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Blue Grass Energy
Cooperative Corporation
Nicholasville, Kentucky
Audited Financial Statements
April 30, 2013 and 2012

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CONTENTS

Independent Auditors' Report	1
Report on Compliance and Internal Control Over Financial Reporting	2
Financial Statements:	
Balance Sheets	3
Statements of Revenue and Comprehensive Income	4
Statements of Members' Equities	5
Statements of Cash Flows	6
Notes to Financial Statements	7 - 12

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Independent Auditor's Report

To the Board of Directors
Blue Grass Energy Cooperative
Nicholasville, Kentucky

Report on the Financial Statements

I have audited the accompanying financial statements of Blue Grass Energy Cooperative, which comprise the balance sheets as of April 30, 2013 and 2012, and the related statements of revenue and comprehensive income, changes in equities, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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 and 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 audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, I express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

I believe the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

Opinion

In my opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Blue Grass Energy Cooperative as of April 30, 2013 and 2012, and the results of their operations and cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, I have also issued a report dated June 27, 2013, on my consideration of Blue Grass 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* in considering internal control over financial reporting and compliance.

Alan M. Zumstein

Alan M. Zumstein, CPA

June 27, 2013

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Report on Internal Control Over Financial Reporting and on Compliance
and Other Matters Based on an Audit of Financial Statements
Performed in Accordance with *Government Auditing Standards*

To the Board of Directors
Blue Grass Energy Cooperative

I have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of Blue Grass Energy Cooperative, which comprise the balance sheets as of April 30, 2013 and 2012, and the related statements of revenue and comprehensive income, members' equities and cash flows for the years then ended, and related notes to the financial statements, and have issued my report thereon dated June 27, 2013.

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 Blue Grass 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 Blue Grass Energy's internal control over financial reporting. Accordingly, I do not express an opinion on the effectiveness of Blue Grass 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 Blue Grass 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*.

Purpose of this Report

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 M. Zumstein

Alan M. Zumstein, CPA
June 27, 2013

Blue Grass Energy Cooperative Corporation
Balance Sheets, April 30, 2013 and 2012

<u>Assets</u>	<u>2013</u>	<u>2012</u>
Electric Plant, at original cost:		
In service	\$ 215,902,124	\$ 208,265,842
Under construction	894,622	1,853,626
	216,796,746	210,119,468
Less accumulated depreciation	62,785,097	57,111,272
	154,011,649	153,008,196
Investments in Associated Organizations	41,980,096	36,208,207
Current Assets:		
Cash and cash equivalents	9,456,967	13,094,943
Accounts receivable, less allowance for 2013 of \$289,485 and 2012 of \$291,411	10,610,977	9,602,203
Other receivables	881,061	715,817
Material and supplies, at average cost	1,262,310	1,271,079
Other current assets	939,864	895,389
	23,151,179	25,579,431
Prepaid Pension Costs	4,342,389	-
Total	\$ 223,485,313	\$ 214,795,834
<u>Members' Equities and Liabilities</u>		
Members' Equities:		
Memberships	\$ 1,039,968	\$ 1,036,183
Patronage capital	77,554,541	70,856,371
Other equities	3,514,547	3,454,621
Accumulated other comprehensive income	(1,072,085)	(1,162,085)
	81,036,971	74,185,090
Long Term Debt	117,114,646	117,116,062
Accumulated Postretirement Benefits	7,611,343	7,481,191
Current Liabilities:		
Accounts payable	7,621,309	6,474,001
Current portion of long term debt	5,500,000	5,300,000
Consumer deposits	1,878,656	1,926,081
Accrued expenses	2,332,774	1,922,815
	17,332,739	15,622,897
Consumer Advances	389,614	390,594
Total	\$ 223,485,313	\$ 214,795,834

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

Statements of Revenue and Patronage Capital
for the years ended April 30, 2013 and 2012

