



Rappahannock Electric Cooperative

A Touchstone Energy® Cooperative 

ANNUAL BUSINESS AND FINANCIAL REPORT

For the year ended December 31, 2017

247 Industrial Court
Fredericksburg, Virginia 22408

(540) 898-8500

Rappahannock Electric Cooperative
2017 Annual Business and Financial Report

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RAPPAHANNOCK ELECTRIC COOPERATIVE

Introduction

Rappahannock Electric Cooperative (REC) was formed in 1980 due to a consolidation of Virginia Electric Cooperative and Northern Piedmont Electric Cooperative. These two cooperatives were formed in the late 1930's as a result of Executive Order No. 7037, which created the Rural Electrification Administration (later RUS) making loan funds available to extend electric service to rural areas. To create greater economies of scale and improve member service, these two cooperatives consolidated into REC.

On June 1, 2010, REC acquired half of the Virginia distribution assets of Allegheny Power (AP), which included 102,000 customers across twelve counties. REC grew by 50% and went from serving 103,000 connections to serving 154,000 connections in 22 counties, becoming Virginia's largest electric cooperative by territory and third largest electric distribution utility. REC's density, services-per-mile-of-line, increased from 7.85 to 9.34.

ITEM 1. BUSINESS OVERVIEW

REC is incorporated under the laws of the Commonwealth of Virginia as a not-for-profit electric distribution cooperative. The Cooperative was organized for the purpose of distributing electric power to its member-owners on a cost-effective basis. REC serves approximately 166,000 meters across 22 counties from the Blue Ridge Mountains to the tidal waters of the Chesapeake Bay between Richmond, Virginia and Washington, D.C.

REC is owned entirely by its members: residential, agricultural, commercial, and industrial. As a result of its proximity to the nation's and state's capital, REC's service territory has seen stable growth in terms of new members. REC continues to be one of the most progressive cooperatives in Virginia and across the country. The Cooperative has been and continues to be a leader in proactive demand management (load control), the installation of smart grid technology and the installation of automatic metering infrastructure. REC's main focus is to enhance the lives of its members and the communities it serves by providing safe, reliable and affordable energy services as good stewards of the environment, while providing its members with the highest quality of customer service.

REC operates as a forward-thinking, innovative utility that is a nationwide leader in safety, reliability and member satisfaction. Among distribution cooperatives, REC benefits from its combination of stable growth; an excellent mix of residential, commercial and industrial members; reasonable wholesale power costs; financial strength; and solid, experienced management and operational team members.

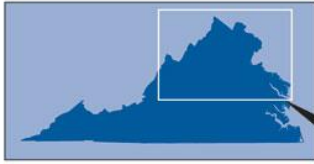
As a not-for-profit electric distribution cooperative, REC is exempt from federal income taxation under Section 501(c) (12) of the Internal Revenue Code of 1986, as amended.

The Cooperative is not a party to any collective bargaining agreement. As of December 31, 2017, REC employed 395 people.

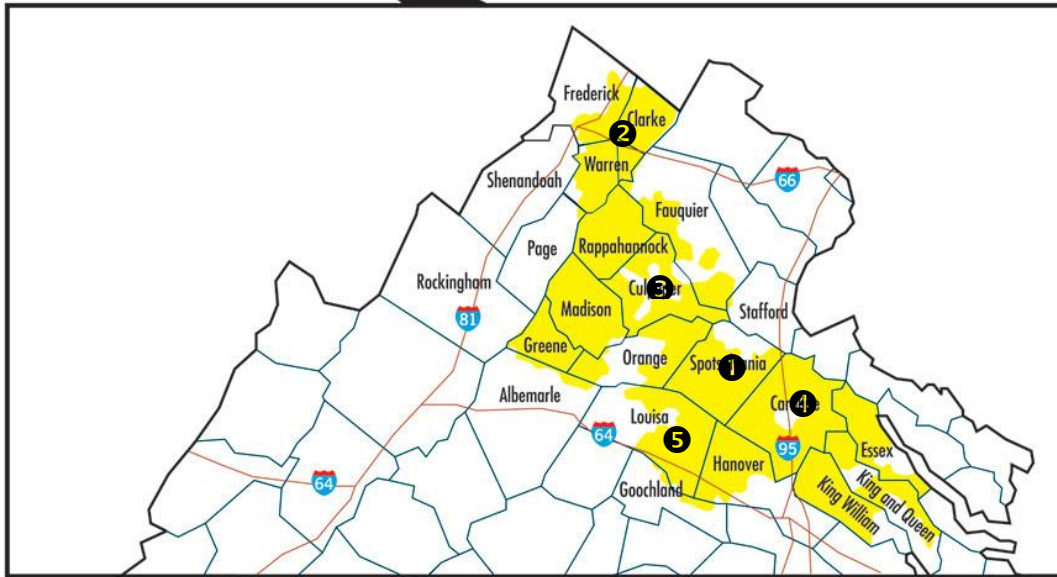
REC's principal executive offices are located at 247 Industrial Court, Fredericksburg, Virginia 22408 and its telephone number is 540-898-8500.

REC is an electric distribution cooperative. Member-ownership is a fundamental principle of the cooperative form of business, making equity management one of the most significant challenges faced by the Cooperative. Electric cooperatives raise capital to pay for utility plant by borrowing from lenders (debt) and by retaining earnings in the form of capital credits (equity). These earnings are returned to members in the form of capital credit retirements. Equity management entails determining the best mix of debt and equity

to provide the level of capital needed, at the lowest cost to members, while maintaining a level of financial strength and flexibility.



SERVICE TERRITORY



Office Locations

GENERAL OFFICE ①
247 Industrial Court
Fredericksburg, VA 22408

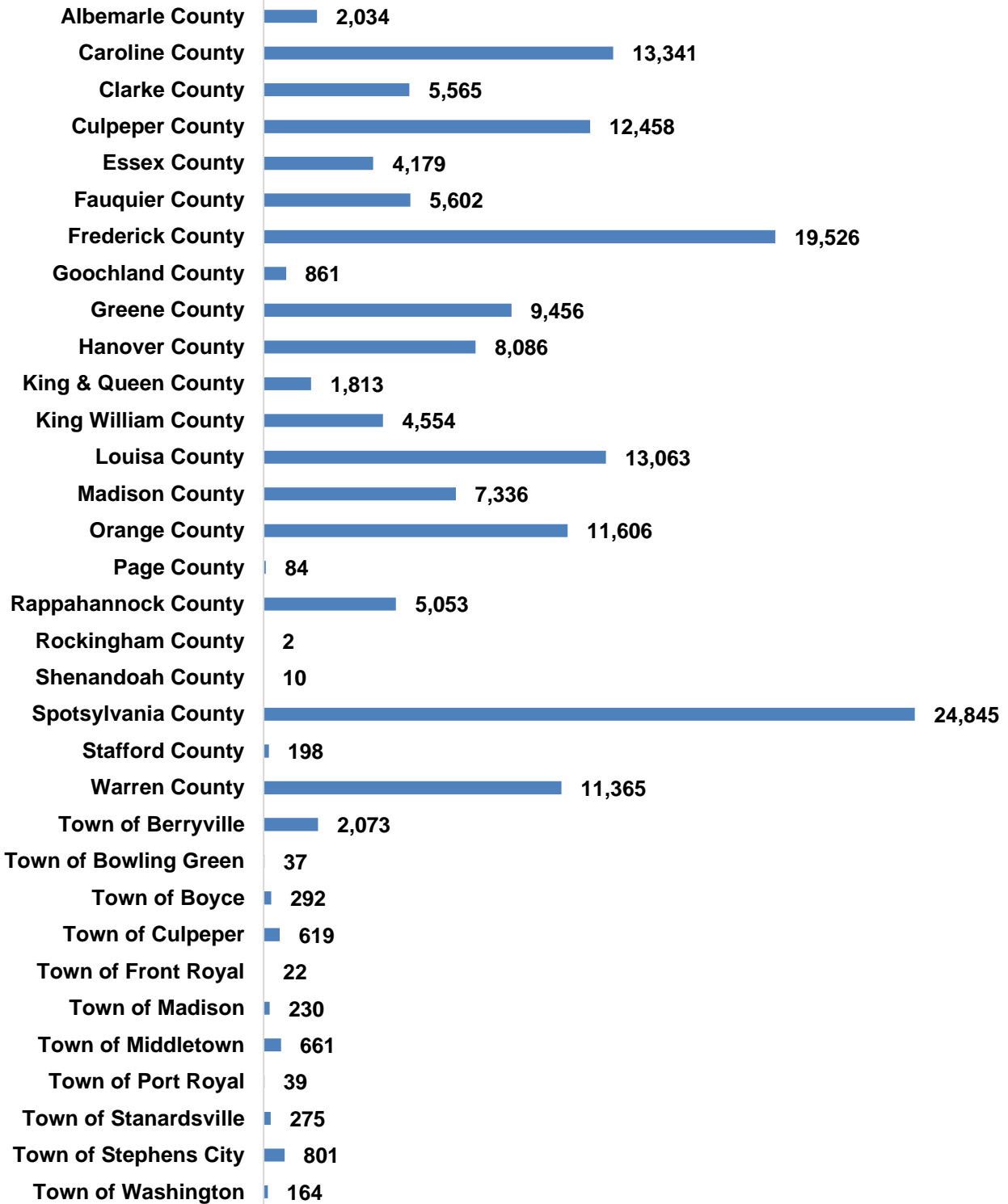
BLUE RIDGE OFFICE ②
137 Kelley Court
Front Royal, VA 22630

CULPEPER OFFICE ③
13252 Cedar Run Church Road
Culpeper, VA 22701

BOWLING GREEN OFFICE ④
14380 Fredericksburg Turnpike
Woodford, VA 22580

LOUISA SERVICE CENTER ⑤
9661 Jefferson Highway
Mineral, VA 23117

REC Active Services by Locale on 12/31/2017



REC's certified service territory includes portions of 22 Virginia counties and 10 towns in the heart of the Mid-Atlantic region. The service territory forms a rough semi-circle that begins in the southeastern corner of King and Queen County, moves westward to a point north of Charlottesville, continues north through the foothills of the Blue Ridge mountains, bordered by the Skyline Drive, into the Shenandoah Valley up to Winchester with a northern border against West Virginia, including much of the area between Richmond and Northern Virginia.

Strategic Planning

REC operates under a strategic plan that is reviewed annually and undergoes a comprehensive update at least every three years. The five-year plan provides a dynamic and flexible roadmap to effectively address the issues and demands of a changing environment, while also enabling REC to proactively focus on continuous improvement in all functional areas for the purpose of providing member services. The most recent plan was approved by the Board in July 2015 and includes the following strategic initiatives:

- **Sustainability** – Continue to focus on the critical functions that will sustain and strengthen REC's ability to accomplish its mission well into the future. This initiative includes safety, reliability, workforce succession and compensation, physical and cyber security, and environmental stewardship.
- **Innovative Technologies** – Investigate, embrace and adopt processes, tools and systems that optimize efficiency, resulting in a workforce that is more productive and responsive to REC's members. This initiative includes a comprehensive process improvement program; cost effective, integrated business systems; a grid modernization program, big data and analytics, and green research and development.
- **Member Engagement** – Broaden and strengthen the Cooperative's relationship with its members through increased positive interaction with members and their communities. This initiative includes improving member transactions, proactive communications and REC's visibility in the community; economic development, and expanding efforts to be the members' trusted energy partner.
- **Affordability** – Manage wholesale power costs and controllable expenses to keep electric service affordable to REC's members. This initiative includes minimizing wholesale power cost increases, containing controllable expenses, minimizing the impacts of regulation, distribution fixed cost recovery, and rate design.

