NELNET INC
Form 10-K
February 29, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K

(Mark One)

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2007

Or

o **TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to .

COMMISSION FILE NUMBER 001-31924

NELNET, INC.

(Exact name of registrant as specified in its charter)

NEBRASKA	**84-0748903**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

121 SOUTH 13TH STREET, SUITE 201 LINCOLN, NEBRASKA	**68508**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: (402) 458-2370

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

TITLE OF EACH CLASS

Class A Common Stock, Par Value $0.01 per Share

NAME OF EACH EXCHANGE ON WHICH REGISTERED:

New York Stock Exchange

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

None

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes o No þ

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.
Yes o No þ

Indicate by check mark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer þ Accelerated filer o Non-accelerated filer o Smaller reporting company o
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No þ
The aggregate market value of the Registrant s voting common stock held by non-affiliates of the Registrant on June 29, 2007 (the last business day of the Registrant s most recently completed second fiscal quarter), based upon the closing sale price of the Registrant s Class A Common Stock on that date of $24.44 per share, was $624,345,266. For purposes of this calculation, the Registrant s directors, executive officers, and greater than 10 percent shareholders are deemed to be affiliates.
As of January 31, 2008, there were 37,939,281 and 11,495,377 shares of Class A Common Stock and Class B Common Stock, par value $0.01 per share, outstanding, respectively (excluding 11,068,604 shares of Class A Common Stock held by a wholly owned subsidiary).

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s definitive Proxy Statement to be filed for its 2008 Annual Meeting of Shareholders scheduled to be held May 22, 2008 are incorporated by reference into Part III of this Form 10-K.

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This report contains forward-looking statements and information that are based on management s current expectations as of the date of this document. When used in this report, the words anticipate, believe, estimate, intend, and e and similar expressions are intended to identify forward-looking statements. These forward-looking statements are subject to risks, uncertainties, assumptions, and other factors that may cause the actual results to be materially different from those reflected in such forward-looking statements. These factors include, among others, the risks and uncertainties set forth in Risk Factors and elsewhere in this Annual Report on Form 10-K (the Report) and changes in the terms of student loans and the educational credit marketplace arising from the implementation of, or changes in, applicable laws and regulations, which may reduce the volume, average term, and yields on student loans under the Federal Family Education Loan Program (the FFEL Program or FFELP) of the U.S. Department of Education (the Department) or result in loans being originated or refinanced under non-FFEL programs or may affect the terms upon which banks and others agree to sell FFELP loans to the Company. The Company could also be affected by changes in the demand for educational financing or in financing preferences of lenders, educational institutions, students, and their families; changes in the general interest rate environment and in the securitization markets for education loans, which may increase the costs or limit the availability of financings necessary to initiate, purchase, or carry education loans; losses from loan defaults; and changes in prepayment rates and credit spreads; and the uncertain nature of the expected benefits from acquisitions and the ability to successfully integrate operations. Additionally, financial projections may not prove to be accurate and may vary materially. The reader should not place undue reliance on forward-looking statements, which speak only as of the date of this Report. The Company is not obligated to publicly release any revisions to forward-looking statements to reflect events after the date of this Report or unforeseen events. Although the Company may from time to time voluntarily update its prior forward-looking statements, it disclaims any commitment to do so except as required by securities laws.

PART I.

ITEM 1. BUSINESS

Overview

The Company is an education planning and financing company focused on providing quality products and services to students, families, and schools nationwide. The Company was formed as a Nebraska corporation in 1977. The Company ranks among the nation s leaders in terms of total student loan assets originated, held, and serviced, principally consisting of loans originated under the FFEL Program (a detailed description of the FFEL Program is included in Appendix A to this Report). The Company offers a broad range of pre-college, in-college, and post-college products and services to students, families, schools, and financial institutions. These products and services help students and families plan and pay for their education and students plan their careers. The Company s products and services are designed to simplify the education planning and financing process and are focused on providing value to students, families, and schools throughout the education life cycle. In recent years, the Company s acquisitions have enhanced its position as a vertically-integrated industry leader. These acquisitions have allowed the Company to expand the products and services delivered to customers and to further diversify its revenue.

Education Life Cycle

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Product and Service Offerings

The Company continues to diversify its sources of revenue including those generated from businesses that are not dependent upon government programs reducing legislative and political risk. The following tables summarize the Company s net interest income and fee-based revenues as a percentage of the Company s total revenue for the years ended December 31, 2005, 2006, and 2007 (dollars in thousands):

Revenue Diversification

Management evaluates the Company s GAAP-based financial information as well as operating results on a non-GAAP performance measure referred to as base net income . Management believes base net income provides additional insight into the financial performance of the core operations. For further information, see Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations.

Operating Segments

The Company has five operating segments as defined in Statement of Financial Accounting Standards (SFAS) No. 131, *Disclosures about Segments of an Enterprise and Related Information* (SFAS No. 131), as follows: Asset Generation and Management, Student Loan and Guaranty Servicing, Tuition Payment Processing and Campus Commerce, Enrollment Services and List Management, and Software and Technical Services. The Company s operating segments are defined by the products and services they offer or the types of customers they serve, and they reflect the manner in which financial information is currently evaluated by management. In accordance with SFAS No. 131, the Company includes separate financial information about its operating segments in note 21 of the notes to the consolidated financial statements included in this Report.

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Asset Generation and Management

The Company s Asset Generation and Management operating segment is its largest product and service offering and has historically driven the majority of the Company s earnings. As discussed below, the yield on student loans have been adversely impacted due to recent legislation and capital market disruptions. As a result, the Company plans to be more selective in pursuing origination activity and will experience a decrease in loan volume. The Company owns a large portfolio of student loan assets through a series of education lending subsidiaries. The Company obtains loans through direct origination or through acquisition of loans.

The Company s education lending subsidiaries are engaged in the securitization of education finance assets. These education lending subsidiaries hold beneficial interests in eligible loans, subject to creditors with specific interests. The liabilities of the Company s education lending subsidiaries are not the direct obligations of Nelnet, Inc. or any of its other subsidiaries. Each education lending subsidiary is structured to be bankruptcy remote, meaning that they should not be consolidated in the event of bankruptcy of the parent company or any other subsidiary. The transfers of student loans to the eligible lender trusts do not qualify as sales under the provisions of SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SFAS No. 140), as the trusts continue to be under the effective control of the Company. Accordingly, all the financial activities and related assets and liabilities, including debt, of the securitizations are reflected in the Company s consolidated financial statements.

Legislative Developments

On September 27, 2007, the President signed into law the College Cost Reduction and Access Act of 2007 (the College Cost Reduction Act). This legislation contains provisions with significant implications for participants in the FFEL Program, including cutting funding to the FFEL Program by $20 billion over a five year period as estimated by the Congressional Budget Office. Among other things, this legislation:

- Reduced special allowance payments to for-profit lenders and not-for-profit lenders by 0.55 percentage points and 0.40 percentage points, respectively, for both Stafford and Consolidation loans disbursed on or after October 1, 2007;

- Reduced special allowance payments to for-profit lenders and not-for-profit lenders by 0.85 percentage points and 0.70 percentage points, respectively, for PLUS loans disbursed on or after October 1, 2007;

- Increased origination fees paid by lenders on all FFELP loan types, from 0.5 percent to 1.0 percent, for all loans first disbursed on or after October 1, 2007;

- Eliminated all provisions relating to Exceptional Performer status, and the monetary benefit associated with it, effective October 1, 2007; and

- Reduces default insurance to 95 percent of the unpaid principal of such loans, for loans first disbursed on or after October 1, 2012.

As a result of this legislation, management expects the annual yield on FFELP loans to decrease by approximately 70 to 80 basis points on student loans originated after October 1, 2007.

Restructuring Charges

Legislative Impact

On September 6, 2007, the Company announced a strategic initiative to create efficiencies and lower costs in advance of the enactment of the College Cost Reduction Act, which impacted the FFEL Program. In anticipation of the federally driven cuts to the student loan programs, management initiated a variety of strategies intended to modify the Company s student loan business model, including lowering the cost of student loan acquisition, creating efficiencies in the Company s asset generation business, and decreasing operating expenses through a reduction in workforce and realignment of operating facilities.

Capital Markets Impact

The Company has significant financing needs that it meets through the capital markets, including the debt and secondary markets. Since August 2007, these markets have experienced unprecedented disruptions, which are having an adverse impact on the Company s earnings and financial condition. On January 23, 2008, the Company announced a plan to further reduce operating expenses related to its student loan origination and related businesses by reducing marketing, sales, service, and related support costs through a reduction in workforce and realignment of certain operating facilities as a result of the ongoing disruption in the global credit markets. Since the Company cannot determine nor control the length of time or extent to which the capital markets remain disrupted, it will reduce its direct and indirect costs related to its asset generation activities and be more selective in pursuing origination activity, in both the direct-to-consumer and campus based channels, for both private loans and FFELP loans. Accordingly, the Company has suspended consolidation student loan originations and will continue to review the viability of continuing to originate and acquire student loans through its various channels. As a result of these items, the Company will experience a decrease in origination volume compared to historical periods.

Student Loan Portfolio

Student loans owned by the Company include those originated under the FFEL Program, including the Stafford Loan Program, a program which allows for loans to be made to parents of undergraduate students and to graduate students (PLUS), and loans that consolidate certain borrower obligations (Consolidation), as well as non-federally insured loans. The following tables summarize the composition of the Company s student loan portfolio as of December 31, 2005, 2006, and 2007, exclusive of the unamortized costs of origination and acquisition (dollars in millions):

Student Loan Portfolio Composition

Historically, the Company s earnings and earnings growth were directly affected by the size of its portfolio of student loans, the interest rate characteristics of its portfolio, the costs associated with financing, servicing, and managing its portfolio, and the costs associated with origination and acquisition of the student loans in the portfolio, which includes, among other things, borrower benefits and rebate fees to the federal government. The Company currently generates a substantial portion of its earnings from the spread, referred to as its student loan spread, between the yield it receives on its student loan portfolio and the costs noted above. While the spread may vary due to fluctuations in interest rates and borrowing costs, the special allowance payments the Company receives from the federal government ensure the Company receives a minimum yield on its student loans, so long as certain requirements are met.

Student Loan Originations and Acquisitions

During the years ended December 31, 2007 and 2006, the Company originated or acquired a total of $2.9 billion and $3.5 billion, respectively, in student loans (net of repayments, consolidation loans lost, and loans sold), as indicated in the table below (dollars in thousands).

	Year ended December 31,	
	2007	2006
Beginning balance	$ 23,414,468	19,912,955
Direct channel:		
Consolidation loan originations	3,096,754	5,299,820
Less consolidation of existing portfolio	(1,602,835)	(2,643,880)
Net consolidation loan originations	1,493,919	2,655,940
Stafford/PLUS loan originations	1,086,398	1,035,695
Branding partner channel	662,629	720,641
Forward flow channel	1,105,145	1,600,990
Other channels	804,019	682,852
Total channel acquisitions	5,152,110	6,696,118
Repayments, claims, capitalized interest, participations, and other	(1,321,055)	(1,332,086)
Consolidation loans lost to external parties	(800,978)	(1,114,040)
Loans sold	(115,332)	(748,479)
Ending balance	$ 26,329,213	23,414,468

The Company originates and acquires loans through various methods, including: (i) direct-to-consumer channel, (ii) campus based channel, and (iii) spot purchases.

Direct-to-Consumer Channel

Through its direct-to-consumer channel, the Company originates student loans directly with students and parent borrowers. Student loans that the Company originates directly historically have been the most profitable because typically the cost to originate is less than the premiums paid or cost to acquire loans acquired through other channels. Included in the direct-to-consumer channel are consolidation loans originated by the Company. Once a student s loans have entered the grace or repayment period, their student loans are eligible to be consolidated if they meet certain requirements. Loan consolidation allows borrowers to make a single payment per month with a fixed interest rate, instead of multiple payments on multiple loans, and also enables borrowers to extend their loan repayment period for up to 30 years, depending upon the size of the consolidation loan.

During 2006 and 2007, the Company originated $5.3 billion and $3.1 billion of consolidation loans, respectively, through this channel. With the changes in legislation and impact of capital markets, the Company has suspended consolidation loan originations in January 2008.

Campus Based Channel

The Company will originate or acquire loans through its campus based channel either directly under one of its brand names or through other originating lenders. Similar to the direct-to-consumer channel, loans originated directly by the Company are generally more profitable because the cost to originate is less than the premiums paid or cost to acquire loans from other originating lenders. In addition to its brands, the Company acquires student loans from lenders to whom the Company provides marketing and/or origination services established through various contracts.

Branding partners are lenders for which the Company acts as a marketing agent in specified geographic areas. A forward flow lender is one for whom the Company provides origination services, but provides no marketing services, or who simply agrees to sell loans to the Company under forward sale commitments. Generally, branding partner loans are more profitable for the Company than loans acquired from forward flow lenders. The Company ordinarily purchases loans originated by branding partners and forward flow lenders pursuant to a contractual commitment, at a premium above par, following full disbursement of the loans. The Company ordinarily retains rights to acquire loans subsequently made to the same borrowers, called serial loans. Origination and servicing of loans made by branding partners and forward flow lenders is primarily performed by the Company so that loans need not be moved from a different servicer upon purchase by the Company. In addition, the loan origination and servicing agreements generally provide for life of loan servicing so that loans cannot be moved to a different servicer.

The Company s agreements and commitments with these lenders to purchase loans are commonly three to five years in duration and ordinarily contain provisions for automatic renewal for successive terms. The Company is generally obligated to purchase all of the loans originated by the Company on behalf of lenders under these commitments as well as some loans originated elsewhere; however, some branding partners retain rights to portions of their loan originations and in some instances forward flow lenders are only obligated to sell loans originated in certain specific geographic regions or exclude loans that are otherwise committed for sale to third parties. Additionally, branding partners and forward flow lenders are not necessarily obligated to provide the Company with a minimum amount of loans. In addition, purchases from branding partners and forward flow lenders are subject to the Company s ability to fund such purchases.

Spot Purchases

The Company also acquires student loan portfolios from various entities under one-time agreements, or spot purchases. Typically, spot purchased loans have higher costs of acquisition compared to other loan channels.

Legislative and Credit Market Impact to Student Loan Originations and Acquisitions

The College Cost Reduction Act has resulted in a reduction in the yields on student loans and, accordingly, a reduction in the amount of the premium the Company is able to pay lenders under its forward flow commitments and branding partner arrangements. As a result, the Company has been working with its forward flow and branding partner clients to renegotiate the premiums payable under its agreements. There can be no assurance that the Company will be successful in renegotiating the premiums under these agreements and, accordingly, the Company may be required to terminate commitments which are not economically reasonable. As a result, the Company will experience a decrease in its forward flow and branding partner loan volume. The Company has also had to terminate its affinity and referral programs and accordingly will experience a decrease in loan volume as a result.

The Company s primary funding needs are those required to finance its student loan portfolio and satisfy its cash requirements for new student loan originations and acquisitions. The Company relies upon secured financing vehicles as its most significant source of funding for student loans. Current conditions in the debt markets include reduced liquidity and increased credit risk premiums for most market participants. These conditions have increased the cost and reduced the availability of debt in the capital markets. As a result, a prolonged period of market illiquidity will affect the Company s loan acquisition and origination volumes. As previously discussed, as a result of the disruptions in the capital markets, the Company plans to be more selective in pursuing origination activity in both the direct-to-consumer and campus based channels. In addition to suspending consolidation loan originations, the Company is also evaluating the economic and market feasibility of continuing its asset generation and acquisition activities in the same manner and scale as historical periods.

Student Loan Financing

A significant portion of the net cash flow the Company receives is generated by the interest earnings on the underlying student loans less amounts paid to the bondholders, loan servicing fees, and any other expenses relating to the financing transactions. The Company generally relies upon secured financing vehicles as its most significant source of funding for student loans. The Company s rights to cash flow from securitized student loans are subordinate to bondholder interests. These secured financing vehicles may be shorter term warehousing programs or longer term permanent financing structures. The size and structure of the financing vehicles may vary, including the term, base interest rate, and applicable covenants.

Student loan warehousing allows the Company to buy and manage student loans prior to transferring them into more permanent financing arrangements. The Company uses its warehouse facilities to pool student loans in order to maximize loan portfolio characteristics for efficient financing and to properly time market conditions for movement of the loans. As of December 31, 2007, the Company had student loan warehousing capacity of $9.2 billion through commercial paper conduit programs (of which $6.9 billion was outstanding and $2.3 billion was available for future use). See Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources.

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The Company had $20.6 billion in asset-backed securities issued and outstanding as of December 31, 2007, which included $17.5 billion of notes with variable interest rates based on a spread to LIBOR and $2.9 billion of notes with variable interest rates which are set and periodically reset via a dutch auction (Auction Rate Securities) or through a remarketing utilizing broker-dealers and remarketing agents (Variable Rate Demand Notes). These asset-backed securities allow the Company to finance student loan assets on a long term basis. In 2007, the Company completed two asset-backed securitizations totaling $3.8 billion.

The Company has significant financing needs that it meets through the capital markets, including the debt and secondary markets. Since August 2007, these markets have experienced unprecedented disruptions, which have had an adverse impact on the Company s earnings and financial condition. See Item 1A, Risk Factors Liquidity and Capital Resources.

Interest Rate Risk Management

The current and future interest rate environment can and will affect the Company s interest earnings, net interest income, and net income. The effects of changing interest rate environments are further outlined in Part II, Item 7A, Quantitative and Qualitative Disclosures about Market Risk Interest Rate Risk.

The interest rate earned by the Company and the interest rate paid by the underlying borrowers on the Company s portfolio of FFELP loans is set forth in the Higher Education Act of 1965, as amended (the Higher Education Act), and the Department s regulations thereunder and, generally, is based upon the date the loan was originated.

FFELP student loans generally earn interest at the higher of a floating rate based on the Special Allowance Payment or SAP formula set by the Department and the borrower rate, which is fixed over a period of time. The SAP formula is based on an applicable index plus a fixed spread that is dependent upon when the loan was originated, the loan s repayment status, and funding sources for the loan. The Company generally finances its student loan portfolio with variable-rate debt. In low and/or declining interest rate environments, when the fixed borrower rate is higher than the rate produced by the SAP formula, the Company s student loans earn at a fixed rate while the interest on the variable-rate debt continues to decline. In these interest rate environments, the Company earns additional spread income that it refers to as fixed rate floor income.

Depending on the type of the student loan and when it was originated, the borrower rate is either fixed to term or is reset to market rate each July 1. As a result, for loans where the borrower rate is fixed to term, the Company earns floor income for an extended period of time, which the Company refers to as fixed rate floor income, and for those loans where the borrower rate is reset annually on July 1, the Company earns floor income to the next reset date, which the Company refers to as variable-rate floor income. In accordance with new legislation enacted in 2006, lenders are required to rebate floor income and variable-rate floor income to the Department for all new FFELP loans originated on or after April 1, 2006.

Absent the use of derivative instruments, a rise in interest rates may reduce the amount of floor income received and this may have an impact on earnings due to interest margin compression caused by increasing financing costs, until such time as the federally insured loans earn interest at a variable rate in accordance with the special allowance payment formula. In higher interest rate environments, where the interest rate rises above the borrower rate and fixed-rate loans effectively become variable rate loans, the impact of the rate fluctuations is reduced.

Credit Risk

The Company s portfolio of student loan assets is subject to minimal credit risk, generally based upon the type of loan, date of origination, and quality of the underlying loan servicing. Substantially all of the Company s loan portfolio (99% at December 31, 2007) is guaranteed at some level by the Department. Depending upon when the loan was first disbursed, and subject to certain servicing requirements, the federal government currently guarantees 97% or 98% of the principal of and the interest on federally insured student loans, which limits the Company s loss exposure to 2% or 3% of the outstanding balance of the Company s federally insured portfolio (for older loans disbursed prior to 1993, the guaranty rate is 100%). The Company s portfolio of non-federally insured loans is subject to credit risk similar to other consumer loan assets.

Drivers of Growth in the Student Loan Industry

The increase in the Company s student loan portfolio has been driven in part by the growth in the overall student loan marketplace. The student loan marketplace growth is a result of rising higher education enrollment and the rising

annual cost of education, which is illustrated in the following charts.

As a result of estimated higher education enrollment and the increase in the cost of education, it is estimated that student loan originations will continue to grow similar to historical levels, which is illustrated in the following chart.

Student Loan Origination Volume

Competition

The Company faces competition from many lenders in the highly competitive student loan industry. Through its size, the Company has successfully leveraged economies of scale to gain market share and to compete by offering a full array of loan products and services. In addition, the Company has attempted to differentiate itself from other lenders through its customer service, comprehensive product offering, vertical integration, technology, and strong relationships with colleges and universities.

The Company views SLM Corporation, the parent company of Sallie Mae, as its largest competitor in loan origination and student loans held. Large national and regional banks are also strong competitors, although many are involved only in the origination of student loans. Additionally, in different geographic locations across the country, the Company faces strong competition from the regional tax-exempt student loan secondary markets. The Federal Direct Loan (FDL) Program, in which the Federal government lends money directly to students and families, has also historically reduced the origination volume available for FFEL Program participants.

The following tables summarize the top FFELP loan holders, originators, and consolidators as of September 30, 2005 (the latest date information was available from the Department):

Top FFELP Loan Holders			Top FFELP Stafford and PLUS Originators			Top FFELP Consolidators		
Rank	**Name**	**$ billions**	**Rank**	**Name**	**$ billions**	**Rank**	**Name**	**$ billions**
1	Sallie Mae	$ 102.3	1	JPMorgan Chase	$ 5.4	1	Sallie Mae	$ 19.3
2	Citigroup	24.6	2	Sallie Mae	5.0	2	Citigroup	4.8
3	**Nelnet**	15.8	3	**Nelnet**	4.1	3	**Nelnet**	4.1
4	Wachovia	10.7	4	Citigroup	3.3	4	JPMorgan Chase	2.2
5	Wells Fargo	9.6	5	Bank of America	2.9	5	SunTrust	1.9
6	Brazos Group	9.0	6	Wells Fargo	2.3	6	Northstar	1.7
7	College Loan Corp.	7.8	7	Wachovia	2.1	7	Goal Financial	1.7
8	JPMorgan Chase	7.5	8	College Loan Corp.	1.2	8	College Loan Corp.	1.6
9	PHEAA	6.8	9	U.S. Bancorp	1.1	9	Brazos Group	1.6
10	Goal Financial	5.3	10	Access Group	1.1	10	PHEAA	1.6

Source: Department of Education

Seasonality

The Company earns net interest income on its portfolio of student loans. Net interest income is primarily driven by the size and composition of the portfolio in addition to the cost of borrowing and the prevailing interest rate environment. Although originations of student loans are generally subject to seasonal trends which will generally correspond to the traditional academic school year, the size of the Company s portfolio, the periodic acquisition of student loans through its various channels, and the run-off of its portfolio limits the seasonality of net interest income. Unlike the lack of seasonality associated with interest income, the Company incurs significantly more asset generation costs prior to and at the beginning of the academic school year.

Student Loan and Guaranty Servicing

The Company s servicing division offers lenders across the United States a complete line of education loan services, including application processing, underwriting, fund disbursement, customer service, account maintenance, federal reporting and billing collections, payment processing, default aversion, claim filing, and recovery/collection services. These activities are performed internally for the Company s portfolio in addition to generating fee revenue when performed for third-party clients. The Company s student loan servicing division uses proprietary systems to manage the servicing process. These systems provide for automated compliance with most of the regulations adopted under Title IV of the Higher Education Act. The Company offers three primary product offerings as part of its loan and guaranty servicing functions. These product offerings and percentage of total Student Loan and Guaranty Servicing revenue provided by each during the year ended December 31, 2007 are as follows:

1. Origination and servicing of FFEL Program loans (43.3%);

2. Origination and servicing of non-federally insured student loans (8.0%); and

3. Servicing and support outsourcing for guaranty agencies (48.7%).

The following table summarizes the Company s loan servicing volumes for FFELP and private loans (dollars in millions):

	As of December 31, 2007		As of December 31, 2006	
	Dollar	**Percent**	**Dollar**	**Percent**
Company	$ 25,640	75.8%	$ 21,869	71.5%

Third Party	8,177	24.2	8,725	28.5
Total	$ 33,817	100.0%	$ 30,594	100.0%

The Company performs the origination and servicing activities for FFEL Program loans for itself as well as third-party clients. The Company believes service, reputation, and/or execution are factors considered by schools in developing their lender lists and customers selecting a servicer for their loans. Management believes it is important to provide exceptional customer service at a reasonable price in order to increase the Company s loan servicing and origination volume at schools with which the Company does business.

The Company s FFELP servicing customers include branding and forward flow lenders who sell loans to the Company as well as other national and regional banks and credit unions. The Company also has various state and non-profit secondary markets as third-party clients. The majority of the Company s external loan servicing activities are performed under life of loan contracts. Life of loan servicing essentially provides that as long as the loan exists, the Company shall be the sole servicer of that loan; however, the agreement may contain deconversion provisions where, for a fee, the lender may move the loan to another servicer.

The Company also provides origination and servicing activities for non-federally insured loans. Although similar in terms of activities and functions (i.e., disbursement processing, application processing, payment processing, statement distribution, and reporting) private loan servicing activities are not focused on compliance with provisions of the Higher Education Act and may be more customized to individual client requirements.

The Company also provides servicing support for guaranty agencies, which are the organizations that serve as the intermediary between the U.S. federal government and FFELP lenders, who are responsible for paying the claims made on defaulted loans. The Department has designated 35 guarantors that have been formed as either state agencies or non-profit corporations that provide FFELP guaranty services in one or more states. Approximately half of these guarantors contract for operational or technology services, or both. The services provided by the Company include operational, administrative, financial, and technology services to guarantors participating in the FFEL Program and state agencies that run financial aid grant and scholarship programs.

The Company s guaranty servicing is limited to a small group of customers, which include Tennessee Student Assistance Corporation (TSAC), College Assist (which is the Colorado state-designated guarantor of FFELP student loans formerly known as College Access Network), National Student Loan Program (NSLP), and the Higher Education Assistance Commission (HESC) of New York.

In October 2005, the Company entered into an agreement to amend an existing contract with College Assist. Under the agreement, the Company provides student loan servicing and guaranty operations and assumed the operational expenses and employment of certain College Assist employees. College Assist pays the Company a portion of the gross servicing and guaranty fees as consideration for the Company providing these services on behalf of College Assist. As a result of the passage of the College Cost Reduction Act, on October 2, 2007, the Department notified College Assist of its decision to formally terminate the Voluntary Flexible Agreement (VFA) between the Department and College Assist effective January 1, 2008. The termination of the VFA will decrease the Company s guaranty income by approximately $9 million annually.

The chart below shows the number of third-party servicing customers, by product, within the Company s Student Loan and Guaranty Servicing segment as of December 31, 2007:

Product Type	**Number of Third-party Servicing Customers**
FFELP	121
Private	19
Guaranty	4
Total	144

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Competition

There is a relatively large number of lenders and servicing organizations who participate in the FFEL Program. The chart below lists the top ten servicing organizations for FFEL loans as of December 31, 2006 (the latest date information was available from the Department).

Top FFELP Loan Servicers

Rank	Name	$ billions
1	Sallie Mae	$ 115.2
2	PHEAA	32.1
3	**Nelnet**	29.2
4	ACS	28.8
5	Great Lakes	26.8
6	Citigroup	19.5
7	JPMorgan Chase	10.6
8	Wells Fargo	10.2
9	Edfinancial	6.4
10	Express Loan Servicing	6.3

Source: Student Loan Servicing Alliance

The principal competitor for existing and prospective loan and guaranty servicing business is SLM Corporation. Sallie Mae is the largest FFELP provider of origination and servicing functions as well as one of the largest service providers of non-federally guaranteed loans. The Company believes the number of guaranty agencies contracting for technology services will increase as states continue expanding the scope of their financial aid grant programs and as a result of existing deficient or outdated systems. Since there is a finite universe of clients, competition for existing and new contracts is considered high. Agencies may choose to contract for part or all of their services, and the Company believes its products and services are competitive. To enhance its competitiveness, the Company continues to focus on service quality and technological enhancements.

Seasonality

The revenue earned by the Company s loan and guaranty servicing operations is primarily related to the outstanding portfolio size and composition and the amount of disbursement and origination activity. Revenue generated by recurring monthly activity is driven based on the outstanding portfolio size and composition and has little seasonality. However, a portion of the fees received by the Company under various servicing contracts do relate to services provided in relation to the origination and disbursement of student loans. Stafford and PLUS loans are disbursed as directed by the school and are usually divided into two or three equal disbursements released at specified times during the school year. The two periods of August through October and December through March account for the majority of the Company s total annual Stafford and PLUS loan disbursements. For private loan origination activities, disbursements peak from June through September and the Company will earn a large portion of its origination fee income during these months. There is also a seasonal fluctuation in guaranty processing levels due to the correlation of the delivery of loans to students attending schools with traditional academic calendars, with peak season occurring from approximately July to September.

Tuition Payment Processing and Campus Commerce

The Company s Tuition Payment Processing and Campus Commerce operating segment provides products and services to help institutions and education seeking families manage the payment of education costs during the pre-college and college stages of the education life cycle. The Company provides actively managed tuition payment solutions, online payment processing, detailed information reporting, and data integration services to K-12 and higher educational institutions, families, and students. In addition, the Company provides financial needs analysis for students applying for aid in private and parochial K-12 schools.

The K-12 market consists of nearly 30,000 private and faith-based educational institutions nationally. In the K-12 market the Company offers tuition management services as well as assistance with financial needs assessment, enrollment management, and donor management. The Company has actively managed tuition payment plans in place

at approximately 3,900 K-12 educational institutions.

Tuition management services include payment plan administration, ancillary billing, accounts receivable management, and record keeping. K-12 educational institutions contract with the Company to administer deferred payment plans where the institution allows the responsible party to make monthly payments over 6-12 months. The Company collects a fee from either the institution or the payer as an administration fee.

The Company offers two principal products to the higher education market actively managed tuition payment plans and campus commerce outsourcing. The Company has actively managed tuition payment plans in place at approximately 600 colleges and universities. Higher educational institutions contract with the Company to administer deferred payment plans where the institution allows the responsible party to make monthly payments on either a semester or annual basis. The Company collects a fee from either the institution or the payer as an administration fee.

The campus commerce solution, QuikPAY®, is sold as a subscription service to colleges and universities. QuikPAY processes payments through the appropriate channels in the banking or credit card networks to make deposits into the client s bank account. It can be further deployed to other departments around campus as requested (e.g., application fees, alumni giving, parking, events, etc.). There are approximately 200 college and university campuses using the QuikPAY system. The Company earns revenue for e-billing, hosting/maintenance, credit card convenience fees, and e-payment transaction fees.

Competition

This segment of the Company s business focuses on two separate markets private and faith-based K-12 schools and higher education colleges and universities.

The Company is the largest provider of tuition management services to the private and faith-based K-12 market in the United States. Competitors range from banking companies, tuition management providers, financial needs assessment providers, accounting firms, and a myriad of software companies. The Company s principal competitive advantages are (i) the service it provides to institutions, (ii) the information management tools provided with the Company s service, and (iii) the Company s ability to interface with the institution s clients.

In the higher education market, the Company targets business officers at colleges and universities. In this market, there are four primary competitors to the Company: SLM Corporation, TouchNet, CashNet, and solutions developed in-house by colleges and universities. The Company believes its clients select products primarily on technological superiority and feature functionality, but price and service also impact the selection process.

Seasonality

This segment of the Company s business is subject to seasonal fluctuations which correspond, or are related to, the traditional school year. Tuition management revenue is recognized over the course of the academic term, but the peak operational activities take place in summer and early fall. Revenue associated with providing QuikPAY subscription services is recognized over the service period with the highest revenue months being July through September and December and January. The Company s operating expenses do not follow the seasonality of the revenues. This is primarily due to fixed year-round personnel costs and seasonal marketing costs.

