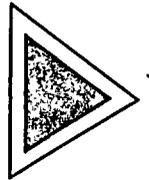


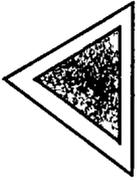
Contents



President's and Chairman's message	2
Highlights	4
Board of Directors	6
Power supply	7
• Susquehanna Steam Electric Station.....	7
• PAsNY.....	7
Project review	11
• Raystown Hydroelectric Project.....	11
• Montgomery Hydroelectric Project.....	11
• Allegheny River Locks and Dams No. 8 and No. 9 Hydroelectric Projects.....	11
• Load management.....	12
• Marketing.....	12
• Transmission.....	12
Legislative and regulatory affairs	15
• Federal legislation.....	15
• State legislation.....	15
• Rural economic and community development.....	16
Financial review	17
• Operating margins.....	17
• Financing.....	17
• Construction.....	17
• Taxability.....	18
Operations	18
• Revenue.....	18
• Non-member revenue.....	18
• Member revenue.....	18
• Wholesale rate negotiation.....	19
• Rates.....	19
• Energy sales.....	20
Financial statements	F- 1
• Five-year financial statement.....	F- 2
• Five-year statement of revenue and expenses.....	F- 3
• Balance sheets.....	F- 4
• Statements of operations and patronage capital.....	F- 6
• Statements of changes in financial position.....	F- 7
• Notes to financial statements.....	F- 8
• Auditor's letter.....	F-13
• Summary of operations — Allegheny member systems.....	F-14

ABOUT THE COVER: Linemen from the Shippensburg District Office of Adams Electric Cooperative work on the rural electric lines in front of an Cumberland County farm on a blustery winter day. Crews like this from the 14 member distribution cooperatives purchasing wholesale power from Allegheny help keep the electricity flowing throughout Pennsylvania and New Jersey.

8806300020 880624
PDR ADOCK 05000387
I DCD



President's message Chairman's message

2



Jesse C. Tilton III
President



James L. Henderson
Chairman of the Board

Pennsylvania and New Jersey are large, multifaceted states. Their diversity provides a level of stability and resilience not seen in other parts of the nation.

Allegheny Electric Cooperative shares this diversity. It is seen in the types of members our distribution cooperatives serve and in the sources we use to provide light and power throughout rural Pennsylvania and New Jersey. Because of our diversity in power supply and the loads we serve, we have greater stability than those power suppliers primarily dependent on one type of generation and a few large industrial loads.

Pictured throughout this year's annual report are examples of the members served by our distribution cooperatives. Farms and rural residences continue to predominate. Distribution cooperative managers report to us that business enterprises of all types, both big and small, are locating in our service areas at an increasing pace.

Sussex County in New Jersey and Adams County in southcentral Pennsylvania are becoming bedroom communities, benefiting from nearby larger metropolitan areas. The new members of Sussex REC and Adams EC bring with them new expectations of what a power supplier should be. Their expectations have caused us to examine our operations and, where justified and needed, to change.

Despite the fact that the number of people who claim farming to be their primary source of income is decreasing nationwide, farming continues to be important as a way of life in the rolling hills of Huntingdon, Bedford, Crawford, Bradford and many other counties served by rural electric cooperatives. Valley, New Enterprise, Bedford, Northwestern and Claverack

rural electric cooperatives, like other rural electric cooperatives served by Allegheny, continue to offer special services and assistance to dairy farmers and others who make a living from the land.

Because of its strategic location in the northeast United States, Pennsylvania has become a recreational magnet for the residents of neighboring states as well as the Commonwealth's natives. Many of Allegheny's distribution cooperatives are increasingly relying on tourism and recreation as growing sources of revenue. Somerset REC, for example, serves a large and growing winter recreation complex, while Warren EC, Tri-County REC and Sullivan County REC serve large numbers of hunting camps and summer residents.

Mining continues to be an important source of revenue for Southwest Central RECC, United EC and Central EC, while all of Allegheny's distribution cooperatives work to increase and expand the industrial and commercial base of their service areas. To this end, several rural electric cooperatives have launched community and economic development programs.

Turning to power supply, Allegheny's sources of power are as diverse as the loads that eventually consume that power. Although purchases from the Power Authority of the State of New York (PASNY) and several private power companies are still important, Allegheny continues to move forward with a balanced energy supply development program begun during the 1970s.

The Susquehanna Steam Electric Station, at Berwick, Pa., a nuclear power plant in which Allegheny has a 10-percent ownership interest, continues to establish records for performance and safety. At a time

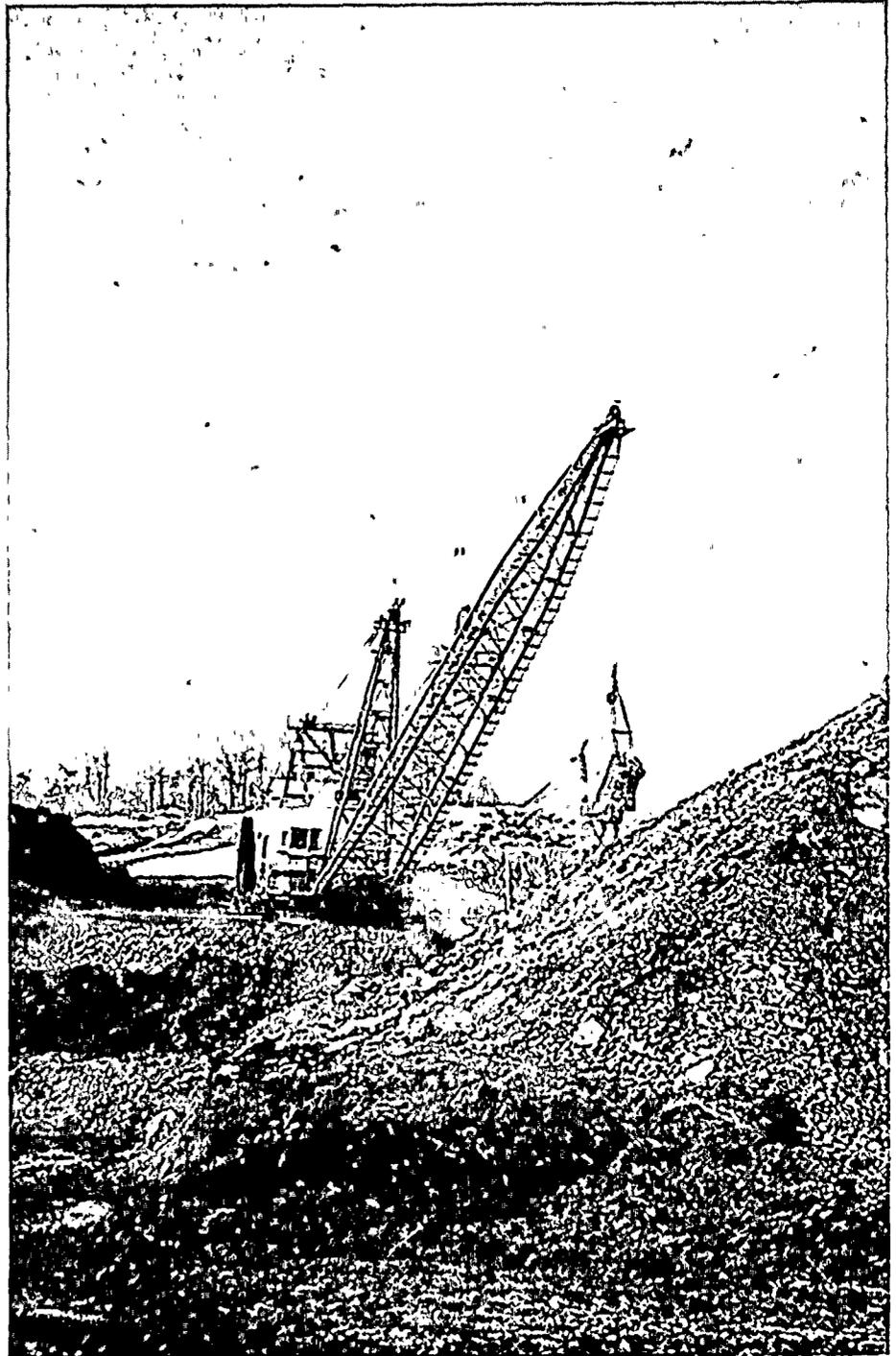
when most newspaper stories regarding nuclear power are bleak, Susquehanna's operating performance in contrast is very bright.

During 1987, work continued on schedule on Allegheny's first wholly owned generating facility, the Raystown Hydroelectric Project at Huntingdon, Pa. When operational in 1988, this 21-megawatt facility will provide dependable, low-cost power — enough electricity to serve 8,500 average rural residences. As work continued on the Raystown project, Allegheny decided to divest itself of its development rights for a hydroelectric site on the Allegheny River, but continues to explore hydro development.

As mentioned previously, Allegheny continues to depend on wholesale power purchases to round out its energy supply. These purchases, made from six utilities that, to differing degrees, generate electricity at hydro, nuclear and coal-fired facilities, provide Allegheny with further diversity of supply.

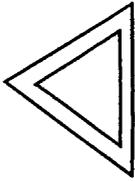
During 1987, we launched new efforts to explore all possible future power supply arrangements. The goal of these efforts is to provide further diversity and, as a result, to provide rate stability for our members.

Because of its sources of power and the wide variety of the customers who consume that power, Allegheny Electric Cooperative and its member distribution systems are well positioned to meet the energy challenges of the 1990s and beyond. Diversity, strength, stability: key elements of Allegheny's future.



ELECTRIC DRAG LINES used in coal mining are large users of electricity. Pennsylvania's extensive coal beds cover most of the western part of the state, stretch over to the north central section, and include many distribution co-ops' service territories.

John C. Tilton III
James L. Henderson



Highlights

4

Careful planning and diligent work showed results in 1987 as power supply projects and legislative activities moved forward.

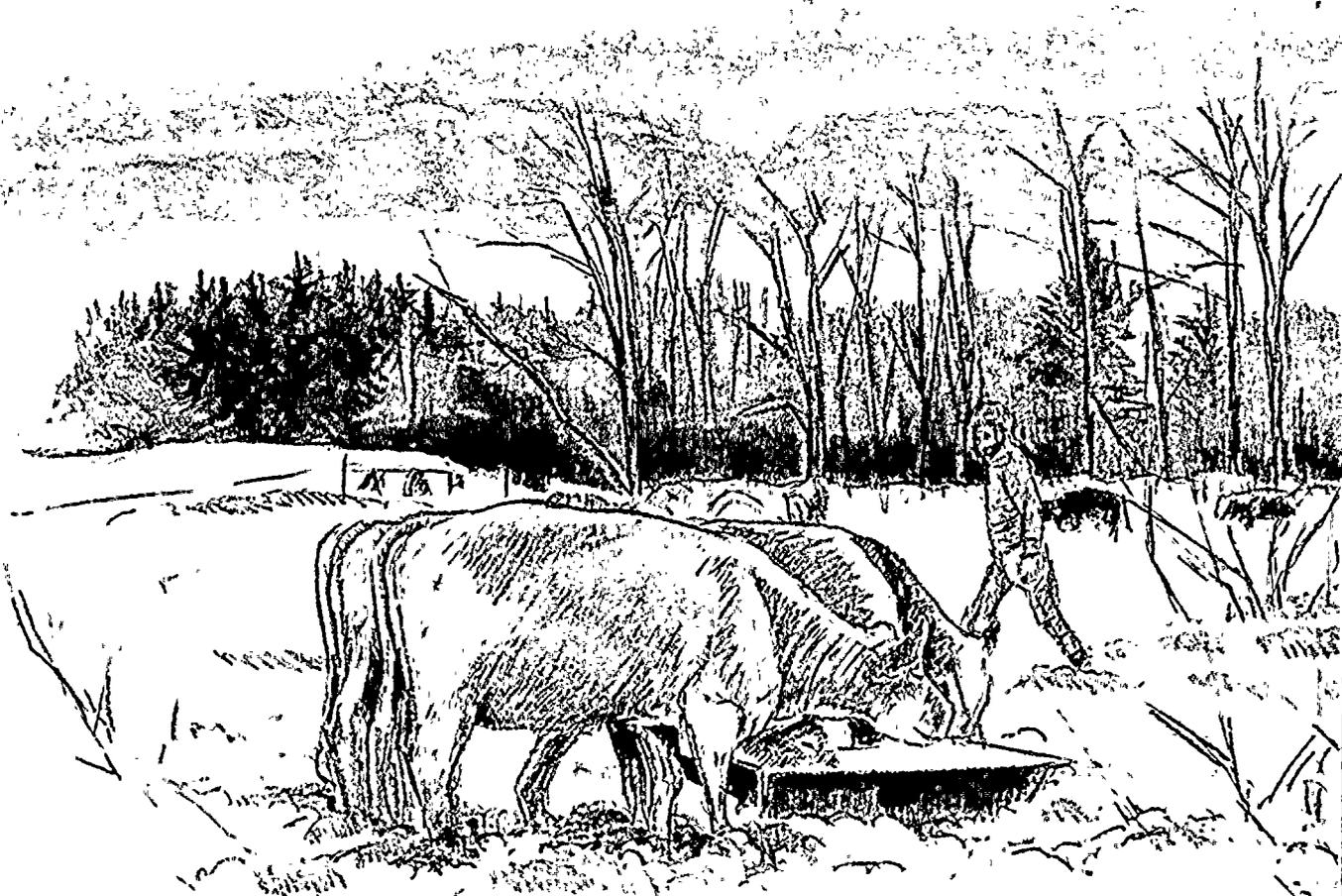
Some highlights of the year included:

- Jesse C. Tilton III officially assumed his duties as president of Allegheny Electric Cooperative, Inc., and its sister service organization, the Pennsylvania Rural Electric Association, on December 1, 1986. The former general manager of the Indiana Municipal Power Agency has a master's degree in electrical engineering from Auburn University and a strong background in both cooperative and municipal power supply.

