KPMG

# KANSAS ELECTRIC POWER COOPERATIVE, INC.

Financial Statements

December 31, 2002 and 2001

(With Independent Auditors' Report Thereon)

KPMG

1000 Walnut, Suite 1600
P.O. Box 13127
Kansas City, MO 64106

# Independent Auditors' Report

The Board of Trustees
Kansas Electric Power Cooperative, Inc.:

We have audited the accompanying balance sheet of Kansas Electric Power Cooperative, Inc., (KEPCo) as of December 31, 2002, and the related statement of revenues and expenses, cash flows, changes in patronage capital, and comprehensive income (loss) for the year then ended. These financial statements are the responsibility of KEPCo's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of KEPCo as of December 31, 2001, and for the year then ended were audited by other auditors who have ceased operations. Those auditors expressed a qualified opinion, related to depreciation and amortization methods more fully described in note 4, on those financial statements in their report dated March 1, 2002.

We conducted our audit 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 audit 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 audit provides a reasonable basis for our opinion.

As more fully described in note 4 to the financial statements, certain depreciation and amortization methods have been used in the preparation of the financial statements which do not, in our opinion, conform to accounting principles generally accepted in the United States of America.

In our opinion, except for the effects on the financial statements of the matters referred to in the preceding paragraph, the 2002 financial statements referred to above present fairly, in all material respects, the financial position of KEPCo as of December 31, 2002, and the results of its operations and its cash flows for the year 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 February 21, 2003, on our consideration of KEPCo's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contacts, 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 audit.

KPMG LLP

Kansas City, Missouri
February 21, 2003

KPMG

1000 Walnut, Suite 1600
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# Independent Auditors' Report on Compliance and on Internal Control Over Financial Reporting

The Board of Trustees
Kansas Electric Power Cooperative, Inc.:

We have audited the financial statements of Kansas Electric Power Cooperative, Inc., (KEPCo) as of and for the year ended December 31, 2002, and have issued our report thereon dated February 21, 2003, which was qualified related to certain depreciation and amortization methods. We conducted our audit in accordance with auditing standards generally accepted in the United States and standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

## Compliance

As part of obtaining reasonable assurance about whether KEPCo's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported herein under Government Auditing Standards.

## Internal Control Over Financial Reporting

In planning and performing our audits, we considered KEPCo's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended for the information of the board of trustees, management, the Rural Utilities Service and supplemental lenders and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

KPMG LLP

Kansas City, Missouri
February 21, 2003

## KANSAS ELECTRIC POWER COOPERATIVE, INC.

Balance Sheets

December 31, 2002 and 2001

| Assets | 2002 | 2001 |
|---|---|---|
| Utility plant: | | |
| In-service | $ 218,602,990 | 213,227,413 |
| Less allowances for depreciation | (107,440,429) | (57,998,723) |
| | 111,162,561 | 155,228,690 |
| Construction work in progress | 644,270 | 708,646 |
| Nuclear fuel, net of amortization | 2,720,014 | 4,266,872 |
| | 114,526,845 | 160,204,208 |
| Restricted assets: | | |
| Investments in the National Rural Utilities Cooperative Finance Corporation | 3,313,106 | 2,603,692 |
| Bond fund reserve | 4,170,284 | 4,135,743 |
| Decommissioning fund | 4,751,284 | 4,702,277 |
| Investments in associated organizations | 51,674 | 49,425 |
| | 12,286,348 | 11,491,137 |
| Current assets: | | |
| Cash and cash equivalents | 8,036,064 | 5,655,642 |
| Member accounts receivable | 6,770,675 | 5,945,212 |
| Materials and supplies, at average cost inventory | 2,556,640 | 2,686,336 |
| Other assets and prepaid expenses | 489,125 | 522,621 |
| | 17,852,504 | 14,809,811 |
| Other long-term assets: | | |
| Deferred charges: | | |
| Wolf Creek disallowed costs (less accumulated amortization of $8,092,079 and $7,334,915 for 2002 and 2001, respectively) | 17,890,842 | 18,648,006 |
| Wolf Creek deferred plant costs (less accumulated amortization of $3,129,920 and $0 for 2002 and 2001 respectively) | 43,818,873 | — |
| Deferred Department of Energy decommissioning costs | 419,336 | 498,626 |
| Deferred incremental outage costs | 1,081,488 | 547,820 |
| Other deferred charges (less accumulated amortization of $916,634 and $741,548 for 2002 and 2001, respectively) | 1,581,057 | 1,756,143 |
| Unamortized debt issue costs | 3,545,787 | 3,933,310 |
| Other investments | 118,081 | 88,543 |
| | 68,455,464 | 25,472,448 |
| | $ 213,121,161 | 211,977,604 |



(Continued)

## KANSAS ELECTRIC POWER COOPERATIVE, INC.

Balance Sheets

December 31, 2002 and 2001

| Patronage Capital and Liabilities | 2002 | 2001 |
|---|---|---|
| Patronage capital: | | |
| Memberships | $ 3,200 | 3,100 |
| Patronage capital (payment restricted as indicated) | 11,801,741 | 11,801,741 |
| Unallocated loss | (2,117,499) | (5,076,532) |
| | 9,687,442 | 6,728,309 |
| Long-term debt: | | |
| Commercial paper | 5,675,641 | — |
| Federal Financing Bank | 98,736,658 | 102,749,728 |
| Grantor Trust Series 1997 | 51,340,000 | 52,690,000 |
| Pollution control revenue bonds | 33,100,000 | 34,300,000 |
| | 188,852,299 | 189,739,728 |
| Less current maturities of long-term debt | (7,814,400) | (6,564,153) |
| | 181,037,899 | 183,175,575 |
| Other long-term liabilities: | | |
| Deferred Department of Energy decommissioning costs | 353,125 | 433,588 |
| Wolf Creek decommissioning liability | 4,751,284 | 4,702,277 |
| Wolf Creek nuclear operating liabilities | 2,034,509 | 1,803,952 |
| Arbitrage rebate long-term liability | 387,730 | 237,423 |
| | 7,526,648 | 7,177,240 |
| Current liabilities: | | |
| Current maturities of long-term debt | 7,814,400 | 6,564,153 |
| Accounts payable | 5,324,521 | 6,473,224 |
| Payroll and payroll-related liabilities | 247,272 | 225,458 |
| Accrued property taxes | 1,088,058 | 1,197,338 |
| Accrued interest payable | 394,921 | 436,307 |
| | 14,869,172 | 14,896,480 |
| | $ 213,121,161 | 211,977,604 |

See accompanying notes to financial statements.

