



Report of Independent Auditors and  
Consolidated Financial Statements

**Alaska Power & Telephone  
Company and Subsidiaries**

December 31, 2011 and 2010

**MOSS ADAMS** LLP

Certified Public Accountants | Business Consultants

*Acumen. Agility. Answers.*

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## REPORT OF INDEPENDENT AUDITORS

The Board of Directors  
Alaska Power & Telephone Company

We have audited the accompanying consolidated balance sheets of Alaska Power & Telephone Company (the Company) and its subsidiaries as of December 31, 2011 and 2010, and the related consolidated statements of income, stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Alaska Power & Telephone Company and its subsidiaries at December 31, 2011 and 2010, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

MOSS ADAMS LLP

Spokane, Washington  
April 6, 2012

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**ALASKA POWER & TELEPHONE COMPANY**  
**CONSOLIDATED BALANCE SHEETS**

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**ASSETS**

|   | December 31,          |                       |
|---|-----------------------|-----------------------|
|   | <u>2011</u>           | <u>2010</u>           |
| <b>PROPERTY, PLANT, AND EQUIPMENT</b>   |                       |                       |
| Electric  | \$ 96,293,374         | \$ 95,031,246         |
| Telecommunications  | 69,238,318            | 68,902,625            |
| Nonutility  | <u>135,054</u>        | <u>1,414,077</u>      |
|   | 165,666,746           | 165,347,948           |
| Less accumulated depreciation and amortization  | <u>87,332,684</u>     | <u>83,796,214</u>     |
|   | 78,334,062            | 81,551,734            |
| Utility plant under construction  | <u>5,004,639</u>      | <u>5,265,785</u>      |
| Total property, plant, and equipment  | <u>83,338,701</u>     | <u>86,817,519</u>     |
| <b>OTHER ASSETS</b>   |                       |                       |
| Investments   | 12,441,248            | 6,734,813             |
| Goodwill  | 9,266,403             | 9,266,403             |
| Rate stabilization asset  | 5,057,013             | 4,828,852             |
| Special funds, restricted   | 2,053,681             | 2,093,494             |
| Other assets  | <u>1,965,463</u>      | <u>3,254,372</u>      |
| Total other assets  | <u>30,783,808</u>     | <u>26,177,934</u>     |
| <b>CURRENT ASSETS</b>   |                       |                       |
| Cash and cash equivalents   | 2,967,758             | 1,952,021             |
| Receivables, less allowance for doubtful accounts<br>of \$32,960 in 2011 and \$21,150 in 2010 | 5,823,335             | 7,800,272             |
| Securities available for sale   | 212,914               | 623,408               |
| Inventory and other current assets  | 2,954,577             | 2,795,982             |
| Income tax refunds receivable   | <u>1,087,662</u>      | <u>1,051,251</u>      |
| Total current assets  | <u>13,046,246</u>     | <u>14,222,934</u>     |
|   | <u>\$ 127,168,755</u> | <u>\$ 127,218,387</u> |

**ALASKA POWER & TELEPHONE COMPANY**  
**CONSOLIDATED BALANCE SHEETS**

**LIABILITIES AND STOCKHOLDERS' EQUITY**

|  | December 31,   |                |
|--|----------------|----------------|
|  | 2011           | 2010           |
| <b>STOCKHOLDERS' EQUITY</b>  |                |                |
| Common stock, \$1 par value, 10,000,000 shares authorized<br>1,497,207 and 1,503,183 shares issued and outstanding<br>in 2011 and 2010, respectively | \$ 1,497,207   | \$ 1,503,183   |
| Additional paid-in capital   | 8,303,139      | 8,407,041      |
| Retained earnings  | 29,647,424     | 26,440,321     |
| Accumulated other comprehensive loss   | (4,274,112)    | (1,085,993)    |
| Total stockholders' equity   | 35,173,658     | 35,264,552     |
| <b>LONG-TERM DEBT, less current portion</b>  |                |                |
| Goat Lake Hydro, Inc. note payable   | 14,518,096     | 15,054,888     |
| Other long-term debt   | 49,728,078     | 52,472,191     |
| Total long-term debt   | 64,246,174     | 67,527,079     |
| <b>INTEREST RATE SWAP</b>  | 7,076,343      | 1,798,001      |
| <b>OTHER LIABILITIES AND DEFERRED CREDITS</b>  |                |                |
| Deferred income taxes  | 13,526,965     | 13,708,407     |
| Other deferred credits   | 836,897        | 939,315        |
| Other  | -              | 1,810          |
| Total other liabilities and deferred credits   | 14,363,862     | 14,649,532     |
| <b>CURRENT LIABILITIES</b>   |                |                |
| Accounts payable and other accrued liabilities   | 2,835,146      | 3,168,102      |
| Deferred income taxes  | 75,981         | 109,941        |
| Current portion of long-term debt  | 3,397,591      | 4,701,180      |
| Total current liabilities  | 6,308,718      | 7,979,223      |
|  | \$ 127,168,755 | \$ 127,218,387 |