Annual Meeting

Article III, Section 1 of REC's Bylaws provides the following details regarding the purpose and procedures for conducting the annual meeting:

"The annual meeting of the members shall be held during the month of August at such place and time within the general area served by the Cooperative, as selected by the Board of Directors and which shall be designated in the notice of the meeting, for the purpose of electing Board members, receiving reports for the previous fiscal year and transacting such other business as may come before the meeting. It shall be the responsibility of the Board of Directors to make adequate plans and preparations for the annual meeting. Failure to hold the annual meeting at the designated time shall not work a forfeiture or dissolution of the Cooperative. At all meetings of the Cooperative, both annual and special, "Robert's Rules of Order" newly revised (10th Edition, November 14, 2000) shall be followed."

Rural Utilities Service (RUS)

REC participates in the U.S. Department of Agriculture Rural Utilities Service (RUS) loan or guarantee programs. Through provisions in their loan documents, RUS exercises control and supervision over participating distribution cooperatives, including areas such as accounting, issuance of securities, rates and charges for the sale of power, construction or acquisition of facilities, and the purchase and sale of power. Financial covenants in these loan documents require us to design rates to achieve a specified times interest earned ratio (TIER) and debt service coverage (DSC) ratio.

State Corporation Commission (SCC)

Electric distribution cooperatives in Virginia, including REC, are subject to rate regulation by the Virginia State Corporation Commission (SCC). Changes in REC's wholesale power rates and costs are passed directly to its members by way of a formulary Power Cost Adjustment rider. Virginia electric distribution cooperatives may also adjust their distribution rates by a maximum net increase or decrease of 5%, on a cumulative basis, in any three-year period without filing a rate case with the SCC (as part of the aforementioned Acquisition, REC temporarily waived this authority through December 31, 2019). The SCC has the authority to audit the Cooperative at any time during a rate filing.

POWER SUPPLY

Old Dominion Electric Cooperative (ODEC)

Old Dominion Electric Cooperative (ODEC) is an electric generation and transmission (G&T) cooperative and a member of PJM Interconnection (PJM), a regional transmission operator that coordinates the movement of wholesale power in much of the Mid-Atlantic area. ODEC was formed in 1948 as a regional, member-owned wholesale power supplier to provide power to a consortium of electric distribution cooperatives. REC is a member of ODEC, along with 10 other cooperatives in Virginia, Maryland and Delaware. ODEC is governed by a 23-member board of directors, including two directors from each of its member cooperatives. Darlene H. Carpenter, Vice Chairman of REC's Board, and Kent D. Farmer, REC President and CEO, each serve on the ODEC Board of Directors, with Farmer serving as the Vice Chairman of the ODEC Board. In 2017, ODEC's president and CEO, Jackson E. Reasor, announced his plans to retire in January of 2018. ODEC's board was successful in its search for Mr. Reasor's successor, naming South Carolina native Marcus Harris as its next President and CEO. Mr. Harris most recently served as Executive Vice President and CEO of Kansas Electric Power Cooperative in Topeka, Kansas.

ODEC's power is generated through a balanced portfolio that includes a mix of coal, nuclear, natural gas, fuel oil, and renewable resources. In 2017, Wildcat Point Generation Station – ODEC's newest resource – was still undergoing the final phases of construction. The facility was fully operational in 2nd quarter of 2018 and is expected to generate approximately 1000 megawatts (MW) and be one of the cleanest natural gas facilities of its size on the east coast. In 2015, ODEC entered into long-term power purchase agreements to buy 30 MW of solar power from two utility-scale projects in Virginia. Construction on both solar facilities was complete by the end of 2017 and their combined generation will provide enough clean energy to power over 6,000 homes. To provide greater value to member cooperatives and their retail members, ODEC is working with several member cooperatives to develop a program where interested retail members can purchase at a fixed rate a greater share of electricity generated from these renewable resources.

In 2017, ODEC's 11 members served over 560,000 retail electric consumers (meters), representing approximately 1.4 million people along 59,000 miles of line. The service territories served by ODEC's members cover large portions of Virginia, Maryland and Delaware ranging from the extended suburbs of Washington, D.C. to the Atlantic shores of these three states to the Appalachian Mountains and the North Carolina border.

REC's Wholesale Power Contract (WPC)

As a member of ODEC, REC receives essentially all of its power requirements from ODEC via a long-term Wholesale Power Contract (WPC). REC's "all-requirements" wholesale power contract with ODEC obligates REC to purchase and receive all power required for the operation of its system, with two exceptions, to the extent that ODEC has the power and facilities available.

The first exception is unlimited, allowing REC to purchase hydroelectric power, allocated to it, from Southeastern Power Administration (SEPA). The second, which is a limited exception, allows REC to purchase up to 5% of its own power requirements or 5 MW from owned generation or other suppliers, whichever is higher. Approval for exercising this option must be given by ODEC's Board of Directors. REC received ODEC board approval and has an agreement with Morgan Stanley Capital Group for the purchase of 51 megawatts (5% of its power requirements) per month. This agreement has been very beneficial to REC members, reaping a savings of over \$1 million dollars in 2017. Energy purchases (kilowatt-hours - kWh) occurring under these exceptions constituted approximately 1.1% and 11.1%, respectively, of REC's total 2017 energy requirements.

REC is required to pay ODEC monthly for the power furnished under its wholesale power contract in accordance with a formulary rate. This formulary rate, which is administered under the jurisdiction of the Federal Energy Regulatory Commission (FERC), is designed to recover ODEC's total cost of service and create a firm equity base. It is intended to meet all of ODEC's costs, expenses, and financial obligations associated with its ownership, operation, maintenance, repair, replacement, improvement, modification, retirement, and decommissioning of its generating plants, transmission system, or related facilities, services provided to its member distribution cooperatives, and the acquisition and transmission of power or related services, including the following:

- Payments of principle and premium, if any, and interest on all indebtedness issued by ODEC (other than payments resulting from the acceleration of the maturity of the indebtedness)
- Any additional cost or expense, imposed or permitted by any regulatory agency
- Additional amounts required to meet the requirement of any rate covenant with respect to coverage of principle and interest on ODEC's indebtedness contained in any indenture or contract with holders of its indebtedness

Per the contract, the ODEC Board of Directors shall review the rate formula at least every three years to determine if it reflects and recovers all such costs and expenses and if it represents the best way to allocate such costs and expenses. If deemed necessary, the ODEC Board may adopt a new formula, subject to regulatory approvals. Written notice must be given to member cooperatives no less than 30 days and no more than 90 days before the effective date of the revised formula. The rate formula was most recently modified in 2013. The new formula was submitted to FERC in the fall of 2013 and implemented on an interim basis on January 1, 2014. In March of 2018, FERC and ODEC agreed upon a revised rate design and FERC approved the rate change.

PJM Interconnection (PJM)

REC receives transmission services from PJM via its membership in ODEC. PJM is a regional transmission organization (RTO) that coordinates the movement of wholesale electricity in all or parts of Delaware, Illinois, Indiana, Kentucky, Maryland, Michigan, New Jersey, North Carolina, Ohio, Pennsylvania, Tennessee, Virginia, West Virginia and the District of Columbia.

- Acting as a neutral, independent party, PJM operates a competitive wholesale electricity market and manages the high-voltage electricity grid to ensure reliability for more than 54 million people.
- PJM's long-term regional planning process provides a broad, interstate perspective that identifies the most effective and cost-efficient improvements to the grid to ensure reliability and economic benefits on a system wide basis.
- An independent Board oversees PJM's activities. Effective governance and a collaborative stakeholder process help PJM achieve its vision: "To be the electric industry leader – today and tomorrow – in reliable operations, efficient wholesale markets and infrastructure development."

Southeastern Power Administration (SEPA)

Southeastern Power Administration (SEPA), headquartered in Elberton, Georgia, is responsible for marketing electric power and energy generated at reservoirs operated by the United States Army Corps of Engineers in the southeastern United States. REC, as well as other distribution cooperatives, has been allotted a certain amount of monthly capacity from the Kerr-Philpott dam in southern Virginia and northern North Carolina. Along with this constant demand comes a varied amount of energy, which is dependent upon the water flow through the dam. Although these wholesale power rates have

increased over the last few years, they are still more attractive than other wholesale power rates.

Renewable Energy

REC has several landfill gas-to-energy facilities and one small hydro-electric generating facility operating in its territory. They all wheel their power to the market and do not sell directly to ODEC or REC. In addition, REC is working with three other Virginia cooperatives on a community solar pilot program so that retail members will be able to purchase a greater share of renewable, solar energy without having to endure the expense of installing solar panels at their homes.

REC follows the Virginia state regulations for Net Metering. Net Metering is a member's installation of a renewable energy generation facility used primarily to supplement their electricity needs. This generation can consist of solar, wind, or biomass, to name a few. At the end of 2017, REC had 456 Net Metering member-owners for a total of 5,001 kilowatts (kW) of connected generation.

REC, through its purchased power agreement with ODEC, currently has approximately 10MW of its power supply coming from solar.

Environmental

When planning additions or maintaining utility plant, REC always considers the environment. Not only do they follow all local, state, and federal guidelines, but many times they exceed what those regulations mandate. Through continued respect for the environment, REC contributes to cleaner and safer communities for the future. REC's environmental stewardship is demonstrated by the recognition of receiving the National Arbor Day Foundation certification of Tree Line USA for 15 consecutive years.

Operating Results

From 2013 through 2017, REC kept its Equity to Total Capitalization Ratio at approximately 46%. The debt service coverage ratio has remained very strong. Over the five-year period, REC has returned \$17,848,083 in capital credits to its members.

REC 2017 AND HISTORICAL FINANCIAL RESULTS

	2017	2016	2015	2014	2013
Equity (annual)	\$392,122,403	\$379,610,008	\$367,768,597	\$355,344,092	\$343,278,683
Capital Credits	\$5,859,530	\$2,904,787	\$2,836,001	\$2,794,996	\$3,452,769
TIER	2.0	1.8	1.9	1.9	1.9
DSC	2.1	2.0	2.1	2.1	2.2
Current Ratio	1.2	1.4	1.6	1.0	0.9
Unencumbered Cash	\$2,702,875	\$4,545,663	\$3,520,998	\$4,826,954	\$7,569,731
Equity to Total Capitalization	47.4	45.9	44.4	45.9	45.9

Historical Sales and Revenue Data

Since 2013, REC's total operating revenue has decreased by 6.73%. During the past five years, Residential revenues have decreased 1.72%, and Commercial and Industrial (excluding Closed Heavy Industrial) revenues have increased by 1.48%. Kilowatt-hour (kWh) sales decreased 0.49% over the past five years in the Residential class and increased 5.84% in the Commercial and Industrial class (excluding Closed Heavy Industrial). Total energy sales decreased 12.56% since 2013. Operating revenue and kWh sales in the Closed Heavy Industrial class decreased significantly due to the only member served in this rate class choosing to receive their electricity service from another power supplier. REC continues to bill this member for relative taxes that are due to the county and state, as well as other charges agreed upon in an operating contract between the member and the Cooperative.

