

CONSOLIDATED FINANCIAL STATEMENTS WITH
REPORT OF INDEPENDENT AUDITORS

SAM HOUSTON ELECTRIC COOPERATIVE, INC.

December 31, 2007 and 2006

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REPORT OF INDEPENDENT AUDITORS

The Board of Directors
Sam Houston Electric Cooperative, Inc.
Livingston, Texas

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

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Sam Houston Electric Cooperative, Inc. as of December 31, 2007 and 2006 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.

As discussed in Note 12 to the consolidated financial statements, in 2007 the Cooperative adopted the provisions of Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106, and 132(R)*.


CERTIFIED PUBLIC ACCOUNTANTS

Lufkin, Texas
March 13, 2008

CONSOLIDATED FINANCIAL STATEMENTS

SAM HOUSTON ELECTRIC COOPERATIVE, INC.
CONSOLIDATED BALANCE SHEETS
December 31, 2007 and 2006

	2007	2006
ASSETS		
Utility Plant:		
Electric plant in service	\$ 322 477 377	\$ 302 905 948
Construction in progress	15 778 709	12 214 979
	338 256 086	315 120 927
Less: accumulated depreciation	97 273 911	89 193 542
	240 982 175	225 927 385
NET UTILITY PLANT		
Investments, at Cost:		
Investments in associated organizations	20 761 804	18 058 787
Other investments	3 842	3 842
	20 765 646	18 062 629
TOTAL INVESTMENTS		
Current Assets:		
Cash and cash equivalents	6 549 082	2 432 197
Scholarship and economic development funds	1 148 379	1 098 377
Accounts receivable (less provision for doubtful accounts of \$392,762 in 2007 and \$158,667 in 2006)	12 435 219	14 056 986
FEMA receivable	3 633 035	6 342 246
Materials and supplies (at average cost)	321 741	341 324
Other current assets	443 070	477 161
	24 530 526	24 748 291
TOTAL CURRENT ASSETS		
Deferred charges	171 966	180 360
	286 450 313	268 918 665
TOTAL ASSETS		

The accompanying notes are an integral part of these financial statements.

	<u>2007</u>	<u>2006</u>
EQUITIES AND LIABILITIES		
Equities:		
Memberships	\$ 188 010	\$ 256 325
Patronage capital	109 665 613	100 008 138
Other equities	67 740	67 740
Accumulated other comprehensive income	<u>(1 068 505)</u>	<u>-</u>
TOTAL EQUITIES	<u>108 852 858</u>	<u>100 332 203</u>
Long-term postretirement benefits liability	<u>2 742 464</u>	<u>1 643 761</u>
Long-term debt, less current maturities	<u>143 547 928</u>	<u>133 807 360</u>
Current Liabilities:		
Accounts payable and accrued liabilities	17 564 948	18 526 035
Accrual for hurricane restoration costs	772 486	1 618 833
Current maturities of long-term debt	8 284 849	4 940 603
Current portion of postretirement benefits liability	185 466	-
Accrued interest payable	1 065 223	1 043 203
Patronage capital payable	216 485	201 065
Consumers' deposits	<u>1 638 066</u>	<u>1 680 900</u>
TOTAL CURRENT LIABILITIES	<u>29 727 523</u>	<u>28 010 639</u>
Deferred credits	<u>1 579 540</u>	<u>5 124 702</u>
TOTAL EQUITIES AND LIABILITIES	<u>\$ 286 450 313</u>	<u>\$ 268 918 665</u>

SAM HOUSTON ELECTRIC COOPERATIVE, INC.
CONSOLIDATED STATEMENTS OF REVENUE AND EXPENSE
For The Years Ended December 31, 2007 and 2006

	2007	2006
Operating Revenues:		
Sale of electricity	\$ 117 522 340	\$ 108 156 711
Other electric revenues	3 348 829	3 253 405
TOTAL OPERATING REVENUES	120 871 169	111 410 116
Operating Expenses:		
Cost of power	71 555 611	68 166 323
Transmission expense	73 877	178 441
Distribution expense - Operation	3 533 776	3 716 451
Distribution expense - Maintenance	9 696 518	8 756 096
Consumer accounts expense	5 780 603	5 630 097
Administrative and general expense	3 680 562	3 342 455
Depreciation expense	11 185 231	10 773 566
Taxes other than income taxes	1 176 529	1 108 126
OPERATING EXPENSES	106 682 707	101 671 555
OPERATING MARGINS BEFORE INTEREST EXPENSE AND FEMA REIMBURSEMENT	14 188 462	9 738 561
Interest on long term debt and consumer deposits	8 171 280	8 375 567
FEMA reimbursement	(1 884 079)	(5 413 443)
OPERATING MARGIN	7 901 261	6 776 437
Generation and transmission capital credits	2 233 044	1 981 889
Patronage capital - Associated organizations	1 286 649	1 196 112
Nonoperating Margins:		
Internet services - Net	(84 021)	(71 776)
Interest income	106 811	125 372
Other nonoperating income	335 421	345 794
TOTAL NONOPERATING MARGINS	358 211	399 390
NET MARGIN	\$ 11 779 165	\$ 10 353 828

The accompanying notes are an integral part of these financial statements.

