

# The Power of Community



Arkansas Electric  
Cooperative Corporation



Year after year, the Electric Cooperatives of Arkansas work hard to provide members with cost-efficient power for their communities. We are dedicated to delivering a better quality of life by providing energy solutions that enhance local economies. Yet, we have never lost sight of the importance of protecting our valuable natural resources. Our commitment—producing safe, reliable electricity and preserving our environment—is best understood in the context of how our plants, people and power converge to serve members in their homes, businesses and farms.

## Financial Highlights

	2004	2003
Energy sales to members	<b>11,110,936 MWh</b>	10,749,769 MWh
Sales to others	<b>518,320 MWh</b>	835,490 MWh
Excess energy sales	<b>794,592 MWh</b>	797,337 MWh
Total	<b>12,423,848 MWh</b>	12,382,596 MWh
Average cost to members	<b>\$ 33.15/MWh</b>	\$ 33.90/MWh
Total operating revenues	<b>\$ 414,733,000</b>	\$ 412,692,000
Operating margins	<b>\$ 2,520,000</b>	\$ 5,633,000
Net margins	<b>\$ 7,761,000</b>	\$ 13,495,000
Cash flows from operations	<b>\$ 51,313,000</b>	\$ 40,220,000
Times interest earned ratio	<b>1.26</b>	1.55
Debt service coverage ratio	<b>1.12</b>	1.70
Earnings to fixed charges	<b>1.23</b>	1.40
Total assets	<b>\$ 1,043,196,000</b>	\$ 1,071,860,000
Net utility plant	<b>\$ 698,313,000</b>	\$ 726,167,000
Total long-term debt	<b>\$ 473,399,000</b>	\$ 496,710,000
Total equity	<b>\$ 418,660,000</b>	\$ 411,723,000
Equity to assets ratio	<b>40.13%</b>	38.41%
Equity as % of capitalization	<b>46.93%</b>	45.32%
Debt to equity ratio	<b>1.22</b>	1.30

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# Providing the Power

## A Message from the Chief Executive Officer

### **Powering the communities we serve.**

The growth and prosperity of Arkansas communities depends on critical infrastructures including a reliable and affordable power supply. Providing this essential resource becomes more demanding each year with escalating capital costs, more stringent environmental controls, limited transmission capacity and volatile energy markets. The Electric Cooperatives of Arkansas are dependable partners with a 60-year record of meeting the rising energy needs of their members while assisting with other resources that strengthen communities.

AECC has maintained a consistent long-term strategy of building financial strength while developing a diverse mix of generation assets. The cooperative exceeded an equity ratio of 40 percent in 2004 and maintained the trend of rotating patronage capital to member distribution systems. The patronage refunded to members has exceeded an average of \$10.6 million per year for the past 10 years. As the result of long-term planning and a dedication to maintaining a strong equity position, AECC is uniquely positioned to meet the growing capacity needs of its member systems.

The capital retained to fund new and upgraded generation and transmission assets provides Arkansas consumers with a diverse power supply that protects them from the most volatile components of the energy market. AECC owns three hydropower plants and generation resources powered by coal, natural gas and fuel oil.

Hydroelectric generation produces nine percent of the annual energy requirements in Arkansas. Dual-fuel (natural gas and fuel oil) capabilities of 426 megawatts of generation capacity at three generation facilities provide protection from volatile natural gas prices and additional reliability when extreme conditions affect natural gas availability. AECC's interests in three coal-fired plants with a combined generation capacity of 1,430 megawatts ensures that base-load power supply needs are met with low-sulfur coal. Geographic diversity enhances reliability with 18 independent generators operating at 10 different sites across Arkansas.

By maintaining access to low-cost fuels and diverse generation resources, AECC provides members with very reliable and affordable power. This strategy minimizes exposure to more volatile energy markets and ultimately secures the financial stability of AECC and its 16 member cooperatives.

**Gary Voigt**

*President and Chief Executive Officer  
Arkansas Electric Cooperative Corporation*

# The Power of Cooperatives at Work

## **AECC Board of Directors**

### *Arkansas Valley Electric Cooperative*

Alan R. Hannah  
Samuel W. Davis

### *Asbley-Chicot Electric Cooperative*

Ronald S. Moore  
Dennis Holland

### *C & L Electric Cooperative*

W. H. Frizzell  
Joe Ralph Thompson

### *Carroll Electric Cooperative*

Rob Boaz  
Charles Burdine

### *Clay Country Electric Cooperative*

Derwood Brett  
Leo Odom

### *Craighead Electric Cooperative*

Tom Sloan

### *First Electric Cooperative*

Alton Higginbotham  
Robert M. Hill

### *Mississippi County Electric Cooperative*

Larry W. Hellums

### *North Arkansas Electric Cooperative*

Mel Coleman  
Jasper Freeman

### *Ouachita Electric Cooperative*

Mark T. Cayce  
Lisa Hendrix

### *Ozarks Electric Cooperative*

Mitchell Johnson  
Jerry Bolinger

### *Petit Jean Electric Cooperative*

Dave Fugitt  
Willard H. Stark

### *Rich Mountain Electric Cooperative*

Bart M. Price

### *South Central Arkansas Electric Cooperative*

Bill Conine  
Danny Buck

### *Southwest Arkansas Electric Cooperative*

C. Wayne Whitaker  
Don Stemple

### *Woodruff Electric Cooperative*

Billy C. Martin, III  
J. A. Wampler

## **AECC Officers**

Wayne Honeycutt, *Craighead Electric Cooperative*  
*Chairman of the Board*

Robert Earl Davis, *Mississippi County Electric Cooperative*  
*Vice Chairman of the Board*

Leon Philpot, *Rich Mountain Electric Cooperative*  
*Secretary/Treasurer*

## **AECC Management Team**

Gary Voigt  
*President & Chief Executive Officer*

Robert M. Lyford  
*Senior Vice President & General Counsel*

Robert McClanahan  
*Vice President, Information Technology*

Michael W. Henderson  
*Vice President & Chief Financial Officer*

Alice Eason  
*Vice President, Systems Services*

Ricky Bittle  
*Vice President, Planning, Rates & Dispatching*

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

Pat McClafferty  
*Vice President, Utility Sales & Services/  
Arkansas Electric Cooperatives, Inc.*

Carmie Henry  
*Vice President, Governmental Affairs/  
Arkansas Electric Cooperatives, Inc.*

## *Plants, People and Power*



Thomas B. Fitzhugh Generating Station

For 55 years, Arkansas Electric Cooperative Corporation (AECC) has provided its members with safe, reliable and affordable electric power for the communities they serve. Through the visionary leadership of AECC's founders, the Little Rock, Arkansas-based generation and transmission cooperative has made the investments necessary to meet its primary goal as a supplier of reasonably priced wholesale electricity. But, AECC's commitment to Arkansas goes far beyond power supply. AECC is dedicated to helping Arkansas improve the quality of life for its citizens through economic development, the development of such infrastructure as fire protection and water systems, as well as the promotion of the efficient use of the state's valuable energy resources and the protection of its natural resources. Fully understanding its role as both an innovator and a good steward, AECC is proud to be the power behind communities across The Natural State.

