RAPPAHANNOCK ELECTRIC COOPERATIVE

Financial Statements

December 31, 2018 and 2017
Years ended December 31, 2018, 2017 and 2016

RAPPAHANNOCK ELECTRIC COOPERATIVE

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ADAMS, JENKINS AND CHEATHAM
CERTIFIED PUBLIC ACCOUNTANTS AND BUSINESS CONSULTANTS

Independent Auditor's Report

The Board of Directors
Rappahannock Electric Cooperative
Fredericksburg, Virginia

We have audited the accompanying financial statements of Rappahannock Electric Cooperative (the Cooperative) which comprise the balance sheets as of December 31, 2018 and 2017 and the related statements of operations, comprehensive income, cash flows and equities for the years ended December 31, 2018, 2017 and 2016, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Cooperative's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Cooperative's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Rappahannock Electric Cooperative as of December 31, 2018 and 2017, and the results of its operations, comprehensive income and its cash flows for the years ended December 31, 2018, 2017 and 2016, in accordance with accounting principles generally accepted in the United States of America.

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Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued a report dated April 5, 2019, on our consideration of the Cooperative's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in considering the Cooperative's internal control over financial reporting and compliance.

Adams, Jenkins & Cheatham

Richmond, Virginia
April 5, 2019

RAPPAHANNOCK ELECTRIC COOPERATIVE

Balance Sheets

December 31, 2018 and 2017

Assets	**2018**	**2017**
	(In thousands)	
Net utility plant	$ 680,747	$ 671,765
Investments:		
Associated organizations	136,070	131,711
Other	3,167	3,146
Total investments	139,237	134,857
Current assets:		
Cash and cash equivalents	5,565	2,703
Short-term investments	31,726	78
Accounts receivable, less allowance for doubtful accounts	33,470	26,790
Unbilled receivables	19,334	21,757
Materials and supplies inventories	5,934	5,435
Prepaid expenses	1,505	4,931
Other	5,113	14,300
Total current assets	102,647	75,994
Deferred charges:		
Pension costs	12,170	13,348
Other	1,197	1,956
Total deferred charges	13,367	15,304
Total assets	$ 935,998	$ 897,920
Equities and Liabilities		
Equities:		
Patronage capital	$ 406,629	$ 391,670
Accumulated other comprehensive income (loss)	(425)	18
Total equities	406,204	391,688
Long-term debt, excluding current installments	443,717	420,852
Current liabilities:		
Current installments of long-term debt	14,779	14,237
Line of credit	—	3,200
Amounts due to power suppliers	27,511	25,331
Accounts payable	7,205	7,514
Consumer deposits	7,048	7,804
Other	6,974	6,866
Total current liabilities	63,517	64,952
Other noncurrent liabilities:		
Postretirement benefit obligation	1,237	1,252
Deferred credits-power cost adjustment	10,685	10,564
Deferred credits-other	8,631	7,133
Other	2,007	1,479
Total other noncurrent liabilities	22,560	20,428
Total equities and liabilities	$ 935,998	$ 897,920

See Independent Auditor's Report and Notes to Financial Statements

RAPPAHANNOCK ELECTRIC COOPERATIVE

Statements of Operations

Years ended December 31, 2018, 2017 and 2016

	2018	2017	2016
		(In thousands)	
Operating revenues	$ 446,656	$ 373,837	$ 418,165
Operating expenses:			
Cost of power/cost of goods sold	293,833	243,983	290,744
Transmission	589	786	877
Distribution – operations	14,796	16,224	15,381
Distribution – maintenance	32,345	24,574	23,460
Consumer accounts	13,863	13,611	12,757
Consumer service	2,958	3,044	2,920
Sales, administrative, and general	17,014	16,666	16,595
Total	375,398	318,888	362,734
Other expenses:			
Depreciation	37,120	30,704	30,470
Interest on long-term debt	17,638	17,572	18,272
Other	1,173	597	1,065
Total other expenses	55,931	48,873	49,807
Total expenses	431,329	367,761	412,541
Operating margins	15,327	6,076	5,624
Nonoperating margins:			
Patronage capital assigned	5,705	10,000	7,334
Interest income	1,171	592	904
Other income (loss), net	(868)	1,095	1,113
Total nonoperating margins	6,008	11,687	9,351
Net margins	$ 21,335	$ 17,763	$ 14,975

Statements of Comprehensive Income

Years ended December 31, 2018, 2017 and 2016

	2018	2017	2016
		(In thousands)	
Net Margins	$ 21,335	$ 17,763	$ 14,975
Other Comprehensive Income (Loss):			
Actuarial change	(14)	175	4
Prior service cost	(456)	—	—
Amortization of prior service cost	27	—	4
Total other comprehensive income (loss)	(443)	175	8
Comprehensive Income	$ 20,892	$ 17,938	$ 14,983

