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

Audited Financial Statements
December 31, 2016 and 2015

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

C O N T E N T S

ALAN M. ZUMSTEIN
CERTIFIED PUBLIC ACCOUNTANT

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

MEMBER
• AMERICAN INSTITUTE OF CPA'S
• KENTUCKY SOCIETY OF CPA'S
• INDIANA SOCIETY OF CPA'S
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Independent Auditor's Report

To the Board of Directors
Shelby Energy Cooperative, Inc.

Report on the Financial Statements

I have audited the accompanying consolidated financial statements of Shelby Energy Cooperative, Inc. and Subsidiary, which comprise the balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of revenue and comprehensive income, changes in equities, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated 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 consolidated 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 consolidated 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 consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated 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 consolidated 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 consolidated 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
Shelby Energy Cooperative, Inc.

Opinion

In my opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Shelby Energy Cooperative, Inc. and Subsidiary as of December 31, 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.

Report on Consolidating Information

My audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating information on pages 15 - 16 are 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, and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In my opinion, the consolidating information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, I have also issued a report dated February 28, 2017, on my consideration of Shelby Energy Cooperative, Inc. and Subsidiary'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 Zumstein

Alan M. Zumstein, CPA
February 28, 2017

Shelby Energy Cooperative and Subsidiary

Consolidated Balance Sheets, December 31, 2016 and 2015

Assets	2016	2015
Utility Plant, at original cost:		
In service	$ 92,166,121	$ 88,647,786
Under construction	1,186,875	881,620
	93,352,996	89,529,406
Less accumulated depreciation	18,409,661	19,274,359
	74,943,335	70,255,047
Investments		
Associated organizations	23,720,386	21,800,426
Goodwill, net of amortization	368,414	368,414
	24,088,800	22,168,840
Current Assets:		
Cash and cash equivalents	2,130,118	3,900,145
Accounts receivable, less allowance for 2016 of $457,034 and 2015 of $375,409	4,311,829	3,390,326
Material and supplies, at average cost	730,037	552,845
Prepayments and other current assets	212,081	236,156
	7,384,065	8,079,472
Total	$ 106,416,200	$ 100,503,359
Members' Equities and Liabilities		
Members' Equities:		
Patronage capital and retained earnings	$ 39,412,541	$ 38,478,257
Other equities and minority interests	2,430,848	2,198,199
Accumulated other comprehensive income	(198,702)	(209,741)
	41,644,687	40,466,715
Long Term Debt	52,588,364	50,602,021
Accumulated Postretirement Benefits	1,997,479	1,984,457
Current Liabilities:		
Accounts payable	4,583,058	3,307,962
Short term borrowings	1,346,472	-
Current portion of long term debt	1,970,000	1,800,000
Consumer deposits	1,529,886	1,543,140
Accrued expenses	385,171	314,717
	9,814,587	6,965,819
Consumer Advances for Construction	371,083	484,347
Total	$ 106,416,200	$ 100,503,359

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

Shelby Energy Cooperative, Inc. and Subsidiary
Consolidated Statements of Revenue and Comprehensive Income
for the years ended December 31, 2016 and 2015

	2016	2015
Operating Revenues	$ 46,148,538	$ 45,375,822
Operating Expenses:		
Cost of power and propane	34,268,137	34,007,521
Distribution - operations	2,128,164	1,953,195
Distribution - maintenance	3,531,327	2,618,855
Consumer accounts	814,963	535,083
Customer service and information	444,955	450,669
Sales	4,105	(66,722)
Administrative and general	1,117,178	1,210,328
Depreciation, excluding $137,357 in 2016 and $165,713 in 2015 charged to clearing accounts	2,862,100	2,581,132
Taxes	72,391	221,304
Interest on long-term debt	1,523,210	1,580,936
Other interest	11,186	28,644
Other deductions	7,342	4,251
Total cost of electric service	46,785,058	45,125,196
Operating Margins	(636,520)	250,626
Nonoperating Margins:		
Interest income	39,721	36,819
Subsidiary and others	(47,937)	254,300
	(8,216)	291,119
Patronage Capital assigned from:		
East Kentucky Power Cooperative, Inc.	2,132,164	1,972,964
Other organizations	62,660	72,162
	2,194,824	2,045,126
Net Margins	1,550,088	2,586,871
Other Comprehensive Income:		
Postretirement benefits	11,039	11,039
Total Comprehensive Income	$ 1,561,127	$ 2,597,910

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

Shelby Energy Cooperative, Inc. and Subsidiary
Statements of Changes in Members' Equity
for the years ended December 31, 2015 and 2016