### **Delivering Power** *the Cooperative Way*

In the late 1940s, Arkansas' electric cooperatives were faced with rising wholesale electricity costs and shrinking power supplies. The answer, they decided, was to create another cooperative that would provide a reliable, affordable power supply.

It was a decision that has paid great dividends. Since its inception on July 11, 1949, AECC has become one of the top generation and transmission cooperatives in the nation with assets of \$1 billion and annual wholesale energy sales of about \$400 million. And, just as the early cooperative leaders envisioned, AECC is providing wholesale electric power to its members—16 of the state's 17 electric distribution cooperatives—at some of the most competitive rates in the nation. AECC's wholesale power rate to members is 17.5 percent lower than the national wholesale power rate among G&T cooperatives. AECC ranks among the nation's top 10 generation and trans-

mission cooperatives for total megawatt-hour sales, megawatt-hours generated, cost per megawatt-hour generated and equity position. And the cooperative's bond ratings clearly reflect AECC's financial strength. Standard and Poor's rates AECC's senior bonds at AA-, while Moody's gives the cooperative an A1 rating and Fitch, an AA-.

During the past 18 years, AECC has invested more than \$514 million in expansion and upgrades to its generating capacity. These improvements have allowed AECC to serve its load obligations. They have also resulted in greater efficiency and diversity of fuel use. The plant investments have been made gradually, while rates to its members have actually been reduced. AECC now owns or co-owns/leases 10 power plants and has 2,429 megawatts of generation resources.

In addition to focusing on its core business, AECC continues to explore innovative ways to ensure the success of the communities served by its member systems.

### Practicing *the Principle*

Like other electric cooperatives across the nation, 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 takes that principle as seriously as it does its primary role as a power supplier.

Either while at work or on their own time, AECC employees fulfill that principle by accomplishing 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.

Electric cooperative employees volunteer approximately 8,500 hours toward community service each year. The time volunteered is typically geared toward increasing the quality of life in communities served by distribution cooperatives around the state.

Much of what AECC does for communities is centered on the children of members. A cornerstone of the



Jimmy Hobbs, Junior Operator, Carl E. Bailey Generating Station

youth activities is the annual Rural Electric Youth Tour to Washington, D.C. Each year, AECC and the state's 17 electric distribution 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. AECC also stresses electrical safety to children through a highly popular magic show presentation known as “Making Accidents Disappear.”

For many years, AECC has 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. To help recruit those businesses, AECC has worked for decades to improve the infrastructure in Arkansas' rural areas by helping bring water systems, fire protection, as well as reliable, affordable electricity service to those areas.

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 15 energy-efficient model homes that thousands of people have toured to learn about the advantages of an all electric, energy efficient home. The program continues with more homes under construction.

### The Power *of the Future*

Throughout its history, AECC's leaders have had to make tough choices and take bold positions to ensure that the cooperative could meet its members' power needs. Today, AECC is continuing in its grand tradition of stressing careful planning and innovation as it prepares to meet the future needs of its members. The cooperative will continue to maximize the value of its generation resources and make wise decisions about adding new resources. And in looking toward the future, AECC's leaders will be mindful of the courage and dedication of the cooperative pioneers who created the cooperative all those years ago.



David Harris, Senior Power Supply Engineer, AECC



## The Power of Teamwork

## A Message from the Chief Financial Officer

Making decisions that will result in a financially strong, efficient cooperative is at the heart of what the Board of Directors and management of Arkansas Electric Cooperative Corporation (AECC) do. During the 1970s and 1980s, the AECC Board of Directors made tough decisions to build base-load coal generating resources, which increased wholesale rates. During the late 1980s and 1990s, the Board of Directors chose to build environmentally friendly hydroelectric generating stations that will benefit cooperative members for generations to come. During the 1990s and early 2000s, the Board of Directors elected to build the financial strength of AECC. Because of these decisions, members of AECC enjoy wholesale rates that are among the lowest in the nation from an institution that is one of the most financially sound in the nation.

