

SMECO ANNUAL REPORT 2008

our promise



reliability, value, commitment



Service Area and Offices

 **Headquarters**

15035 Burnt Store Road
Hughesville, MD 20637-1937
1-888-440-3311

 **Charles-Prince George's Regional Office**

4415 Crain Highway
White Plains, MD 20695-0248

 **Calvert Regional Office**

901 Dares Beach Road
Prince Frederick, MD 20678-0037

 **St. Mary's Regional Office**

23365 Hollywood Road
Leonardtwn, MD 20650-9601

our promise:

Reliability, Value, Commitment



Joseph V. Stone, Jr. and Austin J. Slater, Jr.

Dear Fellow Customer-Members,

We are certain that 2008 is a year that will be documented in history books as a turning point for America and for the world. Various notable and dynamic events have occurred over the past 12 months in our economic, political, and cultural worlds. Some of these changes will bring growth and health to our community, yet others leave us uncertain as to what tomorrow holds.

It is times such as these that SMECO must hold true to the promises we have made to our customer-members. We promise to offer reliable power, to provide our customer-members the greatest value, and to be a responsible and devoted neighbor who continually invests back into the community.

The strength of our partnership with our customer-members has compelled us to stay true to our promises, despite an eventful, challenging year. We've discovered that as an organization, we've made significant progress with new technologies and a new corporate structure in the midst of a changing economic environment. This progress has enabled us to launch the Southern Maryland Reliability Project; move forward with expanding our Hughesville campus with construction of an environmentally friendly facility; continue our various charitable and community-enriching activities; join efforts to bring high-speed Internet to rural areas of Maryland; and, also help initiate a national cooperative that is focused on developing effective renewable energy sources.

Our efforts to fulfill our promises to you were confirmed in very rewarding ways in 2008. For the first time, SMECO was recognized by J.D. Power and Associates for offering award-winning service. We were also honored by being selected as the recipient of the Partnership in Education Leading Edge Award for being a major force behind the area's economic expansion and quality of life. Also, SMECO's system underwent a reliability and security audit with ReliabilityFirst, and we passed with flying colors. It is an honor to serve our customer-members the best way we know how, and it's a privilege to receive these outside recognitions that support our efforts.

The future looks very bright at SMECO, and we continue to fulfill promises made to our customer-members as we have in the past, bringing you safe, reliable power at the lowest cost possible.

Austin J. Slater, Jr.
President and CEO

Joseph V. Stone, Jr.
Chairman of the Board



Our Promise: Prepare for Tomorrow

Even decades ago when SMECO was founded, the primary challenge was to keep the lights on for customer-members. But, these days the demands are much greater, and SMECO must keep the lights on, run heating and cooling systems, power the TV, video games and computers, charge cell phones and iPods, and give life to the many appliances we've come to depend on. Needless to say, electricity usage has greatly increased to the point where power generators and distributors are struggling to meet demand because of constraints presented by the high voltage interstate transmission grid. The growing amount of energy use and Southern Maryland's growing population present a great challenge to the Co-op's electric system.



To fulfill the promise of providing customer-members with reliable service, SMECO launched the Southern Maryland Reliability Project in 2008. Announced in April, this project will upgrade the current 69,000-volt line to 230,000 volts by the year 2015.

The Southern Maryland Reliability Project is an upgrade that will provide additional capacity by creating a continuous “loop” of electricity around SMECO’s service area. The loop design provides greater operational flexibility to feed power from either direction in the event of an outage, which reduces the risk of a prolonged outage and improves the system’s reliability.



Thomas Russell, SMECO Environmental Affairs and Property Rights Manager, reviews the Southern Maryland Reliability Project with customer-members at an open house.



A new transformer, shown being prepared for testing, will be installed at SMECO's Hewitt Road switching station.

The Co-op’s commitment to the community and its pledge to ensure customer-members receive the greatest service and value guide all the decisions for the Southern Maryland Reliability Project. To ensure that the upgrade will have minimal impact on current rates, the environment, and the community, SMECO will use existing rights-of-way when possible. Existing poles will be replaced with new steel poles, but there will be fewer of them placed farther apart, and the \$110 million dollar project will be financed over many years.

As always, SMECO realizes that one of its strengths is having involved members, so in April and May, we held three open-houses to discuss the proposed plan with our customer-members. It was encouraging to hear that the community supports the project and recognizes that the increasing demand for power requires an improvement to the current transmission system in order to ensure continued reliability. The Co-op has also spent considerable time meeting with state and local elected officials, business leaders, environmental organizations, and community groups in the area. SMECO is committed to working with communities along the route to ensure the improvement project is done right.

The plans for the project were submitted in November to the Maryland Public Service Commission (PSC) to apply for a Certificate of Public Convenience and Necessity. Approval may be received by the end of 2009, and construction will start in 2010.

Our Promise: Award-winning Commitment to Customer Service

For many of you who have been long-time customer-members at SMECO, it comes as no surprise that J.D. Power and Associates, known as the voice of the consumer, recognized SMECO as a top award recipient for the 2008 Electric Utility Residential Customer Satisfaction Study.





Joe Slater, President and CEO, receives the Leading Edge Award from the College of Southern Maryland.



Brian Rawlings, Calvin Thomas, Kimberly Farrell, Diamond Lewis, Shawn Harley, and Fay Wood representing SMECO's award winning team.



The study measures customer satisfaction with electric utilities by examining six key factors:

- Power, Quality and Reliability
- Price
- Billing and Payment
- Corporate Citizenship
- Communications
- Customer Service

SMECO was the highest-rated electric utility in its class (those companies serving 125,000 to 499,999 residential customers in the East Region). SMECO consistently received the highest ratings of similar utilities in five of the six categories. In addition, SMECO was rated 57 points higher than the average utility in its class.

With the cooperative business model, there is a partnership between SMECO employees and customer-members that is committed to continually improving the level of customer service. For example, consumers are increasingly enjoying the ease of online payments and automatic deductions from bank accounts versus traditional mailing methods. SMECO responded to this trend and now has approximately 30 percent of its customer-members using our electronic bill presentment and payment service, one of the highest percentages of online services for any electric utility in the nation.

There are many stories and examples of the quality work and service SMECO employees provide daily. The customer satisfaction award is a well-deserved honor that has encouraged SMECO staff to deepen their commitment to providing customer service that is second to none.

Deploying technology in the field has also helped to improve customer service. We began implementing our Mobile Work Force Management system in 2007. At the end of 2008, we had 17 service trucks, 23 meter operations units, and 34 line trucks outfitted with laptops using the system.

Equipping Co-op vehicles with computers enables field employees to increase efficiency and response time. The laptops interface with SMECO's computer systems, such as the outage management, geographical mapping, and customer information systems. Employees in the field and in the office are able to access real-time data, and that helps us work smarter and increase effectiveness and customer satisfaction.

The Mobile Work Force Management system allows us to automate our business processes and to track and measure our workload. This is a universal tool that will help us get a handle on what we did, when we did it, and how long it took, so that we can quantify our work, our performance, and our costs.



Our Promise: Equipping the Area's Workforce

Fulfilling a commitment to the community does not stop at simply providing a service. SMECO's commitment includes empowering members of the community through education and job training. These efforts were honored last year as SMECO earned the 2008 Leading Edge Partnership in Education Award.



SMECO employees, Steve Gardiner, Jeremy Green, and Jeff Drumm, install stadium lights at North Point High School. At right is A.K. Johnson, North Point Athletic Director.



SMECO's Culture of Excellence program, community educational program sponsorships, and college scholarships for high school seniors further demonstrate the Co-op's commitment to meeting current and future management and technical challenges.

The Leading Edge Awards, spearheaded by the Corporate Center at CSM, is an annual event bringing together local government leaders, technology experts, and business people to celebrate businesses that spur economic growth and fuel the potential of the Southern Maryland community.



SMECO employees Scott Gagliardi and Eric Rutherford explain the lineman's job at a Career Fair held in September.

Jeff Jewell, Job Training and Safety Director, presenting Thomas Cooksey, Calvert Regional Operations Director, with the Safety Director's Award.

SMECO accomplishments which have contributed to the receipt of this award include workforce educational programs such as the Electric Power Technician degree offered through the College of Southern Maryland (CSM). In addition, through the college, SMECO offers supervision, customer relations math, science, and composition courses for career development to its employees.



Steve Guy and Wayne Gray wearing new SMECO uniforms.



Our Promise: Dedicated to Reliability

For the first time, SMECO underwent a reliability audit in 2008. Conducted by ReliabilityFirst in September, the off-site compliance audit proved to be a very rewarding confirmation of the Co-op's efforts to maintain the security and integrity of its electric system.





SMECO is registered for the North American Electric Reliability Corporation (NERC) functions of Load Serving Entity and Distribution Provider, which set the parameters for the scope of the audit. The audit was conducted by ReliabilityFirst, which will monitor the Co-op on a six-year basis.

The objectives of the audit were to review and validate SMECO's compliance with applicable reliability standards and requirements regarding self-reported violations, self-certifications, and mitigation plans and to document SMECO's compliance culture. SMECO successfully met all of the national and regional requirements of the reliability audit. The audit findings assure that SMECO has been fulfilling the commitment to provide reliable, dependable service, which guarantees we can continue to live up to the promise we've made to our customer-members.



Left: Tim O'Neal, Chief Surveyor, and Chris Coyle, Associate Surveyor/CAD Supervisor, at the site of the new Aquasco switching station.

Right: Brian Rawlings and Craig Anderson educate customer-members about electricity using the hot line demonstration at the Annual Meeting.

SMECO employees train for the Gaff 'N' Go Lineman's Rodeo. Top, left, Jeremy Green, right, Brian Rawlings. Middle, left, Brent Hancock, right, Daniel Hutchins. Bottom, left, Will Robertson, right, Josh Reithmeyer.



Our Promise: Putting Our Values Into Practice

SMECO is proud to be an expert on energy efficiency. That's why it was only natural that, while working with CDS Associates to expand the Hughesville campus, we are dedicated to putting our values into practice and constructing an environmentally friendly building. Our new building is designed to receive the gold LEED (Leadership in Energy and Environmental Design) certification from the Green Building Council – and will be the only building in the area with this certification.





An architectural rendering of the building designed to qualify for the gold LEED certification.