**ALASKA POWER & TELEPHONE COMPANY**  
**CONSOLIDATED STATEMENTS OF INCOME**

|   | Years Ended December 31, |                     |
|---|--------------------------|---------------------|
|   | 2011                     | 2010                |
| REVENUE   |                          |                     |
| Electric  | \$ 20,952,902            | \$ 18,516,734       |
| Telecommunications                                    | 15,014,890               | 16,226,593          |
| Other nonregulated                                    | 5,697,359                | 4,567,210           |
|   | <u>41,665,151</u>        | <u>39,310,537</u>   |
| EXPENSES  |                          |                     |
| Electric  | 12,199,586               | 9,404,962           |
| Telecommunications                                    | 8,369,549                | 8,227,329           |
| Other nonregulated                                    | 4,519,980                | 5,179,170           |
| Operations and maintenance expense                    | 25,089,115               | 22,811,461          |
| Depreciation and amortization expense                 | 7,470,958                | 8,206,228           |
|   | <u>32,560,073</u>        | <u>31,017,689</u>   |
| Income from operations                                | <u>9,105,078</u>         | <u>8,292,848</u>    |
| OTHER INCOME (EXPENSE)                                |                          |                     |
| Loss from abandoned projects                          | (395,168)                | (213,920)           |
| Gain (loss) from disposal of assets                   | 1,000                    | (9,044)             |
| Dividend income                                       | 500,887                  | 527,639             |
| Miscellaneous   | (5,794)                  | 25,918              |
| Total other income                                    | <u>100,925</u>           | <u>330,593</u>      |
| Interest income                                       | 59,210                   | 111,585             |
| Interest expense                                      | <u>(3,983,023)</u>       | <u>(4,372,054)</u>  |
| Net interest expense                                  | <u>(3,923,813)</u>       | <u>(4,260,469)</u>  |
| Income before income taxes                            | 5,282,190                | 4,362,972           |
| Provision for income taxes                            | <u>(1,944,480)</u>       | <u>(1,516,522)</u>  |
| Net income  | <u>\$ 3,337,710</u>      | <u>\$ 2,846,450</u> |
| Basic and diluted earnings per share                  | <u>\$ 2.22</u>           | <u>\$ 1.91</u>      |
| Weighted-average basic and diluted shares outstanding | <u>1,500,194</u>         | <u>1,491,950</u>    |

**ALASKA POWER & TELEPHONE COMPANY**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

|  | Common<br>Stock     | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total                | Comprehensive<br>Income |
|--|---------------------|----------------------------------|----------------------|---|----------------------|-------------------------|
| Balance at December 31, 2009                               | \$ 1,480,716        | \$ 8,121,634                     | \$ 23,599,282        | \$ -  | \$ 33,201,632        |                         |
| Net income   | -                   | -                                | 2,846,450            | -   | 2,846,450            | \$ 2,846,450            |
| Sale of common stock                                       | 38,016              | 678,477                          | -                    | -   | 716,493              |                         |
| Repurchase of common stock                                 | (15,549)            | (393,070)                        | -                    | -   | (408,619)            |                         |
| Fair value adjustment to<br>interest rate swap, net of tax | -                   | -                                | -                    | (1,085,993)                                   | (1,085,993)          | <u>(1,085,993)</u>      |
| Other  | -                   | -                                | <u>(5,411)</u>       | -   | <u>(5,411)</u>       |                         |
| Comprehensive income                                       |                     |                                  |                      |   |                      | <u>\$ 1,760,457</u>     |
| Balance at December 31, 2010                               | 1,503,183           | 8,407,041                        | 26,440,321           | (1,085,993)                                   | 35,264,552           |                         |
| Net income   | -                   | -                                | 3,337,710            | -   | 3,337,710            | \$ 3,337,710            |
| Sale of common stock                                       | 33,225              | 581,325                          | -                    | -   | 614,550              |                         |
| Repurchase of common stock                                 | (39,201)            | (685,227)                        | -                    | -   | (724,428)            |                         |
| Fair value adjustment to<br>interest rate swap, net of tax | -                   | -                                | -                    | (3,188,119)                                   | (3,188,119)          | <u>(3,188,119)</u>      |
| Other  | -                   | -                                | <u>(130,607)</u>     | -   | <u>(130,607)</u>     |                         |
| Comprehensive income                                       |                     |                                  |                      |   |                      | <u>\$ 149,591</u>       |
| Balance at December 31, 2011                               | <u>\$ 1,497,207</u> | <u>\$ 8,303,139</u>              | <u>\$ 29,647,424</u> | <u>\$ (4,274,112)</u>                         | <u>\$ 35,173,658</u> |                         |



**ALASKA POWER & TELEPHONE COMPANY**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

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|  | <u>Years Ended December 31,</u> |                    |
|--|---------------------------------|--------------------|
|  | <u>2011</u>                     | <u>2010</u>        |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                  |                                 |                    |
| Net income   | \$ 3,337,710                    | \$ 2,846,450       |
| Adjustments to reconcile net income to net cash<br>from operating activities |                                 |                    |
| Depreciation and amortization  | 7,470,958                       | 8,206,228          |
| (Gain) loss from disposal of assets  | (1,000)                         | 9,044              |
| Noncash patronage dividends  | (175,310)                       | (184,772)          |
| Deferred income tax provision  | 1,999,301                       | 1,110,018          |
| Other noncash activity   | (1,810)                         | (46,066)           |
| Loss from abandoned projects   | 395,168                         | 213,920            |
| Accretion of rate stabilization asset  | (228,161)                       | (232,697)          |
| Changes in assets and liabilities  |                                 |                    |
| Receivables  | 1,521,309                       | (1,767,869)        |
| Income taxes   | (36,411)                        | 1,412,376          |
| Other assets and liabilities   | <u>(1,456,077)</u>              | <u>(1,051,573)</u> |
| Net cash from operating activities   | <u>12,825,677</u>               | <u>10,515,059</u>  |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                  |                                 |                    |
| Acquisitions of property, plant, and equipment, net                          | (6,282,465)                     | (6,038,708)        |
| Investment in equity method affiliate  | (1,152,804)                     | (432,420)          |
| Proceeds from sale of available for sale securities                          | 466,114                         | 380,456            |
| Purchase of available for sale securities                                    | <u>(55,620)</u>                 | <u>(139,222)</u>   |
| Net cash from investing activities   | <u>(7,024,775)</u>              | <u>(6,229,894)</u> |