See Independent Auditor's Report and Notes to Financial Statements

RAPPAHANNOCK ELECTRIC COOPERATIVE

Statements of Cash Flows

Years ended December 31, 2018, 2017 and 2016

	2018	2017 (In thousands)	2016
Cash flows from operating activities:			
Net margins	$ 21,335	$ 17,763	$ 14,975
Adjustments:			
Depreciation	37,120	30,704	30,470
Noncash capital credit allocations	(5,705)	(10,151)	(7,334)
Special equipment installation costs	(2,380)	(996)	(909)
Cushion of credit interest expense applied	10,360	10,172	10,524
Loss (gain) on disposal of assets	2,274	169	27
(Increase) decrease in assets:			
Other investments	(22)	(1)	31
Accounts and unbilled receivables	5,088	(9,521)	(3,791)
Other current assets	3,267	(2,326)	(23)
Deferred charges	1,937	949	410
Increase (decrease) in liabilities:			
Accounts payable	1,872	86	(2,256)
Other current liabilities	112	319	413
Deferred credits	1,619	3,962	3,806
Other noncurrent liabilities	65	(147)	(76)
Net cash provided by operating activities	76,942	40,982	46,267
Cash flows from investing activities:			
Extension and replacement of plant	(47,777)	(47,014)	(34,880)
Contributions in aid of construction	4,578	4,182	6,352
Plant removal costs	(3,295)	(1,402)	(9,298)
Retirement of CTC's	47	47	47
Purchases/receipts of investments	(290,694)	(201,266)	(258,533)
Maturities of investments	259,047	223,688	275,769
Net cash used in investing activities	(78,094)	(21,765)	(20,543)
Cash flows from financing activities:			
Net change in memberships	—	—	(80)
Net change in consumer deposits	(756)	(165)	(790)
Proceeds from patronage capital retired	1,299	4,948	2,966
Retirements of patronage capital	(6,376)	(5,860)	(3,062)
Cushion of credit payments	(31,340)	(16,266)	(16,650)
Proceeds from long-term debt	51,975	457	—
Payments on long-term debt	(7,588)	(7,374)	(7,083)
Proceeds from line of credit	16,000	3,200	—
Payments on line of credit	(19,200)	—	—
Net cash provided by (used in) financing activities	4,014	(21,060)	(24,699)
Net increase (decrease) in cash and cash equivalents	2,862	(1,843)	1,025
Cash and cash equivalents, beginning of year	2,703	4,546	3,521
Cash and cash equivalents, end of year	$ 5,565	$ 2,703	$ 4,546
Supplemental disclosure:			
Cash paid for interest	$ 17,771	$ 17,668	$ 18,453

See Independent Auditor's Report and Notes to Financial Statements

RAPPAHANNOCK ELECTRIC COOPERATIVE

Statements of Equities

December 31, 2018 and 2017

	Patronage Capital	Accumulated Other Comprehensive Income (Loss)	Total
		(In thousands)	
Balance, December 31, 2016	$ 379,767	$ (157)	$ 379,610
Net Margins	17,763	—	17,763
Retirement of Patronage Capital	(5,860)	—	(5,860)
Other Comprehensive Income	—	175	175
Balance, December 31, 2017	$ 391,670	$ 18	$ 391,688
Net Margins	21,335	—	21,335
Retirement of Patronage Capital	(6,376)	—	(6,376)
Other Comprehensive Loss	—	(443)	(443)
Balance, December 31, 2018	$ 406,629	$ (425)	$ 406,204

See Independent Auditor's Report and Notes to Financial Statements

(1) Significant Accounting Policies

(a) General

Rappahannock Electric Cooperative (the Cooperative) is an electric distribution utility engaged in the retail sale of electricity to residential and commercial member consumers in the central portion of Virginia. The Cooperative serves its member consumers located in select areas within the counties of Albemarle, Caroline, Clarke, Culpeper, Essex, Fauquier, Frederick, Goochland, Greene, Hanover, King & Queen, King William, Louisa, Madison, Orange, Page, Rappahannock, Rockingham, Shenandoah, Spotsylvania, Stafford and Warren and portions of the towns of Berryville, Bowling Green, Boyce, Culpeper, Front Royal, Madison, Middletown, Port Royal, Stanardsville, Stephens City, and Washington. The rates charged to member consumers of the Cooperative are regulated by the State Corporation Commission of Virginia (SCC).

Rappahannock Electric Communications, Inc. is a wholly owned for-profit subsidiary operating under a management agreement with the Cooperative. The investment is accounted for using the equity method. All transactions of the subsidiary are considered immaterial to the Cooperative's financial statements and therefore have not been consolidated.

The Cooperative is a member of Old Dominion Electric Cooperative (ODEC), a not-for-profit wholesale power supply cooperative. The Cooperative is required to purchase substantially all of its power from ODEC through 2054 (see note 9). The Cooperative's investment of $121,628,061 in ODEC as of December 31, 2018, is 28.4% of ODEC's patronage capital.

As a cooperative regulated by the SCC, the Cooperative has exclusive rights to distribute electricity to portions of the above counties and towns. As of January 1, 2003, the Cooperative completed the transition to allow competition within its service area in accordance with the Electric Utility Restructuring Act of 1999 and the Retail Access Rules established by the SCC. The legislation clarifies that cooperatives will be default suppliers of all competitive services and will continue to be permitted to sell electricity directly to their customers.