Enrollment Services and List Management

The Company s Enrollment Services and List Management operating segment provides education planning resources to help education seeking families and the institutions that serve them during primarily the pre-college phase of the education life cycle. The Company provides an integrated suite of direct marketing products and services to help schools and businesses reach the middle school, high school, college bound high school, college, and young adult market places. In addition, the Company offers enrollment products and services that are focused on helping (i) students plan and prepare for life after high school and (ii) colleges recruit and retain students. The Company s enrollment products and services include the following:

- Test preparation study guides and online courses
- Admissions consulting
- Licensing of scholarship data
- Essay and resume editing services
- Financial aid products
- Student recognition publications
- Vendor lead management services
- Pay per click management

- Email marketing
- Admissions lead generation
- List marketing services
- Call center services

As with all of the Company s products and services, the Company s focus is on the education seeking family both college bound and in college and the Company delivers products and services in this segment through four primary customer channels: higher education, corporate and government, K-12, and direct-to-consumer/customer service. Many of the Company s products in this segment are distributed online; however, products such as study guides and books are distributed as printed materials. In addition, essay and resume editing services are delivered primarily by contract editors. In addition to its other clients, the Company provides on-line test preparation services and products to the United States Army, Navy, and Air Force under contracts with one year terms.

Competition

In this segment, the primary areas in which the Company competes are: lead generation and management, test preparation study guides and online courses, call center services, and student recognition publications.

There are several large competitors in the areas of lead generation, test preparation, and student recognition, but the Company does not believe any one competitor has a dominant position in all of the product and service areas offered by the Company. Additionally, there are few competitors in the college planning resource center arena. The Company has seen increased competition in the area of call center operations, including outsourced admissions, as other companies have recognized the potential in this market.

The Company competes through various methods, including price, brand awareness, depth of product and service selection, and customer service. The Company has attempted to be a one stop shop for the education seeking family looking for career assessment, test preparation, and college and financial aid information. The Company also offers its institutional clients a breadth of services unrivaled in the education industry.

Seasonality

As with the Company s other business segments, portions of the Company s Enrollment Services and List Management segment are subject to seasonal fluctuations based upon the traditional academic school year, with peaks in January and August. Additionally, the Company recognizes revenue from the sale of lists and books when these products are distributed to the customer. Revenue from the sale of lists is dependent on demand for the lists and varies from period to period. Also, the Company s student recognition activities are related to the mailing of two primary publications. These publications have historically been mailed in the December to January and June to July time periods and production costs are recorded as incurred, which are three to nine months prior to book shipment.

Software and Technical Services

The Company uses internally developed student loan servicing software and also licenses this software to third-party student loan holders and servicers. The Company also provides information technology products and services, with core areas of business in educational loan software solutions, business intelligence, technical consulting services, and Enterprise Content Management (ECM) solutions.

The Company licenses, maintains, and supports the following systems and software:

- HELMS/HELM-Net, STAR, and SLSS, systems which are used in the full servicing of FFELP, private, consolidation, and Canadian loans;
- Mariner, which is used for consolidation loan origination;
- InfoCentre, which is a data warehouse and analysis tool for educational loans; and
- Uconnect, a tool to facilitate information sharing between different applications.

The Company s clients within the education loan marketplace include large and small financial institutions, secondary markets, loan originators, and loan servicers. The Company s software and documentation is distributed electronically via its web site and, if necessary, on CD-ROM. Primary support for clients is done remotely from the Company s offices, but the Company does provide on-site support and training when required.

The Company also supplies and supports ECM solutions. The Company s Technical Consulting Services group provides consulting services, primarily Microsoft related, both within and outside of the educational loan marketplace. The Company s Microsoft Enterprise Consulting practice also provides products and solutions for the Microsoft platform. Examples of these products are Uconnect® (an application integration product), Dynamic Payables® (an Accounts Payable automation product), and Dynamic Filer® (a low-cost file, scan, and search solution).

The Company is a reseller of IBM hardware and software, Hummingbird (Open Text), Kofax, and Ultimus document imaging technology, and the Company s products require third party software from Microsoft. All of these third party products and resources are generally available and in some cases the Company relies on its clients obtaining these products directly from the vendors rather than through the Company. The Company is a Microsoft Gold Certified partner and a Microsoft Business Solutions partner.

A significant portion of the software and technology services business is dependent on the existence of and participants in the FFEL Program. If the federal government were to terminate the FFEL Program or the number of entities participating in the program were to decrease, the Company s software and technical services segment would be impacted. The recent legislation and capital market disruptions have had an impact on the profitability of FFEL Program participants. As a result, the number of entities participating in the FFEL Program has and may continue to be adversely impacted. This impact could have an effect on the Company s software and technical services segment.

Competition

The Company is one of the leaders in the education loan software processing industry. Approximately 60% of the top 100 lenders in the FFEL Program utilize the Company s software either directly or indirectly. Management believes the Company s competitors in this segment are much smaller than the Company and do not have the depth of knowledge or products offered by the Company.

The Company s primary method of competition in this segment is based upon its depth of knowledge, experience, and product offerings in the education loan industry. The Company believes it has a competitive edge in offering proven solutions, since the Company s competition consists primarily of consulting firms that offer services and not products. The Company also faces competition from loan servicers; however, loan servicing companies are outsourcing solutions which do not allow a client to differentiate themselves in the market.

Seasonality

Software demonstrations and decisions to purchase software generally take place during year-end budget season, but management believes implementation timeframes vary enough to provide a consistent revenue stream throughout the year. In addition, software support is a year long ongoing process and not generally affected by seasonality.

Intellectual Property

The Company owns numerous trademarks and service marks (Marks) to identify its various products and services. As of December 31, 2007, the Company had approximately 18 pending and 83 registered Marks. The Company actively asserts its rights to these Marks when it believes harmful infringement may exist. The Company believes its Marks have developed and continue to develop strong brand-name recognition in the industry and the consumer marketplace. Each of the Marks has, upon registration, an indefinite duration so long as the Company continues to use the Mark on or in connection with such goods or services as the Mark identifies. In order to protect the indefinite duration, the Company makes filings to continue registration of the Marks. The Company owns four patent applications that have been published, but have not yet been issued and has also actively asserted its rights thereunder in situations where the Company believes its claims may be infringed upon. The Company owns many copyright-protected works, including its various computer system codes and displays, Web sites, publications, and marketing collateral. The Company also has trade secret rights to many of its processes and strategies and its software product designs. The Company s software products are protected by both registered and common law copyrights, as well as strict confidentiality and ownership provisions placed in license agreements which restrict the ability to copy, distribute, or improperly disclose the software products. The Company also has adopted internal procedures designed to protect the Company s intellectual property.

The Company seeks federal and/or state protection of intellectual property when deemed appropriate, including patent, trademark/service mark, and copyright. The decision whether to seek such protection may depend on the perceived value of the intellectual property, the likelihood of securing protection, the cost of securing and maintaining that protection, and the potential for infringement. The Company s employees are trained in the fundamentals of intellectual property, intellectual property protection, and infringement issues. The Company s employees are also required to sign agreements requiring, among other things, confidentiality of trade secrets, assignment of inventions, and non-solicitation of other employees post-termination. Consultants, suppliers, and other business partners are also required to sign nondisclosure agreements to protect the Company s proprietary rights.

Employees

As of December 31, 2007, the Company had approximately 2,800 employees. Approximately 1,450 of these employees held professional and management positions while approximately 1,350 were in support and operational positions. None of the Company s employees are covered by collective bargaining agreements. The Company is not involved in any material disputes with any of its employees, and the Company believes that relations with its employees are good.

Available Information

Copies of the Company s annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to such reports are available on the Company s Web site free of charge as soon as reasonably practicable after such reports are filed with or furnished to the United States Securities and Exchange Commission (the SEC). Investors and other interested parties can access these reports and the Company s proxy statements at

http://www.nelnet.com. The SEC maintains an Internet site (http://www.sec.gov) that contains periodic and other reports such as annual, quarterly, and current reports on Forms 10-K, 10-Q, and 8-K, respectively, as well as proxy and information statements regarding the Company and other companies that file electronically with the SEC.

The Company has adopted a Code of Conduct that applies to directors, officers, and employees, including the Company s principal executive officer and its principal financial and accounting officer, and has posted such Code of Conduct on its Web site. Amendments to and waivers granted with respect to the Company s Code of Conduct relating to its executive officers and directors which are required to be disclosed pursuant to applicable securities laws and stock exchange rules and regulations will also be posted on its Web site. The Company s Corporate Governance Guidelines, Audit Committee Charter, Compensation Committee Charter, and Nominating and Corporate Governance Committee Charter are also posted on its Web site and, along with its Code of Conduct, are available in print without charge to any shareholder who requests them. Please direct all requests as follows:

Nelnet, Inc.
121 South 13th Street, Suite 201
Lincoln, Nebraska 68508
Attention: Secretary

Information on the Company s Web site is not incorporated by reference into this Report and should not be considered part of this Report.

ITEM 1A. RISK FACTORS

Asset Generation and Management and Student Loan and Guaranty Servicing Operating Segments

The following risk factors relate to the Company s operating segments most impacted by the provisions of the FFEL Program which include:

- Asset Generation and Management; and
- Student Loan and Guaranty Servicing.

Additional risk factors affecting these segments are set forth under the Liquidity and Capital Resources caption below.

Changes in legislation and regulations could have a negative impact upon the Company s business and may affect its profitability.

Funds for payment of interest subsidy payments, special allowance payments, and other payments under the FFEL Program are subject to annual budgetary appropriations by Congress. Federal budget legislation has in the past contained provisions that restricted payments made under the FFEL Program to achieve reductions in federal spending. Future federal budget legislation may adversely affect expenditures by the Department, and the financial condition of the guaranty agencies.

Furthermore, Congressional amendments to the Higher Education Act or other relevant federal laws, and rules and regulations promulgated by the Secretary of Education, may adversely impact holders of FFELP loans. For example, changes might be made to the rate of interest or special allowance payments paid on FFELP loans, to the level of insurance provided by guaranty agencies, or to the servicing requirements for FFELP loans. Such changes could have a material adverse effect on the Company and its results of operations.

On September 27, 2007, the President signed into law the College Cost Reduction Act that contained provisions with significant implications for participants in the FFEL Program. In addition to the College Cost Reduction Act, other bills have been introduced in Congress which contain provisions which could significantly impact participants in the FFEL Program. Among other things, the proposals include:

- requiring disclosures relating to placement on preferred lender lists ;
- banning various arrangements between lenders and schools;
- banning lenders from offering certain gifts to school employees;
- eliminating the school-as-lender program;
- encouraging borrowers to maximize their borrowing through government loan programs, rather than private loan programs with higher interest rates;

encouraging schools to participate in the Federal Direct Loan Program through increased federal grant funds; and

increasing the lender origination fee for consolidation loans.

As of the date of this Report, none of these other bills have been enacted into law. The impact of the proposed legislation is difficult to predict; however, increased fees for FFEL Program lenders and decreased loan volume as a result of increased participation in the Federal Direct Loan Program could have a negative impact on the Company s revenues.

The Higher Education Reconciliation Act of 2005 (HERA) was enacted into law on February 8, 2006, and effectively reauthorized the Title IV provisions of the FFEL Program through 2012. HERA did not reauthorize the entire Higher Education Act, which is set to expire on March 31, 2008 (as a result of the Third Higher Education Extension Act of 2007). Therefore, further action will be required by Congress to reauthorize the remaining titles of the Higher Education Act. Reauthorization could result in the Company s revenues being negatively impacted.

The Company cannot predict the outcome of this or any other legislation impacting the FFEL Program and recognizes that a level of political and legislative risk always exists within the industry. This could include changes in legislation further impacting lender margins, fees paid to the Department, new policies affecting the competition between the Federal Direct Loan and FFEL Programs, additional lender risk sharing, or the elimination of the FFEL Program in its entirety.

In addition to changes to the FFEL Program and the Higher Education Act, various state laws targeted at student lending companies have been proposed or are in the process of being enacted. Many of these laws propose or require changes to lending and business practices of student lenders. These laws could have a negative impact on the Company s operations by requiring changes to the Company s business practices and operations.

The Company may be subject to penalties and sanctions if it fails to comply with governmental regulations or guaranty agency rules.

The Company s principal business is comprised of originating, acquiring, holding, and servicing student loans made and guaranteed pursuant to the FFEL Program, which was created by the Higher Education Act. The Higher Education Act governs many aspects of the Company s operations. The Company is also subject to rules of the agencies that act as guarantors of the student loans, known as guaranty agencies. In addition, the Company is subject to certain federal and state banking laws, regulations, and examinations, as well as federal and state consumer protection laws and regulations, including, without limitation, laws and regulations governing borrower privacy protection, information security, restrictions on access to student information, and specifically with respect to the Company s non-federally insured loan portfolio, certain state usury laws and related regulations and the Federal Truth in Lending Act. All or most of these laws and regulations impose substantial requirements upon lenders and servicers involved in consumer finance. Failure to comply with these laws and regulations could result in liability to the Company, the imposition of civil penalties, and potential class action suits.

The Company s failure to comply with regulatory regimes described above may arise from:

- breaches of the Company s internal control systems, such as a failure to adjust manual or automated servicing functions following a change in regulatory requirements;
- privacy issues;
- technological defects, such as a malfunction in or destruction of the Company s computer systems; or
- fraud by the Company s employees or other persons in activities such as borrower payment processing.

Such failure to comply, irrespective of the reason, could subject the Company to loss of the federal guaranty on federally insured loans, costs of curing servicing deficiencies or remedial servicing, suspension or termination of the Company s right to participate in the FFEL Program or to participate as a servicer, negative publicity, and potential legal claims or actions brought by the Company s servicing customers and borrowers.

The Company has the ability to cure servicing deficiencies and the Company s historical losses in this area have been minimal. However, the Company s loan servicing and guaranty servicing activities are highly dependent on its information systems, and while the Company has well-developed and tested business recovery systems, the Company faces the risk of business disruption should there be extended failures of its systems. The Company also manages operational risk through its risk management and internal control processes covering its product and service offerings.

These internal control processes are documented and tested regularly.

Competition created by the Federal Direct Loan Program and from other lenders and servicers and the impact of recent legislation may adversely impact the volume of future originations and the Company s servicing business.

The Company s student loan originations generally are limited to students attending eligible educational institutions in the United States. Volume of originations are greater at some schools than others, and the Company s ability to remain an active lender at a particular school with concentrated volumes is subject to a variety of risks, including the fact that each school has the option to remove the Company from its preferred lender list or to add other lenders to its preferred lender list, and the risk that a school may enter the Federal Direct Loan Program. Additionally, new regulations adopted by the Department relating to preferred lender lists may have the effect of reducing the Company s loan volume.

Under the Federal Direct Loan Program, the Department makes loans directly to student borrowers through the educational institutions they attend. The volume of student loans made under the FFEL Program and available for the Company to originate or acquire may be reduced to the extent loans are made to students under the Federal Direct Loan Program. In addition, if the Federal Direct Loan Program expands, to the extent the volume of loans serviced by the Company is reduced, the Company may experience reduced economies of scale, which could adversely affect earnings. Loan volume reductions could further reduce amounts received by the guaranty agencies available to pay claims on defaulted student loans.

In the FFEL Program market, the Company faces significant competition from SLM Corporation, the parent company of Sallie Mae and other existing lenders and servicers. As the Company seeks to further expand its business, the Company will face numerous other competitors, many of which will be well established in the markets the Company seeks to penetrate. Some of the Company s competitors are much larger than the Company, have better brand recognition, and have greater financial and other resources. In addition, several competitors have large market capitalizations or cash reserves and are better positioned to acquire companies or portfolios in order to gain market share. Consequently, such competitors may have more flexibility to address the risks inherent in the student loan business. Finally, some of the Company s competitors are tax-exempt organizations that do not pay federal or state income taxes and which usually have the ability to issue tax-exempt securities, which typically carry a lower cost of funds than the Company s securities. These factors could give the Company s competitors a strategic advantage.

In 2005, the Company entered into an agreement to amend an existing contract with College Assist. Under the agreement, the Company provides student loan servicing and guaranty operations. College Assist pays the Company a portion of the gross servicing and guaranty fees as consideration for the Company providing these services on behalf of College Assist. The Company is a partner in a loan servicing consortium with College Assist in which lenders agree to use the Company as a FFELP student loan servicer and College Assist as the Guarantor for all loans made to Colorado schools. One of the Company s customers has recently decided to stop participating in the consortium. Other lenders have indicated a willingness to continue participation, but only for time commitments of a month to month or 12 month duration. In the past, these commitments were made for five year terms. Reductions in participation of consortium lenders would have an adverse impact to the Company s operating results as this would impact the Company s loan servicing revenue and its guaranty servicing revenue (as the Company receives a portion of the gross guaranty fees from College Assist for providing such services).

Due to the impact of the recent legislative changes and capital market disruptions, FFELP lenders are re-evaluating the markets in which they will originate loans. Some are looking at the cohort default rates of the schools with which they do business. Several lenders have decided not to purchase loans that have been rehabilitated out of default as established by federal regulation (Rehabilitated Loans). Rehabilitated Loans collections comprise approximately 20 percent of the Company s guaranty servicing revenue. The Company s guaranty servicing revenue could be negatively impacted as a result of the decrease in the number of lenders using this service.

A decrease in third-party servicing volume could have a negative effect on the Company s earnings.

To the extent that third-party servicing clients reduce the volume of student loans that the Company processes on their behalf, the Company s income would be reduced, and, to the extent the related costs could not be reduced correspondingly, net income could be adversely affected. Such volume reductions occur for a variety of reasons, including if third-party servicing clients commence or increase internal servicing activities, shift volume to another service provider, perhaps because of competition or service levels, or exit the FFEL Program completely, for instance as a result of reduced interest rate margins.

The Company s inability or choice not to maintain its relationships with significant branding and forward flow partners and/or customers could have an adverse impact on its business.

The Company s inability or choice not to maintain strong relationships with significant schools, branding and forward flow partners, servicing customers, and guaranty agencies could result in loss of:

- loan origination volume with borrowers attending certain schools;
- loan origination volume generated by some of the Company s branding and forward flow partners; and
- loan and guaranty servicing volume generated by some of the Company s loan servicing and guaranty agency customers.

The Company acquires student loans through forward flow commitments and branding partner arrangements with other student loan lenders, but each of these commitments has a finite term. The passage of the College Cost Reduction Act has resulted in a reduction in the yields on student loans and, accordingly, a reduction in the amount of the premium the Company will be able to pay lenders under its forward flow commitments and branding partner arrangements. As a result, the Company has been working with its forward flow and branding partner clients to renegotiate the premiums payable under its agreements. There can be no assurance that the Company will be successful in renegotiating the premiums under these agreements and, accordingly, the Company may be required to terminate commitments which are not economically reasonable. In addition, the current capital market disruption may render origination or acquisition of student loans through these channels uneconomical. As a result, the Company may experience a decrease in its forward flow and branding partner loan volume. In addition, upon expiration of these agreements, there can be no assurance that these lenders will renew or extend their existing forward flow commitments or branding partner relationships on terms that are favorable to the Company, if at all, following their expiration. Loss of a strong branding or forward flow partner or relationships with schools from which a significant volume of student loans is directly or indirectly acquired, could result in an adverse effect on the Company s business.

The Company could be sanctioned if it conducts activities which are considered prohibited inducements under the Higher Education Act.

The Higher Education Act generally prohibits a lender from providing certain inducements to educational institutions or individuals in order to secure applicants for FFELP loans. The Company has structured its relationships and product offerings in a manner intended to comply with the Higher Education Act and the available communications and guidance from the Department.

If the Department were to change its position on any of these matters, the Company may have to change the way it markets products and services and a new marketing strategy may not be as effective. If the Company fails to respond to the Department s change in position, the Department could potentially impose sanctions upon the Company that could negatively impact the Company s business.

Legislation has been introduced in Congress modifying the prohibited inducement provisions of the Higher Education Act, and the Department of Education published new regulations on November 1, 2007 relating to prohibited inducements that go into effect on July 1, 2008. The Department has requested that companies begin complying with the new regulations immediately even though they are not yet in effect. As a result, the Company has modified, or intends to modify, its business practices to comply with the prohibited inducement provisions as ultimately enacted or adopted, including the termination of the Company s affinity relationships and referral programs. Termination of these programs may result in decreased loan volume for the Company. In addition, changes to the Company s business practices in order to comply with the new prohibited inducement provisions may negatively impact the Company s business.

Future losses due to defaults on loans held by the Company present credit risk which could adversely affect the Company s earnings.

The majority of the Company s student loan portfolio is comprised of federally insured loans. These loans currently benefit from a federal guaranty of their principal balance and accrued interest. The allowance for the federally insured loan portfolio is based on periodic evaluations of the Company s loan portfolios considering past experience, trends in student loan claims rejected for payment by guarantors, changes to federal student loan programs, current economic conditions, and other relevant factors. The federal government currently guarantees 97% of the principal of and the interest on federally insured student loans disbursed on and after July 1, 2006 (and 98% for those loans disbursed prior to July 1, 2006), which limits the Company s loss exposure on the outstanding balance of the Company s federally insured portfolio. Also, in accordance with the Student Loan Reform Act of 1993, student loans disbursed prior to October 1, 1993 are fully insured.

The Company s non-federally insured loans are unsecured and are not guaranteed or reinsured under the FFEL Program or any other federal student loan program and are not insured by any private insurance program. Accordingly, the Company bears the full risk of loss on these loans if the borrower and co-borrower, if applicable, default. In determining the adequacy of the allowance for loan losses on the non-federally insured loans, the Company considers several factors including: loans in repayment versus those in a nonpaying status, months in repayment,

delinquency status, type of program, and trends in defaults in the portfolio based on Company and industry data. The Company places a non-federally insured loan on nonaccrual status and charges off the loan when the collection of principal and interest is 120 days past due.

The evaluation of the allowance for loan losses is inherently subjective, as it requires material estimates that may be subject to significant changes. The provision for loan losses reflects the activity for the applicable period and provides an allowance at a level that the Company s management believes is adequate to cover probable losses inherent in the loan portfolio. However, future defaults can be higher than anticipated due to a variety of factors such as downturns in the economy, regulatory or operational changes in debt management operations effectiveness, and other unforeseen future trends. If actual performance is worse than estimated, this could materially affect the Company s estimate of the allowance for loan losses and the related provision for loan losses in the Company s statement of operations.

The Company must satisfy certain requirements necessary to maintain the federal guarantees of its federally insured loans, and the Company may incur penalties or lose its guarantees if it fails to meet these requirements.

The Company must meet various requirements in order to maintain the federal guaranty on its federally insured loans. These requirements establish servicing requirements and procedural guidelines and specify school and borrower eligibility criteria. The federal guaranty on the Company s federally insured loans is conditioned on compliance with origination, servicing, and collection standards set by the Department and guaranty agencies. Federally insured loans that are not originated, disbursed, or serviced in accordance with the Department s regulations risk partial or complete loss of the guaranty thereof. If the Company experiences a high rate of servicing deficiencies (including any deficiencies resulting from the conversion of loans from one servicing platform to another) or costs associated with remedial servicing, and if the Company is unsuccessful in curing such deficiencies, the eventual losses on the loans that are not cured could be material.

A guaranty agency may reject a loan for claim payment as a result of a violation of the FFEL Program due diligence servicing requirements. In addition, a guaranty agency may reject claims under other circumstances, including, for example, if a claim is not timely filed or adequate documentation is not maintained. Once a loan ceases to be guaranteed, it is ineligible for federal interest subsidies and special allowance payments. If a loan is rejected for claim payment by a guaranty agency, the Company continues to pursue the borrower for payment and/or institutes a process to reinstate the guaranty.

Rejections of claims as to portions of interest may be made by guaranty agencies for certain violations of the due diligence collection and servicing requirements, even though the remainder of a claim may be paid. Examples of errors that cause claim rejections include isolated missed collection calls or failures to send collection letters as required.

The Department has implemented school eligibility requirements, which include default rate limits. In order to maintain eligibility in the FFEL Program, schools must maintain default rates below these specified limits, and both guaranty agencies and lenders are required to ensure that loans are made only to or on behalf of students attending schools that do not exceed the default rate limits.

If the Company fails to comply with any of the above requirements, it could incur penalties or lose the federal guaranty on some or all of its federally insured loans. If the Company s actual loss on denied guarantees were to increase substantially in future periods the impact could be material to the Company s operations.

The Company could experience cash flow problems if a guaranty agency defaults on its guaranty obligation.

A deterioration in the financial status of a guaranty agency and its ability to honor guaranty claims on defaulted student loans could result in a failure of that guaranty agency to make its guaranty payments in a timely manner, if at all. The financial condition of a guaranty agency can be adversely affected if it submits a large number of reimbursement claims to the Department, which results in a reduction of the amount of reimbursement that the Department is obligated to pay the guaranty agency. The Department may also require a guaranty agency to return its reserve funds to the Department upon a finding that the reserves are unnecessary for the guaranty agency to pay its FFEL Program expenses or to serve the best interests of the FFEL Program.

If the Department has determined that a guaranty agency is unable to meet its guaranty obligations, the loan holder may submit claims directly to the Department, and the Department is required to pay the full guaranty claim. However, the Department s obligation to pay guaranty claims directly in this fashion is contingent upon the Department making the determination that a guaranty agency is unable to meet its guaranty obligations. The Department may not ever make this determination with respect to a guaranty agency and, even if the Department does make this determination, payment of the guaranty claims may not be made in a timely manner, which could result in the Company experiencing cash shortfalls.

Management periodically reviews the financial condition of its guarantors and does not believe the level of concentration creates an unusual or unanticipated credit risk. In addition, management believes that based on amendments to the Higher Education Act, the security for and payment of any of the education lending subsidiaries obligations would not be materially adversely affected as a result of legislative action or other failure to perform on its obligations on the part of any guaranty agency. The Company, however, cannot provide absolute assurances to that effect.

Higher rates of prepayments of student loans could reduce the Company s profits.

Pursuant to the Higher Education Act, borrowers may prepay loans made under the FFEL Program at any time without penalty. Prepayments may result from consolidating student loans, which tends to occur more frequently in low interest rate environments, from borrower defaults, which will result in the receipt of a guaranty payment, and from voluntary full or partial prepayments, among other things. High prepayment rates will have the most impact on the Company s asset-backed securitization transactions, since these securities are priced according to their expected average lives. The rate of prepayments of student loans may be influenced by a variety of economic, social, and other factors affecting borrowers, including interest rates and the availability of alternative financing.

The Company s profits could be adversely affected by higher prepayments, which would reduce the amount of interest the Company received and expose the Company to reinvestment risk.

Consolidation loan activity by competitors present a risk to the Company s loan portfolio and profitability.

The Company s portfolio of federally insured loans is subject to refinancing through the use of consolidation loans, which are expressly permitted by the Higher Education Act. In January 2008, the Company suspended consolidation student loan originations as a result of legislative actions and capital market disruptions which impacted the profitability of consolidation loans. As a result, the Company may lose student loans in its portfolio that are consolidated away by competing lenders. Increased consolidations of student loans by the Company s competitors may result in a negative return on loans, when considering the origination costs or acquisition premiums paid with respect to these loans. Additionally, consolidation of loans away by competing lenders can result in a decrease of the Company s servicing portfolio, thereby decreasing fee-based servicing income.

The Company faces liquidity risks associated with financing student loan originations and acquisitions.

The Company s primary funding needs are those required to finance its student loan portfolio and satisfy its cash requirements for new student loan originations and acquisitions. The Company relies upon secured financing vehicles as its most significant source of funding for student loans. Current conditions in the debt markets have resulted in reduced liquidity and increased credit risk premiums for most market participants. These conditions can increase the cost and reduce the availability of debt in the capital markets. As a result, a prolonged period of market illiquidity may affect the Company s loan acquisition and origination volumes and could have an adverse impact on the Company s future earnings and financial condition. See Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources.

Elimination of the FFEL Program would have a significant negative effect on the Company s earnings and operations.

In connection with the 2008 presidential election, certain candidates have proposed the elimination of the FFEL Program. Elimination of the FFEL Program would significantly impact the Company s operations and profitability by, among other things, reducing the Company s interest revenues as a result of the inability to add new FFELP loans to the Company s portfolio and reducing third-party servicing fees as a result of reduced FFELP loan servicing and origination volume from the Company s third-party servicing customers. The Company cannot predict whether any such proposals will ultimately be enacted.

Operating Segments Fee Based Businesses

The following risk factors relate to the Company s operating segments not directly related to the FFEL Program. These operating segments include:

- Tuition Payment Processing and Campus Commerce;
- Enrollment Services and List Management; and
- Software and Technical Services.

If regulatory authorities prohibit student lenders from engaging in non-lending activities, the Company may no longer be allowed to offer certain products and services or may be required to exit the lending business, which could negatively impact the Company s revenues.

As a diversified education services company, the Company offers many products and services which are not related to the FFEL Program. Recently, various regulatory authorities have started to examine the relationships between student lending companies and their customers. In the event state and/or federal authorities adopt restrictions on the products and services which may be offered by student lending companies, the Company may have to cease offering certain products and services or may be limited to marketing those products and services to customers which do not participate in the FFEL Program. Any restrictions on the Company s ability to market or sell products or services may have a negative impact on the Company s revenues.

Changes in legislation and regulations could have a negative impact upon the Company s business and may affect its profitability.

Changes to privacy and direct mail legislation could negatively impact the Company, in particular the Company s list management and lead generation activities. Changes in such legislation could restrict the Company s ability to collect information for its list management and lead generation activities and its ability to use the information it collects. The Company has a privacy policy that covers how certain subsidiaries collect, protect, and use personal information. Depending on the department, product, and/or other factors, certain entities may have more restrictive information handling practices.

The Company s Software and Technical Services operating segment provides information technology products and services, with core areas of business in student loan software solutions for schools, lenders, and guarantors. Many of the Company s customers receiving these services have been negatively impacted as a result of the passage of the College Cost Reduction Act in September 2007 and the recent disruption in the capital markets. This impact could decrease the demand for the Company s products and services and affect the Company s revenue and profit margins.

The Company s results are affected by competitive conditions and customer preferences.

Demand for the Company s products and services, which impact revenue and profit margins, is affected by (i) the development and timing of the introduction of competitive products and services; (ii) the Company s response to pricing to stay competitive; and (iii) the change in customers preferences for the Company s products and services, including the success of products and services offered by competitors. In addition, K-12 and post-secondary enrollment numbers impact the demand for the Company s products and services. Education enrollment numbers are impacted by general population trends and the general state of the economy. Revenue in the Company s fee-based businesses is recurring only to the extent that customer relationships are sustained. Reduction in volume or loss of a customer relationship could have a negative impact on the Company s results of operations.

Liquidity and Capital Resources

The Company faces liquidity risks associated with financing student loan originations and acquisitions.

The Company s primary funding needs are those required to finance its student loan portfolio and satisfy its cash requirements for new student loan originations and acquisitions. In general, the amount, type, and cost of the Company s funding, including securitization and unsecured financing from the capital markets and borrowings from financial institutions, have a direct impact on the Company s operating expenses and financial results and can limit the Company s ability to grow its student loan assets. The Company relies upon secured financing vehicles as its most significant source of funding for student loans. The Company s primary secured financing vehicles are loan warehouse facilities and asset-backed securitizations.

As discussed in more detail below with respect to the Company s loan warehouse facilities and asset-backed securitizations, the recent unprecedented disruptions in the credit markets have had and may continue to have an adverse impact on the cost and availability of financing for the Company s student loan portfolios, and as a result have had and may continue to have an adverse impact on the Company s results of operations and financial condition. Such credit market conditions may continue or worsen in the future.

Student loan warehousing allows the Company to buy and manage student loans prior to transferring them into more permanent financing arrangements. A portion of the Company s operating and warehouse financings are provided by third parties, over which it has no control. Current conditions in the debt markets have resulted in reduced liquidity and increased credit risk premiums for most market participants. These conditions can increase the cost and reduce the availability of debt in the capital markets. If warehouse financing sources are unavailable, the Company may be unable to meet its financial commitments to schools, branding partners, or forward flow lenders when due unless the Company is able to find alternative funding mechanisms. The Company attempts to mitigate the impact of debt market disruptions by obtaining adequate committed and uncommitted facilities from a variety of reliable sources. There can be no assurance, however, that the Company will be successful in these efforts, that such facilities will be adequate, or that the cost of debt will allow the Company to operate at profitable levels.