	<u>2013</u>	<u>2012</u>
Operating Revenues	<u>\$ 125,580,060</u>	<u>\$ 117,447,793</u>
Operating Expenses:		
Cost of power	93,523,721	86,587,999
Distribution - operations	2,469,255	2,724,497
Distribution - maintenance	6,091,468	5,883,684
Consumer accounts	2,812,824	2,873,777
Customer services	961,104	976,730
Sales	429,943	616,348
Administrative and general	4,284,999	4,430,379
Depreciation, excluding \$390,788 in 2013 and \$417,658 in 2012 charged to clearing account:	8,191,159	7,846,524
Other deductions	25,052	61,871
	<u>118,789,525</u>	<u>112,001,809</u>
Operating margins before interest charges	<u>6,790,535</u>	<u>5,445,984</u>
Interest Charges:		
Long-term debt	4,277,389	4,600,621
Other	21,157	112,038
	<u>4,298,546</u>	<u>4,712,659</u>
Operating margins after interest charges	<u>2,491,989</u>	<u>733,325</u>
Nonoperating Margins		
Interest income	221,341	341,852
Others	96,292	204,070
	<u>317,633</u>	<u>545,922</u>
Patronage Capital Credits	<u>5,905,188</u>	<u>6,352,543</u>
Net Margins	8,714,810	7,631,790
Other Comprehensive Income:		
Postretirement benefits	<u>90,000</u>	<u>90,000</u>
Total Comprehensive Income	<u><u>\$ 8,804,810</u></u>	<u><u>\$ 7,721,790</u></u>

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

Statement of Changes in Members' Equity
for the years ended April 30, 2012 and 2013

	<u>Memberships</u>	<u>Patronage Capital</u>	<u>Other Equity</u>	<u>Accumulated Other Comprehensive Income</u>	<u>Total Members' Equity</u>
Balance - Beginning of year	\$ 1,031,115	\$ 56,109,551	\$ 3,408,274	\$ (1,252,085)	\$ 59,296,855
Comprehensive income:					
Net margins		7,631,790			7,631,790
Postretirement benefit obligation					
Amortization				90,000	
Adjustments				-	90,000
Total comprehensive income				<u>90,000</u>	<u>7,721,790</u>
Net change in memberships	5,068				5,068
Refunds to estates		(151,794)			(151,794)
Record unbilled revenue		7,266,824			7,266,824
Other equities			46,347		46,347
					<u>46,347</u>
Balance - April 30, 2012	1,036,183	70,856,371	3,454,621	(1,162,085)	74,185,090
Comprehensive income:					
Net margins		8,714,810			8,714,810
Postretirement benefit obligation					
Amortization				90,000	
Adjustments				-	90,000
Total comprehensive income				<u>90,000</u>	<u>8,804,810</u>
Net change in memberships	3,785				3,785
Refunds to estates		(127,436)			(127,436)
General refund of capital credits					-
Transfers to other equity and prior year's deficits		(1,889,204)			(1,889,204)
Other equities			59,926		59,926
					<u>59,926</u>
Balance - April 30, 2013	<u>\$ 1,039,968</u>	<u>\$ 77,554,541</u>	<u>\$ 3,514,547</u>	<u>\$ (1,072,085)</u>	<u>\$ 81,036,971</u>