(b) 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 (RUS). The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP).

The Cooperative follows the accounting practices set forth in GAAP regarding accounting for the effects of certain types of regulations. 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.

(c) Utility Plant

Utility plant is stated at original cost, which includes direct labor, payroll taxes and other fringe benefits related to employees engaged in construction, materials and certain indirect costs such as maintenance and depreciation of transportation and construction equipment. The costs of depreciable utility plant retired and related removal costs, less salvage values, are charged to accumulated depreciation.

As of December 31, 2015, the Cooperative authorized a depreciation study of its electric utility plant to determine if the rates in use were providing for an accurate recovery of costs. Based on that study, changes were made effective March, 2018. Provision is made for depreciation of plant based on straight-line rates per annum as follows:

Allegheny acquisition adjustment	3.05%
Fort A.P. Hill acquisition adjustment	4.08%
Transmission station equipment	2.47%
Transmission poles and fixtures	3.19%
Transmission overhead conductors and devices	3.47%
Transmission underground conductors and devices	4.74%
Distribution station equipment	4.09%
Distribution station equipment-SCADA	7.27%
Distribution station equipment-Load Management	6.83%
Poles, towers and fixtures	5.22%
Overhead conductors and devices	4.01%
Overhead conductors and devices-SCADA	8.54%
Overhead conductors and devices-load management	6.12%
Underground conduit	4.27%
Underground conductor and devices	3.75%
Underground conductor and devices-nonjacketed cable	0.24%
Line transformers	1.69%
Services	3.83%
Meters	4.79%
Meters-AMR modules	11.36%
Meters-communication devices	5.24%
Security lights	8.55%
Load management equipment	5.65%

Structures and improvements	3.08%
Office furniture and equipment	4.26%
Office furniture and equipment-computerized	10.30%
Office furniture and equipment-software	2.51%
Office furniture and equipment-system hardware	3.47%
Transportation equipment	8.93%
Stores equipment	3.21%
Tools, shop and garage equipment	3.57%
Laboratory equipment	3.39%
Power operated equipment	3.12%
Communications equipment	8.52%
Communications equipment-SCADA	8.00%
Communications equipment-TWACS load management	5.07%
Miscellaneous equipment	4.37%

(d) Cash and Cash Equivalents

The Cooperative considers all highly liquid investments purchased with original maturities of three months or less to be cash equivalents. Cash equivalents are stated at cost, which approximates their fair values.

(e) Short-Term Investments

In 2018 and 2017, the Cooperative earned an average rate of 2.56% and 1.65%, respectively, on prepayments of its ODEC power bill. ODEC allows for the immediate return of these prepayments if requested. Therefore, the Cooperative accounts for these interest-bearing prepayments as short-term investments. At December 31, 2018 and 2017, the Cooperative had short-term investments of $31,725,860 and $78,228, respectively.

(f) Allowance for Doubtful Accounts

At year-end, the provision for doubtful accounts is adjusted based on an analysis of aged accounts receivable balances. At December 31, 2018 and 2017, the Cooperative had allowances of $1,128,744 and $864,302, respectively. The Cooperative maintains a policy, which includes an analysis of aged accounts receivable, of writing off uncollectible accounts with Board approval.

(g) Materials and Supplies Inventories

Materials and supplies inventories are stated at the lower of market or average cost and are generally used for construction or operations, not for resale.

(h) Postretirement Benefits Other Than Pensions

The Cooperative accounts for postretirement benefits other than pensions by charging the projected future cost of providing postretirement benefits, such as health care and life insurance, to expense as such benefits are earned by the employees.

(i) Income Taxes

The Cooperative has been granted exemption from income tax under Internal Revenue Service Code Section 501(c)(12) of the Internal Revenue Code. The Cooperative evaluates the components of the annual test for compliance to maintain its filing status as a tax exempt entity. In accordance with the Financial Accounting Standards Board ASC Topic 740-10, *Accounting for Uncertainty in Income Taxes*, the Cooperative had determined that it is more likely than not that their tax positions will be sustained upon examination by the Internal Revenue Service. Tax years ending on or after December 31, 2015 remain subject to examination by federal and state taxing authorities.

(j) Power Cost Adjustment (PCA)

The Cooperative uses the deferred method of accounting for all power costs. Under this method, a deferred account is adjusted to recognize power costs that are billed to member consumers. Any amounts collected over and above or below the Cooperative's monthly power costs are recorded as a deferred credit or deferred charge as applicable. At December 31, 2018 and 2017, the Cooperative had a cumulative over collection of power costs totaling $10,685,381 and $10,564,220, respectively.

(k) Revenue Recognition

The Cooperative recognizes revenue when earned, that is, when electricity is used by members. Unbilled revenue is recorded based on estimated amounts due from members for electricity used but not yet billed by the Cooperative.

(l) Advertising Costs

The Cooperative expenses advertising costs as incurred. There were no material advertising costs for the years ended December 31, 2018, 2017, and 2016.