Historical Revenues and Sales by Class

	2017	2016	2015	2014	2013
Sales in Dollars					
Residential	\$238,733,004	\$259,454,757	\$275,191,895	\$260,047,689	\$242,919,343
C&I, less than 50 KVA	32,848,279	34,314,737	32,878,797	32,645,516	33,379,835
C&I, more than 50 KVA	93,282,103	102,562,735	112,392,361	101,572,613	90,916,940
Outdoor Lighting	245,279	512,251	534,934	524,440	522,107
Other Public Authorities	3,032,682	3,213,347	3,276,857	2,572,096	1,937,986
Closed Heavy Industrial	305,882	12,554,804	31,854,126	32,071,099	26,211,163
Total Energy Revenues	\$368,447,229	\$412,612,631	\$456,128,970	\$429,433,453	\$395,887,374
Other Electric Revenue	5,390,204	5,552,132	5,738,213	5,415,080	4,912,919
Total Revenue	\$373,837,433	\$418,164,763	\$461,867,183	\$434,848,533	\$400,800,293
Sales in KWH					
Residential	2,168,898,430	2,210,130,998	2,237,890,211	2,270,493,279	2,179,661,594
C&I, less than 50 KVA	300,682,570	303,268,918	301,049,833	309,768,036	309,874,640
C&I, more than 50 KVA	1,212,049,807	1,210,976,227	1,198,044,482	1,176,646,360	1,119,406,582
Outdoor Lighting	1,052,469	2,169,826	2,115,314	1,991,345	2,056,765
Other Public Authorities	28,490,934	27,752,449	26,726,636	21,988,279	16,964,803
Closed Heavy Industrial	0	264,870,312	605,318,049	595,362,957	616,117,489
Total Energy Sales	3,711,174,210	4,019,168,730	4,371,144,525	4,376,250,256	4,244,081,873

Load Growth Forecast

Load projections for REC are updated annually through a Power Requirements Study (PRS) prepared jointly by REC and ODEC. The most recent PRS was completed in 2017 and forecasts load growth through 2031. The PRS employs econometric analysis to forecast the number of consumers and electricity sales for both the residential and small commercial classes. It is prepared in accordance with the RUS 7 CFR 1710 and the ODEC PRS work plan, as approved by the RUS. ODEC uses revised statistics from NPA Data Services, Inc. and accounts for county weights within the REC service area as a basis for the PRS projections.

This study projects growth for residential and small commercial members to be 1.38% annually through 2031. Specifically, REC anticipates adding approximately 33,508 residential consumers by the year 2031.

Products and Services

The cooperative exists to serve its members. Its primary responsibility is to provide members with safe, reliable, and affordable electric service. In addition, REC is committed to offering its members a range of energy-related products and services to meet their individual needs. Optional products and services are listed below.

Energy Advice

Keeping your home as energy efficient as possible can save you money year round. REC offers a variety of tools online at www.myrec.coop. In addition to the tools found on the website, REC's energy experts are trained to provide phone consultations and in-person audits.

ION (Individual Outage Notification)

Whether a power outage affects everyone in a neighborhood or just the line delivering electricity to an individual home, ION notifies REC's dispatch center. Even when no one is home, REC knows when there is a power outage and may be able to address it before it impacts you. ION is maximum peace of mind for just pennies a day.

Outdoor Lighting

Outdoor lighting automatically turns on at dusk and off at dawn, making it easy and convenient to keep homes and businesses safe and secure. The risk of accidents is reduced by lighting steps and other areas that can be hazardous in the dark. Plus, outdoor lighting is an effective way to deter intruders. Most lights installed are energy efficient LED fixtures that are also night-sky friendly.

REC Electrical Services

Getting small electrical jobs done is easy when you call on trained professionals at REC. Certified master electricians are available to do all the jobs other electrical contractors don't have time for, and at competitive rates. Work can even be arranged to accommodate even the busiest of schedules.

SurgeAssist

SurgeAssist is a warranty that helps cover the costs of repairing or replacing electrically powered devices in the home that have been damaged by an electrical surge. This warranty is available exclusively to members of REC.

Water Heater Replacement

Water heating is typically a home's third largest energy expense. A new, more efficient water heater can cut that cost, especially if the current water heater is more than seven years old, leaking or constantly needing repair. REC can arrange delivery and installation of a new water heater and, in many cases, provide up to 36 months to pay for it – interest free.

ENERGY STAR® New Home

A home that earns the ENERGY STAR designation is significantly more efficient than a standard home. By purchasing an ENERGY STAR qualified home, homeowners can have the features they desire in their new home, plus better performance and lower utility bills – all while helping reduce greenhouse gas emissions.

REGULATION

General

First and foremost, as with any cooperative, REC is democratically controlled by its member-owners. Beyond the governance of REC's board, REC is subject to regulation by the Virginia State Corporation Commission (SCC), and to the rules and specifications of the United States Department of Agriculture's Rural Utilities Service (RUS).

Rate Regulation

Rates and Terms and Conditions for the provision of retail electric service are regulated by the SCC. Electric cooperatives in Virginia are subject to a hybrid regulatory structure in which, once Rates and Terms and Conditions are approved by the SCC, they may be adjusted within certain parameters, without the need for additional SCC approval. Per § 56-585.3 of the Code of Virginia, an electric cooperative may, with only the affirmative resolution of its Board of Directors, adjust its distribution rates by no more than a cumulative total of 5% up or down in a three-year period, adjust its Fees and Charges, and make any adjustment to the Terms and Conditions that do not affect revenues from the distribution or supply of electric energy. As a condition of approval of REC's 2010 acquisition of a portion of the service area and assets of Allegheny Power, REC has waived until December 31, 2019 the right to self-adjust rates, and the Board of Directors maintains the ability to adjust Fees and Charges and Terms and Conditions.

Transition Rate Proceeding

In 2014, REC received approval from the State Corporation Commission (SCC) to gradually transition its rates for distribution service in the area formerly served by

Allegheny Power (AP) and now served by REC to the rates that are applicable in the Cooperative's legacy service area. The gradual transition in distribution rates began July 1, 2014 and was completed July 1, 2017. Each July during the transition period, distribution rates in the former AP service area were increased so that overall average rates for each class increased by up to 5%. At the end of the rate transition period, REC recognized approximately \$16 million in additional base revenue.

2017 Rate Application

On May 23, 2017, REC filed a rate application with the SCC. The rate changes proposed in this filing would provide approximately \$21 million in additional distribution revenue and ensure REC is able to achieve a 2.25 jurisdictional TIER. The rate application included two significant changes to REC's rate structure:

- 1) The introduction of residential electricity supply service rates that are higher for usage over 800 kWh per month in the summer months (June through September) and less for all usage in non-summer months (October through May). The summer and non-summer rates are reflective of the fact that a significant portion of REC's capacity obligation costs are the result of peak usage during the summer months. The higher summer rate more equitably recovers that cost from consumers who have high summer usage instead of socializing the costs through higher year round rates to all members.
- 2) An increase in the monthly fixed-charge access fee to provide more consistent revenue and recovery of fixed costs regardless of the volume of electricity sales. The majority of the costs of delivering electricity does not vary based on the volume delivered: the cost of poles, conductors, meters, and associated operations and maintenance are expenses that recur each month. A higher access is more reflective of those actual, fixed monthly costs.

REC negotiated with all parties to reach a stipulated agreement regarding the rate application. That settlement reduced the proposed access fee from \$20.00 to \$14.00 per month, and reduced the revenue increase to \$18 million per year. The settlement was approved and new rates were placed into effect for billings on or after March 1, 2018. Additionally, as a part of the rate filing, the Cooperative updated its Schedule F (Fee Schedule) so that costs for member-specific activities are more accurately recovered from the members for whom those activities are being performed.

Power Cost Adjustment (PCA)

As part of the SCC's approval in 2014 of REC's rate transition plan, the Cooperative also received approval to change the method it uses to pass through wholesale power costs. The primary power cost recovery mechanism has been and remains the base rates charged for electricity supply service, including the newly introduced summer and non-summer rates for residential consumers. In addition, the Cooperative uses a formulary rider to fully recover, or return to its members, changes to wholesale power costs. By having this rider in place, electricity supply service is a 100% pass through where members pay no more or less than what REC is billed for the electricity used.

Prepaid Service

Prepaid electric service, referred to by REC as "PrePay," works very much like a prepaid phone card where the consumer pays in advance and an amount equal to the cost of service is deducted as the service is used. Consumer benefits include no deposit, late fees, collections charges or reconnection fees; greater awareness of electricity usage; and flexibility in payment schedules. PrePay's primary benefit to the Cooperative is the reduction of debt risk. REC filed an application on August 2011 with the State Corporation Commission (SCC) requesting approval to offer Prepaid Service to its members; and after a lengthy regulatory review process, the Commission granted final approval in August 2013. REC became the first electric utility in Virginia offering PrePay Service to its members in September 2013. At the end of 2017, REC had more than 1,085 members taking advantage of the PrePay option.

Other Regulation

In addition to electric service, the SCC also regulates the borrowing activities of Virginia's public service companies in accordance with Chapter 3 of Title 56 of the Code of Virginia, and relations with affiliated interests per Chapter 4 of the same title.

REC's utility facilities are built and operated in compliance with the National Electrical Safety Code (NESC) and utility construction activities (installation of overhead and underground power lines and substations) must comply with applicable state and local regulations. The placement of major utility facilities, such as sub-transmission lines and substations, are subject to approval by either the SCC or the localities in which those facilities are to be located.

ITEM 2. CONTRIBUTING FACTORS

Safety

REC has a responsibility to protect the public and its employees from hazards associated with its electric distribution system. Failure to adequately do so could cause catastrophic loss of life and property. To fulfill this responsibility, REC participates in outreach to schools, first responders and the general public at various community events, as this presents the greatest opportunity for REC to educate the public. As an example, REC uses safety demonstration tools that present real life situations and shows what occurs when contact is made with energized facilities.

Employee positions that require hands-on construction and maintenance of the electric system are placed in apprenticeship programs of various lengths and complexity to become fully qualified to perform the work. REC maintains a proactive safety program that ensures compliance through training, inspections, job safety assessments, and performing thorough, thoughtful investigations when incidents do occur and communicating lessons learned.

Cybersecurity

REC has identified 14 specific cyber related risk/threats that could result in varying degrees of severity if fully realized. Some threats such as Distributed Denial of Service (DDoS) can cause short to mid-term loss of key business systems while others such as unauthorized intrusion or data loss (exfiltration) could have legal ramifications, member identity monitoring expenses and long term (years) public image damage. To aid in mitigating these risks, REC maintains an active Cybersecurity Plan, Incident Response Plan, performing employee awareness and training and annual 3rd party cybersecurity PEN testing and auditing.

