equivalents are considered to be temporary cash investments purchased with an original maturity of three months or less.

(j) Accrued Unbilled Revenue

Accrued unbilled revenue arises when electricity has been delivered, but the amounts have not yet been billed due to the timing of the various cycle billing dates of customer accounts.

(k) Revenue Recognition

Revenue includes billings derived from rates applied to power consumptions and the recording of an estimate of accrued unbilled revenue. Adjustments are made periodically for rates, fees, and the power cost recovery factor when deemed necessary and approved by the board of directors.

Revenue from Envision's hourly software support is recognized when service is performed. Revenue for annual software support is recorded as advance billings and recognized as revenue over the contract period.

Revenue from Texas Skies internet services is recognized when billed. Monthly advance billings are prepared and mailed using various cycle billing dates.

(l) Materials and Supplies

Inventory of materials and supplies to be used in construction and maintenance of plant is carried at the lower of average cost or market.

PEDERNALES ELECTRIC COOPERATIVE, INC.

Notes to Consolidated Financial Statements

December 31, 2007 and 2006

(m) Federal Income Taxes

For federal income tax purposes, PEC is classified as an exempt organization under Section 501(c)(12) of the Internal Revenue Code of 1986. Accordingly, no provision for federal income tax expense on PEC's operations has been made in the consolidated financial statements.

Income taxes for the subsidiaries are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect of a change in tax rates is recognized in income in the period of the enactment date.

Income tax benefit for the years ended December 31, 2007 and 2006 was \$0.

The expected tax benefit for 2007 and 2006 differed from the actual tax benefit due to the change in the valuation allowance on net operating loss carryforwards of \$2,237,555 and \$2,363,744, respectively. Deferred income tax benefit reflects the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The major components of deferred income taxes for the subsidiaries are deferred revenue, internally developed software costs, and net operating loss carryforwards.

Due to the uncertainty surrounding the realization of the benefits of its tax attributes in future tax returns, the subsidiaries provide full valuation allowances on its deferred tax assets. The valuation allowances increased to \$10,275,084 for the year ended December 31, 2007 resulting in a net deferred tax asset of \$0.

The subsidiaries have net operating loss carryforwards for Federal income tax purposes of \$27,931,225 at December 31, 2007 which are available to offset future Federal taxable income, if any, through 2027. The federal net operating loss carryforwards begin to expire in 2022.

(n) Deferred Charges and Credits

Costs incurred with respect to the issuance of the bonds have been capitalized in other assets and are being amortized over the terms of the bonds.

(o) Patronage Capital

Patronage capital represents PEC's accumulated retained excess of revenues over expenses that has been allocated annually to its members. Distributions to members are made at the discretion of the board of directors in accordance with the bylaws, subject to the restrictions contained in the long-term debt agreements. Distributions made in 2007 were based on a first-in, first-out method on a 30 year rotation. In 2007, capital credits totaling \$7,345,414 were retired.

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Under the terms of a settlement agreement (see note 10), PEC will retire \$23,000,000 in patronage capital by bill credits to then-current members over a period of five years, or as soon thereafter as feasible, subject to any restrictions. The current portion of this amount is included in the consolidated financial statements in other current liabilities and the remainder is included in other deferred credits.

(p) Pension and Other Postretirement Benefits

The Cooperative has a defined benefit pension plan covering a majority of its employees. In 2005, the plan was amended to close entry to new participants after January 1, 2006. The benefit is based on years of service and the average of the employee's highest 36 months of compensation. The cost of the program is funded currently.

PEC also sponsors a health care plan for retirees who satisfy eligibility requirements. The cost of PEC's obligation is actuarially determined based on certain weighted average assumptions.

Effective December 31, 2007, the Cooperative adopted the recognition and disclosure provisions of FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (SFAS No. 158). In accordance with SFAS No. 158, PEC recognizes the funded status of defined benefit pension and other postretirement plans as a net asset or liability and the changes in that funded status in the year in which the changes occur through nonowner changes in equity to the extent those changes are not included in the net periodic cost. The funded status reported on the balance sheet as of December 31, 2007 under SFAS No. 158 was measured as the difference between the fair value of plan assets and the benefit obligation on a plan-by-plan basis. The adoption of the recognition provisions of SFAS No. 158 did not impact the Cooperative's compliance with debt covenants or its cash position. The incremental effect of applying the recognition provisions of SFAS No. 158 on the Cooperative's financial position as of December 31, 2007 was as follows (in thousands):