## KANSAS ELECTRIC POWER COOPERATIVE, INC.

Statements of Revenues and Expenses

Years ended December 31, 2002 and 2001

| | 2002 | 2001 |
|---|---|---|
| Operating revenues: | | |
| Sales of electric energy | $ 84,029,678 | 75,957,574 |
| Other | 365,428 | 221,070 |
| | 84,395,106 | 76,178,644 |
| Operating expenses: | | |
| Power purchased | 43,958,461 | 41,812,744 |
| Nuclear fuel | 2,241,445 | 2,780,385 |
| Plant operations | 7,945,144 | 7,339,822 |
| Plant maintenance | 2,581,641 | 2,554,585 |
| Administrative and general | 4,540,653 | 5,036,211 |
| Amortization of deferred charges | 3,887,083 | 896,436 |
| Depreciation and decommissioning | 4,199,109 | 7,112,466 |
| | 69,353,536 | 67,532,649 |
| Net operating revenues | 15,041,570 | 8,645,995 |
| Interest and other deductions: | | |
| Interest on long-term debt | 11,813,952 | 12,564,197 |
| Amortization of debt issue costs | 562,610 | 399,746 |
| Other interest expense | 95,818 | 56,006 |
| | 12,472,380 | 13,019,949 |
| Net operating gain | 2,569,190 | (4,373,954) |
| Other income and expense: | | |
| Interest income | 429,864 | 930,647 |
| Wolf Creek nuclear operating investment loss | — | (946,216) |
| Other expense | (40,021) | (35,262) |
| | 389,843 | (50,831) |
| Net margin | $ 2,959,033 | (4,424,785) |

See accompanying notes to financial statements.

## KANSAS ELECTRIC POWER COOPERATIVE, INC.

Statements of Cash Flows

Years ended December 31, 2002 and 2001

| | | 2002 | 2001 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net margin (deficit) | $ | 2,959,033 | (4,424,785) |
| Adjustments to reconcile net margin (deficit) to net cash provided by operations: | | | |
| Depreciation and amortization | | 3,833,909 | 6,773,126 |
| Amortization of nuclear fuel | | 1,649,860 | 2,197,183 |
| Amortization of deferred charges | | 4,141,460 | 896,436 |
| Amortization of deferred incremental outage costs | | 1,538,471 | 1,827,924 |
| Wolf Creek nuclear operating investment loss | | — | 946,216 |
| Increase in decommissioning liability | | 49,007 | 212,300 |
| Increase in arbitrage rebate payable | | 150,307 | 163,445 |
| Payment of arbitrage rebate payable | | — | (798,087) |
| Payment to Department of Energy for decommissioning | | (80,463) | (72,943) |
| Changes in assets and liabilities: | | | |
| Member accounts receivable | | (825,463) | 509,966 |
| Materials and supplies inventory | | 129,696 | (487,853) |
| Other assets and prepaid expenses | | 33,496 | 63,749 |
| Accounts payable | | (1,148,703) | 706,146 |
| Payroll and payroll-related liabilities | | 21,814 | 8,146 |
| Accrued property taxes | | (109,280) | 114,552 |
| Accrued interest payable | | (41,386) | (1,996,220) |
| Other long-term liabilities | | 230,557 | (61,133) |
| Net cash provided by operating activities | | 12,532,315 | 6,578,168 |
| Cash flows from investing activities: | | | |
| Additions to electric plant, net | | (6,652,197) | (1,846,293) |
| Additions to nuclear fuel | | (103,002) | (2,523,632) |
| Additions to deferred refueling costs | | (2,072,139) | (90,839) |
| Increase in cash surrender value of life insurance contracts | | (29,538) | (304,836) |
| Increase in decommissioning fund assets | | (49,007) | (212,300) |
| Increase in other investments | | (746,204) | (40,044) |
| Sales of other investments, net | | — | 7,459,150 |
| Net cash provided by (used in) investing activities | | (9,652,087) | 2,441,206 |
| Cash flows from financing activities: | | | |
| Borrowings from cash surrender value of life insurance contracts | | — | 304,836 |
| Repayment of long-term debt | | (6,563,070) | (7,272,253) |
| Issuance of debt | | 5,675,641 | — |
| Amortization of debt issue costs | | 387,523 | 399,747 |
| Patronage capital contributions | | 100 | — |
| Net cash used in financing activities | | (499,806) | (6,567,670) |
| Net increase in cash and cash equivalents | | 2,380,422 | 2,451,704 |
| Cash and cash equivalents at: | | | |
| Beginning of year | | 5,655,642 | 3,203,938 |
| End of year | $ | 8,036,064 | 5,655,642 |

See accompanying notes to financial statements.

## KANSAS ELECTRIC POWER COOPERATIVE, INC.

Statements of Changes in Patronage Capital

Years ended December 31, 2002 and 2001

| | | Memberships | Patronage capital | Unallocated margin (loss) | Total |
|---|---|---|---|---|---|
| Balance, December 31, 2000 | $ | 3,100 | 11,801,741 | (651,747) | 11,153,094 |
| Net deficit | | — | — | (4,424,785) | (4,424,785) |
| Patronage capital distributions | | — | — | — | — |
| Balance, December 31, 2001 | | 3,100 | 11,801,741 | (5,076,532) | 6,728,309 |
| Net margin | | — | — | 2,959,033 | 2,959,033 |
| Patronage capital contributions | | 100 | — | — | 100 |
| Balance, December 31, 2002 | $ | 3,200 | 11,801,741 | (2,117,499) | 9,687,442 |

See accompanying notes to financial statements.

## KANSAS ELECTRIC POWER COOPERATIVE, INC.

Statements of Comprehensive Income (Loss)

Years ended December 31, 2002 and 2001

| | | 2002 | 2001 |
|---|---|---|---|
| Net margin (deficit) | $ | 2,959,033 | (4,424,785) |
| Other comprehensive income: | | | |
| Available for sale securities: | | | |
| Unrealized holding gains and losses arising net of reclass for gains and losses included in net margin | | — | 236,052 |
| | $ | 2,959,033 | (4,188,733) |

See accompanying notes to financial statements.

## KANSAS ELECTRIC POWER COOPERATIVE, INC.

Notes to Financial Statements

December 31, 2002 and 2001

### (1) Nature of Operations

Kansas Electric Power Cooperative, Inc. (KEPCo), headquartered in Topeka, Kansas, was incorporated in 1975 as a not-for-profit generation and transmission cooperative (G&T). It is KEPCo's responsibility to procure an adequate and reliable power supply for its 19 distribution rural electric cooperative members pursuant to all requirements of its power supply contracts. KEPCo is governed by a board of trustees representing each of its 19 members, which collectively serves more than 100,000 electric customers in rural Kansas. On January 1, 2002, three cooperative members merged and reduced the total cooperative membership to 19. KEPCo is under the jurisdiction of the Kansas Corporation Commission (KCC) and was granted a limited certificate of convenience and authority in 1980 to act as a G&T public utility.