SAM HOUSTON ELECTRIC COOPERATIVE, INC.
CONSOLIDATED STATEMENTS OF PATRONAGE CAPITAL AND COMPREHENSIVE INCOME
For The Years Ended December 31, 2007 and 2006

		<u>MEMBERSHIPS</u>		<u>PATRONAGE CAPITAL</u>		<u>OTHER EQUITIES</u>		<u>ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)</u>		<u>TOTAL</u>
Balance, December 31, 2005	\$	257 795	\$	89 654 310	\$	67 740	\$	-	\$	89 979 845
Net margin		-		10 353 828		-		-		10 353 828
Comprehensive income										<u>10 353 828</u>
Change in memberships		<u>(1 470)</u>		<u>-</u>		<u>-</u>		<u>-</u>		<u>(1 470)</u>
Balance, December 31, 2006		256 325		100 008 138		67 740		-		<u>100 332 203</u>
Net margin		-		11 779 165		-		-		11 779 165
Comprehensive income										<u>11 779 165</u>
Change in memberships		(68 315)		-		-		-		(68 315)
Patronage capital retired - Net		-		(2 121 690)		-		-		(2 121 690)
Adjustment to initially apply FASB Statement No. 158 - Note 12		<u>-</u>		<u>-</u>		<u>-</u>		<u>(1 068 505)</u>		<u>(1 068 505)</u>
Balance, December 31, 2007	\$	<u>188 010</u>	\$	<u>109 665 613</u>	\$	<u>67 740</u>	\$	<u>(1 068 505)</u>	\$	<u>108 852 858</u>

The accompanying notes are an integral part of these financial statements.

SAM HOUSTON ELECTRIC COOPERATIVE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2007 and 2006

	2007	2006
Cash Flows From Operating Activities:		
Net margin	\$ 11 779 165	\$ 10 353 828
Adjustments to Reconcile Net Margins to Net Cash Provided by Operating Activities:		
Depreciation expense	11 185 231	10 773 566
Capital credits - Non-cash	(3 537 503)	(3 222 736)
Accumulated provision for pensions and benefits	215 664	214 861
(Gain) loss on dispositions of utility plant	(193 715)	(222 143)
Cash Provided by (Used for) the Change in:		
Accounts receivable, net	1 621 767	2 840 738
FEMA receivable	2 709 211	21 323 627
Materials and supplies	19 583	(12 789)
Other current assets	34 091	(74 287)
Deferred charges	8 394	5 825 788
Deferred credits	(3 595 164)	2 480 502
Accounts payable and accrued liabilities	(961 087)	(1 401 131)
Accrual for hurricane restoration	(846 347)	(6 123 642)
Accrued interest payable	22 020	28 411
Consumers' deposits	(42 834)	125 730
TOTAL ADJUSTMENTS	6 639 311	32 556 495
NET CASH PROVIDED BY OPERATING ACTIVITIES	18 418 476	42 910 323
 Cash Flows From Investing Activities:		
Capital expenditures for utility plant, net of retirements	(26 190 021)	(27 390 554)
Proceeds from dispositions of utility plant	193 715	570 374
Proceeds from patronage capital - Associated organizations	834 486	807 813
NET CASH USED IN INVESTING ACTIVITIES	(25 161 820)	(26 012 367)
 Cash Flows From Financing Activities:		
Proceeds from long-term debt	12 000 000	9 000 000
Payments of long-term debt	(4 965 186)	(4 402 475)
Net activity on line of credit	6 000 000	(21 000 000)
Retirement of capital credits - Net	(2 121 690)	-
Decrease in memberships, net	(68 315)	(1 470)
Increase (decrease) in patronage capital payable	15 420	(18 797)
NET CASH PROVIDED (USED) BY FINANCING ACTIVITIES	10 860 229	(16 422 742)
 INCREASE IN CASH AND CASH EQUIVALENTS	4 116 885	475 214
 Cash and cash equivalents at beginning of year	2 432 197	1 956 983
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ 6 549 082	\$ 2 432 197
 Supplemental Disclosures of Cash Flow Information:		
Cash paid during the year for interest expense, net of capitalized amounts	\$ 8 140 866	\$ 8 338 762
 Noncash Investing and Financing Activities:		
Net actuarial loss on postretirement benefit plan	\$ 1 068 505	\$ -
Loan incurred to acquire land	\$ 50 000	\$ -

The accompanying notes are an integral part of these financial statements.