**ALASKA POWER & TELEPHONE COMPANY**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

|  | Years Ended December 31, |                     |
|--|--------------------------|---------------------|
|  | 2011                     | 2010                |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>  |                          |                     |
| Payments on long-term debt   | \$ (4,584,494)           | \$ (4,220,218)      |
| Special funds - restricted   | 39,813                   | (45,795)            |
| Payment on line of credit  | -                        | (1,497,652)         |
| Proceeds from sale of common stock   | 614,550                  | 716,493             |
| Repurchase of common stock   | (724,428)                | (408,619)           |
| Other changes in equity  | (130,607)                | (5,411)             |
|  | <u>(4,785,166)</u>       | <u>(5,461,202)</u>  |
| <b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>   | 1,015,737                | (1,176,037)         |
| <b>CASH AND CASH EQUIVALENTS, beginning of the year</b>  | <u>1,952,021</u>         | <u>3,128,058</u>    |
| <b>CASH AND CASH EQUIVALENTS, end of the year</b>  | <u>\$ 2,967,758</u>      | <u>\$ 1,952,021</u> |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>  |                          |                     |
| Cash paid during the year for  |                          |                     |
| Interest expense   | <u>\$ 5,098,562</u>      | <u>\$ 4,326,591</u> |
| Income taxes   | <u>\$ 500,000</u>        | <u>\$ -</u>         |
| <b>NONCASH INVESTING AND FINANCING ACTIVITIES</b>  |                          |                     |
| Unrealized loss on interest rate swap, net of tax  | <u>\$ 3,188,119</u>      | <u>\$ 1,085,993</u> |
| Acquisition of property, plant, and equipment with capital lease obligation  | <u>\$ -</u>              | <u>\$ 938,908</u>   |
| Transfer of accounts receivable to plant under construction  | <u>\$ -</u>              | <u>\$ 1,401,664</u> |
| Exchange of net assets in HydroWest International and other consideration for investment in HWI Holdings preferred stock | <u>\$ 7,674,165</u>      | <u>\$ -</u>         |

# ALASKA POWER & TELEPHONE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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### Note 1 – The Company and Summary of Significant Accounting Policies

**Description of entity** – Alaska Power & Telephone Company and its subsidiaries (AP&T or the Company) supply electric and telephone service to several communities in the state of Alaska. AP&T is subject to regulation by the Regulatory Commission of Alaska (RCA), the Federal Communications Commission (FCC), and the Federal Energy Regulatory Commission (the Commissions) with respect to rates for service and maintenance of its accounting records. AP&T's accounting policies conform to accounting principles generally accepted in the United States of America as applied to regulated public utilities and are in accordance with the accounting requirements and rate-making practices of the Commissions.

**Consolidation** – The accompanying consolidated financial statements include the accounts of AP&T and its wholly-owned energy subsidiaries, Alaska Power Company, BBL Hydro, Inc., and Goat Lake Hydro, Inc.; its wholly-owned telecommunications subsidiaries, Alaska Telephone Company, AP&T Long Distance, Inc., AP&T Wireless, Inc., Bettles Telephone, Inc., and North Country Telephone, Inc. All material intercompany balances and transactions have been eliminated in consolidation.

During 2011, the Company completed a spin-off of Hydro West International, which is discussed in Note 5. The accounts of Hydro West International prior to the spin-off date are included in the accompanying consolidated financial statements.

**Accounting estimates** – The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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. Significant estimates include depreciation, interstate access revenue settlements, the fair value of goodwill, the fair value of the interest rate swap, unbilled revenue, and deferred income taxes. Actual results could differ from those estimates.

**Cash and cash equivalents** – All highly liquid investments with original maturities of 90 days or less are carried at cost plus accrued interest, which approximates fair value, and are considered to be cash equivalents. All other investments not considered to be cash equivalents are separately categorized as investments or securities available for sale.

**Concentration of risks** – At various times throughout the year, the cash balances deposited in local institutions exceed federally insured limits. A possible loss exists for those amounts in excess of \$250,000. AP&T minimizes this risk by utilizing numerous financial institutions for deposits of cash funds.

In 2011, the Company received \$3.7 million, or 8.7% of its revenue from the Federal Universal Service Fund. In 2010, the Company received \$3.9 million, or 9.8% of its revenue from the Federal Universal Service Fund.

**ALASKA POWER & TELEPHONE COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**Note 1 – The Company and Summary of Significant Accounting Policies (continued)**

**Comprehensive income** – Accounting principles require that recognized revenues, expenses, gains, and losses be included in net income. In addition, certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities and changes in the fair market value of interest rate swaps, are reported as a separate component of equity. These items, along with net income, are components of comprehensive income, which is reported in the consolidated statements of comprehensive income.

**Valuation of accounts receivable** – Accounts receivable are stated at the amount management expects to collect on outstanding balances. AP&T reviews the collectibility of accounts receivable annually based upon an analysis of outstanding receivables, historic collection information, and existing economic conditions. Receivables from power and telecommunications subscribers are due 30 days after issuance of the subscriber bill. Receivables from other customers are typically outstanding 30 to 60 days before payment is received. Management provides for probable uncollectible amounts through a charge to earnings and a credit to a valuation allowance based on its assessment of the current status of individual accounts. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to accounts receivable. Management believes it has established adequate reserves for any risk associated with these receivables.

**Securities available for sale** – Securities not classified as held to maturity or trading are classified as available for sale. Available for sale securities are stated at fair value with any material unrealized gains and losses, net of deferred taxes, reported as a separate component of stockholders' equity. Unrealized gains and losses were not material in 2011 or 2010. Quoted prices in active markets are available for all of the Company's securities available for sale.