### (2) Summary of Significant Accounting Policies

#### *(a) Estimates*

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

#### *(b) System of Accounts*

KEPCo maintains its accounting records substantially in accordance with the Rural Utilities Service (RUS) Uniform System of Accounts and in accordance with accounting practices prescribed by the KCC.

#### *(c) Rates*

The KCC has the authority to establish KEPCo's electric rates under state law in Kansas. Rates are established to meet the times-interest-earned ratio and debt-service coverage set forth by the RUS. On June 29, 2001, KEPCo filed an application with KCC requesting a rate increase of approximately $6.5 million, a new rate design and the re-establishment of an energy cost adjustment (ECA) mechanism, which allows KEPCo to pass along increases in certain energy costs to its cooperative members. On January 17, 2002, the KCC ordered a rate increase of approximately $6.5 million, including an ECA mechanism. The new rates became effective February 1, 2002. Pursuant to this KCC rate order, the depreciable life of Wolf Creek was extended from 40 years to 60 years. In addition, the rate order allowed KEPCo to recover in rates the $53,454,512 cumulative difference between historical present worth (sinking fund) depreciation and straight-line depreciation (note 4) over a 15-year period.

#### *(d) Utility Plant and Depreciation*

Utility plant is stated at cost. The cost of repairs and minor replacements are charged to operating expenses as appropriate. Costs of renewals and betterments are capitalized. The original cost of utility plant retired and the cost of removal, less salvage, are charged to accumulated depreciation.

Through January 31, 1987, the provision for depreciation for electric plant-in-service was computed on the straight-line method at a 3.44% annual composite rate. Effective February 1, 1987, in accordance with an order issued by the KCC, the provision for depreciation was computed on a present-worth (sinking fund) method, which provided for increased annual provisions over 27.736 years.

Pursuant to the January 17, 2002 KCC order, the depreciable life of Wolf Creek was extended from 40 years to 60 years. The composite depreciation rate for electric generation plant for the years ended December 31, 2002 and 2001, was 2.23% and 3.18%, respectively.

The provision for depreciation computed on a straight-line basis for electric and other components of utility plant is as follows:

| | |
|---|---|
| Transportation and equipment | 25 to 33% |
| Office furniture and fixtures | 10 to 20% |
| Leasehold improvements | 20% |
| Transmission equipment | 10% |

### (e) *Nuclear Fuel*

The cost of nuclear fuel in process of refinement, conversion, enrichment, and fabrication is recorded as utility plant asset at original cost and is amortized to nuclear fuel expenses based upon the quantity of heat produced for the generation of electric power. The permanent disposal of spent fuel is the responsibility of the Department of Energy (DOE). KEPCo pays one cent per net MWh of nuclear generation to the DOE for the future disposal service. These disposal costs are charged to nuclear fuel expense.

### (f) *Cash and Cash Equivalents*

All highly liquid investments purchased with an original maturity of three months or less are considered to be cash equivalents and are stated at cost, which approximates market value.

### (g) *Short-Term and Other Investments*

Investments in debt securities are classified as available-for-sale in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, based on KEPCo's intended use of such securities. Investments in debt securities are carried at fair value based on quoted market prices for those or similar securities, with the unrealized gain/loss included as a separate component of capitalization. In the balance sheet, investments in debt securities with an original maturity greater than three months and a remaining maturity less than one year are presented as current assets, and investments with a remaining maturity greater than one year are presented as long-term investments.

### (h) *Materials and Supplies Inventory*

Materials and supplies inventory are stated at cost determined by the average cost method.



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(i) ***Unamortized Debt Issue Costs***

Unamortized debt issue costs relate to the issuance of the floating/fixed rate pollution control revenue bonds, mortgage notes payable to the National Rural Utilities Cooperative Finance Corporation (CFC) trusts and fees for repricing the Federal Financing Bank (FFB) debt. These costs are being amortized using the effective interest method over the remaining life of the bonds.

(j) ***Decommissioning Fund Assets/Decommissioning Liability***

As of December 31, 2002 and 2001, $4,751,284 and $4,702,277, respectively, have been collected and are being retained in an interest-bearing trust fund to be used for the physical decommissioning of Wolf Creek. The trustee invests the decommissioning funds primarily in mutual funds, which are carried at estimated fair market value. During 1989, the KCC extended the estimated useful life of Wolf Creek to 40 years from the original estimates of 30 years only for the determination of decommissioning costs to be recognized for ratemaking purposes. In the year ended December 31, 2000, the KCC approved a 1999 Wolf Creek decommissioning cost study, which increased the estimate of total decommissioning costs to $470 million in 1999 dollars ($28 million – KEPCo's share). KEPCo is providing for overall nuclear decommissioning costs using a fusing method, which assumes a 3.6% rate of inflation and 5.4% real rate of return. KEPCo's current provision for decommissioning, based on the 1999 decommissioning study, is being charged to operations over the life of the plant. Such provision totaled $350,830 and $339,340 for 2002 and 2001, respectively.

On June 30, 2001, the Financial Accounting Standards Board issued its SFAS No. 143, *Accounting for Asset Retirement Obligations*. SFAS No. 143 applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development, and the normal operation of long-lived assets. This statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. This statement is effective for financial statements issued for fiscal years beginning after June 15, 2002. The Company anticipates adopting SFAS No. 143 on March 31, 2003. The Company has not determined the impact, if any, that the adoption of this new standard will have on its financial statements.

(k) ***Cash Surrender Value of Life Insurance Contracts***

The following amounts related to Wolf Creek Nuclear Operating Corporation (WCNOC) Corporate-owned life insurance contracts, primarily with one highly rated major insurance company, are included in Wolf Creek nuclear operating investments on the balance sheets.

| | | 2002 | 2001 |
|---|---|---|---|
| Cash surrender value of contracts | $ | 3,655,136 | 3,332,247 |
| Borrowings against contracts | | (3,655,136) | (3,332,247) |
| Net | $ | — | — |

Borrowings against contracts include a prepaid interest charge. KEPCo pays interest on these borrowings at a discounted rate of 7.4%.

*(l) Income Taxes*

As a tax-exempt cooperative, KEPCo is exempt from income taxes under Section 501(c)(12) of the Internal Revenue Code of 1986, as amended. Accordingly, provisions for income taxes have not been reflected in the accompanying financial statements.

*(m) Revenues*

Revenues from the sale of electricity are recorded based on usage by member cooperatives and customers and on contracts and scheduled power usages, as appropriate.

