Allegheny
ELECTRIC COOPERATIVE, INC.

1997 Annual Report

New Ideas For A New Era

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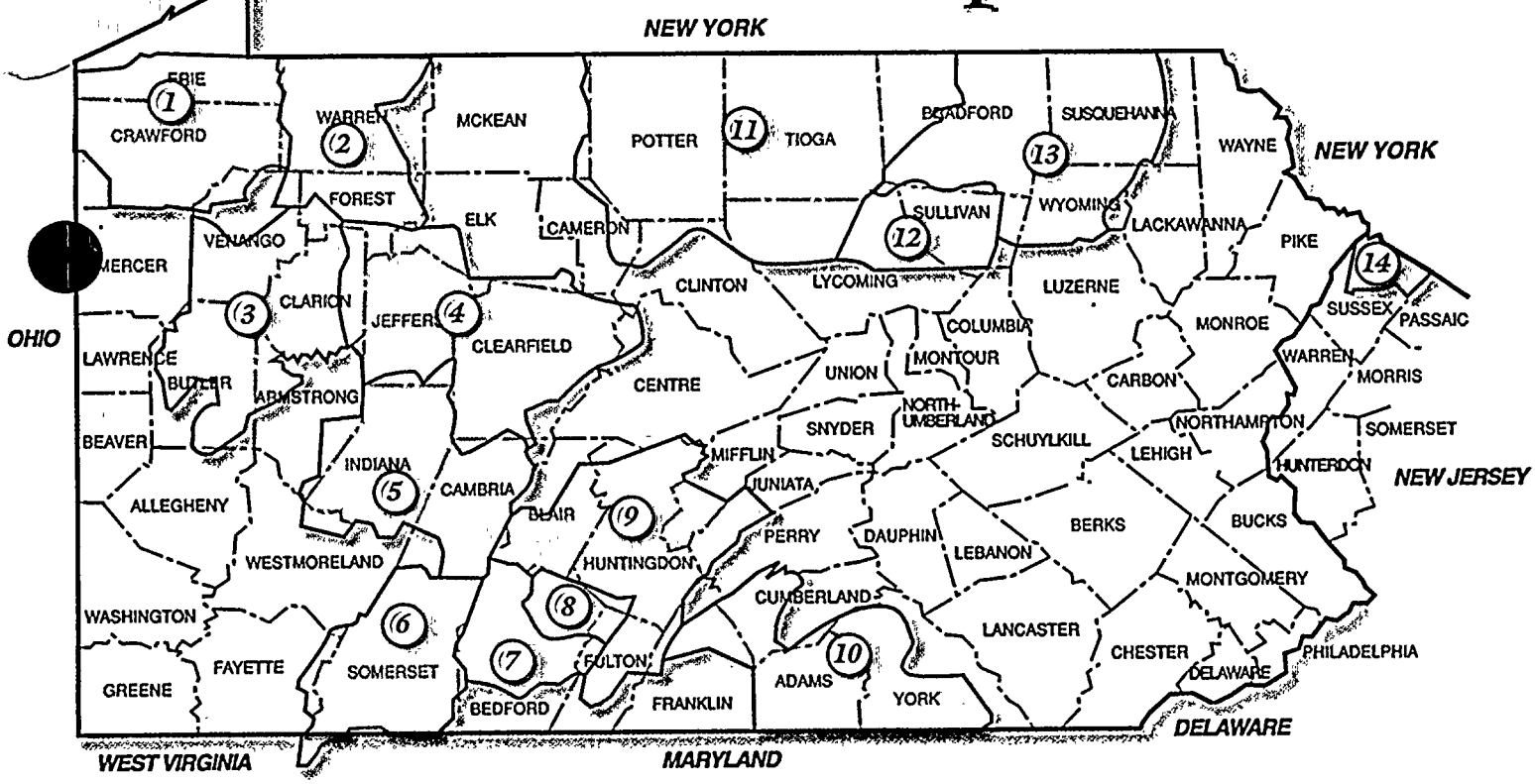
About Allegheny Electric Cooperative, Inc.

Allegheny Electric Cooperative, Inc. provides wholesale power to the 14 electric cooperatives in Pennsylvania and New Jersey. Allegheny's 14 member distribution cooperatives in turn provide electricity to more than 600,000 consumers.

Allegheny is owned and controlled by the 14 distribution cooperatives, which govern its activities. Each member cooperative has one seat on Allegheny's board, ensuring that Allegheny's actions will best serve the consumer-members who depend on the cooperatives for electricity.

Allegheny's member cooperatives own and maintain approximately 12.5 percent of the electric distribution lines in Pennsylvania, covering nearly one-third of the state's land area in 41 counties. These lines, an essential component of business and industry, represent one of the Commonwealth's largest non-government investments in rural infrastructure.

Member Map



1 Northwestern Rural Electric Cooperative Association, Inc.
2 Warren Electric Cooperative, Inc.
3 Central Electric Cooperative, Inc.
4 United Electric Cooperative, Inc.
5 Southwest Central Rural Electric Cooperative Corporation
6 Somerset Rural Electric Cooperative, Inc.
7 Bedford Rural Electric Cooperative, Inc.
8 New Enterprise Rural Electric Cooperative, Inc.
9 Valley Rural Electric Cooperative, Inc.
10 Adams Electric Cooperative, Inc.
11 Tri-County Rural Electric Cooperative, Inc.
12 Sullivan County Rural Electric Cooperative, Inc.
13 Claverack Rural Electric Cooperative, Inc.
14 Sussex Rural Electric Cooperative, Inc.

A Message From The Chairman & President and CEO

From left to right: Frank M. Betley, President and CEO, and Alston A. Teeter, Chairman of the Board.

New Ideas for A New Era. This theme sums up a year of major changes at Allegheny Electric Cooperative, Inc. — changes required by our rapid entry into the competitive electric utility marketplace.

Within the next few years, every consumer in Pennsylvania and New Jersey will be given the chance to choose the company that supplies his or her electric generation. This "customer choice," in fact, began a year of testing in Pennsylvania during 1997, as more than 250,000 consumers of the Commonwealth's largest private power companies (covering 5 percent of load in each customer class) became eligible to shop for power. In 1998, two of Allegheny's 14 member distribution co-ops will launch

customer choice pilot programs of their own, totaling more than 8,500 consumers.

The demands of deregulation dictate that we focus on the ultimate key to success — emphasizing strengths while minimizing weakness. Creating a long-range plan that will accomplish as much became our number one goal during 1997.

In March, the Allegheny board directed that a top-to-bottom review of the organization be conducted. This initiative, called Strategy 138 — after Act 138, Pennsylvania's electric competition law — has provided Allegheny with a new organizational structure that will better ensure the future success of electric cooperatives in the states we serve.

Coupled with this, we have been pulling out the stops to improve Allegheny's competitive position. In this vein, we gained permission from our lenders to offer a 10 percent competitive discount on wholesale power generation rates to member co-ops for the period of January to June 1998. This credit will be self-funded by Allegheny and will not affect our base rate.

One of the most important aspects of this rate reduction is that all wholesale cost savings will be passed directly through to co-op consumer-members. As a result, all co-op members will benefit. This savings stands in stark contrast to our competition. While some private power companies and other generation suppliers are promising savings only to those relatively few consumers selected for customer choice pilot programs, we are delivering savings to all co-op consumers, whether they're in a pilot or not.

In March, the Allegheny board directed that a top-to-bottom review of the organization be conducted. This initiative, called Strategy 138 — after Act 138, Pennsylvania's electric competition law — has provided Allegheny with a new organizational structure that will better ensure the future success of electric cooperatives in the states we serve.

We are also investigating new ventures and strategic relationships as a way to bolster our competitive position. As part of this effort, we issued a Request for Proposals to seek potential alliances, purchase of generating and transmission assets or alternative transactions involving components of Allegheny's system. A June 1998 closing date has been scheduled for any transactions that may add value.

Despite the uncertainties faced by all generation companies, the qualities that have defined Allegheny and our members as cooperatives for more than 50 years will remain our strength, and our competitive edge. Those include qualities like giving consumers a strong voice through local, democratic member control; a community presence and concern unmatched by any of our competitors; and the ability to provide services beyond just generating and distributing electricity.

In the world of competition, change is swift and rewards go to the nimble. Through our member electric distribution co-ops, Allegheny is close to end-use customers — thousands of industries, businesses, residences, farms and seasonal camps across rural Pennsylvania and New Jersey. This gives us the ability to rapidly meet changing consumer needs.

We are confident that Allegheny will remain the first choice in generation for electric co-op consumer-members. After all, co-op consumers have a major stake in Allegheny, too. It is, literally, the electric generation company they own.

Cooperatively yours,

Alston A Teeter

Alston Teeter
Chairman

Frank M. Betley

Frank M. Betley
President and CEO

Customer Choice In Pennsylvania and New Jersey

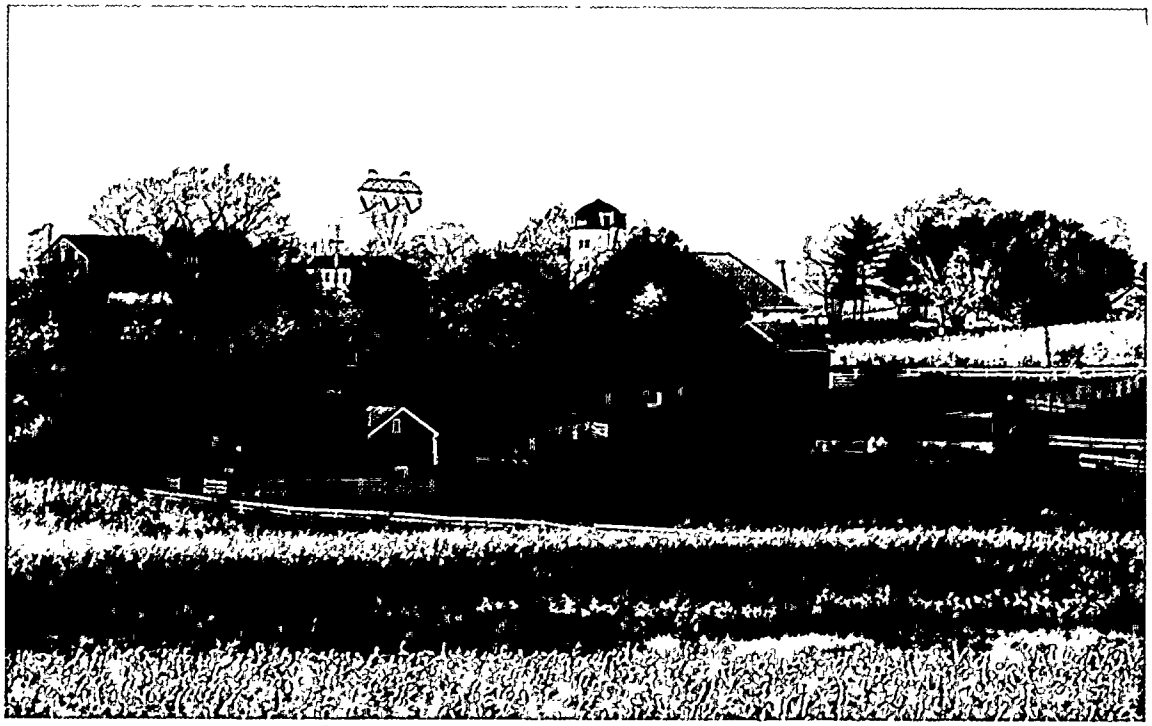
Pennsylvania's Electricity Generation Customer Choice and Competition Act (Act 138), signed into law on December 3, 1996, provides a classic case of how generation and transmission co-operatives, like Allegheny, can craft a level playing field in a rapidly changing political environment.