Environmentally friendly features in the new facility will reduce energy needs and address important environmental concerns. Energy demands for heating and cooling will be a fraction of the typical demands for a building of this size due to geothermal heating and air conditioning which will use the earth's renewable energy below the surface to heat and cool the facility. Also, a vegetative roof will aid in reducing temperatures on top of the facility. Skylights will be installed to provide natural light. Throughout the campus, in place of asphalt, porous concrete will be used that allows storm water to seep into the ground. This will reduce storm water runoff, recharge the groundwater, and remove the need for a storm water management pond to be built on the facility.

In addition to being an energy-efficient and thoughtfully-built facility, the new building will streamline and enhance how the Co-op does business. Part of the project's goal is to replace the Co-op's aging and outgrown regional office in White Plains. Along with the White Plains office staff and construction and maintenance crews, the new building will eventually house SMECO's Call Center, System Operations Center, part of its Engineering and Operations Department, Security Division, and Purchasing and Stores. The building will also include an auditorium and a wellness center for employees. On the grounds of the campus, a nature trail will be built for public use.

The new building will be constructed in sections and is scheduled to start in 2009. SMECO is excited about completing a project of this scale that will be something all SMECO members can appreciate.



Donna Miller and Kim Reaume, Senior Customer Service Representatives in SMECO's Call Center.



Gwen Banks, Field Activity Operations Supervisor, and Calvin Bowling, Distribution Operations Director, reviewing carpet and wall covering samples for the new building.

Our Promise: Improving Quality of Life

Many areas in Southern Maryland still lack access to high-speed Internet. Customers continue to ask what SMECO can do to help. Recognizing that the lack of access is an important issue because it affects quality of life and the economic vitality of the region, this has been a concern at SMECO for almost a decade.





SMECO employees practice techniques for rescuing hurt co-workers and working in confined spaces. From left, Josh Reithmeyer, Robert Wood, Maurice Reid, Brian Cornelius, Ray Gaskill, Harry Jackson, Jesse Pike, and Michael Emory.



Tim O'Neal, Chief Surveyor, left, and John Rutt, Transmission & Substation Engineering Director, right, talk with a customer-member about the Southern Maryland Reliability Project.

In 2008, SMECO joined the Maryland Broadband Cooperative (MDBC), whose mission is to provide high-speed broadband access to Internet Service Providers in the rural areas of the state. The member-owned fiber optic network will be the infrastructure used by service providers to serve individual customers and businesses.

“SMECO has been a vital partner in the creation of the Maryland Broadband Cooperative. The Broadband Cooperative’s efforts in Southern Maryland and the Western Shore will be considerably enhanced by both SMECO’s membership and its participation in the process,” said Governor Martin O’Malley.

MDBC has plans to develop broadband infrastructure throughout Calvert, Charles, and St. Mary’s counties and in southern Prince George’s County. Also, SMECO and MDBC have been working together and have finalized a fiber lease agreement to facilitate the expansion of broadband capabilities in Southern Maryland. The agreement provides for MDBC to lease specific available spare fiber strands from the SMECO fiber network at mutually agreeable locations. SMECO will also be a class E member of MDBC, which is reserved for business partners contributing assets through a lease or shared resources.

Wayne Clark, a member of the Maryland Broadband Cooperative’s Board representing the Tri-County Council for Southern Maryland, concluded, “A ten-year effort from concept to current installation of fiber is the result of many institutions and individuals who have freely shared of their talents and vision. We thank SMECO’s leadership and staff for helping to advance our mission of making broadband available to all.”

This partnership will bring economic development, job growth, and innovation to SMECO’s service area for small businesses, major employers, schools, and residents.



Our Promise: Investing in the Community

Over the years, SMECO has participated in charitable and civic events and has contributed funds to various programs that have helped improve the quality of life for our Southern Maryland neighbors. In 2008 individual employees donated time, thousands of dollars, and even blood to several organizations, and collectively SMECO employees pitched in together for the greater good.





MATHCOUNTS winners from Milton Somers Middle School: Ian Farris, Coach Heather Johnson, Bobby Keim, Assistant Coach Jen Craigmile, Alex Smith, and Chris Hartline.

Throughout the year, SMECO sponsors events to get students excited about math, science, technology, and leadership: the local MATHCOUNTS competition, the Annual Southern Maryland Regional Computer Bowl, the Annual Mathematics Challenge Competition, and the Annual Southern Maryland Youth Leadership Conference. In 2008, over 1,400 students in SMECO's service area participated in these events with the top participants receiving plaques or trophies. All participants learned new skills and were exposed to the excitement and power of knowledge—a powerful lesson for any child to learn.

In addition to sponsoring events for students, SMECO is proud to recognize local educators for their accomplishments in the fields of mathematics and science. In 2008, SMECO and the school systems of Calvert, Charles, and St. Mary's counties honored 17 local teachers who were chosen for their outstanding performance in the areas of creativity, rapport with students, enthusiasm for teaching, professionalism, and innovative teaching methods.

Investing in our future professionals and business leaders is also important to SMECO. Each year the Co-op awards four \$1,500 college scholarships to high school seniors who live and attend high school in the service area. SMECO awards scholarships based on applicants' scholastic achievement, financial need, and school and community involvement.

Obviously, SMECO employees place a lot of value on education, but each year they also donate their personal time to benefit a charity in the Cooperative's service area. During the year-long effort, SMECO employees participate in activities to raise funds for the charity. The Southern Maryland Chapter of the American Red Cross was the Cooperative's charity for 2008. Besides raising funds for the organization, SMECO also donated a retired service truck to the Southern Maryland Chapter of the American Red Cross to help the organization improve its ability to respond to disasters.

Devotion to making a positive impact in the lives of others does not stop with SMECO employees, but is also a priority for many of our customer-members. For over 25 years, customer-members have donated money to Project Match, a fund that helps local families in need of assistance to pay their heating bills. Even though many households have felt an economic pinch, we continued to receive a generous amount of contributions. For the 2008-2009 winter season, we received \$19,120 in donations, which, combined with the SMECO match, totals to more than \$38,000.

The greatest treasure in Southern Maryland is indeed the people and their unwavering generosity. It is this spirit that inspires SMECO to be completely committed to the community and to supporting a better quality of life for all.



SMECO's Employee Community Involvement Committee presents a check for \$18,000 to Donna Bennett, Executive Director of Alternatives for Youth and Families, center. Committee members, from left, are John Barrett, Natalie Brown, Denise Morrisette, and Joan Waters.

Our Promise: Increasing Value through Green Initiatives

To make renewable energy more accessible and to encourage conservation, SMECO values operating with integrity. SMECO employees are intentional with their daily actions in identifying ways to save energy and money. From evolving administrative tasks to require less paper, such as our paperless online billing option, to becoming a national leader for renewable energy, SMECO is increasing the value of service by saving energy and money.





Jeff Shaw, Environmental Programs and Energy Conservation Manager, promotes the value of recycling to customer-members and SMECO employees.

In 2008 SMECO's president and CEO, Austin J. Slater, Jr., led the way for SMECO to join 23 cooperatives from across the nation to form the National Renewables Cooperative Organization (NRCO). Involvement in the NRCO gives SMECO the opportunity to invest in real wind, solar, and other renewable projects to satisfy the state's mandate to purchase renewable energy.



Fulfilling our promise to continue to provide reliable service to

customer-members requires investigating ways to meet the increase in demand for new power over the next decade. By being involved with the NRCO, SMECO will participate in screening renewable energy proposals based on their cost and value. Through the cooperative effort, projects that are built to serve customers in one part of the country can also benefit a Co-op in a different area by providing green energy credits. In addition, power from a new project can be sold directly into the wholesale market, making additional power supply available to energy-intensive areas.



Customer-members learn about the new SMECO CoolSentry load reduction program.

In efforts to launch green initiatives when feasible, the Co-op launched a new load reduction program in 2008, giving customer-members the opportunity to conserve energy and money. The SMECO CoolSentry program is a highly efficient load reduction program that reduces harmful carbon emissions, saves money and energy, aids in keeping electricity prices lower longer, and helps to prevent power shortages during the high demand months of summer.

CoolSentry includes a programmable thermostat that can help customer-members save up to 15 percent on annual heating and cooling bills. But, much more, CoolSentry assists with managing energy demand and preventing power shortages in our community. On selected summer weekday afternoons, when the temperature soars and the demand for electricity is at its highest, CoolSentry will be activated to put air conditioners into conservation mode. During this time, only the air conditioner's fan will continue to circulate cool air throughout the house. Most families won't notice a change in comfort when CoolSentry is operating, but will notice a positive change in their monthly bill.

From our daily operations in the office, to your home and on the national level, SMECO is committed to conserving energy and money while providing reliable service. As energy demands increase, SMECO will be on the forefront of new energy technologies that will not only give customer-members the high quality of service they've come to expect, but also aid in preserving quality of life for future generations.



Our Promise: Honoring Our Core Values

A highlight of any year at SMECO is the Annual Members' Meeting, which is an opportunity for SMECO employees and members to celebrate the past year and look forward to another year of partnership.





The drizzling rain was not enough to deter nearly 2,000 people from attending SMECO's 70th Annual Members' Meeting.

The Co-op's 70th annual meeting was held in August 2008, and despite light rain, nearly 2,000 individuals attended the meeting. SMECO held safety demonstrations, distributed free drinks, and collected over \$1,600 in food sales to benefit the Southern Maryland Chapter of the American Red Cross. Attendees also had the opportunity to visit displays by companies offering solar energy and geothermal heating and cooling systems for homes. After the demonstrations, voting, and socializing, it was time to get down to business.

More than 1,300 members voted for members of the Board of Directors. Re-elected for three-year terms were incumbents Nancy W. Zinn of Calvert County; John H. Bloom of Charles County; Daniel W. Dyer of Prince George's County; and J. Douglas Frederick and Joseph V. Stone, Jr. of St. Mary's County.



SMECO Energy Analyst Joanne Simmons demonstrates how much energy is used by a compact fluorescent light and an incandescent bulb.

Guest speaker William Brier, VP of Policy and Public Affairs at the Edison Electric Institute—as well as a SMECO customer-member—described trends in the utility industry that are affecting energy usage and electric rates. SMECO's President and CEO, Austin J. Slater, Jr., addressed the audience as well. Slater explained that Southern Maryland's electricity demand is greater than ever, and we have an urgent need to find solutions to the increase in demand expected over the next few years. Slater encouraged the audience with news that SMECO purchases 3.5 percent of its power supply from renewable sources such as solar and wind, and that SMECO will increase this percentage to at least 20 percent by the year 2022.

Once again SMECO's annual meeting proved to capture the spirit of our dynamic Co-op. The day was made complete by the members' participation in the election process; our customer-members were enriched by the safety lessons and alternative energy demonstrations; and our community spirit was revitalized through social interaction and raising funds for a local charity. It was an event that easily made everyone proud to be a member of SMECO.