The Company currently relies on two conduit warehouse loan financing vehicles to support its funding needs on a short-term basis a multi-seller bank provided conduit with $8.9 billion of committed funding for FFELP student loans and a private loan warehouse with $250.0 million in authorized financing for non-federally insured student loans. The Company s private loan warehouse terminates in January 2009. The facility for FFELP loans, which terminates in May 2010, is supported by 364-day liquidity which is up for renewal in May 2008. In order to continue funding new originations, the Company s liquidity must be renewed. If not renewed, the Company s ability to fund new originations in the facility will be at risk. If the Company is able to renew its liquidity on this line, it will come at an increased cost compared to historical periods. If the Company is not able to renew the liquidity on this facility or renew the facility at a price acceptable to the Company, it may become a term facility with a maturity date of May 2010. The Company s cost of financing on the term facility would be slightly higher than its current cost of funds as a warehouse facility. If the Company s warehouse facility becomes a term facility, the Company will no longer be able to fund new FFELP

student loan originations or acquisitions.

The terms and conditions of the Company s warehouse facility for FFELP loans provide for advance rates related to financed loans subject to a valuation formula based on current market conditions. Dislocation in the credit markets including disruptions in the current capital markets can and will cause short-term volatility in the loan valuation formulas and could reduce advance rates requiring a portion of the financed loans to be funded using equity or alternative sources. Severe volatility and dislocation in the credit markets, although temporary, could cause the valuation assigned to its student loan portfolio financed by the applicable line to be less than par. Should a significant change in the valuation of subject loans require an equity contribution or reduction in advance rates greater than what the Company can or is willing to inject, the warehouse line could be subject to termination. While the Company does not believe the loan valuation formula is reflective of the fair market value of its loans, it is subject to compliance with provisions of the warehouse documents. The Company s private loan warehouse facility has similar credit enhancement provisions.

The Company uses its warehouse facilities to pool student loans in order to maximize loan portfolio characteristics for efficient financing and to properly time market conditions for movement of the loans into an asset-backed securitization. The Company has historically relied upon, and expects to continue to rely upon, asset-backed securitizations as its most significant source of funding for student loans on a long-term basis. If this market continues to experience difficulties or worsen, the Company may be unable to securitize its student loans or to do so on favorable terms, including pricing, or may do so at an increased price as compared to its current or future warehouse cost.

A number of factors could make such securitization more difficult, more expensive, or unavailable on any terms, including, but not limited to, financial results and losses, changes within the Company s organization, specific events that have an adverse impact on the Company s reputation, changes in the activities of the Company s business partners, disruptions in the capital markets, specific events that have an adverse impact on the financial services industry, counter-party availability, changes affecting the Company s assets, the Company s corporate and regulatory structure, interest rate fluctuations, ratings agencies actions, general economic conditions, and the legal, regulatory, accounting, and tax environments governing the Company s funding transactions. In addition, the Company s ability to raise funds is strongly affected by the general state of the United States and world economies, and may become increasingly difficult due to economic and other factors. If the Company were unable to continue to securitize student loans on favorable terms, it could use alternative funding sources to meet liquidity needs. If the Company is unable to find cost-effective and stable funding alternatives, its funding capabilities and liquidity would be negatively impacted and its cost of funds could increase, adversely affecting the Company s results of operations. In addition, the Company s ability to originate and acquire student loans would be limited or could be eliminated.

The Company is exposed to interest rate risk in the form of basis risk and repricing risk because the interest rate characteristics of the Company s assets do not match the interest rate characteristics of the funding.

The Company s primary market risk exposure arises from fluctuations in its borrowing and lending rates, the spread between which could be impacted by shifts in market interest rates. The borrower rates on the Company s current portfolio of federally insured loans are generally reset by the Department each July 1st based on a formula determined by the date of the origination of the loan, with the exception of rates on consolidation loans, which are generally fixed-rate to the borrower for the life of the loan. For all FFELP loans originated after July 1, 2006, the loans are fixed-rate to the borrower for the life of the loan. For FFELP loans originated prior to April 1, 2006, the interest rate the Company actually receives on federally insured loans is the greater of the borrower rate and a SAP rate determined by a formula based on a spread to either the 91-day Treasury Bill index or the 90-day commercial paper index, depending on when the loans were originated and the current repayment status of the loans. On FFELP loans originated on or after April 1, 2006, the Company only earns interest at the SAP rate determined by a formula based on 90-day commercial paper. For the FFELP portfolio of loans originated on or after April 1, 2006, when the borrower rate exceeds the variable rate based upon the SAP formula, the Company must return the excess to the Department.

The Company issues asset-backed securities, the vast majority being variable-rate, to fund its student loan assets. The variable-rate debt is generally indexed to 3-month LIBOR, set by auction, or through a remarketing process. The income generated by the Company s student loan assets is generally driven by short-term indices (Treasury bills and commercial paper) that are different from those which affect the Company s liabilities (generally LIBOR), which creates basis risk. Moreover, the Company also faces repricing risk due to the timing of the interest rate resets on its liabilities, which may occur as infrequently as every quarter, and the timing of the interest rate resets on its assets, which generally occur daily. In a declining interest rate environment, this may cause the Company s student loan spread to compress, while in a rising rate environment, it may cause it to increase.

In using different index types and different index reset frequencies to fund assets, the Company is exposed to interest rate risk in the form of basis risk and repricing risk, which is the risk that the different indices may reset at different frequencies, or will not move in the same direction or with the same magnitude. While these indices are short-term with rate movements that are highly correlated over a longer period of time, there can be no assurance that this high correlation will not be disrupted by capital market dislocations or other factors not within the Company s control. In such circumstances, the Company s earnings could be adversely affected, possibly to a material extent.

The Company uses derivative instruments to hedge the basis risk due to the timing of the interest rate resets on its assets and liabilities. However, the Company does not generally hedge the basis risk due to the different interest rate indices associated with its assets and liabilities since the relationship between the indices for most of the Company s assets and liabilities is highly correlated. Nevertheless, the basis between the indices may widen from time to time, which would impact the net spread on the portfolio.

Characteristics unique to asset-backed securitizations may negatively affect the Company s continued liquidity.

The interest rates on certain of the Company s asset-backed securities are set and periodically reset via a dutch auction (Auction Rate Securities) or through a remarketing utilizing broker-dealers and remarketing agents (Variable Rate Demand Notes).

For Auction Rate Securities, investors and potential investors submit orders through a broker-dealer as to the principal amount of notes they wish to buy, hold, or sell at various interest rates. The broker-dealers submit their clients orders to the auction agent, who then determines the clearing interest rate for the upcoming period. Interest rates on these Auction Rate Securities are reset periodically, generally every 7 to 35 days, by the auction agent or agents. Recently, as part of the ongoing credit market crisis, several auction rate securities from various issuers have failed to receive sufficient order interest from potential investors to clear successfully, resulting in failed auction status. Since February 8, 2008, the Company s Auction Rate Securities have failed in this manner. Under normal conditions, the banks would step in when investor demand is weak. However, as of recently, they have been allowing these auctions to fail.

As a result of a failed auction, the Auction Rate Securities will generally pay interest to the holder at a maximum rate as defined by the governing documents or indenture. While these rates will vary slightly by class of security, they will generally be based on a spread to Libor or Treasury Securities and will approximate the current one month LIBOR rate plus 75 to 150 basis points. These maximum rates are subject to increase if the credit ratings on the bonds are downgraded.

The Company cannot predict whether future auctions related to its Auction Rate Securities will be successful. The Company is currently seeking alternatives for reducing its exposure to the auction rate market, but may not be able to achieve alternate financing for some or all of its Auction Rate Securities.

For Variable Rate Demand Notes, the remarketing agents set the price, which is then offered to investors. If there are insufficient potential bid orders to purchase all of the notes offered for sale, the Company could be subject to interest costs substantially above the anticipated and historical rates paid on these types of securities. Certain of the Variable Rate Demand Notes are secured by financial guaranty insurance policies issued by Municipal Bond Investors Assurance (MBIA). The Variable Rate Demand Notes insured by MBIA are currently experiencing reduced investor demand and certain of these securities have been put to the liquidity provider, Lloyds TSB Bank, at a cost ranging from Federal Funds plus 150 basis points to LIBOR plus 175 basis points.

If there is no demand for the Company s Auction Rate Securities and Variable Rate Demand Notes, the Company could be subject to interest costs substantially above the anticipated and historical rates paid on these types of securities.

The Company is exposed to interest rate risk because of the interest rate characteristics of certain of its assets and the interest rate characteristics of the related funding of such assets.

FFELP student loans generally earn interest at the higher of a floating rate based on the Special Allowance Payment or SAP formula set by the Department and the borrower rate, which is fixed over a period of time. The Company generally finances its student loan portfolio with variable-rate debt. In low and/or declining interest rate environments, when the fixed borrower rate is higher than the rate produced by the SAP formula, the Company s student loans earn at a fixed rate while the interest on the variable-rate debt continues to decline. In these interest rate environments, the Company earns additional spread income that it refers to as fixed rate floor income.

Depending on the type of the student loan and when it was originated, the borrower rate is either fixed to term or is reset to market rate each July 1. As a result, for loans where the borrower rate is fixed to term, the Company earns floor income for an extended period of time, which the Company refers to as fixed rate floor income, and for those loans where the borrower rate is reset annually on July 1, the Company earns floor income to the next reset date, which the Company refers to as variable-rate floor income. In accordance with new legislation enacted in 2006, lenders are required to rebate floor income and variable-rate floor income to the Department for all new FFELP loans originated on or after April 1, 2006.

Absent the use of derivative instruments, a rise in interest rates may reduce the amount of floor income received and this may have an impact on earnings due to interest margin compression caused by increasing financing costs, until such time as the federally insured loans earn interest at a variable rate in accordance with the special allowance payment formula. In higher interest rate environments, where the interest rate rises above the borrower rate and fixed-rate loans effectively become variable rate loans, the impact of the rate fluctuations is reduced.

The Company is subject to foreign currency exchange risk and such risk could lead to increased costs.

As a result of the Company s offerings in Euro-denominated notes, the Company is exposed to market risk related to fluctuations in foreign currency exchange rates between the U.S. and Euro dollars. The principal and accrued interest on these notes is re-measured at each reporting period and recorded on the Company s balance sheet in U.S. dollars based on the foreign currency exchange rate on that date. When foreign currency exchange rates between the U.S. and Euro dollars change significantly, earnings may fluctuate significantly. The Company entered into cross-currency interest rate swaps in connection with the issuance of these notes.

The Company s derivative instruments may not be successful in managing interest and foreign currency exchange rate risks, which may negatively impact the Company s operations.

When the Company utilizes derivative instruments, it utilizes them to manage interest and foreign currency exchange rate sensitivity. Although the Company does not use derivative instruments for speculative purposes, its derivative

instruments do not qualify for hedge accounting under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities, an Amendment of FASB Statement No. 133* (SFAS No. 133); consequently, the change in fair value, called the mark to market , of these derivative instruments is included in the Company s operating results. Changes or shifts in the forward yield curve and foreign currency exchange rates can and have significantly impacted the valuation of the Company s derivatives. Accordingly, changes or shifts in the forward yield curve and foreign currency exchange rates will impact the financial position, results of operations, and cash flows of the Company. Further, the Company may have to repay certain costs (including transaction fees) or be subject to wide bid/ask spreads if the Company terminates a derivative instrument. The derivative instruments used by the Company are typically in the form of interest rate swaps, basis swaps, interest rate floor contracts, and cross-currency interest rate swaps.

Developing an effective strategy for dealing with movements in interest rates and foreign currency exchange rates is complex, and no strategy can completely insulate the Company from risks associated with such fluctuations. Although the Company believes its derivative instruments are highly effective, because many of its derivatives are not balance guaranteed to a particular pool of student loans, the Company is subject to prepayment risk that could result in the Company being under or over hedged that may result in material losses to the Company. In addition, a counterparty to a derivative instrument could default on its obligation, thereby exposing the Company to counterparty risk. Further, the Company may have to repay certain costs, such as transaction fees or brokerage costs, if the Company terminates a derivative instrument. Finally, the Company s interest rate and foreign currency exchange risk management activities could expose the Company to substantial mark to market losses if interest rates or foreign currency exchange rates move materially differently from the environment when the derivatives were entered into. As a result, the Company cannot offer any assurance that its economic hedging activities will effectively manage its interest and foreign currency exchange rate sensitivity nor have the desired beneficial impact on its results of operations or financial condition.

When the mark to market of a derivative instrument is negative, the Company owes the counterparty and, therefore, has no counterparty risk. Additionally, if the negative mark to market of derivatives with a counterparty exceeds a specified threshold, the Company may have to pay a collateral deposit to the counterparty. If interest and foreign currency exchange rates move materially, the Company could be required to deposit a significant amount of collateral with its derivative instrument counterparties. The collateral deposits, if significant, could negatively impact the Company s capital resources. The Company attempts to manage market risks associated with interest and foreign currency exchange rates by establishing and monitoring limits as to the types and degree of risk that may be undertaken.

The ratings of the Company or of any securities sold by the Company may change, which may increase the Company s costs of capital and may reduce the liquidity of the Company s securities.

Ratings are based primarily on the creditworthiness of the Company, the underlying assets of asset-backed securitizations, the amount of credit enhancement in any given transaction and the legal structure of any given transaction. Ratings are not a recommendation to purchase, hold, or sell any of the Company s securities inasmuch as the ratings do not comment as to the market price or suitability for investors. There is no assurance that ratings will remain in effect for any given period of time or that current ratings will not be lowered or withdrawn by any rating agency. Ratings for the Company or any of its securities may be increased, lowered, or withdrawn by any rating agency if in the rating agency s judgment circumstances so warrant. If the Company s credit ratings are lowered or withdrawn, the Company may experience an increase in interest rates or other costs associated with the capital raising activities by the Company, which may negatively affect the Company s operations. Additionally, a lowered or withdrawn credit rating may negatively affect the liquidity of the Company s securities.

The Company may be limited in its ability to pay dividends or make other payments as a result of the terms of certain outstanding securities issued by the Company.

In September 2006, the Company issued certain junior subordinated hybrid securities (the Hybrid Securities). So long as the Hybrid Securities remain outstanding, if the Company has given notice of its election to defer interest payments but the related deferral period has not yet commenced or a deferral period is continuing, then the Company will not, and will not permit any of its subsidiaries to:

- declare or pay any dividends or distributions on, or redeem, purchase, acquire or make a liquidation payment regarding, any of the Company s capital stock;

- except as required in connection with the repayment of principal, and except for any partial payments of deferred interest that may be made through the alternative payment mechanism described in the indenture relating to the Hybrid Securities, make any payment of principal of, or interest or premium, if any, on, or repay, repurchase or redeem any of the Company s debt securities that rank *pari passu* with or junior to the Hybrid Securities; or

make any guaranty payments regarding any guaranty by the Company of the subordinated debt securities of any of the Company s subsidiaries if the guaranty ranks *pari passu* with or junior in interest to the Hybrid Securities.

In addition, if any deferral period lasts longer than one year, the limitation on the Company s ability to redeem or repurchase any of its securities that rank *pari passu* with or junior in interest to the Hybrid Securities will continue until the first anniversary of the date on which all deferred interest has been paid or cancelled.

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If the Company is involved in a business combination where immediately after its consummation more than 50% of the surviving entity s voting stock is owned by the shareholders of the other party to the business combination, then the immediately preceding sentence will not apply to any deferral period that is terminated on the next interest payment date following the date of consummation of the business combination.

However, at any time, including during a deferral period, the Company will be permitted to:

pay dividends or distributions in additional shares of the Company s capital stock;

declare or pay a dividend in connection with the implementation of a shareholders rights plan, or issue stock under such a plan, or redeem or repurchase any rights distributed pursuant to such a plan; and

purchase common stock for issuance pursuant to any employee benefit plans.

If the Company s stock price falls, the Company s contingent obligations under certain agreements related to business acquisitions increase.

In November 2005, the Company purchased the remaining 50% of the stock of 5280 Solutions, Inc. (5280). Consideration for the purchase was 258,760 restricted shares of the Company s Class A common stock. The 258,760 shares of Class A common stock issued in the acquisition are subject to put option agreements whereby during the 30-day period ending November 30, 2008 the holders may require the Company to repurchase all or part of the shares at a price of $37.10 per share. The value of the put options as of the closing date of the acquisition was $1.2 million and was recorded by the Company as additional purchase price. The change in the value of the put option each reporting period is included in the Company s operating results. As of December 31, 2007, the value of the put options was $6.1 million. The fair value of these options is primarily affected by the strike price and term of the underlying option, the Company s current stock price, and the dividend yield and volatility of the Company s stock. Accordingly, changes or shifts in these inputs will impact the financial position and results of operations of the Company.

In February 2006, the Company purchased the remaining 50% of the stock of infiNET Integrated Solutions, Inc. (infiNET). Consideration for the purchase of the remaining 50% of the stock of infiNET was $9.5 million in cash and 95,380 restricted shares of the Company s Class A common stock. Under the terms of the purchase agreement, the 95,380 shares of Class A common stock issued in the acquisition are subject to stock price guaranty provisions whereby if on or about February 28, 2011 the average market trading price of the Class A common stock is less than $104.8375 per share and has not exceeded that price for any 25 consecutive trading days during the 5-year period from the closing of the acquisition to February 28, 2011, then the Company must pay additional cash to the sellers of infiNET for each share of Class A common stock issued in an amount representing the difference between $104.8375 less the greater of $41.9335 or the gross sales price such seller obtained from a sale of the shares occurring subsequent to February 28, 2011 as defined in the agreement. Any payment on the guaranty is reduced by the aggregate of any dividends or other distributions made by the Company to the sellers. Any cash paid by the Company in consideration of satisfying the guaranteed value of stock issued for this acquisition would be recorded by the Company as a reduction to additional paid-in capital.

General Risk Factors

Incorrect estimates and assumptions by management in connection with the preparation of the Company s consolidated financial statements could adversely affect the reported amounts of assets and liabilities and the reported amounts of income and expenses.

The preparation of the Company s consolidated financial statements requires management to make certain critical accounting estimates and assumptions that could affect the reported amounts of assets and liabilities and the reported amounts of income and expense during the reporting periods. See Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies .

The Company s future results may be affected by various legal and regulatory proceedings.

The outcome of legal proceedings may differ from the Company s expectations because the outcomes of litigation, including regulatory matters, are often difficult to reliably predict. Various factors or developments can lead the Company to change current estimates of liabilities and related insurance receivables where applicable, or make such estimates for matters previously not susceptible of reasonable estimates, such as a significant judicial ruling or

judgment, a significant settlement, significant regulatory developments or changes in applicable law. A future adverse ruling, settlement, or unfavorable development could result in future charges that could have a material adverse effect on the Company s results of operations or cash flows in any particular period.

The Company s failure to successfully manage business and certain asset acquisitions could have a material adverse effect on the Company s business, financial condition, and/or results of operations.

The Company may acquire new products and services or enhance existing products and services through acquisitions of other companies, product lines, technologies, and personnel, or through investments in other companies. During 2004 through 2006, the Company acquired the stock and certain assets of 17 different entities. Any acquisition or investment is subject to a number of risks. Such risks may include diversion of management time and resources, disruption of the Company s ongoing business, difficulties in integrating acquisitions, dilution to existing stockholders if the Company s common stock is issued in consideration for an acquisition or investment, incurring or assuming indebtedness or other liabilities in connection with an acquisition, lack of familiarity with new markets, and difficulties in supporting new product lines. The Company s failure to successfully manage acquisitions or investments, or successfully integrate acquisitions, could have a material adverse effect on the Company s business, financial condition, and/or results of operations. Correspondingly, the Company s expectations to the accretive nature of the acquisitions could be inaccurate.

The market price of the Company s Class A common stock may fluctuate significantly, which may result in losses for investors.

From January 1, 2007 to February 15, 2008, the closing daily sales price of the Company s Class A common stock as reported by the New York Stock Exchange ranged from a low of $9.84 per share to a high of $28.00 per share. The Company expects the Class A common stock to continue to be subject to fluctuations as a result of a variety of factors, including factors beyond the Company s control. These factors include:

- changes in interest rates and credit market conditions affecting the cost and availability of financing for the Company s student loan assets;
- changes in the education financing regulatory framework;
- changes in demand for education financing or other products and services that the Company offers;
- variations in the Company s quarterly operating results;
- changes in financial estimates by securities analysts;
- changes in market valuations of comparable companies; and
- future sales of the Company s Class A common stock.

The Company may not meet the expectations of shareholders and/or of securities analysts at some time in the future, and the market price of the Company s Class A common stock could decline as a result.

The Company may not always pay dividends on its common stock.

The payment of future dividends on the Company s shares of Class A common stock and Class B common stock remains in the discretion of the Company s Board of Directors and will continue to depend on the Company s earnings, capital requirements, financial condition, and other factors. In addition, the payment of dividends is subject to the terms of certain other outstanding securities issued by the Company as discussed above. The Board of Directors may determine in the future to reduce the current quarterly dividend rate of $0.07 per share or discontinue the payment of dividends altogether.

Negative publicity that may be associated with the student lending industry, including negative publicity about the Company, may harm the Company s reputation and adversely affect operating results.

Recently, the student lending industry has been the subject of various investigations and reports. The publicity associated with these investigations and reports may have a negative impact on the Company s reputation. To the extent that potential or existing customers decide not to utilize the Company s products or services as a result of such publicity, the Company s operating results may be adversely affected.

If management does not effectively execute the Company s restructuring plans, this could adversely affect the Company s operations, revenue, and the ability to compete.

On September 6, 2007, the Company announced a strategic restructuring initiative to create efficiencies and lower costs in advance of the enactment of the College Cost Reduction Act, which impacted the FFEL Program in which the Company participates. The Company has significant financing needs that it meets through the capital markets, including the debt and secondary markets. Since August 2007, these markets have experienced unprecedented disruptions, which are having an adverse impact on the Company s earnings and financial condition. On January 23, 2008, the Company announced a plan to further reduce operating expenses related to its student loan origination and related businesses as a result of the ongoing disruption in the credit markets.

The Company continues to implement its restructuring initiatives, including lowering the cost of student loan acquisition, creating efficiencies in its asset generation business, and decreasing operating expenses through a reduction in workforce and realignment of operating facilities. The Company expects these initiatives to be substantially completed during 2008.

If the Company is unable to successfully implement its reorganization initiatives or if those initiatives do not have the desired effects or result in the projected efficiencies, the Company may incur additional or unexpected expenses which would adversely affect the Company s operations and revenues.

Failures in the Company s information technology system could materially disrupt its business.

The Company s servicing and operating processes are highly dependent upon its information technology system infrastructure, and the Company faces the risk of business disruption if failures in its information systems occur, which could have a material impact upon its business and operations. The Company depends heavily on its own computer-based data processing systems in servicing both its own student loans and those of third-party servicing customers and providing tuition payment and campus commerce transactions and lead generation products and services. The Company regularly backs up its data and maintains detailed disaster recovery plans. A major physical disaster or other calamity that causes significant damage to information systems could adversely affect the Company s business. Additionally, loss of information systems for a sustained period of time could have a negative impact on the Company s performance and ultimately on cash flow in the event the Company were unable to process transactions and/or provide services to customers.

A loss of customer data requiring notification to customers could negatively impact the Company s business.

The Company, on its own behalf and on behalf of other entities, stores a significant amount of personal data about the customers to whom the Company provides services. If the Company were to suffer a major loss of customer data, through breach of its systems or otherwise, entities for which the Company provides services might choose to find another service provider.

Certain participants in the Company s stock compensation and benefit plans may have rescission rights with respect to shares of stock acquired under those plans.

In April 2007, the Company discovered that as a result of inadvertent issues related to the delivery of documents to participants, certain participants in the Company s Employee Share Purchase Plan, Restricted Stock Plan, Directors Stock Compensation Plan, and Employee Stock Purchase Loan Plan may not have during certain time frames actually received all of the information required to constitute a fully compliant prospectus under the Securities Act of 1933. While the issuance of shares under those plans has been registered with the Securities and Exchange Commission under registration statements on Form S-8, it is a violation of Section 5 of the Securities Act of 1933 to sell a security for which a registration statement has been filed unless accompanied or preceded by a prospectus that meets the requirements of Section 10 of the Securities Act of 1933.

Section 12 of the Securities Act of 1933 generally provides for a one-year rescission right for an investor who acquires a security from a seller who does not comply with the prospectus delivery requirements of Section 5 of the Securities Act of 1933. As such, an investor successfully asserting a rescission right during the one-year time period has the right to require an issuer to repurchase the securities acquired by the investor at the price paid by the investor for the securities (or if such security has been disposed of, to receive damages with respect to any loss on such disposition), plus interest from the date of acquisition. These rights may apply to affected participants in the Company s plans. The Company believes that its potential liability for rescission claims or other damages is not material to the Company s financial condition; however, the Company s potential liability could become material to results of operations for a particular period if, during the one-year period following non-compliant sales, the market price of the shares of Class A common stock falls significantly below the affected participants acquisition prices.

Exposure related to certain tax issues could decrease the Company s net income.

A corporation is considered to be a personal holding company under the U.S. Internal Revenue Code of 1986, as amended (the Code), if (1) at least 60% of its adjusted ordinary gross income is personal holding company income (generally, passive income) and (2) at any time during the last half of the taxable year more than half, by value, of its stock is owned by five or fewer individuals, as determined under attribution rules of the Code. If both of these tests are met, a personal holding company is subject to an additional tax on its undistributed personal holding company income,

currently at a 15% rate. Five or fewer individuals hold more than half the value of the Company s stock. In June 2003, the Company submitted a request for a private letter ruling from the Internal Revenue Service seeking a determination that its federally guaranteed student loans qualify as assets of a lending or finance business, as defined in the Code. Such a determination would have assured the Company that holding such loans does not make it a personal holding company. Based on its historical practice of not issuing private letter rulings concerning matters that it considers to be primarily factual, however, the Internal Revenue Service has indicated that it will not issue the requested ruling, taking no position on the merits of the legal issue.

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So long as more than half of the Company s value continues to be held by five or fewer individuals, if it were to be determined that some portion of its federally guaranteed student loans does not qualify as assets of a lending or finance business, as defined in the Code, the Company could become subject to personal holding company tax on its undistributed personal holding company income. The Company continues to believe that neither Nelnet, Inc. nor any of its subsidiaries is a personal holding company. However, even if Nelnet, Inc. or one of its subsidiaries was determined to be a personal holding company, the Company believes that by utilizing intercompany distributions, it could eliminate or substantially eliminate its exposure to personal holding company taxes, although it cannot assure that this will be the case.

The Company is subject to federal and state income tax laws and regulations. Income tax regulations are often complex and require interpretation. Changes in income tax regulations could negatively impact the Company s results of operations. If states enact legislation, alter apportionment methodologies, or aggressively apply the income tax nexus standards, the Company may become subject to additional state taxes. The applicability and taxation on the earnings from intangible personal property has been the subject of state audits and litigation with state taxing authorities and tax policy debates by various state legislatures. As the Congress and U.S. Supreme Court have not provided clear guidance in this regard, conflicting state laws and court decisions create tremendous uncertainty and expense for taxpayers conducting interstate commerce.

During 2007, the Company began to be examined by multiple state taxing authorities. These taxing authorities routinely challenge certain filing methodologies, apportionment, and certain deductions reported by the Company on its income tax returns. In accordance with SFAS No. 109, *Accounting for Income Taxes*, and FAS Interpretation No. 48, *Account for Uncertainty in Income Taxes*, the Company establishes reserves for tax contingencies related to deductions and credits that it may be unable to sustain. Differences between the reserves for tax contingencies and the amounts ultimately owed are recorded in the period they become known. Adjustments to the Company s reserves could have a material effect on the Company s financial statements.

In October 2007, the Company received a letter from the Internal Revenue Service (IRS) revoking a previously issued Private Letter Ruling retroactive to September 30, 2003 concerning the Company s arbitrage and excess interest calculations on certain of its tax-exempt bonds. The IRS letter provided procedures for the Company to follow to appeal the retroactive application of the revocation. The Company responded to the IRS in November 2007 requesting relief from retroactivity and has recently received a request for additional information from the IRS. The Company cannot predict the ultimate outcome of the IRS letter and has not determined its legal remedies if its request regarding retroactive application is denied. An adverse outcome could be material to the financial statements and could cause the Company to take action with respect to surplus fund withdrawals since September 30, 2003 if the Private Letter Ruling is applied retroactively.

Transactions with affiliates and potential conflicts of interest of certain of the Company s officers and directors, including the Company s Chief Executive Officer, pose risks to the Company s shareholders that the Company may not enter into transactions on the same terms that the Company could receive from unrelated, third-parties.

The Company has entered into certain contractual arrangements with entities controlled by Michael S. Dunlap, the Company s Chairman, Chief Executive Officer, and a principal shareholder, and members of his family and, to a lesser extent, with entities in which other directors and members of management hold equity interests or board or management positions. Such arrangements constitute a significant portion of the Company s business and include sales of student loans and student loan origination rights by such affiliates to the Company. These arrangements may present potential conflicts of interest. Many of these arrangements are with Union Bank and Trust Company (Union Bank), in which Michael S. Dunlap owns an indirect interest and of which he serves as non-executive chairman. The Company intends to maintain its relationship with Union Bank, which management believes provides substantial benefits to the Company, although there can be no assurance that any transactions between the Company and entities controlled by Mr. Dunlap, his family, and/or other officers and directors of the Company are, or in the future will be, on terms that are no less favorable than what could be obtained from an unrelated third party.

The Company s Chairman and Chief Executive Officer owns a substantial percentage of the Company s Class A and Class B common stock and is able to control all matters subject to a shareholder vote.

Michael S. Dunlap, the Company s Chairman, Chief Executive Officer, and a principal shareholder, beneficially owns a substantial percentage of the Company s outstanding shares of Class A common stock and Class B common stock. Each share of Class A common stock has one vote and each share of Class B common stock has ten votes on all matters to be voted upon by the Company s shareholders. As a result, Mr. Dunlap is able to control all matters requiring approval by the Company s shareholders, including the election of all members of the Board of Directors, and may do so in a manner with which other shareholders may not agree or which they may not consider to be in the best interest of other shareholders. In addition, Stephen F. Butterfield, the Company s Vice Chairman, owns a substantial number of shares of Class B common stock.

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ITEM 1B. UNRESOLVED STAFF COMMENTS

The Company has no unresolved comments from the staff of the Securities and Exchange Commission regarding its periodic or current reports under the Securities Exchange Act of 1934.

ITEM 2. PROPERTIES

The following table lists the principal facilities for office space owned or leased by the Company. The Company owns the building in Lincoln, Nebraska where its principal office is located. The building is subject to a lien securing the outstanding mortgage debt on the property.

Location	Primary Function or Segment	Approximate square feet	Lease expiration date
Lincoln, NE	Corporate Headquarters, Asset Generation and Management, Student Loan and Guaranty Servicing	137,000	
Aurora, CO	Asset Generation and Management, Student Loan and Guaranty Servicing, Software and Technical Services	124,000	February 2015
Jacksonville, FL	Student Loan and Guaranty Servicing, Software and Technical Services	109,000	January 2014
Lawrenceville, NJ	Enrollment Services and List Management	62,000	April 2011

The square footage amounts above exclude a total of approximately 60,000 square feet of owned office space in Lincoln, Nebraska that the Company leases to third parties. The Company also leases approximately 62,000 square feet of office space in Indianapolis, Indiana where Asset Generation and Management and Student Loan and Guaranty Servicing operations were previously conducted, of which 56,000 square feet is now subleased to third parties. The Company leases other office facilities located throughout the United States. These properties are leased on terms and for durations that are reflective of commercial standards in the communities where these properties are located. The Company believes that its respective properties are generally adequate to meet its long-term business goals. The Company s principal office is located at 121 South 13th Street, Suite 201, Lincoln, Nebraska 68508.

ITEM 3. LEGAL PROCEEDINGS

General

The Company is subject to various claims, lawsuits, and proceedings that arise in the normal course of business. These matters principally consist of claims by borrowers disputing the manner in which their loans have been processed and disputes with other business entities. On the basis of present information, anticipated insurance coverage, and advice received from counsel, it is the opinion of the Company s management that the disposition or ultimate determination of these claims, lawsuits, and proceedings will not have a material adverse effect on the Company s business, financial position, or results of operations.

