Kentucky 30
Shelby Energy Cooperative, Inc.
and Subsidiary
Shelbyville, Kentucky

Audited Financial Statements
December 31, 2011 and 2010

Alan M. Zumstein
Certified Public Accountant
1032 Chetford Drive
Lexington, Kentucky 40509

CONTENTS

ALAN M. ZUMSTEIN
CERTIFIED PUBLIC ACCOUNTANT

1032 CHETFORD DRIVE
LEXINGTON, KENTUCKY 40509
(859) 264-7147
zumstein@windstream.net

MEMBER
• AMERICAN INSTITUTE OF CPA'S
• KENTUCKY SOCIETY OF CPA'S
• INDIANA SOCIETY OF CPA'S
• AICPA DIVISION FOR FIRMS
• TENNESSEE STATE BOARD OF ACCOUNTANCY

Independent Auditor's Report

To the Board of Directors
Shelby Energy Cooperative

I have audited the consolidated balance sheets of Shelby Energy Cooperative and Subsidiary, as of December 31, 2011 and 2010, and the related statements of income and patronage capital and cash flows for the years then ended. These financial statements are the responsibility of Shelby Energy Cooperative's management. My responsibility is to express an opinion on these financial statements based on my audits.

I conducted my audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States and 7 CFR Part 1773, Policy on Audits of Rural Utilities Service (RUS) Borrowers. Those standards require that I plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from 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. I believe that my audits provide a reasonable basis for my opinion.

In my opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Shelby Energy Cooperative and Subsidiary as of December 31, 2011 and 2010, and the results of operations and cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, I have also issued a report dated March 29, 2012, on my consideration of Shelby Energy Cooperative's internal control over financial reporting and my tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of my testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of my audits.

As discussed in Note 17, to the financial statements, certain costs required by its regulators have been expensed during the year ending December 31, 2011. Accordingly, the 2011 financial statements have been restated to reflect additional expenses.

Alan Zumstein

Alan M. Zumstein, CPA
March 29, 2012

ALAN M. ZUMSTEIN
CERTIFIED PUBLIC ACCOUNTANT

1032 CHETFORD DRIVE
LEXINGTON, KENTUCKY 40509
(859) 264-7147
zumstein@windstream.net

MEMBER
- AMERICAN INSTITUTE OF CPA'S
- KENTUCKY SOCIETY OF CPA'S
- INDIANA SOCIETY OF CPA'S
- AICPA DIVISION FOR FIRMS
- TENNESSEE STATE BOARD OF ACCOUNTANCY

To the Board of Directors
Shelby Energy Cooperative

I have audited the financial statements of Shelby Energy Cooperative as of and for the years ended December 31, 2011 and 2010, and have issued my report thereon dated March 29, 2012. I conducted my audits in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing my audit, I considered Shelby Energy's internal control over financial reporting as a basis for designing my auditing procedures for the purpose of expressing my opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Shelby Energy's internal control over financial reporting. Accordingly, I do not express an opinion on the effectiveness of Shelby Energy's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more that a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

My consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. I did not identify any deficiencies in internal control over financial reporting that I consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Shelby Energy's financial statements are free of material misstatement, I performed test of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of my audit, and accordingly, I do not express such an opinion. The results of my tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the audit committee, management, the Rural Utilities Service, and supplemental lenders, and is not intended to be and should not be used by anyone other than these specified parties.

Alan Zumstein

Alan M. Zumstein, CPA
March 29, 2012

Shelby Energy Cooperative and Subsidiaries

Consolidated Balance Sheets, December 31, 2011 and 2010

Assets	2011	2010
Utility Plant, at original cost:		
In service	$ 74,943,844	$ 70,261,871
Under construction	2,035,718	3,008,343
	76,979,562	73,270,214
Less accumulated depreciation	14,788,564	13,997,711
	62,190,998	59,272,503
Investments		
Associated organizations	12,614,999	10,452,275
Others	368,414	368,414
	12,983,413	10,820,689
Current Assets:		
Cash and cash equivalents	1,078,340	3,401,410
Accounts receivable, less allowance for 2011 of $361,675 and 2010 of $388,220	4,067,232	4,259,055
Material and supplies, at average cost	497,197	602,862
Prepayments and other current assets	221,441	124,159
	5,864,210	8,387,486
Deferred Charge	570,812	530,599
Total	$ 81,609,433	$ 79,011,277
Members' Equities and Liabilities		
Members' Equities:		
Patronage capital and retained earnings	$ 29,162,204	$ 26,721,338
Other equities and minority interests	1,621,957	1,477,952
Accumulated other comprehensive income	(351,715)	(374,156)
	30,432,446	27,825,134
Long Term Debt	40,250,088	41,805,146
Accumulated Postretirement Benefits	1,926,323	1,904,923
Current Liabilities:		
Accounts payable	3,921,160	4,334,910
Short term borrowings	1,181,269	-
Current portion of long term debt	1,475,000	1,365,000
Consumer deposits	1,109,315	515,390
Accrued expenses	376,327	362,661
	8,063,071	6,577,961
Consumer Advances for Construction	937,505	898,113
Total	$ 81,609,433	$ 79,011,277