- Susquehanna Steam Electric Station Unit 2 broke a worldwide record for boiling water reactor continuous operation and both units generated higher-than-average amounts of electricity. The successful refueling of Unit 1, accomplished for the first time without a lost-time injury, took four days less than budgeted.

- Construction of Allegheny's first wholly owned generating plant, the Raystown Hydroelectric Project, William F. Matson Generating Station, continued on time and under budget.

- Member cooperatives participating in the Coordinated Load Management System reported



gross savings of over \$160,000

- Allegheny and other interested parties were able to negotiate a 42-percent reduction of an energy rate hike planned by the Power Authority of the State of New York (PASNY), a supplier of inexpensive hydropower for Allegheny.

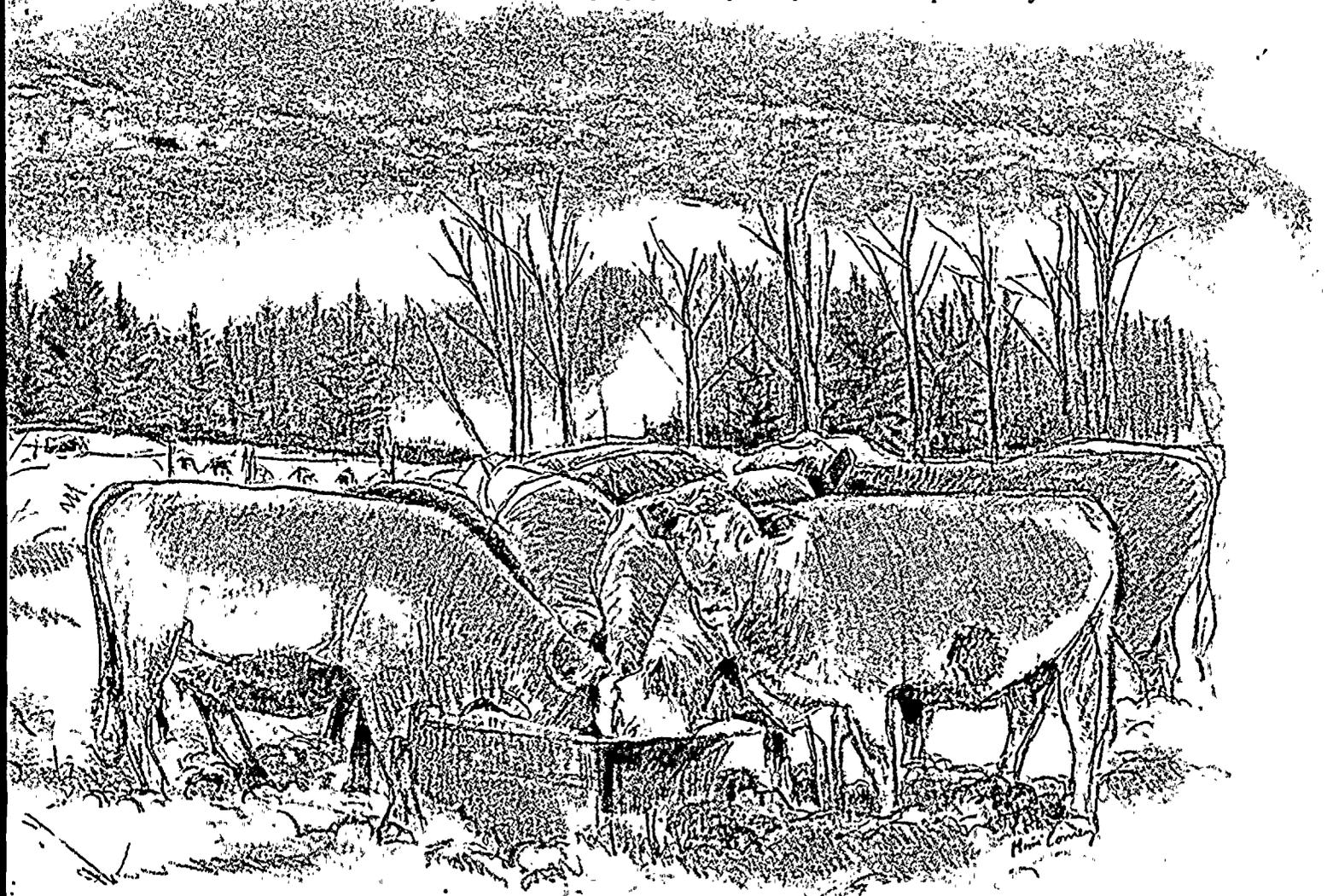
- By deciding not to develop Allegheny River Locks & Dams No. 8 & 9 for hydroelectric production, the board of directors elected not to include the cost of the hydroelectric project, for which the cooperative had development rights, into its rate structure. This will save about \$6 million per year in power costs for Allegheny's member cooperatives.

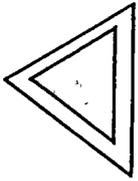
- Arrangements continued for a

leveraged lease of the Raystown Hydroelectric Project, which, if consummated, could save Allegheny several million dollars in project financing costs.

- In the face of serious attacks on the rural electric program by the executive branch of the United States government, the lobbying efforts of PREA on behalf of Allegheny have been essential. These efforts have garnered the support of both Pennsylvania United States senators and most of the Pennsylvania U.S. House members for approval of prepayment of generation and transmission (G&T) cooperatives' Federal Financing Bank (FFB) notes without prepayment penalty.

CATTLE CLUSTER around a feed trough on a farm served by rural electric cooperative electricity. Most of the 22,000 square miles served by Allegheny's member distribution cooperatives are sparsely populated, averaging only seven consumer-members per mile of line.





Board of Directors

6

Officers and members of the Allegheny Board of Directors, seated from left, are: John Drake, Dave Turner, James Henderson and John Looser. Standing from left are: Alston Teeter, Donald Songer, Donald Streams, Harold Hines, Winston Donaldson, Guy Spoerlein, John Ritchey, Harold Ritchey, Thomas Griffith and John Anstadt.



OFFICERS:

James Henderson, Chairman
Sussex Rural Electric Cooperative

John Drake, Vice chairman
Claverack Rural Electric Cooperative, Inc.

John Looser, Secretary
Adams Electric Cooperative, Inc.

Dave Turner, Treasurer
Sullivan County Rural Electric Cooperative, Inc.

BOARD MEMBERS:

John Anstadt
Sullivan County Rural Electric Cooperative, Inc.

Thomas Griffith
Bedford Rural Electric Cooperative, Inc.

Winston Donaldson
Central Electric Cooperative, Inc.

John Ritchey
New Enterprise Rural Electric Cooperative, Inc.

Harold Hines
Northwestern Rural Electric Cooperative Association, Inc.

Guy Spoerlein
Somerset Rural Electric Cooperative, Inc.

Donald Streams
Southwest Central Rural Electric Cooperative Corporation

Alston Teeter
Tri-County Rural Electric Cooperative, Inc.

Donald Songer
United Electric Cooperative, Inc.

Harold Ritchey
Valley Rural Electric Cooperative, Inc.

STAFF MEMBERS:

Jesse C. Tilton III, President

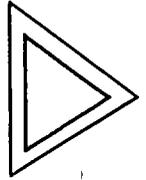
Paul N. Tetherow, Assistant General Manager

Wayne A. Weber, Dir. of Power Supply and Engineering

William E. Mowatt, General Counsel and Assistant Secretary

C. Donald Blackburn, Manager of Office Services

Joe Dudlick, Director of Public Affairs



Allegheny built power supply strength in 1987 through a diverse range of resources. To supply the power needs of its member cooperatives in 1987, Allegheny has a 10-percent ownership interest in the Susquehanna Steam Electric Station nuclear plant, and purchases the balance from five private power companies and the Power Authority of the State of New York.

Susquehanna Steam Electric Station

Allegheny owns 10 percent of this 2,100-megawatt nuclear generating plant in Luzerne County, Pennsylvania, which continued to operate at a high level of safety and efficiency throughout the year. Pennsylvania Power & Light Co., a private power company, is the operator and principal owner of the plant.

The Systematic Assessment of Licensee Performance (SALP) issued in late 1986 by the Nuclear Regulatory Commission (NRC) gave the plant the highest ratings possible in nine out of 10 categories. This ranked it among the best rated nuclear stations in the country.

The third refueling and inspection outage for Unit 1 began on September 12, 1987. During the 73-day outage, over 3,300 individual tests and maintenance tasks were performed in the reactor. New fuel was added by replacing one-fourth of its 764 fuel bundles.

Both Susquehanna units continued to operate extremely well during 1987. Even with the scheduled refueling outage in the fall, Unit 1 achieved a cumulative capacity factor of 73.87 percent during Allegheny's fiscal year. By the end of fiscal 1987, Unit 2 had been operating con-

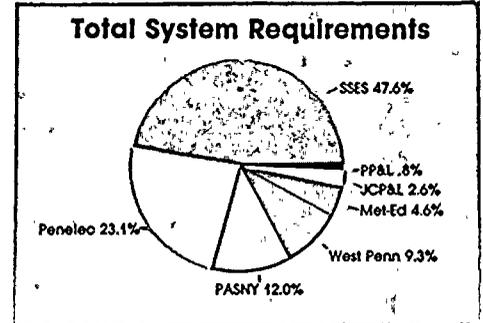
tinuously for 189 days, breaking a world record for longest continuous operation by a boiling water reactor unit in its second fuel cycle. The previous record was 171 days without a shutdown. Through the end of October 1987, Unit 2 achieved a cumulative capacity factor of 83.9 percent for Allegheny's fiscal year. Both capacity factors are much better than the lifetime average of 60 percent for units throughout the industry. In 1987, 47.6 percent of Allegheny's total energy supply came from Susquehanna.

