

**Yadkin Power Generation**  
Combined Statements of Income  
For the years ended December 31, 2010, 2009 and 2008

**Yadkin Power Generation  
Index**

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	Page(s)
Report of Independent Auditors .....	1
Combined Statements of Income Years Ended December 31, 2010, 2009 and 2008.....	2
Notes to Combined Statements of Income Years Ended December 31, 2010, 2009 and 2008.....	3-7



## Report of Independent Auditors

To the Shareholder of Yadkin Power Generation

In our opinion, the accompanying combined statements of income present fairly, in all material respects, the net income and other data shown therein of Yadkin Power Generation, a wholly owned business of Alcoa Inc., as discussed in Note A to the accompanying combined statements of income, (the "Company") for the years ended December 31, 2010, 2009 and 2008 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these financial statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audits to obtain reasonable assurance about whether the combined statements of income are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statement of income, assessing the accounting principles used and significant estimates made by management, and evaluating the overall income statement presentation. We believe that our audits of these statements of income provide a reasonable basis for our opinion.

*PricewaterhouseCoopers LLP*

March 2, 2011

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**Combined Statements of Income**  
**For the years ended December 31, 2010, 2009 and 2008**

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*(in thousands of dollars)*

	2010	2009	2008
<b>Revenues</b>			
Sales to customers	\$ 31,387	\$ 28,275	\$ 28,692
<b>Costs and expenses</b>			
Cost of power generation (exclusive of expenses below)	4,299	4,062	2,183
Cost of transmission	805	458	537
Purchased power	14	540	85
Operating expenses	8,204	7,783	9,045
Taxes other than income taxes	1,425	1,425	1,121
Depreciation and amortization	3,508	2,494	1,475
Restructuring and other charges	-	-	163
Other (income), net	(299)	(1,028)	(181)
	<u>17,956</u>	<u>15,734</u>	<u>14,428</u>
Income before taxes on income	13,431	12,541	14,264
Provision for taxes on income	5,468	5,236	6,394
Net income	<u>\$ 7,963</u>	<u>\$ 7,305</u>	<u>\$ 7,870</u>

The accompanying notes are an integral part of these statements of income.

# Yadkin Power Generation

## Notes to Combined Statements of Income

### For the years ended December 31, 2010, 2009 and 2008

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*(in thousands of dollars)*

#### A. Description of Business

Yadkin Power Generation (Yadkin) is part of Alcoa Power Generating Inc. (APGI), a wholly-owned subsidiary of Alcoa Inc. (Alcoa). Yadkin encompasses four reservoirs, dams and power houses situated along a 38-mile stretch of the Yadkin River through the central part of North Carolina. The four dams at Yadkin (Narrows, Falls, High Rock and Tuckertown) have a combined generation capacity of approximately 215 megawatts, and most of this power is purchased and re-sold to third parties by Alcoa Power Marketing Inc. (APMI), a wholly-owned subsidiary of Alcoa. APMI purchases and sells power to third parties on behalf of APGI, which owns other power generation assets of Alcoa. The combined operating results of Yadkin and the portion of APMI's revenues and administrative costs that relate to Yadkin are collectively referred to herein as the Business; the principles of combination and carve-out are described below.

#### B. Re-Licensing Agreements

The Business is subject to regulation by the Federal Energy Regulatory Commission (FERC). In April 2006, APGI filed an application with FERC for a new 50-year license to operate the Business' hydropower operations along the Yadkin River. Approximately one year later, APGI filed with FERC a Relicensing Settlement Agreement negotiated with the majority of the interested stakeholders that broadly resolved relicensing issues. The National Environmental Policy Act process is complete, with a final environmental impact statement having been issued in April 2008. The remaining requirement for the relicensing was the issuance by North Carolina of the required water quality certification under Section 401 of the Clean Water Act (Section 401). The Section 401 water quality certification was issued on May 7, 2009, but was appealed, and had been stayed since late May 2009 pending substantive determination on the appeal. On December 1, 2010, North Carolina Department of Water Quality revoked the previously-issued Section 401 water quality certification. APGI is currently appealing the revocation.

APGI received a year-to-year license renewal from FERC in May 2008, May 2009, and May 2010. The Business will continue to operate under an annual license until either the Section 401 certification (whose revocation is being appealed) is issued or until APGI files for and receives a new Section 401 certification and the FERC relicensing process is complete.

#### C. Summary of Significant Accounting Policies

##### Principles of Combination

The combined statements of income of the Business include the accounts, based on historical cost, in which Alcoa has a controlling interest. All intercompany balances and transactions between and within entities included in the Business have been eliminated. Intercompany activity with Alcoa and its affiliates (other than the Business) is settled periodically through cash payment or through net settlement. The Business is part of a cash pooling arrangement with Alcoa.