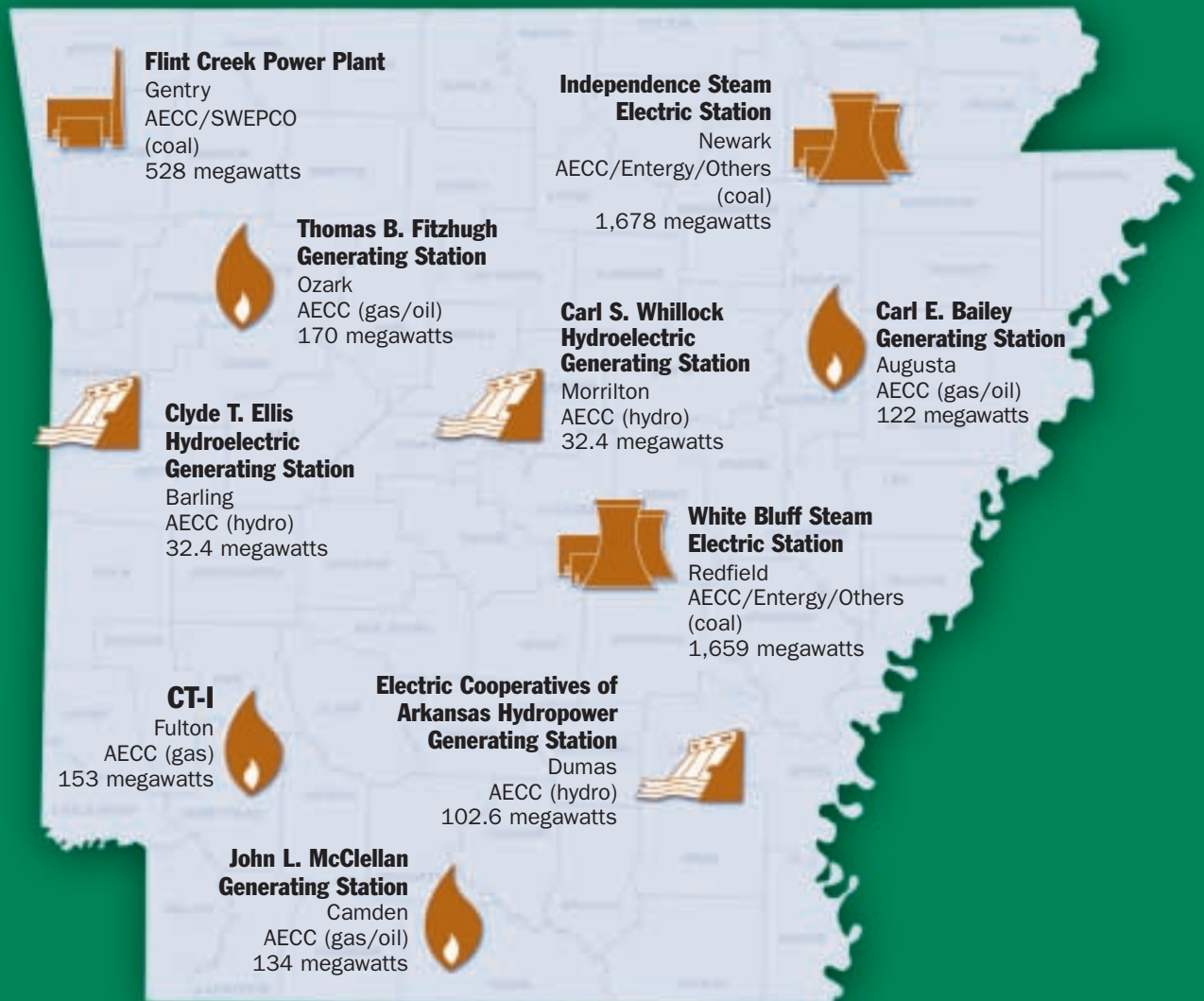
During 2004, the Board of Directors of AECC were faced with another decision that is important to the future of the cooperative. The Board of Directors voted to file for an increase in revenue requirements of approximately five percent. This revenue requirement increase will make certain that AECC and its member systems have reliable electric resources and are financially sound for years to come.

As you review these financial statements and footnotes, please note that the accounting and finance staff has dedicated many hours to ensuring that the financial position of AECC is fairly and accurately presented.

**Michael W. Henderson**

*Vice President and Chief Financial Officer  
Arkansas Electric Cooperative Corporation*

## Generating Power across Arkansas



### AECC at a Glance

<i>Incorporated</i>	July 11, 1949
<i>Generating Resources</i>	2,429 megawatts
<i>Annual Energy Sales</i>	12.4 million megawatt-hours
<i>Operating Revenues</i>	\$415 million
<i>Assets</i>	\$1,043.2 million
<i>Employees</i>	193

## Report of Independent Auditors

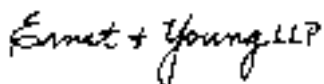
The Board of Directors  
Arkansas Electric Cooperative Corporation:

We have audited the accompanying balance sheets of Arkansas Electric Cooperative Corporation as of October 31, 2004 and 2003, and the related statements of operations, members' equities, and cash flows for each of the three years in the period ended October 31, 2004. 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.

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 2004 and 2003 financial statements referred to above present fairly, in all material respects, the financial position of Arkansas Electric Cooperative Corporation at October 31, 2004 and 2003, and the results of its operations and its cash flows for each of the three years in the period ended October 31, 2004, 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, 2004, 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. That 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 audits.



December 17, 2004

## Balance Sheets

As of October 31 (In Thousands)

<b>ASSETS</b>	<b>2004</b>	<b>2003</b>
Utility plant:		
Electric plant in service	\$ 1,310,716	\$ 1,303,038
Construction work in progress	9,466	10,088
<b>Total utility plant</b>	<b>1,320,182</b>	1,313,126
Less accumulated depreciation	<b>621,869</b>	586,959
<b>Net utility plant</b>	<b>698,313</b>	726,167
Long-term investments:		
Marketable securities	<b>18,347</b>	12,468
Gas reserves	<b>59,989</b>	63,927
Other	<b>14,405</b>	14,506
<b>Total long-term investments</b>	<b>92,741</b>	90,901
Current assets:		
Cash and cash equivalents	<b>47,634</b>	48,624
Short-term marketable securities	—	3,758
Accounts receivable, members	<b>34,005</b>	26,296
Fuel inventories	<b>14,021</b>	16,420
Material and supply inventories	<b>10,263</b>	9,845
Other current assets	<b>4,888</b>	5,646
<b>Total current assets</b>	<b>110,811</b>	110,589
<b>Deferred charges</b>	<b>141,331</b>	144,203
<b>Total assets</b>	<b>\$ 1,043,196</b>	\$ 1,071,860

<b>MEMBERS' EQUITIES AND LIABILITIES</b>	<b>2004</b>	<b>2003</b>
Members' equities:		
Membership fees	\$ 2	\$ 2
Patronage capital	272,988	264,125
Accumulated margins	27,609	28,711
Other equities	118,140	118,140
Net unrealized (loss) gain on investments	(79)	745
<b>Total members' equities</b>	<b>418,660</b>	<b>411,723</b>
Long-term debt:		
Federal Financing Bank	235,143	241,831
Independence Steam Electric Station finance obligation	160,869	171,627
Ellis finance obligation	67,370	70,225
National Rural Utilities Cooperative Finance Corporation – Guaranteed Pollution Control Revenue Bonds	5,240	7,169
Rural Utilities Service	4,683	5,758
Other long-term debt	94	100
<b>Total long-term debt</b>	<b>473,399</b>	<b>496,710</b>
Current liabilities:		
Notes payable	66,454	71,456
Accounts payable and other accrued liabilities	30,815	26,709
Current maturities of long-term debt	36,885	38,733
Accrued property taxes	5,413	5,299
Patronage capital payable	—	9,559
Accrued interest	6,008	6,333
<b>Total current liabilities</b>	<b>145,575</b>	<b>158,089</b>
<b>Deferred credits</b>	<b>5,562</b>	<b>5,338</b>
<b>Commitments and contingencies</b>	<b>—</b>	<b>—</b>
<b>Total members' equities and liabilities</b>	<b>\$ 1,043,196</b>	<b>\$ 1,071,860</b>

See accompanying notes.



