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Shelby Energy Cooperative, Inc.
and Subsidiary
Shelbyville, Kentucky

Audited Financial Statements
December 31, 2018 and 2017

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Independent Auditor's Report

To the Board of Directors
Shelby Energy Cooperative, Inc.
Shelbyville, Kentucky

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, 2018 and 2017, and the related consolidated statements of revenue and comprehensive income, changes in members' 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, 2018 and 2017, and the results of its 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 9, 2019, 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 9, 2019

Shelby Energy Cooperative, Inc. and Subsidiary
Consolidated Balance Sheets, December 31, 2018 and 2017

<u>Assets</u>	<u>2018</u>	<u>2017</u>
Utility Plant, at original cost:		
In service	\$ 98,517,316	\$ 95,544,460
Under construction	691,721	683,932
	<u>99,209,037</u>	<u>96,228,392</u>
Less accumulated depreciation	20,144,964	19,084,963
	<u>79,064,073</u>	<u>77,143,429</u>
Investments		
Associated organizations	26,505,310	24,852,221
Goodwill, net of amortization	368,414	368,414
	<u>26,873,724</u>	<u>25,220,635</u>
Current Assets:		
Cash and cash equivalents	2,505,305	2,038,399
Accounts receivable, less allowance for 2018 of \$506,227 and 2017 of \$491,991	4,416,440	5,019,642
Material and supplies, at average cost	672,999	779,685
Prepayments and other current assets	182,874	254,341
	<u>7,777,618</u>	<u>8,092,067</u>
Total	<u>\$ 113,715,415</u>	<u>\$ 110,456,131</u>
<u>Members' Equities and Liabilities</u>		
Members' Equities:		
Patronage capital and retained earnings	\$ 42,334,747	\$ 39,768,858
Other equities and minority interests	2,902,401	2,688,621
Accumulated other comprehensive income	342,794	360,836
	<u>45,579,942</u>	<u>42,818,315</u>
Long Term Debt	<u>58,058,726</u>	<u>54,829,058</u>
Accumulated Postretirement Benefits	<u>1,481,249</u>	<u>1,466,991</u>
Current Liabilities:		
Accounts payable	3,739,593	3,825,147
Short term borrowings	-	2,692,985
Current portion of long term debt	2,235,000	2,167,425
Consumer deposits	1,596,008	1,541,470
Accrued expenses	541,535	650,244
	<u>8,112,136</u>	<u>10,877,271</u>
Consumer Advances for Construction	<u>483,362</u>	<u>464,496</u>
Total	<u>\$ 113,715,415</u>	<u>\$ 110,456,131</u>

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, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Operating Revenues	\$ 49,647,753	\$ 45,640,420
Operating Expenses:		
Cost of power and propane	35,089,064	33,087,604
Distribution - operations	2,369,777	2,340,330
Distribution - maintenance	3,273,442	3,193,885
Consumer accounts	608,189	730,390
Customer service and information	326,829	292,414
Sales	699	(17,331)
Administrative and general	1,162,572	1,245,369
Depreciation, excluding \$199,999 in 2018 and \$171,872 in 2017 charged to clearing accounts	3,454,237	3,120,122
Taxes	71,288	77,809
Interest on long-term debt	1,985,420	1,786,983
Other interest	42,983	44,851
Other deductions	20,339	21,549
Total cost of electric service	<u>48,404,839</u>	<u>45,923,975</u>
Operating Margins	<u>1,242,914</u>	<u>(283,555)</u>
Nonoperating Margins:		
Interest income	61,900	35,983
Subsidiary and others	77,497	(30,318)
	<u>139,397</u>	<u>5,665</u>
Patronage Capital assigned from:		
East Kentucky Power Cooperative, Inc.	1,633,909	1,114,070
Other organizations	105,585	124,161
	<u>1,739,494</u>	<u>1,238,231</u>
Net Margins	3,121,805	960,341
Other Comprehensive Income:		
Postretirement benefits	(18,042)	559,538
Total Comprehensive Income	<u>\$ 3,103,763</u>	<u>\$ 1,519,879</u>