	Before application of SFAS No. 158	Adjustments	After application of SFAS No. 158
Prepaid retirement benefit	\$ 13,924	(13,924)	—
Total assets	992,344	(13,924)	978,420
Postretirement benefits obligation	(42,588)	(16,997)	(59,585)
Total liabilities	(208,440)	(16,997)	(225,436)
Nonowner changes in equity	—	30,921	30,921
Total membership equity	(227,881)	30,921	(196,960)
Total membership equity and liabilities	(992,344)	13,924	(978,420)

The recognition provisions of SFAS No. 158 had no affect on the consolidated statements of revenues, expenses and patronage capital for the periods presented.

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(q) Significant Accounting Estimates

The preparation of these consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

(r) Commitments and Contingencies

Liabilities for loss contingencies arising from claims, assessments, litigation, fines and penalties, and other sources are recorded when it is probable that a liability has been incurred and the amount of the assessment can be reasonably estimated. Recoveries from third parties which are probable of realization are separately recorded, and are not offset against the related liability, in accordance with FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*.

(s) Long-lived Assets

FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, requires that long-lived assets to be held and used or disposed of by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable and exceeds its fair value. For fiscal years 2007 and 2006, the Cooperative determined that no impairment losses needed to be recognized for applicable assets.

(2) Investments

Subscription and long-term capital certificates are held by the National Rural Utilities Cooperative Finance Corporation (CFC). Maturities of these certificates range from October 2020 to October 2080.

At December 31, 2007 and 2006, the Cooperative's investment securities are classified as follows:

	<u>Cost</u>	<u>Fair value</u>
2007:		
Subscription and long-term capital certificates, held-to-maturity	\$ 3,171,606	3,171,606
2006:		
Subscription and long-term capital certificates, held-to-maturity	\$ 3,171,606	3,171,606

Other investments are comprised of patronage capital and other funds. The investments in patronage capital and other funds are membership fees in organizations that provide services to the Cooperative and are not exchangeable. The balances of such investments totaled \$4,511,358 and \$3,704,776 at December 31, 2007 and 2006, respectively.

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Short-term investments consist of daily funds invested with CFC of approximately \$5,000,000 and \$22,223,000 as of December 31, 2007 and 2006, respectively. The remaining balance of short-term investments consists of certificates of deposit in the amount of approximately \$1,400,000 at December 31, 2007 and 2006. Short-term investments reserve fund and short-term investments contingency fund consist of investments in CFC commercial paper of \$45,500,000 and \$43,500,000, respectively, at December 31, 2007 and 2006.

(3) Contributed Facilities

Contributed facilities are accounted for as a contra-asset within utility plant and offset capitalized amounts for underground facilities constructed by real estate developers and conveyed to PEC. The following table provides a rollforward of contributed facilities, including gross additions and related amortization to reduce depreciation expense associated with these assets to \$0.

Balance at January 1, 2006	\$ 117,195,787
Gross additions	20,461,225
Amortization	<u>(4,143,854)</u>
Balance at December 31, 2006	133,513,158
Gross additions	22,447,763
Amortization	<u>(4,687,811)</u>
Balance at December 31, 2007	<u><u>\$ 151,273,110</u></u>

(4) Membership Equity

The change in the membership certificates balance of \$616,299 and \$260,368 for the years ended December 31, 2007 and 2006, respectively, resulted from net increases in the charges for new members and refunds to disconnected members in those years.

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(5) Long-Term Debt

At December 31, 2007 and 2006, long-term debt consisted of the following:

	<u>2007</u>	<u>2006</u>
Senior Mortgage Bonds, Series 1993, 8.55 percent, due 2020, interest payable semiannually on May 15 and November 15, principal payments begin 2017	\$ 65,000,000	65,000,000
Senior Mortgage Bonds, Series 1993, 8.85 percent, due 2016, interest payable semiannually on May 15 and November 15, principal payments begin 2015	15,000,000	15,000,000
First Mortgage Bonds, 1995 Series A, 7.55 percent, due 2015, interest payable semiannually on May 15 and November 15, principal payments began 1996	77,926,000	85,026,000
First Mortgage Bonds, 2002 Series A, 4.093 percent, due 2012, interest payable semiannually on May 15 and November 15, principal payments began 2003	45,755,000	53,845,000
First Mortgage Bonds, 2002 Series A, 5.952 percent, due 2022, interest payable semiannually on May 15 and November 15, principal payments begin 2013	128,900,000	128,900,000
First Mortgage Bonds, 2002 Series A, 6.202 percent, due 2032, interest payable semiannually on May 15 and November 15, principal payments begin 2023	<u>239,500,000</u>	<u>239,500,000</u>
	572,081,000	587,271,000
Less current maturities	<u>16,057,000</u>	<u>15,190,000</u>
Long-term debt balance	\$ <u><u>556,024,000</u></u>	<u><u>572,081,000</u></u>

The mortgage bonds were issued under the Indenture. All of these bonds are secured equally and ratably by a lien on substantially all of the assets of the Cooperative.

The Indenture related to the agreement with Bank of New York requires PEC to maintain rates that will produce an amount of net revenues at least equal to 1.15 times the aggregate debt service for each fiscal year, as defined by the Indenture. Net revenue is defined in the Indenture and in general is determined before depreciation, noncash expense portion of postretirement medical benefits, and debt service requirements. PEC was in compliance with these requirements at December 31, 2007 and 2006.

PEDERNALES ELECTRIC COOPERATIVE, INC.

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Aggregate maturities of long-term debt for the Cooperative are as follows:

2008	\$	16,057,000
2009		16,979,000
2010		17,960,000
2011		18,996,000
2012		20,092,000
Thereafter		<u>481,997,000</u>
	\$	<u>572,081,000</u>

(6) Lines of credit

The Cooperative has a perpetual line of credit (LOC) agreement with CFC that provides for borrowings of up to \$75,000,000. In March 2007, this LOC was increased to \$100,000,000. The Cooperative had no borrowings under this credit agreement at December 31, 2006 and \$54,000,000 outstanding at December 31, 2007.

(7) Benefit Plans

The Cooperative has a defined benefit retirement plan covering eligible participants. The cost of the plan is determined by an independent actuary and is funded in amounts sufficient to meet the minimum funding requirements of the Employee Retirement Income Security Act of 1974.

PEC also has a 401(k) savings plan (401(k) Plan). The cost of the 401(k) Plan is a maximum of six percent of the participating employee's base annual salary for employees eligible to participate in the defined benefit pension plan. For employees not eligible for the pension plan, the 401(k) plan cost is a maximum of 10% of the participating employee's annual salary. These costs are funded each pay period as accrued. Cooperative contributions to the 401(k) Plan (net of forfeitures) were \$2,038,191 in 2007 and \$1,666,544 in 2006.

PEC also provides medical and dental benefits to eligible retirees pursuant to its postretirement medical plan. The expense was recognized on a pay-as-you-go basis prior to 1995. PEC adopted FASB Statement No. 106 (SFAS No. 106), *Employer's Accounting for Postretirement Benefits Other Than Pensions*, effective January 1, 1995. SFAS No. 106 requires entities to recognize the liability for postretirement benefit plans other than pensions, primarily health care. SFAS No. 106 allows recognition of the transition obligation (liability for prior years' service) in the year of adoption or amortization over the longer of plan participants' future service periods or 20 years. In 1995, PEC elected to amortize the transition obligation of approximately \$4,000,000 over 20 years.

The measurement date used to determine retirement benefit measures for the retirement plan is December 31. The measurement date used to determine other postretirement benefit measures for the postretirement medical benefit plan is December 31.

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Effective December 31, 2007, the Cooperative adopted the recognition and disclosure provisions of FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (SFAS No. 158) (see note 1). SFAS No. 158 requires companies to recognize the funded status of defined benefit pension and other postretirement plans as a net asset or liability and to recognize changes in that funded status in the year in which the changes occur to the extent those changes are not included in the net periodic cost. The Cooperative is required to recognize the funded status of a defined benefit pension and other postretirement plans as of the end of the fiscal year ending after June 15, 2007. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. Gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost of the period are recognized in nonowner changes in equity. The remaining transition obligation from the initial application of SFAS No. 106 is recognized as a component of net periodic benefit cost.