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

Statements of Cash Flows
for the years ended April 30, 2013 and 2012

	<u>2013</u>	<u>2012</u>
Cash Flows from Operating Activities:		
Net margins (deficit)	\$ 8,714,810	\$ 7,631,790
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation:		
Charged to expense	8,191,159	7,846,524
Charged to clearing accounts	390,788	417,658
Patronage capital credits assigned	(5,905,188)	(6,352,543)
Accumulated postretirement benefits	220,152	167,748
Change in assets and liabilities:		
Receivables	(1,174,018)	1,711,817
Material and supplies	8,769	(101,339)
Other assets	(4,386,864)	9,456
Payables	1,147,308	(786,797)
Consumer deposits and advances	(48,405)	159,487
Accrued expenses	409,959	(190,246)
	<u>7,568,470</u>	<u>10,513,555</u>
Cash Flows from Investing Activities:		
Plant additions	(9,033,708)	(8,473,949)
Plant removal costs	(813,249)	(586,406)
Salvage recovered from retired plant	261,557	26,086
Receipts from other investments, net	133,299	135,653
	<u>(9,452,101)</u>	<u>(8,898,616)</u>
Cash Flows from Financing Activities:		
Payments on long term debt	(5,318,166)	(5,079,244)
Advances of long term debt	5,000,000	5,824,000
Advance payments of long term debt	516,750	9,671
Net increase in memberships	3,785	5,068
Refund of patronage capital to members	(127,436)	(151,793)
Increase in other equities	(1,829,278)	46,346
	<u>(1,754,345)</u>	<u>654,048</u>
Net increase in cash	(3,637,976)	2,268,987
Cash and cash equivalents, beginning of year	<u>13,094,943</u>	<u>10,825,956</u>
Cash and cash equivalents, end of year	<u>\$ 9,456,967</u>	<u>\$ 13,094,943</u>
Supplemental cash flows information:		
Interest paid on long-term debt	\$ 4,292,390	\$ 4,640,622

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

Notes to Financial Statements

Note 1. Summary of Significant Accounting Policies

Blue Grass Energy Cooperative Corporation ("Blue Grass") 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:

Electric 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 for distribution plant. Gain or loss is recognized on disposition of general plant items. Electric plant consists of:

	<u>2013</u>	<u>2012</u>
Distribution plant	\$198,648,571	\$191,217,530
General plant	<u>17,253,553</u>	<u>17,048,312</u>
Total	<u>\$215,902,124</u>	<u>\$208,265,842</u>

Depreciation Provision has been made for depreciation on the basis of the estimated lives of assets, using the straight-line method. Depreciation rates range from 2.2% to 6.67%, with a composite rate of 3.81% for distribution plant. General plant rates are as follows:

Structures and improvements	2.5%
Transportation equipment	16%
Other general plant	6% - 16%

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

Off Balance Sheet Risk Blue Grass maintains its cash balances, which may exceed the federally insured limit, with several financial institutions. These financial institutions have strong credit ratings and management believes that the credit risk related to the accounts is minimal.

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.

Revenue Blue Grass records revenue as billed to its consumers based on monthly meter-reading cycles. All consumers are required to pay a refundable deposit, however, it may be waived under certain circumstances. Blue Grass's sales are concentrated in a thirteen county area of central Kentucky. Consumers must pay their bill within 20 days of billing, then are subject to disconnect after another 10 days. 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 customers whose individual account balance exceeded 10% of outstanding accounts receivable at April 30, 2013 or 2012.

Notes to Financial Statements

Note 1. Summary of Significant Accounting Policies, continued

Blue Grass is 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. Blue Grass' 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.

During 2012, Blue Grass changed its method of recording revenues on unbilled revenues. Prior to 2012, Blue Grass recognized revenue as billed to its consumers. Now, revenue is recognized as energy sales are consumed. This resulted in additional revenues recorded in the amount of \$7,266,824, which was recorded as an offset to prior year's deficits in the equity section of the balance sheet.

Cost of Power Blue Grass is one of sixteen (16) members of East Kentucky Power Cooperative ("East Kentucky"). Under a wholesale power agreement, Blue Grass 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.

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 Blue Grass'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 Blue Grass. Long term debt cannot be traded in the market, and is specifically for electric cooperatives and, therefore, a value other than its outstanding principal cannot be determined.

Blue Grass 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 2013 and 2012.

Notes to Financial Statements

Note 1. Summary of Significant Accounting Policies, continued

Environmental Contingency Blue Grass 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 Blue Grass 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 Blue Grass's financial position or its future cash flows.

Risk Management Blue Grass 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.

Advertising Blue Grass expenses advertising costs as incurred.

