The Power Of COMMUNITY

Unity Is Strength. Community Is Trust.

Arkansas Electric Cooperative Corporation • 2003 Annual Report


Arkansas Electric
Cooperative Corporation
Your Local Energy Partner
www.aecc.com
Your Touchstone Energy® Cooperative

A Message from our Chief Executive Officer

Unity is Strength. Community is Trust.

On June 30, 2003, Arkansas Electric Cooperative Corporation (AECC) rededicated the newly refurbished Thomas B. Fitzhugh Generating Station near Ozark, Arkansas. The plant, AECC's first, began operating in 1963 after a long and hard-fought battle for the right of cooperatives to own generation facilities.

To win that battle, Arkansas' electric cooperatives banded together to create AECC and to fight opponents of the rural electrification movement. By working together, they were successful. The Fitzhugh Plant is truly a testament to the unity of the state's electric cooperatives. And through that unity, the cooperatives have gained the trust of their members. It is a level of trust that we will work hard to retain.

Through our unity and our commitment to the communities we serve, AECC and its member cooperatives have grown and prospered, just as rural Arkansas has. In the 17-year period from 1986 to 2003, AECC has invested $503 million in expansion and upgrades to its generating capacity. These improvements have allowed AECC to serve its loads reliably at competitive rates. They have also resulted in greater efficiency and diversity of fuel use. The investments have been made in Arkansas during a period when most other utilities have made no significant increases in generating capacity. The plant investments have been made gradually, while rates to cooperative members have actually been reduced.

AECC's strong financial position reflects the strength and determination of the people who work for the cooperative. It also reflects the vitality of the communities we serve. With a cooperative approach to business, a stalwart commitment to the community and the trust of the members we serve, AECC is well prepared to meet its members' present and future energy needs.

Gary Voigt

President and Chief Executive Officer
Arkansas Electric Cooperative Corporation

Practicing the Principle

The Power of Comm*unity*

Like other electric cooperatives across the nation, Arkansas Electric Cooperative Corporation (AECC) follows a set of guidelines known as the "7 Cooperative Principles" in conducting its business. Principle No. 7—concern for the community—is last on that list, but not in importance. AECC, a Little Rock-based generation and transmission cooperative, takes that principle as seriously as it does its core mission of providing reliable and affordable electricity to its members.

Either while at work or on their own time, AECC employees accomplish countless tasks for their communities. They serve as baseball, softball and soccer coaches. They form teams to participate in fund-raising walk/runs. They serve as ambassadors for their local chambers of commerce. And the cooperative itself sponsors numerous community programs.


Youth Tour

One such program, launched in 2002, is designed to fight cancer in rural areas of the state. AECC and the state's 17 electric distribution cooperatives, known collectively as the Electric Cooperatives of Arkansas, have joined with the University of Arkansas for Medical Sciences (UAMS) to develop a five-year program with a mission to reduce cancer incidence and mortality in rural areas of Arkansas.


Local cooperatives often sponsor electrical safety programs.

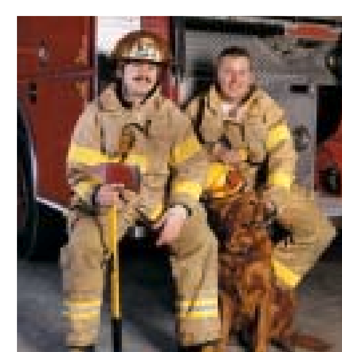
Much of what the cooperatives do for their communities is centered on the children of members. A cornerstone of the youth activities is the annual Rural Electric Youth Tour to Washington, D.C. Each year, the cooperatives send about 40 high school juniors on an all-expense-paid trip to the nation's capital where they tour historic sites and visit with the Arkansas Congressional Delegation.

For many years, the electric cooperatives have played an instrumental role in the development of infrastructure for rural Arkansas. The cooperatives' emphasis on economic development has led to the location or expansion of several industries in the cooperatives' service territory. A key to luring industries is a sound infrastructure and AECC has worked for decades to bring water systems, good fire protection, improved highways and reliable, affordable electricity service to Arkansas' rural areas.

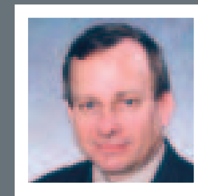
Charles & Imogene Belk *in front of their 2003 Doug Rye Energy-Efficient Home*

AECC is also committed to promoting the efficient use of electricity. In 1997, AECC created an education program to promote building techniques for energy-efficient homes. With this program, cooperatives across the state have built energy-efficient model homes that thousands of people have toured. And more homes are on the drawing board.

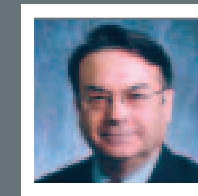
The last five letters of the word community form another word—unity, which describes the underlying key to the success of AECC. AECC is owned by 16 of the state's electric distribution cooperatives, which supply retail electricity to about 440,000 members in Arkansas and surrounding states. Those electric distribution cooperatives are owned by the members they serve. Through this unified, or cooperative, approach to business, AECC has grown to become one of the nation's top generation and transmission cooperatives. Because of its strength, and through its commitment to the communities it serves, AECC is well positioned to continue to help rural Arkansas prosper and grow for decades to come.