**Fuel, supplies, and other inventory** – Fuel, supplies, and other inventory are valued at the lower of average cost or market. Cost is determined on a first-in, first-out basis. The supplies and other inventory are primarily held for use in construction projects including repairs and maintenance of AP&T's delivery systems.

**Property, plant, equipment, and depreciation** – Property, plant, and equipment are stated at cost. Regulated plant includes assets that are jointly used for regulated and nonregulated activities. The cost of additions to and replacements of property, plant, and equipment are capitalized. This cost includes direct material, labor, and similar items and charges for such indirect costs as engineering, supervision, payroll taxes, and pension benefits. AP&T capitalizes, as an additional cost of utility plant, an allowance for funds used during construction (AFUDC), which represents the allowed cost of capital used to finance a portion of construction work in progress for projects of more than one year in duration. AFUDC consists of debt and equity components that, when capitalized, are credited as noncash items to other income and interest charges. There was no AFUDC recorded in 2011 or 2010.

## **ALASKA POWER & TELEPHONE COMPANY**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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#### **Note 1 – The Company and Summary of Significant Accounting Policies (continued)**

**Property, plant, equipment, and depreciation (continued)** – The cost of current repairs and maintenance is charged to expense, while the cost of betterment is capitalized. The original cost of property, plant, and equipment together with removal cost, less salvage, is charged to accumulated depreciation at such times as assets are retired and removed from service. For financial statement purposes, depreciation is computed on the straight-line method using rates based on average service lives. For income tax purposes, AP&T computes depreciation using accelerated methods where permitted.

**Goodwill** – In 1999, AP&T purchased certain telecommunications properties of GTE Alaska and in 1995 through 1997 purchased the power assets of three service areas in Alaska from existing power providers. The excess of the purchase price over the assets acquired has been recorded as goodwill in the amount of \$8,550,741 for the telecommunications properties and \$715,662 for the power properties. The goodwill is tested annually for impairment by management evaluating if current events and circumstances indicate that it is more likely than not that the fair value of the reporting unit is less than its carrying value. If management's analysis indicates that it is more likely than not that the fair value is less than the carrying value, the fair value of the reporting unit is calculated and compared to the carrying value. Management has reviewed events and circumstances that may indicate decreases in fair value of goodwill and has concluded no impairment exists at December 31, 2011.

**Preliminary survey and investigation costs** – AP&T defers costs incurred for the preliminary survey and investigation of proposed construction projects in accordance with the rules of the Commissions. These deferred costs are capitalized into utility plant when the preliminary survey and investigation projects are completed or are charged to expense in the period that a proposed project is abandoned.

**Income taxes** – Deferred taxes are provided on an asset and liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets relate primarily to asset impairment deductions on the books. Deferred tax liabilities relate primarily to the use of accelerated depreciation for income tax purposes. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

The Company records uncertain tax positions if the likelihood the position will be sustained upon examination is less than 50%. As of December 31, 2011 and 2010, the Company had no accrued amounts related to uncertain tax positions. The Company is no longer subject to U.S. federal or state and local income tax examinations by tax authorities for years before 2008.

**ALASKA POWER & TELEPHONE COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**Note 1 – The Company and Summary of Significant Accounting Policies (continued)**

**Other deferred credits** – Other deferred credits consist of customer advances for construction, grant funded projects, and other deferred revenue. Customer advances for construction of additions to the electric distribution systems are recorded as a liability and are amortized through discounted service billings to the customer over a 60-month period. At the end of the amortization period, any remaining balance is recorded as a reduction of the respective utility plant accounts. Customer advances for construction were \$292,789 and \$328,345 at December 31, 2011 and 2010, respectively.

**Revenue recognition – Electric** – AP&T utilizes cycle billing and records revenue billed to its customers when the meters are read each month. In addition, AP&T recognizes unbilled revenue from electric power delivered, but not yet billed.

**Revenue recognition – Telecommunications** – AP&T’s local wireline rates and access revenues (revenues earned for originating and terminating long distance calls) are determined by rates approved by regulators. Other sources of revenues, such as Internet, equipment sales, wireless, and long distance resale are not rate regulated. Pending and future regulatory actions may have a significant impact on AP&T’s future operations and financial condition.

Monthly service fees derived from local wireline, data services, and wireless are billed one month in advance, but recognized in the month that service is provided.

Usage sensitive revenues such as long distance and other wireless services are generally billed as a per-minute charge.

AP&T also receives significant universal service support revenue based on the higher costs of providing rural telecommunications service. These revenues are included in interstate access revenues and are based on AP&T’s relative level of operating expense and plant investment. The interstate program is governed by the FCC and administered by the Universal Service Administrative Company (USAC).

Telecommunications operating revenues include settlements based on AP&T’s participation in the interstate revenue pools administered by the National Exchange Carrier Association (NECA) and regulated by the FCC. These revenues are determined by annually prepared separations and interstate access cost studies. Revenues for the current year are based on estimates prior to the submission of the cost study reporting actual results of operations. Additionally, the studies are subject to a 24-month pool adjustment period and final review and acceptance by the pool administrators. Management does not anticipate significant adjustments to recorded revenues for the years ended December 31, 2011 and 2010.

# ALASKA POWER & TELEPHONE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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### Note 1 – The Company and Summary of Significant Accounting Policies (continued)

**Revenue recognition – Telecommunications (continued)** – Additionally, telecommunications operating revenues include revenues received from intrastate revenue pools administered by the Alaska Exchange Carriers Association that are based on AP&T's relative cost of providing intrastate access service. These revenues are based on projections submitted periodically and intrastate access cost studies that are submitted every two years. Management does not anticipate significant adjustments to recorded revenues for the years ended December 31, 2011 and 2010.