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

Consolidated Statements of Revenue and Patronage Capital

for the years ended December 31, 2011 and 2010

	2011	2010
Operating Revenues	$ 43,520,321	$ 41,365,899
Operating Expenses:		
Cost of power	32,790,003	31,699,704
Distribution - operations	1,928,705	1,821,043
Distribution - maintenance	1,920,189	1,822,029
Consumer accounts	783,002	948,773
Customer service and information	199,827	185,315
Sales	(19,456)	1,877
Administrative and general	1,099,721	1,141,056
Depreciation, excluding $157,719 in 2011 and $158,264 in 2010 charged to clearing accounts	2,262,456	2,029,796
Taxes	55,374	54,359
Other	2,335	2,465
	41,022,156	39,706,417
Operating Margins before Interest Charges	2,498,165	1,659,482
Interest Charges:		
Interest on long-term debt	1,856,541	1,748,238
Other interest	45,928	74,993
	1,902,469	1,823,231
Operating Margins after Interest Charges	595,696	(163,749)
Patronage Capital assigned from:		
East Kentucky Power Cooperative, Inc.	2,161,305	1,182,419
Other organizations	62,460	65,268
	2,223,765	1,247,687
Nonoperating Margins:		
Interest income	37,953	40,991
Subsidiary and others	104,031	56,266
	141,984	97,257
Net Margins	2,961,445	1,181,195
Patronage Capital - beginning of year	26,721,338	25,975,304
Retirements of capital credits	(520,579)	(435,161)
Patronage Capital - end of year	$ 29,162,204	$ 26,721,338

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

Consolidated Statements of Cash Flows

for the years ended December 31, 2011 and 2010

	2011	2010
Cash Flows from Operating Activities:		
Net margins	$ 2,820,148	$ 1,100,720
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation		
Charged to expense	2,262,456	2,029,796
Charged to clearing accounts	157,719	158,264
Patronage capital credits	(2,223,765)	(1,247,687)
Accumulated postretirement benefits	43,841	39,913
Change in assets and liabilities:		
Receivables	196,710	(535,956)
Material and supplies	105,665	(229,390)
Prepayments	(218,815)	(529,654)
Payables	(398,637)	159,572
Consumer deposits	593,925	6,800
Accrued expenses and accumulated benefits	13,666	54,403
Consumer advances for construction	39,392	(3,799)
	3,392,305	1,002,982
Cash Flows from Investing Activities:		
Plant additions	(4,752,184)	(6,654,541)
Salvage, net of removal costs	(471,812)	(63,398)
Other investments, net	61,041	194,546
	(5,162,956)	(6,523,394)
Cash Flows from Financing Activities:		
Other equities and minority interests	110,652	88,936
Additional long term borrowings	-	8,808,000
Short term borrowings (repayments)	1,161,269	(10,000)
Payments on long term debt	(1,383,343)	(1,297,812)
Retirement of patronage capital	(379,282)	(354,686)
Invest in cushion of credit	(61,715)	-
	(552,419)	7,234,438
Net increase in cash	(2,323,070)	1,714,026
Cash balances - beginning of period	3,401,410	1,687,384
Cash balances - end of period	$ 1,078,340	$ 3,401,410
Supplemental cash flows information:		
Interest paid on long term debt	$1,854,735	$1,744,896

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

Note 1. Summary of Significant Accounting Policies

Shelby Energy Cooperative ("Shelby Energy") maintains its records in accordance with the policies prescribed or permitted by the Kentucky Public Service Commission ("PSC") and the United States Department of Agriculture, Rural Utilities Service ("RUS"), which conform in all material respects with generally accepted accounting principles. The more significant of these policies are as follows:

Principles of Consolidation The consolidated financial statements include the accounts of Shelby Energy, Shelby Energy Services Corporation ("Service Corporation") and Shelby Propane Plus, LLC ("Propane Plus"). Shelby Energy owns 75% and East Kentucky Power Cooperative ("East Kentucky") owns 25% of Service Corporation's outstanding stock. Service Corporation owns 100% of the outstanding stock of Propane Plus. All significant inter company accounts and transactions have been eliminated.

Business Activity Shelby Energy provides distribution electric service to residential, business and commercial consumers in a ten (10) county area of central Kentucky. Service Corporation provides overall business direction to Propane Plus. Propane Plus sells propane and related accessories to residential and commercial customers in central Kentucky.

Cash and Cash Equivalents Shelby Energy considers all short-term, highly liquid investments with original maturities of three months or less to be cash equivalents.

Restricted Cash Included in cash and cash equivalents are funds that are solely for economic development activities in the amount of $402,214 and $366,443, for 2011 and 2010, respectively. At December 31, 2011, Shelby Energy had $212,859 advanced for economic development activities.

Off Balance Sheet Risk Shelby Energy has some off-balance sheet risk in that they maintain cash deposits in financial institutions in excess of the amounts insured by the Federal Deposit Insurance Corporation (FDIC). At December 31, 2011, the financial institutions reported deposits in excess of the $250,000 FDIC insured limit several times during the audit period. Deposits in excess of the FDIC limit are 100% secured with collateral at the financial institution.