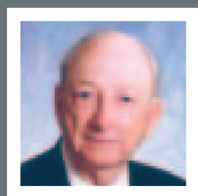
Board of Directors

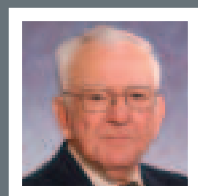

Alan R. Hannah
Arkansas Valley

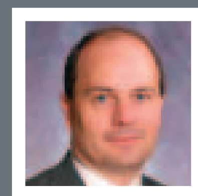

Samuel W. Davis
Arkansas Valley

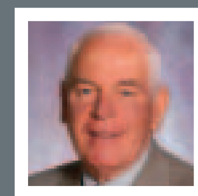

Ronald S. Moore
Ashley-Chicot

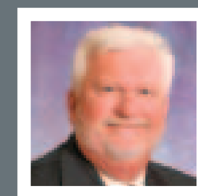

Henry W. Austin
Ashley-Chicot


W. H. Frizzell
C&L

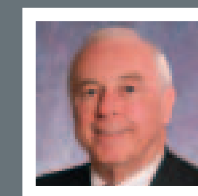

Charles S. Holloway
C&L

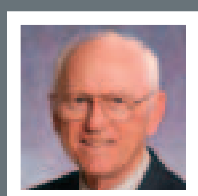

Rob Boaz
Carroll

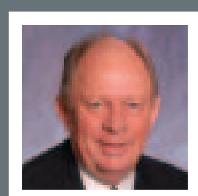

Charles Burdine
Carroll

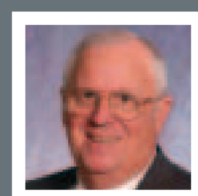

Derwood Brett
Clay County

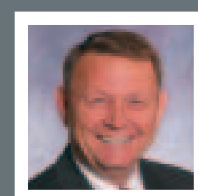

Leo Odom
Clay County

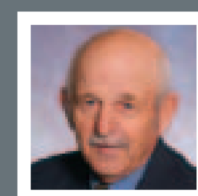

Wayne Honeycutt
Craighead


Tom Sloan
Craighead


Alton Higginbotham
First

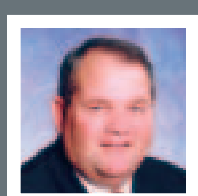

Robert M. Hill
First

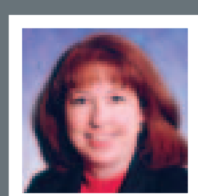

Larry W. Hellums
Mississippi County

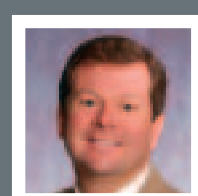

Robert Earl Davis
Mississippi County


Mel Coleman
North Arkansas

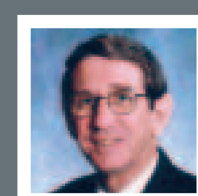

Jasper Freeman
North Arkansas

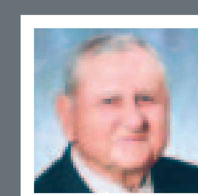

Mark T. Cayce
Ouachita

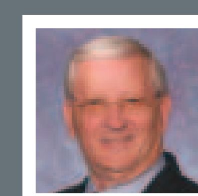

Lisa Hendrix
Ouachita

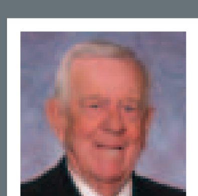

Mitchell Johnson
Ozarks

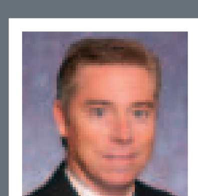

Jerry Bolinger
Ozarks

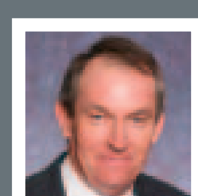

J. D. Todd
Petit Jean

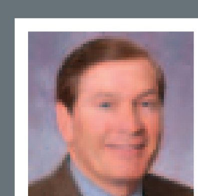

Willard H. Stark
Petit Jean

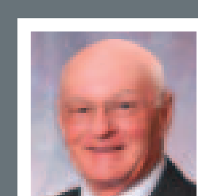

Leon Philpot
Rich Mountain

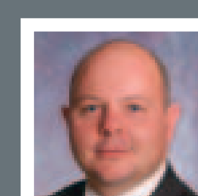

Bart M. Price
Rich Mountain

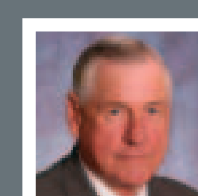

Bill Conine
South Central
Arkansas


Danny Buck
South Central
Arkansas


C. Wayne Whitaker
Southwest Arkansas


Don Stemple
Southwest Arkansas


Billy C. Martin, III
Woodruff


J. A. Wampler
Woodruff

A Message from our Chief Financial Officer

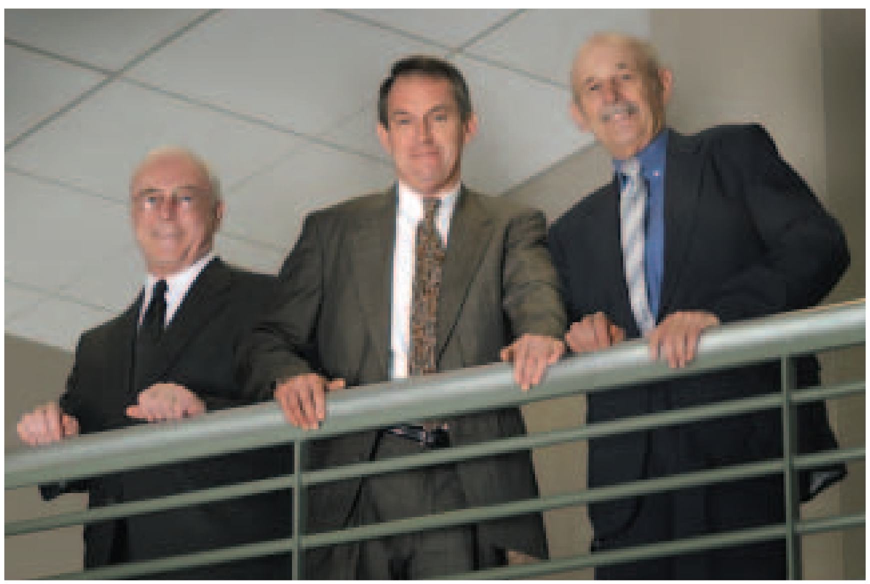
Michael W. Henderson

Financial statements are the foundation from which investors, vendors, analysts, customers, members and management assess the success of a company. The financial statements must be timely and accurate. For AECC to present accurate and timely financial statements, a series of processes and controls must be in place and operating as designed. The process involves a unified effort by not only the financial disciplines, but also by the functions that transcend all aspects of services provided within the cooperative. The internal controls, established by management and reviewed by independent auditors, ensure that the integrity of the financial reporting process is strong.

As you review these financial statements, please take comfort in the fact that many hours are dedicated through a unified effort to ensure that the financial position of AECC is fairly presented.

Michael W. Henderson

Vice President and Chief Financial Officer
Arkansas Electric Cooperative Corporation



Officers

LEFT TO RIGHT

Wayne Honeycutt
Secretary/Treasurer

Danny Buck
Chairman of the Board

Robert Earl Davis
Vice-Chairman of the Board

Management Team

LEFT TO RIGHT

Robert McClanahan
Vice President, Information Technology

Michael W. Henderson
Vice President & Chief Financial Officer

Pat McClafferty
Vice President, Utility Sales & Service/AECI

Robert M. Lyford
Senior Vice President & General Counsel

Doug White
Vice President, Systems Services

Carmie Henry
Vice President, Governmental Affairs/AECI

Ricky Bittle
Vice President; Planning, Rates & Dispatching

S. Maurice Robinson
Vice President; Engineering, Construction & Operations

Report of Independent Auditors

The Board of Directors
Arkansas Electric Cooperative Corporation:

We have audited the accompanying balance sheets of Arkansas Electric Cooperative Corporation as of October 31, 2003 and 2002, and the related statements of operations, members' equities and cash flows for the years then ended. These financial statements are the responsibility of the Cooperative's management. Our responsibility is to express an opinion on these financial statements based on our audits. The financial statements of Arkansas Electric Cooperative Corporation for the year ended October 31, 2001, were audited by other auditors who have ceased operations and whose report dated December 20, 2001, expressed an unqualified opinion on those statements.

We conducted our audits in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the 2003 and 2002 financial statements referred to above present fairly, in all material respects, the financial position of Arkansas Electric Cooperative Corporation as of October 31, 2003 and 2002, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

In accordance with *Government Auditing Standards*, we have also issued our report as of and for the year ended October 31, 2003, on our consideration of Arkansas Electric Cooperative Corporation's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. The report is an integral part of an audit performed in accordance with *Governmental Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

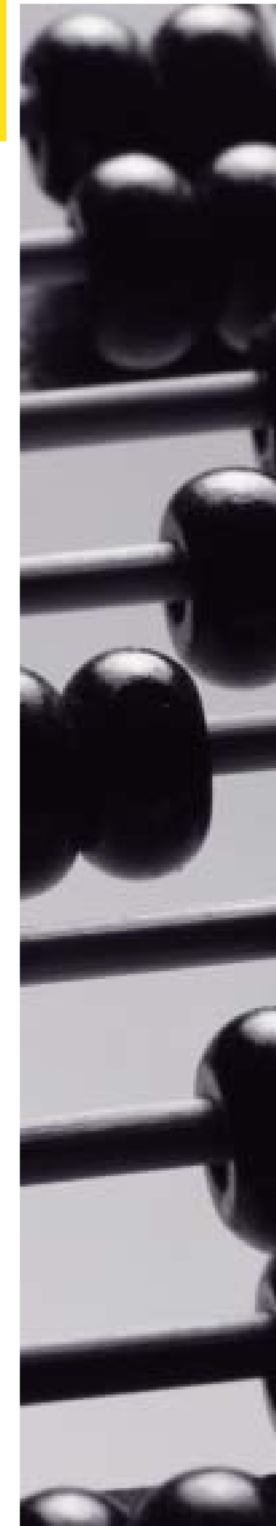
Ernst + Young LLP

December 18, 2003

Balance Sheets

As of October 31 *(In Thousands)*

ASSETS	2003	2002
Utility plant:		
Electric plant in service	**$1,303,038**	$1,106,846
Construction work in progress	**10,088**	63,025
Total utility plant	**1,313,126**	1,169,871
Less accumulated depreciation	**586,959**	486,026
Net utility plant	**726,167**	683,845
Long-term investments:		
Marketable securities	**12,468**	13,317
Gas reserves	**63,927**	67,953
Other	**14,506**	14,273
Total long-term investments	**90,901**	95,543
Current assets:		
Cash and cash equivalents	**48,624**	49,463
Short-term marketable securities	**3,758**	11,698
Accounts receivable, members	**26,296**	26,350
Fuel inventories	**16,420**	16,220
Material and supply inventories	**9,845**	9,560
Other current assets	**5,646**	4,816
Total current assets	**110,589**	118,107
Deferred charges	**144,203**	54,988
Total assets	**$ 1,071,860**	$ 952,483