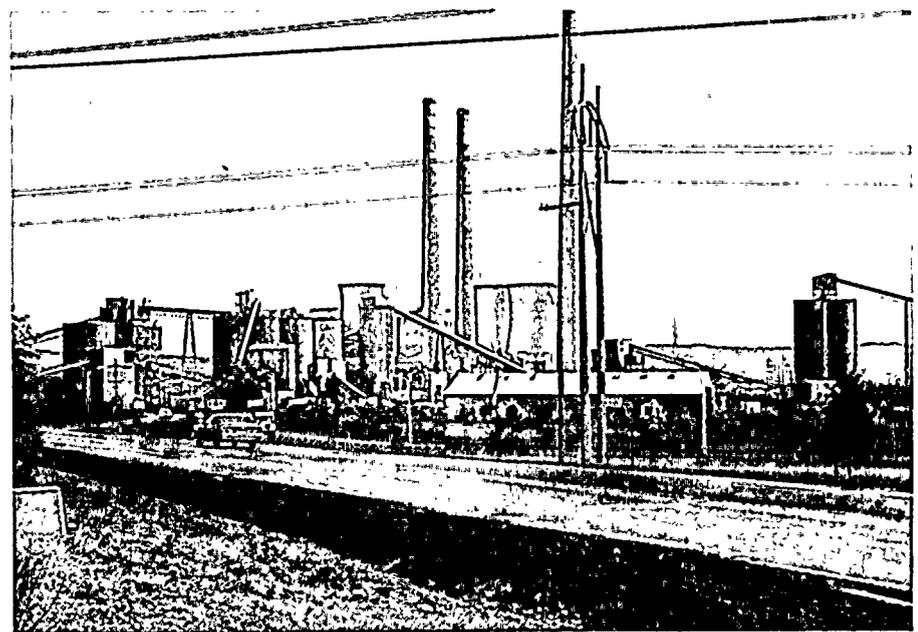
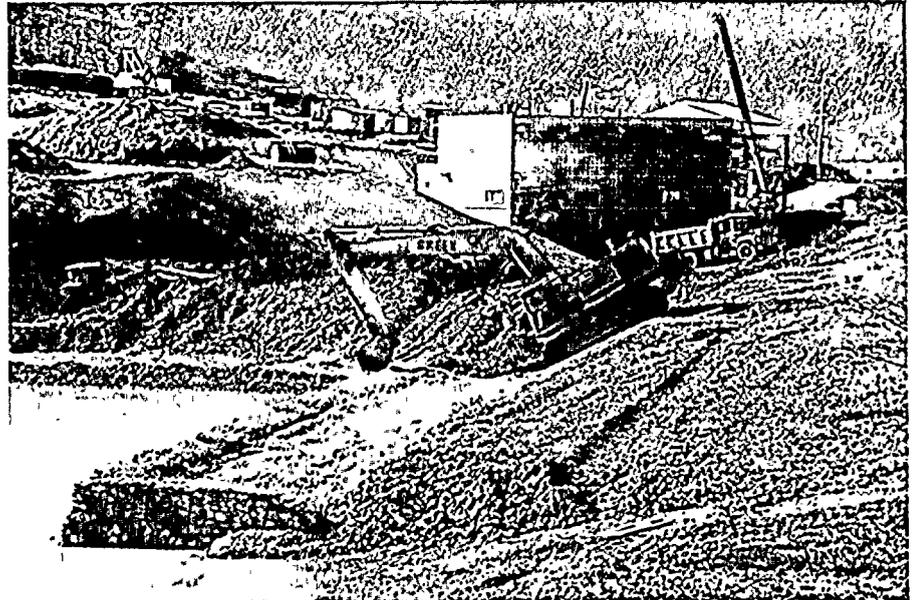
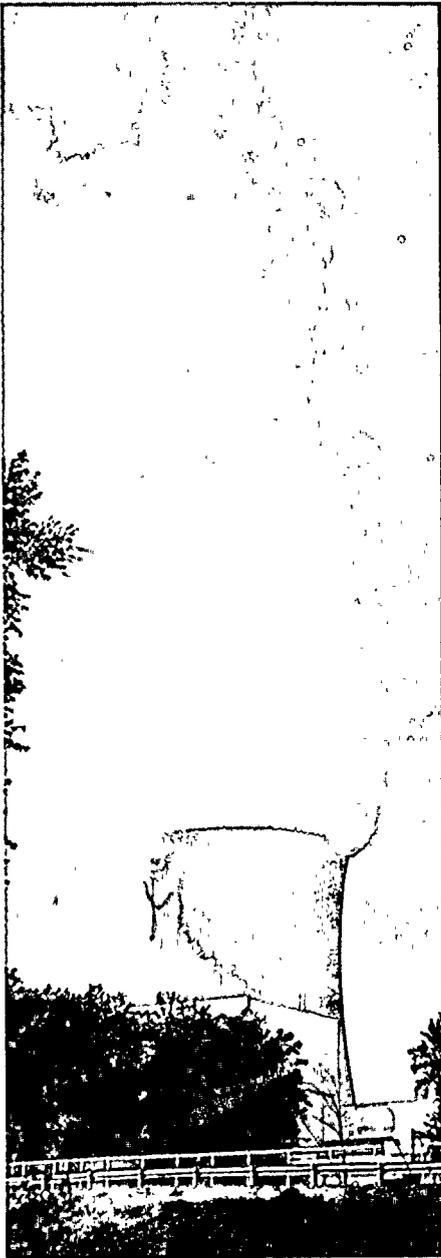
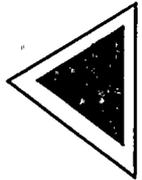
PASNY

Electricity produced at the Niagara Power Project of the Power Authority of the State of New York (PASNY) is among the least expensive power in the United States. Since Allegheny began purchasing it in 1966, PASNY power has saved the cooperative over \$188.8 million when compared to the cost of power which would have been purchased from Allegheny's supplemental power suppliers. PASNY savings for Allegheny amounted to \$5.8 million in 1987.

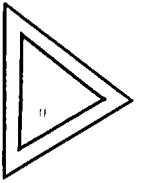
Increased competition for this low-cost electricity led to a substantial decrease in Allegheny's allocation of Niagara power in July 1985 from 107 megawatts to 35 megawatts.

Allegheny continued to work in 1987 to increase its allocation of PASNY power. Allegheny and other out-of-state PASNY power recipients have intervened in a case filed at the Federal Energy Regulatory Commission against PASNY by the Municipal Electric Utilities Association of New York (MEUA) in June 1986. MEUA, Allegheny and the other intervenors contend that municipal distribution authorities





ALLEGHENY CREATED power supply strength with a variety of resources, including nuclear power from the Susquehanna Steam Electric Station (above) and purchased power from other utilities' coal-fired generating plants (right). Construction continued on the Raystown Hydroelectric Project (top right), which will provide power in the future.



recently created within New York state, Vermont and Rhode Island are not "public bodies" as defined by the Niagara Development Act. Therefore, it was argued, they do not qualify for Niagara preference power because they have no real distribution facilities or utility responsibilities. Allegheny participated in the February 1987 hearings and at the end of fiscal 1987 was awaiting an initial decision by the administrative law judge. A FERC ruling that these entities do not qualify as public bodies would make possible an increase of about eight megawatts in Allegheny's Niagara hydropower allocation.

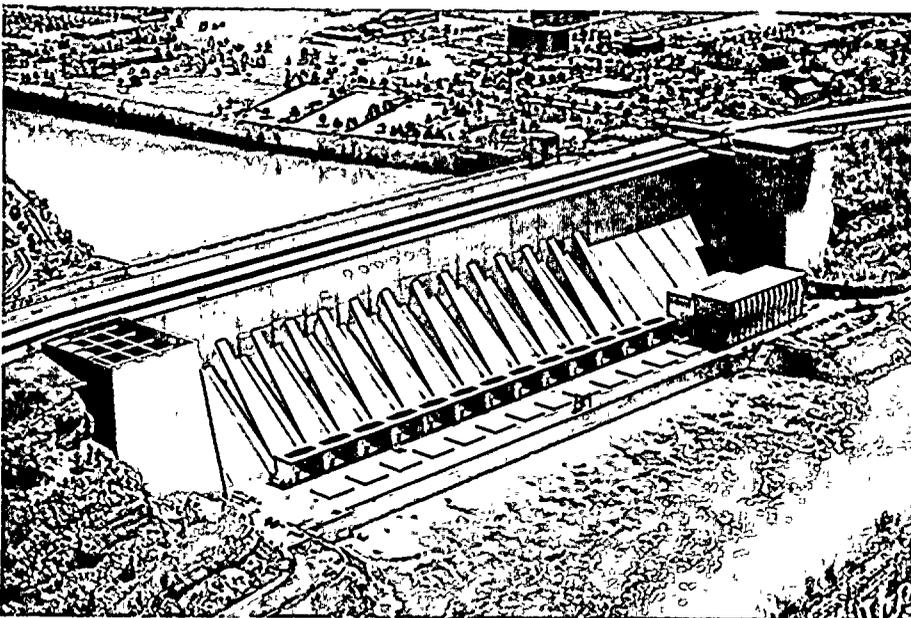
During 1987, Allegheny, as bargaining agent for Pennsylvania, continued to receive interim allocations of Niagara and St. Lawrence Project power. As of October 31, 1987, the total interim allocation of Niagara power amounted to 40.3 megawatts. Of this total, Allegheny retained 35.1 megawatts and the remaining 5.2 megawatts was shared among seven municipal systems. Also at the end of fiscal 1987, the total interim allocation of St.

Lawrence power was 4.5 megawatts, of which Allegheny's portion was 214 kilowatts. The remaining 4,286 kilowatts was distributed among the municipal systems and four private power companies.

A new draft contract was issued by PASNY in late October 1987 for review by participating states.

On December 16, 1986, Allegheny was notified that PASNY planned to implement an energy rate increase from 1.71 mills/kilowatt-hour to 2.2 mills/kilowatt hour, effective May 1987. Over the next four years, the energy charge would be gradually increased to 4.93 mills/kilowatt in 1991. However, after gathering comments from Allegheny and other parties, PASNY announced it would reduce the rate increase by 42 percent. Based on the reduced rate, Pennsylvania's increase will now amount to about \$1.8 million over the five-year period, compared to about \$3.4 under the originally announced rate increase.

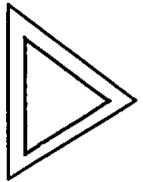
Allegheny purchased almost 12 percent of its total energy supply from this inexpensive source in 1987.



INEXPENSIVE HYDROELECTRIC POWER purchased from the Power Authority of the State of New York's Niagara Project continued to play an important part in Allegheny's total energy supply.



BRIAN COBB, freezerman for P&N Packing, Inc., moves another packed carton of tenderloins into the freezer room prior to shipping. This Bradford County meat processing plant, located near Wyalusing, Pa., processes over 1,000 veal calves and 100 beef cattle during an average week. Farmers within a fifty to seventy mile radius of the plant supply the veal.



To ensure control over a reliable, reasonably-priced supply of electricity in the future, Allegheny continued to explore and develop generating projects of its own. Progress also continued in other projects designed to manage electric use patterns and secure an adequate future delivery system.

Raystown Hydroelectric Project, William F. Matson Generating Station

Following the August 1986 ground breaking at the United States Army Corps of Engineers' Raystown Lake Dam in Huntingdon County, Pennsylvania, construction of Allegheny's first wholly owned generating plant progressed smoothly throughout 1987, on time and under budget. Aggressive negotiations with supplying vendors, favorable interest rates and sound management combined to keep the project well below the original REA loan budget projection of nearly \$41.5 million.

Stone & Webster Power Projects Corporation, an internationally known engineering firm, is the project's design and construction manager. Green Construction Company of Irving, Texas, the original builder of the dam, is the general contractor.

Upon commercial operation expected in early summer 1988, the 21-megawatt, run-of-river hydroelectric plant will generate about 4 percent of the energy supplied by Allegheny — enough to supply about 8,500 average rural homes. When it begins commercial operation, this project is expected to produce power at a cost competitive with wholesale power purchased from Allegheny's suppliers.

Montgomery Hydroelectric Project

In June 1987 Allegheny successfully defended its application against a competing application with the Federal Energy Regulatory Commission (FERC) for a construction and operating license to develop the Corps of Engineers' Montgomery Locks and Dam for hydroelectric generation. This application for the site, located west of Pittsburgh on the Ohio River in Beaver County, Pennsylvania, is still being contested. A separate FERC Environmental Impact Study on the Ohio River Basin has further extended the already lengthy construction and operating license issuance process.

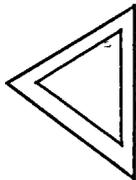
While Allegheny has made no final commitment to build this project, a feasibility study indicates rising wholesale power costs could make later development of the project in the mid-1990s desirable.

Approximately 4 percent of Allegheny's projected energy needs would be supplied by the proposed 20-megawatt hydroelectric plant at the Montgomery Locks and Dam.

Allegheny River Locks and Dams No. 8 & No. 9 Hydroelectric Projects

After careful, detailed study of the projects' technical, environmental and economic aspects by the Allegheny staff and private consultants, the Allegheny board of directors decided not to develop the proposed Allegheny River sites.

The board voted in July 1987 to transfer Allegheny's development rights for the project on the Allegheny River north of Pittsburgh to Sithe Energies U.S.A. Under the agreement with Sithe, Allegheny can regain ownership of the project after 40 years. Also, Allegheny



could receive power from the project at some point prior to the 40th year of the operation of the project, depending on Sithe's arrangements with other utilities to which it would sell electricity from the project. Payments to Allegheny by Sithe are scheduled in phases when certain conditions are met and could total \$2.5 million.

While the board decided that developing hydropower at Allegheny River Locks and Dams No. 8 and No. 9 does not represent Allegheny's best power supply option at this time, it remains committed to fully utilizing the nation's water power resources.