On February 8, 2008, Shockley Financial Corp. (SFC), an indirect wholly owned subsidiary of the Company with two associates that provides investment advisory services for the investment of proceeds from the issuance of municipal and corporate bonds, received a grand jury subpoena issued by the U.S. District Court for the Southern District of New York upon application of the Antitrust Division of the U.S. Department of Justice. The subpoena seeks certain information and documents from SFC in connection with the Department of Justice s ongoing criminal investigation of the bond industry with respect to possible anti-competitive practices related to awards of guaranteed investment contracts (GICs) and other products for the investment of proceeds from bond issuances. The Company and SFC are cooperating with the investigation. In connection with this matter, SFC, the Company, or other subsidiaries of the Company may receive subpoenas from other regulatory agencies. The Company understands that the Antitrust Division of the U.S. Department of Justice, the Securities and Exchange Commission, and the Internal Revenue Service have each been conducting investigations of GIC placement activities. Due to the preliminary nature of this matter as to SFC, the Company is unable to predict the ultimate outcome of this matter.

Industry Investigations

On January 11, 2007, the Company received a letter from the New York Attorney General (the NYAG) requesting certain information and documents from the Company in connection with the NYAG s investigation into preferred lender list activities. Since January 2007, a number of state attorneys general, including the NYAG, and the U.S. Senate Committee on Health, Education, Labor, and Pensions have announced or are reportedly conducting broad inquiries or investigations of the activities of various participants in the student loan industry, including activities which may involve perceived conflicts of interest. A focus of the inquiries or investigations has been on any financial arrangements among student loan lenders and other industry participants which may facilitate increased volumes of student loans for particular lenders. Like many other student loan lenders, the Company has received informal requests for information from certain state attorneys general and the Chairman of the U.S. Senate Committee on Health, Education, Labor, and Pensions in connection with their inquiries or investigations. In addition, the Company has received subpoenas for information from the NYAG, the New Jersey Attorney General, and the Ohio Attorney General. In each case the Company is cooperating with the requests and subpoenas for information that it has received.

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On April 20, 2007, the Company announced that it had agreed with the Nebraska Attorney General to voluntarily adopt a Nelnet Student Loan Code of Conduct, post a review of the Company s business practices on its website, and commit $1.0 million to help educate students and families on how to plan and pay for their education.

On July 31, 2007, the Company announced that it had agreed with the NYAG to adopt the NYAG s Code of Conduct, which is substantially similar to the Nelnet Student Loan Code of Conduct. The NYAG s Code of Conduct also includes an agreement to eliminate two services the Company had previously announced plans to discontinue the Company s outsourcing of calls for financial aid offices and its agreements with college alumni associations providing for marketing of consolidation loans to the associations members. As part of the agreement, the Company agreed to contribute $2.0 million to a national fund for educating high school seniors and their parents regarding the financial aid process.

On October 10, 2007, the Company received a subpoena from the NYAG requesting certain information and documents from the Company in connection with the NYAG s investigation into direct-to-consumer marketing practices of student lenders. The Company is cooperating with the request.

While the Company cannot predict the ultimate outcome of any inquiry or investigation, the Company believes its activities have materially complied with applicable law, including the Higher Education Act, the rules and regulations adopted by the Department of Education thereunder, and the Department s guidance regarding those rules and regulations.

Department of Education Review

The Department of Education periodically reviews participants in the FFEL Program for compliance with program provisions. On June 28, 2007, the Department of Education notified the Company that it would be conducting a review of the Company s administration of the FFEL Program under the Higher Education Act. The Company understands that as of July 23, 2007, the Department of Education had selected 47 schools and 27 lenders for review. Specifically, the Department is reviewing the Company s practices in connection with the prohibited inducement provisions of the Higher Education Act and the provisions of the Higher Education Act and the associated regulations which allow borrowers to have a choice of lenders. The Company has responded to the Department of Education s requests for information and documentation and is cooperating with their review.

While the Company cannot predict the ultimate outcome of the review, the Company believes its activities have materially complied with the Higher Education Act, the rules and regulations adopted by the Department of Education thereunder, and the Department s guidance regarding those rules and regulations.

Department of Justice

In connection with the Company s settlement with the Department of Education in January 2007 to resolve the OIG audit report with respect to the Company s student loan portfolio receiving special allowance payments at a minimum 9.5% interest rate, the Company was informed by the Department of Education that a civil attorney with the Department of Justice had opened a file regarding the issues set forth in the OIG report, which the Company understands is common procedure following an OIG audit report. The Company has engaged in discussions and provided information to the Department of Justice in connection with the review. While the Company is unable to predict the ultimate outcome of the review, the Company believes its practices complied with applicable law, including the provisions of the Higher Education Act, the rules and regulations adopted by the Department of Education thereunder, and the Department s guidance regarding those rules and regulations.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of fiscal 2007.

PART II.

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company s Class A Common Stock is listed and traded on the New York Stock Exchange under the symbol NNI, while its Class B Common Stock is not publicly traded. The number of holders of record of the Company s Class A Common Stock and Class B Common Stock as of January 31, 2008 was 675 and eight, respectively. Because many shares of the Company s Class A Common stock are held by brokers and other institutions on behalf of shareholders, the Company is unable to estimate the total number of beneficial owners represented by these record holders. The following table sets forth the high and low sales prices for the Company s Class A Common Stock for each full quarterly period in 2007 and 2006.

	2007				2006			
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
High	$ 27.92	$ 28.00	$ 24.35	$ 19.61	$ 43.19	$ 42.97	$ 40.65	$ 30.79
Low	23.38	22.99	17.11	11.99	40.00	36.04	28.52	25.24

During each quarter in 2007, the Company paid a cash dividend of $0.07 per share on the Company s Class A and Class B Common Stock. The Company did not pay cash dividends on either class of its Common Stock in 2006. The Company s Board of Directors approved a 2008 first quarter cash dividend of $0.07 per share on the Company s Class A and Class B Common Stock to be paid on March 15, 2008 to shareholders of record as of March 1, 2008. The Company currently plans to continue making a quarterly dividend payment in the future, subject to future earnings, capital requirements, financial condition, and other factors.

Performance Graph

The following graph compares the change in the cumulative total shareholder return on the Company s Class A Common Stock to that of the cumulative return of the Dow Jones U.S. Total Market Index and the Dow Jones U.S. Financial Services Index. The graph assumes that the value of an investment in the Company s Class A Common Stock and each index was $100 on December 11, 2003 (the date of the Company s initial public offering of its Class A Common Stock), and that all dividends, if applicable, were reinvested. The performance shown in the graph represents past performance and should not be considered an indication of future performance.

Company/Index	**12/11/2003**	**12/31/2003**	**12/31/2004**	**12/31/2005**	**12/31/2006**	**12/31/2007**
Nelnet, Inc.	$ 100.00	$ 102.75	$ 123.53	$ 186.61	$ 125.50	$ 59.17
Dow Jones U.S. Index	$ 100.00	$ 103.71	$ 116.17	$ 123.52	$ 142.75	$ 151.33
Dow Jones U.S. Financial Services Index	$ 100.00	$ 103.63	$ 118.41	$ 128.33	$ 163.95	$ 137.54

The preceding information under the caption Performance Graph shall be deemed to be furnished but not filed witl the Securities and Exchange Commission.

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Stock Repurchases

The following table summarizes the repurchases of Class A common stock during the fourth quarter of 2007 by the Company or any affiliated purchaser of the Company, as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934.

Period	Total number of shares purchased (1)		Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs (2) (3)	Maximum number of shares that may yet be purchased under the plans or programs (4)
October 1 - October 31, 2007	3,247	$	18.95	3,247	6,717,146
November 1 - November 30, 2007	65,581		16.08	65,581	7,332,998
December 1 - December 31, 2007	2,100		12.85	2,100	7,555,499
Total	70,928	$	16.11	70,928	

(1) The total number of shares includes: (i) shares purchased pursuant to the 2006 Plan discussed in footnote (2) below; and (ii) shares purchased pursuant to the 2006 ESLP discussed in footnote (3) below, of which there were none for the months of October, November, or December 2007. Shares of Class A common stock purchased pursuant to the 2006 Plan included

(i) 3,247 shares, 1,169 shares, and 1,515 shares in October, November, and December, respectively, that had been issued to the Company s 401(k) plan and allocated to employee participant accounts pursuant to the plan s provisions for Company matching contributions in shares of Company stock, and were purchased by the Company from the plan pursuant to employee participant instructions to dispose of such shares, (ii) 11,312 shares and 585 shares in November and December, respectively, purchased from employees upon termination of employment with the Company, which shares were originally acquired pursuant to the 2006 ESLP, and (iii) 53,100 shares in November purchased in the

open market in transactions not related to the 2006 ESLP.

(2) On May 25, 2006, the Company publicly announced that its Board of Directors had authorized a stock repurchase program to repurchase up to a total of five million shares of the Company s Class A common stock (the 2006 Plan). On February 7, 2007, the Company s Board of Directors increased the total shares the Company is allowed to repurchase to 10 million. The 2006 Plan had an initial expiration date of May 24, 2008, which was extended until May 24, 2010 by the Company s Board of Directors on January 30, 2008.

(3) On May 25, 2006, the Company publicly announced that the shareholders

of the Company approved an Employee Stock Purchase Loan Plan (the 2006 ESLP) to allow the Company to make loans to employees for the purchase of shares of the Company s Class A common stock either in the open market or directly from the Company. A total of $40 million in loans may be made under the 2006 ESLP, and a total of one million shares of Class A common stock are reserved for issuance under the 2006 ESLP. Shares may be purchased directly from the Company or in the open market through a broker at prevailing market prices at the time of purchase, subject to any conditions or restrictions on the timing, volume, or prices of purchases as determined by the Compensation Committee of the Board of Directors and set

forth in the Stock Purchase Loan Agreement with the participant. The 2006 ESLP shall terminate May 25, 2016.

(4) The maximum number of shares that may yet be purchased under the plans is calculated below. There are no assurances that any additional shares will be repurchased under either the 2006 Plan or the 2006 ESLP. Shares under the 2006 ESLP may be issued by the Company rather than purchased in open market transactions.

As of	Maximum number of shares that may yet be purchased under the 2006 Plan (A)	Approximate dollar value of shares that may yet be purchased under the 2006 ESLP (B)	Closing price on the last trading day of the Company's Class A Common Stock (C)	(B / C) Approximate number of shares that may yet be purchased under the 2006 ESLP (D)	(A + D) Approximate number of shares that may yet be purchased under the 2006 Plan and 2006 ESLP
October 31, 2007	4,755,359	$ 36,450,000	$ 18.58	1,961,787	6,717,146
November 30, 2007	4,689,778	36,450,000	13.79	2,643,220	7,332,998
December 31, 2007	4,687,678	36,450,000	12.71	2,867,821	7,555,499

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Equity Compensation Plans

For information regarding the Company s equity compensation plans, see Part III, Item 12 of this Report.

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth selected financial and other operating information of the Company. The selected financial data in the table is derived from the consolidated financial statements of the Company. The following selected financial data should be read in conjunction with the consolidated financial statements, the related notes, and Management s Discussion and Analysis of Financial Condition and Results of Operations included in this Report. As a result of certain transactions as summarized below, the period-to-period comparability of the Company s financial position and results of operations may be difficult.

During 2004 through 2006, the Company acquired the stock and certain assets of 17 different entities;

The Company began recognizing interest income in 2004 on a loan portfolio in which it earned a minimum interest rate of 9.5 percent. Interest income earned on this portfolio decreased as a result of rising interest rates and the pay down of the portfolio. As a result of the Company s settlement entered into with the Department, beginning July 1, 2006 the Company no longer recognizes 9.5 percent floor income on this loan portfolio;

In May 2007, the Company sold EDULINX, a Canadian student loan service provider and subsidiary of the Company. As a result of this transaction, the results of operations for EDULINX are reported as discontinued operations for all periods presented;

Upon passage of the College Cost Reduction Act in September 2007, management evaluated the carrying amount of goodwill and certain intangible assets. Based on the legislative changes and the student loan business model modifications the Company implemented as a result of the legislative changes, the Company recorded an impairment charge of $39.4 million;

In September 2007, the Company recorded an expense of $15.7 million to increase the Company s allowance for loan losses related to the increase in risk share as a result of the elimination of the Exceptional Performer program; and

In September 2007, the Company announced a strategic initiative to create efficiencies and lower costs in advance of the enactment of the College Cost Reduction Act, which impacted the FFEL Program in which the Company participates. As a result of these strategic decisions, the Company recorded restructuring charges of $20.3 million.

Management evaluates the Company s GAAP-based financial information as well as operating results on a non-GAAP performance measure referred to as base net income. Management believes base net income provides additional insight into the financial performance of the core operations.

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	Year ended Decmber 31,				
	2007	2006	2005	2004	2003
	(dollars in thousands, except share data)				
Income Statement Data:					
Net interest income	$ 244,614	308,459	328,999	398,160	171,722
Less provision (recovery) for loan losses	28,178	15,308	7,030	(529)	11,475
Net interest income after provision (recovery) for loan losses	216,436	293,151	321,969	398,689	160,247
Other income	330,835	263,166	145,801	119,893	121,976
Derivative market value, foreign currency, and put option adjustments	26,806	(31,075)	96,227	(11,918)	(1,183)
Derivative settlements, net	18,677	23,432	(17,008)	(34,140)	(1,601)
Salaries and benefits	(236,631)	(214,676)	(142,132)	(130,840)	(124,273)
Amortization of intangible assets	(30,426)	(25,062)	(8,151)	(8,707)	(12,766)
Impairment expense	(49,504)	(21,488)			
Other operating expenses	(219,048)	(185,053)	(117,448)	(98,580)	(96,111)
Income before income taxes and minority interest	57,145	102,395	279,258	234,397	46,289
Income from continuing operations	35,429	65,916	178,074	149,170	27,103
Income (loss) from discontinued operations, net of tax	(2,575)	2,239	3,048	9	
Net income	32,854	68,155	181,122	149,179	27,103
Earnings per share, basic and diluted:					
Continuing operations	$ 0.71	1.23	3.31	2.78	0.60
Discontinued operations	(0.05)	0.04	0.06		
Net income	0.66	1.27	3.37	2.78	0.60
Weighted average shares outstanding (basic)	49,618,107	53,593,056	53,761,727	53,648,605	45,501,583
Weighted average shares outstanding (diluted)	49,628,802	53,593,056	53,761,727	53,648,605	45,501,583
Dividends per common share	$ 0.28				
Other Data:					
Origination and acquisition volume (a)	$ 5,152,110	6,696,118	8,471,121	4,070,529	3,093,014
Average student loans	25,143,059	21,696,466	15,716,388	11,809,663	9,316,354
Student loans serviced (at end of period) (b)	33,817,458	30,593,592	26,988,839	21,076,045	18,773,899
Ratios:					
Core student loan spread	1.13%	1.42%	1.51%	1.66%	1.78%

Net loan charge-offs as a percentage of average student loans	0.030%	0.012%	0.006%	0.070%	0.080%
Shareholders equity to total assets (at end of period)	2.09%	2.51%	2.85%	3.01%	2.56%

	As of December 31,				
	2007	**2006**	**2005**	**2004**	**2003**
	(dollars in thousands)				
Balance Sheet Data:					
Cash and cash equivalents	$ 111,746	102,343	96,678	41,181	198,423
Student loans receivables, net	26,736,122	23,789,552	20,260,807	13,461,814	10,455,442
Goodwill and intangible assets	277,525	353,008	243,630	16,792	11,630
Total assets	29,162,783	26,796,873	22,798,693	15,169,511	11,932,831
Bonds and notes payable	28,115,829	25,562,119	21,673,620	14,300,606	11,366,458
Shareholders equity	608,879	671,850	649,492	456,175	305,489

(a) Initial loans originated or acquired through various channels, including originations through the direct channel; acquisitions through the branding partner channel, the forward flow channel, and the secondary market (spot purchases); and loans acquired in portfolio and business acquisitions.

(b) The student loans serviced does not include loans serviced by EDULINX for all periods presented.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(Management s Discussion and Analysis of Financial Condition and Results of Operations is for the years ended December 31, 2007, 2006, and 2005. All dollars are in thousands, except per share amounts, unless otherwise noted.)

OVERVIEW

The Company is an education planning and financing company focused on providing quality products and services to students, families, and schools nationwide. The Company is a vertically-integrated organization that offers a broad range of products and services to its customers throughout the education life cycle.

Built through a focus on long-term organic growth and further enhanced by strategic acquisitions, the Company earns its revenues from net interest income on its portfolio of student loans and from fee-based revenues related to its diversified education finance and service operations.

During 2007, the Company continued to diversify its revenue streams, increase fee-based revenue, utilize its scale and capacity to create efficiencies, and deploy capital by repurchasing shares of the Company s stock and paying its first quarterly dividends.

- Fee-based revenue for the year ended December 31, 2007 was 56% of total revenues compared to 44% for the year ended December 31, 2006.
- Fee-based revenue increased $71.8 million, or 30%, from $239.8 million for the year ended December 31, 2006 to $311.6 million for the year ended December 31, 2007.
- Operating expenses, excluding acquisitions and restructuring and legislative charges, increased $5.0 million, or 1.2%, from $399.7 million for the year ended December 31, 2006 to $404.7 million for the year ended December 31, 2007.
- The Company repurchased 3.4 million shares of its Class A common stock for $82.1 million during the year ended December 31, 2007.
- The Company paid a cash dividend of $0.07 per share on the Company s Class A and Class B common stock on March 15, 2007, June 15, 2007, September 15, 2007, and December 17, 2007. Total dividends paid in 2007 was $13.8 million.
- As of December 31, 2007, student loan assets were $26.7 billion, an increase of $2.9 billion, or 12.4%, compared to December 31, 2006.

The following events occurred in 2007 that significantly affected the operating results of the Company:

- The Company sold EDULINX and is reporting this transaction as discontinued operations;
- The College Cost Reduction Act was enacted;
- The Company initiated a restructuring plan; and
- The debt and secondary markets experienced unprecedented disruptions.

Sale of EDULINX

On May 25, 2007, the Company sold EDULINX, a Canadian student loan service provider and subsidiary of the Company. The Company recognized a net loss of $8.3 million related to the transaction. As a result of this transaction, the results of operations for EDULINX are reported as discontinued operations for all periods presented.

Legislative Impact

On September 27, 2007, the President signed into law the College Cost Reduction Act. This legislation contains provisions with significant implications for participants in the FFEL Program, including cutting funding to the FFEL

Program by $20 billion over a five year period as estimated by the Congressional Budget Office. Among other things, this legislation:

- Reduced special allowance payments to for-profit lenders and not-for-profit lenders by 0.55 percentage points and 0.40 percentage points, respectively, for both Stafford and Consolidation loans disbursed on or after October 1, 2007;

- Reduced special allowance payments to for-profit lenders and not-for-profit lenders by 0.85 percentage points and 0.70 percentage points, respectively, for PLUS loans disbursed on or after October 1, 2007;

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- Increased origination fees paid by lenders on all FFELP loan types, from 0.5 percent to 1.0 percent, for all loans first disbursed on or after October 1, 2007;
- Eliminated all provisions relating to Exceptional Performer status, and the monetary benefit associated with it, effective October 1, 2007; and
- For loans first disbursed on or after October 1, 2012, reduces default insurance to 95 percent of the unpaid principal of such loans.

As a result of this legislation, management expects the annual yield on FFELP loans to decrease by 70 to 80 basis points on student loans originated after October 1, 2007.

Upon passage of the College Cost Reduction Act, management evaluated the carrying amount of goodwill and certain intangible assets. Based on the legislative changes and the student loan business model modifications the Company implemented as a result of the legislative changes, the Company recorded an impairment charge of $39.4 million during the third quarter of 2007.

The Company also recorded an expense of $15.7 million during the third quarter of 2007 to increase the Company s allowance for loan losses related to the increase in risk share as a result of the elimination of the Exceptional Performer program.

In October 2005, the Company entered into an agreement to amend an existing contract with College Assist. College Assist is the Colorado state-designated guarantor of FFELP student loans. Under the agreement, the Company provides student loan servicing and guaranty operations and assumed the operational expenses and employment of certain College Assist employees. College Assist pays the Company a portion of the gross servicing and guaranty fees as consideration for the Company providing these services on behalf of College Assist. As a result of the passage of the College Cost Reduction Act, on October 2, 2007, the Department notified College Assist of its decision to formally terminate the Voluntary Flexible Agreement (VFA) between the Department and College Assist effective January 1, 2008. The termination of the VFA will decrease the Company s guaranty income by approximately $9 million annually.

Restructuring Charges

Legislative Impact

On September 6, 2007, the Company announced a strategic initiative to create efficiencies and lower costs in advance of the passage of the College Cost Reduction Act.

In anticipation of the federally driven cuts to the student loan programs, management initiated a variety of strategies to modify the Company s student loan business model, including lowering the cost of student loan acquisition, creating efficiencies in the Company s asset generation business, and decreasing operating expenses through a reduction in workforce and realignment of operating facilities. These strategies resulted in the net reduction of approximately 400 positions in the Company s overall workforce, including the elimination of approximately 500 positions and the creation of approximately 100 positions at the Company s larger facilities. In addition, the Company simplified its operating structure to leverage its larger facilities and technology by closing five small origination offices and downsizing its presence in Indianapolis. Implementation of the plan began immediately and was substantially completed during the fourth quarter of 2007. The Company estimates these restructuring activities will result in expense savings of as much as $25 million annually beginning in 2008. During the year ended December 31, 2007, the Company recorded restructuring charges of $20.3 million.

Capital Markets Impact

The Company has significant financing needs that it meets through the capital markets, including the debt and secondary markets. Since August 2007, these markets have experienced unprecedented disruptions, which are having an adverse impact on the Company s earnings and financial condition. On January 23, 2008, the Company announced a plan to further reduce operating expenses related to its student loan origination and related businesses by reducing marketing, sales, service, and related support costs through a reduction in workforce of approximately 300 positions and realignment of certain operating facilities as a result of the ongoing disruption in the credit markets. Since the Company cannot determine nor control the length of time or extent to which the capital markets remain disrupted, the

Company will reduce its direct and indirect costs related to its asset generation activities and be more selective in pursuing origination activity, in both the school and direct to consumer channels, for both private loans and FFELP loans. Accordingly, the Company has suspended Consolidation student loan originations and will continue to review the viability of continuing to originate and acquire student loans through its various channels. As a result of these items, the Company will experience a decrease in origination volume compared to historical periods.

The Company estimates that the total after-tax charge to earnings in 2008 associated with the restructuring plan will be approximately $17 million, consisting of approximately $4 million in severance costs, up to $2 million in contract termination costs, and approximately $11 million in non-cash charges related to the impairment of property and equipment, intangible assets, and goodwill. The Company anticipates that the after-tax charges to earnings will be incurred during the first two quarters of 2008, of which greater than 90% will be incurred in the first quarter.

As a result of this additional restructuring plan, the Company expects to reduce operating expenses by $15 million to $20 million (before tax) annually.

Disruptions in the Debt and Secondary Markets

The Company s primary market risk exposure arises from fluctuations in its borrowing and lending rates, the spread between which could be impacted by shifts in market interest rates. The Company has significant financing needs that it meets through the capital markets, including the debt and secondary markets. Since August 2007, these markets have experienced unprecedented disruptions, which have had an adverse impact on the Company s earnings and financial condition. Current conditions in the debt markets include reduced liquidity and increased credit risk premiums for most market participants. These conditions increased the Company s cost of debt during 2007 and reduced the Company s core student loan spread. If these markets continue to experience difficulties, the Company may be unable to securitize its student loans or to do so on favorable terms, including pricing. If the Company were unable to continue to securitize student loans on favorable terms, it could use alternative funding sources to fund increases in student loans to meet liquidity needs. If the Company was unable to find cost-effective and stable funding alternatives, its funding capabilities and liquidity would be negatively impacted and its cost of funds could increase, adversely affecting the Company s results of operations. In addition, the Company s ability to originate and acquire student loans would be limited or could be eliminated.

In accordance with generally accepted accounting principles, the Company reported net income of $32.9 million and $68.2 million for the years ended December 31, 2007 and 2006, respectively. The change in net income was driven primarily by the restructuring and legislative related charges, the change in the derivative market value, foreign currency, and put option adjustments, and reductions in interest income as a result of no longer receiving 9.5% special allowance payments in accordance with the Company s Settlement Agreement with the Department in January 2007.

RESULTS OF OPERATIONS

The Company s operating results are primarily driven by the performance of its existing portfolio, the cost necessary to generate new assets, the revenues generated by its fee based businesses, and the cost to provide those services. The performance of the Company s portfolio is driven by net interest income and losses related to credit quality of the assets along with the cost to administer and service the assets and related debt.

Acquisitions

Management believes the Company s business and asset acquisitions in recent years have enhanced the Company s position as a vertically-integrated industry leader and established a strong foundation for growth. Although the Company s assets, loan portfolios, and fee-based revenues increased through such transactions, a key aspect of each transaction is its impact on the Company s prospective organic growth and the development of its integrated platform of services. Management believes these acquisitions allow the Company to expand the products and services offered to educational and financial institutions and students and families throughout the education and education finance process. In addition, these acquisitions diversify the Company s asset generation streams and/or diversify revenue by offering other products and services that are not dependent on government programs, which management believes will reduce the Company s exposure to legislative and political risk. The Company also expects to reduce costs from these acquisitions through economies of scale and by integrating certain support services. In addition, the Company expects to increase revenue from these acquisitions by offering multiple products and services to its customers. As a result of these recent acquisitions, the period-to-period comparability of the Company s results of operations may be difficult.

Net Interest Income

The Company generates a significant portion of its earnings from the spread, referred to as its student loan spread, between the yield the Company receives on its student loan portfolio and the cost of funding these loans. This spread income is reported on the Company s consolidated statements of income as net interest income. The amortization of loan premiums, including capitalized costs of origination, the consolidation loan rebate fee, and yield adjustments

from borrower benefit programs, are netted against loan interest income on the Company s statements of operations. The amortization of debt issuance costs is included in interest expense on the Company s statements of operations.

The Company s portfolio of FFELP loans originated prior to April 1, 2006 earns interest at the higher of a variable rate based on the special allowance payment (SAP) formula set by the U.S. Department of Education (the Department) and the borrower rate. The SAP formula is based on an applicable index plus a fixed spread that is dependent upon when the loan was originated, the loan s repayment status, and funding sources for the loan. As a result of one of the provisions of the Higher Education Reconciliation Act of 2005 (HERA), the Company s portfolio of FFELP loans originated on or after April 1, 2006 earns interest at a variable rate based on the SAP formula. For the portfolio of loans originated on or after April 1, 2006, when the borrower rate exceeds the variable rate based on the SAP formula, the Company must return the excess to the Department.

On most consolidation loans, the Company must pay a 1.05% per year rebate fee to the Department. Those consolidation loans that have variable interest rates based on the SAP formula earn an annual yield less than that of a Stafford loan. Those consolidation loans that have fixed interest rates less than the sum of 1.05% and the variable rate based on the SAP formula also earn an annual yield less than that of a Stafford loan. As a result, as consolidation loans matching these criteria become a larger portion of the Company s loan portfolio, there will be a lower yield on the Company s loan portfolio in the short term.

Current legislation will have a significant impact on the Company s net interest income in future periods and should be considered when reviewing the Company s results of operations. On September 27, 2007, the President signed into law the College Cost Reduction Act. Among other things, this legislation:

- Reduced special allowance payments to for-profit lenders and not-for-profit lenders by 0.55 percentage points and 0.40 percentage points, respectively, for both Stafford and Consolidation loans disbursed on or after October 1, 2007;

- Reduced special allowance payments to for-profit lenders and not-for-profit lenders by 0.85 percentage points and 0.70 percentage points, respectively, for PLUS loans disbursed on or after October 1, 2007;

- Increased origination fees paid by lenders on all FFELP loan types, from 0.5 percent to 1.0 percent, for all loans first disbursed on or after October 1, 2007;

- Eliminated all provisions relating to Exceptional Performer status, and the monetary benefit associated with it, effective October 1, 2007; and

- Reduces default insurance to 95 percent of the unpaid principal of such loans, for loans first disbursed on or after October 1, 2012.

Management estimates the impact of this legislation will reduce the annual yield on FFELP loans originated after October 1, 2007 by 70 to 80 basis points. The Company believes it can mitigate some of the reduction in annual yield by creating efficiencies and lowering costs, modifying borrower benefits, and reducing loan acquisition costs.

Because the Company generates a significant portion of its earnings from its student loan spread, the interest rate sensitivity of the Company s balance sheet is very important to its operations. The current and future interest rate environment can and will affect the Company s interest earnings, net interest income, and net income. The effects of changing interest rate environments are further outlined in Item 7A, Quantitative and Qualitative Disclosures about Market Risk - Interest Rate Risk.

Investment interest income, which is a component of net interest income, includes income from unrestricted interest-earning deposits and funds in the Company s special purpose entities which are utilized for its asset-backed securitizations.

Net interest income also includes interest expense on unsecured debt offerings. The proceeds from these unsecured debt offerings were used by the Company to fund general business operations, certain asset and business acquisitions, and the repurchase of stock under the Company s stock repurchase plan.

Provision for Loan Losses

Management estimates and establishes an allowance for loan losses through a provision charged to expense. Losses are charged against the allowance when management believes the collectibility of the loan principal is unlikely.

Recovery of amounts previously charged off is credited to the allowance for loan losses. Management maintains the allowance for federally insured and non-federally insured loans at a level believed to be adequate to provide for estimated probable credit losses inherent in the loan portfolio. This evaluation is inherently subjective because it requires estimates that may be susceptible to significant changes. The Company analyzes the allowance separately for its federally insured loans and its non-federally insured loans.

Management bases the allowance for the federally insured loan portfolio on periodic evaluations of the Company s loan portfolios, considering past experience, trends in student loan claims rejected for payment by guarantors, changes to federal student loan programs, current economic conditions, and other relevant factors. One of the changes to the Higher Education Act as a result of HERA s enactment in February 2006, was to lower the guaranty rates on FFELP loans, including a decrease in insurance and reinsurance on portfolios receiving the benefit of the Exceptional Performance designation by 1%, from 100% to 99% of principal and accrued interest (effective July 1, 2006), and a decrease in insurance and reinsurance on portfolios not subject to the Exceptional Performance designation by 1%, from 98% to 97% of principal and accrued interest (effective for all loans first disbursed on and after July 1, 2006). In February 2006, as a result of the change in these legislative provisions, the Company recorded an expense of $6.9 million to increase the Company s allowance for loan losses.

In September 2005, the Company was re-designated as an Exceptional Performer by the Department in recognition of its exceptional level of performance in servicing FFELP loans. As a result of this designation, the Company received 99% reimbursement (100% reimbursement prior to July 1, 2006) on all eligible FFELP default claims submitted for reimbursement during the applicable period. Only FFELP loans that were serviced by the Company, as well as loans owned by the Company and serviced by other service providers designated as Exceptional Performers by the Department, were eligible for the 99% reimbursement.

On September 27, 2007, the President signed into law the College Cost Reduction Act. Among other things, this legislation eliminated all provisions relating to Exceptional Performer status, and the monetary benefit associated with it, effective October 1, 2007. During the three month period ended September 30, 2007, the Company recorded an expense of $15.7 million to increase the Company s allowance for loan losses related to the increase in risk share as a result of the elimination of the Exceptional Performer program.

In June 2006, the Company submitted its application for Exceptional Performer redesignation to the Department to continue receiving reimbursements at the 99% level for the 12-month period from June 1, 2006 through May 31, 2007. By a letter dated September 28, 2007, the Department informed the Company that it was redesignated as an Exceptional Performer for the period from June 1, 2006 through May 31, 2008. As stated above, the College Cost Reduction Act eliminated the Exceptional Performer designation effective October 1, 2007. Accordingly, the majority of claims submitted on or after October 1, 2007 are subject to reimbursement at 97% or 98% of principal and accrued interest depending on disbursement date of the loan.

In determining the adequacy of the allowance for loan losses on the non-federally insured loans, the Company considers several factors including: loans in repayment versus those in a nonpaying status, months in repayment, delinquency status, type of program, and trends in defaults in the portfolio based on Company and industry data. The Company places a non-federally insured loan on nonaccrual status and charges off the loan when the collection of principal and interest is 120 days past due.