The combined statements of income have been carved out from the books and records of Alcoa, and include all items of revenue and income generated by the Business and all items of expense directly incurred by the Business. These include expenses charged to the Business by Alcoa in the normal course of business. The combined statements of income reflect allocated amounts from Alcoa in order to depict the results of operations of the Business on a stand-alone basis. The amounts have been allocated on a basis considered reasonable by management using either specific identification or proportional allocations based on usage, headcount or other reasonable methods of allocation. As a result of these allocated amounts, the combined statements of income of the Business may not be indicative of the results that would be presented if the Business had operated as an independent stand-alone entity. For additional information concerning expenses charged to the Business by Alcoa refer to Note E.

# Yadkin Power Generation

## Notes to Combined Statements of Income

### For the years ended December 31, 2010, 2009 and 2008

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*(in thousands of dollars)*

#### **Use of Estimates**

The combined statements of income are prepared in conformity with accounting principles generally accepted in the United States of America and require management to make certain estimates and assumptions. These may affect the reported amounts and the disclosure of contingent assets and liabilities at the date of the combined statements of income. They may also affect the reported amounts of revenues and expenses during the reporting period. Areas that require significant judgments, estimates and assumptions include the useful lives of property, plant and equipment, accounting for revenue recognition, tax matters, and environmental matters. Management uses historical experience and all available information to make these judgments and actual results could differ from those estimates upon subsequent resolution of some matters.

#### **Revenue Recognition**

The Business recognizes revenue from the sale of electricity in the period that the electricity is delivered to the customers, including an estimate for unbilled revenues.

#### **Cost of Power Generation**

Costs reported in this line item include direct operating and maintenance labor and material costs incurred at the four dams and generators, as separately reported on APGI's FERC Form 1 submissions dated April 19, 2010, and April 22, 2009, for the years ended December 31, 2009 and 2008, respectively. APGI has not yet filed its FERC Form 1 for the year ended December 31, 2010.

#### **Cost of Transmission**

Costs reporting in this line item include direct operating and maintenance labor and material costs for the transmission system, as separately reported on APGI's FERC Form 1 submissions dated April 19, 2010, and April 22, 2009, for the years ended December 31, 2009 and 2008, respectively. APGI has not yet filed its FERC Form 1 for the year ended December 31, 2010.

#### **Operating Expenses**

This line item includes all other direct and indirect costs to operate and manage the lakes, dams, generation, and transmission systems, including but not limited to 24-hour dispatch and control center, 24-hour sales and marketing desk, property maintenance and management, engineering, capital project management, location management, information technology, human resource management, legal and procurement services. These costs are included in the consolidated APGI totals reported on APGI's FERC Form 1 submissions dated April 19, 2010, and April 22, 2009, for the years ended December 31, 2009 and 2008, respectively. APGI has not yet filed its FERC Form 1 for the year ended December 31, 2010.

#### **Depreciation Expense and Properties, Plants and Equipment**

Properties, plant and equipment are recorded at cost. Depreciation is recorded principally on the straight-line method at rates based on the estimated useful lives of the assets, averaging 33 years for structures and 16 years for machinery and equipment, as useful lives range between 5 and 25 years. Gains or losses from the sale of assets are included in other income. Repairs and maintenance are charged to expense as incurred.

Properties, plant, and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amounts of such assets (asset group) may not be recoverable. Recoverability of assets is determined by comparing the estimated undiscounted net cash flows of the operations to which the assets (asset group) related to their carrying amount. An impairment loss would be recognized when the carrying amount of the assets (asset group) exceeds the estimated undiscounted net cash flows. The amount of an impairment loss to be recorded is calculated as the excess of the carrying value of the assets (asset group) over their fair value, with fair value generally determined using a discounted cash flow analysis.

**Yadkin Power Generation**  
**Notes to Combined Statements of Income**  
**For the years ended December 31, 2010, 2009 and 2008**

(in thousands of dollars)

**Income Taxes**

The provision for income taxes has been calculated on a "separate return" basis on the combined statements of income and is determined using the asset and liability approach of accounting for income taxes. Under this approach, deferred taxes represent the future tax consequences expected to occur when the reported amounts of assets and liabilities are recovered or paid. The provision for income taxes represents income taxes paid or payable for the current year and the change in deferred taxes during the year. Deferred taxes result from differences between the financial and tax bases of the Business' assets and liabilities and are adjusted for changes in tax rates and tax laws when changes are enacted. Valuation allowances are recorded to reduce the deferred tax assets when it is more likely than not that a tax benefit will not be realized. The Business is included in Alcoa's U.S. consolidated tax return.

**Research and Development Expenses**

Research and development expenses are expensed as incurred.

**D. Properties, Plant and Equipment, net**

(as of December 31)

	2010	2009	2008
Land	\$ 9,052	\$ 9,061	\$ 9,061
Structures	28,783	28,783	28,728
Machinery and equipment	82,674	80,485	73,764
	<u>120,509</u>	<u>118,329</u>	<u>111,553</u>
Less: Accumulated depreciation	62,466	58,958	60,035
	58,043	59,371	51,518
Construction work-in-progress	45,368 *	40,646 *	37,353 *
	<u>\$ 103,411</u>	<u>\$ 100,017</u>	<u>\$ 88,871</u>

\* Costs associated with the FERC re-licensing are included in this balance, and at December 31, 2010, 2009 and 2008, totaled \$33,075, \$28,093 and \$24,454, respectively. These costs are deferred until the FERC license is granted, and then amortized over the license period.