The new law allows Pennsylvania's retail electric customers — including electric co-op members — to choose the company that generates their electricity. This means consumers will no longer have to buy electric generation from the utility that delivers it to their home or business — they will be able to "shop for power."

Customer choice will begin for one-third of each consumer class (residential, commercial and industrial) on January 1, 1999. Another third will be phased in by January 1, 2000, with full customer choice in effect statewide by January 1, 2001.

The measure also treats electric co-ops and private power companies separately, something that Pennsylvania's 13 electric co-ops demanded throughout the process.

Electric utility competition legislation in Pennsylvania — made a priority by Governor Tom Ridge as part of his economic revitalization efforts — passed in late November 1996 with strong bipartisan support. Groundwork for passage, though, began through public hearings held by the state Public Utility Commission (PUC) and various state House and Senate committees over the previous two years.



Building on public input, utility representatives, industries, labor groups, environmental organizations, consumer advocates, key legislators and the Governor's

office — under the watchful eye of PUC Chairman John Quain — opened two grueling months of negotiations in September and October 1996 to craft a compromise. The end result was a system of electric competition that gives all parties everything they need, though not necessarily everything they want.

Allegheny and its member co-ops initially opposed retail competition. Our arguments from 1992 until 1996 were consistent — under electric utility competition, we contended, some big industries that use a lot of electricity would save money. But the vast majority of electric consumers — the small businesses and residential consumers that use the bulk of *our* electricity — wouldn't be able to tap into the low-cost power market.

The result, we felt, was that small businesses and homeowners — who consume tiny amounts of electricity — would be out-shopped or out-hustled by the big users to capture what few power bargains were available. Electric co-ops championed this "just say no" approach in testimony before the state General Assembly and PUC, and in our many publications.

Our political strategy changed when it became apparent that the "retail wheeling train was going to leave the station" and Pennsylvania's electric co-ops weren't going to be on it. In early September 1996, Governor Ridge — a long-time supporter of the rural electrification program — threw the state's entire electric utility community a bombshell. In private meetings, he announced his desire to have electric utility competition legislation passed and signed before the end of 1996.

Customer choice, the Governor had determined, was going to be the third linchpin — along with business tax cuts and workers' compensation reform — in his effort to make Pennsylvania "job friendly." He also wanted a competition law on the books before Congress got into the act, hoping that any federal bill would grandfather existing state laws.

Thus began two months of negotiations with other stakeholders on a customer choice plan everyone could live with. The process was grinding, with many of our private power competitors pressing for full regulation and taxation of electric co-ops. Fortunately, our legislative friends told the companies that such proposals were "non-starters."

The eventual compromise everyone signed off on included a separate chapter for electric co-ops that treats us, and our consumers, fairly. Among the highlights:

- Electric co-ops can compete for any customers in the state, just like other electric utilities. However, co-ops have to comply with relevant PUC regulations and be certified to sell generation to customers outside their current service territories.

- Co-ops remain fully exempt from PUC regulation when operating within their current service territories, since they are self-regulated utilities.

In addition, co-op consumer protections were added or maintained:

- Universal service protections continue, meaning that everyone, no matter where they may live, will be guaranteed the right to electric service.

- Existing utility service territories remain intact.

- Any power company that provides transmission service to cooperatives must maintain reliability at the same high levels that are provided to other wholesale customers.

- Co-op members that buy generation from their co-op will be protected from higher rates caused when other members "leave the system" to buy power elsewhere. Under the new law, departing customers of all electric utilities may be required to pay a "transition charge" to cover their share of power plant investments.

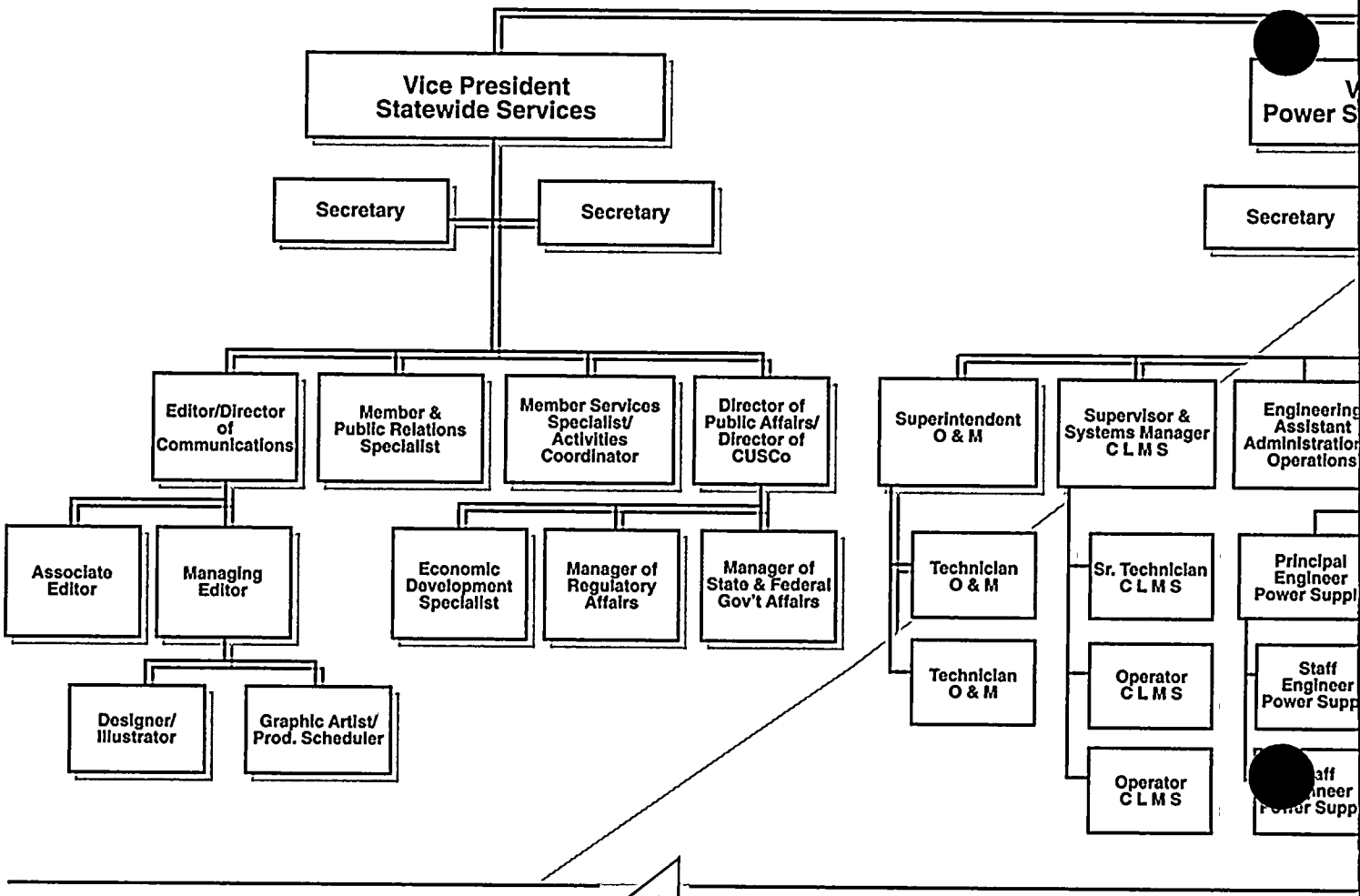
In New Jersey, the state legislature is considering proposals to extend customer choice to consumers, beginning in late 1998. The state's Board of Public Utilities has recommended that 10 percent of a utility's customer load must be open to competition in October 1998, 20 percent by January 1999, 35 percent by April 1999, 50 percent by October 1999, 75 percent in April 2000 and 100 percent by July 2000.

As legislative activity on electric competition continues to unfold, Allegheny and our member electric co-ops will work to ensure that co-op consumer-members not only gain the right to choose their electric generation supplier, but that they remain protected from the excesses of an uncontrolled competitive electricity market. We will do this because we have existed for more than 50 years solely to serve rural residents and rural communities.

A New Look: Gearing Up For Competition

Periods of change are difficult. One of Allegheny Electric Cooperative's major undertakings in 1997 was a complete organizational overhaul dubbed "Strategy 138." Named after Act 138, Pennsylvania's electric competition law, Strategy 138 provides Allegheny and our sister service organization — the Pennsylvania Rural Electric Association (PREA) — with a leaner operating structure that will enable us to more fully meet the challenges of a competitive marketplace.