MEMBERS' EQUITIES AND LIABILITIES	2003	2002
Members' equities:		
Membership fees	**$ 2**	$ 2
Patronage capital	**264,125**	261,625
Accumulated margins	**28,711**	30,149
Other equities	**118,140**	115,266
Net unrealized gain on investments	**745**	830
Total members' equities	**411,723**	407,872
Long-term debt:		
Federal Financing Bank	**241,831**	233,417
Independence Steam Electric Station finance obligation	**173,393**	–
Ellis finance obligation	**70,225**	77,939
National Rural Utilities Cooperative Finance Corporation – Guaranteed Pollution Control Revenue Bonds	**7,169**	11,483
Rural Utilities Service	**5,758**	7,062
Other long-term debt	**100**	105
Total long-term debt	**498,476**	330,006
Current liabilities:		
Notes payable	**71,456**	80,778
Accounts payable	**26,318**	26,901
Current maturities of long-term debt	**38,733**	19,638
Accrued property taxes	**5,299**	5,211
Accrued rent expense	**2,287**	3,473
Patronage capital payable	**9,559**	–
Accrued interest	**2,671**	2,706
Total current liabilities	**156,323**	138,707
Deferred credits:		
Deferred gain on sale and leaseback	**–**	70,445
Retirement obligations	**5,338**	5,453
Total deferred credits	**5,338**	75,898
Commitments and contingencies	**–**	–
Total members' equities and liabilities	**$ 1,071,860**	$ 952,483

See accompanying notes.

Statements of Operations

For the years ended October 31 *(In Thousands)*

	2003	2002	2001
Operating revenues	**$ 412,439**	$ 381,190	$ 499,358
Operating expenses:			
Operation and maintenance, generation	**187,030**	194,788	246,674
Power purchased	**109,285**	76,086	131,224
Operation and maintenance, transmission	**33,970**	28,926	27,583
Administrative and general	**16,359**	15,778	14,608
Depreciation	**34,187**	31,437	29,779
Interest	**25,721**	21,873	24,372
Taxes	**254**	235	196
Total operating expenses	**406,806**	369,123	474,436
Margin from operations	**5,633**	12,067	24,922
Interest income, net	**992**	1,154	2,417
Other income	**6,370**	3,374	8,991
Allowance for funds used during construction	**500**	1,311	1,878
Net margin	**$ 13,495**	$ 17,906	$ 38,208

See accompanying notes.

Education is Prevention

Cooperatives throughout the state present electrical safety programs developed for school children, consumers, fire and police departments and even their employees. Our commitment to safety is evident—cooperative employees use live electric power to teach precautions that should be observed around electrical equipment, and our line crews also receive specialized safety training.

Statements of Members' Equities

For the years ended October 31 *(In Thousands)*

	Membership Fees	Patronage Capital	Accum. Margins	Other Equities	Net Unrealized Gain/(Loss) on Investments	Total Members' Equities
Balance, November 1, 2000	$2	$ 228,686	$ 38,586	$ 107,076	$ 523	$ 374,873
Comprehensive income:						
Net margin	–	–	34,113	4,095	–	38,208
Net unrealized gain on investments	–	–	–	–	524	524
Comprehensive income						38,732
Allocation of patronage capital	–	33,176	(33,176)	–	–	–
Redemption of patronage capital	–	(9,068)	–	–	–	(9,068)
Balance, October 31, 2001	2	252,794	39,523	111,171	1,047	404,537
Comprehensive income:						
Net margin	–	–	13,811	4,095	–	17,906
Net unrealized loss on investments	–	–	–	–	(217)	(217)
Comprehensive income						17,689
Allocation of patronage capital	–	23,185	(23,185)	–	–	–
Redemption of patronage capital	–	(14,354)	–	–	–	(14,354)
Balance, October 31, 2002	2	261,625	30,149	115,266	830	407,872
Comprehensive income:						
Net margin	**–**	**–**	**10,621**	**2,874**	**–**	**13,495**
Net unrealized loss on investments	**–**	**–**	**–**	**–**	**(85)**	**(85)**
Comprehensive income						**13,410**
Allocation of patronage capital	**–**	**12,059**	**(12,059)**	**–**	**–**	**–**
Redemption of patronage capital	**–**	**(9,559)**	**–**	**–**	**–**	**(9,559)**
Balance, October 31, 2003	**$2**	**$ 264,125**	**$ 28,711**	**$ 118,140**	**$ 745**	**$ 411,723**

See accompanying notes.

Statements of Cash Flows

For the year ended October 31 *(In Thousands)*

	2003	2002	2001
Operating activities			
Net margin	**$ 13,495**	$ 17,906	$ 38,208
Adjustments to reconcile net margin to net cash provided by operating activities:			
Depreciation	**34,187**	31,437	29,779
Amortization of gain on sale and leaseback	**(2,874)**	(4,095)	(4,095)
Amortization of gas reserves	**4,026**	4,081	5,215
Allowance for funds used during construction	**(500)**	(1,311)	(1,878)
Changes in operating assets and liabilities:			
Accounts receivable, members	**54**	(1,255)	1,912
Fuel inventories	**(200)**	1,537	(6,263)
Material and supply inventories	**(285)**	(617)	(961)
Other current assets	**(830)**	(35)	7,459
Deferred charges	**(5,022)**	(383)	(4,596)
Accounts payable and accrued liabilities	**(1,716)**	6,804	(14,633)
Other deferred credits	**(115)**	812	234
Net cash provided by operating activities	**40,220**	54,881	50,381
Investing activities			
Net sales (purchases) of marketable securities	**8,704**	(18,037)	64,492
Net (purchases) sales of other investments	**(233)**	97	(74)
Capital expenditures	**(19,748)**	(48,360)	(46,219)
Repurchase of ISES 2 residual	**(26,500)**	–	–
Net cash (used in) provided by investing activities	**(37,777)**	(66,300)	18,199
Financing activities			
Net (payments) borrowings on notes payable	**(9,322)**	9,466	(45,528)
Principal payments on long-term debt	**(17,860)**	(18,780)	(19,120)
Proceeds from long-term debt	**23,900**	45,000	3,412
Redemption of patronage capital	**–**	(14,354)	(9,069)
Net cash (used in) provided by financing activities	**(3,282)**	21,332	(70,305)
Net change in cash and cash equivalents	**(839)**	9,913	(1,725)
Cash and cash equivalents, beginning of year	**49,463**	39,550	41,275
Cash and cash equivalents, end of year	**$ 48,624**	$ 49,463	$ 39,550

See accompanying notes.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

Arkansas Electric Cooperative Corporation (AECC), an electric generation and transmission cooperative, follows the Uniform System of Accounts prescribed by the Rural Utilities Service (RUS) and the Federal Energy Regulatory Commission.

AECC was organized and exists under Arkansas law to provide wholesale electric power and associated energy to its 16 members. AECC provides electric power to its members under wholesale power contracts which may be terminated only upon 60 months prior written notice and, in any event, no earlier than January 1, 2020. The wholesale power contracts require members to purchase, with the limited exception of three members, 100% of their energy requirements at a demand charge and energy rate, the combination of which is designed to recover the operating costs of AECC plus a margin as approved by AECC's Board of Directors (the Board), the RUS and the Arkansas Public Service Commission (APSC).

AECC's power supply resources are primarily comprised of owned, co-owned and leased generating facilities. AECC delivers energy through its owned and contracted transmission facilities. Additionally, AECC maintains interchange agreements with certain utility companies that allow for the purchase and/or sale of electricity.