SAM HOUSTON ELECTRIC COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

Sam Houston Electric Cooperative, Inc. ("Electric") is an electric distribution cooperative formed pursuant to the Texas Electric Cooperative Corporation Act. The accompanying financial statements include the combined results of Electric and a wholly owned subsidiary Sam Houston Services, Inc. ("Service"). The entities are collectively referred to as the ("Cooperative"). All material intercompany balances and transactions have been eliminated. The Cooperative provides electric power and internet service, and has approximately 51,000 members located in ten counties across East Texas. The accounting policies of the Cooperative are consistent with generally accepted utility accounting principles.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities. The estimates and assumptions used in the accompanying financial statements are based upon management's evaluation of the relevant facts and circumstances as of the date of the financial statements. Actual results could differ from the estimates and assumptions used in preparing the accompanying financial statements.

Utility Plant

Utility plant is stated at cost and includes materials, labor, overhead and capitalized interest. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts. The cost of maintenance and repairs is charged to operations as incurred. Significant improvements or refurbishments are capitalized and deductions are made for plant retirements resulting from the improvements or refurbishments.

Depreciation is provided in the accounts for the distribution plant based upon a straight-line rate of 3.50% per annum. The general and transmission plants, which include transportation equipment, are being depreciated on a straight-line basis using rates ranging from 2.65% to 25% per annum.

Revenue Recognition

The Cooperative recognizes revenue from electric power when the power is delivered to customers. To the extent that deliveries have occurred but a bill has not been issued, the Cooperative accrues an estimate of the revenues for energy delivered since the latest billings. The amount of estimated revenue accrued represents the revenue associated with the kilowatt hours consumed by the members in the current month but not billed until the following month. The estimate is calculated based on several factors including billings through the last billing cycle in a month, actual activity, and prices in effect. Each month the estimated unbilled revenue amounts are recorded as revenue and unbilled accounts receivable, and the prior month's estimate is reversed. Therefore, changes in price and volume differences resulting from factors such as weather affect the calculation of unbilled revenues from one period to the next, and may result in variability in reported revenues from one period to the next as prior estimates are reversed and new estimates are recorded. Estimated unbilled revenue accrued aggregated \$5,648,511 and \$5,076,633 at December 31, 2007 and 2006, respectively.

Accounts Receivable

The Cooperative carries its accounts receivable at cost less an allowance for doubtful accounts. On a periodic basis, the Cooperative evaluates its accounts receivable and establishes an allowance for doubtful accounts, when deemed necessary, based on its history of past write-offs and collections.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - CONTINUED

Allowance for Cost of Funds Used During Construction

The accounting policies of the Cooperative provide for the capitalization of an allowance for cost of funds used during construction. Interest capitalized was \$975,606 and \$887,369 for the years ended December 31, 2007 and 2006, respectively.

Cash Flows Statement

Cash and cash equivalents, for purposes of the cash flows statement, consist of all unrestricted cash and temporary cash investments with an original maturity of three months or less.

Accrued Annual Leave

Cooperative accounting procedures provide for the accrual of the employee annual leave liability in accordance with FASB Statement No. 43.

Materials and Supplies

Materials and supplies are stated at lower of cost or market. Cost is determined substantially by the average cost method of inventory valuation.

Advertising Costs

Advertising costs are charged to operations when incurred and were approximately \$715,000 and \$706,000 as of December 31, 2007 and 2006, respectively. All advertising costs are reflected in consumer accounts expense for these years.

Federal Income Taxes

The Cooperative is exempt from Federal income tax under the provisions of Section 501(c)(12) of the Internal Revenue Code of 1986.

Self-Insurance

During the year ended December 31, 2006, the Cooperative became primarily self-insured, up to certain limits, for employee and director group health insurance. A liability for unpaid claims and the associated expenses, including incurred but not reported losses, is estimated and reflected in the balance sheet as an accrued liability. At December 31, 2007 and 2006, the accrued liability for self-insured claims was \$294,987 and \$359,750, respectively. The liability is estimated in part by considering historical claims experience and other assumptions.

Reclassifications

Certain reclassifications have been made to the prior period's financial statements to conform to the classifications used in the current year.

SAM HOUSTON ELECTRIC COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

NOTE 2 - UTILITY PLANT

Listed below are the major classes of the utility plant as of December 31, 2007 and 2006:

	<u>2007</u>	<u>2006</u>
Distribution plant	\$ 252 418 775	\$ 233 933 803
Transmission plant	33 342 934	33 170 683
General plant	<u>36 715 668</u>	<u>35 801 462</u>
Electric plant in service	322 477 377	302 905 948
Construction work in progress	<u>15 778 709</u>	<u>12 214 979</u>
TOTAL	<u>\$ 338 256 086</u>	<u>\$ 315 120 927</u>

The Cooperative has leasing arrangements for a fleet of trucks for operations. The leases are operating leases that expire from 2009 to 2011. At the end of the lease term, the Cooperative has the option to purchase the equipment at fair market value. The individual leasing arrangements provide for annual lease payments ranging from \$12,405 to \$77,912.