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

Shelby Energy Cooperative, Inc. and Subsidiary
Statement of Changes in Members' Equities
for the years ended December 31, 2017 and 2018

	Patronage Capital					Other Equity	Accumulated Comprehensive Income	Total Members' Equities
	<u>Assigned</u>	<u>Assignable</u>	<u>Retirements</u>	<u>Unassigned</u>	<u>Total</u>			
Balance - December 31, 2016	\$ 45,393,205	\$ 1,550,088	\$ (8,872,533)	\$ 1,341,781	\$39,412,541	\$ 2,430,848	\$ (198,702)	\$ 41,644,687
Comprehensive income:								
Net margins		960,341			960,341			960,341
Assigned margins	1,550,088	(1,550,088)			-			-
Postretirement benefit obligation Amortization						559,538		
Adjustment						-	559,538	-
Total comprehensive income							-	1,519,879
Refunds of capital credits			(590,014)		(590,014)			(590,014)
Other equities				(14,010)	(14,010)	257,773		243,763
Balance - December 31, 2017	46,943,293	960,341	(9,462,547)	1,327,771	39,768,858	2,688,621	360,836	42,818,315
Comprehensive income:								
Net margins		3,121,805			3,121,805			3,121,805
Assigned margins	960,341	(960,341)			-			-
Postretirement benefit obligation Amortization						(18,042)		
Adjustment						-	(18,042)	-
Total comprehensive income							-	3,103,763
Refunds of capital credits			(555,916)		(555,916)			(555,916)
Other equities					-	213,780		213,780
Balance - December 31, 2018	\$ 47,903,634	\$ 3,121,805	\$ (10,018,463)	\$ 1,327,771	\$42,334,747	\$ 2,902,401	\$ 342,794	\$ 45,579,942

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, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Cash Flows from Operating Activities:		
Net margins	\$ 3,121,805	\$ 960,341
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation		
Charged to expense	3,454,237	3,120,122
Charged to clearing accounts	199,999	171,872
Patronage capital credits	(1,739,494)	(1,238,231)
Accumulated postretirement benefits	(3,784)	29,050
Change in assets and liabilities:		
Receivables	603,202	(707,813)
Material and supplies	106,686	(49,648)
Prepayments	71,467	(42,260)
Payables	(79,696)	(757,911)
Consumer deposits	48,680	11,584
Accrued expenses and accumulated benefits	(108,709)	265,073
Consumer advances for construction	18,866	93,413
	<u>5,693,259</u>	<u>1,855,592</u>
Cash Flows from Investing Activities:		
Plant additions	(4,882,992)	(4,804,922)
Salvage, net of removal costs	(691,887)	(687,082)
Other investments, net	86,405	106,396
	<u>(5,488,475)</u>	<u>(5,385,609)</u>
Cash Flows from Financing Activities:		
Other equities and minority interests	213,780	242,064
Additional long term borrowings	8,000,000	4,600,000
Short term borrowings (repayments)	(2,692,985)	1,346,513
Payments on long term debt	(2,202,757)	(2,160,265)
Retirement of patronage capital	(555,916)	(590,014)
Cushion of credit (advances) applied	(2,500,000)	-
	<u>262,122</u>	<u>3,438,298</u>
Net increase (decrease) in cash	466,906	(91,719)
Cash balances - beginning of period	<u>2,038,399</u>	<u>2,130,118</u>
Cash balances - end of period	<u>\$ 2,505,305</u>	<u>\$ 2,038,399</u>
Supplemental cash flows information:		
Interest paid on long term debt	\$1,982,574	\$1,748,579

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

Shelby Energy Cooperative, Inc.
Notes to 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”). Shelby Energy owns 100% of the outstanding stock of Propane Plus. Services Corporation was dissolved during 2017. All significant intercompany 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. Shelby Energy 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 \$643,722 and \$609,765, for 2018 and 2017, respectively. At December 31, 2018, Shelby Energy had \$19,230 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, 2018, 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, 2018 and 2017.

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.