Revenue Shelby Energy records revenue as billed to its consumers based on monthly meter-reading cycles. Consumers are required to pay a refundable deposit, however, it may be waived under certain circumstances. Shelby Consumers must pay their bill within 20 days of billing, or consumers will forfeit a 10% discount, at which time a disconnect notice is sent with payment to be within 10 days. If not paid, then consumers are subject to disconnect. Accounts are written off when they are deemed to be uncollectible. The allowance for uncollectible accounts is based on the aging of receivables. There were no individual account balances that exceeded 10% of outstanding accounts receivable at December 31, 2011 and 2010.

Propane Plus recognizes revenue when earned, regardless of the period in which they are billed. Propane sales are recognized when deliveries are made, tank rental is recognized monthly, and sales of related accessories at the time of sale.

Cost of Power Shelby Energy is one of sixteen (16) members of East Kentucky Power Cooperative ("East Kentucky"). Under a wholesale power agreement, Shelby Energy is committed to purchase its electric power and energy requirements from East Kentucky until 2051. The rates charged by East Kentucky are subject to approval of the PSC. The cost of purchased power is recorded monthly during the period in which the energy is consumed, based upon billings from East Kentucky. There are certain surcharges, clauses, and credits that East Kentucky includes to Shelby Energy that are passed on to consumers using a methodology prescribed by the Commission.

Note 1. Summary of Significant Accounting Policies, continued

Propane Inventory Propane is measured at the end of each month and valued based on the current purchase price of propane.

Propane Purchased Propane Plus purchases all of its propane requirements from an unrelated party through Kentucky Propane Plus, LLC, a related party. Propane is delivered to bulk tanks owned by Propane Plus, then delivered to customers on an as needed basis.

Utility Plant Electric plant is stated at original cost, which is the cost when first dedicated to public service. Such amount includes applicable supervisory and overhead cost including any construction period interest and taxes. There was no interest required to be capitalized during the year.

The cost of maintenance and repairs, including renewals of minor items of property, is charged to operating expense. The cost of replacement of depreciable property units, as distinguished from minor items, is charged to electric plant. The units of property replaced or retired, including cost of removal, net of any salvage value, is charged to accumulated depreciation.

Propane Plus's fixed assets consist primarily of propane tanks located on customer's premises, bulk tanks, trucks used for delivery, and buildings and office equipment.

The major classifications of utility plant in service consist of:

	2011	2010
Distribution plant	$69,239,015	$64,635,273
General plant	3,428,008	3,312,417
Subtotal electric plant	72,667,023	67,947,690
Propane tanks on customer premises	1,214,111	1,254,498
Bulk tanks	284,968	281,941
Delivery and other trucks	399,542	399,542
Land and buildings	306,990	306,990
Office and other equipment	71,210	71,210
Subtotal propane plant	2,276,821	2,314,181
	$74,943,844	$70,261,871

Depreciation Shelby Energy's provision has been made for depreciation on the basis of the estimated lives of assets, using the straight-line method. Distribution plant depreciation is based on a composite rate of 2.98% per annum. General plant rates are as follows:

Structures and improvements	2.5%
Transportation equipment	10% - 20%
Other general plant	5% - 10%

Propane Plus' depreciation is computed using the straight-line method over the useful lives of its assets.

Management Services Propane Plus is one of four (4) members of a group of propane companies that utilize the abilities of an individual who manages the day to day operations of each propane company and arranges for the purchase of bulk propane. Propane Plus shares the cost equally for the labor, benefits, and other costs of this manager.

Note 1. Summary of Significant Accounting Policies, continued

Advertising Shelby Energy expenses advertising costs as incurred.

Goodwill Goodwill has been recorded in connection with the purchase of one-half (1/2) of the interest from an unrelated party on June 30, 2000. The excess of the payment price over the value of assets acquired has been recorded as goodwill. Goodwill was tested for impairment and it was determined that goodwill has not been impaired, therefore, there was no amortization for 2011 or 2010.

Fair Value Measurements The Fair Value Measurements and Disclosures Topic of the FASB ASC 820, *Fair Value Measurements and Disclosures,* defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal, or most advantageous, market for the asset or liability in an orderly transaction between market participants at the measurement date. The Fair Values Measurements Topic establishes a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. This hierarchy requires entities to maximize the use of observable inputs when possible. The three levels of inputs used to measure fair value are as follows:

> Level 1: Quoted prices (unadjusted) or identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
>
> Level 2: Significant other observable inputs other than Level 1 prices, such as quoted prices of similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.
>
> Level 3: Significant unobservable inputs that reflect an organization's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The carrying amounts of Shelby Energy's cash and cash equivalents, other receivables, investments, inventories, other assets, trade accounts payable, accrued expenses and liabilities, and other liabilities approximate fair value due to their short maturity. Investments in associated organizations are not considered a financial instrument because they represent nontransferable interests in associated organizations. Other assets are not considered financial instruments because they represent activities specifically related to Shelby Energy. Long term debt can not be traded in the market, and is specifically for electric cooperatives and, therefore, a value other than its outstanding principal cannot be determined.