Physical Security

Safety of REC's employees is paramount. Facilities and all non-public entranceways are equipped with access controls (e-card based readers). Public and Employee areas are separated with access controls. Facilities are protected with after-business hour alarm and monitoring services.

Technology

The effective and efficient use of technology is key to the ongoing success of REC. At the same time, REC's technology solutions must be affordable, reliable and scalable to meet REC's needs both today and tomorrow. To meet this need, REC has selected National

Information Solutions Cooperative (NISC) and their Enterprise Solutions Suite along with other electric industry recognized solutions to meet most of its Information Technology (IT) needs. In addition, REC has partnered with Lockheed Martin Energy (LME) to provide REC with an onsite Service Desk, Datacenter, Cybersecurity, Networking, Business Analysts, IT Management and Infrastructure support via a long-term services agreement. LME resources are onsite and fully dedicated to REC.

Changes in Fuel and Purchased Power Costs

REC does not generate electricity. All electricity that is distributed and sold to its members is purchased, with nearly all acquired from ODEC. REC's purchased power costs are subject to changes within the wholesale power market, which could increase ODEC's cost of generating or purchasing power. The market prices for fuel may fluctuate over relatively short periods of time. Factors that could influence fuel and purchased power costs are:

- Weather
- Supply and demand
- The availability of competitively priced alternative energy sources
- The transportation of fuels
- Price competition among fuels used to produce electricity, including natural gas, coal, and crude oil
- Energy transmission or natural gas transportation capacity constraints
- Implementation of new technologies in the power industry
- Federal, state, and local energy and environmental regulation and legislation
- Natural disasters, war, terrorism, and other catastrophic events

The Cooperative is ensured full recovery of all wholesale power costs through the PCA. REC's Wholesale Power Contract with ODEC allows the Cooperative to purchase up to 5% of its wholesale power from a party other than ODEC. As a hedge against changes in power costs from its primary wholesale provider, REC has entered into an agreement with Morgan Stanley Capital Group and currently purchases 51 MW of its power requirements.

The Impact of Weather on Operational and Maintenance Costs

Energy Efficiency

Increased efficiency standards for appliances and more stringent building codes have combined to flatten the growth in per capita electricity use. Over the long term, this pattern may allow utilities to more conservatively design and build generation and distribution

facilities, but until then, the trend simply results in flat energy sales, and when applied to existing homes, could reduce energy sales.

Distributed Generation

Advances in technology and reductions in the cost of on-site generation, particularly photovoltaic systems, combined with tax incentives and consumer desire to protect the environment and decrease their dependence on utilities, have resulted in the growth of distributed generation (DG). Unlike central station electric service, in which power is generated at a central location and consumers are dependent on the utility to deliver electricity over the distribution grid, DG occurs when at least a portion of the electricity is generated at the consumer's location, reducing the amount purchased from the utility. Because of the intermittent nature of many DG resources, and because DG often is not capable of meeting a consumer's entire demand for electricity, both the grid and power plants have to be built and maintained to serve the load as if DG were not present. This, in effect, means even though utility sales may fall, utility costs remain the same, and may even increase as a result of constantly balancing supply against the varying output of DG.

Environmental Regulation May Limit Operations and Increase Costs

REC is committed to conducting its operations in a manner that demonstrates concern for the natural environment. Rapidly changing and increasing environmental regulations, specifically the federal Environmental Protection Agency's proposals regarding power plant emissions, as well as state and local regulations relative to preserving the Chesapeake Bay, may increase costs and reduce operational flexibility.

ITEM 3. PROPERTIES

Miles of Line

REC owns approximately 17,303 miles of distribution and transmission lines. Of this total, approximately 17,093 miles is 12.5-kilovolt (kV) distribution line, which serves 160,204 active meters. The distribution lines consist of about 7,461 miles of underground and 9,423 miles of overhead lines. Transmission lines account for about 94 miles of 115 kV transmission line and 116 miles of 34.5 kV sub-transmission line. This transmission system is only used to serve REC's own load/substations and is not used for transmission wheeling purposes. REC's meters-per-mile of line is 9.37.

Offices and Substations

REC's General Office is located in Spotsylvania County on 42 acres, just south of Fredericksburg, Virginia. The four building complex houses corporate management, finance, engineering, customer service, call center, safety, human resources, IT, public relations and operational center departments. There are three operational offices across the service territory. They are located in the Town of Bowling Green, County of Culpeper and Town of Front Royal. These operational offices house the operations and maintenance departments, distribution line design, and field customer service functions, as well as payment and member service centers. In addition, the Louisa Service Center is used as a centrally located warehouse and operations center.

REC has 101 combined substations, Distribution Step-down Points (DSPs) and switching stations that are spread across the service territory. These range in size from fractions of an acre to five acres.

ITEM 4. LEGAL PROCEEDINGS

None

ITEM 5. CORE VALUES, CUSTOMER SATISFACTION, AND COMMUNITY INVOLVEMENT

Company Core Values

REC's four core values underpin all member and public interactions:

- "Service" is meeting member needs by providing reliable electricity and quality products.
- "Integrity" means being honest, responsible and ethical throughout every undertaking, making sure actions always match words.
- "Caring" is demonstrating compassion and concern for members and their communities through small gestures, like safety demonstrations, and through larger gestures, like awarding grants and scholarships.
- "Respect" is honoring each person as an individual and being mindful of the impact that actions can have on others.

Customer Satisfaction

A highly satisfied and engaged membership is imperative for successful Cooperative operations. REC conducts ongoing market research utilizing the American Customer Satisfaction Index (ACSI) and the J.D. Power Electric Utility Residential Customer Satisfaction Study. The insights and analysis generated by each survey methodology aid

the Cooperative in identifying what members want, determining what attitudes, opinions and beliefs they hold to be true, and assist in enhancing members' experiences with the Cooperative resulting in continuously improving member satisfaction and engagement.

The ACSI is the only national cross-industry measure of customer satisfaction in the United States, allowing REC to compare its member satisfaction to peers in the electric industry as well as other service providers that members measure their overall experiences against. In 2017, REC achieved an ACSI score of 83 out of 100, which significantly outperformed the Touchstone Energy Cooperatives benchmark of 78 and the Investment Owned Energy Utilities average score of 75.

JD Power is a well-known and recognized industry benchmark for consumer satisfaction, insights, research and analytics that annually surveys over 100,000 customers nationwide from over 130 electric utility brands in the Electric Utility Residential Customer Satisfaction Study. In 2017, REC achieved an Overall Customer Satisfaction Index score of 761 out of 1000 and ranked 16th in the nation out of 138 utility brands included in the study.

Community Involvement

REC supports the communities in its 22-county service area through corporate financial support, employee volunteer activities and community education efforts.

Since 1996, the Cooperative has provided grants to non-profit, educational and emergency services organizations and scholarships to high school seniors seeking to attend a college or trade school. In 2017, those scholarships and grants totaled \$32,000.

In addition to scholarships, REC contributes to community education efforts by hosting electrical safety and energy conservation seminars at local businesses, trade shows and meetings of various civic organizations. The Cooperative supports efforts by local United Way chapters through annual employee contributions and by employee participation in the United Way's Day of Action activities.

REC established Operation Round Up[®] in 2006. In 2017, REC fully rebranded the program name from Operation Round Up to The Power of Change. This program allows members to volunteer to have their electric bills rounded up to the next whole dollar with the extra change benefitting charitable causes. The Community Awareness of Rappahannock Electric Charity, Inc. (C.A.R.E. Charity, Inc.) is the charitable corporation established by REC to administer the donations collected. An independent, volunteer board of REC members reviews applications and awards funding. Twenty-four non-profit organizations received a total of \$78,170 in donations from C.A.R.E. Charity, Inc. in 2017.

REC also supports the volunteer and fundraising efforts of employees through their own charitable organization, Project Big Heart. In 2017, combined donated funds totaled more than \$45,000 and provided support to more than 50 organizations.

Below are some of the many organizations and events that REC assisted through financial and volunteer support in 2017:

- Alzheimer's Association
- American Cancer Society
- Angel Tree Program
- Boy Scouts
- Fauquier Cops for Children
- Habitat for Humanity
- March of Dimes
- Project Santa
- Safe Harbor
- Salvation Army (various programs)
- Susan B. Komen
- Various emergency food pantries and Social Service Agencies
- Various hospice care organizations
- VCU Massey Cancer Center

ITEM 6. SELECTED FINANCIAL DATA

Financial data for the five years ended December 31, 2017 are derived from audited financial statements, the related notes to the financial statements, and the discussion of this information in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in Item 6.

	Year Ended December 31				
	2017	2016	2015	2014	2013
Statement of Operations Data			(Thousands)		
Operating revenues	373,837	418,165	461,867	434,848	400,800
Operating margins	6,076	5,625	8,329	8,515	3,968
Net margins	17,763	14,975	15,269	14,949	15,077
	At December 31				
	2017	2016	2015	2014	2013
Balance Sheet Data			(Thousands)		
Utility plant	671,765	657,207	648,571	632,871	618,773
Total investments	134,857	129,851	125,561	121,205	117,299
Total current assets	75,994	88,446	101,241	67,616	70,989
Total deferred charges	15,304	16,253	16,663	18,678	22,317
Total assets	897,920	891,757	892,036	840,370	829,378
Patronage capital	392,105	379,767	367,854	355,452	343,316
Long-term debt	452,845	434,538	448,315	407,412	394,267
Total Capitalization	844,190	814,305	816,169	762,864	737,583
Equity Ratio ¹	43.65%	42.57%	41.23%	42.28%	41.39%

¹ The Equity Ratio calculations include Membership Fees and Accumulated Comprehensive Loss.

	Year Ended December 31				
	2017	2016	2015	2014	2013
Capital Expenditures			(Thousands)		
Distribution Plant	39,019	35,128	39,717	35,587	41,457
General Plant	7,795	5,335	5,505	7,678	8,788
Total Capital Expenditures	46,814	40,463	45,222	43,265	50,245

ITEM 7. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Caution Regarding Forward Looking Statements:

Management’s Discussion and Analysis of Financial Condition and Results of Operations contains forward looking statements regarding matters that could have an impact on its business, financial condition, and future operations. These statements, based on expectations and estimates, are not guarantees of future performance and are subject to risks, uncertainties, and other factors that could cause actual results to differ materially from those expressed in the forward looking statements. These risks, uncertainties, and other factors include, but are not limited to, general business conditions, demand for energy, federal and state legislative and regulatory actions and legal and administrative proceedings, changes in and compliance with environmental laws and policies, weather conditions, the cost of commodities used in the industry, and unanticipated changes in operating expenses and capital expenditures. These results may vary materially from those discussed in the forward looking statements as a result of these and other factors. Any forward looking statement speaks only as of the date on which the statement is made, and undertake no obligation to update any forward looking statement or statements to reflect events or circumstances after the date on which the statement is made even if new information becomes available or other events occur in the future.

Overview

REC is an electric distribution utility engaged in the retail sale of electricity to residential, commercial, industrial, and non-jurisdictional (local, state, and federal government entities) member consumers in 22 Virginia counties. The rates charged to member consumers of the Cooperative are regulated by the Virginia State Corporation Commission.