*(n) Long-Lived Assets*

Management reviews long-lived assets for impairment whenever events or changes in circumstances indicating the carrying amount of an asset may not be recoverable. In the event a long-lived asset was determined to be impaired, such asset would be required to be written down to its fair value, with the loss recognized in the statement of revenues and expenses.

**(3) Factors that Could Affect Future Operating Results**

KEPCo currently applies accounting standards that recognize the economic effects of rate regulation pursuant to SFAS No. 71, *Accounting for the Effect of Certain Types of Regulation*, and accordingly, has recorded regulatory assets and liabilities related to its generation, transmission, and distribution operations. In the event KEPCo determines that it no longer meets the criteria of SFAS No. 71, the accounting impact could be a noncash charge to operations of an amount that would be material. Criteria that could give rise to the discontinuance of SFAS No. 71 include: (1) increasing competition that restricts KEPCo's ability to establish prices to recover specific costs, and (2) a significant change in the manner rates are set by regulators from a cost-based regulation to another form of regulation. KEPCo periodically reviews these criteria to ensure the continuing application of SFAS No. 71 is appropriate. Any changes that would require KEPCo to discontinue the application of SFAS No. 71 due to increased competition, regulatory changes or other events may significantly impact the valuation of KEPCo's investment in utility plant, its investment in Wolf Creek and necessitate the write-off of regulatory assets. At this time, the effect of competition and the amount of regulatory assets, which could be recovered in such an environment, cannot be predicted.

The 1992 Energy Policy Act began the process of restructuring the United States electric utility industry by permitting the Federal Energy Regulatory Commission to order electric utilities to allow third parties to sell electric power to wholesale customers over their transmission systems. Many states are currently moving toward opening the retail segment to competition. Recent sessions of the Kansas Legislature (1999-2002) did not and have not taken action on industry restructuring. Management will continue to monitor deregulation initiatives, but does not presently expect any actions, which would be unfavorable to KEPCo to be adopted within the next 12 months.

## (4) Departures from Generally Accepted Accounting Principles

Effective February 1, 1987, the KCC issued an order to KEPCo requiring the use of present worth (sinking fund) depreciation and amortization. As more fully described in notes 5 and 9, such depreciation and amortization methods constituted phase-in plans that did not meet the requirements of SFAS No. 92, *Accounting for Phase-In Plans*.

Effective February 1, 2002, the KCC issued an order that extended the depreciable life of Wolf Creek from 40 years to 60 years. This order also permitted recovery in rates of the $53,454,512 cumulative difference between historical present worth (sinking fund) depreciation and amortization and straight-line depreciation and amortization of Wolf Creek generation plant and disallowed costs over a 15-year period. As more fully described in notes 5 and 9, such depreciation and amortization methods constitute phase-in plans that do not meet the requirements of SFAS No. 92. Recovery of these costs in rates is included in operating revenues and the related amortization expense is included in deferred charges in the statement of revenue and expenses.

The effect of these departures from generally accepted accounting principles is to overstate the following items in the financial statements by the following amounts:

| | 2002 | 2001 |
|---|---|---|
| Net utility plant | $ — | 46,948,793 |
| Deferred charges | 49,890,877 | 6,505,719 |
| Patronage capital | 49,890,877 | 53,454,512 |
| Net margin | — | 1,435,794 |

## (5) Wolf Creek Nuclear Generating Station

KEPCo owns 6% of Wolf Creek, which is located near Burlington, Kansas. The remainder is owned by the Kansas City Power & Light Company (KCPL – 47%) and Kansas Gas & Electric Company (KGE – 47%). KGE is a wholly owned subsidiary of Westar Energy, Inc. (formerly known as Western Resources, Inc.). KEPCo's undivided interest in Wolf Creek is consolidated on a pro rata basis. Substantially all of KEPCo's utility plant consists of its pro rata share of Wolf Creek. KEPCo is entitled to a proportionate share of the capacity and energy from Wolf Creek, which is used to supply a portion of KEPCo's members' requirements. KEPCo is billed for 6% of the operations, maintenance, administrative, and general costs, and cost of plant additions related to Wolf Creek.

The KCC declared Wolf Creek commercially operable on September 3, 1985. KEPCo's total investment includes interest and administrative costs during construction.

Effective February 1, 2002, the KCC issued an order permitting recovery in rates of the $46,948,793 cumulative difference between historical present worth (sinking fund) depreciation and straight-line depreciation of Wolf Creek generation plant over a 15-year period. Such depreciation practice does not constitute a phase-in plan that meets the requirements of SFAS No. 92. In 2002, this cumulative difference is reflected as a balance sheet reclassification which increased utility plant allowance for depreciation and deferred charges on the balance sheet to reflect the amount as a regulatory asset (see note 9). This reclassification did not impact net margin in 2002.

If depreciation on Wolf Creek had been calculated using a method in accordance with accounting principles generally accepted in the United States, depreciation expense in 2001 would have increased and KEPCo's operating margin would have decreased by $1,268,516. In addition, net utility plant and patronage capital would have decreased by $46,948,793.

The Low-Level Radioactive Waste Policy Amendments Act of 1985 mandated that the various states, individually or through interstate compacts, develop alternative low-level radioactive waste disposal facilities. The states of Kansas, Nebraska, Arkansas, Louisiana, and Oklahoma formed the Central Interstate Low-Level Radioactive Waste Compact (Compact) and selected a site in Nebraska to locate a disposal facility. The Compact Commission selected US Ecology as the license applicant and developer of the site. The generators of waste (nuclear facilities) in those states provided funds for the evaluation of the suitability of the site.

In December 1998, the Nebraska agencies responsible for considering the developer's license application denied the application. Most of the utilities (generators) that had provided the project's pre-construction financing (including WCNOC), along with the Commission and US Ecology, filed a federal lawsuit contending Nebraska officials acted in bad faith while handling the license application.

In May of 1999, the Nebraska legislature passed a law withdrawing Nebraska from the Compact. The withdrawal is not effective for five years.

On August 29, 2001, the Federal District Court ruled that, due to administrative discretion granted to state administrative agencies, the generators cannot claim a property interest against the State in the capital spent in an attempt to obtain the license. The Court of Appeals had previously ruled that the generators had no right to sue the State of Nebraska for breach of the Compact's good faith obligation. It is noted, however, that the Commission is pursuing its case against Nebraska for breach of the Compact's good faith obligation and that the generators (including WCNOC) are pursuing a cross-claim to recover their expenditures from the Commission.

In view of those rulings, KEPCo recognized its investment in the Nebraska site as a nonoperating expense in 2001.