Shelby Energy may, and also does, invest idle funds in local banks and in National Rural Utilities Cooperative Finance Corporation ("CFC") commercial paper. These investments are classified as held-to-maturity in accordance with provisions of the *Financial Instruments Topic* of FASB ASC 320. Held-to-maturity securities are presented at amortized cost. The fair value of held-to-maturity securities approximates cost at 2011 and 2010.

Risk Management Shelby Energy is exposed to various forms of losses of assets associated with, but not limited to, fire, personal liability, theft, vehicular accidents, errors and omissions, fiduciary responsibility, workers compensation, etc. Each of these areas is covered through the purchase of commercial insurance.

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 disclosures 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 used in the preparation of the financial statements.

Note 1. Summary of Significant Accounting Policies, continued

Income Tax Status Shelby Energy is exempt from federal and state income taxes under provisions of Section 501(c)(12). Accordingly, the financial statements for Shelby Energy include no provision for income taxes. Income taxes for Service Corporation are provided on income as reported in the accompanying statements regardless of when such taxes are payable. Propane Plus is a limited liability company treated as a partnership for federal income tax purposes. All tax related issues would be passed on to Service Corporation. Propane Plus uses the same depreciation for book and taxes, therefore, deferred taxes are considered immaterial and are not recorded.

Effective January 1, 2008, Shelby Energy adopted the provisions of the *Income Taxes Topic* of the FASB ASC that pertains to accounting for uncertainty in income taxes. Shelby Energy had no prior unrecognized tax benefits as a result of the implementation. Management evaluates its potential exposures from tax positions taken that have or could be challenged by taxing authorities. These potential exposures result because taxing authorities may take positions that differ from those taken by management in the interpretation and application of statutes, regulations, and rules. There are no tax positions for which the ultimate deductibility is highly uncertain included in the accompanying financial statements. Shelby Energy recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. Shelby Energy did not recognize any interest or penalties during the years ended December 31, 2011 or 2010.

Subsequent Events Management has evaluated subsequent events through March 29, 2012, the date the financial statements were available to be issued. There were no significant subsequent events to report.

Note 2. Investments in Associated Organizations

Shelby Energy records patronage capital assigned by associated organizations in the year in which such assignments are received.

The Capital Term Certificates ("CTCs") of CFC are recorded at cost. The CTCs were purchased from CFC as a condition of obtaining long-term financing. The CTCs bear interest at 0%, 3%, and 5% and are scheduled to mature at varying times from 2020 to 2080.

Investments in associated organizations consist of:

	2011	2010
East Kentucky, patronage capital	$10,926,977	$8,765,672
CFC, CTC's	645,684	646,296
CFC, patronage capital	184,688	173,508
CFC, Member capital security	25,000	25,000
Other associated organizations	619,791	595,815
Economic development loans	212,859	245,984
Total	$12,614,999	$10,452,275

Note 3. Patronage Capital

Under provisions of the long-term debt agreement, return to patrons of capital contributed by them is limited to amounts which would not allow the total equities and margins to be less than 30% of total assets, except that distributions may be made to estates of deceased patrons. The debt agreement provides, however, that should such distributions to estates not exceed 25% of the net margins for the next preceding year, Shelby Energy may distribute the difference between 25% and the payments made to such estates. The equity at December 31, 2011 was 37% of total assets.

Note 3. Patronage Capital, continued

Patronage capital consists of:

	2011	2010
Assigned to date	$31,698,611	$30,521,410
Assignable margins	2,901,468	1,100,720
Unassigned margins	589,408	665,888
Retirements to date	(5,945,963)	(5,566,680)
Total	$29,243,524	$26,721,338

Note 4. Accumulated Other Comprehensive Income

The changes in accumulated other comprehensive income, which reflects the recording for accumulated postretirement benefits other than pensions, follows:

	2011	2010
Balance, beginning of period	($374,156)	($396,597)
Amortization	22,441	22,441
Adjustments	-	-
Balance, end of period	($351,715)	($374,156)

Note 5. Long Term Debt

All assets, except vehicles, are pledged as collateral on the long term debt to RUS, Federal Financing Bank ("FFB"), and CFC under a joint mortgage agreement. Long term debt consists of:

	2011	2010
RUS, 1.98% to 6.0%	$20,042,239	$23,975,801
FFB, 4.2% to 5.3%	14,805,228	15,149,328
CFC:		
5.85% to 6.65% notes	3,279,328	3,484,432
Refinance RUS loans 2.85% to 5.05%	3,154,070	-
	41,280,865	42,609,561
Less current portion	1,350,000	1,250,000
Long term portion	$39,930,865	$41,359,561

The interest rates on the notes to CFC are subject to repricing at various dates for each individual note. The long term debt is due in quarterly and monthly installments of varying amounts through 2039. RUS assesses 12.5 basis points to administer the FFB loans. At December 31, 2011, there was $10,000,000 of FFB loan funds Unadvanced. During 2011, Shelby Energy refinanced $3,154,070 of higher interest rate loans from RUS with funds from CFC.