	Patronage Capital	Other Equity	Accumulated Other Comprehensive Income	Total Members' Equity
Balance - December 31, 2014	$ 36,730,211	$ 2,557,702	$ (220,780)	$ 39,067,133
Comprehensive income:				
Net margins	2,586,871			2,586,871
Postretirement benefit obligation				
Amortization			11,039	
Adjustments			-	11,039
Total comprehensive income				2,597,910
Refunds of capital credits	(592,321)			(592,321)
Transfers to other equity and minority interests	(246,504)	(557,057)		(803,561)
Other equities		197,554		197,554
Balance - December 31, 2015	38,478,257	2,198,199	(209,741)	40,466,715
Comprehensive income:				
Net margins	1,550,088			1,550,088
Postretirement benefit obligation				
Amortization			11,039	
Adjustments			-	11,039
Total comprehensive income				1,561,127
Refunds of capital credits	(599,902)			(599,902)
Transfers to other equity and minority interests	-			-
Other equities	(15,902)	232,649		216,747
Balance - December 31, 2016	$ 39,412,541	$ 2,430,848	$ (198,702)	$ 41,644,687

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

Shelby Energy Cooperative, Inc. and Subsidiary
Consolidated Statements of Cash Flows
for the years ended December 31, 2016 and 2015

	2016	2015
Cash Flows from Operating Activities:		
Net margins	$ 1,550,088	$ 2,340,367
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation		
Charged to expense	2,862,100	2,581,132
Charged to clearing accounts	137,357	165,713
Patronage capital credits	(2,194,824)	(2,045,126)
Accumulated postretirement benefits	24,061	25,314
Change in assets and liabilities:		
Receivables	(921,503)	824,548
Material and supplies	(177,192)	71,805
Prepayments	24,075	5,572
Payables	1,275,096	(235,952)
Consumer deposits	(13,254)	25,606
Accrued expenses and accumulated benefits	70,454	(80,332)
Consumer advances for construction	(113,264)	6,995
	2,523,194	3,685,642
Cash Flows from Investing Activities:		
Plant additions	(6,838,260)	(3,758,337)
Salvage, net of removal costs	(865,386)	(493,487)
Other investments, net	274,864	145,574
	(7,428,783)	(4,106,251)
Cash Flows from Financing Activities:		
Other equities and minority interests	232,650	197,553
Additional long term borrowings	4,000,000	7,160,886
Short term borrowings (repayments)	1,346,472	(2,974,118)
Payments on long term debt	(1,843,658)	(1,764,552)
Retirement of patronage capital	(599,902)	(592,321)
Invest in cushion of credit	-	(531,769)
	3,135,562	1,495,679
Net increase in cash	(1,770,027)	1,075,070
Cash balances - beginning of period	3,900,145	2,825,075
Cash balances - end of period	$ 2,130,118	$ 3,900,145

	2016	2015
Supplemental cash flows information:		
Interest paid on long term debt	$1,525,127	$1,585,673

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

Note 1. Summary of Significant Accounting Policies

Shelby Energy Cooperative, Inc. ("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"). 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 $566,734 and $320,416, for 2016 and 2015, respectively. At December 31, 2016, Shelby Energy had $92,407 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, 2016, 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, 2016 and 2015.

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 parties 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 customers' premises, bulk tanks, trucks used for delivery, and buildings and office equipment.

The major classifications of utility plant in service consist of:

	2016	2015
Distribution plant	$85,250,049	$82,166,935
General plant	4,438,596	4,045,283
Subtotal electric plant	89,688,645	86,212,218
Propane tanks on customer premises	979,214	1,050,798
Bulk tanks	364,791	306,940
Delivery and other trucks	707,399	707,399
Land and buildings	350,878	307,529
Office and other equipment	75,194	62,902
Subtotal propane plant	2,477,476	2,435,568
	$92,166,121	$88,647,786

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's 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 2016 or 2015.

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, accounts receivables, accounts payable, 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, 2016 or 2015. 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 February 28, 2017, 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:

	2016	2015
East Kentucky, patronage capital	$21,994,666	$19,862,502
CFC, CTC's	635,840	638,073
CFC, patronage capital	251,979	240,343
CFC, Member capital security	25,000	25,000
Other associated organizations	720,494	699,351
Economic development loans	92,407	335,157
Total	$23,720,386	$21,800,426

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, 2016 was 39% of total assets. Patronage capital consists of:

	2016	2015
Assigned to date	$45,347,999	$43,136,250
Assignable margins	1,550,088	2,340,367
Unassigned margins	1,341,780	1,274,270
Retirements to date	(8,827,326)	(8,272,630)
Total	$39,412,541	$38,478,257

Note 4. Long Term Debt

All assets of Shelby Energy Cooperative, except vehicles, are pledged as collateral on the long term debt to RUS, Federal Financing Bank ("FFB"), and CFC under a joint mortgage agreement. During 2015 Shelby Energy Services executed a $560,886 loan from East Kentucky for the purchase of treasury stock. The note is for ten (10) years. Long term debt consists of:

	2016	2015
Shelby Energy Cooperative		
RUS, 2.125% to 4.50%	$2,170,898	$18,143,913
FFB, 0.274% to 5.316%	32,222,683	29,072,308
CFC:		
3.65% to 6.65% notes	2,396,902	2,553,180
Refinance RUS loans 2.6% to 5.05%	17,276,455	2,091,965
	54,066,938	51,861,366
Less current portion	1,920,000	1,750,000
	52,146,938	50,111,366
Shelby Energy Services		
East Kentucky Power Cooperative 3.0%	491,426	540,655
Less current portion	50,000	50,000
	441,426	490,655
Total long term portion	$52,588,364	$50,602,021

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, 2016, there was $9,400,000 of FFB loan funds unadvanced. During 2016, Shelby Energy refinanced $15,684,215 of higher interest rate loans from RUS with funds from CFC.

As of December 31, 2016, the annual principal payments for the next five years are as follows: 2017 - $1,920,000; 2018 - $2,050,000; 2019 - $2,200,000; 2020 - $2,350,000; 2021 - $2,500,000.

Note 4. Short Term Borrowings

At December 31, 2016, Shelby Energy had a short term line of credit of $6,000,000 available from CFC. Advances against this line of credit amounted to $1,346,472, with an interest rate of 2.10%.

Note 5. 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 2016 and 2015 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 $262,133 in 2016 and $260,202 in 2015. There have been no significant changes that affect the comparability of 2016 and 2015. Employees hired after September 2, 2009 can only participate in the NRECA 401(k) plan. Employer contributions to the 401(k) plan amounted to $113,838 for 2016 and $100,500 for 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, 2016 and 2015 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.

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. During 2013 Shelby Energy made the prepayment contribution.

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 2016 was $9,480 and 2015 was $8,795.

Note 6. Postretirement Benefits

Shelby Energy sponsors a noncontributory 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. There have been no significant changes that affect the comparability of 2016 and 2015.

The discount rate used in determining the APBO was 4.5% for 2016 and 2015. The health care cost trend rate used to compute the APBO in an 8% annual rate of increase for 2016, and decreasing gradually to 5.5%, then remain at that level thereafter.

The funded status of the plan is as follows:

	2016	2015
Projected benefit obligation	(1,997,479)	($1,984,457)
Plan assets at fair value	-	-
Total	($1,997,479)	($1,984,457)

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

	2016	2015
Benefit obligation at beginning of year	$1,984,457	$1,970,182
Components of net periodic benefit cost:		
Service cost	43,271	34,365
Interest cost	89,594	98,500
Net periodic benefit cost	132,865	132,865
Benefits paid	(119,843)	(118,590)
Adjustments	-	-
Benefit obligation at end of year	$1,997,479	$1,984,457
Amounts recognized in the balance sheet consists of:		
Noncurrent liabilities	$1,997,479	$1,984,457
Amounts included in other comprehensive income:		
Unrecognized actuarial gain (loss)	($198,702)	($209,741)
Effect of 1% increase in the health care trend:		
Postemployment benefit obligation	$2,127,000	
Net periodic benefit cost	141,500	

Projected retiree benefit payments for the next five years are expected to be as follows: 2017 - $125,000; 2018 - $120,000; 2019 - $115,000; 2020 - $105,000; 2021 - $94,000.

Note 7. 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 8. 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 9. 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 September, 2015 between Shelby Energy and the International Brotherhood of Electric Workers ("IBEW").

Note 10. 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 11. Contingencies

Shelby Energy, on occasion, 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.

* * * * *

Shelby Energy Cooperative and Subsidiary
Consolidating Balance Sheet, December 31, 2016

Assets	Energy	Services	Propane	Eliminations	Consolidated
Utility Plant, at original cost:					
In service	$89,688,645		$2,477,476		$92,166,121
Under construction	1,186,875				1,186,875
	90,875,520		2,477,476		93,352,996
Less accumulated depreciation	17,163,110		1,246,551		18,409,661
	73,712,410		1,230,925		74,943,335
Investments and Other Assets:					
Associated organizations	23,720,386				23,720,386
Goodwill, net of amortization			368,414		368,414
Subsidiary	1,775,642	2,224,339		(3,999,981)	-
	25,496,028	2,224,339	368,414	(3,999,981)	24,088,800
Current Assets:					
Cash and cash equivalents	1,551,427	23,667	555,024		2,130,118
Accounts receivable, less allowance for Energy of $429,034 and Propane of $28,000	4,141,947		169,882	-	4,311,829
Material and supplies, at average cost	669,486		60,551		730,037
Prepayments	190,881		21,200		212,081
	6,553,741	23,667	806,657		7,384,065
Total	$105,762,179	$2,248,006	$2,405,996	($3,999,981)	$106,416,200