Critical Accounting Policies

The preparation of REC's financial statements in conformity with generally accepted accounting principles (GAAP) requires that management make estimates and assumptions that affect the amounts reported in its financial statements. These estimates and assumptions are based on information available as of the date of the financial statements and they are not necessarily indicative of the results to be expected for the year. The following are considered to be critical accounting policies due to the estimation involved in each.

Uniform System of Accounts

The accounts of the Cooperative are maintained in accordance with the Uniform System of Accounts as prescribed by the United States of America – Rural Utilities Service. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America.

The Cooperative follows the accounting practices set forth in Statement of Financial Accounting Standards (SFAS) No. 71, *Accounting for the Effects of Certain Types of Regulations*, as amended. This standard requires entities to capitalize or defer certain costs or revenues based on the Cooperative's ongoing assessment that it is probable that such items will be recovered through future revenues.

ODEC

REC is a member of ODEC, a not-for-profit wholesale power supply cooperative. REC is required to purchase substantially all of its power from ODEC under a contract through 2054. The terms of this contract cannot be terminated by either party unless three years written notice is given. ODEC also performs various power-supply related services for its member cooperatives, such as arranging for transmission service and assisting with information for REC's future power requirement study and forecasting system load. Purchases from ODEC amounted to \$223,687,591 in 2017 and \$272,097,892 in 2016.

On September 30, 2013, ODEC submitted, pursuant to section 205 of the Federal Power Act, a superseding cost-of-service rate schedule which amends ODEC's existing cost-of-service rate schedule for all requirements service provided to its eleven distribution members. FERC accepted the proposed rate schedule revisions for filing to become effective January 1, 2014, subject to refund, and establishing hearing and settlement judge procedures. During the hearing process, some items in the rate filing were found

not to be just and reasonable. As a result, ODEC did revise the rate design and, as of March 2018, FERC has approved ODEC's rate change.

Unbilled Revenue

Unbilled revenue is an estimate used to accrue revenue that has been earned in the current month but has not been billed. While this is an estimate, REC is confident that the method used is accurate. The unbilled calculation is anchored in REC's monthly power purchased from ODEC. Energy sold cannot be more than energy purchased. REC starts with purchased kWh, reducing by: actual billed kWh, its own office use, and line loss, which is calculated by the Cooperative's engineering department. The kWh amount left is what is to be billed in the coming month; however, this calculation was made for the previous month and therefore the previous month's accrual must also be reversed. This calculated unbilled number is then apportioned to the different rate classes based on the current month bills to members.

Deferred Energy

Deferred energy consists of expenses related to energy and capacity charges REC incurs from its wholesale power suppliers. REC pays those expenses as they are billed and then recovers those costs from its members over time via its retail rates. The energy adjustment balance sheet accounts, asset or liability, represent the under or over collection of those charges from its members.

REC uses a PCA, which is an adjustment that is designed to recover purchased power cost on a dollar for dollar basis. It includes an over- and under-recovery mechanism that tracks the difference between purchased power costs recovered from sales and actual purchased power expense. Some of the charges from ODEC are annualized expenses that are billed in twelve equal monthly installments. Naturally occurring seasonal fluctuations in retail energy sales result in the deferral balance rising and falling from month-to-month and season-to-season. Any over- or under-recovery is deferred as a liability or an asset. The PCA provides that the balance of any over- or under-recovery be rolled into the PCA factor at least once per year. It further provides that the billing factor is to be adjusted at any time that there is a change in the rates charged by or capacity allocations from ODEC or SEPA, or a price or volume change in a non-ODEC or non-SEPA power supply contract, but may be adjusted at any time based on prevailing estimates of costs relative to the deferred energy balance. The PCA ensures that energy revenue will equal purchased power costs.

The PCA has two primary components:

1. Differential between projected annual power costs and projected annual base Energy Supply Service (ESS) revenue.
2. Differential factor to return or recover any amount over- or under-collected in the previous twelve months.

The sum of these two components becomes the annual PCA billing factor that is added to each kWh of energy sold by REC, except for sales to members served on a tariff that provides for a complete and direct monthly pass through of the individual member's wholesale power costs, including line losses, energy and capacity allocations. When REC receives charges or credits on its wholesale power bill under the provisions of an energy adjustment clause or changes in energy allocations included in a rate or contract, a third component to reflect the change in the wholesale rate is added to the PCA. In addition to the PCA adjustments that occur at least annually and when there is a change in wholesale power costs, REC may at any time re-calculate the PCA to minimize over- or under-recovery of power costs if actual data and more current information for the remainder of the year warrant a change.

Margin Stabilization

The Margin Stabilization Plan approved by ODEC allows them to maintain their margins within a predetermined range. REC increases or decreases its cost of power when recording this amount from ODEC. Changes in power costs resulting from ODEC margin stabilization must be reflected in the PCA calculation and passed through directly to retail members.

PATRONAGE CAPITAL

Allocation of Margins

Net margins are allocated to the member's capital credit account based on billed sales revenue by rate class for the year in which REC earns the margins. All margins (profits) that REC makes revert to its members in the form of capital credits. For the 2017 fiscal year, the allocation amount is \$17,762,745. ODEC patronage, assigned to REC, is allocated to members' accounts separately from all other margins; however REC will not retire these capital credits until ODEC retires them. REC's Board of Directors determines the amounts, annually, that will be retired to its members via general, estate and special retirements.

General Retirement

The Cooperative's Board of Directors annually determines the percentage of capital credits to be retired to the members, the minimum refund amount for an inactive account and the General Retirement credit issue date. General Retirements are based on a percentage of the prior year's cash margins. In the 2017 fiscal year, REC retired \$5,166,770 to its member-owners in the form of a General Retirement. The retirement was much greater this year than in the past due to the retirement of ODEC patronage. ODEC patronage was retired for fiscal years 1987 and earlier, not on a percentage-based calculation like regular REC retirements. Notification was received in 2017 for another ODEC retirement to occur in 2018.

Estate Retirement

Estate retirements are those paid to the estate of a deceased member or deceased joint members. Estates have the option to receive a discounted payment of the outstanding REC balance, or continue to receive annual retirements as part of the General Retirement process when approved by the Board of Directors. Estate retirements, payable to beneficiaries on the behalf of deceased members, totaled \$1,361,738 in 2017.

Special Retirement

Occasionally, changes such as cost of power rate reductions generate unusually high net margins. Under these circumstances, the Board of Directors may approve a special retirement to active patrons during the year.

Donation of Capital

REC receives donated capital and retains this as permanent equity. The two primary ways this occurs is via estate retirements and a yearly entry where ODEC allocations are donated to REC due to a contractual agreement.

When estate retirements are processed, the total amount of REC allocations are discounted, based upon the following discount schedule.

Year	Discount %	Year	Discount %	Year	Discount %
2016	59.51%	2011	45.05%	2006	25.93%
2015	56.90%	2010	41.86%	2005	21.26%
2014	54.34%	2009	38.27%	2004	11.67%
2013	51.46%	2008	34.21%	2003	11.50%
2012	48.45%	2007	30.07%	2002	5.66%

Estates are paid out for the present value of the capital credits, which is total REC allocations, less the discount amount. This discount is transferred to REC as donated capital and retained by REC as permanent equity. It is important to note, this is a 15-year sliding schedule and REC equity retired from years prior to 2002 are retired at 100%. Donated equity from discounted estates totaled \$300,501 in fiscal year 2017.

There is an agreement in place between REC and Bear Island Paper Company where ODEC allocations attributed to the main Bear Island electric account are donated to REC as permanent equity. The amount of this donated capital in 2017 was \$6,216.

Total donated capital for 2017 was \$306,717.

CONTROLS AND PROCEDURES

Management's Analysis of Internal Controls over Financial Reporting

REC's management believes that as of December 31, 2017, its system of internal controls over financial reporting was properly designed and operating effectively based upon adherence to the policies and procedures established by management. They have not identified any material weaknesses in their internal controls over financial reporting. Its external auditors, Adams, Jenkins and Cheatham, do not express an opinion on the effectiveness of REC's internal control over financial reporting, they did state that their analysis did not identify any deficiencies that were considered to be a material weakness.

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is comprised of policies, procedures, and reports designed to provide reasonable assurance to management and Board of Directors that the financial reporting and the preparation of the financial statements for external reporting purposes have been handled in accordance with accounting principles generally accepted in the United States. Internal control over financial reporting includes those policies and procedures that (1) govern records to accurately and fairly reflect the transactions and dispositions of assets; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and that receipts and expenditures are being made only in accordance with authorizations of management and directors; and (3) provide reasonable safeguard against or timely detection of material unauthorized acquisition, use or disposition of assets.

Changes in Internal Controls over Financial Reporting

There have been no significant changes in REC's internal controls over financial reporting that could significantly affect such controls during the previous fiscal year.

Inherent Limitations on Internal Control

There are inherent limitations to the effectiveness of any system of internal control over financial reporting. No control system can provide absolute assurance that all control issues and instances of error or fraud, if any, have been detected. Even the best designed system can only provide reasonable assurance that the objectives of the control system have been met. Because of these inherent limitations, internal controls over financial reporting may not prevent or detect all misstatements. Additionally, projections as to the effectiveness of controls to future periods are subject to the risk that controls may not continue to operate at their current effectiveness levels due to changes in personnel or in its operating environment.

Financial Condition of the Company

REC finished the year with \$17,762,746 in net margins compared with a budgeted figure of \$14,082,449. Operating revenues were 4.5% lower than budget, purchased power cost was 5.8% lower, and total expenses were 4.1% lower than budget, resulting in operating margins of \$6,076,380. TIER was 2.0, compared to a budget of 1.8; Operating TIER was 1.5, compared to a budget of 1.4; and Modified TIER was 1.6, compared to a budget of 1.5. REC's debt service coverage (DSC) ratio was 2.1, compared to a budget of 2.1.

RAPPAHANNOCK ELECTRIC COOPERATIVE

Significant Change in Statement of Operations

	(thousands)			
	2016	2017	%Change	Explanation
Operating Revenue	\$418,165	\$373,837	-10.60%	Sales lower due to fewer kWh sales and decreased Heavy Industrial load.
Purchased Power	290,744	243,983	-16.10%	Cost of power lower due to fewer kWh purchases.
Other Operating Expenses	71,990	74,905	4.00%	Expenses grew due to labor and labor related costs adjusted for market increases.
Interest Income	904	592	-34.50%	Income decreased due to excess cash used for capital expenditures instead of investing.
Other Income	1,113	1,094	-1.63%	Other income decreased due to higher losses on the disposal of assets.