In October 2011, the FCC issued an order reforming Intercarrier Compensation and Universal Service (USF) mechanisms and issued of a Further Notice of Proposed Rulemaking (FNPRM) on long-term USF reform and transition timing. The order and FNPRM introduce caps on capital expenditure and operating expenses recoverable from the USF and significantly reduce carrier access rates over an extended transition period. Management is monitoring the impact of the reform, but the current order does not appear to have a significant impact on future revenues. This evaluation is subject to change as the FNPRM has not been finalized, and the reform order is being challenged in court.

**Earnings per share** – AP&T has calculated its basic earnings per share based on the weighted-average number of shares of common stock outstanding. Diluted earnings per share reflect the impact of the dilution caused by outstanding stock options using the treasury stock method. There was no dilutive effect of any outstanding stock options in 2011 or 2010. Weighted-average shares outstanding for purposes of calculating basic and diluted earnings per share were 1,500,194 in 2011 and 1,491,950 in 2010.

**Taxes imposed by governmental authorities** – The Company is subject to taxes assessed by various governmental authorities on many different types of revenue transactions with its customers. These specific taxes are charged to and collected from the Company's customers and subsequently remitted to the appropriate taxing authority. The taxes are accounted for on a net basis and excluded from revenues.

**Advertising costs** – AP&T expenses advertising costs as incurred. Advertising expenses during the years ended December 31, 2011 and 2010, were \$130,683 and \$121,580, respectively.

**Fair value measurements** – Fair value represents the price that would be received to sell an asset or transfer a liability in an orderly transaction between market participants at the measurement date. The Company follows the following fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value:

- Level 1**            Quoted prices in active markets for identical assets or liabilities.
- Level 2**            Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets.

**ALASKA POWER & TELEPHONE COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**Note 1 – The Company and Summary of Significant Accounting Policies (continued)**

**Fair value measurements (continued) –**

**Level 3** Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The fair value measurement guidance is applicable to the Company in the following areas:

- Goodwill impairment testing
- Securities available for sale
- Interest rate swaps

The Company's investment in securities available for sale are classified as Level 1 in the above hierarchy at December 31, 2011 and 2010.

The following methods were used to estimate the fair value of all other financial instruments recognized in the accompanying balance sheet:

**Cash and cash equivalents** – The carrying amounts approximate fair value because of the short maturity of those instruments.

**Long term debt** – The fair value of AP&T's long-term debt is estimated by discounting the future cash flows of the various instruments at rates currently available to AP&T for similar debt instruments of comparable maturities.

The carrying amount of long-term debt approximates the estimated fair value at December 31, 2011, due to the low interest rate environment and the current rates for AP&T's long-term debt obligations.

**Subsequent events** – Subsequent events are events or transactions that occur after the balance sheet date but before the financial statements are available to be issued. The Company recognizes in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing the financial statements. The Company's financial statements do not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date and before the financial statements are available to be issued.

The Company has evaluated subsequent events through April 6, 2012, which is the date the financial statements were issued.



## **ALASKA POWER & TELEPHONE COMPANY**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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#### **Note 2 – Rate Stabilization Asset**

The Company defers certain costs that would otherwise be charged to expense, if it is probable future rates will permit the recovery of such costs. In September 2000, the Company received approval from the Commissions to defer the billing of a portion of the allowable annual costs as defined by the power sales agreement in place between Alaska Power Company and Goat Lake Hydro. Such amounts are deferred as a regulatory asset and will be billed in future years when the Company's allowable annual costs decline below certain levels. Management projects the deferred amounts will be recovered through additional billings through 2020.

#### **Note 3 – Operating Lease Agreements**

AP&T leases a portion of its office space and a portion of its utility plant under noncancelable leases. Rent expense on the noncancelable leases was \$374,483 and \$377,858 for 2011 and 2010, respectively. Certain leases include renewal provisions at AP&T's option. Minimum rental commitments under noncancelable operating leases are as follows:

|      |            |
|------|------------|
| 2012 | \$ 239,371 |
| 2013 | 162,989    |
| 2014 | 118,167    |
| 2015 | 77,230     |
| 2016 | 63,830     |

Additional cancellable lease agreements have been secured for the use of the land for hydroelectric operations. The term of the agreements extend for the life of the hydroelectric license of 50 years. Total Company rent expense was \$422,055 in 2011 and \$493,051 in 2010.

**ALASKA POWER & TELEPHONE COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**Note 4 – Property, Plant, and Equipment**

Property, plant, and equipment consist of the following assets at December 31:

|   | <u>2011</u>                  | <u>2010</u>                  | <u>Depreciation<br/>Rate</u> |
|---|------------------------------|------------------------------|------------------------------|
| Electric                                    |                              |                              |                              |
| Hydroelectric                               | \$ 26,439,896                | \$ 26,314,010                | 2%                           |
| Other generation                            | 18,237,058                   | 17,988,838                   | 4% to 8%                     |
| Transmission and distribution               | 36,990,016                   | 36,361,858                   | 2.5% to 4%                   |
| Other                                       | 13,459,164                   | 13,199,300                   | 2.5% to 20%                  |
| Land  | 821,067                      | 821,067                      | ---                          |
| Utility plant acquisition adjustment        | <u>346,173</u>               | <u>346,173</u>               | 6%                           |
|   | <u>96,293,374</u>            | <u>95,031,246</u>            |                              |
| Telecommunications                          |                              |                              |                              |
| General support assets                      | 11,338,077                   | 11,034,741                   | 2.5% to 20%                  |
| Central office assets                       | 14,936,305                   | 17,325,015                   | 8% to 14%                    |
| Cable and wire facilities                   | 19,840,350                   | 18,928,100                   | 3% to 6%                     |
| Nonregulated investment                     | 22,786,949                   | 21,278,132                   | 10% to 20%                   |
| Land  | <u>336,637</u>               | <u>336,637</u>               | ---                          |
|   | <u>69,238,318</u>            | <u>68,902,625</u>            |                              |
| Nonutility                                  |                              |                              |                              |
| Computer equipment                          | -                            | 76,247                       | 13%                          |
| Furniture and other equipment               | -                            | 150,587                      | 5%                           |
| Buildings                                   | 101,924                      | 101,924                      | 4%                           |
| Leasehold improvements                      | -                            | 26,459                       | 10%                          |
| Land  | <u>33,130</u>                | <u>1,058,860</u>             | ---                          |
|   | <u>135,054</u>               | <u>1,414,077</u>             |                              |
| <b>Total property, plant, and equipment</b> | <u><u>\$ 165,666,746</u></u> | <u><u>\$ 165,347,948</u></u> |                              |