Shelby Energy Cooperative, Inc.
Notes to Financial Statements, continued

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:

	<u>2018</u>	<u>2017</u>
Distribution plant	\$91,114,517	\$88,464,201
General plant	4,548,847	4,365,536
Subtotal electric plant	<u>95,663,364</u>	<u>92,829,737</u>
Propane tanks on customer premises	1,077,219	1,060,755
Bulk tanks	387,195	367,906
Delivery and other trucks	820,451	837,835
Land and buildings	465,442	350,878
Office and other equipment	103,645	97,349
Subtotal propane plant	<u>2,853,952</u>	<u>2,714,723</u>
	<u>\$98,517,316</u>	<u>\$95,544,460</u>

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 3.55% per annum. General plant rates are as follows:

Structures and improvements	2.16%
Transportation equipment	10% - 20%
Other general plant	5% - 12%

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 The Companies expense 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 2018 or 2017.

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 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.

Shelby Energy Cooperative, Inc.
Notes to Financial Statements, continued

Note 1. Summary of Significant Accounting Policies, continued

Risk Management The Companies are 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.

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, 2018 or 2017. Shelby Energy'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.

Subsequent Events Management has evaluated subsequent events through February 9, 2019, the date the financial statements were available to be issued.

Note 2. Investments in Associated Organizations

Investments in associated organizations consist of:

	<u>2018</u>	<u>2017</u>
East Kentucky, patronage capital	\$24,742,645	\$23,108,736
CFC, CTC's	630,912	633,456
CFC, patronage capital	327,050	289,337
CFC, Member capital security	25,000	25,000
Other associated organizations	760,473	744,081
Economic development loans	19,230	51,611
Total	<u>\$26,505,310</u>	<u>\$24,852,221</u>

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.

Shelby Energy Cooperative, Inc.
Notes to Financial Statements, continued

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, 2018 was 40% of total assets.

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. This note was transferred to Shelby Propane as of December 31, 2017. The note is for ten (10) years. Long term debt consists of:

	<u>2018</u>	<u>2017</u>
<i>Shelby Energy Cooperative</i>		
RUS, 2.0% to 4.50%	\$1,959,771	\$2,066,797
Cushion of credit, earns 5% interest	(2,511,383)	(2,034)
FFB, 2.399% (1.065% in 2017) to 5.316%	42,677,549	35,780,923
CFC:		
3.65% to 6.65% notes	2,063,628	2,231,021
Refinance RUS loans 2.90% to 5.05%	<u>15,823,347</u>	<u>16,555,935</u>
	60,012,912	56,632,642
Less current portion	<u>2,190,000</u>	<u>2,115,000</u>
	<u>57,822,912</u>	<u>54,517,642</u>
<i>Shelby Propane</i>		
East Kentucky Power Cooperative 3.0%	280,814	363,841
Less current portion	<u>45,000</u>	<u>52,425</u>
	<u>235,814</u>	<u>311,416</u>
Total long term portion	<u><u>\$58,058,726</u></u>	<u><u>\$54,829,058</u></u>

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, 2018, there was \$19,119,000 of FFB loan funds unadvanced. These funds will be used for future plant additions.

As of December 31, 2018, the annual principal payments for the next five years are as follows: 2019 - \$2,190,000; 2020 - \$2,320,000; 2021 - \$2,415,000; 2022 - \$2,525,000; 2023 - \$2,570,000.

Note 5. Short Term Borrowings

At December 31, 2018, Shelby Energy had a short term line of credit of \$6,000,000 available from CFC. Advances against this line of credit have been repaid.

Note 6. 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 2018 and 2017 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 \$219,130 in 2018 and \$229,620 in 2017. There have been no significant changes that affect the comparability of 2018 and 2017. Employees hired after September 2, 2009 can only participate in the NRECA 401(k) plan. Employer contributions to the 401(k) plan amounted to \$145,715 for 2018 and \$119,455 for 2017.

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, 2018 and 2017 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 2018 was \$7,800 and 2017 was \$11,188.

Note 7. 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 2018 and 2017.