Strategy 138 results include a new structure for both organizations and a focused strategic direction. Corporate restructuring has created three new service units — Corporate Services, Statewide Services and Power

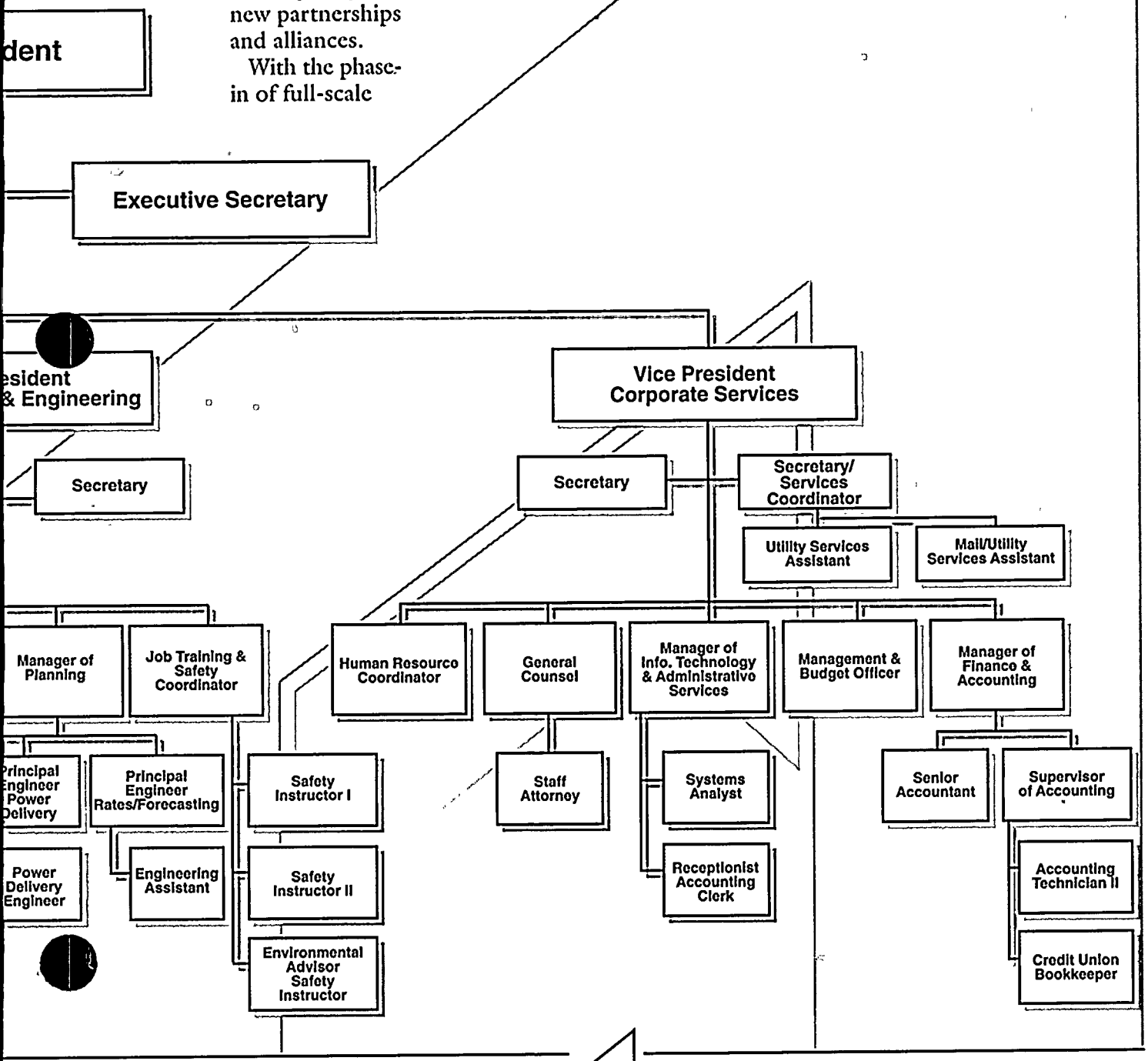


Supply & Engineering (see chart below).

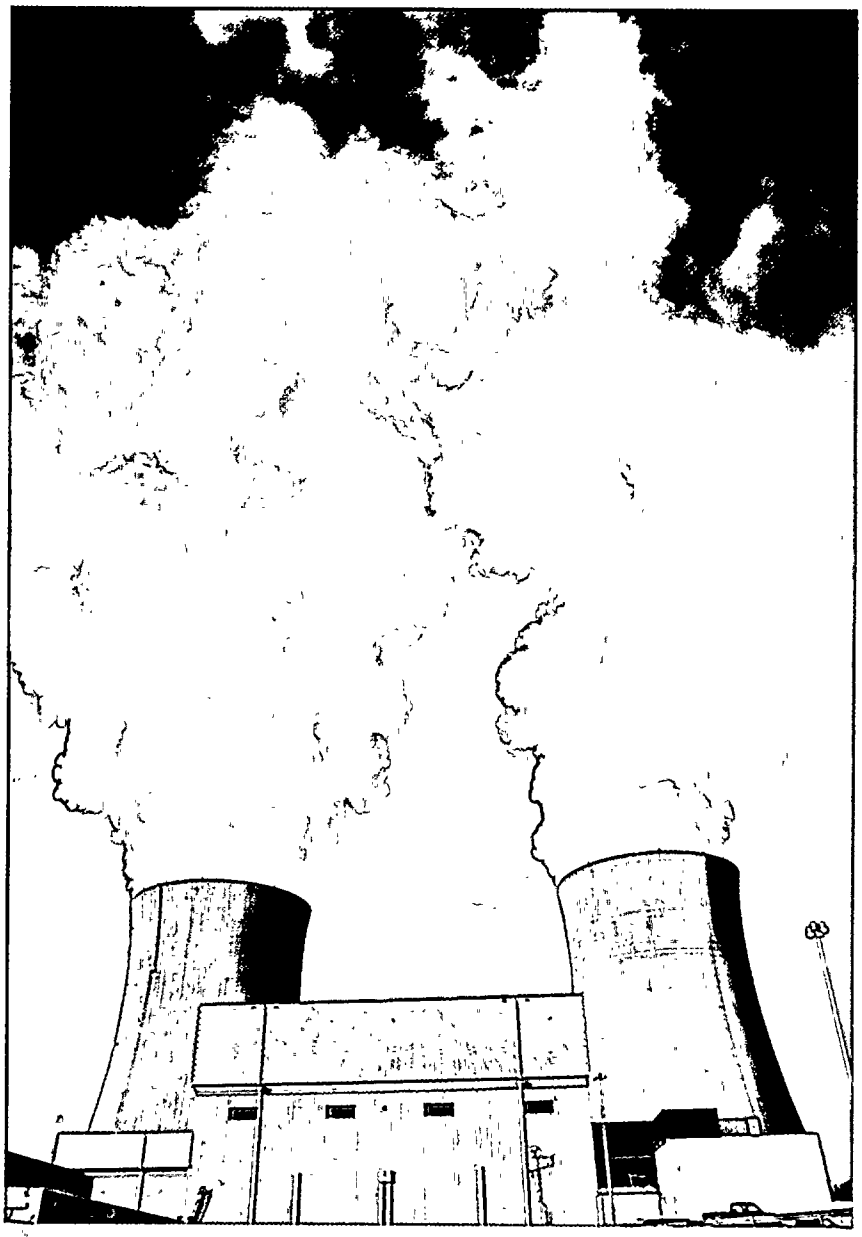
As a result of this process, overhead costs of PREA and Allegheny will be reduced by 20 percent — more than $3 million in annual savings. This is substantial by any measure.

On strategic direction, Allegheny's focus is traditional — provide electricity at the lowest possible cost. This means investigating new partnerships and alliances.

With the phase-in of full-scale electric utility competition to begin in Pennsylvania on January 1, 1999, and perhaps just as early in New Jersey, Allegheny and its member cooperatives realize that "we're not the only game in town anymore." We can not rest on our laurels. We need to continuously generate new ideas and go the extra mile to earn consumer loyalty. Strategy 138 is just one piece of that effort.



Susquehanna Steam Electric Station



Allegheny owns 10 percent of the Susquehanna Steam Electric Station (SSES), a 2,200-megawatt, two-unit nuclear power plant located in Luzerne County, Pa. PP&L, Inc., a private power company based in Allentown, Pa., owns the remaining 90 percent and operates the boiling water reactor facility.

In fiscal 1997, SSES provided 1.57 billion kilowatt-hours of electricity at delivery to Allegheny, supplying 62.6 percent of the cooperative's power supply needs. The capacity factor of SSES Unit 1 was 93.1 percent; Unit 2 was 80.1 percent. This results in an average annual composite capacity factor for the facility of 86.6 percent.

Also during the year, SSES received strong marks in the latest Systematic Assessment of Licensee Performance (SALP) report conducted by the federal Nuclear Regulatory Commission. SSES captured the highest possible "superior" rating in one category — plant support, which includes areas such as radiological controls, emergency planning and security. The plant received the second highest "good" rating in the other three evaluation areas — operations, maintenance and engineering.

The latest SALP report covered the period August 1995 through August 1997. The report concluded that "overall performance of SSES was good during the period. A generally conservative approach was taken to operation of the facility."