Wolf Creek disposes of all classes of its low-level radioactive waste at existing third-party repositories. Should disposal capability become unavailable, Wolf Creek is able to store its low-level radioactive waste in an on-site facility for up to five years under current regulations.

## (6) Other Investments

Other investments consist of the following as of December 31:

| | 2002 | | 2001 | |
|---|---|---|---|---|
| | Cost | Fair value | Cost | Fair value |
| Available-for-sale: | | | | |
| Split-dollar life insurance policy | $ 118,081 | 118,081 | 88,543 | 88,543 |



(Continued)

## (7) Bond Fund Reserve

KEPCo has entered into a bond covenant whereby KEPCo is required to maintain, with a trustee, a bond fund reserve of approximately $4 million. This stipulated amount is sufficient to satisfy certain future interest and principal obligations. The amount held in the bond fund reserve is invested by the trustee in tax-exempt municipal securities, pursuant to the restrictions of the indenture agreement, which are carried at amortized cost.

## (8) Investments in Associated Organizations

Investments in associated organizations are carried at cost. At December 31, 2002 and 2001, investments in associated organizations including CFC consisted of the following:

| | | 2002 | 2001 |
|---|---|---|---|
| CFC: | | | |
| Membership | $ | 1,000 | 1,000 |
| Capital term certificates | | 395,970 | 395,970 |
| Subordinated term certificates | | 2,205,000 | 2,205,000 |
| Patronage capital certificates | | 1,495 | 1,722 |
| Equity term certificates | | 709,641 | — |
| Other | | 51,674 | 49,425 |
| | $ | 3,364,780 | 2,653,117 |

## (9) Deferred Charges

### (a) *Disallowed Costs*

Effective October 1, 1985, the KCC issued a rate order relating to KEPCo's investment in Wolf Creek, which disallowed $25,982,921 of KEPCo's investment in Wolf Creek ($17,890,842 net of accumulated amortization as of December 31, 2002). A subsequent rate order, effective February 1, 1987, allows KEPCo to recover these disallowed costs and other costs related to the disallowed portion (recorded as deferred charges) for the period from September 3, 1985, through January 31, 1987, over a 27.736-year period starting February 1, 1987. Pursuant to a KCC rate order dated December 30, 1998, the disallowed portions recovery period was extended to a 30-year period. Through December 31, 2001, KEPCo used the present worth (sinking fund) method to recover the disallowed costs which enables it to meet the times-interest-earned ratio and debt service requirements in the KCC rate order dated January 30, 1987. The method used by KEPCo through 2001 constituted a phase-in plan which did not meet the requirements of SFAS No. 92.

Effective February 1, 2002, the KCC issued an order permitting recovery in rates of the $6,505,719 cumulative difference between historical present worth (sinking fund) and straight-line amortization of Wolf Creek disallowed costs over a 15-year period. The method used by KEPCo in 2002 constitutes a phase-in plan that does not meet the requirements of SFAS No. 92.

If amortization to recover the disallowed costs was calculated using a method in accordance with accounting principles generally accepted in the United States, amortization of deferred charges would be increased and KEPCo's operating margin would be decreased by $167,278 in 2001. In addition, deferred charges and patronage capital would be decreased by $6,505,719 as of December 31, 2001. The rate order issued by the KCC on January 17, 2002, allowed KEPCo recovery of the $6,505,719 difference between historical present worth (sinking fund) and straight-line amortization over a 15-year period. If the disallowed costs were recovered using a method in accordance with accounting principles generally accepted in the United States, the costs would have been expensed in their entirety upon implementation of the KCC order, with a corresponding decrease in patronage capital.

*(b)* *Wolf Creek Deferred Plant Costs*

Effective February 1, 2002, the KCC issued an order permitting recovery in rates of the $46,948,793 cumulative difference between historical present worth (sinking fund) depreciation and straight-line depreciation of Wolf Creek generation plant over a 15-year period. Such depreciation practice does not constitute a phase-in plan that meets the requirements of SFAS No. 92. In 2002, this cumulative difference was reclassified from utility plant allowance for depreciation to deferred charges on the balance sheet to reflect the amount as a regulatory asset. Amortization of the Wolf Creek deferred plant costs is included in amortization of deferred charges on the statement of revenue and expenses and amounted to $3,129,920 in 2002.

If the deferred plant costs were recovered using a method in accordance with accounting principles generally accepted in the United States, the costs would have been expensed in their entirety upon implementation of the KCC order, with a corresponding decrease in patronage capital.

*(c)* *Decommissioning and Decontamination Assessments*

The Energy Policy Act of 1992 established a fund to pay for the decommissioning and decontamination of nuclear enrichment facilities operated by the DOE. A portion of this fund, not to exceed $2.25 billion, is to be collected from utilities that have purchased enrichment services from the DOE. This portion is limited to no more than $150 million each year and will be in the form of annual assessments that will not be imposed for more than 15 years. KEPCo has recorded its portion of this liability, which is being paid over 15 years. KEPCo has recorded a related deferred asset of $419,336 and $498,626 as of December 31, 2002 and 2001, respectively, and is being amortized to nuclear fuel expense over the 15-year assessment period.

*(d)* *Deferred Incremental Outage Costs*

In 1991 the KCC issued an order that allowed KEPCo to defer its 6% share of the incremental operating, maintenance, and replacement power costs associated with the periodic refueling of Wolf Creek. Such costs are deferred during each refueling outage and are being amortized over the approximate 18-month operating cycle coincident with the recognition of the related revenues.



(Continued)

*(e) Other Deferred Charges*

KEPCo includes in other deferred charges the early call premium resulting from refinancing the 1988 CFC Grantor Trust Certificates prior to maturity. This early call premium is amortized using the interest method over the remaining life of the new Grantor Trust Series 1997 certificates.