Carrying Value of Certain Assets and Liabilities

AECC's accounting policies and the accompanying financial statements conform to accounting principles generally accepted in the United States applicable to rate-regulated enterprises and reflect for financial reporting purposes the effects of the rate-making process in accordance with Statement of Financial Accounting Standards (SFAS) No. 71, "Accounting for the Effects of Certain Types of Regulation." In accordance with SFAS No. 71, AECC has regulatory assets in the amount of approximately $138.3 million attributable to premiums associated with debt refinancings and retirements (which are being amortized over the life of the related debt instruments), the deferred depreciation associated with the Clyde T. Ellis Hydroelectric Station (Ellis) lease and the purchase of the lease residual and subsequent reclassification from an operating to a capital lease for the Independence Steam Electric Station Unit 2 (ISES 2) in June 2003. See "Rental and Lease Commitments" (Note 12) for further discussion. In the event operations are no longer subject to the provisions of SFAS No. 71 as a result of a change in regulation or the effects of competition, AECC would be required to recognize the effects of any regulatory change in assets currently in its statement of operations.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Electric Industry Restructuring

During 1999, the Arkansas General Assembly (the Legislature) approved Act 1556 of 1999 (the Act) to provide consumer choice for electric generation services. Although the Act preserves existing distribution service territory, retail consumers would be allowed to purchase electric power from any qualified generation provider beginning as early as January 1, 2002. In February 2001, the Legislature amended the Act to delay the start of competition to October 1, 2003, but permitted the APSC, under certain conditions to further delay competition to no later than October 1, 2005. During the regular session of 2003 the Legislature approved Act 204, which repealed retail open access in Arkansas. Electric cooperatives retained their expanded authorities granted by the Act.

Utility Plant and Related Depreciation

All utility plant is recorded at original cost. The cost of additions to utility plant includes contracted work, direct labor, materials, allocable overhead and an allowance for funds used during construction as allowed by the APSC. Listed below are the major classes of utility plant at October 31: *(In Thousands)*

	2003	2002
Generation plant	**$ 1,206,167**	$ 1,014,689
Transmission plant	**70,822**	67,257
General plant	**26,049**	24,900
Electric plant in service	**1,303,038**	1,106,846
Construction work in progress	**10,088**	63,025
	$ 1,313,126	$ 1,169,871

The King of Caulk & Talk

Arkansas Electric Cooperative Corporation (AECC) has partnered with widely recognized home energy-efficiency expert Doug Rye, better known as the "King of Caulk and Talk." Doug hosts a national radio show, pens a column and conducts seminars around the United States offering tips on energy efficiency, energy-conscious technology and saving on home utility bills. He and AECC also team up to construct energy-efficient model homes in Arkansas communities.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

The cost of retirements, replacements or betterments is removed from utility plant and, in accordance with industry practice, the cost of the unit and its removal cost, less salvage, are charged to accumulated depreciation. Maintenance and repairs are charged to operating expenses as incurred.

Depreciation of utility plant is recorded using the guidelines as prescribed by the RUS. A provision has been made for depreciation of steam generation plant, gas turbine generation plant, hydroelectric generation plant and transmission plant at annual straight-line composite rates of 3.1%, 3.0%, 2.0%, and 2.75%, respectively. General plant depreciation rates are applied on an annual straight-line composite basis as follows:

Structures and improvements	2%
Office furniture and equipment	4.8% and 9.6%
Transportation equipment	20%
Power operated equipment	15%
Tools, shop and garage equipment	5%
Communication equipment	8%
Other general plant	5% and 6%

The Ellis facility is unique in that it is being depreciated in accordance with rate-making treatment. See "Rental and Lease Commitments" (Note 12) for further discussion.

Electric Revenues and Fuel

Revenues are recorded in the same month that power is generated and billed. AECC charges the cost of fuel to expense as fuel is consumed.

Carrying Costs Capitalized During Construction

AECC capitalizes the carrying costs on certain significant construction and development projects while in progress. Under approval from the APSC, AECC is allowed to capitalize the interest costs for debt specifically borrowed to finance projects during construction and development. Additionally, for the portion of construction and development projects funded without specific borrowings, the APSC allows AECC to capitalize carrying costs based first on the incremental rate incurred in relation to its notes payable and, to the extent the construction and development project costs exceed the balance of the notes payable, AECC may capitalize carrying costs attributable to the remaining costs based on the weighted-average interest rate of AECC's long-term debt, excluding any amounts representing specific borrowings.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

AECC records the interest costs capitalized related to debt specifically borrowed for construction and development projects as interest during construction, which is reflected as a credit to interest expense as part of operating expenses in the accompanying statements of operations. Additionally, AECC is allowed to record the carrying costs capitalized related to construction and development projects funded without specific borrowings as an allowance for funds used during construction, which is reflected below the margin from operations in the accompanying statements of operations.

Interest costs capitalized related to debt specifically borrowed amounted to $.1 million for the year ended October 31, 2003, and recorded as a reduction in interest expense. In addition, for the years ended October 31, 2003, 2002, and 2001, the carrying costs capitalized relating to projects funded without specific borrowings were approximately $.5 million, $1.3 million, and $1.9 million, respectively, and such costs have been recorded as an allowance for funds used during construction in the accompanying statements of operations.

Statements of Cash Flows

For purposes of the statements of cash flows, cash and cash equivalents represent demand deposits in financial institutions and securities with original maturity dates of three months or less. Cash paid for interest was approximately $25.8 million, $21.0 million, and $26.2 million for the years ended October 31, 2003, 2002, and 2001, respectively. No amounts were paid for income taxes for the years ended October 31, 2003, 2002, and 2001.

Inventories

Fuel inventories and materials and supply inventories are stated at average cost.

Use of Estimates

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

New Accounting Pronouncements

SFAS No. 143 "Accounting for Asset Retirement Obligations," which was effective for AECC on October 31, 2003, requires the recording of liabilities for all legal obligations associated with the retirement of long-lived assets that result from the normal operations of those assets. These liabilities are recorded at their fair values (which are likely to be the present values of the estimated future cash outflows) in the period in which they are incurred, with an accompanying addition to the recorded cost of the long-lived asset. The asset retirement obligation is accreted each year through a charge to expense, to reflect the time value of money for this present value obligation. The amounts added to the carrying amounts of the long-lived assets are depreciated over the useful lives of the assets. The net effect of implementing this standard was not material to the financial statements of AECC.

In May 2003, the Financial Accounting Standards Board (FASB) issued Statement No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." Statement No. 150 requires that an issuer classify a financial instrument with characteristics of both liability and equity as a liability (or asset in some circumstances). Many of these instruments were previously classified as equity. This statement is effective for financial instruments entered into or modified after May 31, 2003, and did not have an impact on AECC's October 31, 2003, financial statements and related disclosures.

In March 2003, the FASB issued Interpretation No. 46. Interpretation No. 46 of Accounting Research Bulletin No. 51, Consolidated Financial Statements, addresses consolidation by business enterprises of variable interest entities. This interpretation applies to variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains an interest after that date. The effective date of Interpretation No. 46 was July 1, 2003, but the FASB postponed the effective date to December 31, 2003. AECC is evaluating the effects of Interpretation No. 46 but currently expect it will not have a significant impact on AECC's financial statements and related disclosures.

In November 2002, the FASB issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statement No. 5, 57, and 107 and rescission of FASB Interpretation No. 34." Interpretation No. 45 requires that a guarantor recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken by issuing the guarantee and requires additional disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees it has issued. The adoption of Interpretation No. 45 did not have an impact on AECC's financial statements and related disclosures.

2. INCOME TAXES

In December 1982, AECC elected to revoke its tax-exempt status for federal income tax purposes. For state income tax purposes, AECC operates as a tax-exempt cooperative under Arkansas statutes. No amounts were expensed for income taxes for the years ended October 31, 2003, 2002, and 2001.

The differences between the statutory federal income tax rate on income before income taxes and AECC's effective income tax rate are summarized as follows: *(In Thousands)*

	2003	**Percent**	2002	Percent	2001	Percent
Statutory federal income tax rate	**$ 4,723**	**35.0%**	$ 6,267	35.0%	$ 13,373	35.0%
Non-taxable member income	**(4,723)**	**(35.0)**	(6,267)	(35.0)	(13,373)	(35.0)
Tax credit carryforwards not benefited	**–**	**–**	–	–	–	–
Effective income tax rate	**$ –**	**– %**	$ –	– %	$ –	– %

The components of the net deferred tax liability at October 31 were as follows: *(In Thousands)*

Deferred tax assets:	**2003**	2002
Patronage exclusions available	**$ 51,992**	$ 48,528
ISES 2 sale and leaseback	**23,700**	24,656
Alternative minimum tax (AMT) credit carryforwards	**4,052**	4,052
Other	**2,138**	2,161
	81,882	79,397
Valuation allowance	**(4,052)**	(4,052)
	77,830	75,345
Deferred tax liabilities:		
Utility plant	**(65,947)**	(64,002)
Safe harbor lease	**(8,681)**	(8,059)
Ellis sale and leaseback	**(251)**	(151)
Other	**(2,951)**	(3,133)
	(77,830)	(75,345)
Net deferred tax liability	**$ –**	$ –

2. INCOME TAXES (CONTINUED)

At October 31, 2003, AECC had AMT credit carryforwards of approximately $4.1 million. Based on AECC's historical transactions resulting in non-member losses and the patronage provisions of its bylaws, AECC does not anticipate any future taxable income sufficient to realize the benefit of the tax credits existing at October 31, 2003. Accordingly, AECC has established a valuation allowance for these credits as reflected above.