Other Income

The Company also earns fees and generates income from other sources, including principally loan and guaranty servicing income; fee-based income on borrower late fees, payment management activities, and certain marketing and enrollment services; and fees from providing software services.

Loan and Guaranty Servicing Income Loan servicing fees are determined according to individual agreements with customers and are calculated based on the dollar value or number of loans serviced for each customer. Guaranty servicing fees are calculated based on the number of loans serviced or amounts collected. Revenue is recognized when earned pursuant to applicable agreements, and when ultimate collection is assured.

Other Fee-Based Income Other fee-based income includes borrower late fee income, payment management fees, the sale of lists and print products, and subscription-based products and services. Borrower late fee income earned by the Company s education lending subsidiaries is recognized when payments are collected from the borrower. Fees for payment management services are recognized over the period in which services are provided to customers. Revenue from the sale of lists and printed products is generally earned and recognized, net of estimated returns, upon shipment or delivery. Revenues from the sales of subscription-based products and services are recognized ratably over the term of the subscription. Subscription revenue received or receivable in advance of the delivery of services is included in deferred revenue.

Software Services Software services income is determined from individual agreements with customers and includes license and maintenance fees associated with student loan software products. Computer and software consulting services are recognized over the period in which services are provided to customers.

Other income also includes the derivative market value and foreign currency adjustments and derivative net settlements from the Company s derivative instruments and Euro Notes as further discussed in Item 7A, Quantitative and Qualitative Disclosures about Market Risk. The change in the fair value of put options (issued as part of the consideration for certain business combinations) is also included in other income.

Operating Expenses

Operating expenses includes indirect costs incurred to generate and acquire student loans, costs incurred to manage and administer the Company s student loan portfolio and its financing transactions, costs incurred to service the

Company s student loan portfolio and the portfolios of third parties, costs incurred to provide tuition payment processing, campus commerce, enrollment, list management, software, and technical services to third parties, and other general and administrative expenses. Operating expenses also includes the depreciation and amortization of capital assets and intangible assets. For the year ended December 31, 2007, operating expenses also includes employee termination benefits, lease termination costs, and the write-down of property and equipment related to the Company s restructuring plan and impairment charges from the write-down of intangible assets and goodwill as a result of legislative changes.

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Year ended December 31, 2007 compared to year ended December 31, 2006
Net Interest Income

	Year ended December 31, 2007	December 31, 2006	$ Change
Interest income:			
Loan interest	$ 1,667,057	1,455,715	211,342
Investment interest	80,219	93,918	(13,699)
Total interest income	1,747,276	1,549,633	197,643
Interest expense:			
Interest on bonds and notes payable	1,502,662	1,241,174	261,488
Net interest income	244,614	308,459	(63,845)
Provision for loan losses	28,178	15,308	12,870
Net interest income after provision for loan losses	$ 216,436	293,151	(76,715)

Net interest income for the year ended December 31, 2006 included $32.3 million of 9.5% special allowance payments. In accordance with the Company s Settlement Agreement with the Department in January 2007, the Company did not receive any 9.5% special allowance payments in 2007. Excluding the 9.5% special allowance payments, net interest income before the allowance for loan losses decreased $31.6 million. Interest expense increased $10.8 million for the year ended December 31, 2007 compared to the same period in 2006 as a result of additional issuances of unsecured debt used to fund operating activities of the Company. The remaining change in net interest income before the provision for loan losses is attributable to the growth in the Company s student loan portfolio offset by a decrease in core student loan spread as discussed in this Item 7 under Asset Generation and Management Operating Segment Results of Operations . The provision for loan losses increased for the year ended December 31, 2007 compared to 2006 as a result of the Company recognizing $15.7 million in expense for provision for loan losses as a result of the elimination of the Exceptional Performer program. During the year ended December 31, 2006, the Company recognized $6.9 million in expense for provision for loan losses as a result of HERA s enactment in February 2006.

Other Income

	Year ended December 31, 2007	December 31, 2006	$ Change
Loan and guaranty servicing income	$ 128,069	121,593	6,476
Other fee-based income	160,888	102,318	58,570
Software services income	22,669	15,890	6,779
Other income	19,209	23,365	(4,156)
Derivative market value, foreign currency, and put option adjustments	26,806	(31,075)	57,881
Derivative settlements, net	18,677	23,432	(4,755)

Total other income	$ 376,318	255,523	120,795

Loan and guaranty servicing income increased due to an increase in guaranty servicing income which was offset by a decrease in FFELP loan servicing income.

Other fee-based income increased due to business acquisitions, an increase in the number of managed tuition payment plans, an increase in campus commerce and related clients, and an increase in lead generation sales due to additional customers.

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Software services income increased as a result of new customers, additional projects for existing customers, and increased fees.

Other income decreased as a result of a decrease in gains on the sales of student loan assets of $13.0 million, offset by a gain on the sale of an entity accounted for under the equity method of $3.9 million in September 2007. The remaining change is a result of income earned on certain investment activities.

The change in derivative market value, foreign currency, and put option adjustments was caused by a change in the fair value of the Company s derivative portfolio and foreign currency rate fluctuations which are further discussed in Item 7A, Quantitative and Qualitative Disclosures about Market Risk.

The change in derivative settlements is discussed in Item 7A, Quantitative and Qualitative Disclosures about Market Risk.

Operating Expenses

		Year ended December 31, 2006	Impact of acquisitions	Impact of restructuring and impairment charges	Net change after impact of acquisitions and restructuring and impairment charges	Year ended December 31, 2007
Salaries and benefits	$	214,676	13,562	6,315	2,078	236,631
Other expenses		185,053	27,112	3,916	2,967	219,048
Amortization of intangible assets		25,062	5,364			30,426
Impairment expense		21,488		28,016		49,504
Total operating expenses	$	446,279	46,038	38,247	5,045	535,609

Excluding recent acquisitions and restructuring and impairment charges, operating expenses increased $5.0 million as a result of a $7.2 million increase in the first quarter of 2007, a $0.2 million decrease in the second quarter of 2007, a $2.3 million decrease in the third quarter of 2007, and a $0.3 million increase in the fourth quarter of 2007. The increase in the first quarter of 2007 was a result of (i) increased costs to develop systems to support a larger organizational structure and (ii) organic growth of the organization. The Company s costs to develop its corporate structure include projects such as recruitment, development, and retention of intellectual capital, technology enhancements to support a larger, more diversified customer and employee base, and increased emphasis on marketing services and products and developing the Company s brand. The decreases in the second and third quarters of 2007 are a result of the Company capitalizing on the operating leverage of its business structure and strategies.

Income Taxes

The Company s effective tax rate was 38.0% for the year ended December 31, 2007 compared to 35.4% for the same period in 2006. The effective tax rate increased due to certain enacted state tax law changes and an increase in expense recognized by the Company during 2007 compared to 2006 related to its outstanding put options which are not deductible for tax purposes. Management expects the Company s effective income tax rate to increase in future periods as a result of the various state tax law changes.

The Company adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (FIN 48) as discussed in note 16 in the notes to the consolidated financial statements included in this Report. The adoption of FIN 48 could increase the volatility of the Company s effective tax rate because FIN 48 requires that any change in judgment or change in measurement of a tax position taken in a prior period be recognized as a discrete event in the period in which it occurs. Additional information on the Company s results of operations is included with the discussion of the Company s operating segments in this Item 7 under Operating Segments .

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Year ended December 31, 2006 compared to year ended December 31, 2005
Net Interest Income

	Year ended December 31, 2006	December 31, 2005	$ Change
Interest income:			
Loan interest	$ 1,455,715	904,949	550,766
Investment Interest	93,918	44,161	49,757
Total interest income	1,549,633	949,110	600,523
Interest expense:			
Interest on bonds and notes payable	1,241,174	620,111	621,063
Net interest income	308,459	328,999	(20,540)
Provision for loan losses	15,308	7,030	8,278
Net interest income after provision for loan losses	$ 293,151	321,969	(28,818)

Net interest income for the years ended December 31, 2006 and 2005 included $32.3 million and $94.7 million of 9.5% special allowance payments. Excluding the 9.5% special allowance payments, net interest income before the allowance for loan losses increased $41.8 million. The remaining change in net interest income before the provision for loan losses is attributable to the growth in the Company s student loan portfolio, offset by a decrease in core student loan spread and an increase in interest expense as a result of additional issuances of unsecured debt as discussed in this Item 7 under Asset Generation and Management Operating Segment Results of Operations. The provision for loan losses increased as a result of the Company recognizing $6.9 million in expense for provision for loan losses as a result of HERA s enactment in February 2006.

Other Income

	Year ended December 31, 2006	December 31, 2005	$ Change
Loan and guaranty servicing income	$ 121,593	93,332	28,261
Other fee-based income	102,318	35,641	66,677
Software services income	15,890	9,169	6,721
Other income	23,365	7,659	15,706
Derivative market value, foreign currency, and put option adjustments	(31,075)	96,227	(127,302)
Derivative settlements, net	23,432	(17,008)	40,440
Total other income	$ 255,523	225,020	30,503

Loan and guaranty servicing income increased due to growth from acquisitions offset by a decrease in FFELP loan servicing income.

Other fee-based income increased largely due to recent acquisitions. In addition, the Company experienced an increase in borrower late fee income related to loan portfolio growth, an increase in the number of

managed tuition payment plans, and an increase in list sales volume.

Software services income increased due to the acquisition of 5280 Solutions, LLC (5280).

Other income increased as a result of the gains on the sales of student loan assets.

The change in derivative market value, foreign currency, and put option adjustments was caused by a change in the fair value of the Company s derivative portfolio and foreign currency rate fluctuations which are further discussed in Item 7A, Quantitative and Qualitative Disclosures about Market Risk.

The change in derivative settlements is discussed in Item 7A, Quantitative and Qualitative Disclosures about Market Risk.

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Operating expenses

	Year ended December 31, 2005	Impact of acquisitions	Impact of impairment charges	Net change after impact of acquisitions and impairment charges	Year ended December 31, 2006
Salaries and benefits	$ 142,132	60,222		12,322	214,676
Other expenses	117,448	65,709		1,896	185,053
Amortization of intangible assets	8,151	16,911			25,062
Impairment expense			21,488		21,488
Total operating expenses	$ 267,731	142,842	21,488	14,218	446,279

Excluding the impact of acquisitions and impairment charges, operating expenses increased $14.2 million, or 5.3%. This increase was a result of (i) increased costs to develop systems to support a larger organizational structure and (ii) organic growth of the organization, specifically that of the Company s school-based marketing efforts. The Company s costs to develop its corporate structure include projects such as recruitment, development, and retention of intellectual capital and technology enhancements to support a larger, more diversified customer and employee base.

Income Taxes

The Company s effective tax rate remained relatively consistent from 2005 to 2006, decreasing from 36.0% to 35.4%. During 2006, the Company s effective tax rate would have been negatively affected due to a put option adjustment, but was offset by a favorable rate adjustment from the resolution of various federal and state tax positions.

Financial Condition as of December 31, 2007 compared to December 31, 2006

	As of December 31,		Change	
	2007	2006	Dollars	Percent
Assets:				
Student loans receivable, net	$ 26,736,122	23,789,552	2,946,570	12.4%
Cash, cash equivalents, and investments	1,120,838	1,773,751	(652,913)	(36.8)
Goodwill	164,695	191,420	(26,725)	(14.0)
Intangible assets, net	112,830	161,588	(48,758)	(30.2)
Fair value of derivative instruments	222,471	146,099	76,372	52.3
Assets of discontinued operations		27,309	(27,309)	(100.0)
Other assets	805,827	707,154	98,673	14.0
Total assets	$ 29,162,783	26,796,873	2,365,910	8.8%
Liabilities:				
Bonds and notes payable	$ 28,115,829	25,562,119	2,553,710	10.0%
Fair value of derivative instruments	5,885	27,973	(22,088)	(79.0)
Other liabilities	432,190	534,931	(102,741)	(19.2)
Total liabilities	28,553,904	26,125,023	2,428,881	9.3

Shareholders equity	608,879	671,850	(62,971)	(9.4)
Total liabilities and shareholders equity	$ 29,162,783	$ 26,796,873	$ 2,365,910	8.8%

The Company s total assets increased during 2007 primarily due to an increase in student loans receivable and related assets. The Company originated or acquired $5.2 billion in student loans which was offset by repayments and loan sales. The Company financed the increase of student loans through the issuance of bonds and notes payable. Total equity increased $32.9 million as a result of net income for the year ended December 31, 2007, offset by the repurchase of 3.4 million shares of the Company s Class A common stock for $82.1 million. The acquisition of Packers Service Group, Inc. (Packers) as discussed in note 12 to the consolidated financial statements included in this Report resulted in a $12.5 million decrease in equity. In addition, the Company paid a $0.07 dividend on its Class A and Class B common stock in each quarter of 2007 which reduced equity by $13.8 million.

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OPERATING SEGMENTS

The Company has five operating segments as defined in SFAS No. 131 as follows: Asset Generation and Management, Student Loan and Guaranty Servicing, Tuition Payment Processing and Campus Commerce, Enrollment Services and List Management, and Software and Technical Services. The Company s operating segments are defined by the products and services they offer or the types of customers they serve, and they reflect the manner in which financial information is currently evaluated by management. The accounting policies of the Company s operating segments are the same as those described in note 3 in the notes to the consolidated financial statements included in this Report. Intersegment revenues are charged by a segment to another segment that provides the product or service. Intersegment revenues and expenses are included within each segment consistent with the income statement presentation provided to management. Changes in management structure or allocation methodologies and procedures may result in changes in reported segment financial information.

The management reporting process measures the performance of the Company s operating segments based on the management structure of the Company as well as the methodology used by management to evaluate performance and allocate resources. Management, including the Company s chief operating decision maker, evaluates the performance of the Company s operating segments based on their profitability. As discussed further below, management measures the profitability of the Company s operating segments on the basis of base net income. Accordingly, information regarding the Company s operating segments is provided based on base net income. The Company s base net income is not a defined term within GAAP and may not be comparable to similarly titled measures reported by other companies. Unlike financial accounting, there is no comprehensive, authoritative guidance for management reporting.

In May 2007, the Company sold EDULINX, a Canadian student loan service provider and subsidiary of the Company. As a result of this transaction, the results of operations for EDULINX are reported as discontinued operations for all periods presented. The operating results of EDULINX were included in the Student Loan and Guaranty Servicing operating segment. The Company presents base net income excluding discontinued operations since the operations and cash flows of EDULINX have been eliminated from the ongoing operations of the Company. Therefore, the results of operations for the Student Loan and Guaranty Servicing segment exclude the operating results of EDULINX for all periods presented. See note 2 in the notes to the consolidated financial statements included in this Report for additional information concerning EDULINX s detailed operating results that have been segregated from continuing operations and reported as discontinued operations.

Base net income is the primary financial performance measure used by management to develop the Company s financial plans, track results, and establish corporate performance targets and incentive compensation. While base net income is not a substitute for reported results under GAAP, the Company relies on base net income in operating its business because base net income permits management to make meaningful period-to-period comparisons of the operational and performance indicators that are most closely assessed by management. Management believes this information provides additional insight into the financial performance of the core business activities of the Company s operating segments.

Accordingly, the tables presented below reflect base net income which is reviewed and utilized by management to manage the business for each of the Company s operating segments. Reconciliation of the segment totals to the Company s consolidated operating results in accordance with GAAP are also included in the tables below. Included below under Non-GAAP Performance Measures is further discussion regarding base net income and its limitations, including a table that details the differences between base net income and GAAP net income by operating segment.

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Segment Results and Reconciliations to GAAP

	Year ended December 31, 2007									
	Asset Generation and Management	Student Loan and Guaranty Servicing	Tuition Payment Processing and Campus Commerce	Enrollment Services and List Management	Software and Technical Services	Total Segments	Corporate Activity and Overhead	Eliminations and Reclassifications	"Base net income" Adjustments to GAAP Results	GAAP Results o Operatio
al interest ome	$ 1,730,882	5,459	3,809	347	18	1,740,515	7,485	(3,737)	3,013	1,747,2
rest ense	1,465,883		7	7		1,465,897	40,502	(3,737)		1,502,6
interest ome	264,999	5,459	3,802	340	18	274,618	(33,017)		3,013	244,6
s provision loan losses	28,178					28,178				28,1
interest ome after vision for n losses	236,821	5,459	3,802	340	18	246,440	(33,017)		3,013	216,4
er income:										
n and ranty vicing ome	294	127,775				128,069				128,0
er based ome	13,387		42,682	103,311		159,380	1,508			160,8
tware vices ome				594	22,075	22,669				22,6
er income	8,030		84			8,114	11,095			19,2
rsegment enue		74,687	688	891	15,683	91,949	9,040	(100,989)		
ivative ket value, eign rency, and option ustments									26,806	26,8
ivative lements,	6,628					6,628	12,049			18,6

al other ome	28,339	202,462	43,454	104,796	37,758	416,809	33,692	(100,989)	26,806	376,3
erating enses:										
aries and efits	23,101	85,462	20,426	33,480	23,959	186,428	49,839	(1,747)	2,111	236,6
tructure ense										
erance and tract nination ts	2,406	1,840		929	58	5,233	4,998	(10,231)		
airment ense	28,291			11,401		39,692	9,812			49,5
er enses	29,205	36,618	8,901	60,445	2,995	138,164	77,915	2,969	30,426	249,4
rsegment enses	74,714	10,552	364	335	775	86,740	5,240	(91,980)		
al rating enses	157,717	134,472	29,691	106,590	27,787	456,257	147,804	(100,989)	32,537	535,6
ome s) before ome taxes	107,443	73,449	17,565	(1,454)	9,989	206,992	(147,129)		(2,718)	57,1
ome tax ense nefit) (a)	40,828	27,910	6,675	(553)	3,796	78,656	(57,285)		345	21,7
income s) from tinuing rations	66,615	45,539	10,890	(901)	6,193	128,336	(89,844)		(3,063)	35,4
ome s) from continued rations, net ax									(2,575)	(2,5
income s)	$ 66,615	45,539	10,890	(901)	6,193	128,336	(89,844)		(5,638)	32,8
al assets	$ 28,696,640	206,008	119,084	121,202	21,186	29,164,120	48,147	(49,484)		29,162,7

ar ended ember 31, 7:						
er Tax erating rgin - luding ructure ense, pairment ense, and vision for n losses ted to the s of eptional former	34.0%	22.5%	23.0%	6.4%	16.5%	24.0%
ar ended ember 31, 6:						
er Tax erating rgin - luding pairment ense	34.5%	20.8%	19.7%	11.6%	15.1%	26.8%
ar ended ember 31, 5:						
er Tax erating rgin	40.2%	21.6%	18.4%	29.7%	28.1%	33.7%

(a) Income taxes are based on a percentage of net income before tax for the individual operating segment.

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	Year ended December 31, 2006									
	Asset Generation and Management	Student Loan and Guaranty Servicing	Tuition Payment Processing and Campus Commerce	Enrollment Services and List Management	Software and Technical Services	Total Segments	Corporate Activity and Overhead	Eliminations and Reclassifications	"Base net income" Adjustments to GAAP Results	GAAP Results of Operations
Total interest income	$ 1,534,423	8,957	4,029	531	105	1,548,045	4,446	(2,858)		1,549,633
Interest expense	1,215,529		8			1,215,537	28,495	(2,858)		1,241,174
Net interest income	318,894	8,957	4,021	531	105	332,508	(24,049)			308,459
Less provision for loan losses	15,308					15,308				15,308
Net interest income after provision for loan losses	303,586	8,957	4,021	531	105	317,200	(24,049)			293,151
Other income:										
Loan and guaranty servicing income		121,593				121,593				121,593
Other fee-based income	11,867		35,090	55,361		102,318				102,318
Software services income	238	5		157	15,490	15,890				15,890
Other income	19,966	97				20,063	3,302			23,365
Intersegment revenue		63,545	503	1,000	17,877	82,925	662	(83,587)		
Derivative market value, foreign currency, and put option adjustments									(31,075)	(31,075)

Derivative settlements, net	18,381					18,381	5,051			23,432
Total other income	50,452	185,240	35,593	56,518	33,367	361,170	9,015	(83,587)	(31,075)	255,523
Operating expenses:										
Salaries and benefits	53,036	83,988	17,607	15,510	22,063	192,204	32,979	(12,254)	1,747	214,676
Impairment expense	21,687					21,687	(199)			21,488
Other expenses	51,085	32,419	8,371	30,854	3,238	125,967	59,086		25,062	210,115
Intersegment expenses	52,857	12,577	1,025	17		66,476	4,857	(71,333)		
Total operating expenses	178,665	128,984	27,003	46,381	25,301	406,334	96,723	(83,587)	26,809	446,279
Income (loss) before income taxes	175,373	65,213	12,611	10,668	8,171	272,036	(111,757)		(57,884)	102,395
Income tax expense (benefit) (a)	66,642	24,780	4,791	4,054	3,105	103,372	(46,902)		(20,233)	36,237
Net income (loss) before minority interest	108,731	40,433	7,820	6,614	5,066	168,664	(64,855)		(37,651)	66,158
Minority interest in subsidiary income			(242)			(242)				(242)
Net income (loss) from continuing operations	108,731	40,433	7,578	6,614	5,066	168,422	(64,855)		(37,651)	65,916
Income from discontinued operations, net of tax									2,239	2,239
Net income (loss)	$ 108,731	40,433	7,578	6,614	5,066	168,422	(64,855)		(35,412)	68,155

Total assets	$ 26,174,592	398,939	177,105	152,962	29,359	26,932,957	37,268	(200,661)	27,309	26,796,873

(a) Income taxes are based on a percentage of net income before tax for the individual operating segment.

	Year ended December 31, 2005									
	Asset Generation and Management	Student Loan and Guaranty Servicing	Tuition Payment Processing and Campus Commerce	Enrollment Services and List Management	Software and Technical Services	Total Segments	Corporate Activity and Overhead	Eliminations and Reclassifications	"Base net income" Adjustments to GAAP Results	GAAP Results of Operations
Total interest income	$ 940,390	4,580	1,384	165	21	946,540	2,615	(45)		949,110
Interest expense	609,863					609,863	10,293	(45)		620,111
Net interest income	330,527	4,580	1,384	165	21	336,677	(7,678)			328,999
Less provision for loan losses	7,030					7,030				7,030
Net interest income after provision for loan losses	323,497	4,580	1,384	165	21	329,647	(7,678)			321,969
Other income (expense):										
Loan and guaranty servicing income		93,332				93,332				93,332
Other fee-based income	9,053		14,239	12,349		35,641				35,641
Software services income	127				9,042	9,169				9,169
Other income	3,596	14				3,610	4,049			7,659
Intersegment revenue		42,798		139	5,848	48,785	408	(49,193)		
Derivative market value, foreign currency, and put option									96,227	96,227

adjustments										
Derivative settlements, net	(17,008)					(17,008)				(17,008)
Total other income (expense)	(4,232)	136,144	14,239	12,488	14,890	173,529	4,457	(49,193)	96,227	225,020
Operating expenses:										
Salaries and benefits	39,482	62,204	7,065	3,081	7,197	119,029	33,555	(10,452)		142,132
Other expenses	39,659	24,269	3,815	3,512	968	72,223	45,225		8,151	125,599
Intersegment expenses	33,070	5,196	99		(8)	38,357	384	(38,741)		
Total operating expenses	112,211	91,669	10,979	6,593	8,157	229,609	79,164	(49,193)	8,151	267,731
Income (loss) before income taxes	207,054	49,055	4,644	6,060	6,754	273,567	(82,385)		88,076	279,258
Income tax expense (benefit) (a)	78,680	18,641	1,765	2,302	2,567	103,955	(36,701)		33,327	100,581
Net income (loss) before minority interest	128,374	30,414	2,879	3,758	4,187	169,612	(45,684)		54,749	178,677
Minority interest in subsidiary income			(603)			(603)				(603)
Net income (loss) from continuing operations	128,374	30,414	2,276	3,758	4,187	169,009	(45,684)		54,749	178,074
Income from discontinued operations, net of tax									3,048	3,048
Net income (loss)	$ 128,374	30,414	2,276	3,758	4,187	169,009	(45,684)		57,797	181,122

Total assets	$ 22,327,023	473,538	90,794	41,649	23,178	22,956,182	58,173	(248,081)	32,419	22,798,693

(a) Income taxes are based on a percentage of net income before tax for the individual operating segment.

Non-GAAP Performance Measures

In accordance with the rules and regulations of the Securities and Exchange Commission (SEC), the Company prepares financial statements in accordance with generally accepted accounting principles (GAAP). In addition to evaluating the Company s GAAP-based financial information, management also evaluates the Company s operating segments on a non-GAAP performance measure referred to as base net income for each operating segment. While base net income is not a substitute for reported results under GAAP, the Company relies on base net income to manage each operating segment because management believes these measures provide additional information regarding the operational and performance indicators that are most closely assessed by management.

Base net income is the primary financial performance measure used by management to develop financial plans, allocate resources, track results, evaluate performance, establish corporate performance targets, and determine incentive compensation. Accordingly, financial information is reported to management on a base net income basis by operating segment, as these are the measures used regularly by the Company s chief operating decision maker. The Company s board of directors utilizes base net income to set performance targets and evaluate management s performance. The Company also believes analysts, rating agencies, and creditors use base net income in their evaluation of the Company s results of operations. While base net income is not a substitute for reported results under GAAP, the Company utilizes base net income in operating its business because base net income permits management to make meaningful period-to-period comparisons by eliminating the temporary volatility in the Company s performance that arises from certain items that are primarily affected by factors beyond the control of management. Management believes base net income provides additional insight into the financial performance of the core business activities of the Company s operations.

Limitations of Base Net Income

While GAAP provides a uniform, comprehensive basis of accounting, for the reasons discussed above, management believes that base net income is an important additional tool for providing a more complete understanding of the Company s results of operations. Nevertheless, base net income is subject to certain general and specific limitations that investors should carefully consider. For example, as stated above, unlike financial accounting, there is no comprehensive, authoritative guidance for management reporting. The Company s base net income is not a defined term within GAAP and may not be comparable to similarly titled measures reported by other companies. Investors, therefore, may not be able to compare the Company s performance with that of other companies based upon base net income . Base net income results are only meant to supplement GAAP results by providing additional information regarding the operational and performance indicators that are most closely monitored and used by the Company s management and board of directors to assess performance and information which the Company believes is important to analysts, rating agencies, and creditors.

Other limitations of base net income arise from the specific adjustments that management makes to GAAP results to derive base net income results. These differences are described below.

The adjustments required to reconcile from the Company s base net income measure to its GAAP results of operations relate to differing treatments for derivatives, foreign currency transaction adjustments, discontinued operations, and certain other items that management does not consider in evaluating the Company s operating results. The following table reflects adjustments associated with these areas by operating segment and Corporate Activity and Overhead for the years ended December 31, 2007, 2006, and 2005:

	Asset Generation and Management	Student Loan and Guaranty Servicing	Tuition Payment Processing and Campus Commerce	Enrollment Services and List Management	Software and Technical Services	Corporate Activity and Overhead	Total
				Year ended December 31, 2007			
Derivative market value, foreign currency, and put option adjustments	$ (24,224)					(2,582)	(26,806)
Amortization of intangible assets	5,634	5,094	5,815	12,692	1,191		30,426
Compensation related to business combinations						2,111	2,111
Variable-rate floor income	(3,013)						(3,013)
Income (loss) from discontinued operations, net of tax		2,575					2,575
Net tax effect (a)	8,209	(1,936)	(2,209)	(4,823)	(452)	1,556	345
Total adjustments to GAAP	$ (13,394)	5,733	3,606	7,869	739	1,085	5,638
				Year ended December 31, 2006			
Derivative market value, foreign currency, and put option adjustments	$ 5,483					25,592	31,075

Amortization of intangible assets	7,617	5,641	5,968	4,573	1,263		25,062
Compensation related to business combinations						1,747	1,747
Variable-rate floor income							
Income (loss) from discontinued operations, net of tax		(2,239)					(2,239)
Net tax effect (a)	(4,978)	(2,143)	(2,268)	(1,738)	(480)	(8,626)	(20,233)
Total adjustments to GAAP	$ 8,122	1,259	3,700	2,835	783	18,713	35,412

	Year ended December 31, 2005						
Derivative market value, foreign currency, and put option adjustments	$ (95,854)					(373)	(96,227)
Amortization of intangible assets	1,840	1,082	2,350	2,032	847		8,151
Compensation related to business combinations							
Variable-rate floor income							
Income (loss) from discontinued operations, net of tax		(3,048)					(3,048)
Net tax effect (a)	35,726	(412)	(893)	(772)	(322)		33,327
Total adjustments to GAAP	$ (58,288)	(2,378)	1,457	1,260	525	(373)	(57,797)

(a) Tax effect computed at 38%. The change in the value of the put option (included in Corporate Activity and Overhead) is not tax effected as this is not deductible for income tax purposes.

Differences between GAAP and Base Net Income"

Management s financial planning and evaluation of operating results does not take into account the following items because their volatility and/or inherent uncertainty affect the period-to-period comparability of the Company s results of operations. A more detailed discussion of the differences between GAAP and base net income follows.

Derivative market value, foreign currency, and put option adjustments: Base net income excludes the periodic unrealized gains and losses that are caused by the change in fair value on derivatives in which the Company does not qualify for hedge treatment under GAAP. Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS No. 133), requires that changes in fair value of derivative instruments be recognized currently in earnings unless specific hedge accounting criteria, as specified by SFAS No. 133, are met. The Company maintains an overall interest rate risk management strategy that incorporates the use of derivative instruments to reduce the economic effect of interest rate volatility. Derivative instruments primarily used by the Company include interest rate swaps, basis swaps, interest rate floor contracts, and cross-currency interest rate swaps. Management has structured all of the Company s derivative transactions with the intent that each is economically effective. However, the Company does not qualify its derivatives for hedge treatment as defined by SFAS No. 133, and the stand-alone derivative must be marked-to-market in the income statement with no consideration for the corresponding change in fair value of the hedged item. The Company believes these point-in-time estimates of asset and liability values that are subject to interest rate fluctuations make it difficult to evaluate the ongoing results of operations against its business plan and affect the period-to-period comparability of the results of operations. Included in base net income are the economic effects of the Company s derivative instruments, which includes any cash paid or received being recognized as an expense or revenue upon actual derivative settlements. These settlements are included in Derivative market value, foreign currency, and put option adjustments and derivative settlements, net on the Company s consolidated statements of income.

Base net income excludes the foreign currency transaction gains or losses caused by the re-measurement of the Company s Euro-denominated bonds to U.S. dollars. In connection with the issuance of the Euro-denominated bonds, the Company has entered into cross-currency interest rate swaps. Under the terms of these agreements, the principal payments on the Euro-denominated notes will effectively be paid at the exchange rate in effect at the issuance date of the bonds. The cross-currency interest rate swaps also convert the floating rate paid on the Euro-denominated bonds (EURIBOR index) to an index based on LIBOR. Included in base net income are the economic effects of any cash paid or received being recognized as an expense or revenue upon actual settlements of the cross-currency interest rate swaps. These settlements are included in Derivative market value, foreign currency, and put option adjustments and derivative settlements, net on the Company s consolidated statements of income. However, the gains or losses caused by the re-measurement of the Euro-denominated bonds to U.S. dollars and the change in market value of the cross-currency interest rate swaps are excluded from base net income as the Company believes the point-in-time estimates of value that are subject to currency rate fluctuations related to these financial instruments make it difficult to evaluate the ongoing results of operations against the Company s business plan and affect the period-to-period comparability of the results of operations. The re-measurement of the Euro-denominated bonds correlates with the change in fair value of the cross-currency interest rate swaps. However, the Company will experience unrealized gains or losses related to the cross-currency interest rate swaps if the two underlying indices (and related forward curve) do not move in parallel.

Base net income also excludes the change in fair value of put options issued by the Company for certain business acquisitions. The put options are valued by the Company each reporting period using a Black-Scholes pricing model. Therefore, the fair value of these options is primarily affected by the strike price and term of the underlying option, the Company s current stock price, and the dividend yield and volatility of the Company s stock. The Company believes these point-in-time estimates of value that are subject to fluctuations make it difficult to evaluate the ongoing results of operations against the Company s business plans and affects the period-to-period comparability of the results of operations.