Significant Change in Balance Sheet Accounts

	(thousands)			
	2016	2017	%Change	Explanation

CURRENT ASSETS

Short-term investments	22,500	78	-99.65%	Investment balance decreased due to excess funds used for plant expansion instead of short-term investing.
Other	7,596	14,300	88.24%	REC received notice, and recorded as a receivable, \$10.4 million ODEC Margin Stabilization allocation for 2017 and an estimated ODEC patronage retirement of \$3.7 million

DEFERRED CREDITS

Power Cost Adjustment	6,981	10,564	51.33%	Over collection of wholesale power cost adjustment increased in 2017. This adjustment fluctuates between over and under collection on a month to month basis.
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LONG TERM LIABILITIES

Notes Payable	434,248	420,849	-3.09%	Long term debt declined as principal payments were made in 2017. There were no new loan draws.
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Asset Retirement Obligations

In accordance with GAAP and FERC Order 631 as adopted by the RUS, the Cooperative has determined that it has no material legal asset retirement obligations for the years ended December 31, 2017 and 2016. Regarding non-legal retirement obligations, the cooperative follows the regulatory principle of inter-generational cost allocation by including net salvage (gross salvage less cost of removal) as a component of depreciation rates. For the years ended December 31, 2017 and 2016, the Cooperative followed the RUS prescribed rates for depreciation and, therefore, collections for net salvage and differences in timing of recognition of period costs associated with non-legal retirement obligations had not been specifically identified.

Revenues

The majority of REC's revenue is from the sale of electricity. Total revenue for 2017 was \$373,837,433, with \$368,447,229 from the sale of electricity (approximately 99%). The additional 1% of revenue is related to other electric revenue such as late payment fees, pole attachment fees, trip fees, connection fees, and returned check charges. Late payment fees account for approximately 12.3% of other electric revenue, which is a significant decrease from 24.5% in 2016. Administrative and trip fees combined account for 25.1% of other revenues, which is an increase from 18.0% in 2016. Rent on electric property accounted for 17.5% of other revenues in 2017, up from 16.6% in 2016.

Coverage Ratios

REC's loan contracts with Rural Utilities Service (RUS), which is a USDA Rural Development Utilities program, require the Cooperative to comply with specific affirmative covenants. One of those covenants requires the average TIER achieved by REC in the 2 best years out of the 3 most recent calendar years must not be less than 1.25. TIER is calculated as follows:

$$\text{(Interest on Long-term Debt + Net Margins) / Interest on Long-Term Debt}$$

Another ratio is Operating TIER (OTIER). It has the same achievement requirements as TIER except that the minimum is 1.1. OTIER is calculated as follows:

$$\text{(Interest on Long-term Debt + Operating Margins + Patronage Cash) / Interest on Long-Term Debt}$$

Another ratio is Debt Service Coverage (DSC). It has the same achievement requirements as TIER with the same minimum of 1.25. DSC is calculated as follows:

$$\text{(Interest on Long-term Debt + Net Margins + Depreciation Expense) / Interest on Long-Term Debt + Principal Paid}$$

Financial Banking & Lending

REC maintains financial relationships with three lending institutions. REC receives its primary long term funding from RUS. This program helps rural cooperatives provide reliable, affordable electricity essential to the economic well-being and quality of life for the nation's rural residents. The USDA Electric Programs provide leadership and capital to upgrade, expand, maintain and replace America's vast rural electric infrastructure. Under the authority of the Rural Electrification Act of 1936, the USDA Electric Programs make direct loans and loan guarantees to electric utilities to serve customers in rural areas. The loans and loan guarantees finance the construction of electric distribution, transmission and generation facilities, including system improvements and replacement required to furnish and improve electric service in rural areas.

REC receives its secondary financing for long term and short term debt through relationships with National Rural Utilities Cooperative Finance Corporation (CFC) and CoBank. These lending institutions specialize in financing for cooperatives, RUS borrowers and customers which serve rural agricultural communities.

Private Rating

Fitch Ratings, Inc. is one of the top three credit rating services used to guide investors. REC received a very positive initial rating from Fitch Ratings, Inc. on January 3, 2013.

This initial rating was accepted and converted to a private rating. This keeps the rating out of the public domain, but allows it to be shared with a limited number of outside entities including lenders, ODEC and other significant organizations which may have an interest in REC's credit. On an ongoing basis, REC will provide Fitch Ratings, Inc. with the annual report, audited financials, Form 7 and announcements of materially positive or negative events as they become available. Under a private rating, Fitch is to perform a surveillance review of this documentation every 2 years. REC last received a Fitch rating affirmation on January 18, 2018.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTAL DATA

Report of Management on REC's Internal Control over Financial Reporting

Management of REC has assessed its internal control over financial reporting as of December 31, 2017, based on criteria for effective internal control over financial reporting described in Generally Accepted Accounting Principles (GAAP). Based on this assessment, REC's management believes that as of December 31, 2017 its system of internal control over financial reporting was properly designed and operating effectively based upon the specified criteria.

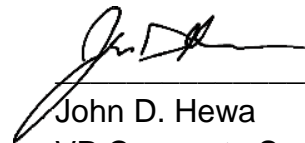
Management of REC is responsible for establishing and maintaining adequate internal control over financial reporting. REC's internal control over financial reporting is comprised of policies, procedures and reports designed to provide reasonable assurance to REC's management and Board of Directors that the financial reporting and the preparation of the financial statements for external reporting purposes has been handled in accordance with accounting principles generally accepted in the United States. Internal control over financial reporting includes those policies and procedures that (1) govern records to accurately and fairly reflect the transactions and dispositions of assets of REC; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and that receipts and expenditures of REC are being made only in accordance with authorizations of the management and directors of REC; and (3) provide reasonable safeguards against or timely detection of material unauthorized acquisition, use or disposition of REC's assets.

Internal controls over financial reporting may not prevent or detect all misstatements. Accordingly, even effective internal control can provide only reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

Date _____



Kent D. Farmer
President and CEO



John D. Hewa
VP Corporate Services

**See Independent Auditors' Report and the Consolidated Financial Statements.
IRS Form 990 attached.**

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Directors

As of December 31, 2017, REC was governed by a board of nine Directors. The Board of Directors consists of one (1) member from each of the nine geographical regions. Pursuant to its Bylaws, each of the board members shall be bona fide residents of the particular region which they represent. All Directors are elected for three-year terms by the Cooperative's membership regardless of the region that they represent. Their terms are staggered. REC's Board of Directors sets policy and provides direction to its President and Chief Executive Officer (CEO). Pursuant to Bylaws, the Board of Directors holds regular monthly meetings.

The Board of Directors elects a Chairman and Vice Chairman at the first meeting of the Board held after the Annual Meeting. This meeting took place during the Board's regular monthly meeting held August 16, 2017. The Chairman, or the Vice Chairman in the Chairman's absence, presides over the meetings of the membership and the meetings of the Board of Directors. The Chairman appoints the members and chairman of each Board committee.

Current information concerning current directors is listed below.

Michael W. Lindsay

Treasurer

Region I - the counties of Frederick, Shenandoah & portions of Page, Warren & Rappahannock



A director since 2010, Michael Lindsay brings over 25 years of experience in the areas of finance, accounting, corporate governance and ethics, and audit to the REC board. He serves on the Finance Committee, the HR Committee, and the Bylaws Committee and is Chairman of the Board for RE Communications a subsidiary of REC.

Lindsay also serves on the Virginia board of the Action Committee for Rural Electrification, a national political action committee focused on the needs of electric cooperatives. Lindsay is the Controller of an environmental and engineering firm in Loudoun County.

His background includes work for the federal government and large professional service firms with a concentration on major operations/maintenance, engineering, geothermal and remediation projects. Lindsay's career with the government and private industry

carried him to Texas, Saudi Arabia, Okinawa and California before he was able to return to his beloved native Virginia. His numerous professional awards include a Superior Accomplishment Commendation from the Army and Air Force Exchange Service (AAFES) for his efforts on behalf of military members in Saudi Arabia and Kuwait during Operation Desert Shield/Desert Storm.

Lindsay is both a Credentialed Cooperative Director as well as a recipient of the Board Leadership Certificate. He holds a B.A degree from Emory and Henry College. Lindsay and his wife, Becky, reside in Frederick County, where both are involved in local activities.

Lindsay serves the community as Board President the Winchester Youth Development Center and also formerly served in county government as a representative on the Public Safety Committee. He is a member of the Frederick County Farm Bureau and the National Rifle Association. In their spare time, Lindsay and Becky enjoy travel and have had the opportunity to visit 16 foreign countries.

Christopher G. Shipe

Chairman

Region II - the counties of Clarke, Fauquier, Stafford & portions of Warren & Rappahannock



Christopher Shipe believes very strongly in the cooperative business model for the delivery of essential services. For most of his professional career he has worked with mutual insurance companies where he has been directly involved in the leadership and governance of cooperatives. His career milestones include becoming CEO of Loudoun Mutual Insurance Company and serving in various capacities on insurance cooperative boards and industry committees, including his time as the chairman of the National Association of Mutual Insurance Companies' Property Casualty Conference. Since joining the REC Board of Directors, he has continued his education by completing the course work to obtain the Credentialed Cooperative Director certification.

Property Casualty Conference. Since joining the REC Board of Directors, he has continued his education by completing the course work to obtain the Credentialed Cooperative Director certification.

Shipe is involved in his community and his church. He is a volunteer with the John H. Enders Fire and Rescue Company in Berryville, Va., where he serves as president, and he is a lay servant and chairman of the trustees of the Duncan Memorial United Methodist Church.

Darlene H. Carpenter

Vice Chairman

Region III - the counties of Albemarle, Madison, Green, Rockingham and a portion of Page County



Darlene Carpenter was elected to the REC board in 1984. Carpenter serves on several Committees of the Virginia, Maryland Delaware Association of Electric Cooperatives and is REC's current director to the Board of ODEC. She is a past Region 1 director of the CFC. She has completed all director certification courses of the National Rural Electric Cooperative Association, which includes the basic, leadership and credential certificates.

Carpenter spent 37 years in banking, where she retired as vice president and area manager of the Wachovia Corporation, and currently is a Realtor for Century 21 New Millennium in Culpeper. She is a member of Culpeper Business Women, Culpeper Toastmasters and serves on the Board of the Culpeper Homeless Shelter. Carpenter was a past president of the Culpeper Chamber of Commerce.

Carpenter is a graduate of Germanna Community College, the Virginia Bankers School of Bank Management at the University of Virginia and the American Institute of Banking. She holds a certificate in Nonprofit Management from UVA. She is married to Edward D. Carpenter, and they have two daughters and three grandchildren. They reside on a small farm in the Reva area of Madison County and are active members of Bethsaida United Methodist Church.

Sanford Reaves, Jr.

Region IV - the counties of Culpeper and Orange



Sanford Reaves Jr. is a life-long native of Culpeper and a 26-year member of REC. Reaves is a 1974 graduate of Culpeper County High School and a 1976 graduate of Smithdeal-Massey Business College of Richmond. In 2005, Reaves graduated from the Virginia Union University School of Theology (Master of Divinity). He is a member of the Antioch Baptist Church of Culpeper, and has been Pastor of the Mt. Zion Baptist Church for 10 years.

Since 1995, Reaves has been the owner and president of Sanford and Sons Construction and Janitorial Services. He has also worked as operations manager for Federal Express for 7 1/2 years and general manager for Omni Services Inc., Sanis Division of Culpeper

for 8 1/2 years. Reaves is also a local realtor, has served on the Culpeper County Planning Commission for 25 years, and holds the position of Chairman.

Reaves serves on the Board of Directors for the Prison Re-Entry, Chamber of Commerce and Salem Educational Foundation as well as Culpeper Jaycees and NAACP (past president) and Wayland Blue Ridge Union (past moderator).