(m) Asset Retirement Obligations

In accordance with the Financial Accounting Standards Board ASC Topic 410, *Accounting for Asset Retirement Obligations*, the Cooperative has determined that it had no material legal asset retirement obligations as of December 31, 2018 and 2017. 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.

(n) Impairment or Disposal of Long-Lived Assets

In accordance with the Financial Accounting Standards Board ASC Topic 360, *Accounting for the Impairment or Disposal of Long-Lived Assets*, long-lived assets and certain identifiable intangibles are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceed the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

(o) Internal Use Software

In accordance with the Financial Accounting Standards Board ASC Topic 350-40, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, the Cooperative capitalizes certain internal and external costs of developing internal use software and amortizes them over the estimated useful life of the software.

(p) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(q) Subsequent Events

Subsequent events have been evaluated through April 5, 2019, which is the date the financial statements were available to be issued (see note 12).

(2) Utility Plant

Utility plant, at cost, as of December 31, 2018 and 2017, consists of the following:

	2018	2017
	(In thousands)	
Distribution	$ 857,169	$ 822,011
Transmission	37,098	37,178
General	108,648	104,288
Acquisition adjustments	54,324	54,324
Utility plant in service	1,057,239	1,017,801
Construction in progress	38,639	48,347
Total utility plant	1,095,878	1,066,148
Less accumulated amortization and depreciation	415,131	394,383
Net utility plant	$ 680,747	$ 671,765

(Continued)

(3) Investments in Associated Organizations and Other Investments

Investments in associated organizations are primarily composed of patronage capital assigned from ODEC, National Rural Utilities Cooperative Finance Corporation (CFC), and CoBank. These investments are recorded at cost plus allocated patronage capital. The patronage allocations are non-interest-bearing and ultimate realization of the amounts is based upon the granting cooperative's policies. At December 31, 2018 and 2017, investments in associated organizations consist of the following:

	2018	2017
	(In thousands)	
ODEC patronage capital assigned	$ 121,628	$ 117,546
CFC patronage capital certificates	1,910	1,772
CoBank Class E stock	5,190	5,166
Other	3,069	2,907
Investments in associated organizations	131,797	127,391
Investment in capital term certificates (CFC):		
Subscription capital term certificates	2,457	2,457
Loan capital term certificates:		
Interest-bearing	916	916
Non-interest-bearing	400	447
Member capital securities	500	500
Capital term certificates and member capital securities	4,273	4,320
Total Investments in Associated Organizations	$ 136,070	$ 131,711

The CFC patronage capital certificates and the CoBank Class E stock may be retired at book value at the sole discretion of those organizations' boards of directors.

The CFC subscription capital term certificates pay interest semiannually at a rate of 5% per annum and are currently scheduled to mature beginning in 2070 and ending in 2080. The CFC interest-bearing loan capital term certificates pay interest semiannually at a rate of 3% per annum and are scheduled to mature beginning in 2020 and ending in 2035. The CFC non-interest-bearing loan capital term certificates include two types of certificates. The first type has each certificate maturing in the same year as the corresponding loan, the last one matured in 2018. The second type pays an annual amount based upon the outstanding loan balance with maturities ranging from 2024 to 2027.

In April, 2014, the Cooperative invested in member capital securities that pay interest semiannually at a rate of 5% per annum, are scheduled to mature in April, 2044 and are callable by CFC beginning April, 2024.

Other investments include TEC Trading, Inc. which is recorded at cost of $1,782,500.

(4) Long-Term Debt

Long-term debt at December 31, 2018 and 2017 consists of the following:

	2018	2017
	(In thousands)	
Mortgage notes:		
RUS-		
due 2031 through 2052; (2.50% - 4.50%)	$ 288,225	$ 257,230
CoBank-		
due 2028 through 2045; (3.06% - 6.85%)	98,490	102,793
CFC-		
due 2024 through 2045; (3.40% - 4.05%)	71,473	74,609
CISCO-		
due 2020; (2.40%)	308	457
Total long-term debt	458,496	435,089
Less current installments	14,779	14,237
Long-term debt, excluding current installments	$ 443,717	$ 420,852

RUS mortgage note balances include advance payments on cushion of credit of approximately $14.3 million and $3,000 at December 31, 2018 and 2017, respectively.

Annual maturities of long-term debt for the five years subsequent to December 31, 2018, and thereafter are approximately $14.8 million in 2019, $16.3 million in 2020, $16.8 million in 2021, $17.6 million in 2022, $18.3 million in 2023 and $374.7 million thereafter.