SMECO Board of Directors



Board Officers, seated, from left: Secretary-Treasurer, Kenneth L. Dyson; Chairman, Joseph V. Stone, Jr.; Vice Chairman, Samuel J. Hammett; and Assistant Secretary-Treasurer, Fern G. Brown.

Directors, standing, from left: W. Rayner Blair III, Daniel W. Dyer, John H. Bloom, Richard A. Winkler, W. Michael Phipps, J. Douglas Frederick, Nancy W. Zinn, Francis E. Hewitt, Gilbert O. Bowling, James A. Richards, and Samuel M. Bailey, Jr.

SMECO President and Vice Presidents



Seated: Austin J. Slater, Jr., President and CEO

Standing, from left: Kenneth M. Capps, VP, Engineering and Operations, and COO; Frank D. Mudd, Jr., VP, Human Resources; Sonja M. Cox, VP, Financial and Economic Services, and CFO; Mark A. MacDougall, VP, External Affairs, and General Counsel; and Joseph Trentacosta, VP, Information and Customer Services, and CIO.



Joseph R. Densford,
Board Attorney



Our Promise: Maintaining Financial Stability

In October 2007, SMECO adjusted its distribution charge for the first time since 1994. The new rates were in effect for the full year. The weather was unusually mild, and kilowatt-hour sales were down, but the new rates helped to stabilize margins, which totaled \$5.5 million.

The biggest news of 2008 was the global financial crisis that affected employment rates, the housing and mortgage markets, the auto industry, banks, lending institutions, and the stock market. Individuals saw their nest eggs crumble, and corporations watched as the value of their investments fell. Likewise, the asset value in the Co-op's retirement plan decreased substantially, losing approximately \$30 million in equity. To compensate, SMECO will be required to make a larger than usual cash contribution to the retirement plan in 2009 to fulfill funding requirements. As the economy recovers over time, we should see improvement in our plan's funding.

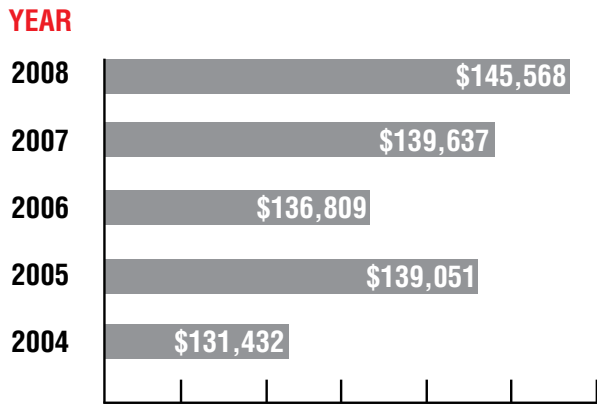
Susan Hamilton, SMECO's Vice President of Customer and Member Services, retired in the spring, with 38 years of service to the Co-op. Upon her retirement, personnel were reassigned to other departments, and the vice president's position was eliminated. Like all of our customers, SMECO is consolidating and economizing where possible.

Although the cost of energy remained stable throughout the year, customers were feeling financially strapped because of the state of the economy. We hosted Energy Assistance Fairs in each regional office in October to help customers apply for energy assistance funds.

The state of the economy has compelled lenders to more closely scrutinize the financial status of their customers, and SMECO is no exception. Our lenders require that we meet certain financial ratios, and we have met those. As always, we continue to monitor indicators to maintain our financial stability.

FINANCIAL HIGHLIGHTS

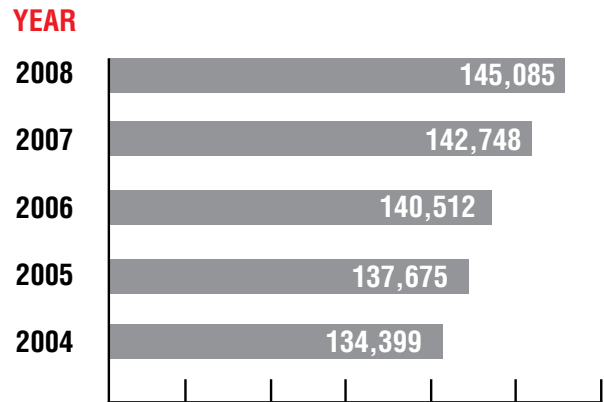
Members' Equity*



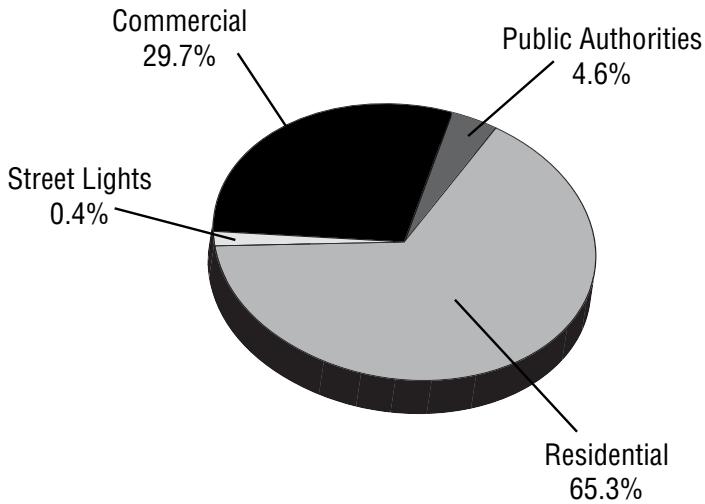
In Thousands

*Excludes Accumulated Other Comprehensive Income (Loss)

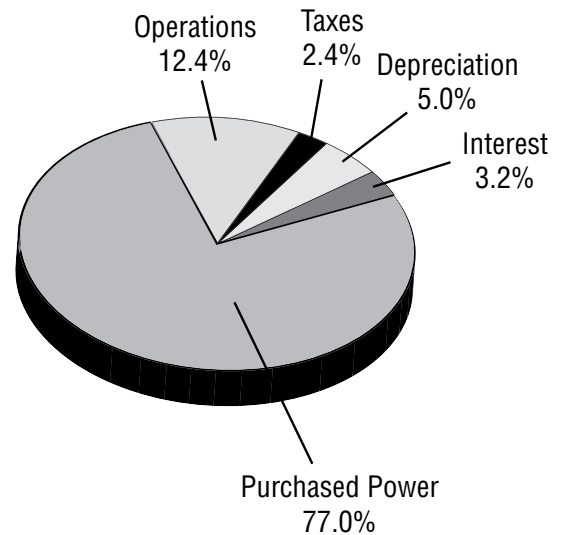
Customer Services (Meters) in Place



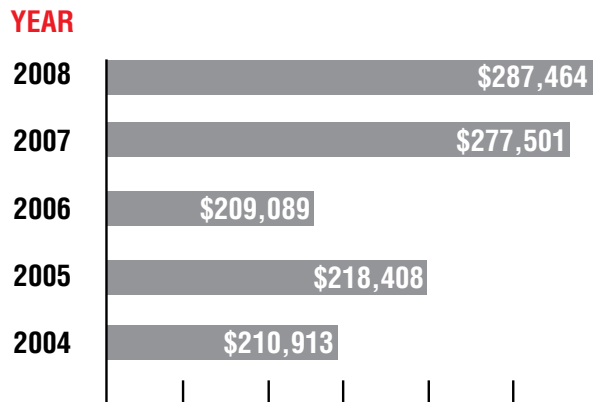
Electric Revenue



Electric Expenses

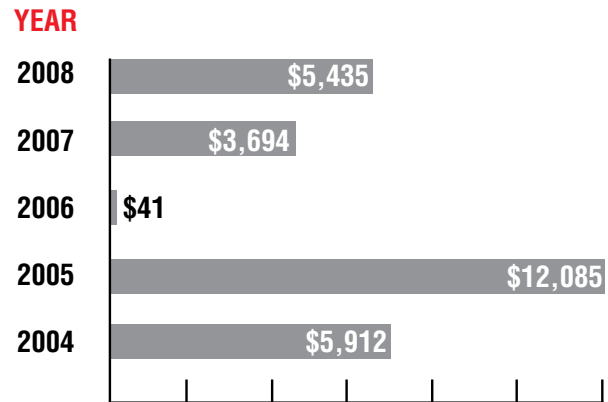


Debt Outstanding



In Thousands

Net Margins



In Thousands

BALANCE SHEETS
DECEMBER 31, 2008 AND 2007

ASSETS	2008	2007
Utility Plant, At Original Cost (Notes 2 and 4)	\$ 645,482,637	\$ 608,741,933
Less: Accumulated Depreciation and Amortization	<u>(230,243,130)</u>	<u>(219,384,649)</u>
Net utility plant	<u>415,239,507</u>	<u>389,357,284</u>
Nonutility Property (Net)	<u>1,696,336</u>	<u>1,341,955</u>
Investments (Note 2):		
Investments in associated organizations, at cost (Note 5)	10,847,293	10,481,449
Investments in unconsolidated entities (Note 6)	1,336,182	4,560,090
Other investments	461,650	1,763,180
Total investments	<u>12,645,125</u>	<u>16,804,719</u>
Current Assets (Note 2):		
Cash and cash equivalents	8,456,222	9,868,299
Accounts receivable, net of allowance for doubtful		
accounts of \$1,700,000 and \$1,000,000, respectively	69,814,779	60,784,462
Materials and supplies inventory	8,335,079	7,542,414
Prepaid expenses	2,896,402	2,647,447
Current portion of direct financing lease (Note 7)	2,194,373	1,920,201
Other current assets	11,765,767	15,511,708
Derivative assets	—	6,930,258
Total current assets	<u>103,462,622</u>	<u>105,204,789</u>
Noncurrent Portion of Direct Financing Lease (Note 7)	21,555,348	23,749,721
Regulatory Assets (Notes 2 and 8)	14,188,640	564,239
Deferred Charges and Other (Note 2)	14,537,198	12,907,889
Total assets	<u>\$ 583,324,776</u>	<u>\$ 549,930,596</u>
 EQUITIES AND LIABILITIES		
Equities (Note 10):		
Patronage capital	\$ 140,353,817	\$ 135,828,700
Other equities	5,214,019	3,808,037
Accumulated other comprehensive (loss) income	(35,794,133)	(5,434,020)
Total equities	<u>109,773,703</u>	<u>134,202,717</u>
Long-Term Debt, Less Current Maturities (Note 11)	<u>273,569,606</u>	<u>265,886,769</u>
Current Liabilities:		
Accounts payable	38,265,183	34,486,714
Current maturities of long-term debt (Note 11)	13,894,510	11,614,162
Notes payable (Note 11)	62,700,000	53,500,000
Customer deposits	3,776,952	3,652,078
Other current liabilities	13,778,446	10,638,088
Total current liabilities	<u>132,415,091</u>	<u>113,891,042</u>
Accrued Pension and Postretirement Benefits (Note 9)	47,727,035	19,830,924
Deferred Credits	7,411,207	15,561,659
Derivative Liabilities (Note 2)	12,428,134	557,485
Commitments and Contingencies (Notes 12 and 13)		
Total equities and liabilities	<u>\$ 583,324,776</u>	<u>\$ 549,930,596</u>

The accompanying notes are an integral part of the above statements.