Shelby Energy Cooperative, Inc.
Notes to Financial Statements, continued

Note 7. Postretirement Benefits, continued

The discount rate used in determining the APBO was 4.5% for 2018 and 2017. The health care cost trend rate used to compute the APBO based a 6% annual rate of increase for 2018, and decreasing gradually to 3%, then remain at that level thereafter.

The funded status of the plan is as follows:

	<u>2018</u>	<u>2017</u>
Projected benefit obligation	(1,481,249)	(\$1,466,991)
Plan assets at fair value	-	-
Total	<u>(\$1,481,249)</u>	<u>(\$1,466,991)</u>

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

	<u>2018</u>	<u>2017</u>
Benefit obligation at beginning of year	<u>\$1,466,991</u>	<u>\$1,997,479</u>
Components of net periodic benefit cost:		
Service cost	61,022	54,914
Interest cost	<u>66,335</u>	<u>77,951</u>
Net periodic benefit cost	127,357	132,865
Benefits paid	(113,099)	(114,854)
Adjustments	-	<u>(548,499)</u>
Benefit obligation at end of year	<u>\$1,481,249</u>	<u>\$1,466,991</u>

Amounts recognized in the balance sheet consists of:

Noncurrent liabilities	<u>\$1,481,249</u>	<u>\$1,466,991</u>
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Amounts included in other comprehensive income:

Unrecognized actuarial gain (loss)	<u>\$342,794</u>	<u>\$360,836</u>
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Effect of 1% increase in the health care trend:

Postemployment benefit obligation	\$1,577,000
Net periodic benefit cost	135,000

Projected retiree benefit payments for the next five years are expected to be as follows: 2019 - \$122,000; 2020 - \$124,000; 2021 - \$128,000; 2022 - \$121,000; 2023 - \$114,000.

Note 8. 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 9. 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 10. 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, 2018 between Shelby Energy and the International Brotherhood of Electric Workers ("IBEW").

Note 11. Environmental Contingency

The Companies from time to time are 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 the Companies 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 the Companies' financial position or its future cash flows.

Note 12. 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, Inc. and Subsidiary
Consolidating Balance Sheet, December 31, 2018

<u>Assets</u>	<u>Energy</u>	<u>Propane</u>	<u>Eliminations</u>	<u>Consolidated</u>
Utility Plant, at original cost:				
In service	\$95,663,364	\$2,853,952		\$98,517,316
Under construction	691,721			691,721
	<u>96,355,085</u>	<u>2,853,952</u>		<u>99,209,037</u>
Less accumulated depreciation	18,576,135	1,568,829		20,144,964
	<u>77,778,950</u>	<u>1,285,123</u>		<u>79,064,073</u>
Investments and Other Assets:				
Associated organizations	26,505,310			26,505,310
Goodwill, net of amortization		368,414		368,414
Subsidiary	2,252,596		(2,252,596)	-
	<u>28,757,906</u>	<u>368,414</u>	<u>(2,252,596)</u>	<u>26,873,724</u>
Current Assets:				
Cash and cash equivalents	1,855,266	650,039		2,505,305
Accounts receivable, less allowance for Energy of \$489,116 and Propane of \$17,111	4,209,173	207,267	-	4,416,440
Material and supplies, at average cost	585,551	87,448		672,999
Prepayments	158,174	24,700		182,874
	<u>6,808,164</u>	<u>969,454</u>		<u>7,777,618</u>
Total	<u>\$113,345,020</u>	<u>\$2,622,991</u>	<u>(\$2,252,596)</u>	<u>\$113,715,415</u>
 <u>Members' Equities and Liabilities</u> 				
Members' and Stockholder's Equities:				
Capital investment		\$497,100	(\$497,100)	\$0
Patronage capital and retained earnings	42,334,747	\$1,755,496	(\$1,755,496)	42,334,747
Other equities	2,902,401			2,902,401
Other comprehensive income	342,794			342,794
	<u>45,579,942</u>	<u>2,252,596</u>	<u>(2,252,596)</u>	<u>45,579,942</u>
Long Term Debt	<u>57,822,912</u>	<u>235,814</u>		<u>58,058,726</u>
Accumulated Postretirement Benefits	<u>1,481,249</u>			<u>1,481,249</u>
Current Liabilities:				
Accounts payable	3,655,870	83,723		3,739,593
Short term borrowings	-		-	-
Current portion of long term debt	2,190,000	45,000		2,235,000
Consumer deposits	1,590,150	5,858		1,596,008
Accrued expenses	541,535			541,535
	<u>7,977,555</u>	<u>134,581</u>		<u>8,112,136</u>
Consumer Advances for Construction	<u>483,362</u>			<u>483,362</u>
Total	<u>\$113,345,020</u>	<u>\$2,622,991</u>	<u>(\$2,252,596)</u>	<u>\$113,715,415</u>

