

Kentucky 64
Blue Grass Energy
Cooperative Corporation
Nicholasville, Kentucky
Audited Financial Statements
April 30, 2016 and 2015

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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, 2016 and 2015, and the related statements of revenue and comprehensive income, changes in members' 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.

To the Board of Directors
Blue Grass Energy Cooperative

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, 2016 and 2015, 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 July 15, 2016, 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
July 15, 2016

Blue Grass Energy Cooperative Corporation
Balance Sheets, April 30, 2016 and 2015

<u>Assets</u>	<u>2016</u>	<u>2015</u>
Electric Plant, at original cost:		
In service	\$ 235,260,289	\$ 228,384,527
Under construction	3,932,619	3,067,349
	<u>239,192,908</u>	<u>231,451,876</u>
Less accumulated depreciation	82,746,138	75,562,670
	<u>156,446,770</u>	<u>155,889,206</u>
Investments in Associated Organizations	<u>62,767,407</u>	<u>57,135,797</u>
Current Assets:		
Cash and cash equivalents	21,729,385	15,569,285
Accounts receivable, less allowance for 2016 of \$318,372 and 2015 of \$322,521	6,013,985	7,744,952
Other receivables	2,025,927	1,526,893
Material and supplies, at average cost	1,208,242	1,508,799
Other current assets	750,272	651,376
	<u>31,727,811</u>	<u>27,001,305</u>
Prepaid Pension Costs	<u>3,377,394</u>	<u>3,666,886</u>
Total	<u>\$ 254,319,382</u>	<u>\$ 243,693,194</u>
<u>Members' Equities and Liabilities</u>		
Members' Equities:		
Memberships	\$ 1,065,675	\$ 1,055,145
Patronage capital	106,336,186	97,932,801
Other equities	3,725,574	3,633,209
Accumulated other comprehensive income	(2,164,186)	(2,246,290)
	<u>108,963,249</u>	<u>100,374,865</u>
Long Term Debt	<u>118,423,163</u>	<u>117,057,877</u>
Accumulated Postretirement Benefits	<u>9,714,980</u>	<u>9,489,293</u>
Current Liabilities:		
Accounts payable	7,154,364	6,823,536
Current portion of long term debt	6,100,000	5,900,000
Consumer deposits	1,605,598	1,653,903
Accrued expenses	1,972,675	2,020,657
	<u>16,832,637</u>	<u>16,398,096</u>
Consumer Advances	<u>385,353</u>	<u>373,063</u>
Total	<u>\$ 254,319,382</u>	<u>\$ 243,693,194</u>

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

Statements of Revenue and Patronage Capital
for the years ended April 30, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Operating Revenues		
Sale of electricity	\$ 119,020,852	\$ 126,890,551
Other electric revenues	2,850,829	2,796,219
	121,871,681	129,686,770
Operating Expenses:		
Cost of power	89,248,859	97,809,258
Distribution - operations	3,008,167	2,779,241
Distribution - maintenance	6,514,463	6,334,719
Consumer accounts	2,675,295	2,728,345
Customer services	916,789	925,517
Sales	(67,678)	206,726
Administrative and general	4,455,168	4,596,021
Depreciation, excluding \$465,305 in 2016 and \$403,188 in 2015 charged to clearing account	8,642,559	8,461,638
Other deductions	3,740	2,208
	115,397,362	123,843,673
Operating margins before interest charges	6,474,319	5,843,097
Interest Charges:		
Long-term debt	4,479,863	4,072,408
Other	2,975	1,682
	4,482,838	4,074,090
Operating margins after interest charges	1,991,481	1,769,007
Nonoperating Margins		
Interest income	905,347	231,155
Others	19,076	109,703
	924,423	340,858
Patronage Capital Credits		
G & T	5,614,986	7,282,377
Others	142,309	195,562
	5,757,295	7,477,939
Net Margins	8,673,199	9,587,804
Other Comprehensive Income:		
Postretirement benefits	82,104	82,104
Total Comprehensive Income	\$ 8,755,303	\$ 9,669,908

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

Statement of Changes in Members' Equity
for the years ended April 30, 2015 and 2016