(a) Mortgage Notes

Under provisions of the mortgage note agreements, if total equities are less than 30% of the total assets of the Cooperative, the return to members of patronage capital is limited to 25% of the margins earned by the Cooperative in the preceding year. Total equities of the Cooperative represented 43.4% and 43.6% of the total assets at December 31, 2018 and 2017, respectively. The mortgage note agreements also restrict the Cooperative's ability to retire equity when its Times Interest Earned Ratio (TIER) and Debt Service Coverage ratio (DSC) are both less than 1.25. TIER was 2.2, 2.0, and 1.8 in 2018, 2017 and 2016, respectively. DSC was 2.4, 2.1, and 2.0 in 2018, 2017 and 2016, respectively. The agreements also contain certain provisions and restrictions relating to, but not limited to, the sale of utility plant, insurance coverage and minimum equity requirements. Substantially all plant assets are pledged as collateral. During 2018, the Cooperative obtained new debt of approximately $52 million from RUS. There was no new debt obtained during 2017 or 2016.

(b) Lines of Credit

The Cooperative has unsecured line-of-credit agreements with two banks in the amounts of $80 million with CFC and $50 million with CoBank. Under authority granted by the SCC, the Cooperative is authorized to incur indebtedness under these agreements in the aggregate amount up to $80 million.

The interest rate on advances under these agreements is equal to the rate to be quoted by each bank based on its discretion. There were zero balances on both lines of credit as of December 31, 2018. The Cooperative had a $3.2 million balance on the CoBank line at 3.22% and a zero balance on the CFC line as of December 31, 2017.

(5) Concentration of Credit Risk

Financial instruments, which potentially subject the Cooperative to concentration of credit risk, consist principally of cash and cash equivalents and customer accounts receivable.

The Cooperative maintains checking accounts in SunTrust Bank, Union Bank & Trust and Wells Fargo. The Federal Deposit Insurance Corporation (FDIC) provides insurance coverage for up to $250,000 of cash held by the Cooperative in each separate FDIC insured bank and savings institution. From time to time, the Cooperative may have amounts on deposit in excess of the insured limits. As of December 31, 2018, the Cooperative had approximately $7.6 million of uninsured deposits. Also, at December 31, 2018, the Cooperative had ODEC prepayments totaling approximately $31.7 million which were not insured. This balance is shown as short-term investments on the balance sheet.

Accounts receivable primarily consist of amounts due from customers for the purchase of electricity. Customers are located within the twenty-two counties and eleven towns of Virginia served by the Cooperative. Approximately 74% of the Cooperative’s receivables are for residential customers and due to the large number of customers involved, are a minimal risk. The commercial and public customers represent approximately 26% of receivables. Management minimizes the credit risk with deposit requirements and provisions for doubtful accounts.

(6) Leases

The Cooperative has operating leases for facilities and office equipment. Future minimum lease payments under noncancellable operating leases that have remaining terms in excess of one year as of December 31, 2018 are as follows:

Year ending December 31:		(In thousands)
2019	$	298
2020		287
2021		42
Thereafter		23
Total minimum lease payments	$	650

Rental expense of $329,176, $328,145 and $162,010 was recognized in 2018, 2017 and 2016, respectively.

(7) Margin Stabilization

The Cooperative's wholesale power supplier, ODEC, has an approved Margin Stabilization Plan. The purpose of this plan is to maintain ODEC's margins within a predetermined range. Margin stabilization payments or charges are passed through to member consumers as deferred credits or deferred charges utilizing the power cost adjustment factor. These payments from ODEC were $4,903,022 and $10,492,411 at December 31, 2018 and 2017, respectively.

(8) Benefits

(a) Pension Plan

All employees of the Cooperative that complete one year of service are participants in the National Rural Electric Cooperative Association (NRECA) Retirement Security Plan (RS Plan) which is a defined benefit pension plan qualified under Section 401 and tax-exempt under Section 501(a) of the Internal Revenue Code. It is a multiemployer plan under the accounting standards. The plan sponsor's Employer Identification Number is 53-0116145 and the Plan Number is 333.

A unique characteristic of a multiemployer plan compared to a single employer plan is that all plan assets are available to pay benefits of any plan participant. Separate asset accounts are not maintained for participating employers. This means that assets contributed by one employer may be used to provide benefits to employees of other participating employers.

At its December 2012 meeting, the Insurance & Financial Services (I&FS) Committee of the NRECA Board of Directors approved an option to allow participating cooperatives in the RS Plan to make a contribution prepayment and reduce future required contributions. The prepayment amount is a cooperative's share, as of January 1, 2013, of future contributions required to fund the RS Plan's unfunded value of benefits earned to date using RS Plan actuarial valuation assumptions. The prepayment amount will typically equal approximately 2.5 times a cooperative's annual RS Plan required contributions as of January 1, 2013. After making the prepayments, for most cooperatives the billing rate is reduced by approximately 25%, retroactive to January 1, 2013. The 25% differential in billing rates is expected to continue for approximately 15 years, however, changes in interest rates, asset returns and other plan experience may affect this.

On April 29, 2013, the Cooperative made a prepayment of $18,843,890 to the NRECA RS Plan. Interest expense associated with the prepayment loan is being accounted for within RUS guidelines. The Cooperative is amortizing the prepayment over 16 years.

The Cooperative's contributions to the RS Plan in 2018 and in 2017 represented less than 5 percent of the total contributions made to the plan by all participating employers. The Cooperative made annual contributions to the plan of $7,003,161 and $6,786,342 in 2018 and 2017, respectively. There have been no significant changes that affect the comparability of 2018 and 2017 contributions.