**STATEMENTS OF REVENUE, EXPENSES AND PATRONAGE CAPITAL
YEARS ENDED DECEMBER 31, 2008 AND 2007**

	2008	2007
Operating Revenue:		
Sales of electricity	\$ 459,162,925	\$ 434,638,377
Lease income (Note 7)	3,360,684	3,600,600
Other	3,990,966	3,369,119
Total operating revenue	<u>466,514,575</u>	<u>441,608,096</u>
Operating Expenses:		
Purchased power (Note 12)	356,658,718	336,534,469
Transmission	2,436,755	2,536,384
Distribution – operations	5,534,900	4,815,732
Distribution – maintenance	15,806,279	15,152,759
Customer accounts	7,143,822	7,260,266
Customer service and information	1,124,388	986,726
Administrative and general	24,817,220	26,864,580
Depreciation and amortization	23,411,483	21,638,270
Taxes	10,961,468	10,111,246
Other	404,535	299,229
Total operating expenses	<u>448,299,568</u>	<u>426,199,661</u>
Operating margins	<u>18,215,007</u>	<u>15,408,435</u>
Interest Expense:		
Interest on long-term debt	14,898,807	13,222,676
Other interest	125,144	1,128,452
Total interest expense	<u>15,023,951</u>	<u>14,351,128</u>
Net Operating Margins	3,191,056	1,057,307
Other Patronage Allocations	1,289,156	1,220,559
Total operating margins	<u>4,480,212</u>	<u>2,277,866</u>
Nonoperating Margins	954,886	1,416,496
Net margins	<u>\$ 5,435,098</u>	<u>\$ 3,694,362</u>
Patronage Capital, Beginning of Year	\$ 135,828,700	\$ 133,149,264
Net Margins	5,435,098	3,694,362
Distribution of Capital Credits	(909,981)	(1,014,926)
Patronage capital, end of year	<u>\$ 140,353,817</u>	<u>\$ 135,828,700</u>

**STATEMENTS OF COMPREHENSIVE INCOME (Loss)
YEARS ENDED DECEMBER 31, 2008 AND 2007**

	2008	2007
Net Margins	\$ 5,435,098	\$ 3,694,362
Other Comprehensive Income:		
Unrecognized actuarial loss	(30,123,363)	(131,100)
Amortization of unrecognized loss	(102,875)	—
Amortization of transition obligation	(133,875)	—
Other comprehensive (loss) income	(30,360,113)	(131,100)
Comprehensive Income (Loss)	<u>\$ (24,925,015)</u>	<u>\$ 3,563,262</u>

The accompanying notes are an integral part of the above statements.

STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2008 AND 2007

	<u>2008</u>	<u>2007</u>
Cash Flows From Operating Activities:		
Net margins	\$ 5,435,098	\$ 3,694,362
Adjustments to reconcile net margins to net cash provided by operating activities:		
Depreciation and amortization	23,411,483	21,638,270
(Earnings) loss in unconsolidated entities	158,908	(129,406)
Other patronage allocations	(1,289,156)	(1,220,559)
Change in operating assets and liabilities:		
Accounts receivable, net	(9,030,317)	(13,753,338)
Prepaid expenses	(248,955)	(1,399,375)
Other current assets	3,745,941	(927,633)
Derivative assets	6,930,258	(6,930,258)
Deferred charges and other	163,267	2,850,294
Regulatory assets	(13,624,401)	1,631,591
Accounts payable	3,778,469	4,890,997
Customer deposits	124,874	(153,847)
Other current liabilities	3,140,358	(998,941)
Deferred credits	(7,063,917)	6,927,723
Derivative liabilities	11,870,649	(1,626,389)
Accrued pension and postretirement benefits	(2,464,002)	3,408,160
Net cash provided by operating activities	<u>25,038,557</u>	<u>17,901,651</u>
 Cash Flows From Investing Activities:		
Construction of utility plant	(54,952,861)	(64,809,259)
Plant removal cost	(1,281,787)	(1,228,240)
Proceeds from the salvage of utility plant	870,524	231,621
Contributions in aid of construction	5,185,614	7,108,044
Capitalized interest	(1,269,610)	(1,147,194)
Materials and supplies inventory	(792,665)	(345,761)
Sale of unconsolidated entity	3,065,000	—
Sale (purchase) of nonutility property	7,457	7,065
Sale of other investments	1,301,530	4,705,259
Net redemption of capital term certificates	14,383	569,384
Net sale of associated investments	908,929	755,593
Net investment in direct financing lease	1,920,201	1,680,286
Net cash used in investing activities	<u>(45,023,285)</u>	<u>(52,473,202)</u>
 Cash Flows From Financing Activities:		
Advances on long-term debt	21,900,000	78,282,000
Payments of long-term debt	(11,936,815)	(9,869,679)
Advances under line of credit agreements	375,300,000	313,400,000
Payments under line of credit agreements	(366,100,000)	(346,800,000)
Distribution of capital credits	(590,534)	(866,816)
Net cash provided by financing activities	<u>18,572,651</u>	<u>34,145,505</u>
 Net (Decrease) Increase in Cash and Cash Equivalents	(1,412,077)	(426,046)
Cash and Cash Equivalents, Beginning of Year	9,868,299	10,294,345
Cash and cash equivalents, end of year	<u>\$ 8,456,222</u>	<u>\$ 9,868,299</u>

The accompanying notes are an integral part of the above statements.



NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2008 AND 2007

Note 1: Description of Business

Southern Maryland Electric Cooperative, Inc. (SMECO) is an electric distribution cooperative that was initially formed as Southern Maryland Tri-County Cooperative Association on February 5, 1937. In 1942, the members voted to change the form of the organization from an association to a cooperative, nonprofit membership corporation under the Maryland Electric Cooperative Act and adopted the current name. SMECO serves about 147,000 customers in a 1,150 square-mile area in Southern Maryland comprised of Calvert, Charles, Prince George's and St. Mary's counties.

Note 2: Summary of Significant Accounting Policies

A. System of Accounts and Regulation – The accounting records are maintained in accordance with the Uniform System of Accounts for Electric Borrowers prescribed by the Rural Development Utilities Programs (RDUP). SMECO is subject to regulation by the Maryland Public Service Commission (PSC). The accompanying financial statements have been prepared in accordance with United States generally accepted accounting principles. The financial statements reflect the ratemaking policies of the PSC in conformity with Statement of Financial Accounting Standards (SFAS) No. 71, Accounting for the Effects of Certain Types of Regulation. This standard allows SMECO to record certain regulatory assets and liabilities, which will be included in future rates and would not be recorded under generally accepted accounting principles for nonregulated entities in the United States (see Note 8).

If portions of SMECO's operations no longer become subject to the provisions of SFAS No. 71, a write-off of any related regulatory assets and liabilities would be required unless some form of transition cost recovery continues through rates established and collected for the remaining regulated operations. In addition, a determination of any impairment to the carrying costs of deregulated plant and inventory assets would be required.

B. Estimates – The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of revenues, expenses, assets, liabilities and disclosure of contingencies as of the date of the financial statements. Actual results could differ from those estimates and assumptions.

C. Utility Plant – Utility plant is stated at cost which includes the cost of labor, material and applicable indirect costs. When a retirement unit of property is replaced or removed, the cost of such property is deducted from utility plant and such cost, together with the cost of removal less salvage, is charged to accumulated depreciation. Expenditures for additions and replacements that are not considered units of property, as well as routine repairs and maintenance, are expensed as incurred.

SMECO periodically evaluates long-lived assets such as utility plant when events or changes in circumstances indicate that the carrying value of these assets may not be recoverable. The determination of whether impairment has occurred is based on an estimate of undiscounted cash flows attributable to these assets, as compared to the carrying value of the assets.

D. Depreciation – For financial reporting purposes, depreciation is computed on a straight-line composite basis using the estimated useful service lives of the depreciable property.

E. Investments – Investments in one unconsolidated entity at December 31, 2008 and two unconsolidated entities at December 31, 2007 are accounted for under the equity method because SMECO has influence over, but does not control, the entities. SMECO records its proportionate share of equity in earnings or loss of the unconsolidated entities in the Statements of Revenue, Expenses and Patronage Capital under Nonoperating Margins (see Note 6).

Investments in associated organizations are considered held to maturity since that is a condition for membership in the respective organization. Other investments are considered as available-for-sale and are recorded at their fair value at the balance sheet date.

F. Cash and Cash Equivalents – Cash and cash equivalents are considered to be highly liquid investments with an original maturity of three months or less.

G. Accounts Receivable – Credit is extended to customers for electric service received as customers are billed on a monthly basis after the service is rendered and the electric meter is read. These readings occur as nearly as practicable every 30 days. Bills are payable within 20 days of rendering. If not paid timely, late payment charges may be applied. In compliance with the rules and regulations of the PSC, SMECO may require both residential and nonresidential customers to make and maintain cash deposits to secure the payment of final bills. The allowance for doubtful accounts is calculated as a percentage of sales. Accounts are reviewed periodically to determine collectibility. Bad debts are written off automatically throughout the year after one year of nonpayment.

H. Materials and Supplies Inventory – Materials and supplies inventory is generally used for construction or maintenance of operations. Inventory is recorded using the average cost method and issued items are charged to construction or operations at the recorded average cost.

I. Derivative Instruments – SMECO uses derivative instruments such as forward purchase contracts and options (written and purchased) to manage the commodity and financial risks associated with meeting its power supply requirements. SMECO accounts for derivatives in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended, which requires all derivatives, subject to certain exceptions, to be accounted for at fair value. Forward purchase contracts qualify for the normal purchases and sales exception under SFAS No. 133 and are accounted for on an accrual basis at the time the power is used. Since all of SMECO's power supply related costs are subject to rate recovery, changes in the fair value of option contracts are periodically reflected as derivative assets and regulatory liabilities or derivative liabilities and regulatory assets, respectively, under SFAS No. 71 (see Note 2 A). As of December 31, 2008 and 2007, SMECO had entered into commitments for options totaling \$13.1 million and \$15.2 million, respectively.