The gains and/or losses included in Derivative market value, foreign currency, and put option adjustments and derivative settlements, net on the Company s consolidated statements of income are primarily caused by interest rate and currency volatility, changes in the value of put options based on the inputs used in the Black-Scholes pricing

model, as well as the volume and terms of put options and of derivatives not receiving hedge treatment. Base net income excludes these unrealized gains and losses and isolates the effect of interest rate, currency, and put option volatility on the fair value of such instruments during the period. Under GAAP, the effects of these factors on the fair value of the put options and the derivative instruments (but not the underlying hedged item) tend to show more volatility in the short term.

Amortization of intangible assets: Base net income excludes the amortization of acquired intangibles, which arises primarily from the acquisition of definite life intangible assets in connection with the Company s acquisitions, since the Company feels that such charges do not drive the Company s operating performance on a long-term basis and can affect the period-to-period comparability of the results of operations.

Compensation related to business combinations: The Company has structured certain business combinations in which the consideration paid has been dependent on the sellers continued employment with the Company. As such, the value of the consideration paid is recognized as compensation expense by the Company over the term of the applicable employment agreement.

Base net income excludes this expense because the Company believes such charges do not drive its operating performance on a long-term basis and can affect the period-to-period comparability of the results of operations. If the Company did not enter into the employment agreements in connection with the acquisition, the amount paid to these former shareholders of the acquired entity would have been recorded by the Company as additional consideration of the acquired entity, thus, not having an effect on the Company s results of operations.

***Variable-rate floor income*:** Loans that reset annually on July 1 can generate excess spread income compared with the rate based on the special allowance payment formula in declining interest rate environments. The Company refers to this additional income as variable-rate floor income. The Company excludes variable-rate floor income from its base net income since its timing and amount (if any) is uncertain, it has been eliminated by legislation for all loans originated on and after April 1, 2006, and it is in excess of expected spreads. In addition, because variable-rate floor income is subject to the underlying rate for the subject loans being reset annually on July 1, it is a factor beyond the Company s control which can affect the period-to-period comparability of results of operations.

Variable-rate floor income is calculated by the Company on a statutory basis. As a result of the disruptions in the debt and secondary capital markets beginning in August 2007, the benefit of variable-rate floor income has not been realized by the Company due to the widening of the spread between short term interest rate indices and the Company s actual cost of funds. The Company entered into interest rate swaps with effective dates beginning in January 2008 to hedge a portion of the variable-rate floor income. Settlements on these derivatives will be presented as part of the Company s statutory calculation of variable-rate floor income.

Discontinued operations: In May 2007, the Company sold EDULINX. As a result of this transaction, the results of operations for EDULINX are reported as discontinued operations for all periods presented. The Company presents base net income excluding discontinued operations since the operations and cash flows of EDULINX have been eliminated from the ongoing operations of the Company.

ASSET GENERATION AND MANAGEMENT OPERATING SEGMENT RESULTS OF OPERATIONS

The Asset Generation and Management segment includes the acquisition, management, and ownership of the Company s student loan assets. Revenues are primarily generated from net interest income on the student loan assets. The Company generates student loan assets through direct origination or through acquisitions. The student loan assets are held in a series of education lending subsidiaries designed specifically for this purpose.

In addition to the student loan portfolio, all costs and activity associated with the generation of assets, funding of those assets, and maintenance of the debt transactions are included in this segment. This includes derivative activity and the related derivative market value and foreign currency adjustments. The Company is also able to leverage its capital market expertise by providing investment advisory services and other related services to third parties through a licensed broker dealer subsidiary. Revenues and expenses for those functions are also included in the Asset Generation and Management segment.

Student Loan Portfolio

The table below outlines the components of the Company s student loan portfolio:

	As of December 31, 2007		As of December 31, 2006		As of December 31, 2005	
	Dollars	Percent	Dollars	Percent	Dollars	Percent
Federally insured:						
Stafford	$ 6,725,910	25.2%	$ 5,724,586	24.1%	$ 6,434,655	31.8%
PLUS/SLS	429,941	1.6	365,112	1.5	376,042	1.8
Consolidation	18,898,547	70.7	17,127,623	72.0	13,005,378	64.2
Non-federally insured	274,815	1.0	197,147	0.8	96,880	0.5
Total	26,329,213	98.5	23,414,468	98.4	19,912,955	98.3
Unamortized premiums and deferred origination costs	452,501	1.7	401,087	1.7	361,242	1.8

Allowance for loan losses:						
Allowance federally insured	(24,534)	(0.1)	(7,601)		(98)	
Allowance non-federally insured	(21,058)	(0.1)	(18,402)	(0.1)	(13,292)	(0.1)
Net	$ 26,736,122	100.0%	$ 23,789,552	100.0%	$ 20,260,807	100.0%

The impact of the College Cost Reduction Act reduces the yield on FFELP student loans originated on or after October 1, 2007. As of December 31, 2007, the Company has $0.4 billion of loans originated on or after October 1, 2007.

The Company s net student loan assets have increased $2.9 billion, or 12.4%, to $26.7 billion as of December 31, 2007 compared to $23.8 billion as of December 31, 2006. The Company s net student loan assets increased $3.5 billion, or 17.4%, from $20.3 billion as of December 31, 2005 to $23.8 billion as of December 31, 2006.

Origination and Acquisition

The Company originates and acquires loans through various methods and channels including: (i) direct-to-consumer channel (in which the Company originates student loans directly with student and parent borrowers), (ii) campus based origination channels, and (iii) spot purchases.

The Company will originate or acquire loans through its campus based channel either directly under one of its brand names or through other originating lenders. In addition to its brands, the Company acquires student loans from lenders to whom the Company provides marketing and/or origination services established through various contracts. Branding partners are lenders for which the Company acts as a marketing agent in specified geographic areas. A forward flow lender is one for whom the Company provides origination services but provides no marketing services or whom simply agrees to sell loans to the Company under forward sale commitments. The following table sets forth the activity of loans originated or acquired through each of the Company s channels:

	Year ended December 31,		
	2007	**2006**	**2005**
Beginning balance	$ 23,414,468	19,912,955	13,299,094
Direct channel:			
Consolidation loan originations	3,096,754	5,299,820	4,037,366
Less consolidation of existing portfolio	(1,602,835)	(2,643,880)	(1,966,000)
Net consolidation loan originations	1,493,919	2,655,940	2,071,366
Stafford/PLUS loan originations	1,086,398	1,035,695	720,545
Branding partner channel (a) (b)	662,629	720,641	657,720
Forward flow channel	1,105,145	1,600,990	1,153,125
Other channels (b)	804,019	682,852	796,886
Total channel acquisitions	5,152,110	6,696,118	5,399,642
Repayments, claims, capitalized interest, participations, and other	(1,321,055)	(1,332,086)	(1,002,260)
Consolidation loans lost to external parties	(800,978)	(1,114,040)	(855,000)
Loans acquired in portfolio and business acquisitions			3,071,479
Loans sold	(115,332)	(748,479)	
Ending balance	$ 26,329,213	23,414,468	19,912,955

(a) Included in the branding partner channel are private loan originations of $110.5 million, $55.7 million, and $13.4 million for the years ended December 31, 2007, 2006, and

2005, respectively.

(b) Included in other channels for the year ended December 31, 2006 is $190.1 million of acquisitions that were previously presented as branding partner channel acquisitions. This reclassification was made for comparative purposes due to the nature of the transactions.

During 2006 and 2007, the Company originated $5.3 billion and $3.1 billion of consolidation loans, respectively. With the changes in legislation and impact of capital markets, the Company has suspended consolidation loan originations in January 2008.

The other channels for the year ended December 31, 2005 includes $630.8 million of student loans purchased from Union Bank and Trust (Union Bank), an entity under common control with the Company. The acquisition of these loans was made by the Company as part of an agreement with Union Bank entered into in February 2005. As part of this agreement, Union Bank also committed to transfer to the Company substantially all of the remaining balance of Union Bank s origination rights in guaranteed student loans. As such, beginning in the second quarter of 2005, all loans originated by Union Bank on behalf of the Company are presented in the table above as direct channel originations.

Loans acquired in portfolio and business acquisitions for the year ended December 31, 2005 includes $2.2 billion and $0.9 billion of student loans purchased in October 2005 from Chela Education Funding, Inc. (Chela) and LoanSTAR Funding Group, Inc. (LoanSTAR), respectively.

Nova Southeastern University (Nova), a school-as-lender customer, elected not to renew their existing contract with the Company, which expired in December 2006. Total loans acquired from Nova were $44.6 million, $275.6 million, and $299.3 million for the years ended December 31, 2007, 2006, and 2005, respectively. Loans acquired from Nova are included in the forward flow channel in the above table.

As part of the Company s asset management strategy, the Company periodically sells student loan portfolios to third parties. During the years ended December 31, 2007 and 2006, the Company sold $115.3 million and $748.5 million (par value), respectively, of student loans resulting in the recognition of gains of $3.6 million and $16.1 million, respectively. There were no loans sold during the year ended December 31, 2005.

Legislative and Credit Market Impact to Student Loan Originations and Acquisitions

The College Cost Reduction Act has resulted in a reduction in the yields on student loans and, accordingly, a reduction in the amount of the premium the Company is able to pay lenders under its forward flow commitments and branding partner arrangements. As a result, the Company has been working with its forward flow and branding partner clients to renegotiate the premiums payable under its agreements. There can be no assurance that the Company will be successful in renegotiating the premiums under these agreements and, accordingly, the Company may be required to terminate commitments which are not economically reasonable. As a result, the Company will experience a decrease in its forward flow and branding partner loan volume. The Company has also had to terminate its affinity and referral programs and accordingly will experience a decrease in loan volume as a result.

The Company s primary funding needs are those required to finance its student loan portfolio and satisfy its cash requirements for new student loan originations and acquisitions. The Company relies upon secured financing vehicles as its most significant source of funding for student loans. Current conditions in the debt markets include reduced liquidity and increased credit risk premiums for most market participants. These conditions have increased the cost and reduced the availability of debt in the capital markets. As a result, a prolonged period of market illiquidity will affect the Company s loan acquisition and origination volumes. As previously discussed, as a result of the disruptions in the capital markets, the Company plans to be more selective in pursuing origination activity in both the direct-to-consumer and campus based channels. In addition to suspending consolidation loan originations, the Company is also evaluating the economic and market feasibility of continuing its asset generation and acquisition activities in the same manner and scale as historical periods.

Activity in the Allowance for Loan Losses

The provision for loan losses represents the periodic expense of maintaining an allowance sufficient to absorb losses, net of recoveries, inherent in the portfolio of student loans. An analysis of the Company s allowance for loan losses is presented in the following table:

	Year ended December 31,		
	2007	**2006**	**2005**
Balance at beginning of period	$ 26,003	13,390	7,272
Provision for loan losses:			
Federally insured loans	23,158	9,268	280
Non-federally insured loans	5,020	6,040	6,750
Total provision for loan losses	28,178	15,308	7,030
Charge-offs, net of recoveries:			
Federally insured loans	(6,225)	(1,765)	(299)
Non-federally insured loans	(1,193)	(930)	(613)
Net charge-offs	(7,418)	(2,695)	(912)
Sale of non-federally insured loans	(1,171)		
Balance at end of period	$ 45,592	26,003	13,390
Allocation of the allowance for loan losses:			
Federally insured loans	$ 24,534	7,601	98
Non-federally insured loans	21,058	18,402	13,292

Total allowance for loan losses	$ 45,592	26,003	13,390
Net loan charge-offs as a percentage of average student loans	0.030%	0.012%	0.006%
Total allowance as a percentage of average student loans	0.181%	0.120%	0.085%
Total allowance as a percentage of ending balance of student loans	0.173%	0.111%	0.067%
Non-federally insured allowance as a percentage of the ending balance of non-federally insured loans	7.663%	9.334%	13.720%
Average student loans	$ 25,143,059	21,696,466	15,716,388
Ending balance of student loans	26,329,213	23,414,468	19,912,955
Ending balance of non-federally insured loans	274,815	197,147	96,880

In 2006, the Company recognized a $6.9 million provision on its federally insured portfolio as a result of HERA which was enacted into law on February 8, 2006. See note 3 in the accompanying consolidated financial statements included in this Report for additional information related to HERA. In 2007, the Company recorded an expense of $15.7 million to increase the Company s allowance for loan losses related to the increase in risk share as a result of the elimination of the Exceptional Performer program.

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Delinquencies have the potential to adversely impact the Company s earnings through increased servicing and collection costs and account charge-offs. The table below shows the Company s student loan delinquency amounts:

	As of December 31, 2007		As of December 31, 2006	
	Dollars	Percent	Dollars	Percent
Federally Insured Loans:				
Loans in-school/grace/deferment(1)	$ 7,115,505		$ 6,271,558	
Loans in forebearance(2)	3,015,456		2,318,184	
Loans in repayment status:				
Loans current	13,937,702	87.5%	12,944,768	88.5%
Loans delinquent 31-60 days(3)	682,956	4.3	623,439	4.3
Loans delinquent 61-90 days(3)	353,303	2.2	299,413	2.0
Loans delinquent 91 days or greater(4)	949,476	6.0	759,959	5.2
Total loans in repayment	15,923,437	100.0%	14,627,579	100.0%
Total federally insured loans	$ 26,054,398		$ 23,217,321	
Non-Federally Insured Loans:				
Loans in-school/grace/deferment(1)	$ 111,946		$ 83,973	
Loans in forebearance(2)	12,895		6,113	
Loans in repayment status:				
Loans current	142,851	95.3%	101,084	94.4%
Loans delinquent 31-60 days(3)	3,450	2.3	2,681	2.5
Loans delinquent 61-90 days(3)	1,247	0.8	1,233	1.2
Loans delinquent 91 days or greater(4)	2,426	1.6	2,063	1.9
Total loans in repayment	149,974	100.0%	107,061	100.0%
Total non-federally insured loans	$ 274,815		$ 197,147	

(1) Loans for borrowers who still may be attending school or engaging in other permitted educational activities and are not yet required to make payments on the loans, *e.g.*, residency periods for medical students or a grace period for bar

exam preparation for law students.

(2) Loans for borrowers who have temporarily ceased making full payments due to hardship or other factors, according to a schedule approved by the servicer consistent with the established loan program servicing procedures and policies.

(3) The period of delinquency is based on the number of days scheduled payments are contractually past due and relate to repayment loans, that is, receivables not charged off, and not in school, grace, deferment, or forbearance.

(4) Loans delinquent 91 days or greater include loans in claim status, which are loans which have gone into default and have been submitted

to the guaranty agency for FFELP loans, or, if applicable, the insurer for non-federally insured loans, to process the claim for payment.

Student Loan Spread Analysis

The following table analyzes the student loan spread on the Company s portfolio of student loans and represents the spread on assets earned in conjunction with the liabilities and derivative instruments used to fund the assets:

	Year ended December 31,		
	2007	**2006**	**2005**
Student loan yield (a)	7.76%	7.85%	6.90%
Consolidation rebate fees	(0.77)	(0.72)	(0.65)
Premium and deferred origination costs amortization (b)	(0.36)	(0.39)	(0.49)
Student loan net yield	6.63	6.74	5.76
Student loan cost of funds (c)	(5.49)	(5.12)	(3.75)
Student loan spread	1.14	1.62	2.01
Variable-rate floor income (d)	(0.01)		
Special allowance yield adjustments, net of settlements on derivatives (e)		(0.20)	(0.50)
Core student loan spread	1.13%	1.42%	1.51%
Average balance of student loans	$ 25,143,059	21,696,466	15,716,388
Average balance of debt outstanding	26,599,361	23,379,258	16,759,511

(a) The student loan yield for the year ended December 31, 2006 does not include the $2.8 million charge to write off accounts receivable from the Department related to third quarter 2006 9.5% special allowance payments that will not be

received under the Company s previously disclosed Settlement Agreement with the Department. The $2.8 million relates to loans earning 9.5% special allowance payments that were not subject to the OIG audit.

(b) Premium and deferred origination costs amortization for the year ended December 31, 2006 excludes premium amortization related to the Company s portfolio of 9.5% loans purchased in October 2005 as part of a business combination.

(c) The student loan cost of funds includes the effects of net settlement costs on the Company s derivative instruments (excluding the $2.0 million settlement related to the derivative instrument entered into in connection with the issuance of the junior subordinated hybrid securities for the year ended December 31, 2006 and the net settlements of $12.1 million and $7.0 million for the years ended

December 31, 2007 and December 31, 2006, respectively, on those derivatives no longer hedging student loan assets).

(d) Variable-rate floor income is calculated by the Company on a statutory basis. As a result of the disruptions in the debt and secondary capital markets which began in August 2007, the benefit of variable-rate floor income has not been realized by the Company due to the widening of the spread between short term interest rate indices and the Company s actual cost of funds. The Company entered into interest rate swaps with effective dates beginning in January 2008 to hedge a portion of the variable-rate floor income. Settlements on these derivatives will be

presented as part of the Company s statutory calculation of variable-rate floor income.

(e) The special allowance yield adjustment represents the impact on net spread had certain 9.5% loans earned at statutorily defined rates under a taxable financing. The special allowance yield adjustment includes net settlements on derivative instruments that were used to hedge this loan portfolio earning the excess yield. On January 19, 2007, the Company entered into a Settlement Agreement with the Department to resolve the audit by the OIG of the Company s portfolio of student loans receiving 9.5% special allowance payments. Under the terms of the

Agreement, all 9.5% special allowance payments were eliminated for periods on and after July 1, 2006. The Company had been deferring recognition of 9.5% special allowance payments related to those loans subject to the OIG audit effective July 1, 2006 pending satisfactory resolution of this issue.

The compression of the Company s core student loan spread during the year ended December 31, 2007 compared to 2006 and 2005 has been primarily due to (i) the increase in the cost of debt as a result of the disruptions in the debt and secondary capital markets; (ii) an increase in lower yielding consolidation loans and an increase in the consolidation rebate fees; and (iii) the elimination of 9.5% special allowance payments on non-special allowance yield adjustment student loans as a result of the Settlement Agreement with the Department. Additional compression during the year ended December 31, 2007 compared to the year ended December 31, 2006 was due to the mismatch in the reset frequency between the Company s floating rate assets and floating rate liabilities. The Company s core student loan spread benefited in the rising interest rate environment for the first six months in 2006 because the Company s cost of funds reset periodically on a discrete basis, in advance, while the Company s student loans received a yield based on the average daily interest rate over the period. As interest rates remained relatively flat or decreased during 2007, as compared to the same period in 2006, the Company did not benefit from the rate reset discrepancy of its assets and liabilities contributing to the compression. During 2007, the Company entered into basis swaps in which the Company receives three-month LIBOR set discretely in advance and pays a daily weighted average three-month LIBOR less a spread as defined in the individual agreements. The Company entered into these derivative instruments to better match the interest rate characteristics on its student loan assets and the debt funding such assets. The Company expects the impact of these derivatives will diminish the effects of these rate reset discrepancies in future periods.

As a result of the passage of the College Cost Reduction Act, the yield on FFELP loans originated after October 1, 2007 was reduced. The core student loan spread on these loans for the fourth quarter of 2007 was approximately 30 to 40 basis points.

As noted in Item 7A, Quantitative and Qualitative Disclosures about Market Risk , the Company has a portfolio of student loans that are earning interest at a fixed borrower rate which exceeds the statutorily defined variable lender rate creating fixed rate floor income which is included in its core student loan spread. The majority of these loans are consolidation loans that earn the greater of the borrower rate or 2.64% above the average commercial paper rate during the calendar quarter. When excluding fixed rate floor income, the Company s core student loan spread was 1.09%, 1.28%, and 1.23% for the years ended December 31, 2007, 2006, and 2005, respectively.

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Year ended December 31, 2007 compared to year ended December 31, 2006

	Year ended December 31, 2007	December 31, 2006	$ Change
Net interest income after the provision for loan losses	$ 236,821	303,586	(66,765)
Loan and guaranty servicing income	294		294
Other fee-based income	13,387	11,867	1,520
Software services income		238	(238)
Other income	8,030	19,966	(11,936)
Derivative settlements, net	6,628	18,381	(11,753)
Total other income	28,339	50,452	(22,113)
Salaries and benefits	23,101	53,036	(29,935)
Restructure expense severance and contract termination costs	2,406		2,406
Impairment expense	28,291	21,687	6,604
Other expenses	29,205	51,085	(21,880)
Intersegment expenses	74,714	52,857	21,857
Total operating expenses	157,717	178,665	(20,948)
Base net income before income taxes	107,443	175,373	(67,930)
Income tax expense	40,828	66,642	(25,814)
Base net income	$ 66,615	108,731	(42,116)
After Tax Operating Margin	25.1%	30.7%	
After Tax Operating Margin - excluding restructure expense, impairment expense, and provision for loan losses related to the loss of Exceptional Performer	34.0%	34.5%	

Net interest income after the provision for loan losses

	Year ended December 31,		Change	
	2007	2006	Dollars	Percent
Loan interest	$ 1,948,751	1,699,859	248,892	14.6%
Consolidation rebate fees	(193,687)	(156,751)	(36,936)	(23.6)
Amortization of loan premiums and deferred origination costs	(91,020)	(87,393)	(3,627)	(4.2)
Total loan interest	1,664,044	1,455,715	208,329	14.3
Investment interest	66,838	78,708	(11,870)	(15.1)

Total interest income	1,730,882	1,534,423	196,459	12.8
Interest on bonds and notes payable	1,462,679	1,213,446		

Total cash distributions
$
81,414

$
79,616

$
242,369

$
231,762

Cash distributions per unit applicable
to limited partners
$
1.095

$
1.075

$
3.265

$
3.205

11. NET INCOME PER UNIT

We have identified the general partner interest and incentive distribution rights (IDR) as participating securities and use the two-class method when calculating the net income per unit applicable to limited partners, which is based on the weighted-average number of common units outstanding during the period. Basic and diluted net income per unit applicable to limited partners are the same because we have no potentially dilutive securities outstanding.

The following table details the calculation of earnings per unit:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Thousands of Dollars, Except Unit and Per Unit Data)			
Net income attributable to NuStar Energy L.P.	$70,158	$68,310	$191,259	$187,435
Less general partner distribution (including IDR)	10,600	10,160	31,350	29,371
Less limited partner distribution	70,814	69,456	211,019	202,391
Distributions greater than earnings	$(11,256)	$(11,306)	$(51,110)	$(44,327)
General partner earnings:				
Distributions	$10,600	$10,160	$31,350	$29,371
Allocation of distributions greater than earnings (2%)	(225)	(225)	(1,023)	(886)
Total	$10,375	$9,935	$30,327	$28,485
Limited partner earnings:				
Distributions	$70,814	$69,456	$211,019	$202,391
Allocation of distributions greater than earnings (98%)	(11,031)	(11,081)	(50,087)	(43,441)
Total	$59,783	$58,375	$160,932	$158,950
Weighted-average limited partner units outstanding	64,612,423	64,610,549	64,611,181	62,386,373
Net income per unit applicable to limited partners	$0.92	$0.90	$2.49	$2.55

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NUSTAR ENERGY L.P. AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

12. STATEMENTS OF CASH FLOWS
Changes in current assets and current liabilities were as follows:

	Nine Months Ended September 30,	
	2011	2010
	(Thousands of Dollars)	
Decrease (increase) in current assets:		
Accounts receivable	$(148,814)	$(86,025)
Inventories	(176,936)	(114,885)
Other current assets	(25,838)	27,287
Increase (decrease) in current liabilities:		
Accounts payable	153,626	75,345
Payable to related party	2,023	12,697
Accrued interest payable	(6,092)	3,058
Accrued liabilities	(21,471)	(18,436)
Taxes other than income tax	5,607	(858)
Income tax payable	1,468	2,002
Changes in current assets and current liabilities	$(216,427)	$(99,815)

Cash flows related to interest and income taxes were as follows:

	Nine Months Ended September 30,	
	2011	2010
	(Thousands of Dollars)	
Cash paid for interest, net of amount capitalized	$87,576	$66,243
Cash paid for income taxes, net of tax refunds received	$11,974	$9,580

13. SEGMENT INFORMATION

Our reportable business segments consist of storage, transportation, and asphalt and fuels marketing. Our segments represent strategic business units that offer different services and products. We evaluate the performance of each segment based on its respective operating income, before general and administrative expenses and certain non-segmental depreciation and amortization expense. General and administrative expenses are not allocated to the operating segments since those expenses relate primarily to the overall management at the entity level. Our principal operations include terminalling and storage of petroleum products, the transportation of petroleum products and anhydrous ammonia, and petroleum refining and marketing. Intersegment revenues result from storage and throughput agreements with related parties at lease rates consistent with rates charged to third parties for storage and at pipeline tariff rates based upon the applicable published tariff.

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NUSTAR ENERGY L.P. AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Results of operations for the reportable segments were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Thousands of Dollars)			
Revenues:				
Storage:				
Third parties	$128,561	$120,793	$381,460	$353,337
Intersegment	13,042	10,344	35,925	33,241
Related party	286	—	823	—
Total storage	141,889	131,137	418,208	386,578
Transportation:				
Third parties	81,834	80,597	226,406	232,435
Intersegment	65	—	65	382
Total transportation	81,899	80,597	226,471	232,817
Asphalt and fuels marketing:				
Third parties	1,613,669	936,989	4,039,461	2,623,077
Intersegment	5,024	85	9,618	2,917
Total asphalt and fuels marketing	1,618,693	937,074	4,049,079	2,625,994
Consolidation and intersegment eliminations	(18,131)	(10,429)	(45,608)	(36,540)
Total revenues	$1,824,350	$1,138,379	$4,648,150	$3,208,849
Operating income:				
Storage	$48,778	$45,635	$140,322	$131,388
Transportation	38,248	37,512	102,808	106,004
Asphalt and fuels marketing	25,418	35,457	97,689	75,113
Consolidation and intersegment eliminations	29	1	(16)	278
Total segment operating income	112,473	118,605	340,803	312,783
Less general and administrative expenses	17,731	26,860	69,833	76,324
Less other depreciation and amortization expense	1,765	1,455	4,911	4,366
Total operating income	$92,977	$90,290	$266,059	$232,093

Total assets by reportable segment were as follows:

	September 30, 2011	December 31, 2010
	(Thousands of Dollars)	
Storage	$2,556,356	$2,454,264
Transportation	1,251,463	1,256,614
Asphalt and fuels marketing	1,655,442	1,154,499
Total segment assets	5,463,261	4,865,377
Other partnership assets	384,887	521,016
Total consolidated assets	$5,848,148	$5,386,393

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14. CONDENSED CONSOLIDATING FINANCIAL STATEMENTS

NuStar Energy has no operations and its assets consist mainly of its investments in NuStar Logistics and NuPOP, both wholly owned subsidiaries. The senior notes issued by NuStar Logistics and NuPOP are fully and unconditionally guaranteed by NuStar Energy, and each of NuStar Logistics and NuPOP fully and unconditionally guarantee the outstanding senior notes of the other. As a result, the following condensed consolidating financial statements are presented as an alternative to providing separate financial statements for NuStar Logistics and NuPOP.

Condensed Consolidating Balance Sheets
September 30, 2011
(Thousands of Dollars)

	NuStar Energy	NuStar Logistics	NuPOP	Non-Guarantor Subsidiaries (a)	Eliminations	Consolidated
Assets						
Cash and cash equivalents	$122	$6	$—	$ 59,086	$—	$59,214
Receivables, net	1,738	17,781	12,425	435,968	—	467,912
Inventories	—	2,277	14,686	586,969	(249)	603,683
Other current assets	—	13,429	2,378	53,294	—	69,101
Intercompany receivable	—	853,945	745,079	—	(1,599,024)	—
Total current assets	1,860	887,438	774,568	1,135,317	(1,599,273)	1,199,910
Property, plant and equipment, net	—	1,119,814	599,770	1,665,852	—	3,385,436
Intangible assets, net	—	2,001	—	40,498	—	42,499
Goodwill	—	18,094	170,652	657,780	—	846,526
Investment in wholly owned subsidiaries	3,119,736	249,458	1,137,467	2,315,991	(6,822,652)	—
Investment in joint venture	—	—	—	67,203	—	67,203
Deferred income tax asset	—	—	—	9,671	—	9,671
Other long-term assets, net	217	227,657	26,329	42,700	—	296,903
Total assets	$3,121,813	$2,504,462	$2,708,786	$ 5,935,012	$(8,421,925)	$5,848,148
Liabilities and Partners' Equity						
Current portion of long-term debt	$—	$102,510	$253,135	$ —	$—	$355,645
Payables	63	35,459	7,953	429,932	—	473,407
Accrued interest payable	—	16,273	7,318	24	—	23,615
Accrued liabilities	755	30,857	3,925	75,397	—	110,934
Taxes other than income tax	63	4,812	3,586	8,038	—	16,499
Income tax payable	—	1,462	—	1,497	—	2,959
Intercompany payable	510,653	—	—	1,088,371	(1,599,024)	—
Total current liabilities	511,534	191,373	275,917	1,603,259	(1,599,024)	983,059
Long-term debt, less current portion	—	1,883,485	253,709	32,816	—	2,170,010
Long-term payable to related party	—	5,390	—	6,481	—	11,871

Deferred income tax liability	—	—	—	35,917	—	35,917
Other long-term liabilities	—	25,299	245	96,698	—	122,242
Total partners' equity	2,610,279	398,915	2,178,915	4,159,841	(6,822,901)	2,525,049
Total liabilities and partners’ equity	$3,121,813	$2,504,462	$2,708,786	$ 5,935,012	$(8,421,925)	$5,848,148

(a) Non-guarantor subsidiaries are wholly owned by NuStar Energy, NuStar Logistics or NuPOP.

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Condensed Consolidating Balance Sheets
December 31, 2010
(Thousands of Dollars)

	NuStar Energy	NuStar Logistics	NuPOP	Non-Guarantor Subsidiaries (a)	Eliminations	Consolidated
Assets						
Cash and cash equivalents	$53	$107,655	$—	$ 73,413	$—	$181,121
Receivables, net	—	27,708	10,648	266,885	(3,188)	302,053
Inventories	—	1,776	6,712	405,521	(472)	413,537
Other current assets	—	10,116	1,202	31,478	—	42,796
Intercompany receivable	—	786,658	729,365	—	(1,516,023)	—
Total current assets	53	933,913	747,927	777,297	(1,519,683)	939,507
Property, plant and equipment, net	—	1,006,479	614,762	1,566,216	—	3,187,457
Intangible assets, net	—	2,106	—	40,927	—	43,033
Goodwill	—	18,094	170,652	624,524	—	813,270
Investment in wholly owned subsidiaries	3,167,764	159,813	994,249	2,112,355	(6,434,181)	—
Investment in joint venture	—	—	—	69,603	—	69,603
Deferred income tax asset	—	—	—	8,138	—	8,138
Other long-term assets, net	—	267,532	26,329	31,524	—	325,385
Total assets	$3,167,817	$2,387,937	$2,553,919	$ 5,230,584	$(7,953,864)	$5,386,393
Liabilities and Partners' Equity						
Current portion of long-term debt	$—	$832	$—	$ —	$—	$832
Payables	—	28,705	9,559	257,651	(3,188)	292,727
Accrued interest payable	—	21,180	8,490	36	—	29,706
Accrued liabilities	680	18,154	3,973	35,146	—	57,953
Taxes other than income tax	125	4,273	2,587	3,733	—	10,718
Income tax payable	—	1,140	—	153	—	1,293
Intercompany payable	510,812	—	—	1,005,211	(1,516,023)	—
Total current liabilities	511,617	74,284	24,609	1,301,930	(1,519,211)	393,229
Long-term debt, less current portion	—	1,589,189	514,270	32,789	—	2,136,248
Long-term payable to related party	—	3,571	—	6,517	—	10,088
Deferred income tax liability	—	—	—	29,565	—	29,565
Other long-term liabilities	—	33,458	228	80,877	—	114,563
Total partners' equity	2,656,200	687,435	2,014,812	3,778,906	(6,434,653)	2,702,700
Total liabilities and partners' equity	$3,167,817	$2,387,937	$2,553,919	$ 5,230,584	$(7,953,864)	$5,386,393

(a) Non-guarantor subsidiaries are wholly owned by NuStar Energy, NuStar Logistics or NuPOP.