Load Management

Managing electric use patterns represents one of the quickest, most direct ways to improve the use and cost effectiveness of both planned and existing resources. By shifting electricity use for home water heaters from periods of peak demand to periods of lesser demand, the Coordinated Load Management System improves system efficiency, reduces the costly monthly demand charges Allegheny must pay and will reduce the need for new generation capacity.

Load control by Allegheny and its

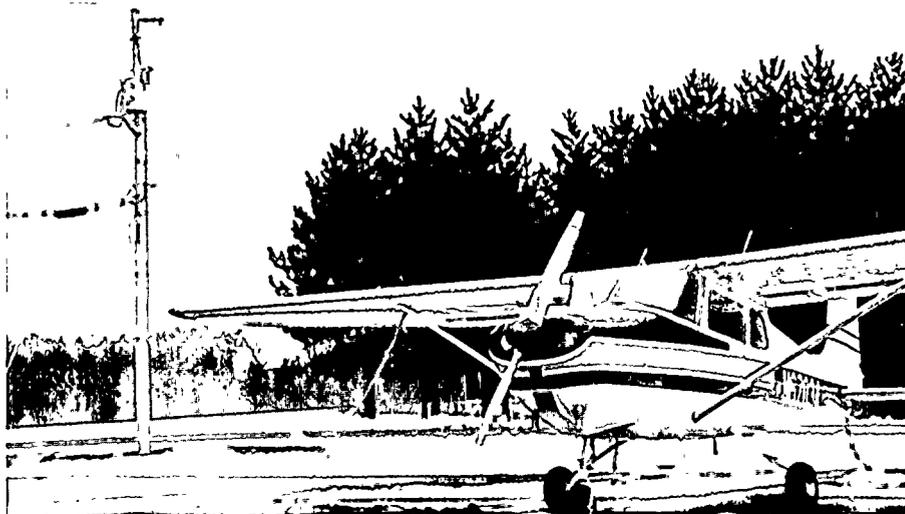
member cooperatives began late in 1986, using the new load management equipment to reduce peak demand at individual substations. By the end of the 1987 fiscal year, 6,941 load control receivers, which switch the heating element in water heaters off for several minutes during peak demand, had been installed in the homes of volunteer consumer-members in the 10 participating distribution cooperatives. This figure includes 675 load control receivers already operating in Central Electric Cooperative's ongoing pilot project. For optimum operation of the system, the program goal is to install load control receivers on about 50 percent of the electric water heaters belonging to participating cooperatives' consumer-members.

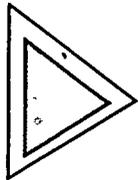
Even using the interim control equipment during fiscal 1987's installation phase, participating cooperatives reported a gross savings of over \$160,000 through the 1987 fiscal year. Projections indicate a potential for a yearly gross savings of over \$1.4 million when the program is operating at optimum level.

Marketing

In 1987, Allegheny continued to

SMALL AIRPORTS, such as Clarion County Airport served by Central Electric Cooperative, depend on electricity to help provide rural residents with time-saving transportation in sparsely populated areas.





support the distribution cooperatives' programs to promote space heating technologies that maximize the benefits of the Coordinated Load Management System. Increasing kilowatt-hour sales and shaping consumer-members' usage patterns allow Allegheny to spread fixed costs over more kilowatt-hours and minimize more costly peak demand energy charges.

Adopted in August 1987 as a supplement to the initial Marketing Handbook, Allegheny's Marketing Assistance Program is based on a market survey of the distribution cooperatives' service territories. Each co-op targets its own program to the individual needs and preferences of its members. Allegheny provides assistance in promotion, research, rate design and computer modeling services when requested by interested co-ops.

By the end of the 1987 fiscal year, Claverack Rural Electric Cooperative and Bedford Rural Electric Cooperative had developed marketing plans with Allegheny's participation involving rate incentives for consumer-members using electric thermal storage and dual fuel heating, with several others progressing on their own marketing plans. Two cooperatives continued operating their ongoing programs: Adams Electric Cooperative with electric thermal storage and North-western Rural Electric Cooperative Association with electric ground-water heat pumps.

Transmission

To ensure an adequate, reliable, cost-effective delivery system for its cooperatives, Allegheny embarked on two transmission system construction projects in fiscal year 1987.

In October, Allegheny signed an engineering service contract with Black and Veatch, an engineering firm based in Kansas City, Kansas, for the planning, design and construction of the Fairfield-Mill Creek 69-kilovolt Transmission Project. The project, involving the construction of 5.5 miles of transmission line and a distribution substation, will be located in Sullivan County Rural Electric Cooperative's territory. Right-of-way acquisition was begun during fiscal year 1987 and construction was scheduled for spring 1988. Project service is planned by the end of the 1988 calendar year.

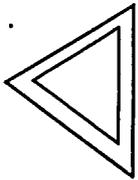
Still in the early planning stage at the end of the fiscal year, a similar transmission project will be located in Somerset Rural Electric Cooperative's territory and will involve building a line to a newly-constructed substation.

Planning for the future

Allegheny remains committed to strategic planning for future energy and capacity requirements. Using detailed projections and careful staff analysis, Allegheny continued to look closely at current resource requirements and load growth expectations to project its capacity and energy requirements for the years ahead.

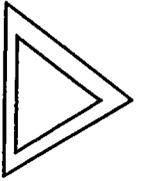
As the cooperative moves closer to becoming a full service generation and transmission utility, improved transmission access and marketing play an important part in Allegheny's strategy.

Allegheny continues to stay abreast of developing technologies for the cost-effective use of high-sulfur coal from the eastern United States. The cooperative will evaluate these technologies, as well as others, for possible integration into the existing resource mix.



RESIDENCES, illustrated above by this Crawford County home in Northwestern Rural Electric Cooperative Association's territory, consume about 82 percent of Allegheny's total energy sales to the member distribution cooperatives. The consumer building the house on the right in Susquehanna County opted to have electric thermal storage (ETS) space heating units installed. The units store electric heat during off-peak, or low usage periods, for use during peak periods. Steve Herrington, load management technician for Claverack Rural Electric Cooperative, installs a load management switch on the new house. One of the two outside meters will record the ETS usage, for which the consumer-member will pay a discounted rate.





The legislative arena was extremely active in 1987 for rural electric cooperatives across the nation. Allegheny's legislative interests continued to be represented by its sister organization, the Pennsylvania Rural Electric Association (PREA), and strongly assisted by member distribution systems.

Federal Legislation

Two principal federal issues consumed most of the PREA legislative staff's time during the past year. The first was the federal budget approval of the financing programs of the Rural Electrification Administration (REA). The second was the effort to win approval of prepayment of generation and transmission (G&T) cooperatives' Federal Financing Bank (FFB) notes without prepayment penalty. The FFB is a federal agency that was established within the U.S. Department of the Treasury to coordinate the borrowing of federal agencies and of entities with federal loan guarantees.

Despite Administration efforts to weaken or eliminate REA's financing programs, Congress continued to support these programs. REA's insured loan program provides up to 70 percent of distribution cooperatives' borrowed capital requirements with 5-percent loans made from the Rural Electrification and Telephone Revolving Fund. REA's guaranteed loan program benefits G&T cooperatives by providing a 100-percent federal guarantee of co-op's borrowing and permits the funding of these federal guarantees through the FFB.

Although generation and transmission cooperatives are currently permitted to prepay their FFB notes, the prepayment penalties associated with these transactions have generally made them economically infeasible. In recent years,

on three separate occasions, Congress has passed legislation to allow G&T cooperatives to prepay their FFB notes without penalty as long as the notes are refinanced with private capital. However, the Administration found ways of blocking widespread prepayment and refinancing. For Allegheny, unrestricted prepayment and refinancing could mean interest cost savings of up to \$20 million at the favorable interest rates seen in 1987.

Although neither of these issues were resolved by the end of Allegheny's fiscal year, Congress enacted legislation that not only continued the existing REA financing programs, but also provided loan limits that will meet the capital needs of rural electric G&T and distribution cooperatives for the next federal fiscal year. In addition, the federal budget legislation will allow for a little over \$2 billion of FFB notes to be refinanced by the G&T cooperatives with the 100-percent federal guarantee for the capital that will be raised in the private markets.

State Legislation

The Pennsylvania General

SPARTY WOOD PRODUCTS, which processes hardwood in this lumber mill near Spartansburg, is the largest commercial consumer-member on Northwestern Rural Electric Cooperative Association's lines.

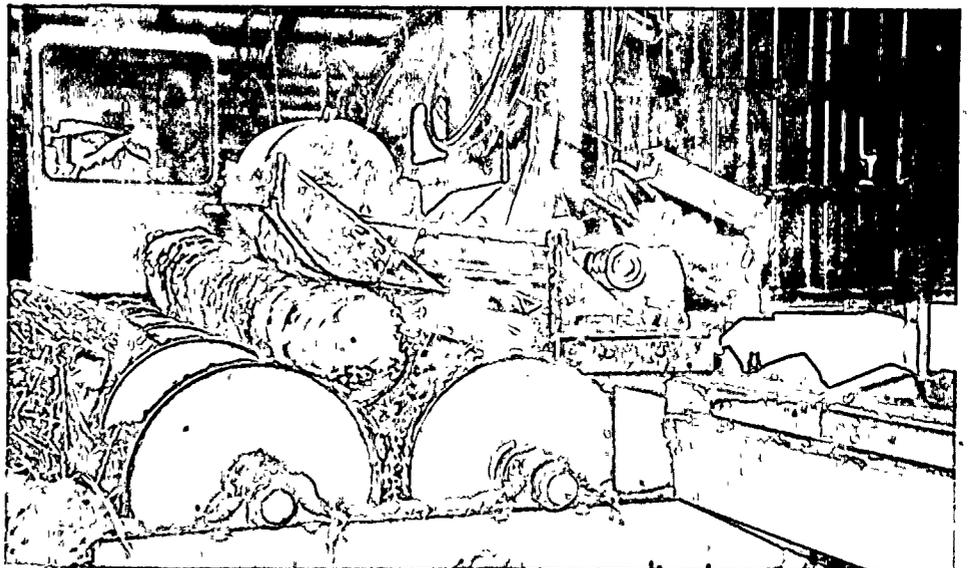


PHOTO COURTESY OF LARRY SHOBER, SOMERSET REC.



JOSIE ISGAN helps to pack the 6,000 dozen eggs produced daily at Brendle Farms to ship to local supermarkets. The two chicken houses on this egg farm in Somerset Rural Electric Cooperative's service territory hold 85,000 birds.

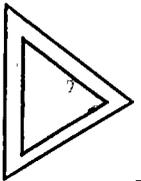
Assembly enacted legislation to protect distribution cooperatives from being sold by a small group of members. The new legislation provides that any successful sellout effort must be approved by two-thirds of all of a cooperative's members. In addition, the legislation also provides a way for other electric cooperatives to assume ownership of distribution cooperatives that are threatened with a sellout.

Rural Economic and Community Development

To improve the economic conditions in all of the areas served by Allegheny's members, which vary widely, and especially those that have not enjoyed the general economic recovery, Allegheny continued to support distribution cooperatives' economic and community development activities.

While not operating economic development departments of their own, both Allegheny and the distribution co-ops support statewide and local economic development agencies. PREA is a member of the Pennsylvania Rural Development Committee which coordinates many federal rural development activities. In addition to these efforts, PREA is working with the Northeast-Midwest Congressional Institute and Pennsylvania's congressional delegation on some innovative economic development strategies.

On the state level, Allegheny and PREA worked with the Commonwealth's newly-elected governor, Robert P. Casey, who has made economic development a key goal of his administration. PREA staff members and officials of distribution cooperatives have been named to regional economic development committees established by the governor.



Prudent financial management continues to be a high priority for Allegheny. Continued investigation and pursuit of new financing options, internal audit procedures and expense monitoring are some of the factors contributing to the cooperative's strong financial position and equity level over the years and in 1987.

This financial review provides a brief discussion of the cooperative's financial condition and results of operations. Additional information is set forth in the financial statements, schedules and notes listed at the end of this report.

Operating Margins

The level of margins needed by generation and transmission cooperatives like Allegheny is often determined based on a Times Interest Earned Ratio, or TIER. As in the past, Allegheny successfully met its TIER goal of 1.1 through cost-of-service billing adjustments. Allegheny's Debt Service Coverage (DSC) ratio for 1987 was 1.14. Both the TIER and DSC ratios meet the requirements stated in the Rural Electrification Administration (REA) mortgage.