## Thomas B. Fitzhugh Generating Station

*Gas/Oil • Ozark, AR • 170 megawatts • AECC*



AECC's first power plant, a 59-megawatt plant at Ozark, Arkansas, began commercial operation on June 27, 1963. The natural gas/oil-fired plant cost \$7.5 million. AECC re-powered the plant in 2003, adding 111.6 megawatts of capacity to it and making it more efficient while lowering air emissions. It was named for Thomas B. Fitzhugh, an attorney who helped form AECC and its sister cooperative, Arkansas Electric Cooperatives, Inc. Fitzhugh led efforts to build the power plant until his death in 1954.

## Statements of Operations

For the years ended in October 31 (In Thousands)

	2004	2003	2002
<b>Operating revenues</b>	<b>\$ 414,733</b>	\$ 412,692	\$ 381,190
<b>Operating expenses:</b>			
Operation and maintenance, generation	<b>204,224</b>	187,030	194,788
Power purchased	<b>87,117</b>	109,285	76,086
Operation and maintenance, transmission	<b>32,164</b>	33,970	28,926
Administrative and general	<b>16,932</b>	16,612	15,778
Depreciation	<b>38,065</b>	34,187	31,437
Interest	<b>33,460</b>	25,721	21,873
Taxes	<b>251</b>	254	235
<b>Total operating expenses</b>	<b>412,213</b>	407,059	369,123
<b>Margin from operations</b>	<b>2,520</b>	5,633	12,067
Interest income, net	<b>1,084</b>	992	1,154
Other income	<b>4,157</b>	6,370	3,374
Allowance for funds used during construction	<b>—</b>	500	1,311
<b>Net margin</b>	<b>\$ 7,761</b>	\$ 13,495	\$ 17,906

See accompanying notes.



### Carl E. Bailey Generating Station

*Gas/Oil • Augusta, AR • 122 megawatts • AECC*



On July 1, 1966, this 122-megawatt power plant at Augusta, Arkansas, began commercial operation. AECC's second generating station, it was named for Carl E. Bailey, governor of Arkansas from 1937 to 1941 and an ardent supporter of the state's electric cooperatives.

## Statements of Members' Equities

For the years ended in October 31 (In Thousands)

	Membership Fees	Patronage Capital	Accum. Margins	Other Equities	Net Unrealized Gain/(Loss) on Investments	Total Members' Equities
<b>Balance, November 1, 2001</b>	\$ 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)
<b>Balance, October 31, 2002</b>	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)
<b>Balance, October 31, 2003</b>	2	264,125	28,711	118,140	745	411,723
Comprehensive income:						
Net margin	—	—	7,761	—	—	7,761
Net unrealized gain on investments	—	—	—	—	147	147
Reclassification of realized gains into net margin	—	—	—	—	(971)	(971)
Comprehensive income						6,937
Allocation of patronage capital	—	8,863	(8,863)	—	—	—
<b>Balance, October 31, 2004</b>	<b>\$ 2</b>	<b>\$ 272,988</b>	<b>\$ 27,609</b>	<b>\$ 118,140</b>	<b>\$ (79)</b>	<b>\$ 418,660</b>

See accompanying notes.

## Statements of Cash Flows

For the years ended in October 31 (In Thousands)

	2004	2003	2002
<b>Operating activities</b>			
Net margin	\$ 7,761	\$ 13,495	\$ 17,906
Adjustments to reconcile net margin to net cash provided by operating activities:			
Depreciation	38,065	34,187	31,437
Net realized gains on marketable securities	(971)	—	—
Amortization of gain on sale and leaseback	—	(2,874)	(4,095)
Amortization of gas reserves	3,938	4,026	4,081
Allowance for funds used during construction	—	(500)	(1,311)
Changes in operating assets and liabilities:			
Accounts receivable, members	(7,709)	54	(1,255)
Fuel inventories	2,399	(200)	1,537
Material and supply inventories	(418)	(285)	(617)
Other current assets	1,257	(830)	(35)
Deferred charges	2,872	(5,022)	(383)
Accounts payable and accrued liabilities	3,895	(1,716)	6,804
Other deferred credits	224	(115)	812
Net cash provided by operating activities	51,313	40,220	54,881
<b>Investing activities</b>			
Net (purchases) sales of marketable securities	(1,974)	8,704	(18,037)
Net sales (purchases) of other investments	100	(233)	97
Capital expenditures	(9,698)	(19,748)	(48,360)
Repurchase of ISES 2 residual	—	(26,500)	—
Net cash used in investing activities	(11,572)	(37,777)	(66,300)
<b>Financing activities</b>			
Net (payments) borrowings on notes payable	(5,002)	(9,322)	9,466
Principal payments on long-term debt	(36,170)	(17,860)	(18,780)
Proceeds from long-term debt	10,000	23,900	45,000
Redemption of patronage capital	(9,559)	—	(14,354)
Net cash (used in) provided by financing activities	(40,731)	(3,282)	21,332
Net change in cash and cash equivalents	(990)	(839)	9,913
Cash and cash equivalents, beginning of year	48,624	49,463	39,550
<b>Cash and cash equivalents, end of year</b>	<b>\$ 47,634</b>	<b>\$ 48,624</b>	<b>\$ 49,463</b>

See accompanying notes.

# Notes to Financial Statements

October 31, 2004

## 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 over 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 \$135.8 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 lease 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.

## Notes to Financial Statements

October 31, 2004

### 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 preserved 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.

The Act also required the APSC to file a report with the Legislature by September 30, 2004, setting forth the APSC's view on whether retail access for large users was warranted. The report filed by the APSC stated that such an action by the Legislature would be unwise.

#### 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)* ▼

	2004	2003
Generation plant	\$ 1,210,963	\$ 1,206,167
Transmission plant	72,574	70,822
General plant	27,179	26,049
Electric plant in service	1,310,716	1,303,038
Construction work in progress	9,466	10,088
	<b>\$ 1,320,182</b>	<b>\$ 1,313,126</b>



### Flint Creek Power Plant

Coal • Gentry, AR • 528 megawatts • AECC/SWEPCO



AECC joined Southwestern Electric Power Co., now a unit of American Electric Power, to build this generation resource at Gentry, Arkansas. This 528-megawatt coal-fired plant began operating commercially on July 1, 1978. AECC owns 50 percent of the plant's assets.