In the RS Plan, a "zone status" determination is not required, and therefore not determined, under the Pension Protection Act (PPA) of 2006. In addition, the accumulated benefit obligations and plan assets are not determined or allocated separately by individual employer. In total, the Retirement Security Plan was over 80 percent funded on January 1, 2018 and over 80 percent funded on January 1, 2017 based on the PPA funding target and PPA actuarial value of assets on those dates.

Because the provisions of the PPA do not apply to the RS Plan, funding improvement plans and surcharges are not applicable. Future contribution requirements are determined each year as part of the actuarial valuation of the plan and may change as a result of plan experience.

In addition to the NRECA Retirement and Security Program, substantially all employees of the Cooperative are eligible to participate in the NRECA SelectRE plan, a defined contribution and multi-employer deferred income plan qualified under section 401(k) of the Internal Revenue Code. The Cooperative's required contribution to the Plan and its' net pension cost was $622,659, $615,036 and $602,775 for the years ended December 31, 2018, 2017 and 2016, respectively.

(b) Benefit Obligations – Defined and Deferred Benefit Plans

The Cooperative has entered into defined benefit agreements with certain of its employees that provide for annual benefit payments to be made over a period of 15 years upon retirement or death of the covered employees. The present value of the estimated future payments under these agreements is being accrued over the period of active employment of the covered employees. The amounts of such accruals were approximately $2,000, $35,000 and $86,000, as of December 31, 2018, 2017 and 2016, respectively, and are included in other liabilities. The expense under these agreements amounted to $1,685, $4,076 and $50,557 in 2018, 2017 and 2016, respectively.

The Cooperative has also entered into deferred benefit agreements with certain of its employees that provide for annual benefit payments to be made over a period of 15 years upon retirement or death of the covered employees. The contributions and related interest under these agreements are being accrued over the period of active employment of the covered employees. The amounts of such accruals were approximately $590,000, $630,000 and $667,000, as of December 31, 2018, 2017 and 2016, respectively, and are included in other liabilities. The expense under these agreements amounted to $34,199, $35,997 and $37,714, in 2018, 2017 and 2016, respectively.

For both the defined and deferred benefit plans, the Cooperative is the beneficiary of life insurance policies on these employees which were acquired to provide for future payments of these benefits. These policies are shown as other investments in the accompanying balance sheets and are carried at current cash surrender value. The face amount of these policies total $3,160,152. As of December 31, 2018 and 2017, the cash surrender values of these policies were $946,121 and $978,439, respectively.

(c) 457(b) Deferred Compensation Plan

The Cooperative participates in a nonqualified, deferred compensation 457(b) Plan limited to certain directors of the board and certain key employees. The Cooperative retains ownership of the assets and earnings until the retirement date of the participant. The plan is administered by Homestead Funds. For the years ended December 31, 2018 and 2017, the balance of the deferred compensation held for the benefit of the directors of the board was $31,871 and $32,025, respectively. For the years ended December 31, 2018 and 2017, the balance of the deferred compensation held for the benefit of the key employees was $384,218 and $352,538, respectively.

(d) Executive Benefit Restoration Plan

The Cooperative participates in an executive benefit 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.

In this first year, the expense recognized for this plan was $121,791 and the accrued amount was $474,608 as of December 31, 2018.

The following sets forth the benefit obligation with the funded status of the plan as December 31, 2018 and 2017:

	2018	2017
	(In thousands)	
Benefit obligation at beginning of year	$ —	$ —
Service cost	78	—
Interest cost	17	—
Plan amendments	456	—
Actuarial (gain)/loss	(76)	—
Benefit obligation at end of year	475	—
Fair value of plan assets at end of year	—	—
Funded status	$ (475)	$ —

The net periodic pension costs are as follows:

	2018	2017
	(In thousands)	
Service cost	$ 78	$ —
Interest cost	17	—
Amortization of prior service cost	27	—
Net periodic pension cost	$ 122	$ —

The reconciliation of accumulated other comprehensive income (loss) is:

	2018	2017
	(In thousands)	
Unrecognized prior service costs	$ (429)	$ —
Unrecognized actuarial gain	76	—
	$ (353)	$ —

Amounts in accumulated other comprehensive income expected to be recognized during subsequent period:

	2018	2017
	(In thousands)	
Net prior service cost	$ 27	$ —

Weighted average assumptions used to determine the benefit obligation and benefit costs:

	2018	2017
Discount rate	4.33%	3.76%
Salary increase assumption	3.00%	0.00%
Measurement date	12/31/2018	12/31/2017

Estimated future benefit payments reflecting expected future service years are as follows (in thousands):

Year ending December 31,	
2019	$ —
2020	$ —
2021	$ —
2022	$ —
2023	$ —
2024 and later	$ 3,047

(e) Postretirement Benefits Other Than Pensions

The Cooperative pays the entire medical premium for employees who retired prior to December 31, 1995, as well as the premium for the spouse and dependents under the age of twenty-six. The Cooperative does not contribute to the cost of the medical coverage after the death of a retired participant. Employees retiring after December 31, 1995 may elect to purchase medical insurance, but are responsible for the entire premium resulting in no employer liability.