The margins and equities not distributed to member systems by Allegheny totaled \$34,226,685 for 1987, compared to \$29,642,775 in 1986. At the end of fiscal year 1987, Allegheny had cash and temporary investments of \$23,063,526, compared to \$5,570,927 at the end of 1986. Also at the end of the fiscal year, Allegheny had 19.3 million outstanding in commercial paper.

Financing

REA makes loans and loan guarantees available to Allegheny. Most of the cooperative's projects have been funded by the Federal Financing Bank (FFB).

REA-guaranteed debt in the

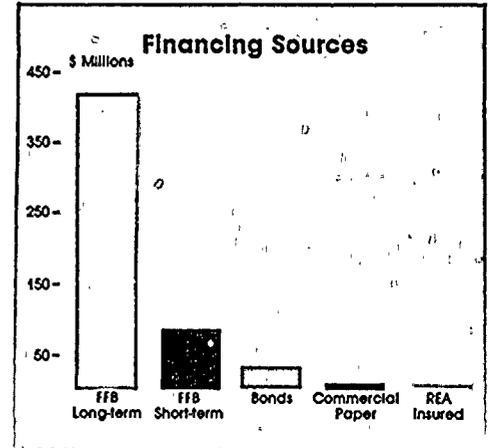
amount of \$8.2 million was drawn from the FFB during 1987, compared to \$5.0 million during 1986. The funds drawn in 1987 were used for post-commercial additions to Susquehanna Steam Electric Station (SSES), the Coordinated Load Management System and the Raystown Hydroelectric Project. In fiscal 1987 Allegheny received approvals from REA to draw down in excess of \$20 million for SSES capital improvements from previously authorized loan commitments.

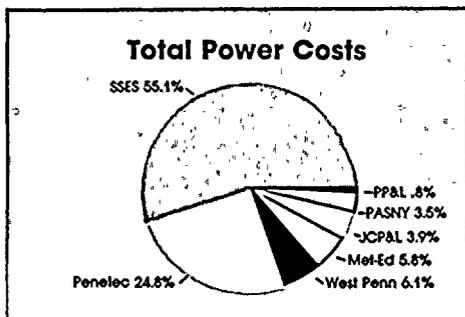
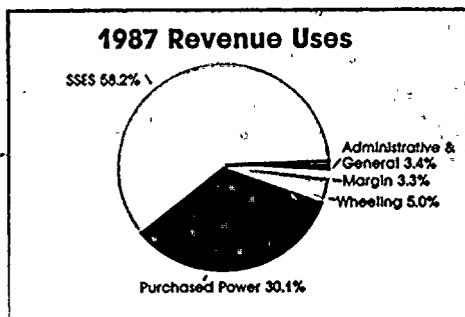
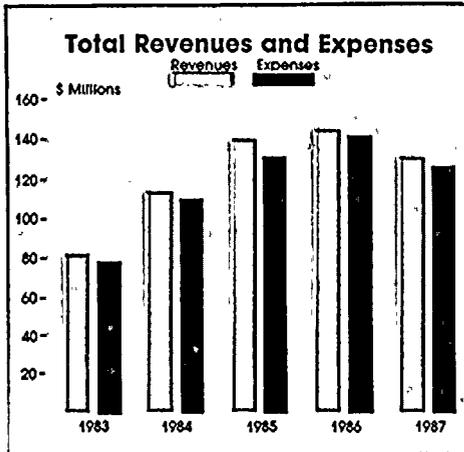
During 1987 Allegheny continued financing some of its pollution control facilities at SSES with tax-exempt bonds. Issued through the Lehigh County Industrial Development Authority and backed by letters of credit, these bonds bear interest at weekly and monthly floating rates.

Use of this type of financing has enabled Allegheny to obtain very attractive interest rates consistent with its goal of obtaining the lowest possible financing cost. The average monthly rate paid on these bonds through 1987 was 5.78 percent. Bank lines of credit totalling \$52 million are available to Allegheny. During 1987, Allegheny did not find it necessary to draw on these funds.

Construction

During 1987, Allegheny spent \$17.1 million on its present major construction project, the Raystown Hydroelectric Project, William F. Matson Generating Station in Huntingdon County, Pennsylvania. Project construction, set for completion in spring 1988, is currently being funded by Allegheny's commercial paper program. Commercial paper provides a much lower up-front financing rate than traditional financing and frees Allegheny from paying penalties for early repayment of borrowed funds.





During 1987, Allegheny began arrangements for a sale/lease-back financing agreement for the Raystown Hydroelectric Project in order to take advantage of the current tax laws. If the planned Raystown Hydroelectric Project leveraged lease is finalized during 1988, Allegheny will remain operator of the plant and the assets will be owned by a trust. If the leveraged lease is not finalized, the cooperative can use traditional financing for this project, since REA has already approved a guaranteed loan.

Taxability

Allegheny has a private letter ruling from the Internal Revenue Service providing for Allegheny to remain taxable until an application is made again to become a tax-exempt organization. Allegheny expects to have tax losses to carry forward to offset estimated tax liability for the foreseeable future.

OPERATIONS

Revenue

Allegheny's total operating revenue for 1987 was \$135.4 million. Of this total, \$103.4 million, or 76.4 percent was member revenue generated from Allegheny's wholesale rate to its member cooperatives. The remaining \$32.0 million or 23.6 percent was classified as non-member revenue.

When compared to 1986, total operating revenue actually decreased by \$4.2 million or 3.0 percent. This decrease was the net result of a member revenue increase of \$6.2 million or 6.4 percent coupled with a non-member revenue decrease of \$10.4 million or 24.5 percent.

Non-member revenue

Non-member revenue resulted from Allegheny's "buyback" agreement with Pennsylvania Power & Light (PP&L) and from the sales of PASNY power and energy to seven municipal electric utilities and four private power companies.

Prior to commercial operation of the Susquehanna Steam Electric Station in 1983, Allegheny's total operating revenue came solely from funds generated by Allegheny's wholesale rate to its members. Under the terms of an agreement with PP&L, Susquehanna's principal owner, each year PP&L "buys back" a portion of the Susquehanna power to which Allegheny is entitled. Taking the power available from Susquehanna in increments allowed Allegheny to largely avoid the rate shock that so many other utilities have faced with the coming on-line of a new generating facility. The agreement ends in 1991, when Allegheny will receive 210 megawatts, its full 10-percent share of Susquehanna power.

Allegheny's second source of non-member revenue is derived from its relationship with PASNY. As the bargaining agent for Pennsylvania in all dealings with PASNY, Allegheny has purchased PASNY power and wheeling service since 1985 for seven municipal electric utilities and four private power companies receiving part of Pennsylvania's PASNY allocation as well as itself.

Member revenue

Allegheny's total wholesale power revenues from its 14 member cooperatives during 1987 was \$103.4 million. This represents an increase of \$6.2 million or 6.4 percent over 1986. Average annual purchased power cost to the

members was 55.75 mills/kilowatt-hour as compared to 54.31 mills/kilowatt-hour for 1986 — an increase of 1.44 mills or 2.63 percent.

The power cost increase was primarily due to the addition of 20 megawatts of Susquehanna Steam Electric Station capacity to Allegheny's rate base (10 megawatts in February and 10 megawatts in June), as planned under the Allegheny/PP&L buyback agreement. Wholesale rate increases granted by the Federal Energy Regulatory Commission to Allegheny's supplemental power suppliers also contributed to the power cost increase to the members.

Although member power cost increased during 1987, Allegheny was able to reduce its wholesale rate to the members in January and July by a total of \$951,888, and to refund \$188,738 to the member cooperatives. The rate settlements which made these actions possible are discussed next.

Wholesale rate negotiation

Allegheny constantly strives to ensure that the wholesale rates which it pays to its six wholesale power suppliers — which are ultimately passed along to the member cooperatives — are as low as possible. Negotiating requested wholesale rate increases has saved Allegheny and its members more than \$25 million since the early 1970s.

During 1987, Allegheny continued to negotiate on behalf of its members in a number of cases. Metropolitan Edison Company, one of Allegheny's wholesale power suppliers, and Niagara Mohawk Power Company, one of its New York state wheeling agents, filed proposed rate increases with the Federal Energy

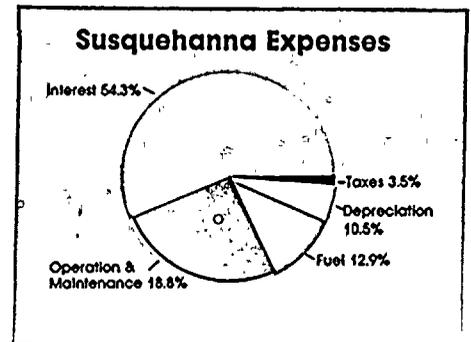
Regulatory Commission. In these cases, Allegheny responded with a Protest and Petition to Intervene. In addition, Allegheny entered into separate negotiations with West Penn Power Company and Pennsylvania Electric Company prior to a rate case filing at the Federal Energy Regulatory Commission. Finally, as described earlier in the **Power Supply** section, the Power Authority of the State of New York (PASNY) notified Allegheny of its plans to implement a rate increase applicable only to energy sold from both the Niagara and St. Lawrence hydroelectric generating projects.

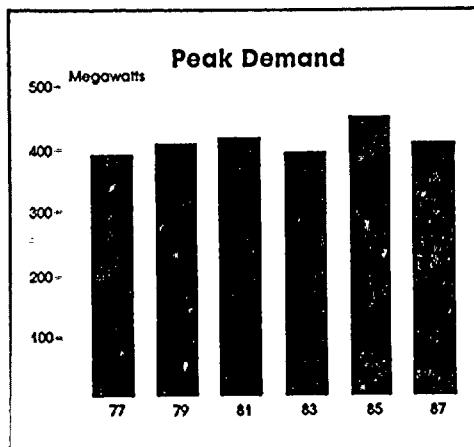
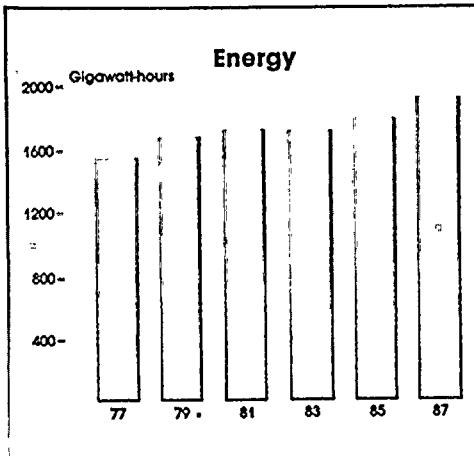
Fortunately, through settlement negotiations which stressed the Tax Reform Act of 1986, Allegheny was successful in reducing its total purchased power cost and wheeling expenses by \$1,794,177. Of this total, \$951,888 applied during fiscal 1987, with the remaining \$842,289 applicable during fiscal 1988.

Rates

Unlike private power companies, Allegheny and its member cooperatives operate on a non-profit basis. This helps keep cooperative electric rates lower than they might be otherwise, since it eliminates one factor leading to rate increases. But cooperatives serve fewer consumers per mile of line than private companies do, which drives up costs, and consequently, electric rates.

Another significant difference between rural electric cooperatives in Pennsylvania and New Jersey is in the rate-making process. As consumer-owned entities, the cooperatives are self-regulated and are therefore neither under the jurisdiction of the Pennsylvania Public Utility Commission nor the New Jersey Board of Public Utilities. The Rural Electrification Administration does review coopera-





THE CLARION RIVER LODGE, nestled in Cook's Forest, Jefferson County, serves a growing tourist trade in the region. This lodge is one of 4,000 seasonal and recreational users in United Electric Cooperative's service territory.

tive rate-making and operating practices, however.

Allegheny's Board of Directors is democratically elected with one director from each of the rural electric cooperatives supplied power by Allegheny. The board governs all cooperative policies, including those which establish rates charged to Allegheny's member distribution cooperatives. Board review of the rate-making process and approval of each rate change assures Allegheny's member cooperatives that the price they pay for electricity is reasonable.

Energy sales

For fiscal 1987, Allegheny's total system energy sales were 1,855 million kilowatt-hours, while peak demand reached 400 megawatts. When compared to 1986, energy sales increased by 66 million kilowatt-hours or 3.7 percent and peak demand actually decreased by 11 megawatts or 2.7 percent. Accordingly, average monthly system load factor increased from 61.8 percent in 1986 to 63.5 percent for 1987.