Reaves lives in the Salem District of Culpeper with his wife of 40 years, Lorraine. They have three children and four grandchildren.

Jesse R. "Randy" Thomas

Region V - Spotsylvania County



A resident of Spotsylvania County for 25 years, Jesse R. "Randy" Thomas has served his community for many years. His contributions include being a charter member and board member of the Stafford Rotary Club as well as serving on the Fredericksburg Area Builders Association board. Additionally, Thomas served on the board of the Fredericksburg Country Club (past president) and its finance committee. Currently, Thomas volunteers as a member of REC's C.A.R.E. Charity, Inc. Board and is a member of the Lake Anna Civic Association.

Thomas graduated from Stafford High School and attended Radford University. He was a partner and vice president of Washington Chichester and Clarke Insurance in Fredericksburg, and has over 25 years' experience in finance, budgeting, planning and acquisitions. His career experience includes working as an insurance agent for REC from 1993-1999, providing liability, worker's compensation, auto and property lines. Currently, Thomas is vice president of Danaher-Skewes and Associates, employed since 2007.

Thomas participates in community activities such as manager and coach in the Cal Ripken and Babe Ruth Baseball Association, coach in the parks and recreation league youth football, and volunteers with the athletic programs at Fredericksburg Christian School. He resides in Spotsylvania County with his wife and two children.

Linda R. Gray

Secretary

Region VI - Caroline County



Linda R. Gray has served on REC's Board of Directors since 1998. She has received her Credentialed Cooperative Director and Board Leadership certifications. She represents REC as Board Director on the VMDAEC Educational Scholarship Foundation. In 2004, she retired from the Federal Aviation Administration in Washington, D.C., and federal government service. Ms. Gray has a B.A. in sociology from Virginia State College (now Virginia State University).

She serves the Bowling Green district as board director of Caroline's Promise, a nonprofit organization that focuses on the youth in Caroline County. She also served as the county's first mentoring coordinator for Rappahannock Big Brothers Big Sisters and has been a Big Sister to two young girls in Fredericksburg and Bowling Green. Gray lives in the Sparta community of Caroline. She is an active member of St. James Baptist Church in Milford, where she serves as trustee and sings on several choirs.

J. Mark Wood

Region VII - Louisa County



J. Mark Wood has resided in Louisa County for over 45 years and is Virginia Department of Transportation's (VDOT) area land use engineer for Fluvanna and Louisa counties. After graduating from high school, Wood worked full time in the surveying and engineering fields while attending college. He earned an associate of applied science in civil engineering technology from J. Sargeant Reynolds Community College and a bachelor of science in civil engineering technology from Old Dominion University.

Wood is licensed as both a professional engineer and a land surveyor in the Commonwealth of Virginia. Wood oversees land development and permitting activities for VDOT and serves on the Fluvanna County Technical Review Committee and the Louisa County Development Review Committee. In November, Wood will be graduating from VDOT's leadership development program.

Wood worked for the Virginia Department of Game and Inland Fisheries for 23 years and received national recognition from the States Organization for Boating Access for his professionalism in boat access design. He has worked extensively on environmental permitting for construction projects from the Department of Environmental Quality,

Virginia Marine Resources Commission, Army Corps of Engineers and the U.S. Fish and Wildlife Service.

Wood is a lifetime member of the Louisa County Historical Society. He has served as a coach and manager for Louisa Little League Baseball, a Sunday school teacher, Sunday school superintendent, an AWANA worker, a deacon and chairman of the deacons. He and his wife, Becky, have two sons and reside in the Cuckoo area of Louisa County.

William C. Frazier

Region VIII - the counties of Hanover and Goochland



William Frazier has served on the REC Board of Directors since 1981. He also served on the ODEC Board of Directors and on its Power Supply Committee and Executive Committee. He has earned both the Credentialed Cooperative Director and Board Leadership Certificates.

Frazier served 16 years on the Hanover County Board of Supervisors and was chair of that board three times. He also served as chair of Hanover County Social Services, the Richmond Regional Economic Development Council and both the Pamunkey and James River Regional Water Study committees. He served four years as moderator on the Board of Trustees of Humana Hospital.

Frazier is a member of St. Peter's United Methodist Church, where he has chaired nearly every committee in the church and has taught Sunday school. He has served as a certified lay speaker on the Ashland District of the United Methodist Church, speaking at Methodist, Baptist and Christian churches. He is the owner of Associates Insurance Agency in Ashland. Frazier has one daughter and lives in the Montpelier area of Hanover County.

Eugene L. Campbell Jr.

Region IX - the counties of Essex, King and Queen, and King William



Eugene L. "Gene" Campbell, Jr., a lifelong resident of King William County, joined REC's Board of Directors in January of 2018. Campbell serves on REC's Bylaws committee and the Annual Meeting committee.

Campbell actively volunteers with both service driven and economic development organizations. He currently chairs the King William Economic Development Authority and is a part of the King William Internet Connectivity Initiative. Campbell was appointed to the County Electoral Board where he currently serves as chairman.

As a Ruritan since 1979, Campbell has volunteered many hours in service and has held leadership positions within the organization. His past affiliations include Businessmen Associations, Bon Secours Memorial Regional Medical Center Community Advisory Board and the County Recreation Commission. Campbell is a volunteer writer and photographer for the local Country Courier newspaper and is a member of the King William Historical Society. He is a lifelong member of McKendree United Methodist Church.

Mr. Campbell holds a B.S. in civil engineering from Virginia Polytechnic Institute and State University and worked as a project engineer and manager throughout his career. Campbell retired in 2014 and remains an active volunteer in his community.

Board Qualifications, Requirements and Structure

REC's Board of Directors are the members' neighbors, and they are elected to work on their behalf. Directors are elected by the membership at their annual membership meeting.

In 2017, all directors were in attendance at the annual membership meeting.

Director qualifications are listed in REC's Bylaws, Article IV, Section 3 and are further defined in the Board Policy below:

- Possesses an understanding of basic financial matters and fiduciary responsibilities of a board member;
- Be recognized as a leader in their industry and community because of their strong record of accomplishment;
- Be experienced in serving on a board or reporting directly to a board;

- Be committed to learning about the Cooperative and its diverse membership and willing to devote 24 to 44 days per year in order to be a meaningful contributor on behalf of all members;
- Be willing and capable of articulating points of view that may challenge the thinking of the board and management;
- Place a high value on personal and corporate integrity and ethical behavior;
- Have an understanding of cooperatives;
- Be willing and able to successfully complete the National Rural Electric Cooperative Association Credentialed Cooperative Director program within five years of becoming a director;
- Be willing and able to participate in the Cooperative's New Director Orientation program;
- Be financially secure (not motivated by director compensation).

Directors are also appointed to serve on one or more board committees. Currently, the five standing board committees are the Executive Committee, Finance Committee, Human Resources Committee, Annual Meeting Committee and the Bylaws Committee. These committees are defined below:

Executive Committee: (1) is a Board committee; (2) may exercise all Board authority granted by the Board and permitted under these Bylaws; and (3) at the next Board meeting following an exercise of Board authority, must report to the Board regarding the Executive Committee's exercise of Board authority. Except as otherwise provided by the Board, the Executive Committee is comprised of the Chairman, Vice-Chairman, Secretary and Treasurer

Finance Committee: shall consist of members of the Board of Directors. The Chairman of the Board and the Board Treasurer shall be voting members of the Finance Committee ex officio. The primary function of the Finance Committee shall be to make recommendations relative to the auditor, review audit reports, and to consider and recommend to the Board policies to insure proper accounting and finance controls.

Human Resources Committee: shall consist of members of the Board of Directors. The Chairman of the Board shall be a voting member of the committee ex officio. The primary function of the Human Resources Committee shall be to consider and make recommendations to the Board relative to Cooperative employees' policies, procedures, compensation and/or benefits.

Annual Meeting Committee: shall consist of members of the Board of Directors. The Chairman of the Board shall be a voting member of the committee ex officio. The primary function of the Annual Meeting Committee shall be to consider and make recommendations to the Board for the organization and planning of the Cooperative's annual membership meeting.

Bylaws Committee: shall consist of members of the Board of Directors. The Chairman of the Board shall be a voting member of the committee ex officio. The primary function of the Bylaws Committee shall be to consider and recommend Bylaw amendments to the Board and to periodically review the Bylaws and report its analysis and recommendations to the Board.

The Cooperative does not have a standing nominating committee.

Nominations for Directors shall be made by written petition executed by twenty-five (25) or more members who are in good standing with the Cooperative. The Secretary shall make nomination petitions available at all REC offices. Said written nomination petitions must be delivered to the office of the President not less than one hundred (100) days prior to the next annual meeting. The Secretary shall mail with the Notice of Meeting a statement of the number of Directors to be elected and all the nominations made for said Directorships. All nominees shall be listed in the member publication in the issue prior to the annual members' meeting. No additional nominations shall be made from the floor at the meeting of members. Advance notification to the membership of the nominations procedure shall be published in the member publication, prior to the annual meeting.

Executive Officers

The executive officers of the cooperative are also elected each year at a meeting of the Board after the annual meeting. These include the President and CEO, three Vice Presidents, Secretary, Assistant Secretary, Treasurer, Assistant Treasurer and such other officers as may be determined from time to time.

REC's executive officers, their positions and recent business experience are listed below.

Kent D. Farmer

President and Chief Executive Officer



Kent D. Farmer became president and chief executive officer of REC on Feb. 1, 2004. He is also president of Rappahannock Electric Communications, Inc., REC's wholly owned subsidiary. Mr. Farmer holds bachelor degrees in business management from Radford University, and accounting and finance from the University of Mary Washington. Joining REC in 1979, Farmer held progressive management positions throughout his career including vice president and COO. Farmer serves as the vice chairman of the ODEC Board of Directors, and as Vice Chairman of Regional Headquarters, Inc. Since 2014, Mr. Farmer served as District 1 director to the CFC and he was elected to serve as the CFC secretary-treasurer. A native of Caroline County, Farmer serves the Greater Fredericksburg region by volunteering and serving on the Board of several organizations. He and his wife live in Caroline County.

Ronald W. Harris

Vice President of Engineering and Operations



Ronald W. Harris became vice president of engineering and operations on July 1, 2015. Harris had been serving as manager of engineering and power supply at REC. In that role, he provided leadership and managerial oversight for system planning, engineering and technical services. With other senior managers, he shared the responsibility of defining the Cooperative's goals and objectives to ensure the successful implementation of the Cooperative's strategic plan. Harris also oversaw the development of the Cooperative's long-range construction work plan. Since beginning his career as a planning engineer in 1987, Harris has continued his professional development through education and industry training. He holds a bachelor's of science degree from Virginia Tech, an MBA from Strayer University, and in 2011, he completed his professional engineer license in Virginia. Harris completed the Robert I. Kabat

Management Internship Program through the National Rural Electric Cooperative Association. Harris is an active member in the Duncan Memorial Methodist Church and the local YMCA in Ashland, Va. He and his wife, Cheryl, live in Hanover County.

