SOUTH KENTUCKY RURAL ELECTRIC COOPERATIVE CORPORATION

POLICY 401
STRATEGIC FINANCIAL AND EQUITY MANAGEMENT

I. OBJECTIVE

To provide guidelines and direction to the management of South Kentucky Rural Electric Cooperative Corporation ("SKRECC") in order to maintain the Cooperative's financial integrity; to ensure SKRECC's financial practices are consistent with the prudent operation of a not-for-profit entity; and to promote the effective and secure management of SKRECC's financial resources.

II. POLICY

The Board of Directors ("Board") of SKRECC recognizes the value of the Cooperative's not-for-profit framework and its responsibility to operate for the mutual benefit of its Members. SKRECC shall be guided in its operations by the rules and practices prescribed by relevant regulatory bodies and lenders, and it shall strive to provide high quality, cost-effective electric service consistent with prudent financial management.

III. EXPECTATIONS

A. **Planning**. All financial decisions made by the Board and SKRECC's management shall be approached judiciously and with appropriate recognition of the Cooperative's short-term and long-term needs and goals. In order to maintain a sound financial position and provide for the most effective management and security of the financial resources of the Cooperative, SKRECC shall undertake thorough planning and forecasting activities that are documented and regularly updated.

1. SKRECC's President/Chief Executive Officer ("CEO"), in conjunction with SKRECC's Vice President of Finance shall ensure that certain planning reports/documents are prepared and updated consistent with the table below. Each report/document listed below shall be reviewed and approved by the Board upon its creation and each time it is updated.

Planning Report Description	**To Be Created/Updated…**
Wholesale Power Contract	*As Necessary*
Load Forecast Study	*Every 3 Years*
Long Range Construction Plan	*As Necessary*
Construction Work Plan	*Every 4 Years*
Cooperative Strategic Plan	*Every 3 Years*
10-Year Financial Forecast	*As Necessary*
Capital Budget	*Annually*
Operating Budget	*Annually*

2. In addition to those reports/documents listed in the above table, the CEO, in conjunction with the Vice President of Finance, shall ensure that such other planning reports/documents are created and/or updated as may be appropriate to meet the intent of this Policy.

3. As indicated by the above table, the CEO, in conjunction with the Vice President of Finance, shall ensure that a Capital Budget and Operating Budget are prepared on an annual basis. These budgets shall be prepared for the ensuing calendar year, shall be based on the planning reports/documents and financial goals and parameters described in this Policy, and shall be presented to the Board for their review and approval no later than November of each year. The budgets shall include, at a minimum, the following items:

   a. Assumptions used to prepare the budgets;

   b. Statement of operations for the year;

   c. Expense Budget Summary by year;

   d. Combined Capital and Expense Budget Summary;

   e. Statement of Operations compared to Financial Forecast; and

   f. Capital Expenditures by quarter.

4. As indicated by the above table, the CEO, in conjunction with the Vice President of Finance, shall ensure that a 10-Year Financial Forecast is prepared and updated as necessary. The first forecast year reflected in the 10-Year Financial Forecast shall contain the financial data from the annual budgets described above. The 10-Year Financial Forecast shall be based on the planning reports/documents and financial goals and parameters described in this Policy, describe the significant assumptions utilized in its preparation, and be reported to the Board as necessary. In order to comply with typical lender requirements, the 10-Year Financial Forecast shall include, at a minimum, the following sections:

   a. Ratios;

   b. Balance sheets;

   c. Statements of Operations;

   d. General funds;

   e. Load projections;

f. Determination of operating revenues;

g. Plant investment; and

h. Determination of debt and debt service.

5. As part of its planning and forecasting activities, the management of SKRECC shall consult and utilize all information and resources at its disposal, including, but not limited to: SKRECC's annual independent audit; National Rural Utilities Cooperative Finance Corporation ("CFC") Key Ratio Trend Analysis ("KRTA"); the Rural Utilities Service ("RUS") Annual Financial and Operating Report Electric Distribution (formerly known as the "Form 7"); historical operating statements, balance sheets and cash flow analyses; and cost of service studies.

B. **<u>Financial Goals and Parameters</u>**. SKRECC's management shall operate the Cooperative so that its financial operating results are within the goals and parameters set forth herein. SKRECC's management shall review these financial goals and parameters annually and recommend changes to the Board as necessary. Should the financial goals and parameters outlined in this Policy conflict with each other to such a degree that the financial forecast cannot reasonably achieve all of them at the same time, SKRECC's management shall communicate the conflict(s) to the Board and the Board shall, with management's guidance, discuss and resolve any such conflicts.