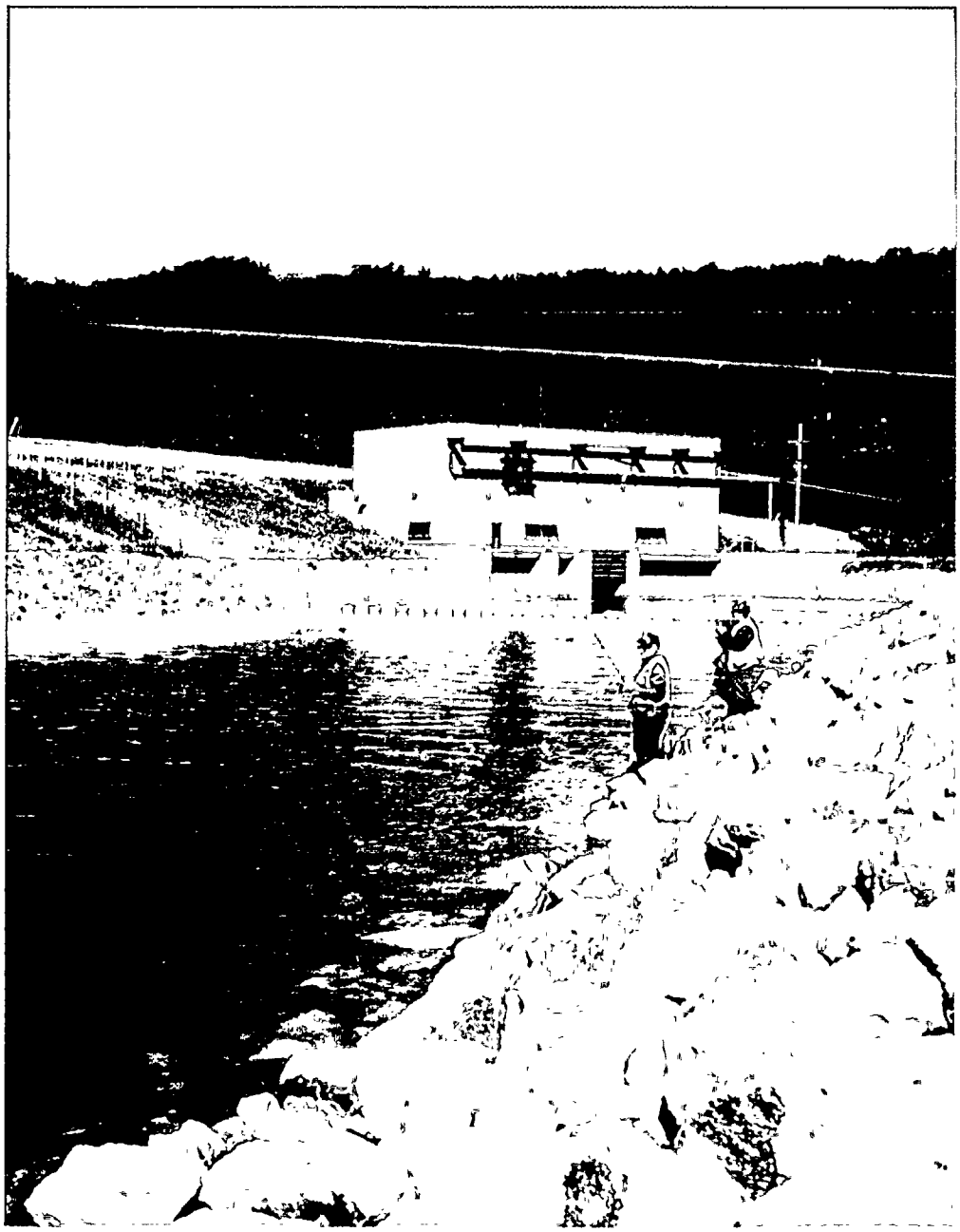
Coordinated Load Management

Allegheny has long recognized the importance of demand-side management as a component of integrated resource planning. In 1986, Allegheny and its member cooperatives launched the Coordinated Load Management System to reduce demand peaks at member co-op substations.

By shifting electricity use of residential water heaters, electric thermal storage units and dual fuel home heating systems from peak demand periods to times of lesser demand, the Coordinated Load Management System improves system efficiency, cuts costly demand charges Allegheny and its member co-ops must pay for purchased power and reduces the need for new generating capacity.

By the end of fiscal 1997, more than 38,000 load control receivers (which switch off controlled appliances) had been installed in the homes of volunteer co-op consumer-members. To date, load management has reduced the purchased power costs of Allegheny's member co-ops by more than $30 million — roughly $6 million in 1997 alone.

Raystown Hydroelectric Project



The Raystown Hydroelectric Project, William F. Matson Generating Station, is a 21-megawatt, run-of-river hydropower facility located at Lake Raystown & Dam in Huntingdon County, Pa. On average, the plant generates approximately 3.6 percent of the energy Allegheny supplies to member cooperatives.

Allegheny operates Raystown in close co-operation with the Baltimore District of the U.S. Army Corps of Engineers. The Corps controls water releases from Lake Raystown, the largest man-made lake in Pennsylvania.

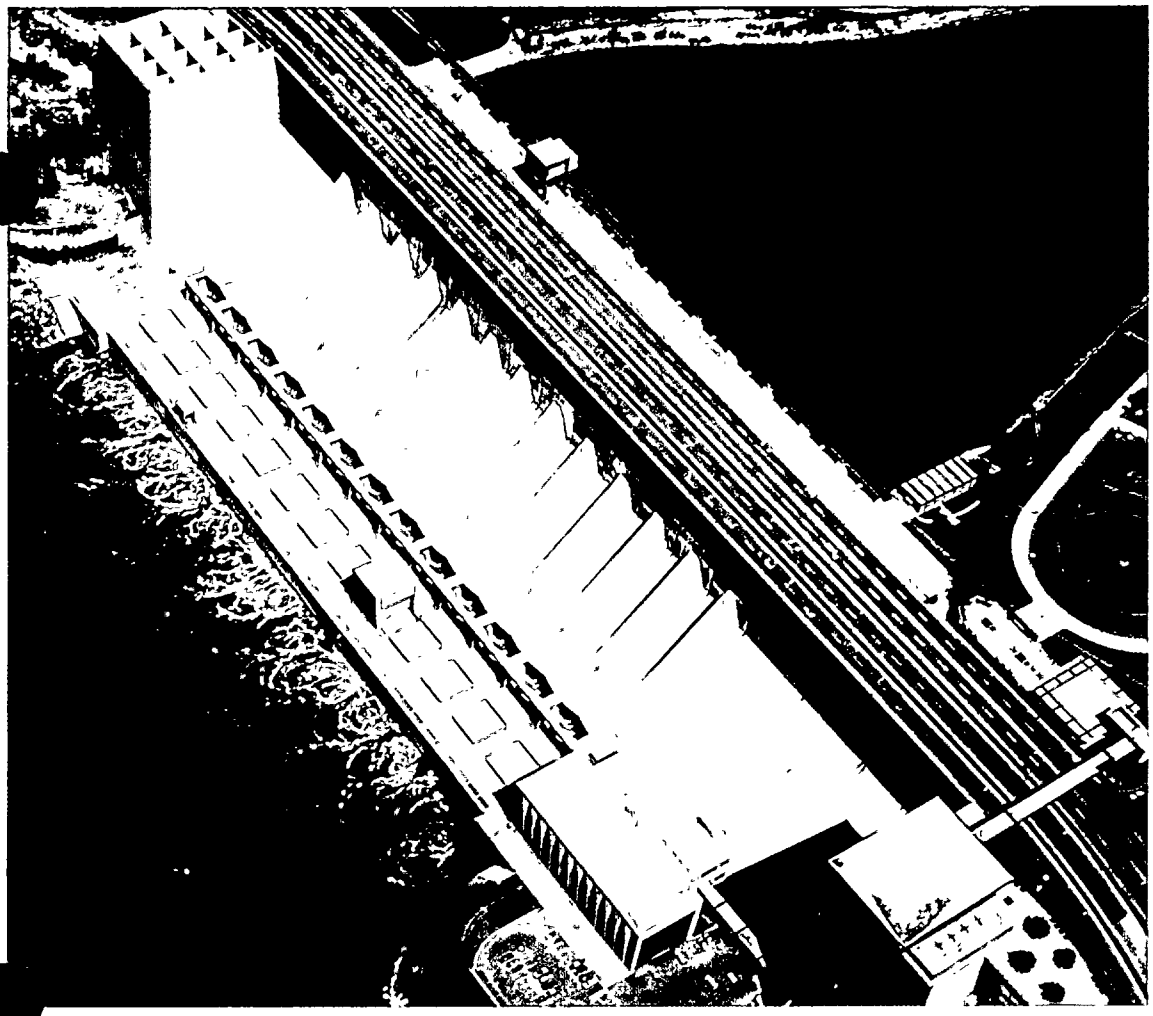
In fiscal 1997, Raystown provided approximately 82 million kilowatt-hours at delivery, slightly above projections. Plant availability of 99.2 percent was recorded, well above the small hydro industry average.

New York Power Authority

Non-profit electric cooperatives and legitimate municipal electric systems within economic transmission distance receive first right, or preference, to 50 percent of the electric power generated at the publicly owned Niagara Power Project of the New York Power Authority (NYPA). A 1990 contract gives Allegheny rights to a portion of this low-cost hydropower through June 30, 2001, with a clause permitting an extension of service through October 31, 2003.

Since it was first purchased in 1966, NYPA power has saved Allegheny more than $250 million compared to the cost of power it would have needed to buy from private power companies. In 1997, Allegheny's NYPA savings amounted to $6.9 million. NYPA accounts for 12.3 percent of Allegheny's power supply needs, but only 4.1 percent of its power costs.

Pennsylvania's NYPA allocation currently stands at 68.2 megawatts (MW), of which Allegheny receives nearly 42 MW. Allegheny also shares the benefits of 2.5 MW allocated to member Sussex Rural Electric Cooperative in New Jersey.



Allegheny Board of Directors

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Tri-County Electric

Lowell Friedline
Vice Chairman
Somerset REC

Sam Eckenrod
Secretary
Southwest Central REC

John McNamara
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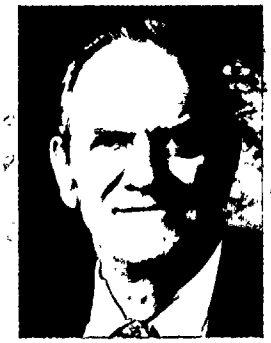
Wayne Hillegass
Bedford REC

George Francisco
Central Electric

John Ritchey
New Enterprise REC

Harold Hines
Northwestern REC



John Anstadt
Sullivan County REC

James Henderson
Sussex REC

Stephen Marshall
United Electric

Harold Ritchey
Valley REC

Dave Turner
Warren Electric

Allegheny
ELECTRIC COOPERATIVE, INC.