John D. Hewa

Vice President of Corporate Services



John D. Hewa joined REC in July, 2017, and is responsible for several functional areas including Finance and Accounting, Human Resources, Safety and Security, and Technology Services. Hewa has more than 20 years of leadership experience in the electric utility industry and a broad knowledge of the cooperative business model. He has served as CEO of electric cooperatives in Texas and Florida, and as vice president of research, engineering, and technical services at the National Rural Electric Cooperative Association. Prior to his cooperative career, Hewa managed the utilities department for the City of Manassas, Virginia. Hewa holds a Bachelor of Science in electrical engineering and a Master of Science in engineering management from the University of Tennessee in Knoxville. He is a registered professional engineer. Hewa and his wife, Laura, and their three daughters reside in Gainesville, Virginia.

David F. Koogler

Vice President of Member Services & External Affairs



David F. Koogler is the vice president of member services and external affairs for REC, where he is responsible for the strategic leadership of all member support activities, including the contact center, billing and collections, key accounts, conservation and renewable energy programs, regulatory and government affairs, and communications. Koogler joined REC in March 2011, and has more than 37 years of experience in Virginia's electric utility business. He graduated Magna Cum Laude with a B.S. in physics/engineering from Washington and Lee University, Lexington, Va. and with a master's in business administration from Virginia Commonwealth University, Richmond, Va. He and his wife, Margie, reside in Hanover County.

Member Communication with the Board of Directors and Executive Leadership

Members of the Cooperative can contact their Board of Directors and executive leadership team in person at the annual meeting, by phone at 1-800-552-3904, via e-mail at office@myrec.coop, or by mail at:

Rappahannock Electric Cooperative Leadership

PO Box 7388

Fredericksburg, VA 22404-7388

ITEM 10. COMPENSATION

General Philosophy

REC's compensation philosophy has four objectives:

- Attract and retain a qualified, diverse workforce through a competitive compensation program.
- Provide equitable and fair compensation.
- Support its business strategy.
- Ensure compliance with applicable laws and regulations.

Total Compensation Package

REC compensates its President and Chief Executive Officer (CEO) and other senior management through the use of a total compensation package which includes base salary, competitive benefits and the potential for an incentive. The CEO's base salary is derived from salary data provided by third parties for positions of similar responsibilities. The compensation of the CEO is reviewed by the Executive Committee of the Board of Directors and this committee provides a recommendation to the entire Board of Directors. The entire Board of Directors approves the CEO's compensation.

Targeted Overall Compensation

REC's compensation program utilizes detailed job descriptions for all of its employees, including senior management with the exception of the CEO, as an instrument to establish benchmarked positions. The market compensation information for each position is derived from salary data provided by third parties through national compensation surveys and includes salary data for positions within the determined competitive labor market. Job descriptions are reviewed annually and include essential and non-essential responsibilities, required knowledge, skills and abilities, and formal education and

experience necessary to accomplish the requirements of the position which in turn helps the Cooperative achieve its operational goals. Using this information, the human resources department, along with a third party compensation consultant, determines a market-based salary for each position based upon salary survey data provided by third parties. The market-based salary data compiled is reviewed annually for reasonableness and fairness. REC's Board of Directors has defined market-based salary as the 75th percentile of the market, excluding new hires that may be hired at the lower range of the market grade until a learning period is complete.

Process

REC's Board of Directors Executive Committee recommends all compensation and awards for the CEO to the entire Board of Directors for approval. The Board of Directors has delegated to the CEO the authority to establish and adjust compensation for all employees other than himself. The compensation for all other employees, other than members of senior management, is approved by the CEO based upon market-based salary data. This is reviewed annually by the Board of Directors. On an annual basis, the Board of Directors reviews the performance and compensation of the CEO and the CEO reviews the performance and compensation of the remaining senior management.

Base Salaries

As a not-for-profit electric cooperative, REC does not issue stock and therefore does not have any equity-based compensation programs. For this reason, substantially all compensation to its executive officers is provided in the form of base salary commensurate with the duties and responsibilities of each position. These salaries are determined based on market data and internal structure for positions with similar responsibilities.

Bonuses

REC's practice has been to, on infrequent occasions, award cash bonuses related to a specific event, such as the consummation of a significant transaction. At the discretion of its Board of Directors, the CEO may be awarded an annual bonus; and at the discretion of the CEO, other members of the senior management and staff/employees may be awarded an annual bonus.

Incentive Compensation Plan

REC also has an Incentive Compensation Plan (Results-Based Variable Pay). The award takes the form of a cash (lump-sum) payment, and is based on REC's success in achieving Key Performance Indicators (KPIs) – Customer Service, Financial Performance and Safe Operations. Payout takes place in April based on the actual company-wide KPI

results achieved through December of the previous year. The percentage payout for 2017 was 6.32%.

This incentive is paid only if merited by financial results. Modified TIER *after* the payout must be greater than 1.5 and total payout cannot exceed Patronage Capital paid to members. The maximum potential payout, achieved by meeting the stretch-level KPI goals, is 10% of an employee's base pay, plus overtime.

Severance Benefits

The Employment Agreement defines contractual severance benefits for the President and CEO based on the reason of termination. No other members of senior management have any contractual severance benefits.

PLANS

Defined Benefit Plan

REC has elected to participate in the NRECA Retirement Security Program (the "RS Plan"), a noncontributory, defined benefit, multiple-employer, master pension plan maintained and administered by the NRECA for the benefit of its member systems and their employees. The RS Plan is a qualified pension plan under Section 401(a) of the Internal Revenue Code of 1986. Benefits which accrue under the RS Plan are based upon the base annual salary as of November of the previous year. As a result of changes in Internal Revenue Service regulations, the base annual salary used in determining benefits is limited to \$270,000 in the year 2017, and will increase to \$275,000 in 2018. REC also participates in a pension restoration plan, which is intended to provide supplemental benefit for employees who would have a reduction in their pension benefit from the RS Plan due to limitations within the IRS code.

Deferred Benefit Plan

REC offers an NRECA sponsored 401(k) plan which is available to all eligible employees. Under the 401(k) plan for 2017, employees may elect to have up to 100% or \$18,000, whichever is less, of their salary withheld on a pre-tax basis, subject to Internal Revenue Service limitations, and invested on their behalf. REC matches the first 1% at 100% and the next 2% at 50% each. Also, a catch-up contribution is available for participants in the plan once they attain age 50. The maximum catch-up contribution for 2017 was \$6,000.

In addition, REC has a non-qualified executive deferred compensation plan. The Board of Directors, at its discretion, determines who may participate in the plan as well as an annual contribution, if any, up to the maximum amount allowed by regulations. Currently,

the Board of Directors has determined that this plan is only available to the CEO and the Vice Presidents.

Pension Prepayment Plan

On April 29, 2013, REC paid \$18,843,890 to participate in the NRECA pension prepayment plan, amortizing the prepayment over a 16-year period. This reduced REC's monthly pension expense from 27.54% to 20.69% of salaries, effective January 1, 2013 retroactively.

Pension Restoration Plan

REC participates in a pension restoration plan, which is intended to provide a supplemental benefit for employees who would have a reduction in their pension benefit because of the Internal Revenue Code limitations. Currently, the CEO is the only participant in this plan. Other executive officers may participate in this plan in the future.

Other Benefits

REC offers other benefits that are available to all employees of the Cooperative. These benefits include medical, dental and vision insurance, health savings accounts, life insurance, flexible spending plans for medical and dependent care, reimbursement for health club membership, supplemental life insurance, supplemental accidental death and dismemberment, tuition reimbursement, educational bonuses, vacation, holiday, and sick leave.

Change in Control

If a change of control occurs, the Employment Agreement defines provisions for employment for the President and CEO until the expiration of the Agreement term and sets forth in detail the facts and circumstances for termination payments. No other members of senior management have any contractual terms for Change in Control.

Employment Agreement

In January 2011, REC entered into an employment agreement with Kent D. Farmer to serve as Rappahannock's President and CEO. The original agreement was amended to continue through August 15, 2017 and included an annual automatic renewal unless Mr. Farmer or the Cooperative gives written notice three months prior to the expiration of the agreement.

The agreement provides that the President and CEO receive a minimum annual base salary subject to annual adjustment by the Board. Mr. Farmer is entitled to participate in all benefit plans available to all other employees.

Under the agreement, if Mr. Farmer voluntarily terminates his employment following material breach by the Cooperative or the Cooperative terminates him without specific cause, the Cooperative will pay Mr. Farmer a salary at the rate in effect on the date of termination for one year, plus medical insurance benefits. The amendment also included an additional termination benefit to include the value of the benefit payable under the Pension Restoration Plan. Both parties may exercise the election not to renew the contract at the expiration of term without termination payments due.

Under the employment contract with Mr. Farmer, “cause” is defined as (i) a willful and deliberate material violation of the Executive’s obligations by the Executive; (ii) deliberate dishonesty of the Executive with respect to the Cooperative’s assets, business, prospects or reputation; (iii) commission of a felony or a misdemeanor involving fraud, breach of trust, or misappropriation.

Board of Directors Compensation

The Board exercises a similar general compensation philosophy when establishing Board compensation. It seeks to attract qualified, diverse business professionals who have the knowledge to support the Cooperative’s business strategy. Compensation is derived from data of similar entities provided by a third party. Using this information, the Board determines fair and equitable compensation for directors. The Cooperative expects directors to enroll in educational courses that provide knowledge of the Cooperative business model and current business practices.

REC directors are compensated by a monthly retainer of \$2,000 and are also paid a Per Diem of \$500 for each day spent on Cooperative business such as regular and special board meetings, off-site meetings and conferences, training, etc. Directors receive an additional \$250 for attending in-person a committee meeting that occurs on a day other than the monthly meeting. REC reimburses all directors for out-of-pocket expenses incurred while attending these meetings.

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Not applicable.

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

Because REC is a cooperative, all of its directors are members and represent all of its member-owners, which are their customers.

Rappahannock Electric Cooperative's Board of Directors are independent of the organization. Any member seeking to serve on the Board must certify and agree to comply with Board Policy on Conflicts of Interest, agree that the Cooperative may request a criminal background and credit report and affirm they have not been convicted of a felony or a crime of moral turpitude. Annually, incumbent directors and officers of the organization must restate, sign and certify compliance as part of the annual audit process. Directors must disclose, fully and promptly, any current or future situation that might involve, or appear to involve, him or her in any conflict of interest with the Cooperative.

Under filing guidelines of Internal Revenue Service Form 990, directors must disclose any conflicting business relationships, direct or indirectly, while doing business with REC, and disclose any relationships with other officers, directors, trustees or key employees. REC's employment policy excludes from consideration for employment a relative of a current employee or current member of the board of directors. A relative is defined as a spouse; a parent (also mother- or father-in-law); a child (also daughter- or son-in-law); sibling (also half sister or brother, sister or brother-in-law); a grandparent; or a grandchild.

ITEM 13: IRS FORM 990 (2017)

The IRS Form 990 is REC's tax return and all tax-exempt organizations are required to file using the Form 990. The Form 990 includes, among other things, a summary of the organization (mission, number of employees, etc.), its revenue, its expenses and its assets; a statement of the Cooperative's accomplishments; and information about the Cooperative's management team and governing body.

To access the Form 990 please visit the Cooperative's website at:
www.myrec.coop/documentcenter.