Utility plant under construction includes all direct and indirect costs incurred during the construction of projects that were not complete and in service at the balance sheet date. The balance also includes approximately \$2.3 million in construction costs related to Soule River Hydro, LLC (SRH). SRH is a project company formed to construct a hydroelectric facility on the Soule River in Alaska that was not operational as of December 31, 2011.

**ALASKA POWER & TELEPHONE COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**Note 5 – Investments**

AP&T's investments consist of the following at December 31:

|   | <u>2011</u>          | <u>2010</u>         |
|---|----------------------|---------------------|
| Investment in CoBank                          | \$ 3,767,083         | \$ 3,591,773        |
| Investment in Ketchikan Electric Company, LLC | 600,000              | 600,000             |
| Investments of Hydro West International       | -                    | 2,143,040           |
| Investment in Hydro West Holdings, Inc.       | 7,674,165            | -                   |
| Investment in Haida Energy, Inc.              | <u>400,000</u>       | <u>400,000</u>      |
|   | <u>\$ 12,441,248</u> | <u>\$ 6,734,813</u> |

**CoBank** – CoBank is organized similar to a cooperative and is owned by the customers it serves. As such, a portion of CoBank's earnings is returned to its customers based on their patronage with the bank. This investment is recorded on the cost method. Dividend income was reported in the amount of \$500,887 and \$527,639 for 2011 and 2010, respectively, related to these earnings.

**Ketchikan Electric Company LLC** – AP&T owns a 50% share of Ketchikan Electric Company LLC (KEC) and accounts for the investment using the equity method. The principal purpose and business of KEC is to construct, own, operate, and manage a hydroelectric power system in the Ketchikan Gateway Borough. The investment represents capital contributions to KEC, as the company is still in the development stage. There was no activity in 2011 or 2010.

**Hydro West International and Hydro West Holdings, Inc.** – Hydro West International (HWI) is an operating entity that manages and owns interests in hydroelectric projects in central America. As of December 31, 2010, HWI was a wholly-owned subsidiary of the Company and its assets, liabilities, and operations were included in the Company's consolidated financial statements. During August 2011, the Company completed a spin-off arrangement where it contributed its ownership interest in HWI to Hydro West Holdings, Inc. (Holdings), a newly formed domestic holding company, in exchange for 7.6 million shares of nonvoting preferred stock in Holdings. The common and voting stock of Holdings is held by the individual stockholders of AP&T. The nonvoting preferred stock in Holdings entitles the Company to receive cumulative dividends at a rate of 8% per annum beginning in August of 2013 and entitles the Company to distribution preference in the event of a liquidation.

The Company's investment in the preferred stock of Holdings is accounted for using the cost method. The fair value of the preferred shares in Holdings at the date of the spin-off was approximately equal to the fair value of HWI. Management reviews the value of this investment by evaluating if current events and circumstances indicate that the fair value is less than the carrying value and has concluded that no impairment exists at December 31, 2011.

**ALASKA POWER & TELEPHONE COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**Note 5 – Investments (continued)**

HWI's assets, liabilities, and stockholder's equity consisted of the following as of the date of the spin-off:

|  |                                |
|--|--------------------------------|
| Cash   | \$ 314,558                     |
| Investments                                    | 2,143,040                      |
| Property, plant, and equipment, net            | 1,143,020                      |
| Utility plant under construction               | 1,832,910                      |
| Other assets                                   | <u>1,999,815</u>               |
| <br>Total assets                               | <br><u><u>\$ 7,433,343</u></u> |
| <br>Accounts payable and accrued liabilities   | <br>\$ 40,481                  |
| <br>Stockholder's equity                       | <br><u>7,392,862</u>           |
| <br>Total liabilities and stockholder's equity | <br><u><u>\$ 7,433,343</u></u> |

HWI's 2011 operations prior to the spin-off were not material.

At December 31, 2010, HWI's investments consisted of 100% of the stock of Rio Hondo Holding Company (RHH), a Cayman Island limited company, which owns 25% of the capital stock of Hidroelectrica Rio Hondo, S.A., a Guatemalan corporation whose principal purpose is to construct the Rio Hondo II project, a 32 MW hydroelectric plant in Guatemala, Central America. The project company has completed the design, licensing, and environmental studies. HWI accounts for its investment in RHH using the equity method.