Amounts paid by the Cooperative under these commitments were $177,350, $153,559 and $189,632, in 2018, 2017 and 2016, respectively.

The Medicare Prescription Drug Improvement and Modernization Act was signed into law as of December 7, 2003. The Medicare Act introduces a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. All measures of the benefit obligation and the net periodic postretirement benefit cost included in this footnote reflect the effects of the Medicare Act on the plan.

The following sets forth the benefit obligation with the funded status of the plan as of December 31, 2018 and 2017:

	2018	2017
	(In thousands)	
Change in benefit obligation:		
Benefit obligation at beginning of year	$ 1,252	$ 1,508
Interest cost	50	51
Actuarial change	90	(175)
Medicare Part D subsidy received	22	22
Benefits paid	(177)	(154)
Benefit obligation at end of year	1,237	1,252
Fair value of plan assets at end of year	—	—
Funded status	$ (1,237)	$ (1,252)

The unrecognized amounts included in accumulated comprehensive income (loss) are as follows:

	2018	2017
	(In thousands)	
Net actuarial gain/(loss)	$ (72)	$ 18
Total	$ (72)	$ 18

Weighted average assumptions used to determine the benefit obligation and benefit costs:

	2018	2017
Medical trend rate next year	8.00%	8.00%
Ultimate trend rate	5.00%	5.00%
Year ultimate trend rate is achieved	2025	2024
Discount rate used to value end of year accumulated postretirement benefit obligation	4.00%	4.00%
Measurement date	12/31/2018	12/31/2017

Estimated future benefit payments shown net of employee contributions are as follows:

Year beginning January 1,	Estimated Gross Benefit Payment	Estimated Medicare Part D Subsidy (In thousands)	Estimated Net Benefit Payment
2019	$ 177	$ 21	$ 156
2020	171	20	151
2021	163	19	144
2022	154	18	136
2023	144	17	127
2024-2028	$ 542	$ 62	$ 480

There are no assets that have been segregated and restricted to pay for the postretirement benefits; rather the plan is being funded on a pay-as-you-go basis. The total net periodic postretirement benefit costs recorded were $50,000, $51,306 and $66,167 in 2018, 2017 and 2016, respectively. There were no estimated amortization amounts in 2018 or 2017.

(9) Commitments

The Cooperative, as a member of ODEC, purchases substantially all of its power from ODEC under a wholesale power contract dated January 1, 2009. The term of this contract is for 45 years and thereafter until terminated by either party giving to the other not less than three years written notice of its intention to terminate. To the extent available, the Cooperative is obligated to purchase from ODEC all electric power and energy that the Cooperative requires for the operation of its system. Purchases from ODEC amounted to $261,054,475, $223,687,591 and $272,097,892 in 2018, 2017 and 2016, respectively.

As part of REC’s agreement with ODEC, the Cooperative has an option to obtain up to 5% of its power requirements from a third party provider. On October 15, 2015, REC’s board of directors authorized the execution of a contract with Morgan Stanley Capital Group to purchase 5% of its power. The contract was dated November 9, 2015. The Cooperative began purchasing from Morgan Stanley on May 1, 2016, and will continue for a term of five years. These purchases amounted to $24,196,371, $23,085,439 and $14,976,496 in 2018, 2017 and 2016, respectively.

The Cooperative has binding contracts for substation work to be done. The balance of these contract commitments are $4,746,850 as of December 31, 2018.

(10) Related Party Transactions

The Cooperative has long-term loans with both CFC and CoBank at market interest rates. At December 31, 2018, liabilities were $71,473,252 and $98,489,804, respectively. At December 31, 2017, liabilities were $74,609,637 and $102,792,708, respectively.

(11) Financial Instruments Carried at Cost

The Cooperative has recorded all financial instruments based on the carrying amount (book value) in the financial statements in accordance with accounting principles generally accepted in the United States of

America. In accordance with the Financial Accounting Standards Board ASC Topic 825, *Disclosures about Fair Value of Financial Instruments*, the Cooperative is required to disclose the fair value of financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using discounted cash flow analysis. This technique involves subjective judgment and is significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. As a result, the derived fair value estimates cannot be substantiated by comparison to independent markets, and in many cases, could not be realized in immediate settlement of the instrument. Accordingly, the following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it was practicable to estimate that value.

(a) Cash and Cash Equivalents, Accounts and Unbilled Receivables, Amounts Due to Power Suppliers, Accounts Payable and Consumer Deposits

The carrying amount approximates fair value due to the short-term nature of these instruments.

(b) Investments in Associated Organizations

Fair value of capital term certificates was determined by computing the present value of estimated future cash flows, discounted at the 30-year Treasury yield curve rate of 3.02% and 2.74% for the years ending December 31, 2018 and 2017, respectively. The fair value of patronage capital is not determinable since no legal obligation exists to retire capital credits. The fair value of the cost and equity method investments are not estimated since there are no identified events or changes in circumstances that may have a significant adverse effect on the fair value and it is not practicable to estimate fair value. The carrying value of memberships approximates fair value.