The reduction in peak demand was a direct result of the milder-than-average winter weather, coupled with the partial implemen-

tation of Allegheny's Coordinated Load Management System. Even though system peak demand was down, Allegheny's average summer load during the months of June, July and August actually increased from 286 megawatts in 1986 to 300 megawatts in 1987. This increase of 14 megawatts or 4.9 percent resulted directly from the very hot summer.

The increase in total system energy sales resulted from the combination of normal (as forecasted) residential load growth coupled with greater-than-expected sales due to the hot weather. In fact, summer sales increased by 22 million kilowatt-hours or 5.5 percent over that of last year. This summer sales increase comprised one-third of the total fiscal year sales increase.

Toward the future

Allegheny Electric Cooperative, Inc. will reach a milestone in 1988 with the commercial operation of the Raystown Hydroelectric Project, William F. Matson Generating Station — its first sole ownership of generation for itself and its members. A leveraged lease transaction, contemplated for 1988, could lower the annual cost of this power supply project for years to come.

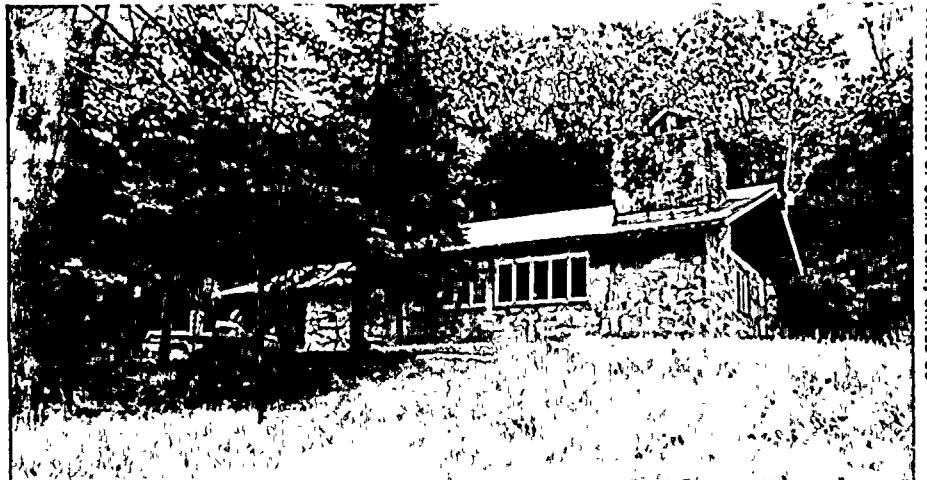


PHOTO COURTESY OF JOHN LACHY, UNITED EC

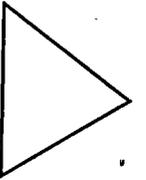
Five-year financial statement

F-2

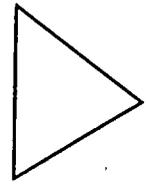
Assets	1987	1986	1985	1984	1983
General plant	602,287,851	578,747,706	567,781,429	310,561,384	295,327,581
Construction work in progress	26,112,471	23,266,827	9,985,560	236,548,274	196,465,179
Total plant	628,400,322	602,014,533	577,766,989	547,109,658	491,792,760
Accumulated provision for depreciation & amortization	55,661,532	38,650,654	25,838,452	12,600,030	5,074,209
Net plant	572,738,790	563,363,879	551,928,537	534,509,628	486,718,551
Non-utility property - net	5,201,705	5,668,218	5,798,843	5,925,468	6,224,421
Capital credits - NRUCFC	330,510	323,392	284,563	113,688	292,629
Investments in associated organizations	3,810,055	3,810,055	4,680,148	8,075,814	4,162,745
Cash - general funds	543,990	-91,688	508,482	2,027,284	3,558,550
Cash - construction/working funds	1,000	1,000	1,000	1,186	4,066
Temporary investments	22,518,536	5,661,615	16,558,634	25,660,405	20,433,000
Special funds	2,173,210	2,782,591	1,775,000	-	-
Accounts receivable	11,915,466	10,585,397	10,367,758	8,478,716	8,337,033
Prepayments	988,752	203,773	406,935	257,702	336,631
Other current & accrued assets	109,812	22,067	165,581	286,629	337,238
Deferred debits	1,396,250	2,397,511	3,737,271	4,992,444	4,647,271
Total assets	621,728,076	594,727,810	596,212,752	590,328,964	535,052,135
Liabilities					
Memberships	2,800	2,800	2,800	2,800	2,800
Patronage capital	34,174,253	29,590,343	24,434,352	19,906,242	16,919,124
Donated capital	49,632	49,632	48,772	48,772	29,665
Long-term debt - REA	502,382,263	499,991,617	509,911,665	474,737,316	457,661,000
Long-term debt - other	30,563,478	30,804,736	20,839,474	20,863,230	2,266,856
Notes payable	19,300,000	2,046,000	8,874,000	41,849,823	19,079,141
Accounts payable	8,923,598	7,267,872	4,863,266	6,869,240	9,160,034
Cost of Service Adjustment	2,469,273	-	1,636,459	921,298	3,991,717
Accrued taxes	513,800	564,363	767,060	302,053	836,440
Accrued interest	3,693,592	3,965,431	4,610,594	4,632,794	4,516,060
Other current & accrued liabilities	85,971	133,179	216,735	-1,940	257,627
Deferred credits	19,569,416	20,311,837	20,007,575	20,197,336	20,331,671
Total liabilities	621,728,076	594,727,810	596,212,752	590,328,964	535,052,135

Member revenues	1987	1986	1985	1984	1983
Adams	13,940,070	13,044,641	11,401,278	10,250,931	8,231,803
Bedford	4,525,951	4,262,468	3,848,858	3,587,411	2,885,799
Central	10,339,008	9,560,522	9,050,392	8,248,665	6,814,686
Claverack	7,971,779	7,557,597	6,808,419	6,118,753	4,980,866
New Enterprise	1,994,346	1,860,382	1,666,860	1,516,303	1,213,020
Northwestern	9,721,237	9,325,703	8,588,967	7,888,073	6,419,787
Somerset	7,683,396	7,319,154	6,799,538	7,826,163	5,940,144
Southwest Central	13,512,528	12,538,752	11,330,541	10,357,797	8,271,456
Sullivan	2,105,638	1,994,687	1,800,012	1,639,492	1,330,679
Sussex	5,530,934	5,082,148	4,468,340	4,059,783	3,236,524
Tri-County	6,525,977	6,195,384	5,658,532	5,122,733	4,229,167
United	7,422,506	7,137,799	6,251,519	5,566,196	4,554,711
Valley	9,177,231	8,549,328	7,694,582	6,957,505	5,563,273
Warren	2,974,793	2,741,810	2,533,829	2,273,870	1,823,688
Total member revenues	103,425,395	97,170,375	87,901,667	81,413,675	65,495,603

Financial statements

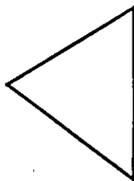


Five-year statement of revenue and expenses



F-3

	1987	1986	1985	1984	1983
Electric energy sales:					
Members	103,425,395	97,170,375	87,901,667	81,413,675	65,495,603
Non-members	31,974,501	42,411,238	43,344,269	28,319,258	12,337,289
Total receipts	135,399,896	139,581,613	131,245,936	109,732,933	77,832,892
Cost of power	41,231,647	43,542,873	43,280,211	51,964,149	50,383,453
Wheeling	6,668,817	5,786,049	6,277,037	6,414,121	5,450,157
SSES:					
Generation					
Operation & Maintenance	14,987,966	16,257,078	14,405,434	8,669,723	2,690,833
Fuel	10,320,233	7,874,925	8,279,668	4,209,158	2,647,300
Depreciation	7,576,680	6,284,511	4,825,542	2,428,770	938,493
Taxes	3,390,699	3,140,926	3,349,637	1,813,050	839,253
Transmission					
Maintenance	194,345	200,626	172,666	164,934	62,000
Depreciation	800,450	780,191	768,673	745,912	312,702
Interest	45,839,094	51,389,042	55,430,177	55,603,868	51,321,801
Interest Charged to					
Construction - Credit	-2,407,405	-3,380,029	-10,149,075	-25,732,692	-38,942,483
General & administrative	4,421,341	4,251,885	2,938,397	3,470,767	1,976,415
Total operation expense	133,023,867	136,128,077	129,578,367	109,751,760	77,679,924
Depreciation	113,532	92,264	79,708	72,384	49,442
Taxes	97,266	95,054	51,742	60,736	46,716
Other deductions	-633,214	-412,172	-546,374	21,001	423,606
Total expenses	132,601,451	135,903,223	129,163,443	109,905,881	78,199,688
Operating margins	2,798,445	3,678,390	2,082,493	-172,948	-366,796
Interest income	1,522,193	1,498,530	2,030,556	2,661,552	1,400,179
Other - profit/(loss) net	245,604	-76,186	-62,573	350,127	165,547
Other capital credits	17,668	55,254	477,634	148,387	39,002
Net margins	4,583,910	5,155,988	4,528,110	2,987,118	1,237,932



Balance sheets

F-4

October 31,
1987 1986
(In thousands)

Assets

Electric utility plant—Note C		
In service—Note B	\$584,815	\$558,098
Construction work in process	26,112	23,267
Nuclear fuel in process	17,473	20,650
	<u>628,400</u>	<u>602,015</u>
Less accumulated depreciation and amortization	55,662	38,651
	<u>572,738</u>	<u>563,364</u>
Other assets and investments		
Non-utility property, at cost (net of accumulated depreciation of \$1,047 in 1987 and \$928 in 1986)	5,202	5,668
Investments in associated organizations—Note D	4,392	5,009
Construction advances	574	327
Other non-current assets	3,968	4,304
	<u>14,136</u>	<u>15,308</u>
Current assets		
Cash and short-term investments of \$22,539 in 1987 and \$5,675 in 1986	22,510	5,257
Accounts receivable from members	8,453	8,022
Other accounts receivable	3,463	2,564
Other	428	213
	<u>34,854</u>	<u>16,056</u>
	<u>\$621,728</u>	<u>\$594,728</u>

October 31,
1987 1986
(In thousands)

Equities and liabilities

Equities

Memberships	\$ 3	\$ 3
Donated capital	50	50
Patronage capital	34,174	29,590
	34,227	29,643

Long-term debt, less current portion—Note F	517,156	494,452
--	----------------	----------------

Current liabilities

Notes payable—Note E	28,400	30,646
Current portion of long-term debt—Note F	6,690	7,744
Accounts payable and accrued expenses	13,187	11,722
Accounts payable to members	2,499	209
	50,776	50,321

Deferred credits

Deferred income tax benefits from Safe Harbor lease—Note G	14,408	15,087
Other	5,161	5,225
	19,569	20,312
	\$621,728	\$594,728

See notes to financial statements.

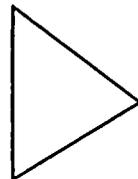
Statements of operations and patronage capital

F-6

	Year Ended October 31,	
	1987	1986
	(In thousands)	
Operating revenue, including sales to members of \$103,425 in 1987 and \$97,170 in 1986	\$135,400	\$139,582
Operating expenses:		
Purchased power	41,232	43,543
Transmission	6,863	5,987
Production	14,975	16,245
Fuel	10,320	7,875
Depreciation	8,491	7,156
Taxes	3,397	3,148
Administrative and general	4,525	4,353
	89,803	88,307
Operating margin before interest and other deductions	45,597	51,275
Interest and other deductions:		
Interest expense	45,839	51,560
Allowance for funds used during construction	(2,407)	(3,380)
Other deductions (credits), net	(6)	(43)
	43,426	48,137
Operating margin	2,171	3,138
Non-operating margins:		
Net non-operating rental income (expense)	246	(76)
Interest income	1,488	1,365
	1,734	1,289
Margin before income taxes	3,905	4,427
Deferred income tax benefits from Safe Harbor lease	679	729
Net margin	4,584	5,156
Patronage capital at beginning of year	29,590	24,434
Patronage capital at end of year	\$ 34,174	\$ 29,590

See notes to financial statements.