The following is a schedule of aggregate future minimum lease payments for the next five years:

December 31, 2008	\$ 297 504
December 31, 2009	\$ 233 639
December 31, 2010	\$ 163 220
December 31, 2011	\$ 99 446
December 31, 2012	\$ -

Lease expenses for the year ended December 31, 2007 and 2006 was approximately \$332,000 and \$196,000, respectively.

NOTE 3 - INVESTMENTS IN ASSOCIATED ORGANIZATIONS

Investments in Associated Organizations consisted of the following at December 31, 2007 and 2006:

	<u>2007</u>	<u>2006</u>
Investments in National Rural Utilities Cooperative Finance Corporation ("CFC"):		
Capital term certificates	\$ 3 546 377	\$ 3 595 288
Patronage capital credits	1 871 920	1 798 459
TOTAL INVESTMENTS IN CFC	<u>5 418 297</u>	<u>5 393 747</u>
Investment in CoBank	<u>1 150 221</u>	<u>757 417</u>
Patronage Capital Credits:		
Sam Rayburn G & T, Electric Cooperative, Inc. ("SRG&T")	12 938 936	10 834 202
Tex-La Electric Cooperative of Texas, Inc. ("Tex-La")	854 891	726 581
Texas Electric Cooperative	300 432	268 226
Other	99 027	78 614
TOTAL PATRONAGE CAPITAL CREDITS	<u>14 193 286</u>	<u>11 907 623</u>
TOTAL INVESTMENTS IN ASSOCIATED ORGANIZATIONS	<u>\$ 20 761 804</u>	<u>\$ 18 058 787</u>

SAM HOUSTON ELECTRIC COOPERATIVE, INC.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

NOTE 3 - INVESTMENTS IN ASSOCIATED ORGANIZATIONS - CONTINUED

SRG&T and Tex-La are power supply cooperatives formed for the purpose of purchasing interests or participations in joint power generation facilities. The Cooperative accounts for its investment in SRG&T and Tex-La using the equity method of accounting. Accordingly, the investment in both SRG&T and Tex-La is carried at cost, adjusted for the Cooperative's proportionate share of their earnings or losses, net of distributions. Generation and transmission capital credits reported in the Statement of Revenue and Expense in the amounts of \$2,233,044 and \$1,981,889 for the years ended December 31, 2007 and 2006, respectively, represent Patronage Capital allocations from SRG&T and Tex-La.

The CFC capital term certificates bear interest at 3% and 5% per annum until their respective maturities, which range from 2020 through 2080. The CFC loan term certificates are non-interest bearing.

In August 1997, the Cooperative created a wholly-owned subsidiary, Sam Houston Services, Inc. to provide diversified products and services to the Cooperative's members. All intercompany transactions and balances have been eliminated in consolidation.

NOTE 4 - MATERIALS AND SUPPLIES

In February 1997, the Cooperative entered into a contract for material management with a management company. Under the agreement, the company manages the Cooperative's warehouse facility, inventory control, and inventory distribution on a daily basis. Materials and supplies are purchased from the management company on an as-needed basis. The Cooperative leases their warehouse facility to the management company for \$3,500 per month.

The materials and supplies inventory at December 31, 2007 and 2006 consisted primarily of conductor and service wire used in daily operations and is purchased from the management company in bulk:

	2007	2006
Materials and supplies for construction, operation and maintenance of utility plant	\$ 321 741	\$ 341 324

NOTE 5 - DEFERRED CHARGES

Following is a summary of amounts recorded as deferred charges as of December 31, 2007 and 2006:

	2007	2006
CoBank closing cost	\$ 71 007	\$ 74 473
CFC Loan prepayment fee	100 959	105 887
TOTAL	\$ 171 966	\$ 180 360

The Cooperative's tariffs for electric service include a power cost calculation under which electric rates charged to customers are adjusted to reflect changes in power costs. In order to match power costs and related revenues, under-recovered power costs to be billed to members in subsequent periods are recognized as a deferred charge and as an increase of classified operating revenues on the statement of revenue and expense. The Cooperative had under-recovered power costs from its members of approximately \$3,808,000 and \$-0- at December 31, 2007 and 2006, respectively. As permitted by the Cooperative's tariff, the Cooperative elected to absorb the 2007 under-recovered power costs rather than collecting those costs in 2008. No amount has been recorded as a deferred charge at December 31, 2007.

SAM HOUSTON ELECTRIC COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

NOTE 6 - DETAIL OF PATRONAGE CAPITAL

	2007	2006
Unallocated	\$ 11 779 165	\$ 9 260 832
Allocated	100 008 138	90 747 306
SUBTOTAL	111 787 303	100 008 138
Less: Retired - net	2 121 690	-
BALANCE	\$ 109 665 613	\$ 100 008 138

Under the provisions of the current mortgage agreement, until the equities and margins equal or exceed twenty percent of the total assets of the Cooperative, the return to patrons of capital contributed by them is limited generally to thirty percent of the patronage capital or margins received by the Cooperative in the prior calendar year. The equities and margins of the Cooperative represent 38% and 37% of the total assets at December 31, 2007 and 2006.

