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

Audited Financial Statements
December 31, 2012 and 2011

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Independent Auditor's Report

To the Board of Directors
Shelby Energy Cooperative

I have audited the accompanying consolidated balance sheets of Shelby Energy Cooperative and Subsidiary, as of December 31, 2012 and 2011, and the related statements of revenue and comprehensive income, changes in members' equity, 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. 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 previously present fairly, in all material respects, the financial position of Shelby Energy Cooperative and Subsidiary as of December 31, 2012 and 2011, 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 January 29, 2013, 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. 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.

Alan Zumstein

Alan M. Zumstein, CPA
January 29, 2013

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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, 2012 and 2011, and have issued my report thereon dated January 29, 2013. 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

Management is responsible for establishing and maintaining effective 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 *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

My consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, 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 previously.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Shelby Energy's financial statements are free of material misstatement, I performed tests 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
January 29, 2013

Shelby Energy Cooperative and Subsidiary
Consolidated Balance Sheets, December 31, 2012 and 2011

Assets	2012	2011
Utility Plant, at original cost:		
In service	$ 78,515,870	$ 74,943,844
Under construction	1,517,877	2,035,718
	80,033,747	76,979,562
Less accumulated depreciation	15,263,165	14,788,564
	64,770,582	62,190,998
Investments		
Associated organizations	14,661,376	12,614,999
Goodwill, net of amaortization	368,414	368,414
	15,029,790	12,983,413
Current Assets:		
Cash and cash equivalents	1,921,218	1,078,340
Accounts receivable, less allowance for 2012 of $399,157 and 2011 of $361,675	4,373,295	4,067,232
Material and supplies, at average cost	497,037	497,197
Prepayments and other current assets	341,029	221,441
	7,132,579	5,864,210
Deferred Charge	395,622	570,812
Total	$ 87,328,573	$ 81,609,433

Members' Equities and Liabilities	2012	2011
Members' Equities:		
Patronage capital and retained earnings	$ 31,232,431	$ 29,162,204
Other equities and minority interests	1,779,961	1,621,957
Accumulated other comprehensive income	(329,274)	(351,715)
	32,683,118	30,432,446
Long Term Debt	41,825,199	40,250,088
Accumulated Postretirement Benefits	1,953,695	1,926,323
Current Liabilities:		
Accounts payable	3,493,271	3,921,160
Short term borrowings	3,297,316	1,181,269
Current portion of long term debt	1,525,000	1,475,000
Consumer deposits	1,245,575	1,109,315
Accrued expenses	370,851	376,327
	9,932,013	8,063,071
Consumer Advances for Construction	934,548	937,505
Total	$ 87,328,573	$ 81,609,433

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

Consolidated Statements of Revenue and Comprehensive Income
for the years ended December 31, 2012 and 2011

	2012	2011
Operating Revenues	$ 43,796,602	$ 43,520,321
Operating Expenses:		
Cost of power	33,204,954	32,790,003
Distribution - operations	1,941,730	1,928,705
Distribution - maintenance	1,950,365	1,920,189
Consumer accounts	674,947	783,002
Customer service and information	342,051	199,827
Sales	1,776	(19,456)
Administrative and general	1,021,969	1,099,721
Depreciation, excluding $161,679 in 2012 and $157,719 in 2011 charged to clearing accounts	2,354,762	2,262,456
Taxes	63,893	55,374
Other	7,568	2,335
	41,564,015	41,022,156
Operating Margins before Interest Charges	2,232,587	2,498,165
Interest Charges:		
Interest on long-term debt	1,775,826	1,856,541
Other interest	84,988	45,928
	1,860,814	1,902,469
Operating Margins after Interest Charges	371,773	595,696
Patronage Capital assigned from:		
East Kentucky Power Cooperative, Inc.	2,015,873	2,161,305
Other organizations	41,026	62,460
	2,056,899	2,223,765
Nonoperating Margins:		
Interest income	40,692	37,953
Subsidiary and others	150,510	104,031
	191,202	141,984
Net Margins	2,619,874	2,961,445
Other Comprehensive Income:		
Postretirement benefits	22,441	22,441
Noncontrolling interests	(44,275)	(35,324)
Total Comprehensive Income	$ 2,598,040	$ 2,948,562