The following table sets forth the plan's benefit obligations, fair value of plan assets, and funded status at December 31, 2007 and 2006 (in thousands):

	Retirement benefits		Postretirement medical benefits	
	2007	2006	2007	2006
Benefit obligation	\$ 93,006	92,765	54,074	63,579
Fair value of plan assets	87,495	82,912	—	—
Funded status	<u>\$ (5,511)</u>	<u>(9,853)</u>	<u>(54,074)</u>	<u>(63,579)</u>
Amounts recognized in the balance sheet consist of:				
Net prepaid assets	\$ —	15,983	—	—
Accrued liabilities	(5,511)	—	(54,074)	(37,172)
Nonowner changes in equity	19,435	—	11,485	—
Net amount recognized	<u>\$ 13,924</u>	<u>15,983</u>	<u>(42,589)</u>	<u>(37,172)</u>

Amounts recognized in nonowner changes in equity consist of:

	Retirement benefits		Postretirement medical benefits	
	2007	2006	2007	2006
Net actuarial gain (loss)	\$ 17,568	—	(1,660)	—
Prior service credits	1,867	—	11,749	—
Transition obligation	—	—	1,396	—
	<u>19,435</u>	<u>—</u>	<u>11,485</u>	<u>—</u>

The accumulated benefit obligation for the retirement plan was \$77,593,719 and \$76,807,720 at December 31, 2007 and 2006, respectively.

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The following table sets forth the plan's net periodic benefit cost recognized and the increase in minimum liability included in nonowner changes in equity at December 31, 2007 and 2006 (in thousands):

	Retirement benefits		Postretirement medical benefits	
	2007	2006	2007	2006
Net periodic benefit cost recognized	\$ 5,743	9,554	6,509	7,836
Increase in minimum liability included in nonowner changes in equity	19,435	N/A	11,485	N/A

Weighted average assumptions used to determine benefit obligations at December 31, 2007 and 2006 were as follows:

	Retirement benefits		Postretirement medical benefits	
	2007	2006	2007	2006
Discount rate	6.50%	5.90%	6.50%	5.90%
Rate of compensation increase	4.10	4.00	N/A	N/A

Weighted average assumptions used to determine net benefit cost for 2007 and 2006 were as follows:

	Retirement benefits		Postretirement medical benefits	
	2007	2006	2007	2006
Discount rate	5.90%	5.50%	5.90%	5.50%
Expected long-term rate of return on plan assets	6.50	3.00	N/A	N/A
Rate of compensation increase	4.00	3.85	N/A	N/A

The Cooperative's overall expected long-term rate of return on assets is 6.5%. The expected long-term rate of return is based on the portfolio as a whole and not on the sum of the returns on individual asset categories. The rate is based exclusively on historical returns, without adjustments.

For measurement purposes, a 10% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2007. The rate was assumed to decrease gradually to 5.50% through 2013 and remain at that level thereafter.

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The following table sets forth the plan's benefit cost, employer contributions, and benefits paid for fiscal years ended December 31, 2007 and 2006 (in thousands):

	Retirement benefits		Postretirement medical benefits	
	2007	2006	2007	2006
Benefit cost	\$ 5,743	9,554	6,509	7,836
Employer contribution	3,685	4,500	914	801
Benefits paid	3,096	3,207	914	801

Plan Assets

The weighted average asset allocation of the Cooperative's pension benefits at December 31, 2007 and 2006 were as follows:

Asset category	Retirement benefits plan assets at December 31	
	2007	2006
Debt securities	5%	60%
Cash and Cash equivalents	53	14
Equity securities	42	26
Total	100%	100%

The Cooperative's investment policies and strategies for the retirement benefits plan do not use target allocations for the individual asset categories. The Cooperative's investment goals are to maximize the rate of current income consistent with maximization of principal safety. Its risk management policies permit investments in U.S. Government obligations with short to intermediate term maturities. The Trustee has been instructed to manage assets in a manner that will give proper recognition to any anticipated liquidity needs of the PEC Plan.

Cash Flows

The estimated 2008 plan year minimum required contribution for the Plan is zero.

The benefits expected to be paid from the pension plan in each year 2008 through 2012 are \$3,592,437, \$3,930,711, \$4,356,584, \$4,798,377 and \$5,210,920, respectively. The aggregate benefits expected to be paid in the five years from 2013 through 2017 are \$32,850,330. The expected benefits are based on the same assumptions used to measure the Cooperative's benefit obligation at December 31 and include estimated future employee service.