Income Tax Status Blue Grass is exempt from federal and state income taxes under provisions of Section 501(c)(12). Accordingly, the financial statements for Blue Grass include no provision for income taxes. Blue Grass's accounting policy provides that a tax expense/benefit from an uncertain tax position may be recognized when it is more likely than not that the position will be sustained upon examination, including resolutions of any related appeals or litigation processes, based on the technical merits. Management believes Blue Grass has no uncertain tax positions resulting in an accrual of tax expense or benefit. Blue Grass recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. Blue Grass did not recognize any interest or penalties during the years ended April 30, 2013 and 2012.

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.

Reclassifications Comparative data for the prior year have presented in certain sections of the accompanying financial statements in order to provide an understanding of changes in the financial position and operations.

Subsequent Events Management has evaluated subsequent events through June 27, 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

Blue Grass 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:

	<u>2013</u>	<u>2012</u>
East Kentucky, patronage capital	\$37,500,418	\$31,765,513
CFC, patronage capital	721,709	685,867
CFC, CTCs	1,848,107	1,889,987
Others	1,909,862	1,866,840
Total	<u>\$41,980,096</u>	<u>\$36,208,207</u>

Notes to Financial Statements

Note 3. Patronage Capital

Patronage capital consisted of:

	<u>2013</u>	<u>2012</u>
Assigned to date	\$90,446,355	\$82,805,694
Assignable margins	1,817,490	2,699,346
Unassigned	158,999	158,999
Prior year's deficits	-	(66,802)
Retirements to date	<u>(14,868,303)</u>	<u>(14,740,866)</u>
Total	<u>\$77,554,541</u>	<u>\$70,856,371</u>

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, Blue Grass may distribute the difference between 25% and the payments made to such estates. At April 30, 2013, the equities and margins were 36% of total assets.

Note 4. Other Equities

Other equities consist of:

	<u>2013</u>	<u>2012</u>
Donated capital	\$372,884	\$358,501
Retired capital credit gains	3,133,282	3,087,739
Capital credit gains and losses	<u>8,381</u>	<u>8,381</u>
Total	<u>\$3,514,547</u>	<u>\$3,454,621</u>

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:

	<u>2013</u>	<u>2012</u>
RUS, 3.23% to 6.0%	\$76,785,778	\$78,581,197
Advance payment	<u>(674,351)</u>	<u>(1,168,132)</u>
	<u>76,111,427</u>	<u>77,413,065</u>
FFB, 0.73% to 4.906%	<u>34,167,178</u>	<u>30,385,567</u>
CFC:		
5.65% to 7.10% notes	5,326,670	5,873,758
Refinance RUS loans, 5.05% to 5.45%	<u>7,009,371</u>	<u>8,743,672</u>
	<u>12,336,041</u>	<u>14,617,430</u>
	122,614,646	122,416,062
Less current portion	<u>5,500,000</u>	<u>5,300,000</u>
Long term portion	<u>\$117,114,646</u>	<u>\$117,116,062</u>

Notes to Financial Statements

Note 5. Long Term Debt, continued

As of April 30, 2013, annual current principal due for the next five years are as follows: 2014 - \$5,500,000; 2015 - \$5,800,000; 2016 - \$6,000,000; 2017 - \$6,100,000; 2018 - \$6,200,000.

The long term debt payable to RUS and CFC are due in quarterly and monthly installments of varying amounts through 2041. During 2004, Blue Grass refinanced \$22,710,297 of 5% RUS loans with funds advanced from CFC. The long term debt to refinance the RUS loans is due in a combination of 14 annual installments of \$1,094,587 and 9 annual installments of \$640,039. During 2006, Blue Grass restructured one of the installments into four (4) installments of \$273,674 to be paid in 2019. Blue Grass has loan funds available from FFB in the amount of \$32,992,000 as of April 30, 2013. RUS assesses 1.25 basis points to administer the FFB loans.