3. INVESTMENTS

AECC uses SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities." In accordance with SFAS No. 115, AECC has classified all marketable investments as available-for-sale. Available-for-sale investments are stated at fair value with unrealized gains and losses included in members' equities. Realized gains and losses, which were immaterial for all periods presented, are included in other income. The cost of investments sold is based on the specific-identification method.

Long-term and short-term marketable securities classified as available-for-sale were as follows at October 31, 2003 and 2002: *(In Thousands)*

	2003			
Description	**Amortized Cost**	**Gross Unrealized Gain**	**Gross Unrealized Loss**	**Fair Value**
U.S. Treasury notes, bills and bonds	**$ 2,992**	**$ 775**	**$ –**	**$ 3,767**
Other U.S. government agency securities	**8,475**	**–**	**38**	**8,437**
Other debt securities	**4,014**	**8**	**–**	**4,022**
	$ 15,481	**$ 783**	**$ 38**	**$ 16,226**

	2002			
Description	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
U.S. Treasury notes, bills and bonds	$ 3,185	$ 921	$ –	$ 4,106
Other U.S. government agency securities	2,014	1	–	2,015
Other debt securities	18,987	133	226	18,894
	$ 24,186	$ 1,055	$ 226	$ 25,015

3. INVESTMENTS (CONTINUED)

At October 31, 2003, contractual maturities of marketable securities were as follows: *(In Thousands)*

Description	Less Than One Year	One Through Five Years	After Five Years	Total
U.S. Treasury notes, bills and bonds	$ –	$ –	$ 2,992	$ 2,992
Other U.S. government agency securities	–	5,475	3,000	8,475
Other debt securities	3,756	258	–	4,014
	$ 3,756	$ 5,733	$ 5,992	$ 15,481

Subordinated term certificates were purchased in connection with the issuance of the National Rural Utilities Cooperative Finance Corporation (CFC) Guaranteed Pollution Control Revenue Bonds. These amounts are recorded in the accompanying balance sheets as part of long-term investments, other and totaled $8.4 million and $9.0 million at October 31, 2003 and 2002, respectively. In accordance with SFAS No. 115, these investments have been classified as held-to-maturity and, accordingly, are recorded at amortized cost. These investments have maturity dates consistent with the retirement of the CFC Guaranteed Pollution Control Revenue Bonds, which extend through 2008.

AECC has a leasehold interest in the revenue stream of certain gas wells being administered by Sedna Energy, Inc. (Sedna), formerly known as Freedom Energy Inc. Sedna is a wholly owned subsidiary of Dernick Resources, Inc., located in Houston, Texas. According to the agreements with AECC, Sedna disburses AECC's proportionate share of net revenue interests on a monthly basis. AECC is accounting for its mineral interest using the successful efforts method of accounting and the mineral interest is being depleted on a field-by-field basis using the unit-of-production method based on estimated proven reserves. At October 31, 2003 and 2002, AECC's leasehold interests in the gas reserves totaled approximately $63.9 million and $68.0 million, respectively. The net revenue interests received less the amortization of the gas reserves resulted in other income/(loss) of approximately $3.3 million, ($0.7) million, and $4.7 million for the years ended October 31, 2003, 2002, and 2001, respectively.

Night Lights

There's nothing quite like a night game—just ask any of the players and fans who benefit from the Electric Cooperatives of Arkansas' willingness to install and maintain field lights for schools and communities. Cooperatives have provided labor for outdoor lights at a number of playing fields across the state as well as safety lighting for public venues, oftentimes in areas not directly served by an electric cooperative.

4. PATRONAGE CAPITAL

Patronage allocations are based on an amount not less than the fiscal year's taxable income for federal income tax purposes. Patronage allocations are assigned to patrons' accounts as credits on a patronage basis. Using this allocation method, approximately $12.1 million and $23.2 million of patronage capital were allocated for the years ended October 31, 2003 and 2002, respectively.

Patronage retirements are restricted by the terms of the RUS mortgage and AECC bylaws. The mortgage requires the RUS approval for payments which reduce members' equities below 30.0% of total assets. At October 31, 2003, 2002, and 2001, total members' equities as a percentage of total assets amounted to 38.4%, 42.8%, and 44.5%, respectively.

The Board authorized patronage retirements of approximately $9.9 million, $14.4 million, and $9.1 million for the years ended October 31, 2003, 2002, and 2001, respectively.

5. OTHER EQUITIES

Other equities include proceeds approximating $43 million received from the sale of tax benefits under the Economic Recovery Tax Act of 1981, net of applicable expenses. The tax benefits sold were the depreciation and tax credits applicable to the Independence Steam Electric Station Unit No. 1 (ISES 1) boiler and turbine, coal handling equipment and certain common and related items having a cost of approximately $114 million.

In connection with the sale of tax benefits, AECC has agreed to indemnify the purchaser against the loss of such tax benefits. CFC, in turn, agreed to guarantee approximately $51 million of the indemnification, with the guaranteed amount decreasing annually until expiration during fiscal year 2013. At October 31, 2003, the guaranteed amount by CFC was approximately $17.3 million. The maximum exposure under the indemnification clause is dependent upon the facts, circumstances and timing of any loss; however, management is not aware of any existing conditions that would result in such a loss.

The other equities balance also includes income related to the amortization of the deferred gain resulting from a sale and leaseback transaction. During December 1984, AECC sold and leased back its 35% undivided interest in ISES 2. The sales price was $275 million, which resulted in a gain of approximately $143 million. In accordance with SFAS No. 71, due to rate-making treatment, the gain from this sale will be recognized for financial reporting purposes over the lease term. The proceeds from the sale were used to retire debt, including prepayment penalties and accrued interest, of approximately $220 million and to provide working capital. During 2003, AECC purchased the ISES 2 lease residual resulting in the operating lease being reclassified as a capital lease. See "Rental and Lease Commitments" (Note 12) for further discussion.

6. LONG-TERM DEBT

Long-term debt consisted of the following at October 31: *(In Thousands)*

	2003	2002
Mortgage notes payable to Federal Financing Bank (FFB) at interest rates varying from 4.65% to 6.89% at October 31, 2003 and 2002, due in quarterly installments through December 2031	**$ 257,317**	$ 247,056
ISES 2 finance obligation under sale and leaseback, at an implicit rate of 6.05% at October 31, 2003, due in semiannual installments through 2019	**183,292**	–
Ellis finance obligation under sale and leaseback, at an implicit interest rate of 4.29%, at October 31, 2003 and 2002, due in semiannual installments through 2013	**77,939**	78,471
CFC Guaranteed Pollution Control Revenue Bonds:		
City of Siloam Springs and Jefferson County, Arkansas, at interest rates varying from 4.65% to 5.00%, at October 31, 2003, and from 4.55% to 5.00% at October 31, 2002, due in semiannual installments through 2008	**9,025**	10,795
Jefferson County and Independence County, Arkansas, at an interest rate of 4.50%, at October 31, 2003, and from 4.40% to 4.5% at October 31, 2002, due in annual installments through 2003	**2,485**	4,865
	11,510	15,660
RUS 2% mortgage notes due in quarterly installments through May 2018	**3,088**	4,058
RUS 5% mortgage notes due in quarterly installments through August 2015	**3,974**	4,316
	7,062	8,374
Other long-term debt	**105**	110
Total long-term debt	**537,225**	349,671
Unamortized discounts	**(16)**	(27)
	537,209	349,644
Less current maturities of long-term debt	**38,733**	19,638
	$ 498,476	$ 330,006