NOTE 7 - DETAIL OF OTHER EQUITIES

	2007	2006
Donated capital	\$ 67 740	\$ 67 740

NOTE 8 - DEFERRED CREDITS

Following is a summary of the amounts recorded as deferred credits as of December 31, 2007 and 2006:

	2007	2006
Deferred patronage payable	\$ 332 459	\$ 269 263
Scholarship and economic development funds	1 148 379	1 098 377
Deposit - sale of internet customer base - Note 21	63 320	-
Power cost over-recovered	-	3 757 061
TOTAL	\$ 1 544 158	\$ 5 124 701

During the year ended December 31, 2006, the Cooperative opted to purchase power from its supplier at actual monthly power costs rather than under a levelized billing plan. Under the levelized billing plan, the Cooperative paid a monthly levelized bill computed using the actual kilowatt-hours and a levelized billing rate. The difference between the actual monthly power cost and the amount paid to the supplier under the levelized billing plan was accumulated by the Cooperative in a designated deferred account. In order to match power costs and related revenues, levelized power cost to be paid to power suppliers in subsequent periods was recognized as a deferred credit and as an increase in cost of power on the statement of revenue and expense. The Cooperative now purchases power from its supplier at the actual monthly power cost, therefore resulting in no levelized power cost for the year ended December 31, 2007 or 2006, respectively.

In addition, the Cooperative's tariffs provide for a power cost calculation under which electric rates charged to customers are adjusted to reflect changes in power costs. Over-recovered power costs to be credited to members in subsequent periods are recognized as a deferred credit and as a reduction of classified operating revenues on the statement of revenue and expense. For the year ended December 31, 2007 and 2006, over-recovered power cost aggregated \$-0- and \$3,757,061, respectively. The 2006 over-recovery of \$3,757,061 was effectively returned to the Cooperative's members during the year ended December 31, 2007 by means of reduced power bills throughout the year.

SAM HOUSTON ELECTRIC COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

NOTE 9 - LONG-TERM DEBT

Long-term debt at December 31, 2007 and 2006 consisted of the following:

	2007	2006
Variable and fixed rate mortgage notes payable to CFC, with principal and interest due in quarterly installments; scheduled repayment varies between 2009 and 2039, interest varies: from 5.35% to 7.55%	\$ 56 760 070	\$ 59 674 187
Variable and fixed rate mortgage notes payable to CoBank with principal and interest due in quarterly installment; scheduled repayment varies between 2007 and 2028, interest varies from 4.20% to 6.72%	95 022 707	79 073 776
Other notes, principal and interest due annually, maturing June 1, 2017, interest rate fixed at 8.0%	50 000	-
	151 832 777	138 747 963
Less: Current maturities	8 284 849	4 940 603
	\$ 143 547 928	\$ 133 807 360

As of December 31, 2007, estimated annual maturities of long-term debt outstanding for the next five years are as follows:

FOR THE YEARS ENDING DECEMBER 31,	
2008	\$ 8 284 849
2009	5 530 902
2010	5 788 412
2011	6 023 601
2012 and Thereafter	126 205 013
	\$ 151 832 777

The notes are collateralized by the utility plant and contain certain limitations as to use of funds, additional indebtedness, long-term leases and payment of patronage capital. In addition, the debt covenants require the Cooperative to maintain certain minimum average financial ratios computed using the two most favorable annual ratios in a three-year consecutive period.

The Cooperative has an emergency line of credit with CFC. The line of credit allows the Cooperative to borrow up to a maximum amount of \$20,000,000, with interest at 6.40% and 7.15% as of December 31, 2007 and December 31, 2006, respectively. There was no balance outstanding under this financing arrangement at December 31, 2007 and December 31, 2006. The Cooperative also has a regular line of credit with CFC that allows them to borrow up to a maximum of \$12,000,000, with no balances outstanding, and with interest at 6.40% and 7.15% as of December 31, 2007 and 2006, respectively.

The Cooperative has an additional line of credit with CoBank with a maximum borrowing limit of \$10,000,000. There was \$6,000,000 and \$0- outstanding under this financing arrangement as of December 31, 2007 and 2006. Subsequent to December 31, 2007, the Cooperative repaid \$3,000,000 of this line of credit. The remaining \$3,000,000 outstanding is expected to be refinanced with long-term debt from CoBank, and as such, has been classified as long-term on the consolidated balance sheet.

NOTE 10 - RETIREMENT AND BENEFIT PLANS

The Cooperative participates in the National Rural Electric Cooperative Association ("NRECA") Retirement & Security program (the "Program"), a defined benefit pension plan qualified under Section 401 and tax exempt under Section 501(a) of the Internal Revenue Code, which covers substantially all employees. The Cooperative makes annual contributions to the Program equal to the amounts accrued for pension expense, except for periods when a moratorium on contributions is in effect due to reaching full funding limitation. In this multiemployer plan, which is available to all member cooperatives of NRECA, the accumulated benefits and plan assets have not been determined or allocated separately by NRECA to the individual cooperatives. Therefore, the Cooperative is unable to disclose certain information with respect to the Program as required by Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions*. The Cooperative's contributions approximated \$815,000 and \$727,000 to the Program during 2007 and 2006, respectively.