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

Statements of Changes in Members' Equity
for the years ended December 31, 2011 and 2012

	Patronage Capital	Other Equity	Accumulated Other Comprehensive Income	Total Members' Equity
Balance - Beginning of year	$ 26,721,338	$ 1,477,952	$ (374,156)	$ 27,825,134
Comprehensive income:				
Net margins	2,961,445			2,961,445
Postretirement benefit obligation				
Amortization			22,441	
Adjustments			-	22,441
Total comprehensive income				2,983,886
Refunds of capital credits	(379,282)			(379,282)
Transfers to other equity and minority interests	(35,324)			(35,324)
Other equities	(105,973)	144,005		38,032
Balance - December 31, 2011	29,162,204	1,621,957	(351,715)	30,432,446
Comprehensive income:				
Net margins	2,619,874			2,619,874
Postretirement benefit obligation				
Amortization			22,441	
Adjustments			-	22,441
Total comprehensive income				2,642,315
Refunds of capital credits	(373,591)			(373,591)
Transfers to other equity and minority interests	(44,275)			(44,275)
Other equities	(131,781)	158,004		26,223
Balance - December 31, 2012	$ 31,232,431	$ 1,779,961	$ (329,274)	$ 32,683,118

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

Consolidated Statements of Cash Flows
for the years ended December 31, 2012 and 2011

	2012	2011
Cash Flows from Operating Activities:		
Net margins	$ 2,443,818	$ 2,820,148
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation		
Charged to expense	2,354,762	2,262,456
Charged to clearing accounts	161,679	157,719
Patronage capital credits	(2,056,899)	(2,223,765)
Accumulated postretirement benefits	49,813	43,841
Change in assets and liabilities:		
Receivables	(253,563)	196,710
Material and supplies	160	105,665
Prepayments	55,602	(218,815)
Payables	(430,389)	(398,637)
Consumer deposits	136,260	593,925
Accrued expenses and accumulated benefits	(5,476)	13,666
Consumer advances for construction	(2,957)	39,392
	2,452,810	3,392,305
Cash Flows from Investing Activities:		
Plant additions	(4,554,697)	(4,752,184)
Salvage, net of removal costs	(497,052)	(471,812)
Other investments, net	10,522	61,041
	(5,041,228)	(5,162,956)
Cash Flows from Financing Activities:		
Other equities and minority interests	113,729	110,652
Additional long term borrowings	3,000,000	-
Short term borrowings (repayments)	2,066,047	1,161,269
Payments on long term debt	(1,436,542)	(1,383,343)
Retirement of patronage capital	(373,591)	(379,282)
Invest in cushion of credit	61,653	(61,715)
	3,431,296	(552,419)
Net increase in cash	842,878	(2,323,070)
Cash balances - beginning of period	1,078,340	3,401,410
Cash balances - end of period	$ 1,921,218	$ 1,078,340
Supplemental cash flows information:		
Interest paid on long term debt	$1,779,830	$1,854,735

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 $386,693 and $402,214, for 2012 and 2011, respectively. At December 31, 2012, Shelby Energy had $229,734 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, 2012, 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 15 days of billing, or consumers will forfeit a 10% discount, at which time a disconnect notice is sent with payment to be within 15 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, 2012 and 2011.

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.

The Companies are required to collect, on behalf of the Commonwealth of Kentucky, sales taxes based on 6 percent of gross sales from non-residential consumers, a 3 percent school tax from certain counties on most gross sales, and franchise fees in certain cities. The Company's policy is to exclude sales tax from revenue when collected and expenses when paid and instead, record collection and payment of sales taxes through a liability account.