J. Deferred Charges – Costs of preliminary surveys and studies made for the purpose of determining the feasibility of proposed utility projects are recorded as deferred charges. If a project is constructed, such costs are capitalized as part of the cost of the facility. If the plans for a project are subsequently abandoned, the costs are expensed.

K. Revenue Recognition – Revenue is recognized as service is rendered to customers. Recorded revenue includes an estimate of unbilled revenue for utility service rendered but not billed to customers as of year-end. Estimated unbilled revenue was approximately \$27 million and \$24 million as of December 31, 2008 and 2007, respectively.

L. Income Taxes – As a not-for-profit, membership cooperative under Section 501(c)(12) of the Internal Revenue Code, SMECO is exempt from federal income taxes. Pursuant to the Maryland Electric Cooperative Act, SMECO is also exempt from state income taxes. Accordingly, no provision for such taxes has been made in the accompanying financial statements.

Certain income earned from other unrelated products and services may require SMECO to pay federal and state income taxes. Should this situation arise, the necessary provisions for income tax liability will be recorded in the financial statements.

M. Accumulated Other Comprehensive Income – This item consists of other gains and losses affecting equity that, under U.S. generally accepted accounting principles are excluded from net income. During 2008 and 2007, such items relate to SMECO's unrecognized actuarial loss and transition obligation from the adoption of SFAS No. 158.

Note 3: Newly Adopted Accounting Standard

Effective December 31, 2008, SMECO adopted SFAS No. 157, Fair Value Measurements. SFAS No. 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements.

SMECO's adoption of SFAS No. 157 had no impact on the balance sheet, results of operations or cash flows and it will not affect SMECO's balance sheets, operating results or cash flows in future periods.

Effective December 31, 2007, SMECO adopted SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans. SFAS No. 158 requires an employer to recognize the over funded or under funded status of its defined benefit pension and other postretirement benefit plans as an asset or liability, respectively, in its balance sheet and to recognize changes

in the funded status as a component of other comprehensive income (OCI) in the year in which the changes occur. The funded status is measured as the difference between the fair value of a plan's assets and the benefit obligations. In addition, SFAS No. 158 requires an employer to measure benefit plan assets and obligations that determine the funded status of a plan as of the end of the employer's fiscal year.

SMECO's adoption of SFAS No. 158 had no impact on the results of operations or cash flows and it will not affect operating results or cash flows in future periods. The following table illustrates the incremental effect of adopting the provisions of SFAS No. 158 on the Balance Sheet as of December 31, 2007:

	Prior to Adopting SFAS No. 158	Effect of Adopting SFAS No. 158	As Reported at Dec. 31, 2007
Assets:			
Deferred Charges	\$7,273,079	\$5,634,810	\$12,907,889
Liabilities:			
Accrued Pension and Postretirement Benefits	\$14,196,114	\$5,634,810	\$19,830,924

Upon adoption, regulatory assets were recorded, rather than an adjustment to OCI, for previously unrecognized pension and other postretirement benefit costs expected to be recovered through future rates. The adjustment to OCI, regulatory assets and regulatory liabilities at adoption of SFAS No. 158 represent the net unrecognized actuarial gains (losses), unrecognized prior service costs and unrecognized transition obligation remaining from the initial adoption of SFAS No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, all of which were previously netted against the funded status of our plans in the Balance Sheet. The amounts in OCI and regulatory assets will be subsequently recognized as a component of net periodic benefit costs pursuant to our historical accounting policy for amortizing such amounts. Further, actuarial gains and losses that arise in subsequent periods and are not recognized as net periodic benefit cost in the same periods will be recognized as a component of OCI or regulatory assets as appropriate. Those amounts will be subsequently recognized as a component of net periodic benefit cost on the same basis as the amounts recognized in OCI and regulatory assets at adoption of SFAS No. 158.

Note 4: Utility Plant

The major classes of utility plant in service as of December 31, 2008 and 2007, are as follows:

	2008	2007
Distribution	\$425,784,906	\$405,347,918
Transmission	112,544,404	108,191,614
General	79,434,773	73,473,854
	<u>617,764,083</u>	<u>587,013,386</u>
Construction work in progress	27,718,554	21,728,547
	<u>645,482,637</u>	<u>608,741,933</u>
Less: Accumulated depreciation and amortization	(230,243,130)	(219,384,649)
Net utility plant	<u>\$415,239,507</u>	<u>\$389,357,284</u>

The provision for depreciation, stated as a percentage of the average balance of related properties, approximated the following percentages during 2008 and 2007:

	2008	2007
Distribution	3.33%	3.56%
Transmission	2.56%	2.72%
General	6.99%	8.01%
Composite rate	3.67%	3.95%

The applicable rates have been approved by the RDUP and PSC.

SMECO follows the regulatory principle of intergenerational cost allocation by including net salvage (gross salvage less costs of removal) as a component of depreciation rates. Net salvage is a "non-legal asset retirement obligation," and as such is not subject to the accounting requirements of SFAS No. 143, Accounting for Asset Retirement Obligations and Federal Energy Regulatory Commission (FERC) Order 631 (as adopted by RDUP). SMECO has no legal asset retirement obligations as that term is defined by SFAS No. 143 and FERC Order 631.

In accordance with the reporting requirements of SFAS No. 143 and FERC Order 631, SMECO's accumulated provision for depreciation included a net salvage timing difference of approximately \$500,000 and \$419,000 for the years ending December 31, 2008 and 2007, respectively. This represents the differences in the timing of recognition of the period costs associated with net salvage.

SMECO began capitalizing interest cost incurred on funds used to construct utility plant in 2007. The capitalized interest is recorded as part of the asset to which it relates and is amortized over the asset's estimated useful life. Interest cost capitalized was \$1.3 million and \$1.1 million as of December 31, 2008 and 2007, respectively.

Note 5: Investments in Associated Organizations

Investments in associated organizations, which are recorded at cost (see Note 14), consisted of the following as of December 31, 2008 and 2007:

	2008	2007
National Rural Utilities Cooperative Finance Corporation (CFC):		
Capital Term Certificates		
3%	\$ 1,000,650	\$ 1,000,650
5%	3,164,783	3,164,783
8.55%	2,158,269	2,158,269
Noninterest bearing	501,801	516,184
Patronage capital certificates	1,252,069	1,311,156
CFC membership	1,000	1,000
	<u>8,078,572</u>	<u>8,152,042</u>
Federated Rural Electric Insurance Corporation	490,938	457,481
CoBank, ACB (CoBank)	2,132,119	1,793,546
Cooperative Response Center	19,947	12,068
Electric Research and Manufacturing Cooperative	98,969	36,326
Virginia, Maryland and Delaware Association of Electric Cooperatives	12,400	12,400
United Utility Supply	12,338	12,338
National Rural Telecommuni- cations Cooperative	2,010	5,248
	<u>\$10,847,293</u>	<u>\$10,481,449</u>

Note 6: Equity Method Investments

Effective January 1, 2001, SMECO invested \$2,650,000 in Mid-Atlantic Cooperative Services, LLC (MACS), a for-profit company whose principal business activities include the sale of fuel oil, propane, propane cylinders and related services. This investment represents a one-third interest in MACS and is accounted for under the equity method. During 2002, SMECO's one-third investment interest in MACS was converted to a one-third investment interest in Mid-Atlantic Cooperative Solutions, Inc. During 2008, MACS bought SMECO's investment interest for \$3,065,000 representing the original investment made in 2001 and an additional investment of \$415,000 made in 2006. SMECO realized a loss of \$188,967 as a result of the sale. SMECO's proportionate share of MACS earnings was \$100,958 in 2007. The carrying value of the investment was \$3,253,967 as of December 31, 2007.

Effective August 1, 2003, SMECO invested \$1,000,000 for a membership and equity investment in Alliance for Cooperative Energy Services Power Marketing, LLC (APM). Organized in 1999 and currently comprised of 16 members, APM provides a number of power supply related professional services including, among others, acting as agent for its members in the procurement and sale of wholesale power supply (see Notes 12 and 13). SMECO's proportionate share of APM earnings was \$30,059 in 2008 and \$28,448 in 2007. As of December 31, 2008 and 2007, the carrying value of the investment was \$1,336,182 and \$1,306,123, respectively.

Note 7: Net Investment in Facility Capacity Credit Agreement

Pursuant to the Facility and Capacity Credit Agreement (FCC Agreement) entered into with Potomac Electric Power Company (Pepco) in March 1989, SMECO constructed a 77-megawatt combustion turbine generating unit at Pepco's then-owned Chalk Point Generating Station in Aquasco, Maryland. This facility was placed in commercial operation on December 1, 1990. As part of the FCC Agreement, in exchange for electric capacity and generated energy from the facility, Pepco is obligated to operate and maintain the facility for a period of 25 years, commencing December 1990.



In accordance with SMECO's concurrence under the Agreement and Consent executed in December 2000, Pepco assigned its rights and obligations under the FCC Agreement to Southern Energy, Inc. (SEI), a Delaware corporation. SEI subsequently changed its name to Mirant Corporation, which assigned the FCC Agreement to one of its subsidiaries, Mirant Peaker, LLC (along with Mirant Corporation and Mirant Chalk Point, LLC (Mirant)). The agreement permits Mirant to operate, dispatch and receive all electricity generated from the facility. Mirant is now responsible for all costs associated with operating and maintaining the combustion turbine during the remaining term of the FCC Agreement.

On July 14, 2003, Mirant and certain of its affiliates filed petitions for relief under chapter 11 of the Bankruptcy Code. In accordance with legal considerations, Mirant has yet to pay for any outstanding and unpaid amounts owed SMECO at the time of the filing. Pursuant to the terms of the December 2000 assignment, Pepco subsequently reimbursed SMECO for \$670,029 of the unpaid amounts that Mirant failed to pay.

On March 15, 2004, Mirant filed an adversary proceeding against SMECO and Pepco in its bankruptcy case seeking a declaratory judgment that the FCC Agreement is an unexpired real property lease subject to the cap on damages provided by Section 502(b)(6) of the Bankruptcy Code. Section 502(b)(6) limits damages from the rejection of a real property lease to the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease following the earlier of (i) the date of filing of the bankruptcy petition; and (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus any unpaid rent due under such lease without acceleration, on the earlier of such dates.