The Cooperative participates in a qualified Defined Contribution Pension Plan with Nationwide Trust Company, FSB. The employees who participate in the Plan may contribute up to \$15,500 of their compensation and the Cooperative contributes 6% of the employees' base compensation excluding overtime pay. The Cooperative's contributions to the Plan approximated \$394,000 and \$421,000 in 2007 and 2006, respectively.

The Cooperative has an Annual Incentive Plan ("Bonus Plan") for the benefit of its employees, including executive officers. The amount of cash bonus awards to be made under the Bonus Plan for any plan year depends primarily on the Cooperative's overall satisfaction rate as determined by random surveys of residential customers. For any plan year, the Cooperative's overall satisfaction rate must meet or exceed, or in combination with other factors, satisfy levels targeted by the Cooperative, as established at the beginning of each fiscal year, for any bonus awards to be made. The Cooperative expensed approximately \$133,000 in 2007 and \$188,000 in 2006 in conjunction with the Bonus Plan.

NOTE 11 - ACCRUED ABSENCES

The Cooperative follows a policy whereby hourly employees earn deferred compensation for unused sick and vacation leave. Each hourly employee earns 8 hours of sick leave and vacation leave for each month employed. The employees covered by the policy may accrue a maximum of 520 hours of sick leave and 240 hours of vacation leave. The deferred compensation for unused sick leave and unused vacation leave will be remitted to the employee, or the employee's estate, at the time of the employee's retirement or death, respectively. The cumulative accrual for unused sick leave and unused vacation leave aggregated \$529,854 and \$572,161, respectively at December 31, 2007 and \$502,596 and \$539,968, respectively at December 31, 2006.

NOTE 12 - INCREMENTAL EFFECT OF APPLYING FASB STATEMENT NO. 158

In September 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 158 ("SFAS 158"), *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* - an amendment of FASB Statements No. 87, 88, 106, and 132(R), to be effective for December 31, 2007. SFAS 158 requires employers to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its balance sheet, with limited exceptions. SFAS 158 defines the funded status of a benefit plan as the difference between the fair value of the plan assets and the projected benefit obligation for pension plans or the accumulated postretirement benefit obligation for other postretirement plans. Previously unrecognized items such as gains or losses, prior service credits and transition assets or liabilities are recognized in other comprehensive income and will be subsequently recognized through net periodic benefit cost pursuant to the provisions of Statements 87 and 106. The Cooperative adopted SFAS 158 during the year ended December 31, 2007 and recognized the prior unrecognized service costs, gains and losses, and transition asset/obligation for its defined benefit postretirement plan in other comprehensive income.

SAM HOUSTON ELECTRIC COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

NOTE 12 - INCREMENTAL EFFECT OF APPLYING FASB STATEMENT NO. 158 - CONTINUED

The following is a summary of the incremental effect on individual line items of the Consolidated Balance sheets of applying SFAS 158:

	<u>BEFORE APPLICATION OF SFAS 158</u>	<u>ADJUSTMENTS</u>	<u>AFTER APPLICATION OF SFAS 158</u>
Current portion of postretirement benefits liability	\$ -	\$ 185 466	\$ 185 466
Current liabilities	\$ 29 577 439	\$ 185 466	\$ 29 762 905
Long-term postretirement benefit liability	\$ 1 673 959	\$ 1 068 505	\$ 2 742 464
Accumulated other comprehensive income	\$ -	\$ (1 068 505)	\$ (1 068 505)
Equity	\$ 109 921 363	\$ (1 068 505)	\$ 108 852 858

NOTE 13 - POSTRETIREMENT BENEFIT PLAN

The Cooperative sponsors a defined benefit postretirement plan that covers employees and directors and provides for medical insurance premiums (the "Medical Plan"). For those employees retiring at or after age 55, the Cooperative will contribute 100% of the retiree's premium and, if dependent coverage exists, 70% of the employee and dependent premium for a determined time period. The Cooperative will contribute this amount until the earlier of 36 months have elapsed, the retiree attains age 65, or the retiree dies. Employees may remain in the Medical Plan beyond the determined time period and pay 100% of the premium. The Cooperative contributes 100% of the monthly medical premiums in excess of \$50 for directors and their dependents if the director retired at age 65 or older and provided at least 20 years of service on the board. Other directors may remain in the Medical Plan and pay 100% of the premium.