## (10) Long-Term Debt

Long-term debt consists of mortgage notes payable to the United States of America acting through the FFB, the CFC and others. Substantially, all of KEPCo's assets are pledged as collateral. The terms of the notes as of December 31 are as follows:

| | 2002 | 2001 |
|---|---|---|
| Mortgage notes payable to the FFB at fixed rates varying from 5.501% to 9.206%, payable in quarterly installments through 2018. | $ 98,736,658 | 102,749,728 |
| Mortgage notes payable to the Grantor Trust Series 1997 at a rate of 7.522%, payable semiannually, principal payments commenced in 1999 and continuing annually through 2017. | 51,340,000 | 52,690,000 |
| Floating/fixed rate pollution control revenue bonds, City of Burlington, Kansas, Pooled Series 1985C, variable interest rate (ranging from 1.15% to 1.35% at December 31, 2002) payable annually through 2015. | 33,100,000 | 34,300,000 |
| Commercial paper certificate to the National Rural Utilities Cooperative Finance Corporation at fixed rates of 3.6% and 5.6%, payable quarterly through 2007 and 2017. | 5,675,641 | — |
| | 188,852,299 | 189,739,728 |
| Less current portion | 7,814,400 | 6,564,153 |
| | $ 181,037,899 | 183,175,575 |

Aggregate maturities of mortgage notes payable to FFB, Grantor Trust Series 1997, floating/fixed rate pollution control revenue bonds and commercial paper certificates as of December 31, 2002, are as follows:

| | Amount |
|---|---|
| Year: | |
| 2003 | $ 7,814,400 |
| 2004 | 8,531,313 |
| 2005 | 9,077,289 |
| 2006 | 9,847,942 |
| 2007 | 10,554,544 |
| Thereafter | 143,026,811 |
| | $ 188,852,299 |



(Continued)

Restrictive covenants require KEPCo to design rates that would enable it to maintain a times-interest-earned ratio of at least one-to-one and debt-service coverage of at least one-to-one, on average, in at least two out of every three years. The covenants also prohibit distributions of net patronage capital or margins until, after giving effect to any such distribution, total patronage capital equals or exceeds 20% of total assets unless such distribution is approved by RUS (note 16).

In 1997, KEPCo refinanced its mortgage notes payable to the 1988 CFC Grantor Trust through the establishment of a new CFC Grantor Trust Series 1997 (the Series 1997 Trust) by CFC. This refinancing reduced the guaranteed interest rate payable on the mortgage notes to a fixed rate of 7.522% through the use of an interest rate swap with JP Morgan Chase Bank (counterparty) that was assigned by KEPCo to the Series 1997 Trust. The mortgage notes payable are pre-payable at any time with no prepayment penalties. However, any termination costs relating to the termination of the assigned interest rate swaps is KEPCo's responsibility. At December 31, 2002, the termination obligation associated with the assigned swap agreement to early retire the mortgage notes payable is approximately $14.6 million. This fair value estimate is based on information available at December 31, 2002, and is expected to fluctuate in the future based on changes in interest rates and outstanding principal balance.

KEPCo is also exposed to possible credit loss in the event of noncompliance by Morgan to the Swap Agreement. However, KEPCo does not anticipate nonperformance by Morgan.

## (11) Short-Term Borrowings

As of December 31, 2002, KEPCo had a $15 million unused line of credit outstanding with the CFC. This line of credit has a term of 12 months. There were no outstanding borrowings at either December 31, 2002, or December 31, 2001.

## (12) Operating Lease

KEPCo leases office space and equipment under noncancelable operating leases. Future minimum lease payments at December 31, 2002 are as follows:

| | | Amount |
|---|---|---|
| Year: | | |
| 2003 | $ | 19,519 |
| 2004 | | 3,994 |
| 2005 | | — |
| | $ | 23,513 |

The related rental expenses for 2002 and 2001 were $19,920 and $12,791, respectively.

## (13) Benefit Plans

### *(a) National Rural Electric Cooperative Association (NRECA) Retirement and Security Program*

KEPCo participates in the NRECA Retirement and Security Program for its employees. All employees are eligible to participate in this program after one year of service. In the master multiemployer plan, which is available to all members of NRECA, the accumulated benefits and plan assets are not determined or allocated by individual employees. KEPCo's pension expense under this program was $190,739 and $171,088 for the years ended December 31, 2002 and 2001, respectively.

### *(b) NRECA Savings 401(k) Plan*

Substantially all employees of KEPCo are eligible to participate in the NRECA Savings 401(k) Plan. Under the plan, KEPCo contributes an amount not to exceed 5%, dependent upon each employee's level of participation and completion of one year of service, of the respective employee's base pay to provide additional retirement benefits. KEPCo contributed $80,067 and $75,562 to the plan in 2002 and 2001, respectively.

### *(c) Wolf Creek Nuclear Operating Corporation (WCNOC) Retirement Plan*

KEPCo has an obligation to the WCNOC retirement plan for its 6% ownership interest in Wolf Creek. This plan provides for benefits upon retirement, normally at age 65. In accordance with the Employee Retirement Income Security Act of 1974, KEPCo has satisfied its minimum funding requirements. Benefits under this plan reflect the employee's compensation, years of service, and age at retirement.

The following sets forth KEPCo's share of the plan's changes in benefit obligation, plan assets, and funded status as of December 31:

| | | 2002 | 2001 |
|---|---|---|---|
| Changes in benefit obligation: | | | |
| Benefit obligation at beginning of year | $ | 4,179,704 | 3,285,875 |
| Service cost | | 277,948 | 205,725 |
| Interest cost | | 321,322 | 268,067 |
| Actuarial loss | | 745,856 | 486,381 |
| Benefits paid | | (65,438) | (66,344) |
| Benefit obligation at end of year | $ | 5,459,392 | 4,179,704 |

Plan assets are invested in insurance contracts, corporate bonds, equity securities, United States government securities, and short-term investments.

| | | 2002 | 2001 |
|---|---|---|---|
| Changes in plan assets: | | | |
| Fair value of plan assets at beginning of year | $ | 2,984,114 | 3,081,209 |
| Actual return on plan assets | | (281,605) | (160,539) |
| Contributions during the year | | 206,674 | 129,789 |
| Benefits paid | | (65,438) | (66,345) |
| Fair value of plan assets at end of year | $ | 2,843,745 | 2,984,114 |
| Funded status | $ | (2,615,646) | (1,195,590) |
| Unrecognized net transition obligation | | 1,479,882 | 139,182 |
| Unrecognized prior service cost | | 65,318 | 72,576 |
| Unrecognized net gain | | 31,108 | 34,591 |
| Accrued benefit cost | $ | (1,039,338) | (949,241) |
| Actuarial assumptions: | | | |
| Discount rate | | 7.25% | 7.25% |
| Annual salary increase rate | | 4.00% | 4.80% |
| Long-term rate of return | | 9.25% | 9.25% |

KEPCo's share of the net periodic pension costs were as follows for the years ended December 31:

| | | 2002 | 2001 |
|---|---|---|---|
| Service cost | $ | 277,948 | 205,725 |
| Interest cost on projected benefit obligation | | 321,322 | 268,067 |
| Expected return on plan assets | | (315,268) | (289,044) |
| Other | | 12,768 | (49,052) |
| Total pension expense | $ | 296,770 | 135,696 |

KEPCo has an obligation to the WCNOC supplemental retirement plan for executives for its 6% ownership interest in Wolf Creek. This plan provides for benefits to Wolf Creek executives upon retirement. KEPCo expensed its 6% ownership share of $53,082 and $16,481 in 2002 and 2001, respectively, related to this plan.