6. LONG-TERM DEBT (CONTINUED)

Following are the estimated maturities of long-term debt for each of the next five years ending October 31, and in the aggregate thereafter: *(In Thousands)*

	2004	2005	2006	2007	2008	Thereafter	Total Debt
FFB	$15,486	$ 16,443	$ 17,321	$ 18,172	$ 19,216	$170,679	$257,317
ISES 2 finance obligation	9,900	10,575	11,265	11,980	12,370	127,202	183,292
Ellis finance obligation	7,713	14,298	10,908	7,283	8,674	29,063	77,939
CFC Guaranteed Pollution Control Revenue Bonds	4,325	1,935	2,030	2,130	1,090	–	11,510
RUS	1,304	1,075	730	713	712	2,528	7,062
Other	5	6	6	7	7	74	105
	$38,733	$44,332	$42,260	$40,285	$42,069	$329,546	$537,225

Under the debt agreements, all of AECC's assets were pledged as security at October 31, 2003. The debt agreements contain provisions, which, among other restrictions, require AECC to maintain certain financial ratios. AECC was in compliance with these financial ratios at October 31, 2003.

During 2001, the RUS approved two loan guarantee commitments in the amount of $58.9 million and $57.5 million related to the construction of the Fulton plant and the repowering of the Fitzhugh plant, respectively. The loan commitments have a maturity date of December 31, 2031. During 2002, AECC received advances from FFB of $45 million under the Fulton loan at an average interest rate of 5.586%. During 2003, AECC received the remaining $13.9 million advance from FFB under the Fulton loan at an interest rate of 4.835%. AECC also received an advance from FFB of $10 million under the Fitzhugh loan at an interest rate of 5.041%. It is anticipated that AECC will receive the remainder of the loan funds during 2004. Interest rates and payment terms have not been finalized on the remaining unadvanced loan funds. The proceeds have been and will be used to reimburse AECC's general funds and used to complete the construction related to the Fitzhugh repowering project.

"Riley's Warriors"

Walk (or Run) with Me

Arkansas Electric Cooperative Corporation (AECC) employees are dedicated to causes close to their hearts! In addition to supporting the Susan G. Komen Race for the Cure, which raises funds for the fight against breast cancer, AECC also supports the Easter Seals of Arkansas as a sponsor of Rollin' on the River, a walk to benefit the organization's programs. AECC employees are invited to run or walk in the race as part of the "Riley's Warriors" team and local cooperatives are working to hold similar races throughout Arkansas.

7. NOTES PAYABLE

AECC maintains a $75 million perpetual line of credit with CFC which bears interest at 1% above the prime rate or such lesser total rate per annum as may be fixed by CFC. AECC also has a $10 million line of credit with Regions Bank, which bears interest at 0.5% below the prime rate. The line of credit with Regions Bank is subject to renewal on August 15, 2005. There was no outstanding balance at October 31, 2003 or 2002, under these lines of credit.

AECC has signed related party master promissory notes with all of its member distribution cooperatives. These notes allow members to advance AECC funds with such advances payable upon demand. When needed, AECC may use such advances for its own operating requirements. However, when AECC is in a financial position such that it does not require these advances for operations, members may continue to advance funds to AECC for investment purposes. AECC collectively invests such funds, along with AECC's general funds, and pays its members an interest rate comparable to the monthly average rate earned on the combined investments. AECC invests these funds in U.S. Treasury notes, bills and bonds, other U.S. government agency securities and various other debt securities such as corporate notes, bonds and commercial paper.

At October 31, 2003 and 2002, member advances to AECC totaled approximately $71.5 million and $80.8 million, respectively. At October 31, 2003 and 2002, the interest rate on the notes payable was 2.66%, and 3.1%, respectively. Interest expense on the notes payable was $1.9 million, $2.9 million, and $4.1 million for the years ended October 31, 2003, 2002, and 2001, respectively.

8. EMPLOYEE BENEFITS

Retirement benefits for substantially all employees are provided through participation in the National Rural Electric Cooperative Association (NRECA) Retirement, Safety and Insurance Program. In this master multi-employer plan, which is available to all member cooperatives of NRECA, the accumulated benefits and plan assets are not determined or allocated separately by individual employer. Additionally, AECC has a defined contribution plan for eligible employees, for which contributions are determined annually. Total benefit costs were approximately $3.2 million, $2.9 million, and $2.4 million for the years ended October 31, 2003, 2002, and 2001, respectively.

Youth Tour

Arkansas' electric cooperatives sponsor the Rural Electric Youth Tour each year for high school juniors. Since 1990, approximately 40 participants are selected each year in contests held at the 17 local cooperatives. Winners travel to Washington, D.C., where they learn firsthand about the federal government and the importance of electric cooperatives, visit with members of the Arkansas Congressional Delegation and visit historic sites.

8. EMPLOYEE BENEFITS (CONTINUED)

AECC provides certain postretirement benefits to employees. An actuarial valuation was prepared as of January 1, 2002, in accordance with SFAS No. 106, “Employers’ Accounting for Postretirement Benefits Other Than Pensions,” and the accumulated postretirement benefit obligation was calculated to be $0.3 million and, accordingly, the liability is reflected in retirement obligations in AECC’s balance sheet.

9. RELATED PARTY TRANSACTIONS

AECC has limited joint management and overlapping Boards of Directors with Arkansas Electric Cooperatives, Inc. (AECI). AECI, among other things, is engaged in the production and repair of transformers, construction and maintenance of electrical substations and transmission facilities, and the marketing of new pole-mount and pad-mount transformers and pole-line hardware. Under contractual agreements, AECC and AECI share certain facilities and personnel. Separate accounting records and related information are maintained for each cooperative.

AECI pays AECC monthly rent for use of the general office facilities and other expenses. The total amounts paid to AECC for the years ended October 31, 2003, 2002, and 2001, were approximately $2.5 million, $2.4 million, and $1.8 million, respectively. AECI owed AECC approximately $0.2 million at both October 31, 2003 and 2002, related to the reimbursement of these expenses.

AECI provides various services for AECC. The amounts incurred by AECC for shared salaries, reimbursement of expenses, purchases of supplies and services, and right-of-way clearing and construction were approximately $2.1 million, $3.2 million, and $3.1 million for the years ended October 31, 2003, 2002, and 2001, respectively. At October 31, 2003 and 2002, AECC owed AECI approximately $0.3 million and $0.2 million, respectively, for materials and services. The prices charged by AECI to AECC for supplies and services are based on quotations submitted by AECI, i.e., “bids” and, in management’s opinion, are lower or at least comparable to prices AECC would be required to pay other suppliers.

10. POWER PLANTS

AECC has an ownership or leasehold interest in and is responsible for providing its share of the costs for jointly owned or certain leased facilities in Arkansas, with the corresponding direct expenses included in the statements of operations as operating expenses. AECC’s share of each operating facility at October 31, 2003, is as follows (Dollars In Thousands):

10. POWER PLANTS (CONTINUED)

Generating Plants	Ownership or Leasehold Interest %	Amount of Utility Plant in Service	Accumulated Provision for Depreciation	Amount of Plant Under Construction	Current Available Net Capacity (MW)
Flint Creek	50 %	$ 85,373	$ 58,628	$ 1,582	264 MW
White Bluff 1 and 2	35	293,045	188,039	3,133	580
ISES 1 and 2	35	336,068	195,313	1,638	588
Fitzhugh	100	71,818	10,056	–	171
Bailey	100	13,002	12,252	80	122
McClellan	100	18,302	16,485	34	134
Ellis	100	70,340	41,210	–	26
Whillock	100	75,669	14,990	–	17
Electric Cooperatives of Arkansas	100	183,951	14,715	–	35
Fulton CT 1	100	58,599	4,195	–	153

Under a purchase agreement with Southwestern Power Administration (SPA), which expires June 30, 2013, AECC has the right to purchase, except in certain circumstances, up to 189 MW of power and associated energy from SPA. AECC can draw power and energy under this contract for up to 200 hours a month, but not over 600 hours in any four consecutive months and not over 1,200 hours in any 12-month period.