Capital expenditures totaled \$6,911, \$13,639 and \$20,598 for the years ended December 31, 2010, 2009 and 2008, respectively, including \$4,982, \$3,639 and \$2,504, respectively, associated with the FERC re-licensing efforts.

**E. Related Party Transactions**

Alcoa charges the Business for various services which Alcoa performs on a centralized basis for its businesses. These services include information technology, financial shared services (accounts receivable, accounts payable, shared ledger, payroll, etc.), insurance, credit and collection, audit, environmental, health and safety and other administrative costs. These charges are allocated primarily based on headcount or usage. Insurance costs are allocated based upon historical claims cost per person for the Business.

# Yadkin Power Generation

## Notes to Combined Statements of Income

### For the years ended December 31, 2010, 2009 and 2008

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*(in thousands of dollars)*

The expenses charged to the Business by Alcoa totaled \$1,312, \$1,976 and \$1,382 for the years ended December 31, 2010, 2009 and 2008, respectively, and are reflected in the operating expenses line item in the combined statements of income.

In addition, APMI incurs various costs in connection with its role as the marketer of third-party power sales for the Business; these costs totaled \$752, \$553 and \$649 for the years ended December 31, 2010, 2009 and 2008, respectively, and are reflected in the operating expenses line item in the combined statements of income.

#### **F. Restructuring and Other Charges**

During the year ended December 31, 2008, the Business incurred \$163 in restructuring costs. The charge was for employee termination costs related to headcount reductions. As of December 31, 2010 and 2009, the lay-off liability is \$0.

#### **G. Pension and Other Postretirement Benefit Plans**

The Business participates in the Alcoa-sponsored multi-employer pension plans. For purposes of the combined statements of income, total pension plan expense is calculated and allocated to all locations that have active participants. A location's charge is based upon their employees' service cost, active interest cost, prior service cost/benefit for plan amendments less any remaining expected return on plan assets. It is assumed the expected return on plan assets first offsets retiree interest cost and amortization of gains/losses. If any remains, it then offsets a location's direct allocation of the cost. Pension expense recognized in the combined statements of income totaled \$190 for the year ended December 31, 2010, and \$127 for each of the years ended December 31, 2009 and 2008.

The Business also participates in the Alcoa-sponsored multi-employer postretirement benefit plans. For purposes of the combined statements of income, total other postretirement benefit plan expense is calculated and allocated to all locations that have participants. A location's charge is based upon their active and retiree population's service cost, active and retiree interest cost, prior service cost/benefit for plan amendments and amortization of gains/losses. Other postretirement benefit expense recognized in the combined statements of income totaled \$117, \$127 and \$130 for the years ended December 31, 2010, 2009 and 2008, respectively.

The Business also participates in a defined contribution benefit plan. Expenses were \$61, \$37 and \$81 for the years ended December 31, 2010, 2009 and 2008, respectively.

#### **H. Income Taxes**

The effective rates of 40.7%, 41.8% and 44.8% for the years ended December 31, 2010, 2009 and 2008, respectively, primarily represent the combined impact of the federal statutory rate of 35% and U.S. state income taxes of 6.9% (net of the federal benefit for state income taxes), plus the tax effect of imputed interest income (totaling \$148, \$253 and \$665 for the years ended December 31, 2010, 2009 and 2008, respectively) on certain intercompany balances that is recognized for tax purposes only (primarily state taxes).

**Yadkin Power Generation**  
**Notes to Combined Statements of Income**  
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*(in thousands of dollars)*

**I. Other Income, net**

	Year ended December 31,		
	2010	2009	2008
Timber income	\$ -	\$ 494	\$ 116
Premium on call option	-	540	-
Other	299	(6)	65
	<u>\$ 299</u>	<u>\$ 1,028</u>	<u>\$ 181</u>

Timber income results from the sale of timber located on the property surrounding the facilities in North Carolina. The premium income in 2009 results from the sale by the Business in December 2008 of a call option that provided the counter-party with the right to purchase power under certain conditions throughout calendar 2009 (the option period). The premium received by the Business of \$540 represented the fair value of the option at its inception. The counter-party did not exercise its rights under the option.

**J. Contingencies and Commitments**

Various lawsuits, claims and proceedings have been or may be instituted or asserted against the Business, including those pertaining to environmental, safety and health matters. While the amounts claimed may be substantial, the ultimate liability cannot be determined now because of the considerable uncertainties that exist. Therefore, it is possible that the Business's financial position, results of operations or liquidity in a particular period could be materially affected by certain contingencies. However, based on currently available facts, management believes that the disposition of matters that are pending or asserted will not have a materially adverse effect, individually or in the aggregate, on the Business's financial position, results of operations or liquidity.

**K. Subsequent Events**

Management evaluated all activity of the Business through March 2, 2011, (the issue date of the Combined Statements of Income) and concluded that no subsequent events have occurred that would require recognition in the Combined Statements of Income or disclosure in the Notes to the Combined Statements of Income.