## 1. Summary of Significant Accounting Policies (continued)

The cost of retirements, replacements, or betterments are 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 guidelines 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. Uncollectible accounts have historically been negligible, so AECC does not provide an allowance for doubtful accounts.

### 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.

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 \$0.2 million for the year ended October 31, 2003, and were recorded as a reduction in interest expense. In addition, for the years ended October 31, 2003, and 2002, the carrying costs capitalized relating to projects funded without specific borrowings were approximately \$0.5 million, and \$1.3 million, respectively, and such costs have been recorded as an allowance for funds used during construction in the accompanying statements of operations. No interest costs were capitalized during the year ended October 31, 2004.

## Notes to Financial Statements

October 31, 2004

### 1. Summary of Significant Accounting Policies (continued)

#### 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 \$32.0 million, \$25.8 million, and \$21.0 million for the years ended October 31, 2004, 2003, and 2002, respectively. No amounts were paid for income taxes for the years ended October 31, 2004, 2003, and 2002.

#### 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.

#### Reclassifications

Certain reclassifications have been made to the October 31, 2003 financial statement presentation to conform with the October 31, 2004 presentation. These reclassifications did not have an effect on net margins.

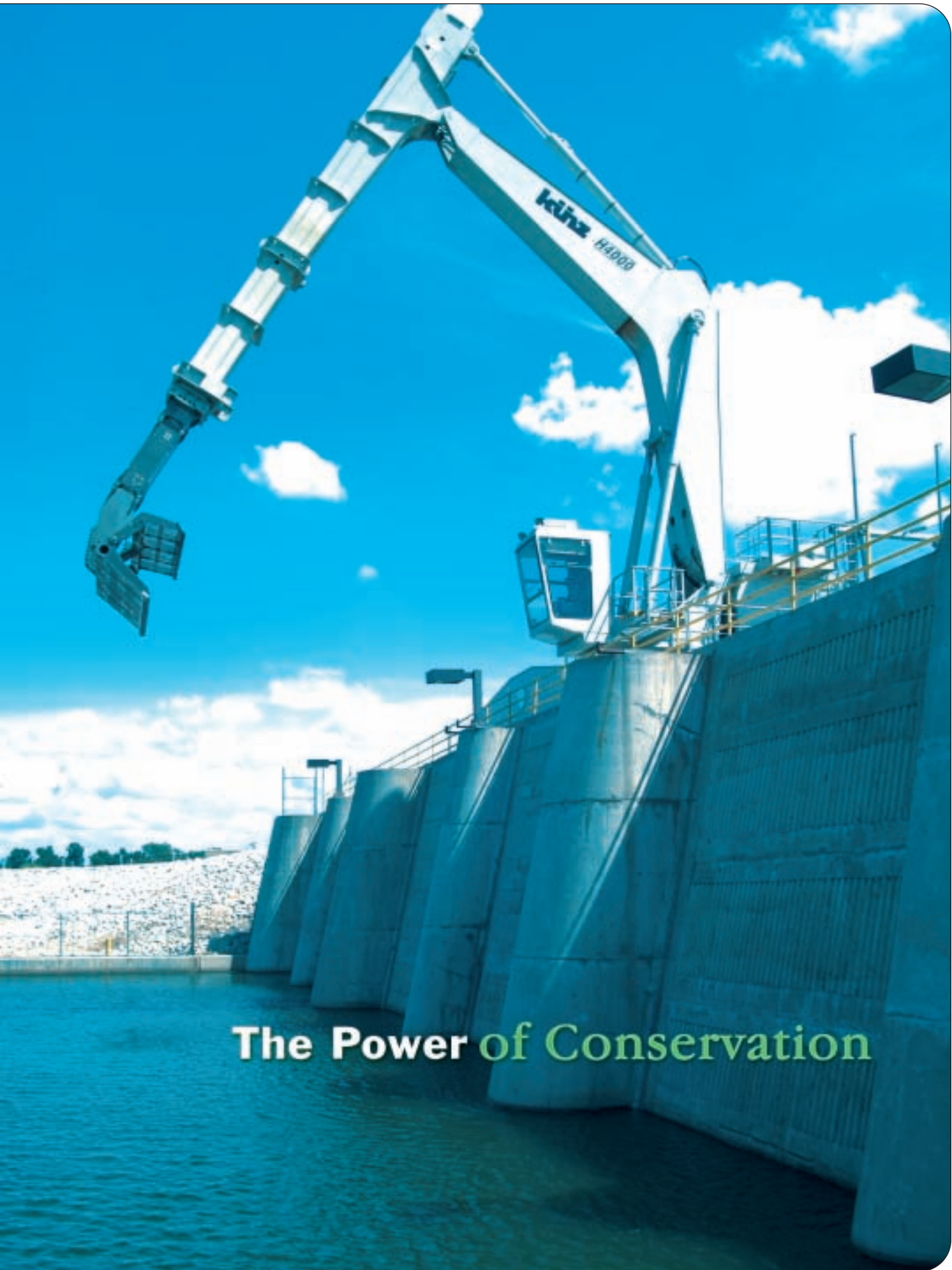


### White Bluff Steam Electric Station

*Coal • Redfield, AR • 1,659 megawatts • AECC/Entergy/Others*



On August 27, 1980, Unit 1 of the White Bluff Steam Electric Station at Redfield, Arkansas, began commercial operation. About a year later, the plant's Unit 2 began operating commercially. AECC owns 35 percent of this 1,659-megawatt coal-fired plant.



# The Power of Conservation

## Notes to Financial Statements

October 31, 2004

### 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.

### 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, 2004, 2003, and 2002.

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

	2004	Percent	2003	Percent	2002	Percent
Statutory federal income tax rate	\$ 2,716	35.0%	\$ 4,723	35.0%	\$ 6,267	35.0%
Non-taxable member income	(2,716)	(35.0)	(4,723)	(35.0)	(6,267)	(35.0)
Tax credit carryforwards not benefited	—	—	—	—	—	—
Effective income tax rate	\$ —	—%	\$ —	—%	\$ —	—%



### John L. McClellan Generating Station

Gas/Oil • Camden, AR • 134 megawatts • AECC



This 134-megawatt natural gas/oil-fired plant at Camden, Arkansas, began commercial operation on May 19, 1972. It was named for John L. McClellan, who served as a U.S. senator from Arkansas from 1942 to 1977.