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

Note 1. Summary of Significant Accounting Policies, continued

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

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.

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:

	2012	2011
Distribution plant	$72,548,174	$69,239,015
General plant	3,643,260	3,428,008
Subtotal electric plant	76,191,434	72,667,023
Propane tanks on customer premises	1,214,180	1,214,111
Bulk tanks	286,148	284,968
Delivery and other trucks	445,908	399,542
Land and buildings	306,990	306,990
Office and other equipment	71,210	71,210
Subtotal propane plant	2,324,436	2,276,821
	$78,515,870	$74,943,844

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.

Note 1. Summary of Significant Accounting Policies, continued

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.

Advertising Shelby Energy expenses advertising costs as incurred.

Goodwill The 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 2012 or 2011.

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: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities
>
> Level 2: Quoted prices in markets that are not considered to be active or financial instruments for which all significant inputs are observable, either directly or indirectly.
>
> Level 3: Prices or valuations that require inputs that are both significant to the fair value measure and unobservable.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

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 and liabilities 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 CFC Commercial Paper. The inputs used to measure idle funds are Level 1 measurements, as these funds are exchange traded funds in an active market.

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

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.

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, 2012 or 2011. Shelby Energy's income tax return is subject to possible examination by taxing authorities until the expiration of related statues of limitations on the return, which is generally three years.

Comprehensive Income Comprehensive income includes both net margin and other comprehensive income. Other comprehensive income represents the change in funded status of the accumulated postretirement benefit obligation.

Subsequent Events Management has evaluated subsequent events through January 29, 2013, the date the financial statements were available to be issued. There were no significant subsequent events to report.

Note 2. Investments in Associated Organizations

Investments in associated organizations consist of:

	2012	2011
East Kentucky, patronage capital	$12,942,850	$10,926,977
CFC, CTC's	643,963	645,684
CFC, patronage capital	196,457	184,688
CFC, Member capital security	25,000	25,000
Other associated organizations	623,372	619,791
Economic development loans	229,734	212,859
Total	$14,661,376	$12,614,999

Note 2. Investments in Associated Organizations, continued

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.

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, 2012 was 37% of total assets.

Patronage capital consists of:

	2012	2011
Assigned to date	$34,433,558	$31,698,611
Assignable margins	2,443,818	2,820,148
Unassigned margins	711,769	589,408
Retirements to date	(6,356,714)	(5,945,963)
Total	$31,232,431	$29,162,204

Note 4. 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:

	2012	2011
RUS, 1.98% to 6.0%	$19,635,416	$20,042,239
FFB, 0.104% to 5.3%	17,439,829	14,805,228
CFC:		
3.10% to 6.65% notes	3,080,936	3,279,328
Refinance RUS loans 2.85% to 5.05%	2,869,399	3,154,070
	43,025,580	41,280,865
Less current portion	1,400,000	1,350,000
Long term portion	$41,625,580	$39,930,865

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, 2012, there was $7,000,000 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, 2012, the annual principal payments for the next five years are as follows: 2013 - $1,400,000; 2014 - $1,475,000; 2015 - $1,575,000; 2016 - $1,650,000; 2017 - $1,750,000.

Note 5. 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, 2012 was 2.75% and at 2011 was 3.75%.

As of December 31, 2012, the annual principal payments for the next five years are as follows: 2013 - $125,000; 2014 - $130,000; 2015 - $70,000; 2016 - none.

Note 7. Short Term Borrowings

At December 31, 2012, Shelby Energy had a short term line of credit of $6,000,000 available from CFC of which $1,757,314 was advanced at an interest rate of 2.90%.

Propane Plus has advanced unsecured funds from Clark Energy Propane Plus, LLC, in the amount of $0 and $30,000 at December 31, 2012 and 2011, respectively. The advances bear interest at 5%. In addition, Propane Plus advanced funds from Service Corporation in the amount of $130,000 and $140,000 at December 31, 2012 and 2011, respectively, using the "Federal Fund" interest rate. The interest rate at December 31, 2012 and 2011 was 2.25%.