## (14) Commitments and Contingencies

### (a) *Litigation*

There is a provision in the Wolf Creek operating agreement whereby the owners treat certain claims and losses arising out of the operation of Wolf Creek as a cost to be borne by the owners separately (but not jointly) in proportion to their ownership shares. Each of the owners has agreed to indemnify the others in such cases.



(Continued)

As is the case with other electric utilities, KEPCo, from time-to-time, is subject to various actions, which occasionally include punitive damage claims. KEPCo maintains insurance providing liability coverage; however, the insurance companies generally reserve the right to challenge insurance coverage for punitive damage recoveries. As of December 31, 2002, it is the opinion of the general counsel of KEPCo that there is not a significant probability that, as a result of pending or threatened personal injury actions, KEPCo will be liable for payment of actual or punitive damages in an amount material to the financial position of KEPCo.

*(b)* ***Nuclear Liability and Insurance***

Pursuant to the Price-Anderson Act, KEPCo is required to insure against public liability claims resulting from nuclear incidents to the full limit of public liability, approximately $9.5 billion currently. This limit of liability consists of the maximum available commercial insurance of $300 million and the remaining $9.2 billion is provided through mandatory participation in an industry-wide retrospective assessment program. Under this plan, owners are jointly and severally subject to a retrospective assessment of up to $88.1 ($5.3 million – KEPCo's share) in the event there is a major nuclear incident involving any of the nation's commercial reactors. There is a limitation of $10 million ($600,000 – KEPCo's share) in retrospective assessments per incident per year. This assessment is subject to an inflation adjustment based on the Consumer Price Index and applicable premium taxes. If the $9.5 billion liability limitation is insufficient, the United States Congress will consider taking whatever action is necessary to compensate the public for valid claims.

The Price-Anderson Act expired in August 2002. In February 2003, the Act was extended to December 31, 2003, with no changes except for its expiration date.

The owners carry decontamination liability, premature decommissioning liability and property damage insurance for Wolf Creek totaling approximately $2.8 billion ($168 million – KEPCo's share). This insurance is provided by Nuclear Electric Insurance Limited (NEIL). In the event of an accident, insurance proceeds must first be used for reactor stabilization and site decontamination in accordance with a plan mandated by the NRC. KEPCo's share of any remaining proceeds can be used to pay for property damage or decontamination expenses or, if certain requirements are met including decommissioning the plant, toward a shortfall in the decommissioning trust fund.

The Owners also carry additional insurance with NEIL to cover costs of replacement power and other extra expenses incurred during a prolonged outage resulting from accidental properly damage at Wolf Creek. If significant losses were incurred at any of the nuclear plants insured under the NEIL policies, KEPCo may be subject to retrospective assessments under the current policies of approximately $3.1 million.

Although KEPCo maintains various insurance policies to provide coverage for potential losses and liabilities resulting from an accident or an extended outage, KEPCo's insurance coverage may not be adequate to cover the costs that could result from a catastrophic accident of extended outage at Wolf Creek. Any substantial losses not covered by insurance, to the extent not recoverable through rates, would have a material adverse effect on KEPCo's financial condition and result of operations.



(Continued)

(c) *Decommissioning Insurances*

KEPCo carries premature decommissioning insurance which has several restrictions, one of which can only be used if Wolf Creek incurs an accident exceeding $500 million in expenses to safely stabilize the reactor, to decontaminate the reactor and reactor station site in accordance with a plan approved by the NRC, and to pay for on-site property damages. Once the NRC Property Rule, requiring insurance proceeds to first be used for stabilization and decontamination, has been complied with, the premature decommissioning coverage could pay for the decommissioning fund shortfall in the event an accident at Wolf Creek exceeds $500 million in covered damages and causes Wolf Creek to be prematurely decommissioned.

(d) *Nuclear Fuel Commitments*

At December 31, 2002, KEPCo's share of Wolf Creek's nuclear fuel commitments were approximately $725,000 for uranium concentrates and conversion expiring at various times through 2003, $2.7 million for enrichment expiring at various times through 2006, and $7.3 million for fabrication through 2025.

(e) *Purchase Power Commitments*

KEPCo has supply contracts with various utility companies to purchase power to supplement generation in the given service areas. KEPCo has recently executed a new five-year contract with Westar Energy to replace purchase agreements that terminate mid-2003.

**(15) Fair Value of Financial Instruments**

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value as set forth in SFAS No. 107:

*Cash and Cash Equivalents* – The carrying amount approximates the fair value because of the short-term maturity of these investments.

*Other Investments, Decommissioning Trust, Investments in Associated Organizations and Bond Fund Reserve* – The fair value of these assets is primarily based on quoted market prices as of December 31, 2002.

*Variable-Rate Debt* – The carrying amount approximates the fair value because of the short-term variable rates of those debt instruments.

*Fixed-Rate Debt* – The fair value of the fixed-rate FFB debt and the fixed-rate Series 1997 Trust debt is based on the sum of the estimated value of each issue, taking into consideration the current rates offered to KEPCo for debt of similar remaining maturities.

The estimated fair values of KEPCo's financial instruments are as follows:

| | | December 31, 2002 | |
|---|---|---|---|
| | | Carrying value | Fair value |
| Cash and cash equivalents | $ | 8,036,064 | 8,036,064 |
| Investments in associated organizations (including investments in NRUCFC) | | 3,364,780 | 3,364,780 |
| Bond fund reserve | | 4,170,284 | 4,410,954 |
| Decommissioning trust | | 4,751,284 | 4,751,284 |
| Fixed-rate debt | | 155,752,299 | 172,520,695 |
| Variable-rate debt | | 33,100,000 | 33,100,000 |

## (16) Patronage Capital

In accordance with KEPCo's by-laws, KEPCo's current margins are to be allocated to members. KEPCo's current policy is to allocate margins to the members based on revenues collected from the members as a percentage of total revenues. If KEPCo's financial statements were adjusted to reflect accounting principles generally accepted in the United States, total patronage capital would be negative. As noted in the statements of changes in patronage capital, no patronage capital distributions were made to members in 2002 and 2001.

February 21, 2003

Board of Trustees
Kansas Electric Power Cooperative, Inc.
P.O. Box 4877
Topeka, KS 66604-0877

Dear Sirs:

We have audited the financial statements of Kansas Electric Power Cooperative, Inc., (KEPCo) for the year ended December 31, 2002, and have issued our report thereon dated February 21, 2003, which was qualified related to certain depreciation and amortization methods. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards for financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and 7 CFR Part 1773, Policy on Audit of Rural Utilities Service (RUS) Borrowers. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit of the financial statements of Kansas Electric Power Cooperative, Inc., for the year ended December 31, 2002, we considered its internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting.