The following schedule summarizes the changes in the postretirement benefits liabilities reported on the balance sheets as of December 31, 2007 and 2006:

	<u>2007</u>	<u>2006</u>
Postretirement Benefit Obligation at beginning of year	\$ 3 080 080	\$ 2 888 200
Service cost	156 102	147 870
Expected benefits and expenses	(180 568)	(166 285)
Interest cost	171 913	161 291
Experience (gain)/loss	(299 597)	49 004
Postretirement Benefit Obligation at end of year	<u>\$ 2 927 930</u>	<u>\$ 3 080 080</u>

Change in plan assets includes the following:

	<u>2007</u>	<u>2006</u>
Balance at beginning of year	\$ -	\$ -
Expected benefits and expenses	(180 568)	(166 285)
Net employer funding	180 568	166 285
Balance at end of year	<u>-</u>	<u>-</u>
Funded (unfunded) status at end of year	<u>\$ (2 927 930)</u>	<u>\$ (3 080 080)</u>

Amounts recognized in the Consolidated Balance Sheets consist of:

	<u>2007</u>	<u>2006</u>
Non-current assets	\$ -	\$ -
Current liabilities	(185 466)	-
Long-term liabilities	<u>(2 742 464)</u>	<u>(1 643 761)</u>
Accrued postretirement benefit cost	<u>\$ (2 927 930)</u>	<u>\$ (1 643 761)</u>

SAM HOUSTON ELECTRIC COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

NOTE 13 - POSTRETIREMENT BENEFIT PLAN - CONTINUED

Amounts recognized in Accumulated Other Comprehensive Income consist of:

	2007	2006
Net actuarial loss	\$ 1 068 505	\$ -
Total Accumulated Other Comprehensive Income	\$ 1 068 505	\$ -

The components of Net Periodic Benefit Costs consist of:

	2007	2006
Service cost	\$ 156 102	\$ 147 870
Interest cost	171 913	161 291
Expected return on assets	-	-
Amortization of (gain)/loss	68 217	71 985
Net periodic benefit cost	\$ 396 232	\$ 381 146

The estimated net loss and prior service cost for the defined benefit postretirement plans that will be amortized from Accumulated Other Comprehensive Income into net periodic benefit cost over the next fiscal year are \$48,191 and \$0, respectively.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid during the years ending:

ENDING DECEMBER 31,	
2008	\$ 185 466
2009	\$ 171 774
2010	\$ 74 400
2011	\$ 70 115
2012	\$ 80 984
2013 - 2018	\$ 795 202

For measurement purposes, annual rates of increase in the per capita cost of covered health care benefits of 9.0% and 11.0% were assumed for 2007 and 2006, respectively. These rates were assumed to decrease gradually to 5.0% in 2015 and remain at that level thereafter. The health care cost trend rate assumption has a significant effect on the amounts reported. Increasing the health care cost trend rates by 1% in each year would increase the accumulated postretirement benefit obligation by approximately 12% and 12.5%, for 2007 and 2006, respectively. An increase of 1% in cost trend rates would also cause an increase in the service and interest cost components of postretirement expense for the years ended December 31, 2007 and 2006 of approximately 13.0% and 17.0%, respectively.

The weighted-average discount rate used in determining the accumulated postretirement benefit obligation was 5.75% in 2007 and 2006, respectively.

NOTE 14 - PATRONAGE CAPITAL PAYABLE

Patronage capital payable at December 31, 2007 and 2006, in the amounts of \$216,485 and \$201,065, includes the amounts approved by the Board of Directors for general retirements payable in 2007 and 2006, respectively, and amounts unclaimed from prior years.

NOTE 15 - FAIR VALUE OF FINANCIAL INSTRUMENTS

The Cooperative's financial instruments consist of cash and cash equivalents, notes receivable, certain investments, consumer deposits, and long-term debt. The Cooperative believes that the carrying value of these instruments on the accompanying balance sheets approximates their fair value.

SAM HOUSTON ELECTRIC COOPERATIVE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

NOTE 16 - CONTINGENCIES

The Cooperative is involved in lawsuits involving claims arising in the ordinary course of its business. The Cooperative believes there is no merit to these lawsuits and is vigorously contesting, with the assistance of its insurance carriers, all damage claims involved. In management's opinion, the ultimate resolution of such matters will not be material to the Cooperative's financial position.

NOTE 17 - COMMITMENTS

The Cooperative has executed wholesale power agreements with the SRG&T and Tex-La. Under these agreements, the Cooperative is committed to purchase its total electric power and energy requirements over long-term periods.

NOTE 18 - CONCENTRATION OF CREDIT RISK

The Cooperative periodically carries cash deposits in excess of federal deposit insurance limits. Management monitors the financial stability of correspondent banks and considers amounts advanced in excess of FDIC insurance to present no significant additional risk to the Cooperative.

NOTE 19 - RELATED PARTY TRANSACTIONS

One of the Cooperative's directors serves on the Board of Directors of a bank. As of December 31, 2007 and 2006, the Cooperative had approximately \$3,290,000 and \$3,042,000, respectively, deposited in various cash and money market accounts with this bank.