Note 8. Pension Plan

All eligible employees of Shelby Energy participate in the NRECA Retirement and Security Plan ("R&S Plan"), a defined benefit pension plan qualified under section 401 and tax exempt under section 501(a) of the Internal Revenue Code. It is a multiemployer plan under the accounting standards. The Plan sponsor's identification number is 53-0116145 and the Plan Number is 333. Eligible employees include employees hired prior to September 2, 2009. Non-eligible employees are those hired after September 2, 2009. A unique characteristic of a multiemployer plan compared to a single employer plan is that all plan assets are available to pay benefits of any plan participant. Separate asset accounts are not maintained for participating employers. This means that assets contributed by one employer may be used to provide benefits to employees of other participating employers.

Shelby Energy's contributions to the R&S Plan in 2012 and 2011 represent less than 5 percent of the total contributions made to the plan by all participating employers. Shelby Energy made contributions to the plan of $327,596 in 2012 and $331,957 in 2011. There have been no significant changes that affect the comparability of 2012 and 2011. 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(k) plan amounted to $39,855 for 2012 and $43,382 for 2012.

In the R&S Plan, a "zone status" determination is not required, and therefore not determined, under the Pension Protection Act ("PPA") of 2006. In addition, the accumulated benefit obligations and plan assets are not determined or allocated separately by individual employer. In total, the R&S Plan was between 65 percent and 80 percent funded at January 1, 2012 and 2011 based on the PPA funding target and PPA actuarial value of assets on those dates. Because the provisions of the PPA do not apply to the R&S Plan, funding improvement plans and surcharges are not applicable. Future contribution requirements are determined each year as part of the actuarial valuation of the plan and may change as a result of plan experience.

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 2012 was $8,062 and 2011 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.

The funded status of the plan is as follows:

	2012	2011
Projected benefit obligation	($1,953,695)	($1,926,323)
Plan assets at fair value	-	-
Total	($1,953,695)	($1,926,323)

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

	2012	2011
Benefit obligation at beginning of year	$1,926,323	$1,904,923
Components of net periodic benefit cost:		
Service cost	61,867	63,086
Interest cost	97,000	95,781
Net periodic benefit cost	158,867	158,867
Benefits paid	(131,495)	(137,467)
Accumulated other comprehensive accounting	-	-
Benefit obligation at end of year	$1,953,695	$1,926,323

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

The discount rate used in determining the APBO was 5.5% for 2012 and 6.0% for 2011. The health care cost trend rate used to compute the APBO in an 8% annual rate of increase for 2012, 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 31, 2012, is for a period of 5 years, with a renewal option for 5 additional years. This is an operating lease with monthly payments of $525 per month.

Note 11. Commitments

Shelby Energy has various other agreements outstanding with local contractors. Under these agreements, the contractors will perform certain construction, maintenance, and other 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. 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 13. 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 14. 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, 2012 between Shelby Energy and the International Brotherhood of Electric Workers ("IBEW").

Note 15. 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.

* * * * *

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, 2012 and 2011, 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
January 29, 2013

Shelby Energy Cooperative and Subsidiary
Consolidating Balance Sheet, December 31, 2012