	<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	\$ 1,047,475	\$ 88,521,264	\$ 3,574,552	\$ (2,328,394)	\$ 90,814,897
Comprehensive income:					
Net margins		9,587,804			9,587,804
Postretirement benefit obligation					
Amortization				82,104	
Adjustments				-	82,104
Total comprehensive income				-	9,669,908
Net change in memberships	7,670				7,670
Refunds of capital credits		(176,267)			(176,267)
Other equities			58,657		58,657
Balance - April 30, 2015	1,055,145	97,932,801	3,633,209	(2,246,290)	100,374,865
Comprehensive income:					
Net margins		8,673,199			8,673,199
Postretirement benefit obligation					
Amortization				82,104	
Adjustments				-	82,104
Total comprehensive income				-	8,755,303
Net change in memberships	10,530				10,530
Refunds of capital credits		(269,814)			(269,814)
Other equities			92,365		92,365
Balance - April 30, 2016	<u>\$ 1,065,675</u>	<u>\$ 106,336,186</u>	<u>\$ 3,725,574</u>	<u>\$ (2,164,186)</u>	<u>\$ 108,963,249</u>

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

Statements of Cash Flows
for the years ended April 30, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Cash Flows from Operating Activities:		
Net margins	\$ 8,673,199	\$ 9,587,804
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation:		
Charged to expense	8,642,559	8,461,638
Charged to clearing accounts	465,305	403,188
Patronage capital credits assigned	(5,757,295)	(7,477,939)
Accumulated postretirement benefits	307,791	327,809
Change in assets and liabilities:		
Receivables	1,231,933	2,823,918
Material and supplies	300,557	(65,332)
Other assets	190,596	495,020
Payables	330,828	(1,013,656)
Consumer deposits and advances	(36,015)	(147,572)
Accrued expenses	(47,982)	(164,663)
	<u>14,301,476</u>	<u>13,230,215</u>
Cash Flows from Investing Activities:		
Plant additions	(9,087,658)	(9,255,641)
Plant removal costs	(634,062)	(530,068)
Salvage recovered from retired plant	56,292	134,052
Receipts from other investments, net	125,685	121,197
	<u>(9,539,743)</u>	<u>(9,530,460)</u>
Cash Flows from Financing Activities:		
Payments on long term debt	(5,944,667)	(5,162,635)
Advances of long term debt	16,192,000	10,000,000
Advance payments of long term debt	(8,682,047)	(5,134,407)
Net increase in memberships	10,530	7,670
Refund of patronage capital to members	(269,814)	(176,267)
Increase in other equities	92,365	58,657
	<u>1,398,367</u>	<u>(406,982)</u>
Net increase in cash	6,160,100	3,292,773
Cash and cash equivalents, beginning of year	<u>15,569,285</u>	<u>12,276,512</u>
Cash and cash equivalents, end of year	<u>\$ 21,729,385</u>	<u>\$ 15,569,285</u>
Supplemental cash flows information:		
Interest paid on long-term debt	\$ 4,448,863	\$ 4,068,408

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

Blue Grass Energy Cooperative Corporation
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>2016</u>	<u>2015</u>
Distribution plant	\$216,568,244	\$210,328,899
General plant	<u>18,692,045</u>	<u>18,055,628</u>
Total	<u>\$235,260,289</u>	<u>\$228,384,527</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, 2016 or 2015.

Blue Grass Energy Cooperative Corporation
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.

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 2016 and 2015.

Blue Grass Energy Cooperative Corporation
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, 2016 and 2015. Blue Grass's income tax return is subject to possible examination by taxing authorities until the expiration of related statutes 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.

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.

Subsequent Events Management has evaluated subsequent events through July 15, 2016, 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:

Blue Grass Energy Cooperative Corporation
Notes to Financial Statements

Note 2. Investments in Associated Organizations, continued

	<u>2016</u>	<u>2015</u>
East Kentucky, patronage capital	\$58,155,222	\$52,540,237
CFC, patronage capital	809,584	784,704
CFC, CTC's	1,744,328	1,775,148
Others	<u>2,058,273</u>	<u>2,035,708</u>
Total	<u>\$62,767,407</u>	<u>\$57,135,797</u>

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, Blue Grass may distribute the difference between 25% and the payments made to such estates. At April 30, 2016, the equities and margins were 43% of total assets. Other equities consist primarily of retired capital credit gains.

Patronage capital consisted of:

	<u>2016</u>	<u>2015</u>
Assigned to date	\$119,377,262	\$110,923,481
Assignable margins	2,304,514	2,085,096
Unassigned	158,999	158,999
Retirements to date	<u>(15,504,589)</u>	<u>(15,234,775)</u>
Total	<u>\$106,336,186</u>	<u>\$97,932,801</u>

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.

As of April 30, 2016, annual current principal due for the next five years are as follows: 2017 - \$6,100,000; 2018 - \$6,250,000; 2019 - \$6,300,000; 2020 - \$6,400,000; 2021 - \$6,700,000.