The benefits expected to be paid from the postretirement medical benefit plan in each year 2008 through 2012 are \$1,561,305, \$1,807,800, \$2,091,998, \$2,337,727, and \$2,577,904, respectively. The aggregate benefits expected to be paid in the five years from 2013 through 2017 are \$15,595,853. The expected benefits are based on the same assumptions used to measure the Cooperative's benefit obligation at January 1 and include estimated future employee service.

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Notes to Consolidated Financial Statements

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(8) Supplemental Cash Flow Information

Cash payments for interest expense (net of amounts capitalized) for the years ended December 31, 2007 and 2006, were \$38,527,368 and \$37,826,777, respectively. Noncash investing activity included utility plant contributions of \$22,447,763 and \$20,461,225 in 2007 and 2006, respectively. Additionally, noncash investing activity also included receipts of long-term capital certificates of \$902,909 and \$66,513 in 2007 and 2006, respectively. Other noncash items reflected in the consolidated financial statements include a \$30,920,594 decrease to membership equity upon adoption of the recognition provisions of SFAS No. 158 in 2007 (notes 1 and 7).

(9) Disclosure about Fair Value of Financial Instruments

The following table presents the carrying amounts and estimated fair values of the Cooperative's financial instruments at December 31, 2007 and 2006. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties.

	2007		2006	
	Carrying amount	Fair value	Carrying amount	Fair value
Assets:				
Capital certificates	\$ 3,171,606	3,171,606	3,171,606	3,171,606
Cash and other	4,326,942	4,326,942	5,455,804	5,455,804
Liabilities:				
Long-term debt	\$ 572,081,000	465,396,366	587,271,000	428,460,502

The carrying amounts shown in the table are included in the consolidated balance sheets under the indicated captions.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

(a) Capital Certificates

The estimated fair value of PEC's capital certificates is equal to cost because fair value is not readily determinable.

(b) Cash and Other

The carrying amounts approximate fair value because of the short maturity of these instruments.

(c) Long-Term Debt

Interest rates that are currently available to PEC for issuance of debt with similar terms and maturities are used to estimate fair value for its debt issues that are not quoted on an exchange.

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(10) Commitments and Contingencies

(a) Power Supply Contracts

In 2007, PEC purchased electricity from the Lower Colorado River Authority (LCRA) and American Electric Power (AEP). Purchases from the LCRA in 2007 were pursuant to a Wholesale Power Agreement, as amended in May 1987, which provided that, with certain exceptions, the LCRA would supply to PEC all of PEC's electric power and energy requirements through the term of the agreement. At its November 17, 2008 Board meeting, Pedernales Electric's Board of Directors unanimously approved a resolution authorizing a new wholesale power contract with the Lower Colorado River Authority. The new agreement, signed on November 19, 2008, extends the relationship between PEC and LCRA through 2041. The agreement includes progressive power provisions, greater flexibility to purchase power from other suppliers and heightened transparency and information sharing on costs and rates. The agreement does not require the Cooperative to take or pay for any minimum amount of electricity, nor does it supplant any contracts acquired through the purchase of other electric systems. Rates charged to PEC by the LCRA are set by the LCRA Board of Directors.

In 1990, PEC entered into an agreement to lease its transmission facilities to the LCRA. The lease resulted from a settlement of the LCRA's general rate proceeding before the PUC wherein the LCRA agreed to lease the transmission lines and transmission and distribution substations owned by its wholesale customers. The purpose of this agreement was to provide a more equitable rate structure for those LCRA wholesale customers who own their own facilities. Either party may terminate the lease upon written five-year notice of the intent to terminate.

During 2007, purchases from AEP were made through two separate contracts, each with a one-year term (May 1, 2006 through April 30, 2007 and May 1, 2007 through April 30, 2008). In general, the contracts are for energy required only and are not take-or-pay.

(b) Litigation Note

The Cooperative is a defendant in actions that are in various stages of litigation and investigation. Due to the inherent uncertainty of litigation, management believes it is reasonably possible that PEC may suffer a loss with respect to one or more of the actions. However, after reviewing with counsel all legal and administrative actions pending or threatened, insurance coverage provided and the recent resolution of a class action suit described below, management believes that liability resulting from the ultimate resolution of these matters will not be material. In addition, Management also describes below a matter involving a previously dormant subsidiary company and a criminal investigation of past operational practices of the Cooperative.