(c) Long-Term Debt

The carrying amount of the Cooperative's long-term debt includes certain interest rates that are below quoted market prices for the same or similar issues. Therefore, the fair value of the Cooperative's long-term debt is estimated based on current market prices offered for debt of the same and remaining maturities.

The estimated fair values of the Cooperative's financial instruments as of December 31, 2018 and 2017 are as follows:

2018	**Carrying Value**	**Fair Value**
	(In thousands)	
Capital term certificates (CFC)	$ 3,773	$ 5,000
Member capital securities	500	700
Long-term debt	458,496	473,000

2017	Carrying Value	Fair Value
	(In thousands)	
Capital term certificates (CFC)	$ 3,820	$ 5,400
Member capital securities	500	700
Long-term debt	435,089	468,800

(12) Current Issues

The Cooperative is involved in legal actions and claims that arise as a result of events that occur in the normal course of operations. The ultimate resolution of these actions is not expected to have a material adverse effect on the Cooperative's financial position.

ADAMS, JENKINS AND CHEATHAM
CERTIFIED PUBLIC ACCOUNTANTS AND BUSINESS CONSULTANTS

Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

The Board of Directors
Rappahannock Electric Cooperative
Fredericksburg, Virginia

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of Rappahannock Electric Cooperative (the Cooperative), which comprise the balance sheets as of December 31, 2018 and 2017, and the related statements of operations, comprehensive income, cash flows and equities for the years ended December 31, 2018, 2017 and 2016, and the related notes to the financial statements, and have issued our report thereon dated April 5, 2019.

Internal Control Over Financial Reporting

In planning and performing our audits of the financial statements, we considered the Cooperative's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Cooperative's internal control. Accordingly, we do not express an opinion on the effectiveness of the Cooperative's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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

(Continued)

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Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Cooperative's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audits, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*. We noted certain matters that we reported to management of the Cooperative in a separate letter dated April 5, 2019.

Purpose of this Report

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

Adams, Jenkins & Cheatham

Richmond, Virginia
April 5, 2019

ADAMS, JENKINS AND CHEATHAM
CERTIFIED PUBLIC ACCOUNTANTS AND BUSINESS CONSULTANTS

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

The Board of Directors
Rappahannock Electric Cooperative
Fredericksburg, Virginia

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of Rappahannock Electric Cooperative (the Cooperative), which comprise the balance sheets as of December 31, 2018 and 2017, and the related statements of operations, comprehensive income, cash flows and equities for the years ended December 31, 2018, 2017, and 2016, and the related notes to the financial statements, and have issued our report thereon dated April 5, 2019. In accordance with *Government Auditing Standards*, we have also issued a report dated April 5, 2019 on our consideration of the Cooperative's internal control over financial reporting and on our tests of it compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. No reports other than the reports referred to above and our schedule of findings and recommendations related to our audit have been furnished to management.

In connection with our audit, nothing came to our attention that caused us to believe that the Cooperative failed to comply with the terms, covenants, provisions, or conditions of their loan, grant, and security instruments as set forth in 7 CFR Part 1773, *Policy on Audits of Rural Utilities Service Borrowers*, §1773.33 and clarified in the RUS policy memorandum dated February 7, 2014, insofar as they relate to accounting matters as enumerated below. However, our audit was not directed primarily toward obtaining knowledge of noncompliance. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding the Cooperative's noncompliance with the above-referenced terms, covenants, provisions, or conditions of the contractual agreements and regulatory requirements, insofar as they related to accounting matters. In connection with our audit, we noted no matters regarding the Cooperative's accounting and records to indicate that the Cooperative did not:

Maintain adequate and effective accounting procedures;

Utilize adequate and fair methods for accumulating and recording labor, material, and overhead costs, and the distribution of these costs to construction, retirement, and maintenance or other expense accounts;

Reconcile continuing property records to the controlling general ledger plant accounts;

Clear construction accounts and accrue depreciation on completed construction;

Record and properly price the retirement of plant;

Seek approval of the sale, lease or transfer of capital assets and disposition of proceeds for the sale or lease of plant, material, or scrap;

Maintain adequate control over materials and supplies;

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Prepare accurate and timely Financial and Operating Reports;

Obtain written RUS approval to enter into any contract for the management, operations, or maintenance of the borrower's system if the contract covers all or substantially all of the electric system;

Disclose material related party transactions in the financial statements, in accordance with requirements for related parties in generally accepted accounting principles;

Record depreciation in accordance with RUS requirements (See RUS Bulletin 183-1, Depreciation Rates and Procedures);

Comply with the requirements for the detailed schedule of deferred debits and deferred credits; and

Comply with the requirements for the detailed schedule of investments.

This report is intended solely for the information and use of the board of directors, management, and the RUS and supplemental lenders and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Adams, Jenkins & Cheatham

Richmond, Virginia
April 5, 2019