## 2. Income taxes (continued)

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

Deferred tax assets:	2004	2003
Patronage exclusions available	\$ 54,914	\$ 51,992
Alternative minimum tax (AMT) credit carryforwards	4,052	4,052
Other	2,199	2,138
	<b>61,165</b>	58,182
Valuation allowance	<b>(4,052)</b>	(4,052)
	<b>57,113</b>	54,130
Deferred tax liabilities:		
Utility plant	<b>(42,020)</b>	(42,247)
Safe harbor lease	<b>(9,463)</b>	(8,681)
Ellis sale and leaseback	<b>(2,865)</b>	(251)
Other	<b>(2,765)</b>	(2,951)
	<b>(57,113)</b>	(54,130)
Net deferred tax liability	\$ —	\$ —

At October 31, 2004, 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, 2004. 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. Net realized gains and losses, which were \$1.0 million in 2004 and immaterial for 2003 and 2002, are included in other income. The cost of investments sold is based on the specific-identification method.

## Notes to Financial Statements

October 31, 2004

### 3. Investments (continued)

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

Description	2004			
	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
Other U.S. government agency securities	\$ 18,169	\$ 4	\$ 76	\$ 18,097
Other debt securities	257	—	7	250
	\$ 18,426	\$ 4	\$ 83	\$ 18,347

Description	2003			
	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

At October 31, 2004, contractual maturities of marketable securities were as follows: (In Thousands) ▼

Description	Less Than One Year	One Through Five Years	After Five Years	Total
Other U.S. government agency securities	\$ —	\$ 15,169	\$ 3,000	\$ 18,169
Other debt securities	—	—	257	257
	\$ —	\$ 15,169	\$ 3,257	\$ 18,426

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 \$7.9 million and \$8.4 million at October 31, 2004 and 2003, 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, 2004 and 2003, AECC's leasehold interests in the gas reserves totaled approximately \$60.0 million and \$63.9 million, respectively. The net revenue interests received less the depletion of the gas reserves resulted in other income (loss) of approximately \$3.2 million, \$3.3 million, and (\$0.7) million for the years ended October 31, 2004, 2003, and 2002, respectively.

## 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 \$8.9 million, \$12.1 million, and \$23.2 million of patronage capital were allocated for the years ended October 31, 2004, 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, 2004 and 2003, total members' equities as a percentage of total assets amounted to 40.1% and 38.4%, respectively.

The Board authorized patronage retirements of approximately \$9.6 million and \$14.4 million for the years ended October 31, 2003 and 2002, respectively. There was no retirement for the year ended October 31, 2004; however, subsequent to year end, the Board authorized retirements of \$8.2 million payable on November 30, 2004.

## 5. Other Equities

Other equities include proceeds of approximately \$43 million 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, 2004, the guaranteed amount by CFC was approximately \$15.4 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.



### Independence Steam Electric Station

*Coal • Newark, AR • 1,678 megawatts • AECC/Entergy/Others*



The first unit of this power plant at Newark, Arkansas, began operation on January 18, 1983. About two years later, the second unit went on line. AECC has an interest in 35 percent of Unit 2 of this 1,678-megawatt coal-fired plant.

## Notes to Financial Statements

October 31, 2004

### 5. Other Equities (continued)

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's 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)* ▼

	2004	2003
Mortgage notes payable to Federal Financing Bank (FFB) at varying interest rates (4.52% to 6.77% at October 31, 2004), due in quarterly installments through December 2031	\$ 251,773	\$ 257,317
ISES 2 finance obligation under sale and leaseback, at an implicit rate of 6.05% at October 31, 2004 and 2003, due in semiannual installments through 2019	171,587	181,526
Ellis finance obligation under sale and leaseback, at an implicit interest rate of 4.29%, at October 31, 2004 and 2003, due in semiannual installments through 2013	73,639	77,939
North Antelope finance obligation, with no stated interest rate at October 31, 2004, due in monthly installments through January 2005	253	—
CFC Guaranteed Pollution Control Revenue Bonds:		
City of Siloam Springs and Jefferson County, Arkansas, at varying interest rates (4.75% to 5.00%, at October 31, 2004), due in semiannual installments through 2008	7,185	9,025
Jefferson County and Independence County, Arkansas, at an interest rate of 4.50% at October 31, 2003, due in annual installments through 2003	—	2,485
	7,185	11,510
RUS 2% mortgage notes due in quarterly installments through May 2018	2,143	3,088
RUS 5% mortgage notes due in quarterly installments through August 2015	3,614	3,974
	5,757	7,062
Other long-term debt	100	105
Total long-term debt	510,294	535,459
Unamortized discounts	(10)	(16)
	510,284	535,443
Less current maturities of long-term debt	36,885	38,733
	\$ 473,399	\$ 496,710

## 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)* ▼

	2005	2006	2007	2008	2009	Thereafter	Total Debt
FFB	\$16,630	\$17,514	\$18,377	\$19,431	\$20,539	\$159,282	\$251,773
ISES 2 finance obligation	10,718	11,458	12,192	12,532	9,321	115,366	171,587
Ellis finance obligation	6,269	18,359	7,277	7,600	7,667	26,467	73,639
North Antelope finance obligation	253	—	—	—	—	—	253
CFC Guaranteed Pollution Control Revenue Bonds	1,935	2,030	2,130	1,090	—	—	7,185
RUS	1,074	730	713	712	629	1,899	5,757
Other	6	6	7	7	8	66	100
	\$36,885	\$50,097	\$40,696	\$41,372	\$38,164	\$303,080	\$510,294

Under the debt agreements, all of AECC's assets were pledged as security at October 31, 2004. 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, 2004.

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%. During 2004, AECC received an advance from FFB of \$10 million under the Fitzhugh loan at an interest rate of 4.767%. It is anticipated that AECC will receive the remainder of the loan funds during 2005. Interest rates and payment terms have not been finalized on the remaining unadvanced loan funds.



### Clyde T. Ellis Hydroelectric Generating Station

Hydro • Barling, AR • 32.4 megawatts • AECC



In the late 1970s, AECC began looking toward hydroelectric power as a long-term source of clean, economical energy. As a result of the vision of AECC's leaders, the Clyde T. Ellis Hydroelectric Generating Station was built on the Arkansas River near Barling, Arkansas, and began operating on December 8, 1988. It was named for Clyde T. Ellis, an Arkansas congressman and the first general manager of the National Rural Electric Cooperative Association (NRECA), serving from 1942 to 1967.