Under a unit power sales agreement with Entergy Power Ventures, L.P., AECC has the right to call on up to 150 MW of unit contingent power and associated energy. The agreement is for a five-year period beginning January 1, 2004. The unit contingency provision will be based on the availability of the Harrison County Plant near Marshall, Texas.

11. FUEL SUPPLY AGREEMENTS

AECC pays Entergy Arkansas, Inc. (Entergy), in accordance with provisions of joint operating agreements, for its 35% interest in the coal stockpiles at the White Bluff and ISES generating plants. Entergy retains all ownership rights to the coal. AECC makes monthly payments to Entergy to maintain the stockpiles. These payments are classified as fuel inventories in the accompanying balance sheets. In addition, in prior years AECC paid the coal supplier of the ISES plants approximately $8 million for start-up costs at the North Antelope/Rochelle coalmine complex, the primary source of coal of ISES 1 and 2. These amounts have been recorded as deferred charges in the accompanying balance sheets, and such amounts are being amortized into fuel expense over the life of the agreements.

11. FUEL SUPPLY AGREEMENTS (CONTINUED)

AECC also has a joint operating agreement with Southwestern Electric Power Company, in connection with its 50% interest of the Flint Creek generating station, whereby AECC pays for its share of the fuel consumed at that station.

12. RENTAL AND LEASE COMMITMENTS

AECC is leasing ISES 2 under a 35-year leveraged lease requiring future minimum lease payments for the next five years ending October 31 and in the aggregate thereafter as follows: *(In Thousands)*

Year	Amount
2004	$ 21,006
2005	21,185
2006	21,284
2007	21,332
2008	20,944
Thereafter	171,457
	$277,208

On June 27, 2003, AECC repurchased its future ownership interest in the leased ISES 2 assets at the end of the current lease period. The $26.5 million purchase price was funded through the use of general funds. As a result of this payment, the facility's ownership will now transfer back to AECC on December 31, 2019, as long as AECC complies with all other terms of the lease through that date. Therefore, effective June 27, 2003, the operating lease was reclassified as a capital lease and will be accounted for accordingly through the remainder of the lease term.

The change to a capital lease resulted in AECC recording ISES 2 assets of $128.1 million, accumulated depreciation of $71.8 million, a regulatory created asset in the amount of $105.7 million, and a lease finance obligation in the amount of $181.5 million (of which the current portion is $9.9 million as of October 31, 2003). In addition, AECC removed from its balance sheet the unamortized deferred gain on the ISES 2 sale-leaseback in the amount of $67.5 million and deferred rent expense under the operating lease in the amount of $21.5 million.

The reclassification from an operating to a capital lease has a balance sheet impact only, with the exception of the $26.5 million lease residual purchase, as far as the total expense recognized through the term of the lease. The impact to the income statement is to recognize depreciation, interest and the amortization of regulatory asset expenses under the capital lease versus rent expense and gain amortization under the operating lease. The difference between the consideration paid for the leased assets and their carrying value has been recorded as a regulatory created asset at the transaction date. This asset has been recorded as "Unamortized Loss on Reacquired Debt" and will be amortized over the remaining lease period. The annual straight-line expense recognized through the capital lease is $15.6 million since it is treated as an operating lease for rate-making purposes.

12. RENTAL AND LEASE COMMITMENTS (CONTINUED)

Related expenses recorded in the year October 31, 2003, totaled $17.6 million (composed of rent expense of approximately $12.4 million, depreciation expense of approximately $1.3 million, interest expense of approximately $3.7 million, and amortization expense on the regulatory created asset of approximately $0.2 million). Related rent expense was $18.7 million for each of the years ended October 31, 2002, and 2001.

In conjunction with the ISES lease, AECC has agreed to indemnify, under certain circumstances, the beneficial owner against loss of certain tax benefits related to ownership of ISES 2. The maximum exposure under the indemnification clause is dependent upon the facts, circumstances and timing of any loss; however, management does not believe there are existing conditions which will result in such a loss.

AECC has entered into a leveraged operating lease for coal mining equipment at the North Antelope/Rochelle mine complex near Gillette, Wyoming, sublet to a coal supplier, which expires January 2, 2004. AECC is contractually obligated to the coal supplier to continue furnishing mining equipment until the expiration of the coal supply contract, which expires in 2011. Renewal options are at fair rental value for one or more successive five-year periods specified by AECC or with rentals equal to one-half the average of the semiannual rents. If AECC renews the lease at one-half of the average of the semiannual rents, the renewal period is limited to 80% of the estimated useful life of the equipment when added to the initial term, or a term providing no less than a 20% residual value of the equipment, based on the lessor's original cost. AECC also has the right to terminate the lease or purchase the equipment at fair market value. According to an agreement with the coal supplier, if AECC terminates the lease and does not purchase the equipment then AECC must replace the equipment with comparable equipment. Regardless of the option that AECC chooses with respect to the coal mining equipment, AECC does not anticipate that the expiration of the lease will have a material effect on its financial position. AECC is currently in negotiations to either extend the lease and/or purchase the leased assets.

Related to the North Antelope/Rochelle lease, the future minimum lease payment for the year ended October 31, 2004, is $585,000. Rent expense was approximately $1.2 million under the lease agreement for each of the years ended October 31, 2003, 2002, and 2001.

On December 29, 1988, AECC sold and leased back its interest in Ellis. The proceeds from the sale were $105 million. The sale and leaseback terms contain a provision which allows AECC to repurchase the property for its fair market value (at an amount not to exceed $139.4 million) at future specified dates. In anticipation of repurchasing the Ellis facility, AECC has segregated investments of $22.9 million and $22.1 million at October 31, 2003 and 2002, respectively.

12. RENTAL AND LEASE COMMITMENTS (CONTINUED)

As a result of the above sale and leaseback, under the provisions of SFAS No. 98, "Accounting for Leases," this transaction is reflected in the accompanying balance sheets as a long-term finance obligation. This lease was treated as an operating lease for rate-making purposes. In accordance with SFAS No. 71, the recognition of the gain on the sale of the facility and the timing of expense recognition will be modified during the lease term to conform with rate treatment. The lease rentals include a return to the owner participant as well as principal and interest on the outstanding debt. The interest portion of lease rental payments, less the amortization of the gain on the sale allowed for rate-making, determines the annual charge to interest expense. The amount of straight-line expense that would be recognized under an operating lease, in excess of the net interest expense charged under the capital lease method, determines the amount of depreciation to be recorded each year with respect to the facility. This facility will be fully depreciated at the end of the 25-year base lease term. Depreciation expense was approximately $2.8 million, $2.8 million, and $2.5 million for the years ended October 31, 2003, 2002, and 2001, respectively. Interest expense, net of amortized gain, was approximately $3.3 million, $3.3 million, and $4.3 million for the years ended October 31, 2003, 2002, and 2001, respectively.

Related to the Ellis lease, the future minimum lease payments for the next five years ending October 31 and in the aggregate thereafter are as follows: *(In Thousands)*

Year	**Amount**
2004	$ 7,604
2005	9,341
2006	20,930
2007	9,278
2008	9,292
Thereafter	37,911
	$94,356

Rental payments related to the Ellis lease were approximately $3.9 million, $3.2 million, and $8.9 million for the years ended October 31, 2003, 2002, and 2001, respectively. AECC has also agreed to indemnify, under certain circumstances, the beneficial owner against loss of certain tax benefits related to the ownership of Ellis. The maximum exposure under the indemnification clause is dependent upon the facts, circumstances and timing of loss; however, management does not believe there are existing conditions which will result in such a loss.

13. COMMITMENTS AND CONTINGENCIES

AECC is not a party to any pending legal proceedings which management believes to be material to the financial condition or results of operations of the Cooperative. AECC maintains liability insurance against risks, subject to certain self-insurance limits, arising out of the normal course of its business.

At October 31, 2003, contractual commitments have been entered into for construction totaling approximately $8.9 million. Of this amount, $8.2 million relates to AECC's jointly owned coal plants and $0.7 million relates to the Fitzhugh repowering project.

AECC entered into a contractual agreement to purchase 150 MW of capacity for the period from January 1, 2004 through December 31, 2008. AECC will pay a total of $63.7 million over the life of the agreement in annual installments of which $12.2 million relates to 2004.