As of December 31, 2011, the annual principal payments for the next five years are as follows: 2012 - $1,350,000; 2013 - $1,425,000; 2014 - $1,500,000; 2015 - $1,600,000; 2016 - $1,700,000.

Note 6. Note Payable to Related Party

On September 12, 2000, East Kentucky issued a "Commercial Note With Guaranty" in the amount of $1,061,193 to Propane Plus. The interest rate is variable, with the rate being the "Index Rate" as published in the Wall Street Journal, minus one-half (1/2) percent. The rate as of December 31, 2011 was 3.75% and at 2010 was 4.25%.

Note 6. Note Payable to Related Party, continued

As of December 31, 2011, the annual principal payments for the next five years are as follows: 2012 - $125,000; 2013 - $130,000; 2014 - $140,000; 2015 - $150,000; 2016 - $160,000.

Note 7. Short Term Borrowings

At December 31, 2011, Shelby Energy had a short term line of credit of $6,000,000 available from CFC of which $1,181,269 was advanced at an interest rate of 3.20%.

At December 31, 2011, Propane Plus had a short term line of credit of $150,000 available from Peoples Bank of Mt. Washington. Collateral for the line of credit is the trucks and equipment. The interest rate is prime, plus two points, with a floor of 7.5%. There were no advances against this line of credit during the audit period.

Propane Plus has advanced unsecured funds from Clark Energy Propane Plus, LLC, in the amount of $30,000 and $50,000 at December 31, 2011 and 2010, respectively. The advances bear interest at 5%. In addition, Propane Plus advanced funds from Service Corporation in the amount of $140,000, using the "Federal Fund" interest rate. The interest rate at December 31, 2011 and 2010 was 2.25%.

Note 8. Pension Plan

Shelby Energy provides retirement benefits for substantially all employees through participation in the NRECA Retirement and Security Program, a multi-employer plan. In this defined benefit plan, contributions for pension expense were $311,957 for 2011 and $348,963 for 2010. In this master multi-employer plan, which is available to all member cooperatives of NRECA, the accumulated benefits and plan assets are not determined or allocated separately by individual employer. Employees hired after September 2, 2009 can only participate in the NRECA 401(k) plan. Shelby Energy will contribute 6% of base wages, plus it will match the employee contribution up to an additional 4%. Contributions to the 401(l) plan amounted to $43,382 for 2011 and $46,174 for 2010.

Propane Plus has a profit sharing plan of 10% of net profits before the pension amount, where managers receive 5% of the plan amount and the remaining employees sharing 5%. The pension amount for 2011 was $8,062 and 2010 was $7,386

Note 9. Postretirement Benefits

Shelby Energy sponsors a defined benefit plan that provides medical insurance coverage to retired employees hired prior to July 1, 1996. Employees hired after July 1, 1996 are not eligible to participate. The plan calls for benefits to be paid at retirement based primarily upon years of service with Shelby Energy. The following is a reconciliation of the postretirement obligation.

Note 9. Postretirement Benefits, continued

The funded status of the plan is as follows:

	2011	2010
Projected benefit obligation	($1,926,323)	($1,904,923)
Plan assets at fair value	-	-
Total	($1,926,323)	($1,904,923)

The components of net periodic postretirement benefit costs are as follows:

	2011	2010
Benefit obligation at beginning of year	$1,904,923	$1,887,451
Components of net periodic benefit cost:		
Service cost	63,086	40,340
Interest cost	95,781	113,247
Expected return on assets	-	-
Net periodic benefit cost	158,867	153,587
Benefits paid	(137,467)	(136,115)
Accumulated other comprehensive accounting	-	-
Benefit obligation at end of year	$1,926,323	$1,904,923

Projected retiree benefit payments for the next five years are expected to be as follows: 2012 - $98,000; 2013 - $106,000; 2014 - $112,000; 2015 - $98,000; 2016 - $96,000.

The discount rate used in determining the APBO was 6.0% for 2011 and 2010. The health care cost trend rate used to compute the APBO in an 8% annual rate of increase for 2011, and decreasing gradually to 5.5%, then remain at that level thereafter.

Note 10. Lease

Shelby Energy leases space for its branch office from an unrelated party. The lease, dated October 24, 1997, is for a period of 10 years, with a renewal option for 5 additional years. This is an operating lease with monthly payments of $475 per month.

Note 11. Commitments

Shelby Energy is contingently liable as guarantor for approximately $70,000 of long term obligations of East Kentucky to RUS, CFC, and institutional investors. Substantially all assets of Shelby Energy are pledged as collateral for this guarantee, in addition to the pledge in the mortgage agreement referred to in Note 5. This contingent liability was part of an overall financing plan for the construction of a generating facility near Maysville, Kentucky.

Shelby Energy has various other agreements outstanding with local contractors. Under these agreements, the contractors will perform certain meter reading, construction, and maintenance work at specified hourly rates or unit cost, or on an as needed basis. The duration of these contracts are one to three years.