## Notes to Financial Statements

October 31, 2004

### 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, 2004 or 2003, 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, 2004 and 2003, member advances to AECC totaled approximately \$66.5 million and \$71.5 million, respectively. At October 31, 2004 and 2003, the interest rate on the notes payable was 2.86%, and 2.66%, respectively. Interest expense related to the notes payable was \$1.9 million, \$1.9 million, and \$2.9 million for the years ended October 31, 2004, 2003, and 2002, 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 \$3.6 million, \$3.2 million, and \$2.9 million for the years ended October 31, 2004, 2003, and 2002, respectively.

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, which is included in deferred credits on 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, 2004, 2003, and 2002, were approximately \$2.2 million, \$2.5 million, and \$2.4 million, respectively. AECI owed AECC approximately \$0.2 million at both October 31, 2004 and 2003, related to the reimbursement of these expenses.

## 9. Related Party Transactions (continued)

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 \$1.8 million, \$2.1 million, and \$3.2 million for the years ended October 31, 2004, 2003, and 2002, respectively. At October 31, 2004 and 2003, AECC owed AECI approximately \$0.1 million and \$0.3 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, 2004, is as follows (*Dollars In Thousands*): ▼

<b>Generating Plants</b>	<b>Ownership or Leasehold Interest %</b>	<b>Amount of Utility Plant in Service</b>	<b>Accumulated Provision for Depreciation</b>	<b>Amount of Plant Under Construction</b>	<b>Current Available Net Capacity (MW)</b>
					<i>(unaudited)</i>
Flint Creek	50%	\$ 86,015	\$ 60,510	\$ 881	264 MW
White Bluff 1 and 2	35	294,294	196,662	3,457	580
ISES 1 and 2	35	336,042	204,604	2,744	588
Fitzhugh	100	72,610	12,254	26	171
Bailey	100	13,013	12,636	92	122
McClellan	100	18,309	17,042	24	134
Ellis	100	70,342	43,992	9	26
Whillock	100	75,671	16,494	9	17
Electric Cooperatives of Arkansas	100	184,292	18,396	7	35
Fulton CT-1	100	58,616	5,939	—	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 through 2008. 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.

## Notes to Financial Statements

October 31, 2004

### 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 leases ISES 2 under a 35-year leveraged lease. 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's 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. 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 had 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.

Related expenses for the year ended October 31, 2004, were \$15.6 million, including depreciation expense of approximately \$4.0 million, interest expense of approximately \$10.9 million, and amortization expense on the regulatory created asset of approximately \$0.7 million. Related expenses for the year October 31, 2003, were \$17.6 million, including 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 the year ended October 31, 2002.

Future ISES 2 minimum lease payments for the next five years ending October 31 and in the aggregate thereafter are as follows: *(In Thousands)* ►

<b>Year</b>	<b>Amount</b>
2005	\$ 21,185
2006	21,284
2007	21,332
2008	20,944
2009	16,982
Thereafter	154,475
	<u>256,202</u>
Less amounts representing interest (implicit rate – 6.05%)	84,615
Capitalized lease obligation	<u>\$171,587</u>

## 12. Rental and Lease Commitments (continued)

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.

In October 1983, AECC entered into an operating lease for coal mining equipment at the North Antelope/Rochelle mine complex near Gillette, Wyoming. The equipment was sublet to a coal supplier. The lease and sublease expired January 2, 2004. During January 2004, AECC renewed the lease for the coal mining equipment. The lease renewal divided the equipment into two groups, "Equipment A" and "Equipment B." Effective January 2, 2004, both groups of equipment have been sublet to the coal supplier. The sublease expires January 2, 2011. AECC's operating lease with respect to the Equipment A expires January 2, 2011, and its renewal option with respect to Equipment A is at fair rental value, \$75,083 semi-annually in arrears, for one or more successive one year periods as specified by AECC. At the end of the Equipment B term, January 2, 2005, AECC has the option, which has already been exercised, to purchase the equipment for \$1.

Related to the North Antelope/Rochelle lease, the future minimum lease payments for the next five years ending October 31 and in the aggregate thereafter is as follows:

	<b>Year</b>	<b>Amount</b>
Future ISES 2 minimum lease payments for the next five years ending October 31 and in the aggregate thereafter are as follows: <i>(In Thousands)</i> ►	2005	\$ 403
	2006	150
	2007	150
	2008	150
	2009	150
	Thereafter	375
		<b>\$ 1,378</b>

Rent expense was approximately \$0.3 million, \$1.2 million, and \$1.2 million under the lease agreement for the years ended October 31, 2004, 2003, and 2002 respectively.



### Carl S. Whillock Hydroelectric Generating Station

*Hydro • Morrilton, AR • 32.4 megawatts • AECC*



This hydropower plant on the Arkansas River near Morrilton, Arkansas, began operating commercially on October 20, 1993. The 32.4-megawatt plant was named after Carl S. Whillock, who served as president and chief executive officer of AECC and its sister cooperative, Arkansas Electric Cooperatives, Inc., from 1980 to 1996.

## Notes to Financial Statements

October 31, 2004

### 12. Rental and Lease Commitments (continued)

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 \$23.7 million and \$22.9 million at October 31, 2004 and 2003, respectively.

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 \$2.9 million, \$2.8 million, and \$2.8 million for the years ended October 31, 2004, 2003, and 2002, respectively. Interest expense, net of amortized gain, was approximately \$3.3 million for each of the years ended October 31, 2004, 2003, and 2002.

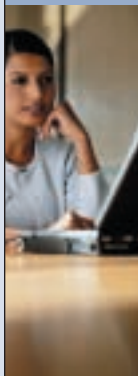
Related to the Ellis lease, the future minimum lease payments for the next five years ending October 31 and in the aggregate thereafter are as follows:  
(In Thousands) ▶

<b>Year</b>	<b>Amount</b>
2005	\$ 9,341
2006	20,930
2007	9,278
2008	9,292
2009	8,999
Thereafter	28,912
	<b>\$ 86,752</b>



### Electric Cooperatives of Arkansas Hydropower Generating Station

Hydro • Dumas, AR • 102.6 megawatts • AECC



This 102.6-megawatt hydropower plant on the Arkansas River near Dumas, Arkansas, was AECC's third hydroelectric power plant. It began commercial operation during the fall of 1999.