1997 Financial Review

New Ideas For A New Era

Summary of Operations — Allegheny Member Systems

	Adams	Bedford	Central	Claverack	New Enterprise	Northwe
SUMMARY OF OPERATIONS						
Operating revenue	$33,392,594	$10,233,675	$21,468,920	$17,952,730	$3,648,348	$20,307,137
OPERATING EXPENSES						
Purchased power	$21,618,910	$6,542,526	$12,624,461	$9,812,272	$2,449,717	$12,020,956
Operations & maintenance	$6,356,222	$2,203,011	$5,189,564	$5,109,541	$1,382,795	$5,077,542
Depreciation	$2,236,683	$534,101	$1,386,447	$1,498,557	$81,000	$1,250,213
Taxes	$359,031	$82,335	$167,828	$243,904	$32,575	$259,825
Interest	$2,104,270	$466,857	$1,504,523	$1,364,941	$0	$1,293,112
Cost Of Electric Service	$32,675,116	$9,828,830	$20,872,823	$18,029,215	$3,946,087	$19,901,648
Operating Margins	$717,478	$404,845	$596,097	($76,485)	($297,739)	$405,489
Non-operating margins & capital credits	$123,571	$54,112	$240,302	$127,251	$20,496	$218,132
Net margins	$841,049	$458,957	$836,399	$50,766	($277,243)	$623,621
ASSETS						
Total Utility plant	$72,590,420	$20,795,421	$51,909,378	$52,407,972	$3,698,421	$44,723,224
Less accumulated depreciation	$16,570,398	$4,441,164	$11,997,399	$12,795,503	$2,574,627	$12,360,885
Net utility plant	$56,020,022	$16,354,257	$39,911,979	$39,612,469	$1,123,794	$32,362,339
Other property & investments	$7,836,842	$2,094,110	$5,396,467	$3,868,356	$355,965	$5,29
Current & accrued assets	$5,615,057	$1,981,085	$5,001,889	$2,580,541	$337,189	$2,745,022
Deferred debits	$89,621	$88,008	($702)	$817,064	$0	$682,962
Total assets	$69,561,542	$20,517,460	$50,309,633	$46,878,430	$1,816,948	$41,084,628
LIABILITIES						
Margins & equities	$24,341,777	$8,785,242	$17,254,841	$12,695,405	$1,591,407	$15,869,273
Long-term debt	$39,981,284	$10,345,539	$29,526,021	$26,654,446	$0	$18,587,728
Current & accrued liabilities	$5,234,778	$1,206,928	$3,288,780	$7,529,584	$225,541	$5,286,266
Other credits & reserves	$3,703	$179,751	$239,991	($1,005)	$0	$1,341,361
Total Liabilities	$69,561,542	$20,517,460	$50,309,633	$46,878,430	$1,816,948	$41,084,628
OTHER STATISTICS						
Miles Of Line	2,614	1,193	3,031	2,535	393	2,460
Consumers served	25,735	8,347	23,289	16,480	3,098	17,917
Consumers per mile	9.8	7.0	7.7	6.5	7.9	7.3
kWh sold per consumer	13,276	12,618	8,482	8,629	12,075	11,060
MWh sales	341,655	105,324	197,539	142,211	37,407	198,163
Annual revenue per consumer	$1,298	$1,226	$922	$1,089	$1,178	$1,133
Plant investment per consumer	$2,177	$1,959	$1,714	$2,404	$363	$1,806
Revenue per mile of line	$12,775	$8,578	$7,083	$7,082	$9,283	$

Somerset	Southwest Central	Sullivan	Sussex	Tri-County	United	Valley	Warren	TOTAL
$14,683,304	$25,216,374	$4,641,108	$13,386,564	$15,736,917	$15,508,297	$20,400,398	$5,591,919	$222,168,285
$9,885,902	$17,237,375	$2,684,012	$6,800,950	$8,017,338	$7,545,939	$13,104,416	$2,827,819	$133,172,593
$2,748,962	$4,320,194	$1,204,104	$3,436,700	$4,345,271	$4,908,299	$4,349,361	$1,614,719	$52,246,285
$689,134	$1,253,661	$373,326	$940,475	$1,240,623	$1,343,184	$1,323,113	$376,925	$14,527,442
$144,572	$195,202	$59,986	$1,480,004	$211,326	$37,609	$170,815	$63,588	$3,508,600
$666,658	$1,193,085	$338,099	$919,653	$1,501,123	$1,468,624	$879,581	$131,413	$13,831,939
$14,135,228	$24,199,517	$4,659,527	$13,577,782	$15,315,681	$15,303,655	$19,827,286	$5,014,464	$217,286,859
$548,076	$1,016,857	($18,419)	($191,218)	$421,236	$204,642	$573,112	$577,455	$4,881,426
$154,668	$124,350	$32,371	$122,742	$86,214	$212,606	$249,132	$33,873	$1,799,820
$702,744	$1,141,207	$13,952	($68,476)	$507,450	$417,248	$822,244	$611,328	$6,681,246
$27,165,818	$47,259,586	$13,004,971	$31,704,278	$46,903,835	$49,989,029	$49,298,389.	$14,244,361	$525,695,103
$7,160,457	$8,509,399	$4,449,773	$8,980,662	$10,537,058	$11,750,855	$13,464,801	$4,450,450	$130,043,431
$20,005,361	$38,750,187	$8,555,198	$22,723,616	$36,366,777	$38,238,174	$35,833,588	$9,793,911	$395,651,672
[illegible]54,130	$6,097,774	$1,072,145	$2,816,270	$6,990,202	$4,158,063	$4,367,614	$1,539,635	$57,341,078
[illegible],173,909	$3,943,457	$675,935	$3,842,860	$3,137,878	$2,844,971	$5,272,206	$820,110	$41,972,909
$46,442	$5,131	$11,091	$35,143	($9,343)	$110,312	$35,257	$452,912	$2,363,898
$28,679,842	$48,796,549	$10,314,369	$29,417,889	$46,485,514	$45,351,520	$45,508,665	$12,606,568	$497,329,557
$13,555,586	$21,577,380	$3,485,170	$8,905,448	$15,807,150	$14,574,027	$24,755,733	$9,485,500	$192,683,939
$12,971,211	$22,953,861	$6,256,653	$17,089,545	$26,276,864	$28,426,640	$16,555,786	$2,402,055	$258,027,633
$1,528,742	$4,060,777	$572,411	$3,391,171	$4,385,531	$2,079,650	$3,793,498	$450,047	$43,033,704
$624,303	$204,531	$135	$31,725	$15,969	$271,203	$403,648	$268,966	$3,584,281
$28,679,842	$48,796,549	$10,314,369	$29,417,889	$46,485,514	$45,351,520	$45,508,665	$12,606,568	$497,329,557
1,901	2,462	841	642	2,994	2,648	2,613	1,036	27,363
11,862	20,641	5,370	10,522	16,833	16,961	19,400	8,687	205,142
6.2	8.4	6.4	16.4	5.6	6.4	7.4	8.4	7.5
13,857	12,989	8,220	10,621	7,742	7,272	10,627	5,153	10,311
164,371	268,096	44,143	111,755	130,322	123,333	206,167	44,765	2,115,251
$1,238	$1,222	$864	$1,272	$935	$914	$1,052	$644	$1,083
$1,687	$1,877	$1,593	$2,160	$2,160	$2,254	$1,847	$1,127	$1,929
$7,724	$10,242	$5,519	$20,851	$5,256	$5,857	$7,807	$5,398	$8,119

Five-Year Comparative Statements of Operations (in thousands)

	1997	1996	1995	1994	1993
ASSETS:					
Utility Plant In Service	$702,791	$693,362	$684,880	$669,886	$651,983
Construction Work in Progress	3,824	2,965	2,641	3,449	7,691
Nuclear Fuel in Process	8,243	6,254	3,981	6,901	11,762
TOTAL PLANT	**714,858**	**702,581**	**691,502**	**680,236**	**671,436**
Accumulated provision for Depreciation & Amortization	267,313	244,704	221,876	200,983	184,785
NET PLANT	**447,545**	**457,877**	**469,626**	**479,253**	**486,651**
Non-Utility Property — Net	4,905	4,904	4,742	4,818	4,741
Investments in Assoc. Organizations	4,022	4,052	4,053	4,057	4,035
Notes Receivable from members	1,606	2,370	3,130	2,473	2,899
Other Investments	10,861	9,551	8,821	7,895	7,737
Other Non-Current Assets	358	391	423	456	488
Cash and Cash Equivalents	27,717	28,026	22,360	19,982	35,530
Accounts Receivable	20,605	18,918	19,652	20,432	9,769
Inventories	4,596	4,471	4,892	5,164	4,842
Other Current Assets	266	4,621	2,303	2,652	3,936
Deferred Charges	12,257	13,026	13,749	14,442	14,156
TOTAL ASSETS	**$534,738**	**$548,207**	**$553,751**	**$561,624**	**$574,7[illegible]**
EQUITIES:					
Memberships	$3	$3	$3	$3	$3
Donated Capital	38	38	38	51	51
Patronage Capital	34,122	34,122	35,722	37,342	37,952
Other Margins and Equities	(2,776)	(2,805)	(8,909)	(14,338)	(12,154)
Net Unrealized Gains (Losses)	661	392	408		
TOTAL EQUITIES	**32,048**	**31,750**	**27,262**	**23,058**	**25,852**
LIABILITIES:					
Long-Term Debt	447,975	462,260	477,295	490,192	496,411
Current portion of Long-Term Debt	14,265	13,405	12,933	12,092	12,237
Accounts Payable and Accrued Exp.	11,864	14,183	11,535	11,883	12,887
Accounts Payable to Members	757	481	369	302	285
Accrued Nuclear Decommissioning	17,190	14,082	11,081	9,720	8,551
Accrued Decontamination and Decommissioning of Nuclear Fuel	2,521	2,996	3,288	3,502	4,150
Deferred Income Tax Benefits from Safe Harbor Lease	6,656	7,539	8,383	9,194	9,969
Other Deferred Credits	1,462	1,511	1,605	1,681	4,442
TOTAL LIABILITIES	**502,690**	**516,457**	**526,489**	**538,566**	**548,93[illegible]**
TOTAL EQUITIES AND LIABILITIES	**$534,738**	**$548,207**	**$553,751**	**$561,624**	**$574,784**

	1997	1996	1995	1994	1993
Operating Revenue — including member sales	$139,695	$139,773	$138,720	$139,465	$144,635
Operating Expenses:					
Purchased Power	29,821	26,197	27,613	40,399	31,554
Transmission — Operation	13,649	13,554	13,138	12,229	11,940
Transmission — Maintenance	5	132	71	129	160
Production — Operation	19,577	18,752	17,091	17,934	20,882
Production — Maintenance	7,063	6,637	7,728	6,562	4,657
Fuel	8,400	8,031	7,864	6,820	7,996
Depreciation	19,284	17,875	16,491	15,007	13,806
Taxes	3,655	3,676	3,869	4,078	3,956
Administrative and General	9,580	8,828	7,882	7,469	6,520
Total Operating Expenses	**111,034**	**103,682**	**101,747**	**110,627**	**101,471**
Operating Margins	28,661	36,091	36,973	28,838	43,164
Interest Expense	31,889	33,017	34,064	34,086	34,921
Other Deductions (Income), net	605	651	591	(489)	(342)
Operating Income (Loss)	(3,833)	2,423	2,318	(4,759)	8,585
Non-Operating Margins:					
Net Non-Operating Rental Loss	(72)	(82)	(118)	(177)	(133)
Interest Income	2,474	2,439	2,366	1,976	1,803
Other	1,460	1,324	863	776	1,152
Net Margins	**$29**	**$6,104**	**$5,429**	**($2,184)**	**$11,407**
MEMBERS REVENUES (in thousands)					
Adams	$21,554	$21,642	$20,876	$20,508	$21,198
Bedford	6,606	7,218	7,701	8,094	7,824
Central	12,669	12,592	12,355	12,031	12,440
Claverack	9,812	9,877	9,929	10,056	10,191
New Enterprise	2,483	2,516	2,508	2,539	2,594
Northwestern	11,967	11,991	11,874	11,746	11,778
Somerset	9,886	9,913	9,755	10,401	10,747
Southwest Central	17,237	16,931	16,625	16,929	17,501
Sullivan	2,662	2,856	2,781	2,739	2,733
Sussex	6,802	7,186	7,159	7,119	7,086
Tri-County	8,050	8,337	8,057	8,190	8,205
United	7,617	7,897	7,998	8,473	8,681
Valley	13,041	12,682	12,261	12,200	12,420
Warren	2,828	2,843	2,784	2,966	3,072
TOTAL MEMBER REVENUES	**$133,214**	**$134,481**	**$132,663**	**$133,991**	**$136,470**

Coopers &Lybrand

Coopers & Lybrand L.L.P.

a professional services firm

Report of Independent Accountants

Board of Directors
Allegheny Electric Cooperative, Inc.