Note 12. Environmental Contingency

Shelby Energy from time to time is required to work with and handle PCBs, herbicides, automotive fluids, lubricants, and other hazardous materials in the normal course of business. As a result, there is the possibility that environmental conditions may arise which would require Shelby Energy to incur cleanup costs. The likelihood of such an event, or the amount of such costs, if any, cannot be determined at this time. However, management does not believe such costs, if any, would materially affect Shelby Energy's financial position or its future cash flows.

Note 13. Related Party Transactions

Several of the Directors of Shelby Energy, its President & CEO, and another employee are on the boards of directors of various associated organizations.

Note 14. Rate Matters

East Kentucky increased its base rates to Shelby Energy during August 2007, by 2%, in April 2009, by 7%, and in January 2011 by another 5%. Shelby Energy passes East Kentucky's increases on to its customers using the methodology prescribed by the PSC. Effective August 2010, the PSC granted Shelby Energy an increase in base rate revenues in the amount of approximately $1,900,000, or 6%.

Note 15. Labor Force

Approximately 35% of Shelby Energy's labor force is subject to a collective bargaining agreement. A three (3) year agreement was negotiated and approved for the period starting November, 2009 between Shelby Energy and the International Brotherhood of Electric Workers ("IBEW").

Note 16. Contingencies

Shelby Energy is involved in litigation arising in the normal course of business. While the results of such litigation cannot be predicted with certainty, management, based upon advice of counsel, believes that the final outcome will not have a material adverse effect on the financial statements.

Note 17. Restatement of Financial Statements

The PSC has required Shelby Energy to recognize additional expenses related to amortization of the retirement of metering equipment and devices. Shelby Energy recorded one (1) month of amortization, the PSC is requiring a full year of amortization. This has resulted in additional amortization expense of $81,320.

* * * * *

Independent Auditor's Report

To the Board of Directors
Shelby Energy Cooperative

My report on the audits of the consolidated financial statements of Shelby Energy Cooperative and Subsidiary as of December 31, 2011 and 2010, and for the years then ended appears on page 1. My audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations and cash flows of the individual companies. The supplementary consolidating information has been subjected to the auditing procedures applied in the audit of the basic consolidated financial statements and, in my opinion, is fairly stated, in all material respects, in relation to the basic consolidated financial statements taken as a whole.

Alan Zumstein

Alan M. Zumstein, CPA
March 29, 2012

Shelby Energy Cooperative and Subsidiaries

Consolidating Balance Sheet, December 31, 2011

Assets	Energy	Services	Propane	Eliminations	Consolidated
Utility Plant, at original cost:					
In service	$72,667,023		$2,276,821		$74,943,844
Under construction	2,035,718				2,035,718
	74,702,741		2,276,821		76,979,562
Less accumulated depreciation	13,744,717		1,043,847		14,788,564
	60,958,024		1,232,974		62,190,998
Investments and Other Assets:					
Associated organizations	12,614,999				12,614,999
Goodwill, net of amortization			368,414		368,414
Subsidiary	1,061,579	1,269,224		(2,330,803)	-
	13,676,578	1,269,224	368,414	(2,330,803)	12,983,413
Current Assets:					
Cash and cash equivalents	998,892	8,970	70,478		1,078,340
Accounts receivable, less allowance for Energy of $347,060 and Propane of $14,615	3,927,413	139,206	174,808	(174,195)	4,067,232
Material and supplies, at average cost	409,924		87,273		497,197
Prepayments	202,323		19,118		221,441
	5,538,552	148,176	351,677	(174,195)	5,864,210
Deffered charges	570,812				570,812
Total	$80,743,966	$1,417,400	$1,953,065	($2,504,998)	$81,609,433

Members' Equities and Liabilities	Energy	Services	Propane	Eliminations	Consolidated
Members' and Stockholder's Equities:					
Capital investment		$1,379,000	$860,941	($2,239,941)	$0
Patronage capital and retained earnings	29,162,204	(319,399)	408,391	(88,992)	29,162,204
Minority interests and other equities	1,270,294	353,533		(1,870)	1,621,957
Accum other comprehensive income	(351,715)				(351,715)
	30,080,783	1,413,134	1,269,332	(2,330,803)	30,432,446
Long Term Debt	39,930,865		319,223		40,250,088
Accumulated Postretirement Benefits	1,926,323				1,926,323
Current Liabilities:					
Accounts payable	3,851,579	4,266	69,510	(4,195)	3,921,160
Short term borrowings	1,181,269		170,000	(170,000)	1,181,269
Current portion of long term debt	1,350,000		125,000		1,475,000
Consumer deposits	1,109,315				1,109,315
Accrued expenses	376,327				376,327
	7,868,490	4,266	364,510	(174,195)	8,063,071
Consumer Advances for Construction	937,505				937,505
Total	$80,743,966	$1,417,400	$1,953,065	($2,504,998)	$81,609,433