Members' Equities and Liabilities	Energy	Services	Propane	Eliminations	Consolidated
Members' and Stockholder's Equities:					
Capital investment		$1,379,000	$860,941	($2,239,941)	$0
Patronage capital and retained earnings	39,412,541	396,642	1,366,751	(1,763,393)	39,412,541
Other equities	2,446,557	(19,062)		3,353	2,430,848
Other comprehensive income	(198,702)				(198,702)
	41,660,396	1,756,580	2,227,692	(3,999,981)	41,644,687
Long Term Debt	52,146,938	441,426			52,588,364
Accumulated Postretirement Benefits	1,997,479				1,997,479
Current Liabilities:					
Accounts payable	4,404,754		178,304	-	4,583,058
Short term borrowings	1,346,472			-	1,346,472
Current portion of long term debt	1,920,000	50,000			1,970,000
Consumer deposits	1,529,886				1,529,886
Accrued expenses	385,171				385,171
	9,586,283	50,000	178,304		9,814,587
Consumer Advances for Construction	371,083				371,083
Total	$105,762,179	$2,248,006	$2,405,996	($3,999,981)	$106,416,200

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

Shelby Energy Cooperative, Inc. and Subsidiary
Consolidating Statement of Revenue and Comprehensive Income
for the year ended December 31, 2016

	Energy	Services	Propane	Eliminations	Consolidated
Operating Revenues	$44,666,885		$1,481,653		$46,148,538
Operating Expenses:					
Cost of purchases	33,721,739		546,398		34,268,137
Distribution - operations	1,704,628		423,536		2,128,164
Distribution - maintenance	3,531,327				3,531,327
Consumer accounts	706,504		108,459		814,963
Customer service and information	444,955				444,955
Sales	4,105				4,105
Administrative and general	988,871	4,165	124,142		1,117,178
Depreciation, excluding $137,357 charged to clearing accounts	2,729,386		132,714		2,862,100
Taxes	52,282	1,355	18,754		72,391
Interest on long term debt	1,508,329	14,881			1,523,210
Other interest	11,186				11,186
Other	7,342				7,342
Total cost of electric service	45,410,654	20,401	1,354,003		46,785,058
Operating Margins	(743,769)	(20,401)	127,650		(636,520)
Nonoperating Margins:					
Interest income	38,060		1,661		39,721
Subsidiary and others	60,973	135,470	6,159	(250,539)	(47,937)
	99,033	135,470	7,820	(250,539)	(8,216)
Patronage Capital assigned from:					
East Kentucky Power Cooperative	2,132,164				2,132,164
Other organizations	62,660				62,660
	2,194,824				2,194,824
Net Margins	1,550,088	115,069	135,470	(250,539)	1,550,088
Other comprehensive Income:					
Postretirement benefits	11,039				11,039
Total Comprehensive Income	$1,561,127	$115,069	$135,470	($250,539)	$1,561,127

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

ALAN M. ZUMSTEIN
CERTIFIED PUBLIC ACCOUNTANT

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

MEMBER
• AMERICAN INSTITUTE OF CPA'S
• KENTUCKY SOCIETY OF CPA'S
• INDIANA SOCIETY OF CPA'S
• AICPA DIVISION FOR FIRMS

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
Shelby Energy Cooperative, Inc.

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 Shelby Energy Cooperative, Inc. (the "Cooperative"), which comprise the balance sheets as of December 31, 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 February 28, 2017.

Internal Control Over Financial Reporting

In planning and performing my audit of the financial statements, I considered the Cooperative'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 the Cooperative's internal control. Accordingly, I do not express an opinion on the effectiveness of the Cooperative'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 the Cooperative'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

To the Board of Directors
Shelby Energy Cooperative, Inc.

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 Zumstein

Alan M. Zumstein, CPA
February 28, 2017

ALAN M. ZUMSTEIN
CERTIFIED PUBLIC ACCOUNTANT

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

MEMBER
• AMERICAN INSTITUTE OF CPA'S
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Independent Auditor's Report on Compliance with Aspects of Contractual Agreements and Regulatory Requirements for Electric Borrowers

Board of Directors
Shelby Energy Cooperative, Inc.

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 Shelby Energy Cooperative, Inc. (the "Cooperative"), which comprise the balance sheet as of December 31, 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 February 28, 2017. In accordance with *Government Auditing Standards,* we have also issued my report dated February 28, 2017, 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 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 28, 2017, 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;
- 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;

Board of Directors
Shelby Energy Cooperative, Inc.

- 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; and
- Comply with the requirements for the detailed schedule of investments, which are listed below.

The deferred credits are as follows:

Consumer advances for construction	$371,083

Shelby Energy is a 100% 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	$281,573
Activity for 2016	-	115,069
Balance, end of year	$1,379,000	$396,642

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
February 28, 2017