We have audited the accompanying balance sheets of Allegheny Electric Cooperative, Inc. as of October 31, 1997 and 1996, and the related statements of operations, equities, and cash flows for the years then ended. These financial statements are the responsibility of Allegheny Electric Cooperative, Inc.'s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. 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 financial statements referred to above present fairly, in all material respects, the financial position of Allegheny Electric Cooperative, Inc. as of October 31, 1997 and 1996, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Coopers & Lybrand L.L.P.

One South Market Square
Harrisburg, Pennsylvania
January 23, 1998

Allegheny Electric Cooperative, Inc.

Balance Sheets as of October 31, 1997 and 1996 (in thousands)

ASSETS	1997	1996
Electric utility plant:		
In service	$ 702,791	$ 693,362
Construction work-in-process	3,824	2,965
Nuclear fuel in process	8,243	6,254
	714,858	702,581
Less: accumulated depreciation and amortization	267,313	244,704
	447,545	457,877
Other assets and investments:		
Nonutility property, at cost (net of accumulated depreciation of $2,894 in 1997 and $2,687 in 1996)	4,905	4,904
Investments in associated organizations	4,022	4,052
Notes receivable from members, less current portion	1,606	2,370
Other investments	10,861	9,551
Other noncurrent assets	358	391
	21,752	21,268
Current assets:		
Cash and cash equivalents	27,717	28,026
Accounts receivable, including accounts receivable from members of $19,671 in 1997 and $18,593 in 1996	20,605	18,918
Inventories	4,596	4,471
Other current assets	266	4,621
	53,184	56,036
Deferred charges	12,257	13,026
Total assets	$ 534,738	$ 548,207
EQUITIES AND LIABILITIES		
Equities:		
Memberships	3	3
Donated capital	38	38
Patronage capital	34,122	34,122
Other margins and equities	(2,776)	(2,805)
Net unrealized gains	661	392
	32,048	31,750
Long-term debt, less current portion	447,975	462,260
Current liabilities:		
Current portion of long-term debt	14,265	13,405
Accounts payable and accrued expenses	11,864	14,183
Accounts payable to members	757	481
	26,886	28,069
Other liabilities and deferred credits:		
Accrued nuclear decommissioning	17,190	14,082
Accrued decontamination and decommissioning of nuclear fuel	2,521	2,996
Deferred income tax benefits from safe harbor lease	6,656	7,539
Other deferred credits	1,462	1,511
	27,829	26,128
Total equities and liabilities	$ 534,738	$ 548,207

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

Allegheny Electric Cooperative, Inc.

Statements of Operations for the years ended October 31, 1997 and 1996 (in thousand

	1997	1996
Operating revenue, including sales to members of $133,214 in 1997 and $134,481 in 1996	$ 139,695	$ 139,773
Operating expenses:		
Purchased power	29,821	26,197
Transmission - operation	13,649	13,554
Transmission - maintenance	5	132
Production - operation	19,577	18,752
Production - maintenance	7,063	6,637
Fuel	8,400	8,031
Depreciation	19,284	17,875
Taxes	3,655	3,676
Administrative and general	9,580	8,828
	111,034	103,682
Operating margin before interest and other deductions	28,661	36,091
Interest and other deductions:		
Interest expense, net of allowance for funds used during construction of $836 in 1997 and $741 in 1996	31,889	33,017
Other deductions, net	605	651
	32,494	33,668
Operating (loss) income	(3,833)	2,423
Nonoperating margins:		
Net nonoperating rental loss	(72)	(82)
Interest income	2,474	2,439
Other	1,460	1,324
	3,862	3,681
Net margin	$ 29	$ 6,104

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

Allegheny Electric Cooperative, Inc.

Statements of Equities for the years ended October 31, 1997 and 1996 (in thousands)

	Memberships	Donated Capital	Patronage Capital	Other Margins and Equities	Net Unrealized Gains (Losses)	Total
Balance at October 31, 1995	$ 3	$ 38	$ 35,722	$ (8,909)	$ 408	$ 27,262
Change in unrealized gains (losses), net					(16)	(16)
Net margin				6,104		6,104
Return of capital			(1,600)			(1,600)
Balance at October 31, 1996	3	38	34,122	(2,805)	392	31,750
Change in unrealized gains (losses), net					269	269
Net margin				29		29
Balance at October 31, 1997	$ 3	$ 38	$ 34,122	$ (2,776)	$ 661	$ 32,048

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

Allegheny Electric Cooperative, Inc.

Statements of Cash Flows for the years ended October 31, 1997 and 1996 (in thousands)

	1997	1996
Cash flows from operating activities:		
Net margin	$ 29	$ 6,104
Adjustments to reconcile net margin to net cash provided by operating activities:		
Depreciation and fuel amortization	26,122	24,352
Amortization of deferred charges and deferred credits	(176)	(182)
Gain on sale of other investments	(479)	(358)
(Increase) decrease in:		
Accounts receivable	(1,687)	734
Inventories	(125)	421
Other current and noncurrent assets	4,448	(2,217)
Increase (decrease) in:		
Accounts payable and accrued expenses	(2,319)	2,648
Accounts payable to members	276	112
Other liabilities and deferred credits	2,646	2,676
Net cash provided by operating activities	28,735	34,290
Cash flows from investing activities:		
Additions to electric utility plant and nonutility property	(15,791)	(12,765)
Redemption of investments in associated organizations	30	1
Decrease in notes receivable from members	704	691
Purchases of other investments	(8,933)	(7,138)
Proceeds from sale of other investments	8,371	6,750
Net cash used in investing activities	(15,619)	(12,461)
Cash flows from financing activities:		
Payments on long-term debt	(13,425)	(14,563)
Return of capital		(1,600)
Net cash used in financing activities	(13,425)	(16,163)
Increase (decrease) in cash and cash equivalents	(309)	5,666
Cash and cash equivalents at beginning of year	28,026	22,360
Cash and cash equivalents at end of year	$ 27,717	$ 28,026

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

1. Summary of Significant Accounting Policies:

Business and Operations:

Allegheny Electric Cooperative, Inc. (Allegheny) is a rural electric cooperative utility established under the laws of the Commonwealth of Pennsylvania. Financing assistance has been provided by the U.S. Department of Agriculture, Rural Utilities Service (RUS) formerly known as the Rural Electrification Administration (REA) and, therefore, Allegheny is subject to certain rules and regulations promulgated for rural electric borrowers by RUS. Allegheny is a generation and transmission cooperative, providing power supply to 14 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 RUS.

Electric Utility Plant and Depreciation:

Electric utility plant is stated at cost, which includes an allowance for funds used during construction. Depreciation for nuclear utility plant and production assets is provided on the modified sinking fund method under the amended phase-in plan adopted to conform to Statement of Financial Accounting Standards (SFAS) 92, "Regulated Enterprises - Accounting for Phase-in Plans." The straight-line method is used 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 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.

1. Summary of Significant Accounting Policies, continued:

Cost of Decommissioning Nuclear Plant:

Allegheny's portion of the estimated cost of decommissioning SSES is approximately $80.4 million and is being accrued over the estimated useful life of the plant. Decommissioning costs are included in rates to the extent required to meet this funding.

As required by the Nuclear Regulatory Commission (NRC), Allegheny established a Decommissioning Trust Fund (Trust Fund B) which is restricted for use to ultimately decommission SSES. In accordance with the NRC funding schedule, $1.2 million and $1.1 million was funded to Trust Fund B for the years ended October 31, 1997 and 1996, respectively. Allegheny's Board of Directors has restricted as of October 31, 1997 and 1996, $.04 million and $.60 million, respectively, of Trust Fund A for future payments to Trust Fund B. Trust Fund A and B are included in other investments.

Accrued nuclear decommissioning as of October 31, 1997 and 1996 was $17.2 million and $14.1 million, respectively.

Allowance for Funds Used During Construction:

Allowance for funds used during construction represents the cost of directly related borrowed funds used for construction of or additions to an 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. 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 charged to operations when the project is determined to be abandoned.

Cash Equivalents:

For purposes of the statements of cash flows, Allegheny considers all highly liquid investments with an original maturity of three months or less when purchased to be cash equivalents. Cash equivalents are carried at cost.

1. Summary of Significant Accounting Policies, continued:

Inventories:

Allegheny accounts for certain power plant spare parts using a deferred inventory method. Under this method, purchases of spare parts under inventory control are included in an inventory account and then charged to the appropriate capital or expense accounts when the parts are used or consumed.

Inventories are carried at the lower of cost or market value, cost being determined on the average cost method.

Other Investments:

Allegheny accounts for debt and equity securities included in other investments under the provisions of SFAS 115, "Accounting for Certain Investments in Debt and Equity Securities." Management determines the proper classification of debt and equity securities at the time of purchase. As of October 31, 1997 and 1996, all securities covered by SFAS 115 were designated as available for sale. Accordingly, these securities are stated at fair value, with net unrealized gains and losses reported as a separate component of equities. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in the statements of operations.