Assets	Energy	Services	Propane	Eliminations	Consolidated
Utility Plant, at original cost:					
In service	$76,191,434		$2,324,436		$78,515,870
Under construction	1,517,877				1,517,877
	77,709,311		2,324,436		80,033,747
Less accumulated depreciation	14,146,239		1,116,926		15,263,165
	63,563,072		1,207,510		64,770,582
Investments and Other Assets:					
Associated organizations	14,661,376				14,661,376
Goodwill, net of amortization			368,414		368,414
Subsidiary	1,193,360	1,447,493		(2,640,853)	-
	15,854,736	1,447,493	368,414	(2,640,853)	15,029,790
Current Assets:					
Cash and cash equivalents	1,740,877	13,498	166,843		1,921,218
Accounts receivable, less allowance for Energy of $385,157 and Propane of $14,000	4,180,377	140,760	186,353	(134,195)	4,373,295
Material and supplies, at average cost	415,446		81,591		497,037
Prepayments	324,411		16,618		341,029
	6,661,111	154,258	451,405	(134,195)	7,132,579
Deffered charges	395,622				395,622
Total	$86,474,541	$1,601,751	$2,027,329	($2,775,048)	$87,328,573
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	31,232,431	(185,640)	586,660	(401,020)	31,232,431
Minority interests and other equities	1,384,023	395,830		108	1,779,961
Accum other comprehensive income	(329,274)				(329,274)
	32,287,180	1,589,190	1,447,601	(2,640,853)	32,683,118
Long Term Debt	41,625,580		199,619		41,825,199
Accumulated Postretirement Benefits	1,953,695				1,953,695
Current Liabilities:					
Accounts payable	3,369,796	2,561	125,109	(4,195)	3,493,271
Short term borrowings	3,287,316	10,000	130,000	(130,000)	3,297,316
Current portion of long term debt	1,400,000		125,000		1,525,000
Consumer deposits	1,245,575				1,245,575
Accrued expenses	370,851				370,851
	9,673,538	12,561	380,109	(134,195)	9,932,013
Consumer Advances for Construction	934,548				934,548
Total	$86,474,541	$1,601,751	$2,027,329	($2,775,048)	$87,328,573

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

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					
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.

Consolidating Statement of Revenue and Comprehensive Incom
for the year ended December 31, 2012

	Energy	Services	Propane	Eliminations	Consolidated
Operating Revenues	$42,087,182		$1,709,420		$43,796,602
Operating Expenses:					
Cost of purchases	32,333,801		871,153		33,204,954
Distribution - operations	1,585,252		356,478		1,941,730
Distribution - maintenance	1,950,365				1,950,365
Consumer accounts	583,660		91,287		674,947
Customer service and information	342,051				342,051
Sales	1,776				1,776
Administrative and general	910,557	6,926	104,486		1,021,969
Depreciation, excluding $161,679 charged to clearing accounts	2,270,691		84,071		2,354,762
Taxes	45,024		18,869		63,893
Other	7,568				7,568
	40,030,745	6,926	1,526,344		41,564,015
Operating Margins before Interest Charges	2,056,437	(6,926)	183,076		2,232,587
Interest Charges:					
Interest on long term debt	1,762,335		13,491		1,775,826
Other interest	84,988				84,988
	1,847,323		13,491		1,860,814
Operating Margins after Interest Charges	209,114	(6,926)	169,585		(1,518,763)
Patronage Capital assigned from:					
East Kentucky Power Cooperative	2,015,873				2,015,873
Other organizations	41,026				41,026
	2,056,899				2,056,899
Nonoperating Margins:					
Interest income	35,973	4,713	6		40,692
Subsidiary and others	141,832	178,269	8,678	(178,269)	150,510
	177,805	182,982	8,684	(178,269)	191,202
Net Margins	2,443,818	176,056	178,269	(178,269)	2,619,874
Other comprehensive Income:					
Postretirement benefits	22,441				22,441
Noncontrolling interests		(44,275)			(44,275)
Total Comprehensive Income	$2,466,259	$131,781	$178,269	($178,269)	$2,598,040

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

Consolidating Statement of Revenue and Comprehensive Income
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
Other comprehensive Income:					
Postretirement benefits	22,441				22,441
Noncontrolling interests		(35,324)			(35,324)
Total Comprehensive Income	$2,842,589	$105,973	$148,191	($148,191)	$2,948,562