A description of the responsibility of management for establishing and maintaining the internal control over financial reporting and the objectives of and inherent limitations in such control is set forth in our independent auditors' report on compliance and internal control over financial reporting dated February 21, 2003, and should be read in conjunction with this report.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting that we consider to be a material weakness.

Section 1773.33 requires comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions and other additional matters. We have grouped our comments accordingly. In addition to obtaining reasonable assurance about whether the financial statements are free from material misstatements, at your request, we performed tests of specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and of additional matters. The specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions and additional matters tested include, among other things, the accounting procedures and records, materials control, compliance with specific RUS loan and security instrument provisions set forth in 7 CFR Part 1773.33(e)(1), related-party transactions and depreciation rates and a schedule of deferred charges, upon which we express an opinion. In addition, our audit of the financial statements also included the procedures specified in 7 CFR 1773.38-45. Our objective was not to provide an opinion on these specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, or other additional matters, and accordingly, we express no opinion thereon.

No reports (other than our report of independent public accountants, and our report of independent public accountants on compliance on internal control over financial reporting, all dated February 21, 2003) have been furnished to management.

Our comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters as required by 7 CFR 1773.33 are presented below.

**Comments on Certain Specific Aspects of the Internal Control over Financial Reporting**

We noted no matters regarding Kansas Electric Power Cooperative, Inc.'s internal control over financial reporting and its operation that we consider to be a material weakness as previously defined with respect to:

- The accounting procedures and records.
- The process of accumulating and recording labor, material, and overhead costs, and the distribution of these costs to construction, retirement, and maintenance or other expense accounts.
- The materials control.

**Comments on Compliance with Specific RUS Loan and Security Instrument Provisions**

Management's responsibility for compliance with laws, regulations, contracts, and grants is set forth in our report of independent public accountants on compliance with applicable laws and regulations dated February 21, 2003, and should be read in conjunction with this report. At your request, we have performed the procedures enumerated below with respect to compliance with certain provisions of laws, regulations, contracts, and grants. The procedures we performed are summarized as follows:

- Procedures performed with respect to the requirement for a borrower to obtain written approval of the mortgagee to enter into any contract for the operation or maintenance of property, or for the use of mortgaged property by others for the year ended December 31, 2002, of Kansas Electric Power Cooperative, Inc.:
  - Obtained and read a borrower-prepared schedule of new written contracts entered into during the year for the operation or maintenance of its property, or for the use of its property by others as defined in 1773.33(e)(1)(ii).
  - Reviewed board of trustee's minutes to ascertain whether board-approved written contracts entered into during the year for the operation or maintenance of all or any part of the borrower's property, or for the use of its property by others.
  - Noted the existence of written RUS approval of each contract listed by the borrower.
- Procedure performed with respect to the requirement to submit RUS Form 12 to the RUS:
  - Agreed amounts reported in Form 12 to Kansas Electric Power Cooperative, Inc.'s records.

The results of our tests indicate that, with respect to the items tested, Kansas Electric Power Cooperative, Inc., complied in all material respects, with the specific RUS loans and security instruments provisions referred to below. The specific provisions tested, as well as any exceptions noted, include the requirements that:

- The borrower has obtained written approval of the RUS to enter into any contract for the operation or maintenance of property, or for the use of its mortgaged property by others as defined in 1773.33(e)(1)(ii).
- The borrower has submitted its Form 12 to the RUS and the Form 12, Financial and Statistical Report as of December 31, 2002, represented by the borrower as having been submitted to RUS, is in agreement with Kansas Electric Power Cooperative, Inc.'s audited records in all material respects, and appears reasonable based upon the audit procedures performed.

**Comments on Other Additional Matters**

In connection with our audit of the financial statements of Kansas Electric Power Cooperative, Inc., nothing came to our attention that caused us to believe that Kansas Electric Power Cooperative, Inc., failed to comply with respect to:

- The reconciliation of subsidiary plant records to the controlling general ledger plant accounts addressed at 7 CFR Part 1773.33(c)(1).
- The clearing of the construction accounts and the accrual of depreciation on completed construction addressed at 7 CFR Part 1773.33(c)(2).
- The retirement of plant addressed at 7 CFR Part 1773.33(c)(3) and (4).
- Sales of plant, material, or scrap addressed at 7 CFR Part 1773.33(c)(5).
- The disclosure of material related-party transactions, in accordance with SFAS No. 57, *Related-Party Transactions*, for the year ended December 31, 2002, in the financial statements referenced in the first paragraph of this report addressed at 7 CFR Part 1773.33(f).
- The depreciation rates addressed at 7 CFR Part 1773.33(g).

**Detailed Schedule of Deferred Charges**

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The detailed schedule of deferred debits and deferred credits required by 7 CFR Part 1773.343(h) and provided below is present for purposes of additional analysis and is not a required part of the basic financial statements. This information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, except for the effects of certain amortization methods which do not constitute a phase-in plan under the requirements of SFAS No. 92, *Accounting for Phase-in Plans*; as ordered by the regulatory body having jurisdiction over its rates which do not, in our opinion, conform to accounting principles generally accepted in the United States, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

| | | 2002 |
|---|---|---|
| Deferred charges: | | |
| Wolf Creek disallowed costs (less accumulated amortization of $8,092,079) | $ | 17,890,842 |
| Wolf Creek deferred plant costs (less accumulated amortization of $3,129,920 and $0 for 2002 and 2001, respectively) | | 43,818,873 |
| Deferred Department of Energy decommissioning costs | | 419,336 |
| Deferred incremental outage costs | | 1,081,488 |
| Other deferred charges (less accumulated amortization of $916,634) | | 1,581,057 |
| | $ | 64,791,596 |

Written approval for the above deferrals has not been received from the RUS, however, such deferrals have been approved by the regulatory body having jurisdiction over Kansas Electric Power Cooperative, Inc.'s rates.

KEPCo Services, Inc. (KSI), is a wholly owned for-profit subsidiary providing engineering services to both KEPCo members and nonmember cooperatives in the state of Kansas. The investment in KSI is accounted for as a consolidated subsidiary in KEPCo's financial statements as it is 100% owned by KEPCo.

| | | |
|---|---|---|
| Original investment cost | $ | — |
| Book value of investment as of December 31, 2001 | | (183,817) |
| Dividends in 2002 | | — |
| Undistributed gain in 2002 | | 7,795 |
| Book value of investment as of December 31, 2002 | | (175,842) |
| Accumulated losses in excess of original investment | | (175,842) |

This report is intended solely for the information and use of the board of trustees, management, and the RUS and supplemental lenders and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Very truly yours,

KPMG LLP