1. <u>Rates and Margins</u>.

a. SKRECC's rates shall be designed to at least meet a minimum revenue requirement that shall, on a calendar year basis, cover all costs of service and produce net margins necessary to support the accomplishment of the strategic financial objectives outlined in this Policy. The rates shall include a power cost factor adjustment designed to automatically adjust revenues based on changes in the Cooperative's wholesale power cost, such as the environmental surcharge and fuel adjustment clause.

b. The Board and SKRECC's management shall strive to maintain a fair, equitable and risk rated balance between the collection of revenue and incurring of expenses between all revenue classes. This balance shall be determined through completion of an industry accepted cost-of-service study, accomplished when financial indicators signal revenue resources are not sufficient to meet operational needs or there is a change in consumer demographics that warrant such a review as determined by management and the Board of Directors.

c. SKRECC's annual operating margins shall be positive and shall generate sufficient cash flow to satisfy established working capital requirements. SKRECC shall maintain a sufficient level of working capital in order to satisfy all of its financial obligations as they become due.

2. Equity and Coverage Ratios.

a. SKRECC shall achieve a minimum equity ratio (defined as Total Margins & Equity divided by Total Assets & Other Debits, as calculated by KRTA ratio #16) of 42% by December 31, 2017. Once the minimum equity ratio has been achieved, SKRECC shall maintain an equity ratio between 35% and 45%.

b. SKRECC shall achieve a minimum equity ratio excluding equity in Investment in Associated Organizations Patronage Capital (defined as Total Margins & Equity (less Investment in Assoc. Org. Patronage Capital) divided by Total Assets & Other Debits (less Investment in Assoc. Org. Patronage Capital), as calculated by KRTA ratio # 17) of 27% by December 31, 2018. Once the minimum equity ratio excluding equity in Investment in Associated Organizations Patronage Capital has been achieved, SKRECC shall maintain an equity ratio excluding equity in Investment in Associated Organizations Patronage Capital between 27% and 30%.

c. In accordance with the mortgage requirements of RUS, SKRECC shall maintain:

i. A minimum Times Interest Earned Ratio (2 of 3 year high average), as calculated by KRTA ratio #7, of **1.25**.

ii. A minimum Operating Times Interest Earned Ratio (2 of 3 year high average), as calculated by KRTA ratio #9, of **1.1**.

iii. A minimum Debt Service Coverage Ratio (2 of 3 year high average), as calculated by KRTA ratio #13, of **1.25**.

iv. A minimum Operating Debt Service Coverage Ratio (2 of 3 year high average), as calculated by KRTA ratio #15, of **1.1**.

d. In accordance with the mortgage requirements of CFC and CoBank, SKRECC shall maintain a minimum Modified Debt Service Coverage Ratio (2 of 3 year high average), as calculated by KRTA ratio #11, of **1.35**.

3. Debt Portfolio Management.

    a. SKRECC shall maintain a debt portfolio that allows it to responsibly accomplish its financial and operational objectives. SKRECC management shall regularly review its debt portfolio, relevant markets, interest rates, and lender offerings consistent with prudent financial management. The CEO shall report to the Board the status of SKRECC's debt portfolio on a regular basis.

    b. SKRECC shall maintain a line-of-credit for short-term operating purposes in an amount not to exceed $15,000,000.

    c. The CEO shall consider and discuss establishing a line-of-credit for interim or bridge financing with the Board on a case-by-case basis.

    d. The CEO may establish emergency lines-of-credit as necessary to support the capital and operating needs of SKRECC if extraordinary circumstances warrant such action (*e.g.*, for storm recovery efforts).

    e. The aggregate amount of all loans drawn and available to be drawn by SKRECC shall not exceed the maximum debt limit established by the Board as contained in the Cooperative's mortgage documents.

    f. SKRECC's long-term debt portfolio shall be composed of the following targets:

Loan Type	Current Percentage	Target Percentage From	To
1) Short Term Debt (Line of Credit)	**0%**	**0%**	**10%**
2) Long Term Variable	**10%**	**10%**	**30%**
3) Total Long Term Fixed (Add 3a + 3b + 3c)			
3a) Long Term Fixed: Rates fixed for 1 – 9 years	**0%**	**0%**	**0%**
3b) Long Term Fixed: Rates fixed 10+ years	**0%**	**0%**	**0%**
3c) Long Term Fixed: Rates fixed to maturity	**90%**	**70%**	**90%**
Total (Add 1 + 2 + 3)	**100%**	**100%**	

IV. RESPONSIBILITY

A. The Board shall see that the provisions of this Policy are carried out. The Board shall also review this Policy at least annually, shall regularly seek and evaluate the recommendations of SKRECC management concerning the terms of this Policy, and shall revise this Policy as circumstances warrant.

B. The CEO, with the assistance and advice of the Vice President of Finance, shall be responsible for the overall administration and implementation of this Policy. The CEO and Vice President of Finance shall also be responsible for recommending to the Board such revisions to this Policy as circumstances warrant, and they shall develop practices and procedures necessary to maintain the financial integrity of SKRECC.

APPROVED BY THE BOARD OF DIRECTORS

BOARD CHAIRPERSON

DATE APPROVED: 11-9-17

DATE(S) REVIEWED: ____________

DATE(S) REVISED: ____________