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NUSTAR ENERGY L.P. AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Condensed Consolidating Statements of Income
For the Three Months Ended September 30, 2011
(Thousands of Dollars)

	NuStar Energy	NuStar Logistics	NuPOP	Non-Guarantor Subsidiaries (a)	Eliminations	Consolidated
Revenues	$—	$78,554	$46,076	$ 1,708,288	$(8,568)	$1,824,350
Costs and expenses	482	38,068	32,090	1,669,422	(8,689)	1,731,373
Operating (loss) income	(482)	40,486	13,986	38,866	121	92,977
Equity in earnings of subsidiaries	70,641	7,285	29,828	51,102	(158,856)	—
Equity in earnings of joint venture	—	—	—	2,599	—	2,599
Interest expense, net	—	(15,210)	(5,685)	(670)	—	(21,565)
Other income, net	—	109	246	412	—	767
Income (loss) before income tax expense	70,159	32,670	38,375	92,309	(158,735)	74,778
Income tax expense	1	542	—	3,954	—	4,497
Net income (loss)	70,158	32,128	38,375	88,355	(158,735)	70,281
Less net income attributable to noncontrolling interest	—	—	—	123	—	123
Net income (loss) attributable to NuStar Energy L.P.	$70,158	$32,128	$38,375	$ 88,232	$(158,735)	$70,158

(a) Non-guarantor subsidiaries are wholly owned by NuStar Energy, NuStar Logistics or NuPOP.

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Condensed Consolidating Statements of Income
For the Three Months Ended September 30, 2010
(Thousands of Dollars)

	NuStar Energy	NuStar Logistics	NuPOP	Non-Guarantor Subsidiaries (a)	Eliminations	Consolidated
Revenues	$—	$72,051	$44,675	$1,025,036	$(3,383)	$1,138,379
Costs and expenses	367	46,664	31,267	973,091	(3,300)	1,048,089
Operating (loss) income	(367)	25,387	13,408	51,945	(83)	90,290
Equity in earnings of subsidiaries	68,677	24,837	25,808	39,563	(158,885)	—
Equity in earnings of joint venture	—	—	—	2,454	—	2,454
Interest expense, net	—	(14,330)	(5,827)	(426)	—	(20,583)
Other income, net	—	69	(16)	(288)	—	(235)
Income (loss) before income tax expense	68,310	35,963	33,373	93,248	(158,968)	71,926
Income tax expense	—	465	—	3,151	—	3,616
Net income (loss)	$68,310	$35,498	$33,373	$90,097	$(158,968)	$68,310

(a) Non-guarantor subsidiaries are wholly owned by NuStar Energy, NuStar Logistics or NuPOP.

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NUSTAR ENERGY L.P. AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Condensed Consolidating Statements of Income
For the Nine Months Ended September 30, 2011
(Thousands of Dollars)

	NuStar Energy	NuStar Logistics	NuPOP	Non-Guarantor Subsidiaries (a)	Eliminations	Consolidated
Revenues	$—	$212,483	$136,525	$4,325,226	$(26,084)	$4,648,150
Costs and expenses	1,283	124,399	98,669	4,184,028	(26,288)	4,382,091
Operating (loss) income	(1,283)	88,084	37,856	141,198	204	266,059
Equity in earnings of subsidiaries	192,543	41,827	86,491	146,940	(467,801)	—
Equity in earnings of joint venture	—	—	—	6,997	—	6,997
Interest expense, net	—	(43,234)	(17,236)	(2,174)	—	(62,644)
Other income, net	—	292	265	(6,256)	—	(5,699)
Income (loss) before income tax expense	191,260	86,969	107,376	286,705	(467,597)	204,713
Income tax expense	1	1,569	—	11,741	—	13,311
Net income (loss)	191,259	85,400	107,376	274,964	(467,597)	191,402
Less net income attributable to noncontrolling interest	—	—	—	143	—	143
Net income (loss) attributable to NuStar Energy L.P.	$191,259	$85,400	$107,376	$274,821	$(467,597)	$191,259

(a) Non-guarantor subsidiaries are wholly owned by NuStar Energy, NuStar Logistics or NuPOP.

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Condensed Consolidating Statements of Income
For the Nine Months Ended September 30, 2010
(Thousands of Dollars)

	NuStar Energy	NuStar Logistics	NuPOP	Non-Guarantor Subsidiaries (a)	Eliminations	Consolidated
Revenues	$—	$219,277	$117,535	$2,888,095	$(16,058)	$3,208,849
Costs and expenses	1,042	139,698	87,245	2,766,926	(18,155)	2,976,756
Operating (loss) income	(1,042)	79,579	30,290	121,169	2,097	232,093
Equity in earnings of subsidiaries	188,476	39,295	93,698	134,457	(455,926)	—
Equity in earnings of joint venture	—	—	—	7,571	—	7,571
Interest expense, net	1	(38,744)	(17,671)	(1,645)	—	(58,059)
Other income, net	—	1,308	243	13,331	—	14,882
Income (loss) before income tax expense	187,435	81,438	106,560	274,883	(453,829)	196,487
Income tax expense	—	1,191	—	7,861	—	9,052
Net income (loss)	$187,435	$80,247	$106,560	$267,022	$(453,829)	$187,435

(a) Non-guarantor subsidiaries are wholly owned by NuStar Energy, NuStar Logistics or NuPOP.

Condensed Consolidating Statements of Cash Flows
For the Nine Months Ended September 30, 2011
(Thousands of Dollars)

	NuStar Energy	NuStar Logistics	NuPOP	Non-Guarantor Subsidiaries (a)	Eliminations	Consolidated
Net cash provided by (used in) operating activities	$239,146	$84,681	$20,883	$ (2,244)	$(240,595)	$101,871
Cash flows from investing activities:						
Capital expenditures	—	(152,764)	(4,954)	(86,240)	—	(243,958)
Acquisitions	—	—	—	(100,693)	—	(100,693)
Investment in other long-term assets	—	—	—	(8,449)	—	(8,449)
Proceeds from sale or disposition of assets	—	57	79	309	—	445
Investment in subsidiaries	(57,300)	(47,820)	(56,727)	(56,727)	218,574	—
Net cash used in investing activities	(57,300)	(200,527)	(61,602)	(251,800)	218,574	(352,655)
Cash flows from financing activities:						
Debt borrowings	—	738,702	—	—	—	738,702
Debt repayments	—	(379,753)	—	—	—	(379,753)
Issuance of common units, net of issuance costs	1,583	—	—	—	—	1,583
General partner contribution	70	—	—	—	—	70
Distributions to unitholders and general partner	(240,571)	(240,571)	—	(24)	240,595	(240,571)
Contributions from (distributions to) affiliates	57,300	(57,300)	56,727	161,847	(218,574)	—
Proceeds from termination of interest rate swaps	—	12,632	—	—	—	12,632
Net intercompany borrowings (repayments)	(159)	(66,833)	(16,008)	83,000	—	—
Other, net	—	181	—	(966)	—	(785)
Net cash provided by (used in) financing activities	(181,777)	7,058	40,719	243,857	22,021	131,878
Effect of foreign exchange rate changes on cash	—	1,139	—	(4,140)	—	(3,001)
Net (decrease) increase in cash and cash equivalents	69	(107,649)	—	(14,327)	—	(121,907)
Cash and cash equivalents as of the	53	107,655	—	73,413	—	181,121

beginning of the period						
Cash and cash equivalents as of the end of the period	$122	$6	$—	$ 59,086	$—	$59,214

(a) Non-guarantor subsidiaries are wholly owned by NuStar Energy, NuStar Logistics or NuPOP.

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NUSTAR ENERGY L.P. AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

Condensed Consolidating Statements of Cash Flows
For the Nine Months Ended September 30, 2010
(Thousands of Dollars)

	NuStar Energy	NuStar Logistics	NuPOP	Non-Guarantor Subsidiaries (a)	Eliminations	Consolidated
Net cash provided by (used in) operating activities	$223,178	$122,613	$14,937	$45,666	$(225,561)	$180,833
Cash flows from investing activities:						
Capital expenditures	—	(75,175)	(10,017)	(106,266)	—	(191,458)
Acquisition	—	—	—	(43,026)	—	(43,026)
Proceeds from insurance recoveries	—	—	—	13,500	—	13,500
Investment in other long-term assets	—	—	—	(3,400)	—	(3,400)
Proceeds from sale or disposition of assets	—	16	28	1,948	—	1,992
Investment in subsidiaries	(245,604)	—	—	(25)	245,629	—
Net cash used in investing activities	(245,604)	(75,159)	(9,989)	(137,269)	245,629	(222,392)
Cash flows from financing activities:						
Debt borrowings	—	952,475	—	—	—	952,475
Debt repayments	—	(1,343,224)	—	—	—	(1,343,224)
Senior note offering, net	—	445,574	—	—	—	445,574
Issuance of common units, net of issuance costs	240,158	—	—	—	—	240,158
General partner contribution	5,078	—	—	—	—	5,078
Contributions from (distributions to) affiliates	—	245,604	—	25	(245,629)	—
Distributions to unitholders and general partner	(225,538)	(225,538)	—	(23)	225,561	(225,538)
Net intercompany borrowings (repayments)	2,728	(90,801)	(4,947)	93,020	—	—
Other, net	—	(6,987)	(1)	(1,758)	—	(8,746)
Net cash provided by (used in) financing activities	22,426	(22,897)	(4,948)	91,264	(20,068)	65,777
Effect of foreign exchange rate changes on cash	—	(5,290)	—	4,932	—	(358)
Net decrease in cash and cash equivalents	—	19,267	—	4,593	—	23,860
	53	1,602	—	60,351	—	62,006

Cash and cash equivalents as of the beginning of the period						
Cash and cash equivalents as of the end of the period	$53	$20,869	$—	$ 64,944	$—	$85,866

(a) Non-guarantor subsidiaries are wholly owned by NuStar Energy, NuStar Logistics or NuPOP.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

FORWARD-LOOKING STATEMENTS

This Form 10-Q contains certain estimates, predictions, projections, assumptions and other forward-looking statements that involve various risks and uncertainties. While these forward-looking statements, and any assumptions upon which they are based, are made in good faith and reflect our current judgment regarding the direction of our business, actual results will almost always vary, sometimes materially, from any estimates, predictions, projections, assumptions or other future performance suggested in this report. These forward-looking statements can generally be identified by the words "anticipates," "believes," "expects," "plans," "intends," "estimates," "forecasts," "budgets," "projects," "could," "should," "may" and similar expressions. These statements reflect our current views with regard to future events and are subject to various risks, uncertainties and assumptions. Please read our Annual Report on Form 10-K for the year ended December 31, 2010, Part I, Item 1A "Risk Factors," as well as our subsequent current and quarterly reports, for a discussion of certain of those risks, uncertainties and assumptions.

If one or more of these risks or uncertainties materialize, or if the underlying assumptions prove incorrect, our actual results may vary materially from those described in any forward-looking statement. Other unknown or unpredictable factors could also have material adverse effects on our future results. Readers are cautioned not to place undue reliance on this forward-looking information, which is as of the date of this Form 10-Q. We do not intend to update these statements unless it is required by the securities laws to do so, and we undertake no obligation to publicly release the result of any revisions to any such forward-looking statements that may be made to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events.

OVERVIEW

NuStar Energy L.P. (NuStar Energy) is a publicly held Delaware limited partnership engaged in the terminalling and storage of petroleum products, the transportation of petroleum products and anhydrous ammonia, and petroleum refining and marketing. Unless otherwise indicated, the terms "NuStar Energy," "the Partnership," "we," "our" and "us" are us in this report to refer to NuStar Energy L.P., to one or more of our consolidated subsidiaries or to all of them taken as a whole. NuStar GP Holdings, LLC (NuStar GP Holdings) (NYSE: NSH) owns our general partner, Riverwalk Logistics, L.P., and owns a 17.6% total interest in us as of September 30, 2011. Our Management's Discussion and Analysis of Financial Condition and Results of Operations is presented in six sections:

- Overview
- Results of Operations
- Outlook
- Liquidity and Capital Resources
- Related Party Transactions
- Critical Accounting Policies

Acquisitions

On April 19, 2011, we purchased certain refining and storage assets, inventory and other working capital items from AGE Refining, Inc. for $62.0 million, including the assumption of certain environmental liabilities (the San Antonio Refinery Acquisition). The assets consist of a 14,500 barrel per day refinery in San Antonio, Texas and 200,000 barrels of storage capacity in Elmendorf, Texas. The consolidated statements of income include the results of operations for the San Antonio Refinery Acquisition commencing on April 19, 2011.

On February 9, 2011, we acquired 75% of the outstanding capital of a Turkish company, which owns two terminals in Mersin, Turkey, with an aggregate 1.3 million barrels of storage capacity, for approximately $57.3 million (the Turkey Acquisition). Both terminals are connected via pipelines to an offshore platform located approximately three miles off

the Mediterranean Sea coast. The operations of the Turkey Acquisition are included in the Results of Operations commencing on February 9, 2011.

Operations

We conduct our operations through our subsidiaries, primarily NuStar Logistics, L.P. (NuStar Logistics) and NuStar Pipeline Operating Partnership L.P. (NuPOP). Our operations are divided into three reportable business segments: storage, transportation, and asphalt and fuels marketing.

Storage. We own terminals and storage facilities in the United States, Canada, Mexico, the Netherlands, including St. Eustatius in the Caribbean, the United Kingdom and Turkey providing approximately 85.0 million barrels of storage capacity. Our terminals and storage facilities provide storage and handling services on a fee basis for petroleum products, specialty chemicals and other liquids, including crude oil and other feedstocks.

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Transportation. We own common carrier refined product pipelines in Texas, Oklahoma, Colorado, New Mexico, Kansas, Nebraska, Iowa, South Dakota, North Dakota and Minnesota covering approximately 5,478 miles, consisting of the Central West System, the East Pipeline and the North Pipeline. The East and North Pipelines also include 21 terminals providing storage capacity of 4.6 million barrels, and the East Pipeline includes two tank farms providing storage capacity of 1.2 million barrels. In addition, we own a 2,000 mile anhydrous ammonia pipeline located in Louisiana, Arkansas, Missouri, Illinois, Indiana, Iowa and Nebraska. We also own 939 miles of crude oil pipelines in Texas, Oklahoma, Kansas, Colorado and Illinois, as well as 1.9 million barrels of crude storage in Texas and Oklahoma that is located along those crude oil pipelines. We charge tariffs on a per barrel basis for transporting refined products, crude oil and other feedstocks in our refined product and crude oil pipelines and on a per ton basis for transporting anhydrous ammonia in our ammonia pipeline.

Asphalt and Fuels Marketing. Our asphalt and fuels marketing segment includes our refining operations and fuels marketing operations. We refine crude oil to produce asphalt and other refined products from our asphalt operations. Our two asphalt refineries have a combined throughput capacity of 104,000 barrels per day, and the related terminal facilities provide storage capacity of 5.0 million barrels. This segment also include a fuels refinery in San Antonio, Texas with throughput capacity of 14,500 barrels per day. Additionally, as part of our fuels marketing operations, we purchase crude oil and refined petroleum products for resale. The results of operations for the asphalt and fuels marketing segment depend largely on the gross margin between our costs and the sales price of the products we market. Therefore, the results of operations for this segment are more sensitive to changes in commodity prices compared to the operations of our storage and transportation segments. We enter into derivative contracts to attempt to mitigate the effect of commodity price fluctuations.

The following factors affect the results of our operations:

- company-specific factors, such as facility integrity issues and maintenance requirements that impact the throughput rates of our assets;
- seasonal factors that affect the demand for products transported by and/or stored in our assets and the demand for products we sell, particularly asphalt;
- industry factors, such as changes in the prices of petroleum products, that affect demand and operations of our competitors;
- factors such as commodity price volatility and market structure; and
- other factors, such as refinery utilization rates and maintenance turnaround schedules, that impact our refineries, as well as the operations of refineries served by our storage and transportation assets.

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RESULTS OF OPERATIONS
Three Months Ended September 30, 2011 Compared to Three Months Ended September 30, 2010
Financial Highlights
(Unaudited, Thousands of Dollars, Except Unit and Per Unit Data)

	Three Months Ended September 30,		Change
	2011	2010	
Statement of Income Data:			
Revenues:			
Services revenues	$210,681	$201,390	$9,291
Product sales	1,613,669	936,989	676,680
Total revenues	1,824,350	1,138,379	685,971
Costs and expenses:			
Cost of product sales	1,535,609	860,942	674,667
Operating expenses	135,615	121,748	13,867
General and administrative expenses	17,731	26,860	(9,129)
Depreciation and amortization expense	42,418	38,539	3,879
Total costs and expenses	1,731,373	1,048,089	683,284
Operating income	92,977	90,290	2,687
Equity in earnings of joint venture	2,599	2,454	145
Interest expense, net	(21,565)	(20,583)	(982)
Other income (expense), net	767	(235)	1,002
Income before income tax expense	74,778	71,926	2,852
Income tax expense	4,497	3,616	881
Net income	$70,281	$68,310	$1,971
Net income per unit applicable to limited partners	$0.92	$0.90	$0.02
Weighted-average limited partner units outstanding	64,612,423	64,610,549	1,874

Highlights
Net income increased $2.0 million for the three months ended September 30, 2011, compared to the three months ended September 30, 2010, primarily due to a decrease in general and administrative expenses, partially offset by lower segment operating income.

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Segment Operating Highlights
(Thousands of Dollars, Except Barrels/Day Information)

	Three Months Ended September 30,		Change
	2011	2010	
Storage:			
Throughput (barrels/day)	721,618	673,121	48,497
Throughput revenues	$21,743	$19,139	$2,604
Storage lease revenues	120,146	111,998	8,148
Total revenues	141,889	131,137	10,752
Operating expenses	71,386	66,153	5,233
Depreciation and amortization expense	21,725	19,349	2,376
Segment operating income	$48,778	$45,635	$3,143
Transportation:			
Refined products pipelines throughput (barrels/day)	523,279	526,825	(3,546)
Crude oil pipelines throughput (barrels/day)	319,103	382,845	(63,742)
Total throughput (barrels/day)	842,382	909,670	(67,288)
Throughput revenues	$81,899	$80,597	$1,302
Operating expenses	30,796	30,488	308
Depreciation and amortization expense	12,855	12,597	258
Segment operating income	$38,248	$37,512	$736
Asphalt and Fuels Marketing:			
Product sales	$1,618,693	$937,074	$681,619
Cost of product sales	1,545,340	864,904	680,436
Gross margin	73,353	72,170	1,183
Operating expenses	41,862	31,575	10,287
Depreciation and amortization expense	6,073	5,138	935
Segment operating income	$25,418	$35,457	$(10,039)
Consolidation and Intersegment Eliminations:			
Revenues	$(18,131)	$(10,429)	$(7,702)
Cost of product sales	(9,731)	(3,962)	(5,769)
Operating expenses	(8,429)	(6,468)	(1,961)
Total	$29	$1	$28
Consolidated Information:			
Revenues	$1,824,350	$1,138,379	$685,971
Cost of product sales	1,535,609	860,942	674,667
Operating expenses	135,615	121,748	13,867
Depreciation and amortization expense	40,653	37,084	3,569
Segment operating income	112,473	118,605	(6,132)
General and administrative expenses	17,731	26,860	(9,129)
Other depreciation and amortization expense	1,765	1,455	310
Consolidated operating income	$92,977	$90,290	$2,687

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Storage

Throughputs increased 48,497 barrels per day and throughput revenues increased $2.6 million for the three months ended September 30, 2011, compared to the three months ended September 30, 2010, primarily due to operational issues at the refinery served by our Benicia crude oil storage tanks in the third quarter of 2010.

Storage lease revenues increased $8.1 million for the three months ended September 30, 2011, compared to the three months ended September 30, 2010, primarily due to an increase of $5.2 million from completed tank expansion projects at our St. Eustatius and St. James terminals. In addition, revenues increased $2.9 million at our St. Eustatius facility mainly due to higher throughput and related handling fees, as well as new customer contracts and rate escalations.

Operating expenses increased $5.2 million for the three months ended September 30, 2011, compared to the three months ended September 30, 2010, primarily due to maintenance on tanks and increased expenses at our St. Eustatius terminal due to increased marine vessel activity.

Depreciation and amortization expense increased $2.4 million for the three months ended September 30, 2011, compared to the three months ended September 30, 2010, primarily due to the completion of various terminal upgrade and expansion projects.

Transportation

Revenues increased $1.3 million for the three months ended September 30, 2011, compared to the three months ended September 30, 2010, primarily due to:

- an increase in revenues of $3.1 million and an increase in throughputs of 17,562 barrels per day on refined product pipelines serving the McKee refinery due to operational issues at the refinery during the third quarter of 2010;
- an increase in revenues of $0.9 million and an increase in throughputs of 22,464 barrels per day from the reactivation of a previously idled pipeline in South Texas;
- an increase in revenues of $0.9 million, despite decreased throughputs of 4,633 barrels per day, on crude oil pipelines serving the McKee refinery mainly because volumes were shifted to a crude oil pipeline with a higher tariff; and
- an increase in revenues of $0.7 million on the East Pipeline, despite decreased throughputs of 6,316 barrels per day, due to a tariff increase in July 2011 and increased long-haul deliveries resulting in a higher average tariff.

These increases in revenues were partially offset by:

- a decrease in revenues of $1.8 million and a decrease in throughputs of 34,568 barrels per day on our Corpus Christi to Three Rivers crude oil pipeline due to a customer receiving crude oil from alternate sources, thus reducing the volume transported on our pipeline;
- a decrease in revenues of $1.6 million and a decrease in throughputs of 47,574 barrels per day on our crude oil pipelines serving the Ardmore refinery mainly due to operational issues at the refinery and a shift in supply volumes; and
- a decrease in revenues of $1.3 million on the ammonia pipeline, despite only slightly lower throughputs, due to fewer long-haul movements as flooding in the second quarter continued to cause operational issues in the third quarter of 2011.

Asphalt and Fuels Marketing

Sales and cost of product sales increased $681.6 million and $680.4 million, respectively, resulting in an increase in total gross margin of $1.2 million for the three months ended September 30, 2011, compared to the three months ended September 30, 2010. The change in total gross margin was due to an increase of $19.6 million in the gross margin from our fuels marketing operations, partially offset by a decrease of $18.4 million in the gross margin from our asphalt operations.

The gross margin from our fuels marketing operations increased for the three months ended September 30, 2011, compared to the three months ended September 30, 2010, mainly due to increased volumes and higher sales prices in 2011 for our bunker fuel sales, fuel oil trading and crude trading. The San Antonio Refinery Acquisition in April 2011 also contributed to the increase in gross margin.

The gross margin per barrel for our asphalt operations decreased to $5.96 for the three months ended September 30, 2011, compared to $7.83 for the three months ended September 30, 2010. Weak demand for asphalt in our market combined with asphalt produced by Midwest refiners, which have access to lower cost crude oil, that is being sold in our market contributed to the decrease in gross margin per barrel. The decrease in gross margin was partially offset by a $6.3 million crude oil pricing adjustment associated with our crude supply agreement with PDVSA that serves to keep our actual crude costs in line with a market reference price.

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Operating expenses increased $10.3 million for the three months ended September 30, 2011, compared to the three months ended September 30, 2010, primarily due to higher idle capacity costs at our asphalt refineries, the San Antonio Refinery Acquisition in April 2011 and increased rental expenses associated with our fuels marketing operations.

Depreciation and amortization expense increased $0.9 million for the three months ended September 30, 2011, compared to the three months ended September 30, 2010, primarily due the San Antonio Refinery Acquisition in April 2011 and amortization of deferred costs related to completed turnarounds at our asphalt refineries.

Consolidation and Intersegment Eliminations
Revenue, cost of product sales and operating expense eliminations primarily relate to storage and transportation fees charged to the asphalt and fuels marketing segment by the transportation and storage segments.

General
General and administrative expenses decreased $9.1 million for the three months ended September 30, 2011, compared to the three months ended September 30, 2010, primarily due to lower compensation expense associated with our long-term incentive plans, which fluctuates with our unit price.

Interest expense, net increased $1.0 million for the three months ended September 30, 2011, compared to the three months ended September 30, 2010, mainly due to the issuance of $450.0 million of 4.80% senior notes in August 2010. This increase in interest expense was partially offset by the amortization of deferred gains related to terminated interest rate swaps, which reduce interest expense over the remaining lives of the associated senior notes.

Other income (expense), net changed by $1.0 million for the three months ended September 30, 2011, compared to the three months ended September 30, 2010. Other income (expense), net included a foreign exchange gain of $3.1 million in 2011, compared to a foreign exchange loss of $0.3 million in 2010, mainly related to one of our Canadian subsidiaries. For the three months ended September 30, 2011, other income (expense), net also includes a contingent loss adjustment of $3.3 million.

Income tax expense increased $0.9 million for the three months ended September 30, 2011, compared to the three months ended September 30, 2010, mainly due to higher taxable income.

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RESULTS OF OPERATIONS
Nine Months Ended September 30, 2011 Compared to Nine Months Ended September 30, 2010
Financial Highlights
(Unaudited, Thousands of Dollars, Except Unit and Per Unit Data)

	Nine Months Ended September 30,		Change
	2011	2010	
Statement of Income Data:			
Revenues:			
Services revenues	$608,689	$585,772	$22,917
Product sales	4,039,461	2,623,077	1,416,384
Total revenues	4,648,150	3,208,849	1,439,301
Costs and expenses:			
Cost of product sales	3,797,424	2,422,751	1,374,673
Operating expenses	390,480	363,028	27,452
General and administrative expenses	69,833	76,324	(6,491)
Depreciation and amortization expense	124,354	114,653	9,701
Total costs and expenses	4,382,091	2,976,756	1,405,335
Operating income	266,059	232,093	33,966
Equity in earnings of joint venture	6,997	7,571	(574)
Interest expense, net	(62,644)	(58,059)	(4,585)
Other (expense) income, net	(5,699)	14,882	(20,581)
Income before income tax expense	204,713	196,487	8,226
Income tax expense	13,311	9,052	4,259
Net income	$191,402	$187,435	$3,967
Net income per unit applicable to limited partners	$2.49	$2.55	$(0.06)
Weighted-average limited partner units outstanding	64,611,181	62,386,373	2,224,808

Highlights
Net income increased $4.0 million for the nine months ended September 30, 2011, compared to the nine months ended September 30, 2010, primarily due to an increase in segment operating income, partially offset by a decrease in other income. Segment operating income increased $28.0 million for the nine months ended September 30, 2011, compared to the nine months ended September 30, 2010, due to increased operating income from the asphalt and fuels marketing segment and storage segment, partially offset by a decrease in operating income from the transportation segment.

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Segment Operating Highlights
(Thousands of Dollars, Except Barrels/Day Information)

	Nine Months Ended September 30,		Change
	2011	2010	
Storage:			
Throughput (barrels/day)	679,031	666,635	12,396
Throughput revenues	$58,388	$56,085	$2,303
Storage lease revenues	359,820	330,493	29,327
Total revenues	418,208	386,578	31,630
Operating expenses	213,230	198,186	15,044
Depreciation and amortization expense	64,656	57,004	7,652
Segment operating income	$140,322	$131,388	$8,934
Transportation:			
Refined products pipelines throughput (barrels/day)	509,354	529,380	(20,026)
Crude oil pipelines throughput (barrels/day)	304,554	381,606	(77,052)
Total throughput (barrels/day)	813,908	910,986	(97,078)
Throughput revenues	$226,471	$232,817	$(6,346)
Operating expenses	85,381	88,784	(3,403)
Depreciation and amortization expense	38,282	38,029	253
Segment operating income	$102,808	$106,004	$(3,196)
Asphalt and Fuels Marketing:			
Product sales	$4,049,079	$2,625,994	$1,423,085
Cost of product sales	3,821,379	2,438,703	1,382,676
Gross margin	227,700	187,291	40,409
Operating expenses	113,506	96,924	16,582
Depreciation and amortization expense	16,505	15,254	1,251
Segment operating income	$97,689	$75,113	$22,576
Consolidation and Intersegment Eliminations:			
Revenues	$(45,608)	$(36,540)	$(9,068)
Cost of product sales	(23,955)	(15,952)	(8,003)
Operating expenses	(21,637)	(20,866)	(771)
Total	$(16)	$278	$(294)
Consolidated Information:			
Revenues	$4,648,150	$3,208,849	$1,439,301
Cost of product sales	3,797,424	2,422,751	1,374,673
Operating expenses	390,480	363,028	27,452
Depreciation and amortization expense	119,443	110,287	9,156
Segment operating income	340,803	312,783	28,020
General and administrative expenses	69,833	76,324	(6,491)
Other depreciation and amortization expense	4,911	4,366	545
Consolidated operating income	$266,059	$232,093	$33,966

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Storage

Storage revenues increased $31.6 million for the nine months ended September 30, 2011, compared to the nine months ended September 30, 2010, primarily due to:

- an increase of $11.5 million due to completed tank expansion projects at our St. Eustatius and St. James terminals;
- an increase of $5.9 million related to our acquisition of three terminals in Mobile County, Alabama in May 2010 and the Turkey Acquisition;
- an increase of $5.7 million at our St. Eustatius facility mainly due to higher throughput and related handling fees, as well as new customer contracts, rate escalations and higher reimbursable revenues; and
- an increase of $5.2 million at our UK and Amsterdam terminals, primarily due to the effect of foreign exchange rates, new customer contracts and increased customer utilization.

Operating expenses increased $15.0 million for the nine months ended September 30, 2011, compared to the nine months ended September 30, 2010, primarily due to cancelled capital projects, increased expenses at our St. Eustatius, Amsterdam and UK terminals, the Turkey Acquisition in February 2011 and a full nine months of operating expenses from our three terminals in Mobile County, Alabama acquired in May 2010.

Depreciation and amortization expense increased $7.7 million for the nine months ended September 30, 2011, compared to the nine months ended September 30, 2010, primarily due to the completion of various terminal upgrade and expansion projects, the Turkey Acquisition and our acquisition of three terminals in Mobile County, Alabama in May 2010.

Transportation

Throughputs decreased 97,078 barrels per day and revenues decreased $6.3 million for the nine months ended September 30, 2011, compared to the nine months ended September 30, 2010, primarily due to:

- a decrease of 61,087 barrels per day and a decrease of $5.9 million on our pipelines serving the Ardmore refinery, mainly due to a turnaround in March and April 2011, followed by operational issues and a shift in supply volumes;
- a decrease of 25,562 barrels per day and a decrease of $5.6 million on the Houston pipeline mainly due to market conditions that favored exporting instead of shipping on our pipeline;
- a decrease of 17,721 barrels per day and a decrease of $3.7 million on our Corpus Christi to Three Rivers crude oil pipeline due to a customer receiving crude oil from alternate sources, thus reducing the volume transported on our pipeline; and
- a decrease of 8,710 barrels per day and a decrease of $1.9 million on our refined product pipelines serving the Three Rivers refinery mainly due to operational issues and the start of a turnaround at the refinery in 2011.

These decreases were partially offset by:

- an increase of 16,909 barrels per day and an increase in revenues of $7.3 million on pipelines serving the McKee refinery mainly due to increased production in 2011 and operational issues and turnaround activity at the refinery in 2010; and
- an increase of 5,806 barrels per day and an increase in revenues of $4.1 million on the North Pipeline mainly due to turnaround activity during the second quarter of 2010 at the refinery served by the pipeline.

Operating expenses decreased $3.4 million for the nine months ended September 30, 2011, compared to the nine months ended September 30, 2010, primarily due to a reduction in overhead expenses and lower power expenses consistent with the decrease in throughputs.

Asphalt and Fuels Marketing

Sales and cost of product sales increased $1,423.1 million and $1,382.7 million, respectively, resulting in an increase in total gross margin of $40.4 million for the nine months ended September 30, 2011, compared to the nine months

ended September 30, 2010. The increase in total gross margin was primarily due to an increase in the gross margin from our fuels marketing operations resulting from increased volumes and higher sales prices in 2011 for our fuel oil trading and crude trading. The San Antonio Refinery Acquisition in April 2011 also contributed to the increase in gross margin.

Operating expenses increased $16.6 million for the nine months ended September 30, 2011, compared to the nine months ended September 30, 2010, primarily due to higher idle capacity costs at our asphalt refineries, the San Antonio Refinery Acquisition in April 2011 and increased rental expenses associated with our fuels marketing operations.