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 2021. Blue Grass has a loan pending from FFB in the amount of \$44,000,000. RUS assesses 1.25 basis points to administer the FFB loans.

The advance payments earn 5% interest from RUS and can only be used to apply to debt service payments of either RUS or FFB.

Blue Grass Energy Cooperative Corporation
Notes to Financial Statements

Note 4. Long Term Debt, continued

Long term debt consisted of:

	<u>2016</u>	<u>2015</u>
RUS, 2.375% to 6.0%	\$70,953,873	\$72,970,320
Advance payment	<u>(16,633,508)</u>	<u>(7,951,461)</u>
	54,320,365	65,018,859
FFB, 0.203% to 4.906%	<u>61,855,306</u>	<u>47,967,029</u>
CFC:		
2.90% to 7.10% notes	4,784,608	5,593,642
Refinance RUS loans, 5.4% to 5.65%	<u>3,562,884</u>	<u>4,378,347</u>
	8,347,492	9,971,989
	124,523,163	122,957,877
Less current portion	<u>6,100,000</u>	<u>5,900,000</u>
Long term portion	<u>\$118,423,163</u>	<u>\$117,057,877</u>

Note 5. 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, 2016 Blue Grass had repaid all advances against this line of credit.

Note 6. 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 2016 and 2015 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 \$1,320,620 in 2016 and \$1,335,509 in 2015. There have been no significant changes that affect the comparability of 2016 and 2015.

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 over 80 percent funded at January 1, 2015 and 2014 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.

Blue Grass Energy Cooperative Corporation
Notes to Financial Statements

Note 6. Pension Plan, continued

At the December 2012 meeting of the I&FS Committee of the NRECA Board of Directors, the Committee approved an option to allow participating cooperatives in the Retirement Security (“R&S”) Plan (a defined benefit multiemployer pension plan) to make a prepayment and reduce future required contributions. The prepayment amount is a cooperative share, as of January 1, 2013, of future contributions required to fund the R&S Plan’s unfunded value of benefits earned to date using Plan actuarial valuation assumptions. The prepayment amount will typically equal approximately 2.5 times a cooperative’s annual R&S Plan required contribution as of January 1, 2013. After making the prepayment, for most cooperatives the billing rate is reduced by approximately 25%, retroactive to January 1, 2013. The 25% differential in billing rates is expected to continue for approximately 15 years. However, changes in interest rates, asset returns and other plan experience different from that expected, plan assumptions changes, and other factors may have an impact on the differential in billing rates and the 15 year period.

Two prepayment options were available to participating cooperatives:

1. Use current assets to make the prepayment over a period of not more than 4 years, or,
2. Borrow funds sufficient to make the prepayment in a lump sum, with the prepayment of the borrowed amount determined by the loan’s amortization schedule.

On February 14, 2015, RUS issued a memorandum to all of its borrowers regarding the proper accounting treatment of the R&S Plan prepayment. RUS stipulated that the prepayment shall be recorded as a long term prepayment in Account 186, Miscellaneous Deferred Debits. This prepaid expense shall be amortized to Account 926, Employee Pensions and Benefits, over a ten year period. Alternatively, RUS borrowers may calculate the amortization period by subtracting the cooperative’s average age of its workforce as provided by NRECA from the cooperative’s normal retirement age under the R&S Plan, up to a maximum period of 20 years. If the entity choses to finance the prepayment, interest expense associated with the loan shall be recorded in the year incurred as is required under the RUS Uniform System of Accounts (“USoA”).

Section 6.13(e) of the RUS Loan Contract limits the amount of unsecured debt that a borrower may incur to 15% on Net Utility Plant if the equity level of the borrower, after considering such unsecured debt, is below 30% of its Total Assets, unless the borrower obtains RUS consent. RUS will consider any unsecured debt associated with the

R&S Plan prepayment to be “Permitted Debt” and accordingly, it will be excluded from the application of Section 6.13(e). During April, 2015, the Corporation made a prepayment of \$4,342,389 to the R&S Plan. The amount is being amortized over 15 years.

Note 7. 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 2012, 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 5.0% in 2016 and 2015.