Morgan Nick Alert Partnership

The Electric Cooperatives of Arkansas support the Morgan Nick Alert Program, an emergency plan to raise immediate awareness across the state when a child is abducted or reported missing. Using the Internet, e-mail, government communication channels and broadcast stations, photographs and information about a missing child are quickly distributed across Arkansas to law enforcement and the general public—adding thousands of eyes and ears to the search.

14. SIGNIFICANT CUSTOMERS

Sales to members amounted to 88%, 89%, and 78% of operating revenues for the years ended October 31, 2003, 2002, and 2001, respectively. AECC had the following members that accounted for more than 10% of operating revenue for the years ended October 31: *(In Thousands)*

	2003		2002		2001	
Customer	**Amount**	**Percent**	Amount	Percent	Amount	Percent
Mississippi County Electric Cooperative, Inc.	**$82,732**	**20.1 %**	$76,489	20.1 %	$88,741	17.8 %
First Electric Cooperative Corporation	**57,711**	**14.0**	54,442	14.3	61,706	12.4
Carroll Electric Cooperative Corporation	**52,397**	**12.7**	47,576	12.5	53,561	10.7

The Mentoring Scholarship Program

The Electric Cooperatives of Arkansas sponsor a mentoring scholarship program for the University of Arkansas at Pine Bluff (UAPB) to encourage students to stay in school, remain in their home state and become community leaders. Freshman UAPB students are paired with faculty mentors and they work together on research projects. Since 1998, the scholarship program has kept young leaders in school—and in Arkansas.

15. FAIR VALUE OF FINANCIAL INSTRUMENTS

The following methods and assumptions were used to estimate the fair value of each class of financial instruments, other than those instruments recorded at fair value in the accompanying balance sheets, at October 31, 2003 and 2002, for which it is possible to estimate the fair value:

Long-term investments - The fair value of the gas reserves is estimated based on reserve estimates provided by an independent oil and gas consulting firm and using current market prices at October 31, 2003. Future cash flows were discounted using a rate of 5.5%. Based on the nature of other investments, the carrying amount approximates fair value.

Cash and cash equivalents - The carrying amount of cash and cash equivalents approximates fair value.

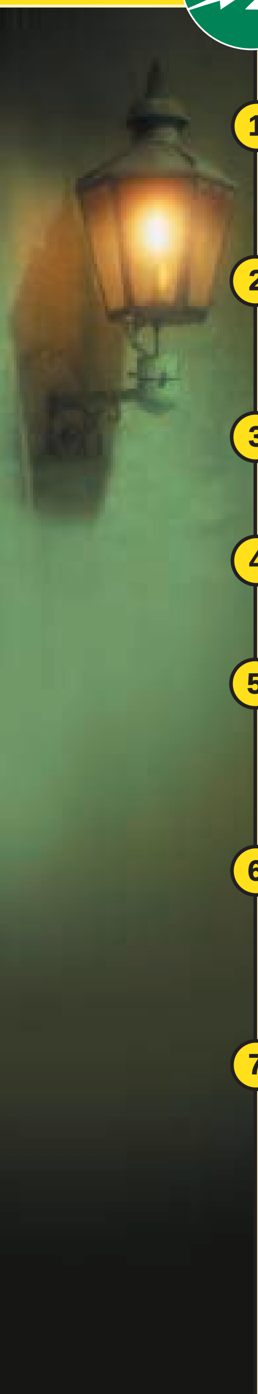
Long-term debt - The fair value of long-term debt is estimated based on quoted market prices for the same or similar issues or on the current rates available to AECC for debt of the same remaining maturation.

Notes payable - The carrying amount of the notes payable to distribution members and others represents the fair value as these notes are due on demand and bear interest at market rates.

Based on the above methods and assumptions, the following amounts represent the carrying amount and fair value of each financial instrument of AECC at October 31: *(In Thousands)*

	2003		2002	
	Carrying Amount	**Fair Value**	Carrying Amount	Fair Value
Long-term investments:				
Gas reserves	**$ 63,927**	**$ 59,477**	$ 67,953	$ 70,008
Other	**14,506**	**14,506**	14,273	14,273
Cash and cash equivalents	**48,624**	**48,624**	49,463	49,463
Long-term debt:				
RUS	**7,062**	**7,126**	8,374	9,463
CFC	**11,510**	**12,029**	15,660	16,250
FFB	**257,317**	**274,240**	247,056	268,610
ISES 2	**183,292**	**196,725**	–	–
Ellis	**77,939**	**81,509**	78,471	78,849
Notes payable	**71,456**	**71,456**	80,778	80,778

All Cooperative Businesses Adhere To These Seven Guiding Principles



1 Voluntary and Open Membership

Cooperatives are voluntary organizations, open to all persons able to use their services and willing to accept the responsibilities of membership.

2 Democratic Member Control

Cooperatives are democratic organizations controlled by their members, who actively participate in setting policies and making decisions.

3 Members' Economic Participation

Members contribute equitably to, and democratically control, the capital of their cooperative.

4 Autonomy and Independence

Cooperatives are autonomous, self-help organizations controlled by their members.

5 Education, Training, and Information

Cooperatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their cooperatives.

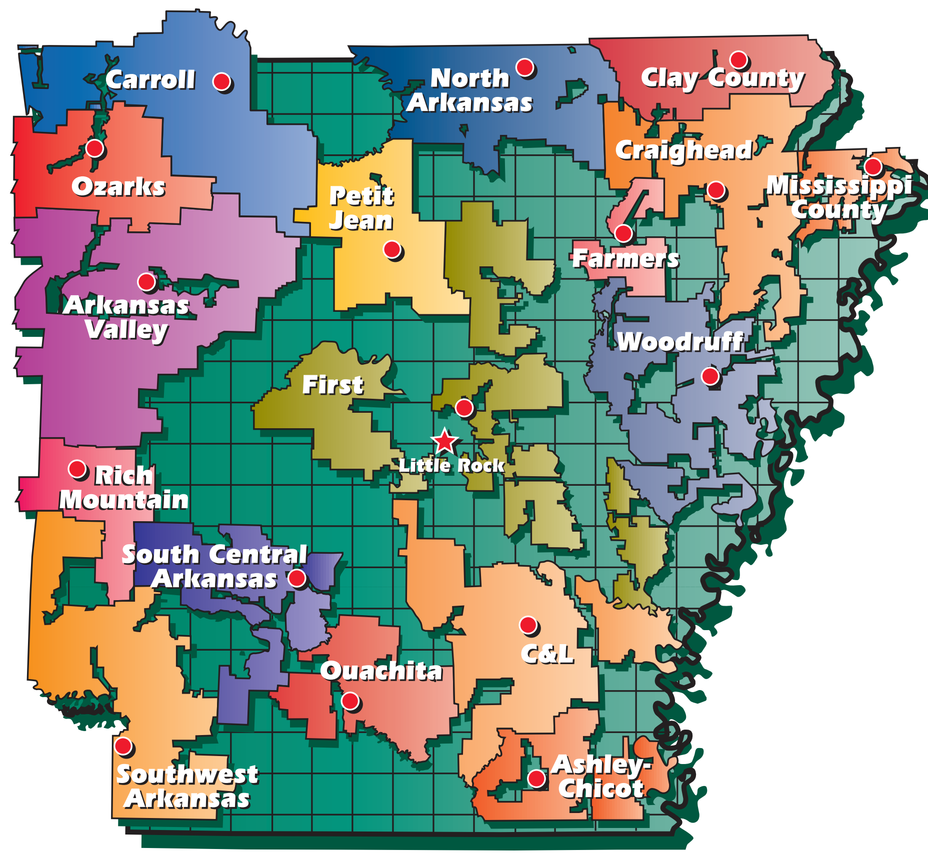
6 Cooperation Among Cooperatives

Cooperatives serve their members most effectively and strengthen the cooperative movement by working together through local, national, regional and international structures.

7 Concern for Community

While focusing on member needs, cooperatives work for the sustainable development of their communities through policies accepted by their members.

Electric Cooperatives of Arkansas Service Area Map



● Distribution Cooperative Headquarters

★ Statewide Association; Generation and Transmission Headquarters

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