Depreciation and amortization expense increased $1.3 million for the nine months ended September 30, 2011, compared to the nine months ended September 30, 2010, primarily due to the San Antonio Refinery Acquisition in April 2011 and amortization of deferred costs related to completed turnarounds at our asphalt refineries.

Consolidation and Intersegment Eliminations

Revenue, cost of product sales and operating expense eliminations primarily relate to storage and transportation fees charged to the asphalt and fuels marketing segment by the transportation and storage segments.

General

General and administrative expenses decreased $6.5 million for the nine months ended September 30, 2011, compared to the nine months ended September 30, 2010, primarily due to lower compensation expense associated with our long-term incentive plans, which fluctuates with our unit price.

Interest expense, net increased $4.6 million for the nine months ended September 30, 2011, compared to the nine months ended September 30, 2010, mainly due to the issuance of $450.0 million of 4.80% senior notes in August 2010. This increase in interest expense was partially offset by the effect of additional fixed-to-floating interest rate swap agreements we entered into in September and October 2010 and the amortization of deferred gains related to terminated interest rate swaps, which reduce interest expense over the remaining lives of the associated senior notes.

Other (expense) income, net changed by $20.6 million for the nine months ended September 30, 2011, compared to the nine months ended September 30, 2010. Other expense, net for the nine months ended September 30, 2011 included $5.0 million of expense associated with the early termination of a third-party storage agreement at our Paulsboro, New Jersey asphalt refinery and a contingent loss adjustment of $3.3 million. Other income, net for the nine months ended September 30, 2010 included a $13.5 million gain from insurance recoveries, which resulted from insurance claims related to damage in the third quarter of 2008 primarily at our Texas City, Texas terminal caused by Hurricane Ike. In addition, other expense, net included a foreign exchange gain of $2.5 million in 2011, compared to a foreign exchange loss of $0.6 million in 2010, related to one of our Canadian subsidiaries.

Income tax expense increased $4.3 million for the nine months ended September 30, 2011, compared to the nine months ended September 30, 2010, mainly due to the reversal of a deferred tax asset valuation allowance included in 2010 income tax expense, which was partially offset by lower taxable income in 2011.

TRENDS AND OUTLOOK

For the full year 2011, we expect our operating income to be higher than 2010 due to increased earnings from our storage segment. However, net income for the full year likely will decline mainly due to a decline in other income. Other income in 2010 included a gain related to insurance proceeds. Lower net income combined with the dilutive effect of our equity issuance in 2010 should cause earnings per unit to decline.

Storage Segment

We are continuing our pursuit of growth in this segment through expansion and optimization of our existing assets. We expect to continue to benefit from internal growth projects in this segment that were completed in the second half of 2010 and in 2011, including our 3.2 million barrel storage tank expansion project at our St. James, Louisiana terminal facility, which was completed during the third quarter of 2011, and projects at our St. Eustatius terminal in the Caribbean. As a result, we expect the storage segment results for the fourth quarter and for the full year 2011 to exceed 2010.

Transportation Segment

We expect throughputs in our transportation segment for the fourth quarter and the full year 2011 to be less than the comparable periods in 2010. Fourth quarter throughputs are expected to be negatively affected by planned turnaround activity at several refineries served by our pipelines. The tariffs on our pipelines regulated by the Federal Energy Regulatory Commission were increased by 6.9 percent effective July 1, 2011. In addition, we completed pipeline

projects at the end of the second and third quarter that serve Eagle Ford Shale production, including the reactivation and reversal of a previously idle eight-inch refined products pipeline that now gives us capability to transport Eagle Ford crude and condensate to Valero Energy's Corpus Christi refinery, which should contribute positively to our earnings for the remainder of 2011. However, the tariff increase and the pipeline projects will only partially offset the impact from the lower throughputs. Therefore, we expect the fourth quarter and full year 2011 earnings for this segment to be lower than 2010.

We are continuing our strategy for growth in this segment through construction of new assets and optimization of existing assets, including a plan to construct a new 12-inch pipeline that will connect existing pipeline segments and move crude oil from Corpus Christi to Valero's Three Rivers refinery, as well as a plan to reverse our 16-inch Corpus Christi crude oil pipeline. This new pipeline and the reversal are expected to be completed in the third quarter of 2012. We expect that completion of these and our other announced growth projects will have a favorable impact on our results of operations in future periods.

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Asphalt and Fuels Marketing Segment
During the third quarter 2011, the results for our asphalt and fuels marketing segment, compared to the same period in the prior year, were negatively affected by lower earnings from our asphalt operations. As a result, overall earnings for the segment declined despite improved earnings in our fuels marketing operations and the addition of the San Antonio refinery.

Weak demand for asphalt in our markets contributed to the reduced earnings from our asphalt operations. Additionally, asphalt produced by Midwest refiners, which currently have access to lower-cost crude oil, is being sold in our markets. The combination of weak demand and the pressure of lower-cost asphalt from Midwest refiners have adversely affected our asphalt margins. We expect these factors to continue to exert downward pressure on the margin for our asphalt operations in the fourth quarter. As a result, our asphalt operations could generate a loss for the fourth quarter that could more than offset expected improvements from our fuels marketing operations and the San Antonio refinery, which may result in a loss for the entire segment for the fourth quarter. Nevertheless, we expect the full year 2011 results for the segment to be comparable to 2010 as the expected improvement in our fuels marketing operations and the addition of the San Antonio refinery should offset reduced full-year earnings from our asphalt operations.

The factors negatively affecting the results of our asphalt operations could continue into 2012. In that case, our results from our asphalt operations could continue to deteriorate. However, in 2012 we expect to take steps to address these factors, including obtaining and processing alternative, lower-cost crude for our asphalt refineries. We currently expect the results in 2012 for the asphalt and fuels marketing segment to improve compared to 2011.

Our outlook for the company overall could change depending on, among other things, the prices of crude oil, the state of the economy, changes to refinery maintenance schedules, and other factors that affect overall demand for the products we store, transport and sell, as well as changes in commodity prices for the products we market.

LIQUIDITY AND CAPITAL RESOURCES
General
Our primary cash requirements are for distributions to partners, working capital requirements, including inventory purchases, debt service, capital expenditures, acquisitions and operating expenses. On an annual basis, we attempt to fund our operating expenses, interest expense, reliability capital expenditures and distribution requirements with cash generated from our operations. If we do not generate sufficient cash from operations to meet those requirements, we utilize available borrowing capacity under our revolving credit agreement and, to the extent necessary, funds raised through equity or debt offerings under our shelf registration statements. Additionally, we typically fund our strategic capital expenditures from external sources, primarily borrowings under our revolving credit agreement or funds raised through equity or debt offerings. However, our ability to raise funds by issuing debt or equity depends on many factors beyond our control. The volatility of the capital and credit markets could restrict our ability to issue debt or equity or may increase our cost of capital beyond rates acceptable to us.

Cash Flows for the Nine Months Ended September 30, 2011 and 2010
The following table summarizes our cash flows from operating, investing and financing activities:

	Nine Months Ended September 30,	
	2011	2010
	(Thousands of Dollars)	
Net cash provided by (used in):		
Operating activities	$ 101,871	$ 180,833
Investing activities	(352,655)	(222,392)

Financing activities	131,878	65,777
Effect of foreign exchange rate changes on cash	(3,001)	(358)
Net decrease in cash and cash equivalents	$(121,907)	$23,860

Net cash provided by operating activities for the nine months ended September 30, 2011 was $101.9 million, compared to $180.8 million for the nine months ended September 30, 2010, primarily due to higher investments in working capital in 2011 compared to the same period in 2010. Our working capital increased by $216.4 million in 2011, compared to $99.8 million in 2010. Please refer to the Working Capital Requirements section below for a discussion on the changes in working capital.

For the nine months ended September 30, 2011, net cash provided by operating activities, proceeds from long-term debt

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borrowings, net of repayments, combined with cash on hand, were used to fund our distributions to unitholders and our general partner, capital expenditures primarily related to various terminal projects and two acquisitions.

For the nine months ended September 30, 2010, cash from operating activities, proceeds from long-term and short-term debt borrowings, net of repayments, our issuance of common units and cash on hand were used to fund our distributions to unitholders and our general partner, capital expenditures and an acquisition. Cash flows from investing activities also included insurance proceeds of $13.5 million related to damages caused by Hurricane Ike in the third quarter of 2008 primarily at our Texas City terminal.

2007 Revolving Credit Agreement

As of September 30, 2011, we had $376.2 million available for borrowing under our $1.2 billion five-year revolving credit agreement (the 2007 Revolving Credit Agreement). Due to a covenant in our 2007 Revolving Credit Agreement that requires us to maintain, as of the end of any four consecutive fiscal quarters, a consolidated debt coverage ratio not to exceed 5.00-to-1.00, we may not be able to borrow the maximum available amount. On March 7, 2011, we amended the 2007 Revolving Credit Agreement to exclude unused proceeds from the Gulf Opportunity Zone bond issuances from total indebtedness in the calculation of the consolidated debt coverage ratio. As of September 30, 2011, the consolidated debt coverage ratio was 4.5x. The 2007 Revolving Credit Agreement matures in December 2012, and we do not have any other significant debt maturing until 2012.

Shelf Registration Statements

On April 29, 2011, the Securities and Exchange Commission declared effective our shelf registration statement on Form S-3, which permits us to offer and sell various types of securities, including NuStar Energy common units and debt securities of NuStar Logistics and NuPOP, having an aggregate value of up to $200.0 million (the 2011 Shelf Registration Statement). The 2011 Shelf Registration Statement is in addition to our shelf registration statement on Form S-3 the Securities and Exchange Commission declared effective in May 2010.

On May 23, 2011, in connection with the 2011 Shelf Registration Statement, we entered into an Equity Distribution Agreement (the Equity Distribution Agreement) with Citigroup Global Markets Inc. (Citigroup). Under the Equity Distribution Agreement, we may from time to time sell an aggregate of up to $200.0 million NuStar Energy common units representing limited partner interests, using Citigroup as our sales agent. Sales of common units will be made by means of ordinary brokers' transactions on the New York Stock Exchange at market prices, in block transactions or as otherwise agreed by us and Citigroup. Under the terms of the Equity Distribution Agreement, we may also sell common units to Citigroup as principal for its own account at a price to be agreed upon at the time of sale.

In September 2011, we sold 59,971 NuStar Energy common units under the Equity Distribution Agreement for approximately $3.3 million. We also received $0.1 million from our general partner in order to maintain its 2% general partner interest.

If the capital markets become more volatile, our access to the capital markets may be limited, or we could face increased costs. In addition, it is possible that our ability to access the capital markets may be limited at a time when we would like or need access, which could have an impact on our ability to refinance maturing debt and/or react to changing economic and business conditions.

Capital Requirements

Our operations are capital intensive, requiring significant investments to maintain, upgrade or enhance existing operations and to comply with environmental and safety laws and regulations. Our capital expenditures consist of:

- reliability capital expenditures, such as those required to maintain equipment reliability and safety and to address environmental and safety regulations; and

- strategic capital expenditures, such as those to expand and upgrade pipeline capacity or refinery operations and to construct new pipelines, terminals and storage tanks. In addition, strategic capital expenditures may include acquisitions of pipelines, terminals or storage tank assets, as well as certain capital expenditures related to support functions.

During the nine months ended September 30, 2011, our reliability capital expenditures totaled $41.3 million, consisting of $32.8 million primarily related to maintenance upgrade projects at our terminals, which is classified as "Reliability capital expenditures" in the consolidated statements of cash flows, and $8.5 million of turnaround expenditures at our refineries, which is classified as "Investment in other long-term assets" in our consolidated statements of cash flows. Strategic capital expenditures for the nine months ended September 30, 2011 totaled $211.2 million and were primarily related to projects at our St. James, Louisiana and St. Eustatius terminals and our corporate office.

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For the full year 2011, we expect to incur approximately $370.0 million of capital expenditures, including $60.0 million for reliability capital projects and $310.0 million for strategic capital projects, not including acquisitions. Thus far in 2011, we have spent approximately $100.0 million, including working capital, related to the Turkey Acquisition and the San Antonio Refinery Acquisition. We continue to evaluate our capital budget and make changes as economic conditions warrant. Depending upon current economic conditions, our actual capital expenditures for 2011 may exceed or be lower than the budgeted amounts. We believe cash generated from operations, combined with other sources of liquidity previously described, will be sufficient to fund our capital expenditures in 2011, and our internal growth projects can be accelerated or scaled back depending on the condition of the capital markets.

Working Capital Requirements

Our asphalt and fuels marketing segment requires us to make substantial investments in working capital. Increases in the prices of the commodities we purchase cause our working capital requirements to increase, which reduces our liquidity. Our working capital requirements vary with the seasonal nature of asphalt demand as we build and store asphalt inventories during periods of lower demand in order to sell it during periods of higher demand. This seasonal variance in demand also affects our accounts receivable and accounts payable balances, which vary depending on timing of payments.

Within working capital, our inventory balances increased by $176.9 million during the nine months ended September 30, 2011, compared to $114.9 million during the nine months ended September 30, 2010, due to rising crude oil prices in 2011. In addition, accounts receivable increased by $148.8 million during the nine months ended September 30, 2011, compared to $86.0 million during the nine months ended September 30, 2010, mainly due to the timing of payments and higher overall sales, resulting mainly from increased crude trading activity and the San Antonio Refinery Acquisition. Other current assets increased $25.8 million during the nine months ended September 30, 2011, compared to a decrease of $27.3 million during the nine months ended September 30, 2010, primarily due to variations in our derivative positions and an increase in prepaid assets in 2011.

Higher inventory balances also result in higher amounts of accounts payable, offsetting the impact to working capital. In 2011, accounts payable increased $153.6 million, compared to $75.3 million in 2010, due to higher inventory costs and the timing of payments.

Distributions

On August 12, 2011, we paid a quarterly cash distribution totaling $81.3 million, or $1.095 per unit, related to the second quarter of 2011. On October 28, 2011, we announced a quarterly cash distribution of $1.095 per unit related to the third quarter of 2011. This distribution will be paid on November 14, 2011 to unitholders of record on November 8, 2011 and will total $81.4 million.

The following table reflects the allocation of total cash distributions to the general and limited partners applicable to the period in which the distributions were earned:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Thousands of Dollars, Except Per Unit Data)			
General partner interest	$1,628	$1,592	$4,847	$4,635
General partner incentive distribution	8,972	8,568	26,503	24,736
Total general partner distribution	10,600	10,160	31,350	29,371
Limited partners’ distribution	70,814	69,456	211,019	202,391
Total cash distributions	$81,414	$79,616	$242,369	$231,762

Cash distributions per unit applicable to limited partners	$1.095	$1.075	$3.265	$3.205

Distributions declared for the quarter are paid within 45 days following the end of each quarter based on the partnership interests outstanding as of a record date that is set after the end of each quarter.

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Debt Obligations

We are a party to the following debt agreements:

- the 2007 Revolving Credit Agreement due December 10, 2012, with a balance of $456.3 million as of September 30, 2011;
- NuStar Logistics' 6.875% senior notes due July 15, 2012 with a face value of $100.0 million; 6.05% senior notes due March 15, 2013 with a face value of $229.9 million; 7.65% senior notes due April 15, 2018 with a face value of $350.0 million; and 4.80% senior notes due September 1, 2020 with a face value of $450.0 million;
- NuPOP's 7.75% senior notes due February 15, 2012; and 5.875% senior notes due June 1, 2013 with an aggregate face value of $500.0 million;
- $55.4 million revenue bonds due June 1, 2038; $100.0 million revenue bonds due July 1, 2040; $50.0 million revenue bonds due October 1, 2040; $85.0 million revenue bonds due December 1, 2040; and $75.0 million revenue bonds due August 1, 2041 associated with the St. James terminal expansion (Gulf Opportunity Zone Revenue Bonds);
- the £21 million term loan due December 11, 2012 (UK Term Loan); and
- the $12.0 million note payable in annual installments through December 31, 2015 to the Port of Corpus Christi Authority of Nueces County, Texas, with a balance of $1.8 million as of September 30, 2011, associated with the construction of a crude oil storage facility in Corpus Christi, Texas.

Management believes that, as of September 30, 2011, we are in compliance with all ratios and covenants of both the 2007 Revolving Credit Agreement and the UK Term Loan, which has substantially the same covenants as the 2007 Revolving Credit Agreement. Our other long-term debt obligations do not contain any financial covenants that are different than those contained in the 2007 Revolving Credit Agreement. However, a default under any of our debt instruments would be considered an event of default under all of our debt instruments.

Please refer to Note 4 of the Condensed Notes to Consolidated Financial Statements in Item 1. "Financial Statements" for a more detailed discussion on certain of our long-term debt agreements.

Interest Rate Swaps

As of September 30, 2011 and December 31, 2010, we were a party to fixed-to-floating interest rate swap agreements and forward-starting swap agreements for the purpose of hedging interest rate risk. The weighted-average interest rate that we paid under our fixed-to-floating interest rate swaps was 2.6% as of September 30, 2011.

The following table aggregates information on our interest rate swap agreements:

	Notional Amount		Fair Value	
	September 30, 2011	December 31, 2010	September 30, 2011	December 31, 2010
	(Thousands of Dollars)			
Type of interest rate swap agreements:				
Fixed-to-floating	$450,000	$617,500	$23,125	$(18,820)
Forward-starting	$500,000	$500,000	$(40,930)	$35,000

During the nine months ended September 30, 2011, we terminated interest rate swap agreements with an aggregate notional amount of $207.5 million associated with our 6.875%, 6.05% and 7.65% senior notes. We received $12.6 million in connection with the terminations, which is being amortized into "Interest expense, net" over the remaining lives of the related senior notes. Please refer to Note 7 of the Condensed Notes to Consolidated Financial Statements in Item 1. "Financial Statements" for a more detailed discussion of our interest rate swaps.

Environmental, Health and Safety

We are subject to extensive federal, state and local environmental and safety laws and regulations, including those relating to the discharge of materials into the environment, waste management, pollution prevention measures, pipeline integrity and operator qualifications, among others. Because more stringent environmental and safety laws and regulations are continuously being enacted or proposed, the level of future expenditures required for environmental, health and safety matters is expected to increase.

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Contingencies

We are subject to certain loss contingencies, the outcomes of which could have an adverse effect on our cash flows and results of operations, as further disclosed in Note 5 of the Condensed Notes to Consolidated Financial Statements in Item 1. “Financial Statements.”

RELATED PARTY TRANSACTIONS

Please refer to Note 8 of the Condensed Notes to Consolidated Financial Statements in Item 1. “Financial Statements” for a detailed discussion of our related party transactions.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in accordance with United States generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. Our critical accounting policies are disclosed in our Annual Report on Form 10-K for the year ended December 31, 2010.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

We manage our exposure to changing interest rates principally through the use of a combination of fixed-rate debt and variable-rate debt. In addition, we utilize fixed-to-floating interest rate swap agreements to manage a portion of the exposure to changing interest rates by converting certain fixed-rate debt to variable-rate debt. We also enter into forward-starting interest rate swap agreements to lock in the rate on the interest payments related to forecasted debt issuances. Borrowings under the 2007 Revolving Credit Agreement and Gulf Opportunity Zone Revenue Bonds expose us to increases in applicable interest rates.

The following tables provide information about our long-term debt and interest rate derivative instruments, all of which are sensitive to changes in interest rates. For long-term debt, principal cash flows and related weighted-average interest rates by expected maturity dates are presented. For our fixed-to-floating interest rate swaps, the table presents notional amounts and weighted-average interest rates by expected (contractual) maturity dates. Weighted-average variable rates are based on implied forward interest rates in the yield curve at the reporting date.

	September 30, 2011							
	Expected Maturity Dates							
	2011	2012	2013	2014	2015	There-after	Total	Fair Value
	(Thousands of Dollars, Except Interest Rates)							
Long-term Debt:								
Fixed rate	$832	$383,713	$479,994	$—	$—	$800,000	$1,664,539	$1,787,353
Weighted average interest rate	8.0 %	7.4 %	6.0 %	—	—	6.0 %	6.3 %	
Variable rate	$—	$456,259	$—	$—	$—	$365,440	$821,699	$808,180
Weighted average interest rate	—	0.9 %	—	—	—	0.2 %	0.6 %	
Interest Rate Swaps								
Fixed–to-Floating:								
Notional amount	$—	$—	$—	$—	$—	$450,000	$450,000	$23,125
Weighted average pay rate	2.5 %	2.6 %	2.8 %	3.4 %	4.0 %	4.9 %	4.0 %	
Weighted average receive rate	4.8 %	4.8 %	4.8 %	4.8 %	4.8 %	4.8 %	4.8 %	

	December 31, 2010							
	Expected Maturity Dates							
	2011	2012	2013	2014	2015	There-after	Total	Fair Value
	(Thousands of Dollars, Except Interest Rates)							
Long-term Debt:								
Fixed rate	$832	$383,687	$479,986	$—	$—	$800,000	$1,664,505	$1,775,842
Weighted average interest rate	8.0 %	7.4 %	6.0 %	—	—	6.0 %	6.3 %	
Variable rate	$—	$188,282	$—	$—	$—	$290,440	$478,722	$473,348
Weighted average interest rate	—	1.0 %	—	—	—	0.3 %	0.6 %	
Interest Rate Swaps								
Fixed–to-Floating:								

Notional amount	$—	$60,000	$107,500	$—	$—	$450,000	$617,500	$(18,820)
Weighted average pay rate	2.5 %	3.3 %	4.3 %	5.3 %	6.1 %	6.8 %	5.4 %	
Weighted average receive rate	5.2 %	5.2 %	5.0 %	4.8 %	4.8 %	4.8 %	4.9 %	

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The following table presents information regarding our forward-starting interest rate swap agreements:

Notional Amount	Period of Hedge	Weighted-Average Fixed Rate	Fair Value	
			September 30, 2011	December 31, 2010
(Thousands of Dollars)			(Thousands of Dollars)	
$ 125,000	03/13 - 03/23	3.5 %	$ (10,588)	$ 8,717
150,000	06/13 - 06/23	3.5 %	(11,718)	11,243
225,000	02/12 - 02/22	3.1 %	(18,624)	15,040
$ 500,000		3.3 %	$ (40,930)	$ 35,000

Commodity Price Risk

Since the operations of our asphalt and fuels marketing segment exposes us to commodity price risk, we enter into derivative instruments to mitigate the effect of commodity price fluctuations. The derivative instruments we use consist primarily of commodity futures and swap contracts. We have a risk management committee that oversees our trading controls and procedures and certain aspects of risk management. Our risk management committee also reviews all new risk management strategies in accordance with our risk management policy, which was approved by our board of directors.

During the second quarter of 2011, we entered into commodity swap contracts to hedge the price risk associated with the San Antonio Refinery. These contracts fix the purchase price of crude oil and sales prices of refined products for a portion of the expected production of the San Antonio Refinery, thereby mitigating the risk of volatility of future cash flows associated with hedged volumes. These contracts qualified and we designated them as cash flow hedges.

We record commodity derivative instruments in the consolidated balance sheets as assets or liabilities at fair value. We recognize mark-to-market adjustments for derivative instruments designated and qualifying as fair value hedges (Fair Value Hedges) and the related change in the fair value of the associated hedged physical inventory or firm commitment within "Cost of product sales." For derivative instruments designated and qualifying as cash flow hedges (Cash Flow Hedges), we record the effective portion of mark-to-market adjustments as a component of "Accumulated other comprehensive income" until the underlying hedged forecasted transactions occur and are recognized in income. For derivative instruments that do not qualify for hedge accounting (Economic Hedges and Other Derivatives), we record the mark-to-market adjustments in "Cost of product sales."

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The commodity contracts disclosed below represent only those contracts exposed to commodity price risk at the end of the period. Please refer to Note 7 of Condensed Notes to Consolidated Financial Statement in Item 1. "Financial Statements" for the volume and related fair value of all commodity contracts.

	September 30, 2011			
	Contract Volumes (Thousands of Barrels)	Weighted Average Pay Price	Weighted Average Receive Price	Fair Value of Current Asset (Liability) (Thousands of Dollars)
Fair Value Hedges:				
Futures – long:				
(refined products)	15	$117.19	N/A	$ 7
Futures – short:				
(refined products)	50	N/A	$118.78	$ 103
Swaps – long:				
(refined products)	196	$95.13	N/A	$ 581
Swaps – short:				
(refined products)	1,067	N/A	$96.17	$ 3,986
Cash Flow Hedges:				
Swaps – long:				
(crude oil)	9,988	106.80	N/A	$ (238,832)
Swaps – short:				
(refined products)	9,988	N/A	127.55	$ 186,724
Economic Hedges and Other Derivatives:				
Futures – long:				
(crude oil and refined products)	337	$79.74	N/A	$ (2,157)
Futures – short:				
(crude oil and refined products)	422	N/A	$85.91	$ 2,428
Swaps – long:				
(refined products)	434	$90.98	N/A	$ (2,432)
Swaps – short:				
(refined products)	673	N/A	$86.65	$ 3,319
Forward purchase contracts:				
(crude oil)	4,016	$100.72	N/A	$ (23,479)
Forward sales contracts:				
(crude oil)	4,016	N/A	$102.23	$ 29,544
Total fair value of open positions exposed to commodity price risk				$ (40,208)

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	December 31, 2010			
	Contract Volumes	Weighted Average		Fair Value of Current Asset (Liability)
		Pay Price	Receive Price	
	(Thousands of Barrels)			(Thousands of Dollars)
Fair Value Hedges:				
Futures – short:				
(crude oil and refined products)	436	N/A	$96.00	$ (1,015)
Swaps – long:				
(refined products)	380	$76.05	N/A	$ (557)
Swaps – short:				
(refined products)	823	N/A	$74.53	$ (2,541)
Economic Hedges and Other Derivatives:				
Futures – long:				
(crude oil and refined products)	278	$93.80	N/A	$ 802
Futures – short:				
(crude oil and refined products)	936	N/A	$100.74	$ (2,102)
Swaps – long:				
(refined products)	385	$76.27	N/A	$ 1,684
Swaps – short:				
(refined products)	157	N/A	$73.22	$ (698)
Forward purchase contracts:				
(crude oil)	4,680	$85.81	N/A	$ 38,434
Forward sales contracts:				
(crude oil)	4,680	N/A	$86.48	$ (38,989)
Total fair value of open positions exposed to commodity price risk				$ (4,982)

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Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures.
Our management has evaluated, with the participation of the principal executive officer and principal financial officer of NuStar GP, LLC, the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report, and has concluded that our disclosure controls and procedures were effective as of September 30, 2011.
(b) Changes in internal control over financial reporting.
There has been no change in our internal control over financial reporting that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

The information below describes new proceedings or material developments in proceedings that we previously reported in our annual report on Form 10-K for the year ended December 31, 2010.
Grace Energy Corporation Matter. In 1997, Grace Energy Corporation (Grace Energy) sued subsidiaries of Kaneb Pipeline Partners, L.P. (KPP) and Kaneb Services LLC (KSL and collectively with KPP and their respective subsidiaries, Kaneb) in Texas state court. We acquired Kaneb on July 1, 2005. The complaint sought recovery of the cost of remediation of fuel leaks in the 1970s from a pipeline that had once connected a former Grace Energy terminal with Otis Air Force Base in Massachusetts (Otis AFB). Grace Energy alleges the Otis AFB pipeline and related environmental liabilities had been transferred in 1978 to an entity that was part of Kaneb's acquisition of Support Terminal Services, Inc. and its subsidiaries from Grace Energy in 1993. Kaneb contends that it did not acquire the Otis AFB pipeline and never assumed any responsibility for any associated environmental damage.

In 2000, the court entered final judgment that: (i) Grace Energy could not recover its own remediation costs of $3.5 million, (ii) Kaneb owned the Otis AFB pipeline and its related environmental liabilities and (iii) Grace Energy was awarded $1.8 million in attorney costs. Both Kaneb and Grace Energy appealed the final judgment of the trial court to the Texas Court of Appeals in Dallas. In 2001, Grace Energy filed a petition in bankruptcy, which created an automatic stay of actions against Grace Energy. In September 2008, Grace Energy filed its Joint Plan of Reorganization and Disclosure Statement.

The Otis AFB is a part of a Superfund Site pursuant to the Comprehensive Environmental Response Compensation and Liability Act (CERCLA). The site contains a number of groundwater contamination plumes, two of which are allegedly associated with the Otis AFB pipeline. Relying on the final judgment of the Texas state court assigning ownership of the Otis AFB pipeline to Kaneb, the United States Department of Justice (the DOJ) advised Kaneb in 2001 that it intends to seek reimbursement from Kaneb for the remediation costs associated with the two plumes. In November 2008, the DOJ forwarded information to us indicating that the past and estimated future remediation expenses associated with one plume are $71.9 million. The DOJ has indicated that they will not seek recovery of remediation costs for the second plume. The DOJ has not filed a lawsuit against us related to this matter, and we have not made any payments toward costs incurred by the DOJ. We are currently in settlement discussions with other potentially responsible parties and the DOJ, and a change in our estimate of this liability may occur in the near term. However, the proposed settlement must be approved by multiple parties and requires the approval of the bankruptcy court and the federal district court. We estimate that a settlement may be finalized in early to mid-2012.

Eres Matter. In August 2008, Eres N.V. (Eres) forwarded a demand for arbitration to CITGO Asphalt Refining Company (CARCO), CITGO Petroleum Corporation (CITGO), NuStar Asphalt Refining, LLC (NuStar Asphalt) and NuStar Marketing LLC (NuStar Marketing, and together with CARCO, CITGO and NuStar Asphalt, the Defendants) contending that the Defendants breached a tanker voyage charter party agreement, dated November 2004, between Eres and CARCO (the Charter Agreement). The Charter Agreement provided for CARCO's use of Eres' vessels for the shipment of asphalt. Eres contended that NuStar Asphalt and/or NuStar Marketing (together, the NuStar Entities) assumed the Charter Agreement when NuStar Asphalt purchased the CARCO assets, and that the Defendants had failed to perform under the Charter Agreement. Eres valued its damages for the alleged breach of contract claim at approximately $78.1 million. On October 14, 2011, Eres and the Defendants entered into a Settlement Agreement and Mutual Release. Pursuant to the terms of the Settlement Agreement and Mutual Release, the NuStar Entities paid $33.5 million in full and final settlement of all of Eres' claims against the Defendants. The settlement amount was included in the accrual for contingent losses as of September 30, 2011.

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Item 6. Exhibits

Exhibit Number	Description
*12.1	Statement of Computation of Ratio of Earnings to Fixed Charges
*31.01	Rule 13a-14(a) Certification (under Section 302 of the Sarbanes-Oxley Act of 2002) of principal executive officer
*31.02	Rule 13a-14(a) Certification (under Section 302 of the Sarbanes-Oxley Act of 2002) of principal financial officer
*32.01	Section 1350 Certification (under Section 906 of the Sarbanes-Oxley Act of 2002) of principal executive officer
*32.02	Section 1350 Certification (under Section 906 of the Sarbanes-Oxley Act of 2002) of principal financial officer
**101	The following interactive data files pursuant to Rule 405 of Regulation S-T from NuStar Energy L.P.'s Form 10-Q for the quarter ended September 30, 2011, formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Cash Flows, and (iv) Condensed Notes to Consolidated Financial Statements.

* Filed herewith.
** Filed electronically herewith.

In accordance with Rule 406T of regulation S-T, the XBRL information in Exhibit 101 to this quarterly report on Form 10-Q shall not be deemed to be "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (Exchange Act), or otherwise subject to the liability of that section, and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, as amended, or the Exchange Act. The financial information contained in the XBRL-related documents is "unaudited" or "unreviewed."

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

NUSTAR ENERGY L.P.
(Registrant)

By: Riverwalk Logistics, L.P., its general partner
By: NuStar GP, LLC, its general partner

By: /s/ Curtis V. Anastasio
Curtis V. Anastasio
President and Chief Executive Officer
November 7, 2011

By: /s/ Steven A. Blank
Steven A. Blank
Senior Vice President, Chief Financial Officer and Treasurer
November 7, 2011

By: /s/ Thomas R. Shoaf
Thomas R. Shoaf
Vice President and Controller
November 7, 2011