The assets, liabilities, and operations of the HWI's investment in RHH were as follows at December 31, 2010:

|                    |                               |
|--------------------|-------------------------------|
| Assets             | <u><u>\$ 7,140,935</u></u>    |
| Liabilities        | <u>\$ 1,881,491</u>           |
| Equity             | <u><u>\$ 5,259,444</u></u>    |
| Operating revenues | \$ 7,683                      |
| Operating expenses | 141,341                       |
| Other income       | <u>51,484</u>                 |
| <br>Net loss       | <br><u><u>\$ (82,174)</u></u> |

**ALASKA POWER & TELEPHONE COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**Note 6 - Long-Term Debt**

The Company's long-term debt consists of the following at December 31:

|  | <u>2011</u>          | <u>2010</u>          |
|--|----------------------|----------------------|
| <b>Goat Lake Hydro, Inc.</b> (GLH) note payable to secure Power Revenue Bonds Series 1997. Face amount of \$23,000,000 less issue discount of \$136,904 in 2011 and \$150,113 in 2010 and the bond sinking fund amount of \$565,000 in 2011 and \$535,000 in 2010 secured by the Power Sales Agreement, a Construction Funding Agreement, and all assets of Goat Lake Hydro, Inc. Interest rate average of 6% per year, principal due in annual installments through 2029. | \$ 15,068,096        | \$ 15,619,888        |
| <b>CoBank</b> notes payable, secured by all assets of AP&T and its subsidiaries, due in monthly installments and based on a 25-year amortization with interest rates ranging from 5.50% to 5.65% through August of 2013. Interest rates will be adjusted in 2013 with monthly payments continuing until 2023.  | 48,955,468           | 51,174,662           |
| <b>Notes payable to state of Alaska</b> , secured by certain electric assets, with interest rates ranging from 0.00% to 5.45%, maturing at various dates from 2014 through 2037.   | 3,323,897            | 3,316,433            |
| Unsecured Class 8 term debt - Tranche A  | -                    | 1,130,057            |
| Capital lease obligation   | 198,685              | 668,666              |
| Other term debt  | <u>97,618</u>        | <u>318,553</u>       |
|  | 67,643,765           | 72,228,259           |
| Less current portion   | <u>(3,397,591)</u>   | <u>(4,701,180)</u>   |
|  | <u>\$ 64,246,174</u> | <u>\$ 67,527,079</u> |

Annual maturities for the five years beginning January 1, 2012, are \$ 3,397,591, \$2,958,756, \$3,929,723, \$4,216,436, and \$4,527,760, respectively, and \$48,613,499 thereafter.

**ALASKA POWER & TELEPHONE COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**Note 6 – Long-Term Debt (continued)**

The Company uses variable-rate debt to finance its operations and these debt obligations expose the Company to variability in interest payments due to changes in interest rates. Management believes that it is prudent to limit the variability of a portion of its interest payments as well as the uncertainty associated with interest rates when its balloon payment with CoBank becomes due. To meet this objective, management periodically considers interest rate swap agreements to manage fluctuations in cash flows resulting from interest rate risk. These swaps change the variable-rate cash flow exposure on the debt obligations to fixed cash flows. The Company does not enter into derivative instruments for speculative purposes. Under the terms of the interest rate swaps, the Company receives variable interest rate payments and makes fixed interest rate payments, thereby creating the equivalent of fixed-rate debt. Changes in the fair value of interest rate swaps designated as hedging instruments that effectively offset the variability of cash flows associated with variable-rate debt obligations are reported in accumulated other comprehensive loss. At December 31, 2009, the Company had entered into an interest rate swap agreement on all of its long-term debt with CoBank. The interest rate swap becomes effective in August 2013 and amortizes over an additional 10-year term at 7.62% per annum. The fair value of the interest rate swap liability was \$7,076,343 and \$1,789,001 at December 31, 2011 and 2010, respectively, and is classified within Level 2 of the valuation hierarchy.

The note payable by GLH to secure the Power Revenue Bonds Series 1997 is the result of the issuance on December 31, 1997, of a series of tax-exempt bonds by the Alaska Industrial Development and Export Authority (AIDEA). The proceeds are restricted in use for the purpose of financing the acquisition, purchase, construction, improvement, and equipment of the project known as the Upper Lynn Canal Regional Power Supply System.

Of these restricted funds, approximately \$2 million is required to remain in reserve for the term of the bonds. To secure payment of bond principal and interest, AIDEA has assigned to U.S. Bank Trust National Association all rights and interests in the note. The note is secured by all assets and revenues of GLH and a Power Sales Agreement (PSA) between GLH and Alaska Power Co. (APC), both wholly-owned subsidiaries of AP&T. The Regulatory Commission of Alaska has approved the PSA for the life of the GLH note. This approval allows APC to charge its customers the entire annual costs as defined in the PSA. A portion of these annual costs is charged to the rate stabilization asset (see Note 2), representing the amounts to be collected from customers in future years. The PSA requires all GLH's production and sales of electricity be sold to and purchased by APC for the life of the agreement.

**ALASKA POWER & TELEPHONE COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**Note 7 – Income Taxes**

The components of the consolidated provision for income taxes are as follows for the years ended December 31:

|          | <u>2011</u>         | <u>2010</u>         |
|----------|---------------------|---------------------|
| Current  | \$ (54,821)         | \$ 415,103          |
| Deferred | <u>1,999,301</u>    | <u>1,101,419</u>    |
|          | <u>\$ 1,944,480</u> | <u>\$ 1,516,522</u> |

Total tax expense differs from that computed at the statutory federal income tax rate due to the following:

|   | <u>2011</u>         | <u>2010</u>         |
|---|---------------------|---------------------|
| Income tax provision at federal rate of 34% | \$ 1,618,836        | \$ 1,169,336        |
| State income taxes, net of federal benefit  | <u>325,644</u>      | <u>347,186</u>      |
| Provision for income taxes                  | <u>\$ 1,944,480</u> | <u>\$ 1,516,522</u> |

The components of the deferred tax (assets) and liabilities as of December 31 are as follows:

|                                       | <u>2011</u>          | <u>2010</u>          |
|---------------------------------------|----------------------|----------------------|
| Current                               |                      |                      |
| Deferred tax assets                   | \$ (237,739)         | \$ (229,307)         |
| Deferred tax liabilities              | <u>313,720</u>       | <u>339,248</u>       |
| Net current deferred tax liability    | <u>\$ 75,981</u>     | <u>\$ 109,941</u>    |
| Noncurrent                            |                      |                      |
| Deferred tax assets                   | \$ (3,861,307)       | \$ (1,853,223)       |
| Deferred tax liabilities              | <u>17,388,272</u>    | <u>15,561,630</u>    |
| Net noncurrent deferred tax liability | <u>\$ 13,526,965</u> | <u>\$ 13,708,407</u> |

**Note 8 – Employee Stock Ownership Plan**

AP&T maintains an employee stock ownership plan (the Plan). All employees expected to work at least 1,000 hours per year become eligible to participate in the Plan upon attaining the age of 18 and completing 3 months of service. Participants may elect to contribute from 1% to 80% of their wages to the Plan, subject to IRS maximums, which can be invested in the common stock of AP&T or into other investment accounts.