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, 2018

	<u>Energy</u>	<u>Propane</u>	<u>Eliminations</u>	<u>Consolidated</u>
Operating Revenues	<u>\$47,163,668</u>	<u>\$2,484,085</u>		<u>\$49,647,753</u>
Operating Expenses:				
Cost of purchases	33,950,034	1,139,030		35,089,064
Distribution - operations	1,893,075	476,702		2,369,777
Distribution - maintenance	3,273,442			3,273,442
Consumer accounts	486,115	122,074		608,189
Customer service and information	326,829			326,829
Sales	699			699
Administrative and general	1,022,848	139,724		1,162,572
Depreciation, excluding \$199,999 charged to clearing accounts	3,275,963	178,274		3,454,237
Taxes	55,557	15,731		71,288
Interest on long term debt	1,971,796	13,624		1,985,420
Other interest	42,983			42,983
Other	<u>20,339</u>			<u>20,339</u>
Total cost of electric service	<u>46,319,680</u>	<u>2,085,159</u>		<u>48,404,839</u>
Operating Margins	<u>843,988</u>	<u>398,926</u>		<u>1,242,914</u>
Nonoperating Margins:				
Interest income	59,754	2,146		61,900
Subsidiary and others	<u>478,569</u>	<u>13,240</u>	<u>(414,312)</u>	<u>77,497</u>
	<u>538,323</u>	<u>15,386</u>	<u>(414,312)</u>	<u>139,397</u>
Patronage Capital assigned from:				
East Kentucky Power Cooperative	1,633,909			1,633,909
Other organizations	<u>105,585</u>			<u>105,585</u>
	<u>1,739,494</u>			<u>1,739,494</u>
Net Margins	3,121,805	414,312	(414,312)	3,121,805
Other comprehensive Income:				
Postretirement benefits	<u>(18,042)</u>			<u>(18,042)</u>
Total Comprehensive Income	<u>\$3,103,763</u>	<u>\$414,312</u>	<u>(\$414,312)</u>	<u>\$3,103,763</u>

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

ALAN M. ZUMSTEIN
CERTIFIED PUBLIC ACCOUNTANT

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MEMBER
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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
Shelby Energy Cooperative, Inc.
Shelbyville, Kentucky

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, 2018 and 2017, and the related statements of revenue and comprehensive income, changes in 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 9, 2019.

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 9, 2019

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MEMBER
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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.
Shelbyville, Kentucky

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, 2018, and the related statements of revenue and comprehensive income, changes in members' equities and cash flows for the year then ended, and the related notes to the financial statements, and have issued my report thereon dated February 9, 2019. In accordance with *Government Auditing Standards*, we have also issued my report dated February 9, 2019, 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 9, 2019, 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	<u>\$483,362</u>
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Shelby Energy is a 100% owner of a subsidiary, Shelby Propane Plus, LLC, which is engaged in the distribution sales of propane gas 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:

	<u>Investment</u>
Beginning balance	\$1,845,736
Net income	414,312
Returns of income/others	<u>(7,452)</u>
Ending balance	<u>\$2,252,596</u>

The purpose of this report is solely to communicate, in connection with the audit of the financial statements, on compliance with aspects of contractual agreements and the regulatory requirements for electric borrowers based on the requirements of 7 CFR Part 1773, Policy on Audits of Rural Utilities Service Borrowers and Grantees. Accordingly, this report is not suitable for any other purpose.

Alan Zumstein

Alan M. Zumstein, CPA
February 9, 2019