Statements of changes in financial position

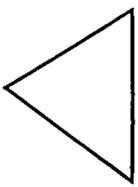


F-7

Year Ended October 31,
1987 1986
(In thousands)

Source of working capital		
Net margin	\$ 4,584	\$ 5,156
Charges (credits) to margin not affecting working capital:		
Depreciation	8,626	7,291
Fuel amortization	8,784	6,775
Deferred income tax benefits from Safe Harbor lease	(679)	(729)
Total from operations	21,315	18,493
Additions to long-term debt	27,494	4,990
Decrease in construction advances	-	521
Other sources	953	2,270
	49,762	26,274
Application of working capital		
Additions to electric utility plant	26,318	25,371
Reduction of long-term debt	4,790	15,686
Increase in construction advances	247	-
Other applications	64	71
	31,419	41,128
Increase (decrease) in working capital	\$18,343	\$(14,854)
Changes in components of working capital		
Increase (decrease) in current assets:		
Cash and short-term investments	\$17,253	\$(10,985)
Accounts receivable from members	431	814
Other accounts receivable	899	(596)
Other	215	(337)
	18,798	(11,104)
Increase (decrease) in current liabilities:		
Notes payable	(2,246)	3,172
Current portion of long-term debt	(1,054)	741
Accounts payable and accrued expenses	1,465	1,316
Accounts payable to members	2,290	(1,479)
	455	3,750
Increase (decrease) in working capital	\$18,343	\$(14,854)

See notes to financial statements.



Notes to financial statements

F-8

Note A — Summary of significant accounting policies

Allegheny Electric Cooperative, Inc. (Allegheny) is a rural electric cooperative utility established under the laws of the Commonwealth of Pennsylvania. Financing assistance is provided by the U.S. Department of Agriculture, Rural Electrification Administration (REA) and, therefore, Allegheny is subject to certain rules and regulations promulgated for rural electric borrowers by REA. Allegheny is a generation and transmission cooperative, providing power supply to fourteen owner/members who are rural electric distribution cooperative utilities providing electric power to consumers in certain areas of Pennsylvania and New Jersey.

Allegheny maintains its accounting records in accordance with the Federal Energy Regulatory Commission's chart of accounts as modified and adopted by REA.

Electric utility plant and depreciation: The electric utility plant is stated at cost, which includes an allowance for funds used during construction. Depreciation is provided on the modified sinking fund method for nuclear utility plant production assets and the straight-line method for all other assets, except nuclear fuel. The cost of units of property retired or replaced is removed from utility plant accounts and charged to accumulated depreciation.

Nuclear fuel: Nuclear fuel usage is charged to fuel expense based on the quantity of heat produced for electric generation. Under the Nuclear Waste Policy Act of 1982, the U.S. Department of Energy (DOE) is responsible for the permanent storage and disposal of spent nuclear fuel removed from nuclear reactors. Allegheny currently pays to Pennsylvania Power & Light Company (PP&L), co-owner of Susquehanna Steam Electric Station (SSES), its portion of DOE fees for such future disposal services.

Cost of decommissioning nuclear plant: Allegheny's portion of the estimated decommissioning costs of SSES is charged to operating expenses over the estimated useful life of the plant.

Allowance for funds used during construction: Allowance for funds used during construction represents the cost of directly related borrowed funds used for construction of electric utility plant. The allowance is capitalized as a component of the cost of electric utility plant while under construction.

Investments in associated organizations: Investments in associated organizations are carried at cost.

Preliminary Surveys: Costs of preliminary surveys for potential development projects are recorded as deferred charges in other noncurrent assets. If construction of a project results from such surveys, the deferred charges are transferred to the cost of the facilities. If a preliminary survey is abandoned, the costs incurred are written off.

Short-Term Investments: Short-term investments are carried at cost, plus accrued interest, which approximates market value.

Income Taxes: Investment tax credits, other than those sold through the Safe Harbor lease arrangement, are accounted for under the flow-through method whereby credits are recognized as a reduction of income tax expense in the year in which the credit is utilized for tax purposes.

The Tax Reform Act of 1986 (the Act), enacted on October 22, 1986, repealed the Investment Tax Credit as of January 1, 1986. Provisions exist within the Act which allow for investment tax credits on certain property referred to as "transition property" placed in service after December 31, 1985. During the years ended October 31, 1987 and 1986, Allegheny placed in service transition property eligible for investment tax credits.

Variations in the customary relationship between pretax accounting income and income tax expense are the result of patronage dividends. Net operating losses for financial and tax reporting purposes differ as a result of timing differences relating primarily to depreciation.

Accounting for Phase-In Plans: In August 1987, the Financial Accounting Standards Board issued Statement No. 92, "Regulated Enterprises - Accounting for Phase-in Plans" (Statement). The Statement specifies the accounting for existing and future phase-in plans and is effective for fiscal years beginning after December 15, 1987. The Statement, if ultimately determined to be applicable to Allegheny, would require Allegheny to recognize an immediate charge against income for the difference between the modified sinking method of depreciation currently used for nuclear utility plant production assets and the straight-line method of depreciation. The difference between these two methods is approximately \$21.9 million at October 31, 1987 and is estimated to be approximately \$25.8 million at October 31, 1988, the effective date of the Statement for Allegheny. Management is currently evaluating the potential alternatives available to minimize the charge against income which may be required as a result of this Statement, including modifying the existing phase-in plan or obtaining REA approval to avoid having to apply the Statement.

Note B — Electric utility plant in service

Electric utility plant in service consists of the following:

	Depreciation/ amortization, lives/rates	October 31, 1987	1986
		(In thousands)	
Nuclear utility plant:			
Production	39 years	\$502,283	\$482,021
Transmission	2.75%	30,174	29,713
General plant	3%-12.5%	827	829
Nuclear fuel	Heat production	50,368	44,466
Non-nuclear utility plant	3%-33%	1,163	1,069
Total		\$584,815	\$558,098

Note C — Susquehanna Steam Electric Station

Allegheny owns a 10% undivided interest in SSES. PP&L owns the remaining 90%. Both participants provide their own financing. Allegheny's portion of costs associated with the station totalled \$605 million and \$596 million at October 31, 1987 and 1986, respectively. Allegheny's share of anticipated costs for ongoing construction and nuclear fuel for SSES are estimated to be approximately \$39.2 million over the next four years. Allegheny receives a portion of the total station output equal to its percentage ownership. The statement of operations reflects Allegheny's share of fuel and other operating costs associated with the station.

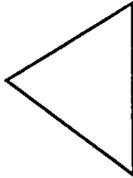
Note D — Investments in associated organizations

Investments in associated organizations consist primarily of National Rural Utilities Cooperative Finance Corporation (CFC) patronage capital, "Capital Term Certificates," and "Subordinate Term Certificates," and Baltimore Bank for Cooperatives (BBC) "C" stock. Certificates bear interest at 3 percent and begin maturing in 2025.

Allegheny is required to maintain these investments pursuant to certain loan and guarantee agreements.

Note E — Notes payable

Allegheny has short-term lines of credit available with banks and CFC of \$52 million of which \$2.0 million was outstanding at October 31, 1986. There were no amounts outstanding at October 31, 1987. Interest rates are generally at prime plus 1%.



Notes payable of \$28.4 million and \$28.6 million were outstanding at October 31, 1987 and 1986, respectively, relating to Pollution Control Revenue Bonds issued by an Industrial Development Authority on Allegheny's behalf. The bonds are subject to purchase on demand of the holder and remarketing on a "best efforts" basis. Sinking fund redemption is scheduled in varying amounts through 2014, and interest is due monthly at variable rates (3.4% to 6.8% for 1987 and 4.0% to 8.3% for 1986). The bonds are convertible to a fixed interest rate and fixed term at Allegheny's option. \$1.8 million of investments included in other noncurrent assets at both October 31, 1987 and 1986 relate to a debt service reserve fund required under the bond indenture.

Restrictions are imposed under short-term credit arrangements including, among other things, maintenance of ratio requirements under existing long-term debt arrangements and limitation of total short-term indebtedness outstanding to an amount not to exceed the remaining unadvanced portion of certain existing REA long-term loan commitments (\$60 million at October 31, 1987).

Note F -- Long-term debt

Long-term debt consists principally of mortgage notes payable for the electric utility plant to REA and to the United States of America acting through the Federal Financing Bank (FFB) and guaranteed by REA, a mortgage loan payable to CFC relating to non-utility property, and commercial paper issued by Allegheny for temporary construction financing. Substantially all the assets of Allegheny are pledged as collateral. Long-term debt consists of the following:

	October 31, 1987	1986 (In thousands)
Mortgage notes payable to FFB at interest rates varying from 6.473% to 13.820%, due in varying amounts through 2021	\$499,877	\$499,575
Mortgage loan payable to CFC, payable in various quarterly installments, including interest through January 2015. The interest rate was converted during 1987 from a fixed rate of 9.25% to a variable rate. Variable rates ranged from 7.38% to 9.00% for 1987	2,085	2,106
5% mortgage notes payable to REA due in varying amounts through 2015	2,505	417
Commercial paper with interest at 8.275%	19,300	-
Other	79	98
	523,846	502,196
Less current portion	6,690	7,744
	\$517,156	\$494,452

Allegheny has signed a letter of intent to enter into a lease financing arrangement with an outside party (see Note J) and intends to use a portion of the proceeds received under the arrangement to retire its outstanding commercial paper in April 1988. If the arrangement is not consummated, Allegheny intends to retire the outstanding commercial paper in April 1988 through proceeds from long-term borrowings available under an existing financing agreement with REA which provides for advances up to \$41.5 million. Accordingly, the \$19.3 million of commercial paper has been classified as long-term debt at October 31, 1987.

Allegheny has the option on FFB promissory note advances to elect (subject to REA approval) interim maturity dates of not less than two years nor more than seven years after the date of the advance. At the date of the advance or on the maturity of an interim advance, Allegheny may also designate that it desires a long-term maturity of 34 years after the end of the calendar year in which the advance was made. At October 31, 1987, Allegheny had \$34 million of advances maturing within one year which it intends to refinance for 34 years.

Aggregate maturities of long-term debt for the four years subsequent to October 31, 1988 are as follows (in thousands):

1989	\$ 7,165
1990	9,120
1991	10,473
1992	12,849

The above maturity schedule reflects management's intent to convert FFB advances with interim maturity dates to long-term debt. Allegheny has used an interest rate it estimates to be an appropriate long-term rate, based on the October 31, 1987 interest rate, to compute the annual principal requirements.

Allegheny is required by mortgage covenants to maintain certain levels of interest coverage and annual debt service coverage. Allegheny was in compliance with such requirements at October 31, 1987.

Note G — Income taxes

At October 31, 1987, Allegheny had available net operating loss carryforwards of \$2.9 million for financial reporting purposes and \$256.1 million for tax reporting purposes, and investment tax credit carryforwards of approximately \$33.5 million for both financial and tax reporting purposes, expiring through 2002. Under the Tax Reform Act of 1986, the amount of investment tax credit allowable as a result of a carryforward must be reduced by 35%.

In 1983, Allegheny sold certain investment and energy tax credits and depreciation deductions pursuant to a Safe Harbor lease. The proceeds from the sale, including interest earned thereon, have been deferred and are being recognized over the term of the lease (30 years). The net proceeds and related interest were required by REA to be used to retire outstanding FFB debt.

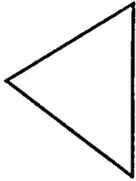
Under the terms of the Safe Harbor lease, Allegheny is contingently liable in varying amounts in the event the lessor's tax benefits are disallowed and in the event of certain other occurrences. The maximum amount for which Allegheny was contingently liable approximated \$21 million at October 31, 1987. Payment of this contingent liability has been guaranteed by CFC.

Note H — Related party transactions

Allegheny has an arrangement with an associated organization, Pennsylvania Rural Electric Association (PREA), under which PREA provides Allegheny with certain management, general, and administrative services on a cost reimbursement basis. Total costs for the services provided for the years ended October 31, 1987 and 1986, were \$1.8 million and \$2.1 million, respectively.

Note I — Commitments and contingencies

Allegheny and PP&L are members of certain insurance programs which provide coverage for property damage to members' nuclear generating plants. Allegheny's portion of the facilities at SSES is insured against property damage losses up to \$139.5 million under these programs. Allegheny is also a member of an insurance program which provides coverage for the cost of replacement power during prolonged outages of nuclear units caused by certain specified conditions. Under the property and replacement power insurance programs, Allegheny could be assessed retrospective premiums in the event the insurers' losses exceed their reserves. The maximum amount Allegheny could be assessed under these programs during the current policy year is \$1.5 million.



Allegheny's public liability for claims resulting from a nuclear incident is currently limited to \$72 million under provisions of the Price-Anderson Act (Act). Allegheny is protected against this potential liability by a combination of commercial insurance and an industry retrospective assessment program.