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

Shelby Energy Cooperative and Subsidiaries

Consolidating Balance Sheet, December 31, 2010

Assets	Energy	Services	Propane	Eliminations	Consolidated
Utility Plant, at original cost:					
In service	$67,947,690		$2,314,181		$70,261,871
Under construction	3,008,343				3,008,343
	70,956,033		2,314,181		73,270,214
Less accumulated depreciation	13,005,670		992,041		13,997,711
	57,950,363		1,322,140		59,272,503
Investments and Other Assets:					
Associated organizations	10,452,275				10,452,275
Goodwill, net of amortization			368,414		368,414
Subsidiary	953,635	1,121,033		(2,074,668)	0
	11,405,910	1,121,033	368,414	(2,074,668)	10,820,689
Current Assets:					
Cash and cash equivalents	3,322,073	10,010	69,327		3,401,410
Accounts receivable, less allowance for Energy of $377,530 and Propane of $10,690	4,087,982	140,794	220,279	(190,000)	4,259,055
Material and supplies, at average cost	513,712		89,150		602,862
Prepayments	115,959		8,200		124,159
	8,039,726	150,804	386,956	(190,000)	8,387,486
Deffered charges	530,599				530,599
Total	$77,926,598	$1,271,837	$2,077,510	($2,264,668)	$79,011,277
Members' Equities and Liabilities					
Members' and Stockholder's Equities:					
Capital investment		$1,379,000	$860,941	($2,239,941)	$0
Patronage capital and retained earnings	26,721,338	(425,372)	260,099	165,273	26,721,338
Minority interests and other equities	1,159,743	318,209			1,477,952
Accum other comprehensive income	(374,156)				(374,156)
	27,506,925	1,271,837	1,121,040	(2,074,668)	27,825,134
Long Term Debt	41,359,561		445,585		41,805,146
Accumulated Postretirement Benefits	1,904,923				1,904,923
Current Liabilities:					
Accounts payable	4,129,025		205,885	0	4,334,910
Short term borrowings			190,000	(190,000)	0
Current portion of long term debt	1,250,000		115,000		1,365,000
Consumer deposits	515,390				515,390
Accrued expenses	362,661				362,661
	6,257,076		510,885	(190,000)	6,577,961
Consumer Advances for Construction	898,113				898,113
Total	$77,926,598	$1,271,837	$2,077,510	($2,264,668)	$79,011,277

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

Consolidating Statement of Revenue and Patronage Capital

for the year ended December 31, 2011

	Energy	Services	Propane	Eliminations	Consolidated
Operating Revenues	$41,455,240		$2,065,081		$43,520,321
Operating Expenses:					
Cost of purchases	31,570,882		1,219,121		32,790,003
Distribution - operations	1,562,550		366,155		1,928,705
Distribution - maintenance	1,920,189				1,920,189
Consumer accounts	691,948		91,054		783,002
Customer service and information	199,827				199,827
Sales	(19,456)				(19,456)
Administrative and general	987,029	8,456	104,236		1,099,721
Depreciation, excluding $157,719 charged to clearing accounts	2,159,641		102,815		2,262,456
Taxes	36,859		18,515		55,374
Other	2,335				2,335
	39,111,804	8,456	1,901,896		41,022,156
Operating Margins before Interest Charges	2,343,436	(8,456)	163,185		2,498,165
Interest Charges:					
Interest on long term debt	1,838,774		17,767		1,856,541
Other interest	45,928				45,928
	1,884,702		17,767		1,902,469
Operating Margins after Interest Charges	458,734	(8,456)	145,418		(1,702,642)
Patronage Capital assigned from:					
East Kentucky Power Cooperative	2,161,305				2,161,305
Other organizations	62,460				62,460
	2,223,765				2,223,765
Nonoperating Margins:					
Interest income	36,382	1,562	9		37,953
Subsidiary and others	101,267	148,191	2,764	(148,191)	104,031
	137,649	149,753	2,773	(148,191)	141,984
Net Margins	2,820,148	141,297	148,191	(148,191)	2,961,445
Patronage Capital - beginning of year	26,721,338	(425,372)	260,099	165,273	26,721,338
Retirements of capital credits and others	(379,282)	(35,324)	101	(106,074)	(520,579)
Patronage Capital - end of year	$29,162,204	($319,399)	$408,391	($88,992)	$29,162,204

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

Consolidating Statement of Revenue and Patronage Capital
for the year ended December 31, 2010

	Energy	Services	Propane	Eliminations	Consolidated
Operating Revenues	$39,296,982		$2,068,917		$41,365,899
Operating Expenses:					
Cost of purchases	30,381,181		1,318,523		31,699,704
Distribution - operations	1,483,748		337,295		1,821,043
Distribution - maintenance	1,822,029				1,822,029
Consumer accounts	862,395		86,378		948,773
Customer service and information	185,315				185,315
Sales	1,877				1,877
Administrative and general	1,033,641	8,549	98,866		1,141,056
Depreciation, excluding $158,264 charged to clearing accounts	1,921,863		107,933		2,029,796
Taxes	36,140		18,219		54,359
Other	2,465				2,465
	37,730,654	8,549	1,967,214		39,706,417
Operating Margins before Interest Charges	1,566,328	(8,549)	101,703		1,659,482
Interest Charges:					
Interest on long term debt	1,729,536		18,702		1,748,238
Other interest	74,993				74,993
	1,804,529		18,702		1,823,231
Operating Margins after Interest Charges	(238,201)	(8,549)	83,001		(1,637,916)
Patronage Capital assigned from:					
East Kentucky Power Cooperative	1,182,419				1,182,419
Other organizations	65,268				65,268
	1,247,687				1,247,687
Nonoperating Margins:					
Interest income	36,951	4,030	10		40,991
Subsidiary and others	54,283	84,983	1,983	(84,983)	56,266
	91,234	89,013	1,993	(84,983)	97,257
Net Margins	1,100,720	80,464	84,994	(84,983)	1,181,195
Patronage Capital - beginning of year	25,975,304	(485,720)	175,105	310,615	25,975,304
Retirements of capital credits and others	(354,686)	(20,116)		(60,359)	(435,161)
Patronage Capital - end of year	$26,721,338	($425,372)	$260,099	$165,273	$26,721,338