## 12. Rental and Lease Commitments (continued)

Rental payments related to the Ellis lease were approximately \$7.6 million, \$3.9 million, and \$3.2 million for the years ended October 31, 2004, 2003, and 2002, 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, 2004, contractual commitments have been entered into for construction totaling approximately \$8.1 million. Of this amount, \$7.8 million relates to AECC's jointly owned coal plants and \$0.3 million relates to the Fitzhugh repowering project.

## 14. Significant Customers

Sales to members amounted to 89%, 88%, and 89% of operating revenues for the years ended October 31, 2004, 2003, and 2002, respectively. AECC had the following members that accounted for more than 10% of operating revenue for the years ended October 31 : *(Dollars In Thousands)* ▼

Customer	2004		2003		2002	
	Amount	Percent	Amount	Percent	Amount	Percent
Mississippi County Electric Cooperative, Inc.	\$88,336	21.3%	\$82,732	20.1%	\$76,489	20.1%
First Electric Cooperative Corporation	57,587	13.9	57,711	14.0	54,442	14.3
Carroll Electric Cooperative Corporation	52,150	12.6	52,397	12.7	47,576	12.5

## 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, 2004 and 2003, 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, 2004. 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.

## Notes to Financial Statements

October 31, 2004

### 15. Fair Value of Financial Instruments (continued)

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) ▼

	2004		2003	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Long-term investments:				
Gas reserves	\$ 59,989	\$ 72,413	\$ 63,927	\$ 59,477
Other	14,404	14,404	14,506	14,506
Cash and cash equivalents	47,634	47,634	48,624	48,624
Long-term debt:				
RUS	5,757	5,804	7,062	7,126
CFC	7,185	7,516	11,510	12,029
FFB	251,773	271,848	257,317	274,240
ISES 2	171,587	188,564	183,292	196,725
Ellis	73,639	76,564	77,939	81,509
Notes payable	66,454	66,454	71,456	71,456

### 16. Rate Request Application

On October 15, 2004, AECC filed an application for wholesale rate relief with the APSC. The APSC is currently reviewing the application. The effective date of the wholesale rate increase would follow final approval of the APSC. The proposed wholesale electric rates reflect an annual increase of approximately \$15.6 million. There is no assurance that the application will be approved by the APSC or if approved, when approval will occur and whether it will be for the full amount proposed.

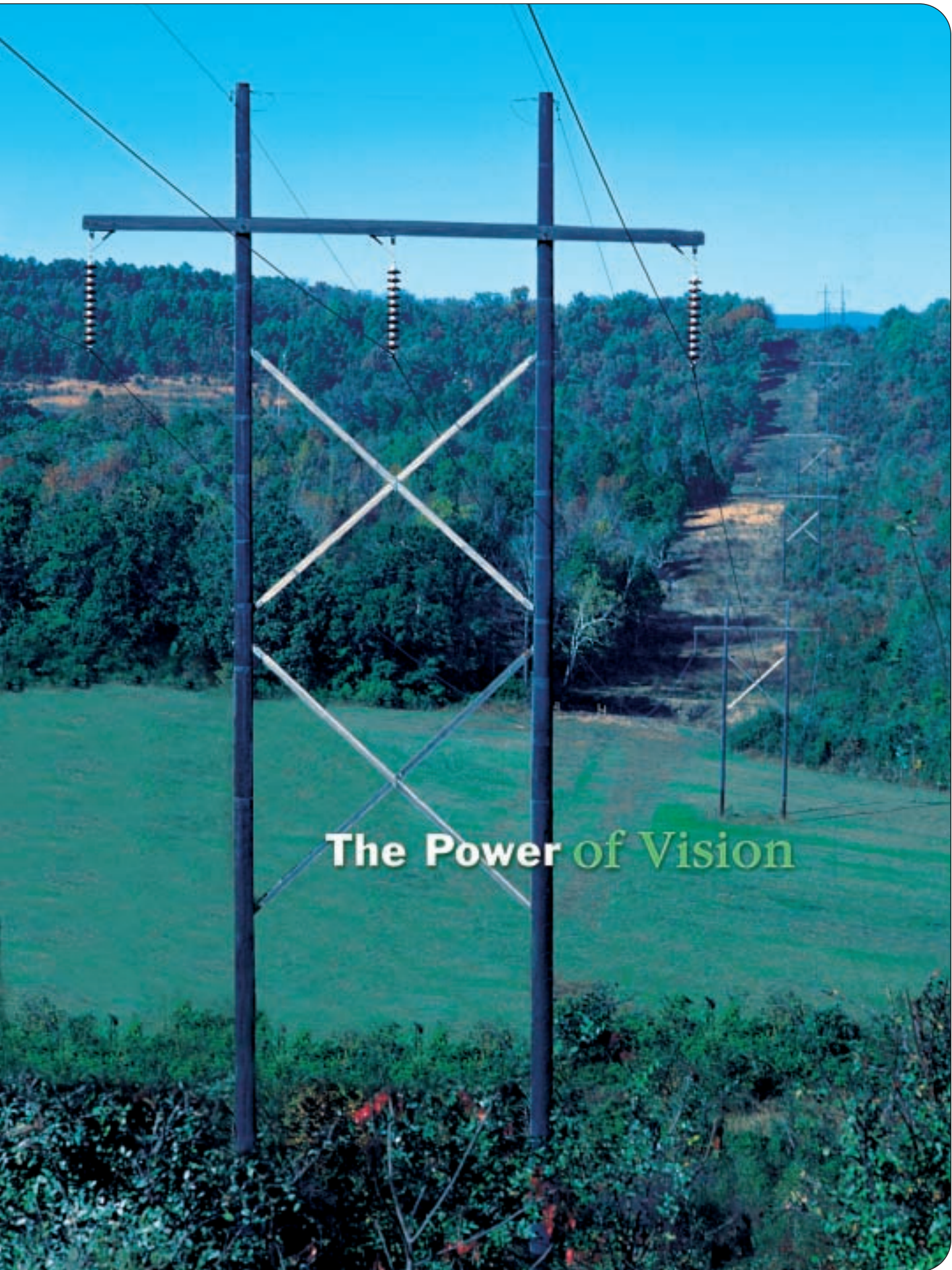


#### CT-I

*Gas • Fulton, AR • 153 megawatts • AECC*



AECC's 153-megawatt natural gas-fired combustion turbine power plant near Fulton, Arkansas, began commercial operation on May 26, 2001. It is used primarily during periods of peak power demand, which typically occur in Arkansas during the summer. It is AECC's first combustion turbine power plant.



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