In the event of a nuclear incident at any of the facilities owned by others and covered by the Act, Allegheny could be assessed up to \$1 million per incident, but not more than \$2 million in a calendar year in the event more than one incident is experienced. Congress is in the process of amending the Act. The proposed amendments generally include provisions which would increase the public liability limit of utilities in the event of a nuclear incident. Management is unable to predict what action Congress might ultimately take regarding the Act and what effect such action might have on Allegheny's potential liability.

Allegheny is currently constructing a hydroelectric generation facility at Raystown Dam (the Facility) with operations expected to begin in 1988. In addition, Allegheny is also purchasing equipment for a project to reduce peak power demand (Load Management Project). Temporary construction financing for the Facility is being made through short-term commercial paper issued by Allegheny (see Notes F and J). Financing for the Load Management Project has been arranged with REA (\$7.3 million) and CFC (\$3.2 million). At October 31, 1987, total project costs of the Facility and Load Management Project were estimated at \$33 million and \$11.4 million, respectively. Costs incurred through October 31, 1987 were \$20.8 million for the Facility and \$4.7 million for the Load Management Project.

On July 31, 1987, Allegheny entered into an agreement with Sithe Energies USA, Inc. (Sithe) to transfer its interests in the development of the Allegheny River Locks and Dams Number 8 and 9 Hydroelectric Project to Sithe. Interests to be transferred included Allegheny's license granted by the Federal Energy Regulatory Commission (FERC) to construct the hydroelectric project. The agreement calls for three payments to be made by Sithe. The first payment, in the amount of \$250,000, was received and recorded by Allegheny in November 1987 in exchange for deliverance of evidence of release of any liens or claims against the FERC license. The second and third payments are contingent upon certain events as follows. These payments will be recorded when the amounts become payable under the terms of the agreement.

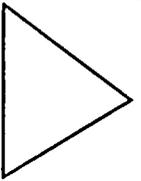
\$1.4 million payable upon the execution by Sithe of a power purchase agreement for sale of all or part of the energy and capacity produced by the project.
\$800 thousand payable upon consummation of construction financing or 12 months subsequent to the date of execution of the aforementioned power purchase agreement.

In addition, FERC requires that construction must begin by March 1989. Title to the project reverts back to Allegheny after 40 years of operation or on August 24, 2030, whichever is earlier.

Note J — Lease financing arrangement

On September 23, 1987, Allegheny signed a letter of intent to enter into a lease financing arrangement with Ford Motor Credit Company (Ford) for the Facility (see Note I). Under terms of the arrangement, Allegheny will sell the Facility to Ford for an amount equal to its fair market value, not to exceed \$30 million plus or minus ten percent. The Facility will then be leased back to Allegheny for an initial term of 30 years. The arrangement is expected to qualify for treatment as an operating lease. At the end of the 30-year term, Allegheny will have the option to purchase the Facility for an amount equal to the Facility's fair market value. Allegheny also has the option to renew the lease as provided in the arrangement. Allegheny will retain co-licensee status for the Facility throughout the term of the arrangement.

In accordance with the letter of intent, Allegheny made a commitment deposit to Ford on November 11, 1987 in the amount of \$150,000. The deposit will be applied to Allegheny's first rental payment. The arrangement is expected to be consummated in April 1988.



300 Locust Court
212 Locust Street
Harrisburg, Pennsylvania 17101
717/232-7575

Board of Directors
Allegheny Electric Cooperative, Inc.
Harrisburg, Pennsylvania

We have examined the balance sheets of Allegheny Electric Cooperative, Inc. as of October 31, 1987 and 1986, and the related statements of operations and patronage capital and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Allegheny Electric Cooperative, Inc. at October 31, 1987 and 1986, and the results of its operations and changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

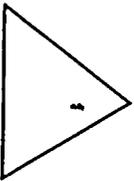
Ernst & Whinney

Harrisburg, Pennsylvania
January 22, 1988

Summary of operations — Allegheny member systems

F-14

	Adams EC, Inc. A. Daniel Murray Manager	Bedford REC, Inc. Wayne Miller Manager	Central EC, Inc. Larry S. Adams Manager	Claverack REC, Inc. Leo A. Davenport Manager	New Enterprise REC, Inc. Rick L. Eichelberger Manager	Northwestern RECA, Inc. Harry C. Grube Manager
Summary of operations						
Operating revenue	\$22,150,227	\$7,164,953	\$16,633,266	\$13,362,818	\$2,640,755	\$15,170,419
Operating expenses						
Purchased power	\$14,337,815	\$4,655,224	\$10,530,946	\$8,190,131	\$2,058,667	\$10,213,704
Operations & maintenance	\$4,105,404	\$1,316,656	\$3,711,774	\$2,866,532	\$703,862	\$2,823,926
Depreciation	\$1,206,568	\$307,479	\$726,470	\$756,221	\$102,000	\$713,691
Taxes	\$177,330	\$58,768	\$130,452	\$168,775	\$19,388	\$191,969
Interest	\$1,281,567	\$299,246	\$944,332	\$686,188	\$0	\$694,029
Cost of electric service	\$21,108,684	\$6,637,373	\$16,043,974	\$12,667,847	\$2,883,918	\$14,637,319
Operating margins	\$1,041,544	\$527,580	\$589,292	\$694,971	(\$243,163)	\$533,100
Non-operating margins & capital credits	\$805,178	\$299,378	\$678,446	\$534,925	\$39,007	\$790,671
Net margins	\$1,846,721	\$826,958	\$1,267,738	\$1,229,896	(\$204,156)	\$1,323,771
Assets						
Total utility plant	\$38,085,838	\$11,544,423	\$27,507,573	\$25,343,603	\$3,036,012	\$26,762,467
Less accumulated depreciation	\$8,234,269	\$3,715,658	\$7,395,747	\$6,540,979	\$1,314,148	\$7,006,746
Net utility plant	\$29,851,569	\$7,828,765	\$20,111,826	\$18,802,624	\$1,721,864	\$19,755,721
Other property & investments	\$5,775,701	\$1,845,966	\$4,266,971	\$3,299,239	\$671,978	\$4,728,826
Current & accrued assets	\$4,938,566	\$1,773,629	\$5,015,400	\$2,553,843	\$284,034	\$2,695,284
Deferred debits	\$306,369	\$39,304	\$114,076	\$8,228	\$0	\$31,419
Total assets	\$40,872,205	\$11,487,664	\$29,508,273	\$24,663,934	\$2,677,876	\$27,211,250
Liabilities						
Margins & equities	\$15,202,661	\$5,319,939	\$12,183,648	\$9,052,616	\$2,515,063	\$12,798,588
Long-term debt	\$23,911,909	\$5,393,528	\$15,660,924	\$14,245,258	\$0	\$12,911,948
Current & accrued liabilities	\$1,745,635	\$533,042	\$1,436,250	\$1,186,111	\$162,813	\$1,375,353
Other credits & reserves	\$12,000	\$241,155	\$227,451	\$179,949	\$0	\$125,361
Total liabilities	\$40,872,205	\$11,487,664	\$29,508,273	\$24,663,934	\$2,677,876	\$27,211,250
Other Statistics						
Miles of line	2,327	1,103	2,880	2,282	280	2,299
Consumers served	19,701	7,303	21,123	13,766	2,707	15,684
Consumers per mile	8.5	6.6	7.3	6.0	9.7	6.8
Kwh sold per consumer	11,931	10,088	8,073	9,224	11,382	10,373
Mwh sales	235,047.6	73,671.6	170,522.2	126,976.8	30,811.6	162,688.8
Annual revenue per consumer	\$1,124	\$981	787	\$971	\$976	\$967
Plant investment per consumer	\$1,515	\$1,072	\$952	\$1,366	\$636	\$1,260
Revenue per mile of line	\$9,519	\$6,496	\$5,775	\$5,856	\$9,431	\$6,599



Somerset REC, Inc. Harold E. Nicholson Manager	Southwest Central RECC Richard S. Orange Manager	Sullivan County REC, Inc. Edward A. Dezich Manager	Sussex REC, Inc. Benjamin A. Pitts Manager	Tri-County REC, Inc. Robert O. Toombs Manager	United EC, Inc. Donald A. Widder Manager	Valley REC, Inc. D.W. Smith Manager	Warren EC, Inc. H. Richard Slagle Manager	Total
\$11,346,607	\$17,871,044	\$3,374,876	\$10,993,708	\$11,170,298	\$12,556,285	\$14,210,350	\$4,605,536	\$163,251,143
\$7,925,795	\$13,897,140	\$2,207,589	\$5,711,737	\$6,684,824	\$7,636,436	\$9,461,673	\$3,040,024	\$106,551,705
\$1,698,047	\$2,725,486	\$695,273	\$1,774,630	\$2,449,742	\$2,706,452	\$2,301,307	\$921,692	\$30,800,784
\$485,450	\$749,830	\$183,882	\$587,048	\$695,151	\$770,239	\$773,846	\$255,125	\$8,313,000
\$107,565	\$126,194	\$33,673	\$1,233,628	\$122,155	\$76,874	\$115,703	\$42,652	\$2,605,126
\$634,604	\$909,351	\$175,197	\$675,233	\$858,353	\$934,951	\$481,479	\$160,276	\$8,734,806
\$10,851,461	\$18,408,001	\$3,295,614	\$9,982,276	\$10,810,225	\$12,124,952	\$13,134,008	\$4,419,770	\$157,005,421
\$495,146	(\$536,957)	\$79,262	\$1,011,432	\$360,073	\$431,333	\$1,076,342	\$185,767	\$6,245,722
\$603,944	\$775,468	\$147,365	\$464,701	\$742,032	\$549,314	\$615,991	\$231,589	\$7,278,009
\$1,099,090	\$238,511	\$226,627	\$1,476,133	\$1,102,105	\$980,647	\$1,692,333	\$417,356	\$13,523,231
\$18,922,023	\$28,032,925	\$6,747,945	\$17,648,120	\$26,993,088	\$28,990,705	\$28,036,201	\$9,516,205	\$297,167,127
\$3,969,833	\$4,381,814	\$2,220,142	\$3,238,929	\$6,863,341	\$7,415,972	\$7,508,775	\$3,264,474	\$73,070,807
\$14,952,190	\$23,651,111	\$4,527,803	\$14,409,191	\$20,129,747	\$21,574,733	\$20,527,426	\$6,251,730	\$224,096,300
\$3,422,231	\$4,918,452	\$1,021,604	\$2,351,016	\$3,290,283	\$3,402,724	\$3,770,021	\$1,347,950	\$44,112,963
\$2,956,723	\$1,822,903	\$684,237	\$2,325,029	\$1,872,920	\$2,921,222	\$2,568,784	\$775,830	\$33,188,405
\$11,098	\$49,392	\$38,040	\$44,845	\$9,380	\$100,929	\$35,199	\$0	\$788,279
\$21,342,242	\$30,441,858	\$6,271,684	\$19,130,081	\$25,302,330	\$27,999,608	\$26,901,431	\$8,375,510	\$302,185,947
\$8,608,020	\$13,211,810	\$2,403,635	\$5,557,950	\$8,929,741	\$8,713,573	\$15,579,111	\$5,075,099	\$125,151,455
\$11,835,673	\$15,700,405	\$3,590,858	\$11,196,371	\$15,255,208	\$18,274,125	\$9,803,342	\$3,154,848	\$160,934,397
\$785,512	\$1,465,901	\$273,533	\$2,261,452	\$1,003,426	\$1,010,449	\$1,202,299	\$131,413	\$14,573,188
\$113,037	\$63,742	\$3,659,	\$114,308	\$113,955	\$1,461,	\$316,679	\$14,150	\$1,526,907
\$21,342,242	\$30,441,858	\$6,271,684	\$19,130,081	\$25,302,330	\$27,999,608	\$26,901,431	\$8,375,510	\$302,185,946
1,801	2,385	760	576	2,750	2,576	2,237	1,003	25,258
10,351	18,672	4,622	9,147	14,844	15,468	16,047	8,693	178,128
5.7	7.8	6.1	15.9	5.4	6.0	7.2	8.7	7.1
12,014	11,761	7,392	10,290	6,727	7,502	9,404	5,373	9,462
124,352.2	219,602.5	34,167.7	94,125.9	99,858.6	116,041.6	150,912.4	46,707.4	1,685,486.8
\$1,096	\$957	\$730	\$1,202	\$753	\$812	\$886	\$530	\$916
\$1,445	\$1,267	\$980	\$1,575	\$1,356	\$1,395	\$1,279	\$719	\$1,258
\$6,300	\$7,493	\$4,441	\$19,103	\$4,062	\$4,874	\$6,352	\$4,593	\$6,463