On November 22, 2005, the U.S. Bankruptcy Court for the Northern District of Texas issued an opinion holding the FCC Agreement to be an unexpired real property lease. On December 1, 2005, Mirant filed a motion to reject the FCC Agreement under Section 365 of the Bankruptcy Code. On December 1, 2005, Mirant also filed a complaint against SMECO and Pepco for disgorgement and a declaratory judgment with respect to the bankruptcy court's jurisdiction.

On December 2, 2005, SMECO and Pepco appealed the bankruptcy court's November 22, 2005, opinion. On December 15, 2005, SMECO and Pepco filed a joint objection to Mirant's motion to reject the FCC Agreement.

In May 2006, Mirant, Pepco and SMECO entered into Settlement Agreements pursuant to which, among other things, all pending litigation between Mirant, Pepco and SMECO was resolved and Mirant agreed to assume the FCC Agreement and continue to perform under its terms. The purchasers of certain claims in the Mirant bankruptcy case objected to the settlements. Mirant, Pepco and SMECO all defended the terms of the settlements in response. The U.S. Bankruptcy Court for the Northern District of Texas overruled the objections and approved the settlements on August 9, 2006. The objectors filed an appeal before the United States District Court for the Northern District of Texas, which affirmed the ruling of the Bankruptcy Court upholding the settlements on December 6, 2006. The objectors have subsequently filed another appeal before the U.S. Court of Appeals for the Fifth Circuit. SMECO continues to protect its legal rights in this matter and will oppose the appeal before the U.S. Court of Appeals.

On August 7, 2007, the objectors, Mirant, Pepco and SMECO resolved all outstanding issues on appeal and entered into a letter agreement confirming the settlement of all outstanding litigation matters by and between the parties. The settlement involved no cost to SMECO, did not modify the terms of the existing Settlement Agreements pursuant to which Mirant agreed to assume the FCC Agreement and perform under its terms and released SMECO and its officers, directors, employees, attorneys, agents, shareholders, subsidiaries and affiliates from all claims asserted by the objectors. All pending appeals were dismissed with prejudice and all litigation related to this matter is resolved.

The FCC Agreement is accounted for as a direct financing lease. The current monthly payment is \$437,510.

The following sets forth the components of the net investment in the FCC Agreement as of December 31, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Total minimum FCC payments receivable	\$36,750,840	\$42,000,960
Estimated residual value of FCC property	<u> </u>	<u> </u>
Gross investment in FCC	36,750,840	42,000,960
Less: Unearned income	(13,001,119)	(16,331,038)
Net investment in FCC Agreement	<u>\$23,749,721</u>	<u>\$25,669,922</u>

Current portion	\$ 2,194,373	\$ 1,920,201
Noncurrent portion	<u>21,555,348</u>	<u>23,749,721</u>
Net investment in FCC Agreement	<u>\$23,749,721</u>	<u>\$25,669,922</u>

Future minimum FCC receivables due under this direct financing lease as of December 31, 2008, are as follows:

2009	\$ 5,250,120
2010	5,250,120
2011	5,250,120
2012	5,250,120
2013	5,250,120
Thereafter	<u>10,500,240</u>
Total	<u>\$36,750,840</u>

Note 8: Regulatory Assets

Regulatory assets, consisting of demand-side management (DSM) and demand response (DR) programs and energy and energy-related costs, as described below, aggregated \$14,188,640 and \$564,239 as of December 31, 2008 and 2007, respectively.

A. DSM and DR Programs – Conservation expenditures pertaining to DSM and DR programs are recognized as regulatory assets and amortized over a one-year or five-year period in accordance with PSC requirements. Conservation costs are recovered through a rate surcharge approved by the PSC that reflects expenditures, lost revenue and an allowed rate of return. The related amounts of regulatory assets for the DSM and DR programs were \$1,760,506 and \$6,754 as of December 31, 2008 and 2007, respectively.

B. Energy and Energy-Related Costs – As of December 31, 2008 and 2007, the regulatory asset pertaining to energy and energy-related costs was \$12,428,134 and \$557,485, respectively (see Note 2).

Note 9: Employee Benefit Plans

A. Pension Plan and Other Postretirement Benefits – SMECO has a qualified, noncontributory, defined benefit pension plan covering substantially all employees. The plan provides for retirement benefits based upon age, years of service and compensation. The Retirement Annuity Plan for Employees of SMECO was closed effective December 31, 2006, so that employees who were hired or re-hired on or after January 1, 2007, were not eligible to participate (or recommence participation) in the Pension Plan. SMECO will continue to maintain the Pension Plan for current employees through December 31, 2010. Employees hired prior to January 1, 2007, were eligible to participate in the Pension Plan in accordance with the terms of the Pension Plan. The Pension Plan will be frozen as of December 31, 2010, meaning that no employee who participates in the Pension Plan will accrue any benefits under the Pension Plan after December 31, 2010. Service completed, and compensation earned, after December 31, 2010, will not be taken into account in computing benefits under the Pension Plan. The net effect is that a participant's benefits under the Pension Plan will be calculated as if the participant terminated employment with SMECO on December 31, 2010. As a result of this curtailment, SMECO requested an SFAS 71 deferral to amortize the prior service costs (benefit cost) of \$4.7 million, over an eight-year period. Annual provisions for accrued pension costs are based upon independent actuarial valuations. SMECO's policy is to fund accrued pension costs in accordance with provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

SMECO provides additional retirement benefits to certain employees under a nonqualified plan established in accordance with Section 457 of the Internal Revenue Code. The periodic plan expenses are based on the present value of the retirement benefits earned during the year.

SMECO supplements health care insurance premiums for retirees and covered dependents through their inclusion in the same insurance coverage pool as active employees. The expected cost of these benefits under the unfunded plan is recognized during the years in which employees render service.

The following sets forth the obligations, funded status and periodic costs for the plans and the actuarial assumptions used:

	Pension Benefits	
	2008	2007
Benefit obligation at year end	\$ 96,680,502	\$ 85,989,861
Fair value of plan assets at year end	56,209,752	73,635,128
Funded status	<u>\$ (40,470,750)</u>	<u>\$ (12,354,733)</u>
Amounts recognized in the Balance Sheets:		
Accrued benefit cost	\$ (40,470,750)	\$ (12,354,733)
Accumulated other comprehensive loss	36,314,734	5,434,020
Deferred charges	3,551,259	3,788,010
Weighted-average assumptions used to determine benefit obligations as of year end:		
Discount rate	6.25%	6.50%
Rate of compensation increase	4.00%	4.00%
Benefit cost	\$ 1,690,098	\$ 1,592,809
Employer contribution	4,224,324	4,996,324
Benefits paid	4,655,248	4,294,339
Weighted-average assumptions used to determine benefit costs:		
Discount rate	6.25%	6.00%
Expected return on plan assets	8.00%	8.00%
Rate of compensation increase	4.00%	4.00%
Expected contributions for year ending December 31, 2009:		
Employer	\$ 6,024,324	—
Employees	—	—
Estimated future benefit payments reflecting expected future service for years ending December 31:		
2009	\$ 4,870,166	
2010	5,099,806	
2011	5,337,160	
2012	5,597,758	
2013	5,882,645	
2014–2018	32,954,829	
Estimated Amortization for Next Fiscal Year	\$ 645,551	\$ —
Plan Assets:		
Equity Securities (a) (c)	46%	51%
Fixed Income Securities (b) (c)	54%	49%

- (a) The portfolio's target asset allocation range is 50% equity with an allowable range of 30% to 75%.
 (b) The portfolio's target asset allocation range is 50% fixed income with an allowable range of 25% to 70%.
 (c) The portfolio's target asset allocation also allows for up to 20% in cash.

SMECO's investment strategy with respect to pension assets is designed to achieve a moderate level of overall portfolio risk in keeping with its desired risk objective, which is established after careful consideration of plan liabilities, plan funded status and SMECO's overall financial condition. The portfolio's target asset allocation is 50% equity and 50% fixed income with specified allowable ranges around these targets. The equity segment is broadly diversified across growth/value and small-, mid- and large-cap equities. The fixed income segment is diversified by investing in preferred stocks, corporate debt securities and obligations of the U.S. Government and its agencies.

	Other Postretirement Benefits	
	2008	2007
Benefit obligation at year end	\$ 7,256,285	\$ 7,476,191
Fair value of plan assets at year end	—	—
Funded status	<u>\$ (7,256,285)</u>	<u>\$ (7,476,191)</u>

Amounts recognized in the Balance Sheets:

Accrued benefit cost	\$(7,256,285)	\$(7,476,191)
Accumulated other comprehensive income	(520,601)	—
Weighted-average assumptions used to determine benefit obligations as of year end:		
Discount rate	6.25%	6.50%
Benefit cost	\$ 868,457	\$ 1,263,551
Employer contribution	218,085	123,754
Benefits paid	218,085	123,754
Weighted-average assumptions used to determine benefit costs:		
Discount rate	6.25%	6.00%
Expected contributions for year ending December 31, 2009:		
Employer	\$ 390,754	—
Employees	—	—
Estimated future benefit payments reflecting expected future service for years ending December 31:		
2009	\$ 390,754	
2010	353,669	
2011	350,964	
2012	335,641	
2013	317,914	
2014–2018	2,195,542	
Estimated Amortization for Next Fiscal Year	\$ 236,977	\$ 236,977

For measurement purposes, a 9% annual rate of increase in per capita cost of covered health care benefits was assumed for 2009. The rate is assumed to decrease gradually to 5% to 2016 and remain at that level thereafter. A 15% annual rate of increase in employee premiums was assumed for 2009. This rate is assumed to gradually decrease to 5% to 2016 and remain at that level thereafter.

In accordance with the Financial Accounting Standards Board (FASB) Staff Position SFAS No. 106-2, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003, SMECO was required to determine whether its plan is at least actuarially equivalent to the Medicare benefit as of January 1, 2005, and account for the effects of the 2003 Medicare Act, if any, beginning in 2005. SMECO has determined that its postretirement benefit plan is actuarially equivalent to the Medicare benefit and has accepted the federal subsidy option effective January 1, 2005. As of 2008, the plan no longer qualifies for the Medicare Part D credit according to actuarial analysis.