Patronage Capital and Other Margins and Equities:

Allegheny had established an unallocated equity account, Other Margins and Equities, as a result of a charge against income in connection with the adoption of SFAS No. 92. This charge against income was recorded as a deficiency in an unallocated equity account since the amount is not allocable to Allegheny's members. All net margins recognized by Allegheny are required by RUS to be used to reduce this deficiency.

Regulatory Assets and Liabilities:

Allegheny records deferred charges and credits in accordance with SFAS 71, "Accounting for the Effects of Certain Types of Regulation." If Allegheny were to terminate application of SFAS 71, all such amounts deferred would be recognized in the statement of operations at that time, resulting in a charge to earnings, net of applicable income taxes.

1. Summary of Significant Accounting Policies, continued:

Rates:

The Board of Directors of Allegheny has full authority to establish electric rates subject to approval by RUS.

Revenues:

Revenues from the sale of electricity are recorded based on billings to members and on contracts and scheduled power usages, as appropriate.

Income Taxes:

Allegheny complies with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (SFAS 109) which requires recognition of deferred tax assets and liabilities resulting from the deferred tax consequences of temporary differences in recognition of assets, liabilities, income and expense for financial reporting and income tax reporting. The resulting deferred tax assets and liabilities are established based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Allegheny's future temporary differences result primarily from the financial statement and income tax recognition of depreciation expense and rental payments for safe harbor leasing arrangements. The future deferred tax liability resulting from these differences would be fully offset by the utilization of available net operating loss carryforwards.

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.

Utilization of Estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets 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.

1. Summary of Significant Accounting Policies, continued:

Change in Accounting Principle:

Effective November 1, 1996, Allegheny adopted Statement of Financial Accounting Standards for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of (SFAS 121). Long-lived assets subject to the requirements of SFAS 121 are evaluated for impairment through a review of undiscounted expected future cash flows. If the sum of the undiscounted expected future cash flows is less than the carrying amount of the asset, an impairment loss will be recognized. There was no effect of adopting SFAS 121 for the fiscal year ended October 31, 1997.

2. Electric Utility Plant In Service:

Electric utility plant in service consists of the following as of October 31, 1997 and 1996:

	Depreciation/ Amortization, Lives/Rates	1997	1996
		(in thousands)	
Nuclear Utility Plant:			
Production	39 years	$ 531,824	530,878
Transmission	2.75%	46,421	46,368
General plant	3% - 12.5%	846	846
Nuclear fuel	Heat production	115,577	107,284
		694,668	685,376
Non-Nuclear Utility Plant	3% - 33%	8,123	7,986
Total		$ 702,791	693,362

3. 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 SSES' gross assets, which includes electric utility plant in service, construction and nuclear fuel in progress, totaled $682 million and $672 million as of October 31, 1997 and 1996, respectively. Allegheny's share of anticipated costs for ongoing construction and nuclear fuel for SSES is estimated to be approximately $53 million over the next five years. Allegheny receives a portion of the total SSES output equal to its percentage ownership. SSES accounted for 68% and 62% of the total kilowatts sold by Allegheny during 1997 and 1996, respectively. The balance sheets and statements of operations reflect Allegheny's respective share of assets, liabilities and operations associated with SSES.

4. Investments in Associated Organizations:

Investments in associated organizations, at cost, consists of the following as of October 31, 1997 and 1996:

	1997	1996
	(in thousands)	
National Rural Utilities Cooperative Finance Corporation (CFC) Subordinated Term Certificates, bearing interest from 0% to 5%, maturing January 1, 2014 through October 1, 2080	$ 3,827	$ 3,857
National Rural Utilities CFC Capital Term Certificates	185	185
Other	10	10
	$ 4,022	$ 4,052

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

5. Notes Receivable From Members:

Notes receivable from members arise from the lease of load management equipment to the member cooperatives. Such notes bear interest at a variable rate (6.55% and 6.20% as of October 31, 1997 and 1996, respectively) and mature at various dates through March 31, 2009. Notes receivable from members were $2.4 million and $3.1 million as of October 31, 1997 and 1996, respectively.

6. Other Investments:

Other investments consist of the following as of October 31, 1997 and 1996:

	1997 (in thousands)			
	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Decommissioning Trust Fund A:				
Cash	$ 42			$ 42
	42			42
NRC mandated Decommissioning Trust Fund B:				
Cash	111			111
U.S. Government securities	2,534	$ 37	$ (14)	2,557
Corporate bonds	3,230	51	(7)	3,274
Common stocks	2,489	663	(69)	3,083
	8,364	751	(90)	9,025
Debt Service Reserve Fund:				
U.S. Government securities	1,775			1,775
Accrued interest receivable	19			19
	$ 10,200	$ 751	$ (90)	$ 10,861

6. Other Investments, continued:

	1996 (in thousands)			
	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Decommissioning Trust Fund A:				
Cash	$ 20			$ 20
Corporate bonds	39	$ 4	.	43
Common stocks	573	186	$ (11)	748
	632	190	(11)	811
NRC mandated Decommissioning Trust Fund B:				
Cash	178			178
U.S. Government securities	3,073	20	(13)	3,080
Corporate bonds	2,108	31	(6)	2,133
Common stocks	1,371	203	(22)	1,552
	6,730	254	(41)	6,943
Debt Service Reserve Fund:				
U.S. Government securities	1,775			1,775
Accrued interest receivable	22			22
	$ 9,159	$ 444	$ (52)	$ 9,551

Proceeds from sales of securities available for sale were approximately $8,371 and $6,750 in 1997 and 1996, respectively. Gross realized gains and losses on such sales were not material.

7. Deferred Charges:

Deferred charges consist of the following as of October 31, 1997 and 1996:

	1997	1996
	(in thousands)	
Unamortized FFB debt repurchase premium	$ 8,256	$ 8,787
Accrued decontamination and decommissioning of nuclear fuel	3,125	3,365
Low level radiation waste facility costs	599	599
Safe harbor lease closing costs	183	195
Preliminary surveys	94	80
	$ 12,257	$ 13,026

8. Long-Term Debt:

Long-term debt consists principally of advances under mortgage notes payable for electric utility plant to RUS and to the United States of America acting through the Federal Financing Bank (FFB) and guaranteed by RUS. Substantially all of the assets of Allegheny are pledged as collateral. Long-term debt consists of the following as of October 31, 1997 and 1996:

	1997	1996
	(in thousands)	
Advances under mortgage notes payable to FFB at interest rates varying from 5.07% to 10.30% in 1997 and 5.21% to 10.30% in 1996, due in varying amounts through 2021.	$ 422,781	$ 435,398
Pollution Control Revenue Bonds, payable semiannually, including interest through 2014. Variable rates ranged from 2.80% to 4.60% in 1997 and 2.50% to 5.25% in 1996.	24,200	24,700
Mortgage loan payable to CFC in various quarterly installments, including interest through January 2015. Variable rates ranged from 6.20% to 6.55% in 1997 and 6.10% to 6.45% in 1996.	1,730	1,778
Notes payable to CFC in various quarterly installments, including interest through October 2019. Variable rates ranged from 6.20% to 6.55% in 1997 and 6.10% to 6.45% in 1996.	4,100	4,164
5.00% mortgage notes payable to RUS due in varying amounts through 2019.	9,429	9,625
	462,240	475,665
Less current portion	14,265	13,405
	$ 447,975	$ 462,260

8. Long-Term Debt, continued:

Allegheny has the ability under long-term mortgage notes payable to FFB to select (subject to RUS approval) various short-term interest rates and interim maturity date options on outstanding advances. At the date of the advance or on the maturity of an interim advance, Allegheny may also designate that it desires a long-term interest rate with a long-term maturity up to a maximum of 34 years from the end of the calendar year in which the note was issued. As of October 31, 1997 and 1996, Allegheny had elected short-term interest rates with interim maturities on advances under these mortgage notes payable to FFB of $49.7 million and $51.0 million, respectively. The remaining advances under mortgage notes payable to FFB have previously been converted to long-term interest rates and maturities. As of October 31, 1997, Allegheny had $49.7 million of advances which are scheduled to mature and have interest rates reset within one year. Allegheny intends to roll these advances over for additional interim maturities or to extend them to long-term maturities, in accordance with the mortgage agreement.

Allegheny has previously executed three-party agreements modifying promissory notes with FFB and RUS resulting in a one-time reduction of the interest rates on certain advances made to Allegheny by FFB under the original mortgage notes. Total outstanding advances modified under the agreement amounted to $131.4 million. Under terms of the individual agreements, Allegheny was required to pay repurchase premiums, as calculated by RUS, of $10.9 million. These premiums were recorded as a deferred charge and are being amortized over the remaining term of the advances modified by the agreement.

Long-term Pollution Control Revenue Bonds (Bonds) were 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 until the Bonds are converted to a fixed interest rate at Allegheny's option. If a fixed interest rate is established for the Bonds, the Bonds will cease to be subject to purchase by the remarketing agent or the trustee. The Bonds are collateralized by irrevocable letters of credit from Rabobank Nederland which are backed by a five-year credit facility in the event the bondholders tender the Bonds prior to the conversion to a fixed interest rate and the Bonds cannot be remarketed. The stated amount of the letters of credit are equal to the amount of outstanding Bonds plus an amount equal to 65 days' interest accrued on the Bonds at 12%. The indenture agreement contains various redemption provisions with redemption prices ranging from 100% to 103%. Included in other investments, at both October 31, 1997 and 1996, are $1.8 million of investments which relate to a debt service reserve fund required under the Bond indenture.

8. Long-Term Debt, continued:

Future maturities of all long-term debt for the next five years are as follows (in thousands):

1998	$ 14,265
1999	$ 15,197
2000	$ 16,249
2001	$ 17,330
2002	$ 18,192

The above maturity schedule reflects management's intent to extend short-term advances over for additional interim maturities under mortgage notes payable to FFB with interim maturity dates to long-term debt.

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 as of October 31, 1997 and 1996.

Certain of Allegheny's long-term debt is at variable interest rates and is therefore subject to various market and interest rate fluctuations.

During 1997 and 1996, Allegheny incurred interest costs of $32.7 million and $33.8 million, respectively, of which $0.8 million and $0.7 million, respectively, was capitalized as part of the construction of the electric utility plant. Interest paid, net of amounts capitalized, was $32.1 million and $33.1 million, respectively.