**ALASKA POWER & TELEPHONE COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**Note 8 – Employee Stock Ownership Plan (continued)**

A 3% defined matching contribution is made to each eligible participant’s account throughout the year. Additionally, a contribution may be made annually at the discretion of the employer in an amount up to 5% of an eligible participant’s wages. The discretionary contribution can be made in cash, Company stock, or a combination of both. The Plan provides that participants’ interests in employer-funded contributions become fully vested after the completion of three years of service. The Plan defines a year of service as the completion of not fewer than 1,000 hours of service within the calendar year.

In 2011, employer matching contributions and discretionary contributions were \$270,177 and \$137,923, respectively. In 2010, employer matching contributions and discretionary contributions were \$280,448 and \$292,417, respectively.

**Note 9 – Business Segment Information**

AP&T’s electric segment provides retail and wholesale electric service including both hydro electric and diesel generation facilities in rural portions of Alaska. AP&T’s telecommunications segment provides local telephone service also in rural areas of Alaska. AP&T’s reportable segments are strategic business units managed separately due to their different operating and regulatory environments. The “other nonregulated” category includes the parent company and segments below the quantitative threshold for separate disclosure.

| (All numbers in thousands)<br>2011 | Regulated<br>Electric | Regulated<br>Telecom | Other<br>Nonregulated | Consolidated |
|------------------------------------|-----------------------|----------------------|-----------------------|--------------|
| Operating revenue                  | \$ 20,953             | \$ 15,015            | \$ 5,697              | \$ 41,665    |
| Depreciation and amortization      | 3,121                 | 2,984                | 1,366                 | 7,471        |
| Operating income                   | 5,633                 | 2,022                | 1,450                 | 9,105        |
| Interest expense                   | 1,066                 | -                    | 2,917                 | 3,983        |
| Interest income                    | 46                    | -                    | 13                    | 59           |
| Total fixed assets                 | 96,293                | 46,451               | 22,922                | 165,666      |
| Capital expenditure                | 1,072                 | 2,384                | 2,826                 | 6,282        |

| (All numbers in thousands)<br>2010 | Regulated<br>Electric | Regulated<br>Telecom | Other<br>Nonregulated | Consolidated |
|------------------------------------|-----------------------|----------------------|-----------------------|--------------|
| Operating revenue                  | \$ 18,517             | \$ 16,227            | \$ 4,567              | \$ 39,311    |
| Depreciation and amortization      | 3,137                 | 3,806                | 1,263                 | 8,206        |
| Operating income (loss)            | 5,975                 | 2,763                | (445)                 | 8,293        |
| Interest expense                   | 1,025                 | -                    | 3,347                 | 4,372        |
| Interest income                    | 66                    | -                    | 46                    | 112          |
| Total fixed assets                 | 95,031                | 47,624               | 22,692                | 165,347      |
| Capital expenditure                | 1,624                 | 1,651                | 2,764                 | 6,039        |



**ALASKA POWER & TELEPHONE COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**Note 10 – Special Funds – Restricted**

Special funds - restricted consists of the balance of proceeds from the note payable to secure Power Revenue Bonds Series 1997 at Goat Lake Hydro, Inc. (see Note 6). U.S. Bank Trust National Association in accordance with the Trust Indenture dated December 1, 1997, is holding these funds. The funds are restricted for use according to provisions of the loan agreement and by the Use of Proceeds and Arbitrage Certificate dated December 1, 1997.

Restricted funds are held in the following accounts and are recorded at cost:

|                                      | <u>2011</u>         | <u>2010</u>         |
|--------------------------------------|---------------------|---------------------|
| Bond Reserve Fund                    | \$ 1,527,400        | \$ 1,538,493        |
| Bond Renewal and Replacement Fund    | 506,281             | 535,001             |
| Other miscellaneous restricted funds | <u>20,000</u>       | <u>20,000</u>       |
|                                      | <u>\$ 2,053,681</u> | <u>\$ 2,093,494</u> |

AP&T is required to maintain in the Bond Reserve Fund, at a minimum, an amount equal to the interest and principal due in the next 12 months. The Bond Renewal and Replacement Funds are required to remain in reserve for the term of the bonds.

**Note 11 – Other Assets**

Other assets consist of the following at December 31:

|   | <u>2011</u>         | <u>2010</u>         |
|---|---------------------|---------------------|
| Deferred loan origination fees          | \$ 803,644          | \$ 816,227          |
| Deferred bond issuance costs            | 227,809             | 256,004             |
| Miscellaneous regulatory assets - power | 531,207             | 519,895             |
| Other                                   | <u>402,803</u>      | <u>1,662,246</u>    |
|   | <u>\$ 1,965,463</u> | <u>\$ 3,254,372</u> |

The deferred loan origination fees are related to the note payable to CoBank and are being amortized on a straight-line basis over the 10-year life of the note.

The deferred bond issuance costs are related to the note payable at Goat Lake Hydro to secure power revenue bonds and are being amortized over the 35-year life of the note.