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

Consolidating Statement of Cash Flows
for the year ended December 31, 2011

	Energy	Services	Propane	Eliminations	Consolidated
Cash Flows from Operating Activities:					
Net margins	$2,820,148	$141,297	$148,191	($289,488)	$2,820,148
Adjustments to reconcile to net cash provided by operating activities:					
Depreciation					
Charged to expense	2,159,641		102,815		2,262,456
Charged to clearing accounts	157,719				157,719
Patronage capital credits	(2,223,765)				(2,223,765)
(Profit) or loss in subsidiary	(141,297)	(148,191)		289,488	-
Accumulated postretirement benefits	43,841				43,841
Change in assets and liabilities:					
Receivables	160,569	1,588	45,471	(10,918)	196,710
Material and supplies	103,788		1,877		105,665
Prepayments and deferred debits	(207,897)		(10,918)		(218,815)
Payables	(277,446)	4,266	(136,375)	10,918	(398,637)
Consumer deposits	593,925				593,925
Accrued expenses	13,666				13,666
Consumer advances for construction	39,392				39,392
	3,242,284	(1,040)	151,061		3,392,305
Cash Flows from Investing Activities:					
Plant additions	(4,738,535)		(13,649)		(4,752,184)
Salvage, net of removal costs	(471,812)				(471,812)
Other investments, net	61,041				61,041
	(5,149,307)		(13,649)		(5,162,956)
Cash Flows from Financing Activities:					
Other equities	110,551		101	-	110,652
Additional long term borrowings	-				-
Short term borrowings (repayments)	1,181,269		(20,000)		1,161,269
Payments on long term debt	(1,266,981)		(116,362)		(1,383,343)
Retirement of patronage capital	(379,282)				(379,282)
Invest in cushion of credit	(61,715)				(61,715)
	(416,158)		(136,261)		(552,419)
Net increase in cash	(2,323,181)	(1,040)	1,151		(2,323,070)
Cash and cash equivalents - beginning	3,322,073	10,010	69,327		3,401,410
Cash and cash equivalents - end	$998,892	$8,970	$70,478		$1,078,340
Supplemental cash flows information:					
Interest paid on long term debt	$1,836,968		$17,767		$1,854,735

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

Consolidating Statement of Cash Flows

for the year ended December 31, 2010

	Energy	Services	Propane	Eliminations	Consolidated
Cash Flows from Operating Activities:					
Net margins	$1,100,720	$80,464	$84,994	($165,458)	$1,100,720
Adjustments to reconcile to net cash provided by operating activities:					
Depreciation					
Charged to expense	1,921,863		107,933		2,029,796
Charged to clearing accounts	158,264				158,264
Patronage capital credits	(1,247,687)				(1,247,687)
(Profit) or loss in subsidiary	(80,464)	(84,983)		165,447	-
Accumulated postretirement benefits	39,913				39,913
Change in assets and liabilities:					
Receivables	(500,604)	9,202	(45,554)	1,000	(535,956)
Material and supplies	(199,075)		(30,315)		(229,390)
Prepayments and deferred debits	(530,654)		1,000		(529,654)
Payables	131,111	(4,510)	33,971	(1,000)	159,572
Consumer deposits	6,800				6,800
Accrued expenses	54,403				54,403
Consumer advances for construction	(3,799)				(3,799)
	850,791	173	152,029	(11)	1,002,982
Cash Flows from Investing Activities:					
Plant additions	(6,643,154)		(11,387)		(6,654,541)
Salvage, net of removal costs	(63,398)				(63,398)
Other investments, net	194,546				194,546
	(6,512,007)		(11,387)		(6,523,394)
Cash Flows from Financing Activities:					
Other equities	88,925			11	88,936
Additional long term borrowings	8,808,000				8,808,000
Short term borrowings (repayments)	-		(10,000)		(10,000)
Payments on long term debt	(1,184,602)		(113,210)		(1,297,812)
Retirement of patronage capital	(354,686)				(354,686)
Invest in cushion of credit	-				-
	7,357,637		(123,210)	11	7,234,438
Net increase in cash	1,696,421	173	17,432		1,714,026
Cash and cash equivalents - beginning	1,625,652	9,837	51,895		1,687,384
Cash and cash equivalents - end	$3,322,073	$10,010	$69,327		$3,401,410
Supplemental cash flows information:					
Interest paid on long term debt	$1,726,194		$18,702		$1,744,896

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