9. Deferred Credits:

Deferred credits consist of the following as of October 31, 1997 and 1996:

	1997	1996
	(in thousands)	
Raystown lease gain	$ 1,462	$ 1,511

10. Income Taxes:

As of October 31, 1997, Allegheny had available nonmember net operating loss carryforwards of approximately $225.4 million for tax reporting purposes expiring through 2009 and investment tax credit carryforwards of approximately $22 million expiring through 2004. Allegheny also had net operating loss carryforwards attributable to member activities of approximately $66.2 million for tax reporting purposes which may be carried forward indefinitely.

11. Related Party Transactions:

Allegheny has an arrangement with an affiliated 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, 1997 and 1996 were approximately $6.7 million and $5.9 million, respectively.

Allegheny leases office space to PREA under a year-to-year lease. Rental income was $73,000 and $67,000 for the years ended October 31, 1997 and 1996, respectively.

Allegheny expensed $470,000 to PREA during 1996 for advertising campaign purposes and $60,000 to a PREA subsidiary for the development of certain wastewater projects.

12. Commitments and Contingencies:

Insurance:

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 $275 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 $0.9 million.

12. Commitments and Contingencies, continued:

Insurance, continued:

Allegheny's public liability for claims resulting from a nuclear incident is currently limited to $892.0 million under provisions of the Price-Anderson Amendments Act of 1988 (Act), which extended the Price-Anderson Act to August 1, 2002. 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 $15.1 million per incident, but not more than $2.0 million in a calendar year.

Safe Harbor Lease:

Allegheny previously 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 on the statements of operations over the 30-year term lease. The deferred income tax benefits were $6.7 and $7.5 million as of October 31, 1997 and 1996, respectively. The net proceeds and related interest were required by RUS to be used to retire outstanding FFB debt.

Under the term 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 as of October 31, 1997 was approximately $13.7 million. Payment of this contingent liability has been guaranteed by CFC.

Litigation:

In the normal course of business, there are various claims and suits pending against Allegheny. In the opinion of Allegheny's management, the amount of such losses that might result from these claims and suits, if any, would not materially affect the financial position or results of operations of Allegheny.

Settlements:

In May 1992, Allegheny received a settlement of $4.5 million through noncash discounts on purchases of capital equipment. This amount was utilized as of October 31, 1997.

13. Sale/Leaseback Arrangement:

Allegheny previously completed a sale and leaseback of its hydroelectric generation facility at the Raystown Dam (the Facility). The Facility was sold to a trustee bank representing Ford Motor Credit Company (Ford) for $32.0 million in cash. During 1996, Ford transferred its interest in the Facility to a third-party. Under terms of the arrangement, Allegheny is leasing the Facility for an initial term of 30 years. Payments under the lease are due in semi-annual installments which commenced January 10, 1989. 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 or for a certain amount fixed by the transaction documents (determined by 1988 appraisal of the then foreseeable residual value at the end of the lease term), whichever is less.

Allegheny also has the option to renew the lease for a five-year fixed rate renewal and three fair market renewal periods, each of which may not be for a term of less than two years. Payments during the fixed rate renewal period are 30% of the average semi-annual installments during the initial lease term. Allegheny will retain co-licensee status for the Facility throughout the term of the lease. The gain of $1.9 million related to the sale is being recognized over the lease term in the same proportion that the annual rental payments relate to total rental payments. The unrecognized gain is recorded in deferred credits and was approximately $1.5 million as of October 31, 1997 and 1996, respectively.

The payments by Allegheny under this lease were determined in part on the assumption that Ford, or its successor, will be entitled to certain income tax benefits as a result of the sale and leaseback of the Facility. In the event that Ford, or its successor, were to lose all or any portion of such tax benefits, Allegheny would be required to indemnify Ford, or its successor, for the amount of the additional federal income tax payable by Ford, or its successor, as a result of any such loss.

13. Sale/Leaseback Arrangement, continued:

The leaseback of the Facility is accounted for as an operating lease by Allegheny. As of October 31, 1997, future minimum lease payments under this lease, which can vary based on the interest paid on the debt used to finance the transaction, are estimated as follows (in thousands):

1998	$ 2,051
1999	2,361
2000	2,361
2001	2,361
2002	2,361
Thereafter	35,919
Total minimum lease payments	$ 47,414

The future minimum lease payments shown above are for the initial lease term and the five-year renewal period. These payments are based on an assumed interest rate of 8.8% and may fluctuate based on differences between the future interest rate and the assumed interest rate.

Rental expense for this lease totaled $1.9 million and $1.7 million for each of the years ended October 31, 1997 and 1996, respectively.

14. Concentrations of Credit Risk:

Allegheny is comprised of member rural electric cooperatives, whose operations are located in Pennsylvania and New Jersey. The member cooperatives' primary service areas are small communities located throughout much of rural Pennsylvania and New Jersey.

Allegheny's investments are invested in a variety of financial instruments. The related values as presented in the financial statements are subject to various market fluctuations, which include changes in the equity markets, interest rate environment and the general economic conditions. Allegheny's credit losses have historically been minimal and within management's expectations.

15. Government Regulations:

The Energy Policy Act of 1992 established, among other things, a fund to pay for the decontamination and decommissioning of three nuclear enrichment facilities operated by DOE. A portion of the fund is to be collected from electric utilities that have purchased enrichment services from DOE and will be in the form of annual special assessments for a period not to exceed more than 15 years. The special assessments will be based on a formula that takes into account the amount of enrichment services purchased by the utilities in past periods.

Allegheny has previously recorded its share of the liability in connection with PP&L's recognition of the liability in the accounts of SSES. Allegheny's share of the liability is $4.4 million which will be paid over a period of 15 years. Allegheny recorded its share of the liability as a deferred charge which will be amortized to expense over 15 years, consistent with the ratemaking treatment. The remaining liability to be amortized was $2.5 million and $3.0 million as of October 31, 1997 and 1996, respectively.

On December 3, 1996, House Bill No. 1509, Pennsylvania's "Electricity Generation Customer Choice and Competition Act" was signed by the Governor of Pennsylvania, with an effective date of January 1, 1997 as Act No. 138 of 1996. This act enables retail electric customers, including consumer-members of Pennsylvania's thirteen Rural Electric Cooperatives, to choose the power supplier, or generator, from which they buy electricity. As of January 1, 1999, a maximum of thirty-three percent of the peak load of each customer class shall have the opportunity for direct access. As of January 1, 2000, a maximum of sixty-six percent of the peak load of each customer class shall have the opportunity for direct access, with full customer choice in effect statewide by January 1, 2001. The effects of Act 138 on Allegheny Electric Cooperative, Inc. are unknown at this time.

As a result of Act 138, the Board of Directors is evaluating the need to eliminate certain functions currently being performed. This will enable Allegheny to more effectively meet the needs of its members in the new deregulated and competitive environment. Certain functions may be eliminated during fiscal year 1998.

On September 26, 1997, RUS published in the Federal Register a final rule on debt restructuring. The rule, 7 CFR Part 1717, "Settlement of Debt Owed by Electric Borrowers," became effective upon its publication. This rule sets forth the provisions that electric borrowers must follow when seeking a settlement of debt. The impact of 7 CFR 1717 is unknown at this time.

16. Fair Value of Financial Instruments:

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

Cash and Cash Equivalents:

The carrying amount reported approximates fair value because of the short maturity of these financial instruments.

Other Investments and Investments in Associated Organizations:

The fair value of other investments are estimated based on quoted market prices. Fair values of investments in associated organizations approximate their carrying amount.

Notes Receivable from Members:

The carrying amount of Allegheny's notes receivable from members, which primarily relate to sales-type leases, approximates fair value because the notes bear a variable rate of interest which is reset on a frequent basis.

Long-Term Debt:

The carrying amount of Allegheny's variable rate long-term debt approximates fair value. The fair value of Allegheny's fixed rate long-term debt is estimated using discounted cash flows based on current rates offered to Allegheny for similar debt of the same remaining maturities.

Summary of Fair Values:

The estimated fair values of Allegheny's financial instruments at October 31, 1997 and 1996, are as follows (in thousands):

	1997		1996	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Cash and cash equivalents	$ 27,717	$ 27,717	$ 28,026	$ 28,026
Other investments	$ 10,861	$ 10,861	$ 9,551	$ 9,551
Investment in associated organizations	$ 4,022	$ 4,022	$ 4,052	$ 4,052
Notes receivable from members	$ 2,391	$ 2,391	$ 3,095	$ 3,095
Long-term debt	$ 462,240	$ 467,237	$ 475,665	$ 481,256

17. Accounting Pronouncement:

The Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) has issued EITF Issue No. 97-4, "Deregulation of the Pricing of Electricity - Issues Related to the Application of FASB Statement No. 71, 'Accounting for the Effects of Certain Types of Regulation,' and No. 101, 'Regulated Enterprises - Accounting for the Discontinuation of Application of FASB Statement No. 71.'" EITF No. 97-4 determines when an entity should cease applying SFAS No. 71 and to what extent stranded costs and regulatory assets and liabilities should continue to be recognized. Allegheny reviewed the provisions set forth in EITF No. 97-4 and determined that regulatory assets and liabilities should continue to be accounted for under the provisions of SFAS No. 71.

18. Subsequent Event:

Allegheny has been working closely with RUS in an effort to provide its members with more competitive generation and transmission rates, while at the same time enhancing its ability to meet its obligations to creditors and other stakeholders. As part of its efforts, Allegheny is considering filing an application for debt settlement under the recently issued debt settlement regulations. To assure that Allegheny's activities meet the requirements set forth in the regulations, Allegheny consulted with RUS in both the selection of a financial advisor and in the preparation and implementation of a Request for Proposals (RFP). On November 18, 1997, Allegheny announced that an RFP would be issued. The RFP was subsequently issued in December 1997, with responses due back February 1998. RUS will review all proposal evaluation activities and will be actively involved in Allegheny's negotiations with respondents.

1997 At A Glance

Energy sales	2.5 million megawatt-hours
To members	2.3 million megawatt-hours
To non-members (NYPA)	230,688 megawatt-hours
To non-members (SSES)	206,345 megawatt-hours
Total operating revenue	$ 222 million *(member cooperatives)*
Net margins	$ 6.7 million *(member cooperatives)*
Assets	$ 497 million *(member cooperatives)*
Member peak demand	428 megawatts *(coincident, January 1997)*
Meters served	205,142
Kilowatt-hours sold per consumer	10,311
Revenue per consumer	$ 1,083
Consumers per mile of line	7.5
Revenue per mile of line	$ 8,119

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