Blue Grass Energy Cooperative Corporation
Notes to Financial Statements

Note 7. Postretirement Benefits, continued

The funded status of the plan is as follows:

	<u>2016</u>	<u>2015</u>
Projected benefit obligation	(9,714,980)	(\$9,489,293)
Plan assets at fair value	-	-
Total	<u>(\$9,714,980)</u>	<u>(\$9,489,293)</u>

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

	<u>2016</u>	<u>2015</u>
Benefit obligation at beginning of year	<u>\$9,489,293</u>	<u>\$9,243,588</u>
Components of net periodic benefit cost:		
Service cost	231,482	244,446
Interest cost	528,118	515,154
Net periodic benefit cost	759,600	759,600
Benefits paid	(533,913)	(513,895)
Actuarial gain/loss	-	-
Benefit obligation at end of year	<u>\$9,714,980</u>	<u>\$9,489,293</u>

Projected retiree benefit payments for the next five years are expected to be as follows: 2017 - \$520,000; 2018 - \$525,000; 2019 - \$515,000; 2020 - \$510,000; 2021 - \$500,000.

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.

Note 12. Rate Matters

Effective June 2015 the Kentucky PSC granted Blue Grass an increase in base electric rates in the amount of \$1,400,000.

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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, 2016 and 2015, 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 July 15, 2016.

Internal Control Over Financial Reporting

In planning and performing my audit of the financial statements, I considered Blue Grass Energy's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances 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. Accordingly, I do not express an opinion on the effectiveness of Blue Grass Energy's internal control.

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. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

My consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during my audit I did not identify any deficiencies in internal control that I consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

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,

To the Board of Directors
Blue Grass Energy Cooperative

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

The purpose of this report is solely to describe the scope of my testing on internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the organization's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the organization's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Alan M. Zumstein

Alan M. Zumstein, CPA
July 15, 2016

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Independent Auditor's Report on Compliance with Aspects of Contractual
Agreements and Regulatory Requirements for Electric Borrowers

Board of Directors
Blue Grass Energy Cooperative

Independent Auditor's Report

I have audited, 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, the financial statements of Blue Grass Energy Cooperative ("the Cooperative"), which comprise the balance sheet as of April 30, 2016, and the related statements of revenue and comprehensive income, patronage capital, and changes in cash flows for the year then ended, and the related notes to the financial statements, and have issued my report thereon dated July 15, 2016. In accordance with *Government Auditing Standards*, we have also issued my report dated July 15, 2016, on my consideration of the Cooperative's internal control over financial reporting and on my tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. No reports other than the reports referred to above and my schedule of findings and recommendations related to my audit have been furnished to management.

In connection with my audit, nothing came to my attention that caused me to believe that the Cooperative failed to comply with the terms, covenants, provisions, or conditions of their loan, grant, and security instruments as set forth in 7 CFR Part 1773, *Policy on Audits of Rural Utilities Service Borrowers*, §1773.33 and clarified in the RUS policy memorandum dated February 7, 2016, insofar as they relate to accounting matters as enumerated below. However, my audit was not directed primarily toward obtaining knowledge of noncompliance. Accordingly, had I performed additional procedures, other matters may have come to my attention regarding the Cooperative's noncompliance with the above-referenced terms, covenants, provisions, or conditions of the contractual agreements and regulatory requirements, insofar as they relate to accounting matters. In connection with my audit, I noted no matters regarding the Cooperative's accounting and records to indicate that the Cooperative did not:

- Maintain adequate and effective accounting procedures;
- Utilize adequate and fair methods for accumulating and recording labor, material, and overhead costs, and the distribution of these costs to construction, retirement, and maintenance or other expense accounts;
- Reconcile continuing property records to the controlling general ledger plant accounts;
- Clear construction accounts and accrue depreciation on completed construction;
- Record and properly price the retirement of plant;

Board of Directors
Blue Grass Energy Cooperative

- Seek approval of the sale, lease, or transfer of capital assets and disposition of proceeds for the sale or lease of plant, material, or scrap;
- Maintain adequate control over material and supplies;
- Prepare accurate and timely Financial and Operating Reports;
- Obtain written RUS approval to enter into any contract for the management, operation, or maintenance of the borrower's system if the contract covers all or substantially all of the electric system;
- Disclose material related party transactions in the financial statements, in accordance with requirements for related parties in generally accepted accounting principles;
- Record depreciation in accordance with RUS requirements ("See RUS Bulletin 183-1, Depreciation Rates and Procedures");
- Comply with the requirements for the detailed schedule of deferred debits and deferred credits, which are listed below; and
- Comply with the requirements for the detailed schedule of investments, of which there were none.

The deferred debits are as follows:

Deferred pension costs	<u><u>\$3,377,394</u></u>
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The deferred credits are as follows:

Consumer advances for construction	<u><u>\$385,353</u></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. However, this report is a matter of public record and its distributions is not limited.

Alan Zumstein

Alan M. Zumstein, CPA
July 15, 2016