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

Consolidating Statement of Cash Flows
for the year ended December 31, 2012

	Energy	Services	Propane	Eliminations	Consolidated
Cash Flows from Operating Activities:					
Net margins	$2,443,818	$176,056	$178,269	($354,325)	$2,443,818
Adjustments to reconcile to net cash provided by operating activities:					
Depreciation					
Charged to expense	2,270,691		84,071		2,354,762
Charged to clearing accounts	161,679				161,679
Patronage capital credits	(2,056,899)				(2,056,899)
(Profit) or loss in subsidiary	(176,056)	(178,269)		354,325	-
Accumulated postretirement benefits	49,813				49,813
Change in assets and liabilities:					
Receivables	(252,964)	8,446	(11,545)	2,500	(253,563)
Material and supplies	(5,522)		5,682		160
Prepayments and deferred debits	53,102		2,500		55,602
Payables	(481,783)	(1,705)	55,599	(2,500)	(430,389)
Consumer deposits	136,260				136,260
Accrued expenses	(5,476)				(5,476)
Consumer advances for construction	(2,957)				(2,957)
	2,133,706	4,528	314,576		2,452,810
Cash Flows from Investing Activities:					
Plant additions	(4,496,090)		(58,607)		(4,554,697)
Salvage, net of removal costs	(497,052)				(497,052)
Other investments, net	10,522				10,522
	(4,982,621)		(58,607)		(5,041,228)
Cash Flows from Financing Activities:					
Other equities	113,729			-	113,729
Additional long term borrowings	3,000,000				3,000,000
Short term borrowings (repayments)	2,106,047		(40,000)		2,066,047
Payments on long term debt	(1,316,938)		(119,604)		(1,436,542)
Retirement of patronage capital	(373,591)				(373,591)
Invest in cushion of credit	61,653				61,653
	3,590,900		(159,604)		3,431,296
Net increase in cash	741,985	4,528	96,365		842,878
Cash and cash equivalents - beginning	998,892	8,970	70,478		1,078,340
Cash and cash equivalents - end	$1,740,877	$13,498	$166,843		$1,921,218
Supplemental cash flows information:					
Interest paid on long term debt	$1,766,339		$13,491		$1,779,830

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.

ALAN M. ZUMSTEIN
CERTIFIED PUBLIC ACCOUNTANT

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MEMBER
• AMERICAN INSTITUTE OF CPA'S
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To the Board of Directors
Shelby Energy Cooperative

I have audited the financial statements of Shelby Energy Cooperative for the year ended December 31, 2012, and have issued my report thereon dated January 29, 2013. I conducted my audit 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 the Rural Utilities Service (RUS) Borrowers. Those standards require that I plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing my audit of the financial statements of Shelby Energy for the year ended December 31, 2012, I considered its internal control over financial reporting in order to determine my auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting.

My consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be a material weakness. A material weakness is a condition in which the design or operation of the specific internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. I noted no matters involving the internal control over financial reporting that I consider to be a material weakness.

7 CFR Part 1773.3 requires comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions and other additional matters. I have grouped my comments accordingly. In addition to obtaining reasonable assurance about whether the financial statements are free from material misstatements, at your request, I performed tests of specific aspects of the internal control over financial reporting, of compliance with specific RUS loan and security instrument provisions and of additional matters. The specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and additional matters tested include, among other things, the accounting procedures and records, material control, compliance with specific RUS loan and security instrument provisions set forth in 7 CFR Part 1773.3(d)(1) related transactions, depreciation rates, a schedule of deferred debits and credits and a schedule of investments, upon which I express an opinion. In addition, my audit of the financial statements also included the procedures specified in 7 CFR Part 1773.38-.45. My Objective was not to provide an opinion on these specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, or additional matters, and accordingly, I express no opinion thereon.

No reports, other than my independent auditor's report, and my independent auditor's report on internal control over financial reporting and compliance and other matters, all dated January 29, 2013, or summary of recommendations related to my audit have been furnished to management.

My comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions and other additional matters as required by 7 CFR Part 1773.33 are presented below.