B. Health Insurance – SMECO is self-insured for medical and dental claims of its current employees and retirees and their covered dependents. SMECO is liable for claims of up to \$100,000 per occurrence for medical claims and \$2,000 per year per participant for dental claims. Catastrophic coverage is maintained to pay claims in excess of these amounts. Claims paid under this plan approximated \$4.5 million and \$5.2 million in 2008 and 2007, respectively. Provisions for claims incurred but not reported have been made based on claim experience and approximated \$481,000 and \$518,000 as of December 31, 2008 and 2007, respectively.

C. 401(k) Plans – SMECO maintains 401(k) plans for its management and bargaining unit employees. All full-time employees are eligible to participate in the plans after meeting minimum service requirements. SMECO matches employee contributions to the management plan up to 6% of annual compensation. Effective January 1, 2007, SMECO contributes a non-elective, 3% contribution for all eligible employees. Effective with the freeze of the Pension Plan as noted in Note 9A, the amount of SMECO's non-elective employer contribution for compensation earned on or after January 1, 2011, will vary based on length of service. For employees with 0 – 5 years of service, the contribution will be 3% of base pay; 6 – 20 years of service, 6% of base pay; and more than 20 years of service, 8% of base pay. During 2008 and 2007, SMECO recorded 401(k) plan-related expenses of \$788,000 and \$721,000, respectively.



D. Workers' Compensation Trust – SMECO is self-insured for workers' compensation insurance through a separate trust which was established to pay workers' compensation claims. Contributions to the trust are based upon an annual actuarial valuation and SMECO maintains excess liability insurance coverage of up to \$2 million per incident for claims exceeding the net assets available for benefits in the trust. Transactions within the trust are not reflected in the accompanying financial statements. During 2008 and 2007, SMECO made aggregated contributions to the trust of \$125,000 and \$539,000, respectively. At December 31, 2008 and 2007, the trust had net assets available for benefits of approximately \$346,000 and \$484,000, respectively.

Note 10: Patronage Capital and Other Equities

Assigned patronage capital consists of net margins that have been allocated to individual member patronage accounts. Patronage capital is applied against unpaid accounts receivable when customers leave SMECO. Patronage capital retirements to date represent amounts that have been paid to individual members. Patronage capital activity as of December 31, 2008 and 2007, consisted of the following:

	2008	2007
Assignable	\$ 9,169,937	\$ 3,694,362
Assigned to date	<u>207,870,467</u>	<u>207,910,944</u>
	217,040,404	211,605,306
Less: Retirements to date	<u>(76,686,587)</u>	<u>(75,776,606)</u>
Patronage capital	<u>\$140,353,817</u>	<u>\$135,828,700</u>

Other equities consist of donated capital from members and nonrefundable membership fees that were previously collected from new members upon joining SMECO.

Note 11: Long-Term Debt

SMECO has obtained long-term debt from the RDUP; CFC; CoBank; National Cooperative Services Corporation (NCSC), a wholly-owned subsidiary of CFC; and Federal Financing Bank (FFB). SMECO is subject to various loan covenants under its master mortgage and substantially all assets are pledged as collateral for the long-term debt. The covenants include maintaining certain minimum debt service and equity to assets ratio requirements. The following debt was outstanding as of December 31, 2008 and 2007:

Lender	Interest Rates	Maturity (Year)	2008	2007
RDUP	2.00–5.62%	2008-40	\$ 171,262,501	\$152,415,161
CFC	3.85–9.50%	2007-30	33,976,469	37,305,988
CoBank	4.57–6.44%	2010-40	48,534,785	51,665,495
NCSC	7.25%	2015	19,075,701	21,099,142
FFB	5.98–8.07%	2025	<u>14,614,660</u>	<u>15,015,145</u>
Total debt outstanding			287,464,116	277,500,931
Less: Current maturities			13,894,510	11,614,162
Long-term debt			<u>\$ 273,569,606</u>	<u>\$265,886,769</u>

At December 31, 2008, the required principal payments of the long-term debt are as follows:

2009	\$ 13,894,510
2010	20,877,488
2011	12,867,657
2012	18,895,986
2013	12,263,455
Thereafter	<u>208,665,020</u>
Total	<u>\$ 287,464,116</u>

Cash paid for interest totaled \$16.9 million and \$17 million for the years ended December 31, 2008 and 2007, respectively. SMECO had unadvanced loan funds in the amount of \$17.7 million and \$39.6 million as of December 31, 2008 and 2007, respectively. In 2006, RDUP approved a \$97.9 million loan under their Treasury Rate Loan Program (TRLP). Under the TRLP, 100% of the funding is provided by RDUP and the applicable Treasury interest rate is set at the time of the respective loan advance. Of the \$97.9 million loan, SMECO advanced \$21.9 million in 2008 and \$58.3 million in 2007. In December 2008, SMECO authorized repricing and rate agreements with NRUCFC regarding two outstanding loans with balances of \$817,000 and \$98,000 at a rate of 5.75% for one year effective January 1, 2009. On September 7, 2007, SMECO converted \$20 million in a partial conversion of CoBank's Promissory Note and Committed Revolving Credit Supplement to a term loan of \$10 million at a

fixed rate of 5.79% per annum through November 20, 2010 and \$10 million at a fixed rate of 5.97% per annum through November 20, 2012.

SMECO maintains unsecured revolving line of credit agreements at variable interest rates with CoBank and CFC for its short-term borrowing needs. The CoBank agreement expires March 31, 2009. The CFC agreement automatically renews each March unless CFC or SMECO provides written notice not to renew at least 90 days in advance of the renewal date.

As of December 31, 2008, SMECO had authorized lines of credit of \$100 million with CFC and \$85 million with CoBank. Pursuant to limitations on total unsecured debt of \$100 million, amounts borrowed from either CFC or CoBank may reduce the amounts available from the other party. SMECO received a temporary waiver on limitations of unsecured debt of \$135 million until December 31, 2009.

As of December 31, 2008 and 2007, SMECO had outstanding letters of credit totaling \$48.4 million and \$29.9 million, respectively.

The applicable interest rate as of December 31, 2008 and 2007 for CoBank were 3.87% and 5.79%, respectively. There were outstanding advances against the CoBank line of credit as of December 31, 2008 and 2007 of \$62.7 million and \$53.5 million, respectively.

Note 12: Commitments and Contingencies

SMECO contracts with various suppliers for energy and energy-related products to serve its native load requirements. As of December 31, 2008, SMECO had forward purchase commitments with multiple parties through December 2012 covering a significant portion of SMECO's power supply needs.

At December 31, 2008 and 2007, SMECO had made commitments for capital expenditures of approximately \$5.3 million and \$7.9 million, respectively. Pursuant to a 50-year operating lease, SMECO is obligated to rent the parcel of land on which SMECO's combustion turbine is located at the Chalk Point Generating Station (see Note 7). SMECO makes annual rental payments of \$5,000 under the lease agreement that expires in 2039. SMECO has entered into several operating lease agreements for computer equipment, vehicles and power operated equipment. The future minimum lease obligations at December 31, 2008, are \$316,000 for 2009; \$316,000 for 2010; and \$225,000 for 2011, for a total of \$857,000. Operating lease expense amounted to \$291,000 and \$29,000 in 2008 and 2007, respectively.

SMECO is involved in legal proceedings in the normal course of business. Management is of the opinion that the final disposition of these proceedings will not have a material adverse effect on SMECO's financial position, results of operations or cash flows.

Note 13: Concentration of Risk

The electric utility industry continues to be subject to increasing competitive pressures, consolidation and restructuring. Federal and state legislatures and regulators, including the United States Congress, Maryland General Assembly and Public Service Commission, and large industrial electricity consumers are working to reshape the industry through legislative and regulatory initiatives that increase electric competition at the generation, transmission and distribution levels.

In 1999, Maryland enacted the Electric Customer Choice and Competition Act and the Electric and Gas Utility Tax Reform Act. Under Maryland law, electric customers residing in Maryland are entitled to select or choose their electric energy supplier, the company that generates or supplies the commodity of electricity. The law required electric cooperatives to offer this choice on or before July 1, 2003. In accordance with that law and a settlement approved by the PSC, SMECO elected to begin offering customer choice in 2001. Under customer choice, SMECO provides "standard offer service" for customers who do not select an alternative electricity supplier. SMECO continues to provide distribution service to all of its customers. Despite having choice available in 2001, only a very limited number of customers have elected to date to be served by an alternative electricity supplier in SMECO's service territory. As of December 31, 2008 and 2007, all SMECO customers were provided standard offer service.

The outcome of these initiatives and their impact on SMECO is uncertain. Customer choice and the resulting retail competition will likely continue to affect the entire industry.

With the assistance of APM (see Notes 6 and 12), SMECO has developed a more diversified market strategy to meet future power supply needs, including reduced dependence on a single supplier and varied contract termination dates. This approach represents a significant departure from the traditional cooperative model of multiple year contracts with a sole supplier. Given the changes in the wholesale power market in recent years, SMECO has concluded that it is no longer operationally or economically prudent to engage in the



traditional full-requirements contract with one supplier.

In order to meet its power supply requirements for its standard offer service customers, SMECO has executed numerous Master Power Purchase and Sale Agreements with a number of counterparties. Such agreements stipulate credit limits and other information pertaining to the establishment of trading relationships. Accordingly, SMECO is subject to the normal market, credit and performance risks inherent in these arrangements. To monitor and mitigate such risk exposure, SMECO continues to work closely with APM personnel, has created and implemented related trading and credit policies and has established Board and internal risk oversight committees that meet frequently to address pertinent matters.

Financial instruments that subject SMECO to concentration of credit risks include customer accounts receivable and the RDUP loan programs. All of SMECO's depository accounts are in institutions insured by the Federal Deposit Insurance Corporation; however, the deposits exceeded the insurance limits by approximately \$4.3 million and \$9.8 million at December 31, 2008 and 2007, respectively. SMECO grants credit to customers, substantially all of whom are local residents of SMECO's four-county service area. SMECO typically obtains 70% of its new debt under the RDUP loan program. The RDUP loan program is subject to federal legislative changes which could affect the interest rates and availability of future loans under the program.

Note 14: Fair Value of Financial Instruments

SMECO has accounted for all financial instruments, classified as derivatives, at fair market value. SMECO has accounted for all other financial instruments based on the carrying amount (book value) in the financial statements in accordance with accounting principles generally accepted in the United States. According to SFAS No. 107, SMECO is required to disclose the fair value of financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using discounted cash flow analysis. This technique involves subjective judgment and is significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. As a result, the derived fair value estimates cannot be substantiated by comparison to independent markets, and in many cases, could not be realized in immediate settlement of the instrument.