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John Worrall, et al. v. Pedernales Electric Cooperative, Inc. et al.

On March 17, 2009, the Third Court of Appeals issued a mandate disposing of an appeal to a class action lawsuit, styled *John Worrall, et al. v. Pedernales Electric Cooperative, Inc. et al.*, Cause No. D-1-GN-07-002234, filed in the 353rd Judicial District Court of Travis County, Texas. The plaintiffs in the suit alleged that PEC, its board of directors and Senior Management committed negligence, gross negligence, breaches of fiduciary duties, breaches of contract, and violated the Electric Cooperative Corporation Act by failing to return patronage capital to members, by wasting the Cooperative's assets on the purchase and operation of a for-profit subsidiary, Envision, and by overcompensating the Board and Senior Management.

Under the terms of a settlement agreement dated April 8, 2008, PEC commenced the retirement of \$23,000,000 in patronage capital by bill credits to then-current members over a period of five (5) years, or as soon thereafter as feasible, subject to any restrictions imposed by any lending institutions as those restrictions are reflected in any agreements to which PEC is a party and the maintenance of PEC's financial integrity. In accordance with the settlement agreement, PEC retired in 2008 approximately \$4,700,000 of the \$23,000,000 patronage capital through bill credits. PEC will endeavor to retire the remaining balance of agreed upon patronage capital over the next four (4) years subject to the aforementioned restrictions. If PEC is unable to retire the full \$23,000,000 during the five-year period, the program will be extended until the full \$23,000,000 is retired.

Additionally, pursuant to the settlement agreement, PEC and its insurer agreed to pay the costs awarded by the court, including attorneys' fees, compensation to the named plaintiffs, nontaxable costs, court costs, and reimbursement of reasonable out-of-pocket expenses up to but not exceeding \$4,000,000. Of the \$4,000,000, PEC will pay \$1,600,000 and its insurer will pay \$2,400,000. PEC's liability has been recorded as of December 31, 2007 and is included in accounts payable. Finally, PEC agreed under the settlement agreement to a comprehensive and independent review of the financial and management operations of PEC by Navigant Consulting Inc., at PEC's expense. This comprehensive and independent review was completed by Navigant Consulting Inc. on December 15, 2008 and delivered to the PEC Board on that same day.

On May 5, 2008, the trial court entered a judgment certifying the class and approving the settlement. Three class members appealed the judgment. On November 21, 2008, the Third Court of Appeals granted one appellant's request to be dismissed, and dismissed another appellant for want of prosecution. That left one class member as the sole appellant in the lawsuit. On March 5, 2009, the Third Court of Appeals issued an opinion affirming the trial court's judgment. Thereafter, on March 17, 2009, the Court issued a mandate granting the remaining class member's motion to expedite the Court's decision and finally closing the matter.

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Cattleman's National Bank v. Texland Electric Cooperative, Inc. et. al.

Management does not believe that it is subject to any liability in connection with an interpleader lawsuit involving a previously dormant subsidiary company named Texland Electric Cooperative, Inc. PEC and Bluebonnet Electric Cooperative, Inc. (Bluebonnet Electric) are the sole owners of Texland Electric Cooperative, Inc., with Pedernales Electric being the majority interest owner. After Management discovered a non-interest bearing account in the amount of approximately \$565,000 held in the name of Texland at Cattleman's National Bank of Johnson City Texas, Cattleman's filed an interpleader suit in the 424th Judicial District Court in Blanco County Texas against Texland Electric Cooperative, Inc., PEC, Bluebonnet Electric and the Lower Colorado River Authority (LCRA). PEC, Bluebonnet Electric and LCRA filed answers disclaiming an interest to the funds. Texland is the only party making a claim to the funds. A hearing is scheduled for April 2009 to resolve the ownership of the funds.

Criminal Investigation

PEC is aware that a criminal investigation is being conducted before the Blanco County Grand Jury located in Blanco County Texas involving the past operational practices of the Cooperative. Since grand jury proceedings are private proceedings, there is limited information on the nature of the investigation and its status. PEC has fully cooperated with any request made in connection with this investigation. In the event a claim is asserted against PEC, there is a reasonable possibility that a loss may be incurred. However, an estimate of the possible loss or range of loss cannot be made at this time.