Comments on Certain Specific Aspects of the Internal Control Over Financial Reporting

I noted no matters regarding the Cooperative's internal control over financial reporting and its operation that I consider to be a material weakness as previously defined with respect to:

- The accounting procedures and records;
- the process for accumulating and recording labor, material and overhead costs, and the distribution of these costs to construction, retirement, and maintenance and other expense accounts, and;
- the material controls.

Comments on Compliance with Specific RUS Loan and Security Instrument Provisions

At your request, I have performed the procedures enumerated below with respect to compliance with certain provisions of laws, regulations, and contracts. The procedures I performed are summarized as follows:

- Procedures performed with respect to the requirement for a borrower to obtain written approval of the mortgagee to enter into any contract for the operation or maintenance of property, or for the use of mortgaged property by others for the year ended December 31, 2012, of the Cooperative.
    1. The Cooperative has not entered into any contract during the year for the operation or maintenance of its property, or for the use of its property by others as defined in 1773.33(e)(1)(i).
- Procedures performed with respect to the requirement to submit RUS *Financial and Operating Report Electric Distribution* to RUS:
    1. Agreed amounts reported in RUS *Financial and Operating Report Electric Distribution* to the Cooperative's records as of December 31, 2012.

The results of my tests indicate that, with respect to the items tested, the Cooperative complied in all material respects, with the specific RUS loan and security instrument provisions referred to below. With respect to items not tested, nothing came to my attention that caused me to believe that the Cooperative had not complied, in all material respects, with those provisions. The specific provisions tested, as well as any exceptions noted, include the requirements that:

- The borrower has submitted its RUS *Financial and Operating Report Electric Distribution* to RUS and the *Financial and Operating Report Electric Distribution*, as of December 31, 2012, represented by the borrower as having been submitted to RUS appears to be in agreement with its audited records in all material respects.
- During the period of this review, the Cooperative received no long term advances from CFC on loans controlled by the RUS/CFC Mortgage and Loan Agreement.

Comments on Other Additional Matters

In connection with my audit of Shelby Energy, nothing came to my attention that caused me to believe that Shelby Energy failed to comply with respect to:

- The reconciliation of continuing property records to controlling general ledger plant accounts addressed at 7 CFR Part 1773.33(c)(1);
- The clearing of the construction accounts and the accrual of depreciation on completed construction addressed at 7 CFR Part 1773.33(c)(2);

- The retirement of plant addressed at 7 CFR 1773.33(c)(3) and (4);
- Approval of the sale, lease, or transfer of capital assets and disposition of proceeds for the sale or lease of plant, material, or scrap addressed at 7 CFR Part 1773.33(c)(5);
- The disclosure of material related party transactions, in accordance with Statement of Financial Accounting Standard No. 57, Related party Transactions, for the year ended December 31, 2012, in the financial statements referenced in the first paragraph of this report addressed at 7 CFR Part 1773.33(f);
- The depreciation rates addressed at 7 CFR Part 1773.33(g);
- The detailed schedule of deferred debits and deferred credits; and
- The detailed schedule of investments.

My audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The detailed schedule of deferred debits and deferred credits required by 7 CFR Part 1773(h) and provided below is presented for purposes of additional analysis and is not a required part of the basic financial statements. This information has been subjected to the auditing procedures applied in my audit of the basic financial statements and, in my opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The deferred credits are as follows:

Consumer advances for construction	$934,548

Shelby Energy is a 75% owner of a subsidiary, Shelby Energy Services Corporation, which is engaged in the distribution sales of propane gas through a limited liability company (LLC) in and around the areas in which Shelby Energy provides electric service. The investment is accounted for using the equity method of accounting. The original investment was $7,500. The investment is as follows:

	Investment	Profits
Balance, beginning of year	$1,379,000	($319,399)
Activity for 2012	-	133,759
Balance, end of year	$1,379,000	($185,640)

This report is intended solely for the information and use of the Board of Directors, management, RUS, 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
January 29, 2013