During 2008, SMECO adopted SFAS No. 157, which clarifies the definition of fair value for financial reporting and establishes a framework for measuring fair value and requires additional disclosures about the use of the fair value measurements. SFAS No. 157 also establishes a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability. Inputs may be observable or unobservable and refer broadly to the assumptions that market participants would use in pricing the asset or liability. Observable inputs reflect the assumptions market participants would use in pricing the asset or liability based on market data obtained from sources independent of the reporting entity. Unobservable inputs reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

The three levels of the fair value hierarchy are described as follows:

- Level 1 – Quoted prices in active markets for identical assets or liabilities.
- Level 2 – Other significant observable inputs, including quoted prices for similar assets or liabilities in markets that are not active.
- Level 3 – Significant unobservable inputs, which are generally based on SMECO's own assumptions.

Accordingly, the following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it was practicable to estimate that value.

Cash and Cash Equivalents

The carrying amount of cash and cash equivalents approximates fair value due to the short maturity of these instruments.

Accounts Receivable

The carrying amount of accounts receivable approximates fair value due to the short period of time amounts are outstanding.

Investments in Associated Organizations

Fair value of capital term certificates was determined by computing the present value of estimated future cash flows, discounted at the long-term treasury rate of 2.69% and 4.375% as of December 31, 2008 and 2007, respectively. The fair value of patronage capital is not determinable since no legal obligation exists to retire capital credits. The fair value of the equity method investment is not estimated since there are no identified events or

changes in circumstances that may have a significant adverse effect on the fair value and it is not practicable to estimate fair value. The carrying value of memberships approximates fair value.

Accounts Payable

The carrying amount of accounts payable approximates fair value due to the short period of time amounts are outstanding.

Long-Term Debt

The carrying amount of SMECO's fixed long-term debt includes certain interest rates that are below quoted market prices for the same or similar issues. Therefore, the fair value of fixed long-term debt is estimated based on current market prices for the same or similar issues offered for debt of the same and remaining maturities which was 8% and 7.25% as of December 31, 2008 and 2007, respectively.

The carrying amount of lines of credit approximates fair value due to the short maturity of these instruments.

Consumer Deposits

The carrying amount approximates fair value due to the relatively short maturity of the deposits.

Derivative Instruments

The fair value of all forward trades is calculated by a third party, APM, using market prices when possible and supply-demand model generated forecasts when market prices are not available. The power positions are valued at PJM West prices and the gas positions are valued using NYMEX Henry Hub pricing.

The following is a summary of the level 2 inputs used as of December 31, 2008 and 2007 in estimating the fair value of SMECO's financial instruments:

	Carrying Value		Fair Value	
	2008	2007	2008	2007
	(000 Omitted)		(000 Omitted)	
Assets:				
Capital Term				
Certificates	\$ 6,826	\$ 6,854	\$ 10,020	\$ 7,741
Derivative Assets	—	6,930	—	6,930
Liabilities:				
Long-term Debt	(287,464)	(277,501)	(274,970)	(271,441)
Derivative Liabilities	(12,428)	(557)	(12,428)	(557)

As of December 31, 2008 and 2007, there are no level 1 and level 3 inputs used in estimating the fair value of SMECO's financial instruments.

Note 15: Related Party Transactions

SMECO is a member of CFC, NCSC and CoBank. Pursuant to the member relationships, SMECO has invested in CFC and CoBank, entered into various loan agreements with the three organizations and maintains unsecured lines of credit with CFC and CoBank (see Notes 5 and 11). SMECO earned interest income of \$371,000 and \$413,000 in 2008 and 2007, respectively, on investments with CFC. During years 2008 and 2007, SMECO paid interest expense of \$8,158,237 and \$9,306,890, respectively, on aggregated loans from CFC, NCSC and CoBank.

As a customer, Mirant is a member of SMECO. SMECO has entered into a direct financing lease with Mirant (see Note 7).

At December 31, 2007, SMECO had an equity investment in MACS (see Note 6). MACS is a customer and member of SMECO as a result of doing business as Aero Energy, which has business operations in SMECO's service territory. During 2007, SMECO purchased \$1,758 of highway-use propane from Aero Energy.

SMECO invested in and became a member of APM during 2003 to engage APM's professional assistance in meeting future power supply needs (see Note 6). In addition to the membership fee, SMECO paid APM \$1,018,814 and \$917,041 for such services during 2008 and 2007, respectively.

Note 16: Storm Loss

In February 2007, an ice storm struck SMECO's service territory and caused system damage. Because there was no disaster declaration, SMECO did not receive any reimbursement from the Maryland Emergency Management Agency or from the Federal Emergency Management Agency. The accompanying financial statements reflect expenses for this storm in the amount of \$883,000 as of December 31, 2007.



INDEPENDENT AUDITORS' REPORT

To the Board of Directors of Southern Maryland Electric Cooperative, Inc.

We have audited the accompanying balance sheets of Southern Maryland Electric Cooperative, Inc. (SMECO) as of December 31, 2008 and 2007, and the related statements of revenue, expenses and patronage capital, comprehensive income and cash flows for the years then ended. These financial statements are the responsibility of SMECO's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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 financial statements referred to above present fairly, in all material respects, the financial position of SMECO as of December 31, 2008 and 2007, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued a report dated March 4, 2009, on our consideration of SMECO's compliance and internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audits.

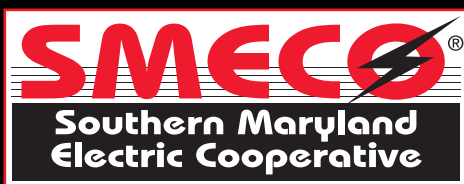
Adams, Jenkins & Cheatham

Richmond, Virginia
March 4, 2009

COMPARATIVE SUMMARY OF OPERATIONS
YEARS ENDED DECEMBER 31, 2008 - 2004

	2008	2007	2006	2005	2004
Operating Revenue:					
Sales of electricity	\$ 459,162,925	\$ 434,638,377	\$ 370,274,906	\$ 340,688,742	\$ 220,149,999
Lease income	3,360,684	3,600,600	3,810,539	3,994,249	4,156,590
Other	3,990,966	3,369,119	2,790,890	2,684,276	2,200,688
Total operating revenue	<u>466,514,575</u>	<u>441,608,096</u>	<u>376,876,335</u>	<u>347,367,267</u>	<u>226,507,277</u>
Operating Expenses:					
Purchased power	356,658,718	336,534,469	284,213,354	242,639,381	131,095,752
Transmission	2,436,755	2,536,384	2,209,352	1,701,567	1,912,242
Distribution - operations	5,534,900	4,815,732	4,202,032	4,133,196	4,400,541
Distribution - maintenance	15,806,279	15,152,759	15,030,182	10,870,762	10,896,589
Customer accounts	7,143,822	7,260,266	6,625,604	6,221,814	5,369,672
Customer service and information	1,124,388	986,726	950,082	1,085,662	1,394,066
Administrative and general	24,817,220	26,864,580	25,145,257	31,001,914	29,122,668
Depreciation and amortization	23,411,483	21,638,270	18,517,273	17,177,883	17,343,102
Taxes	10,961,468	10,111,246	9,838,093	9,551,952	9,318,146
Other	404,535	299,229	363,504	277,740	355,078
Total operating expenses	<u>448,299,568</u>	<u>426,199,661</u>	<u>367,094,733</u>	<u>324,661,871</u>	<u>211,207,856</u>
Operating margins	<u>18,215,007</u>	<u>15,408,435</u>	<u>9,781,602</u>	<u>22,705,396</u>	<u>15,299,421</u>
Interest Expense:					
Interest on long-term debt	14,898,807	13,222,676	11,563,636	11,389,620	11,185,110
Other interest	125,144	1,128,452	2,630,171	1,414,653	211,370
Total interest expense	<u>15,023,951</u>	<u>14,351,128</u>	<u>14,193,807</u>	<u>12,804,273</u>	<u>11,396,480</u>
Net Operating Margins	3,191,056	1,057,307	(4,412,205)	9,901,123	3,902,941
Other Patronage Allocations	1,289,156	1,220,559	1,796,757	544,001	495,562
Total operating margins	<u>4,480,212</u>	<u>2,277,866</u>	<u>(2,615,448)</u>	<u>10,445,124</u>	<u>4,398,503</u>
Nonoperating Margins	954,886	1,416,496	2,656,487	1,639,928	1,513,067
Net margins	<u>\$ 5,435,098</u>	<u>\$ 3,694,362</u>	<u>\$ 41,039</u>	<u>\$ 12,085,052</u>	<u>\$ 5,911,570</u>
Patronage Capital, Beginning of Year	\$ 135,828,700	\$ 133,149,264	\$ 135,976,568	\$ 128,417,150	\$ 128,907,952
Net Margins	5,435,098	3,694,362	41,039	12,085,052	5,911,570
Distribution of Capital Credits	(909,981)	(1,014,926)	(2,868,343)	(4,525,634)	(6,402,372)
Patronage capital, end of year	<u>\$ 140,353,817</u>	<u>\$ 135,828,700</u>	<u>\$ 133,149,264</u>	<u>\$ 135,976,568</u>	<u>\$ 128,417,150</u>
Electric Revenue:					
Residential	\$ 299,968,162	\$ 283,047,230	\$ 241,419,982	\$ 223,892,304	\$ 147,630,355
Small commercial	115,173,356	111,404,947	94,292,995	84,852,030	53,201,231
Large commercial	21,255,647	18,055,163	15,651,946	14,341,109	8,961,877
Street lights	1,636,917	1,185,243	1,012,121	887,781	887,998
Public authorities	21,128,843	20,945,794	17,897,862	16,715,518	9,468,538
Total	<u>\$ 459,162,925</u>	<u>\$ 434,638,377</u>	<u>\$ 370,274,906</u>	<u>\$ 340,688,742</u>	<u>\$ 220,149,999</u>
Kilowatt-Hour Sales (000 omitted):					
Residential	2,032,606	2,155,844	1,995,745	2,122,667	2,033,541
Small commercial	930,366	934,098	901,841	901,532	875,115
Large commercial	182,189	172,977	169,104	171,031	166,255
Street lights	4,990	3,811	3,902	3,778	5,506
Public authorities	196,636	197,364	195,763	196,020	193,970
Total	<u>3,346,787</u>	<u>3,464,094</u>	<u>3,266,355</u>	<u>3,395,028</u>	<u>3,274,387</u>
Customers at Year End (Billings)	<u>147,036</u>	<u>144,727</u>	<u>142,177</u>	<u>139,094</u>	<u>135,335</u>





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