Note 6. Short Term Borrowings

Blue Grass has executed a twenty-three (23) month line of credit agreement with CFC in the amount of \$16,000,000. At April 30, 2013 Blue Grass had repaid all advances against this line of credit.

Note 7. Pension Plan

All eligible employees of Blue Grass 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. 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.

Blue Grass's contributions to the R&S Plan in 2013 and 2012 represent less than 5 percent of the total contributions made to the plan by all participating employers. Blue Grass made contributions to the plan of \$1,677,536 in 2013 and \$1,641,886 in 2012. There have been no significant changes that affect the comparability of 2013 and 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.

Cooperatives participating in the NRECA R&S plan were allowed to make an Accelerated Funding Payment ("prepayment") and receive an immediate reduction in their current contribution requirement equal to approximately 25% of their 2013 billing rate. Although the new (reduced) billing rate can change over time, the relative value of the reduction will continue to benefit prepaying cooperatives in future years, potentially for as many as 10-15 years or longer. During April, 2013, Blue Grass Energy made an accelerated payment to NRECA in the amount of \$4,342,389. The amount was recorded as a deferred debit and is being amortized over 15 years through the benefits matrix.

Notes to Financial Statements

Note 8. Postretirement Benefits

Blue Grass sponsors a defined benefit plan that provides medical insurance coverage for qualified retired employees and their spouses. Blue Grass pays premiums for retirees and their dependents based on years of service. Qualified employees are those that have been hired prior to January 1, 1999. For measurement purposes, an annual rate of increase of 8.5% in 2008, then decreasing by 0.5% per year until 5% per year, in the per capita cost of covered health care benefit was assumed. The discount rate used in determining the accumulated postretirement benefit obligation was 6.0% in 2013 and 2012.

The funded status of the plan is as follows:

	<u>2013</u>	<u>2012</u>
Projected benefit obligation	(\$7,611,343)	(\$7,481,191)
Plan assets at fair value	-	-
Total	(\$7,611,343)	(\$7,481,191)

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

	<u>2013</u>	<u>2012</u>
Benefit obligation at beginning of year	\$7,481,191	\$7,403,443
Components of net periodic benefit cost:		
Service cost	184,955	192,661
Interest cost	415,045	407,339
Net periodic benefit cost	600,000	600,000
Benefits paid	(469,848)	(522,252)
Actuarial gain/loss	-	-
Benefit obligation at end of year	\$7,611,343	\$7,481,191

Projected retiree benefit payments for the next five years are expected to be as follows: 2014 - \$470,000; 2015 - \$474,000; 2016 - \$490,000; 2017 - \$491,000; 2018 - \$473,000.

Note 9. Commitments

Blue Grass has various other agreements outstanding with local contractors. Under these agreements, the contractors will perform certain 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 10. Related Party Transactions

Several of the Directors of Blue Grass and its President & CEO are on the Boards of Directors of various associated organizations.

Note 11. Contingencies

Blue Grass 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.

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ALAN M. ZUMSTEIN
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MEMBER
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• INDIANA SOCIETY OF CPA'S
• AICPA DIVISION FOR FIRMS

To the Board of Directors
Blue Grass Energy Cooperative

I have audited the financial statements of Blue Grass Energy Cooperative for the year ended April 30, 2013, and have issued my report thereon dated June 27, 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 the Cooperative for the year ended April 30, 2013, 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 June 27, 2013, or summary of recommendations related to my audit have been furnished to management.

To the Board of Directors
Blue Grass Energy Cooperative – 2

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 April 30, 2013, 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 RUS 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 the Cooperative, nothing came to my attention that caused me to believe that the Cooperative 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);

To the Board of Directors
Blue Grass Energy Cooperative – 3

- 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 April 30, 2013, 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 debits are as follows:

Deferred pension costs	<u>\$4,342,389</u>
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The deferred credits are as follows:

Consumer advances for construction	<u>\$389,614</u>
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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 M. Zumstein

Alan M. Zumstein, CPA
June 27, 2013