Sam Rayburn G & T Electric Cooperative, Inc.

The Cooperative is a member of SRG&T, which is a generating and transmission cooperative. The Cooperative's General Manager/CEO and two members of the Board of Directors serve on the Board of Directors of SRG&T. The Cooperative has entered into an agreement with SRG&T to supply a portion of the Cooperative's wholesale power. The following summary represents the significant transactions, assets and liabilities with SRG&T for the years ending December 31, 2007 and 2006:

	<u>2007</u>	<u>2006</u>
Power purchased from SRG&T	\$ 67 810 234	\$ 64 751 512
Payable to SRG&T for purchased power at December 31	\$ 11 554 075	\$ 11 666 291
Capital credits allocated from SRG&T	\$ 2 104 734	\$ 1 868 989
Total accumulated capital credits from SRG&T (unpaid) at December 31	<u>\$ 12 938 936</u>	<u>\$ 10 834 202</u>

Tex-La Electric Cooperative of Texas, Inc.

The Cooperative is also a member of Tex-La, which is a generating and transmission cooperative. The Cooperative's General Manager/CEO and one member of the Board of Directors serve on the Board of Directors of Tex-La. The Cooperative has entered into an agreement with Tex-La to supply a portion of its wholesale power. The following summary represents the significant transactions and liabilities with Tex-La for the years ending December 31, 2007 and 2006:

	<u>2007</u>	<u>2006</u>
Power purchased from Tex-La	\$ 3 180 521	\$ 3 445 225
Payable to Tex-La for purchased power at December 31	\$ 288 057	\$ 335 816
Capital credits allocated from Tex-La	\$ 128 310	\$ 112 900
Total accumulated capital credits from Tex-La (unpaid) at December 31	<u>\$ 854 891</u>	<u>\$ 726 581</u>

NOTE 20 - HURRICANE RELATED COSTS AND REIMBURSEMENTS

In September 2005, Hurricane Rita caused significant damage to the Cooperative's service territory. The storm resulted in widespread power outages and significant damage to the Cooperative's electric distribution infrastructure. Total clean up and restoration costs for the repair and/or replacement of the Cooperative's electric facilities damaged by Hurricane Rita was approximately \$35,098,000, including \$1,800,000 in construction expenditures. The Cooperative has recorded a liability for restoration costs for the portion of the estimated \$35,098,000 not yet paid. The liability was approximately \$772,000 and \$1,619,000 for the years ended December 31, 2007 and 2006, respectively.

The Federal Government declared the Cooperative's service territory a disaster area and, as a result, the Cooperative became eligible for reimbursement from the Federal Emergency Management Agency ("FEMA") for disaster-related costs of debris removal, emergency protective measures, and the repair, replacement or restoration of disaster-damaged facilities. The Cooperative has received approximately \$31,446,000 from FEMA as of December 31, 2007.

In addition, on September 14, 2006 and on July 13, 2007, FEMA announced that it would increase its cost share for certain eligible disaster-related costs. The cost share adjustment results in an additional 15% of federal funds from FEMA in 2006 and an additional 10% of federal funds in 2007. The additional cost share adjustments make the reimbursement from FEMA a 100% reimbursement of eligible disaster related costs. These additional funds approximated a \$5,413,000 additional reimbursement in 2006 and an additional \$1,884,000 in 2007 for the Cooperative. These cost share adjustments have been recorded as material gains in the accompanying Statement of Revenue and Expense.

For the year ended December 31, 2007 and 2006, the Cooperative has recorded approximately \$3,633,000 and \$6,373,000 as receivable from FEMA on the Cooperative's Consolidated Balance Sheets. These receivables consist of costs expended, approved, and awaiting reimbursement from FEMA as well as projected costs to restore the Cooperative's system for which work has not commenced. All reimbursements from FEMA are subject to audit by both the State and Federal Government to determine if any reimbursements were related to non-eligible storm costs and therefore would be disallowed. As a result of future government audits, it is at least reasonably possible that the Cooperative may have to repay FEMA for any disallowed reimbursements. Although management is unable to predict the outcome of these audits, management believes that the ultimate resolution of these matters will not have a material adverse effect on the Cooperative's results of operations and financial condition.

NOTE 21 - SUBSEQUENT EVENTS

On January 31, 2008, the Cooperative closed on the sale of its internet services customer base owned by Sam Houston Services. The agreement provided for a sales price of \$80 per customer with an estimated 1,170 customers. The total sales price aggregated \$93,600 of which an initial installment payment of \$63,320 was received on December 14, 2007. The remaining \$30,280 was received in January 2008. The initial installment payment has been recorded as a deposit and is reflected in Deferred credits in the Consolidated Balance Sheet at December 31, 2007. The initial installment and the \$30,280 received in 2008 will be recognized as a gain on sale in the amount of \$93,600 in 2008. Consistent losses of Sam Houston Services caused the Cooperative to approve a plan to sell their customer base and discontinue providing internet services to members.