RAPPAHANNOCK ELECTRIC COOPERATIVE

Financial Statements

December 31, 2017 and 2016
Years ended December 31, 2017, 2016 and 2015

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, 2017 and 2016 and the related statements of operations, comprehensive income, cash flows and equities for the years ended December 31, 2017, 2016 and 2015, 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, 2017 and 2016, and the results of its operations, comprehensive income and its cash flows for the years ended December 31, 2017, 2016 and 2015, 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 13, 2018, 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 13, 2018

RAPPAHANNOCK ELECTRIC COOPERATIVE

Balance Sheets

December 31, 2017 and 2016

Assets	**2017**	**2016**
	(In thousands)	
Net utility plant	$ 671,765	$ 657,207
Investments:		
Associated organizations	131,711	126,706
Other	3,146	3,145
Total investments	134,857	129,851
Current assets:		
Cash and cash equivalents	2,703	4,546
Short-term investments	78	22,501
Accounts receivable, less allowance for doubtful accounts	26,790	25,886
Unbilled receivables	21,757	21,144
Materials and supplies inventories	5,435	5,468
Prepaid expenses	4,931	1,465
Other	14,300	7,436
Total current assets	75,994	88,446
Deferred charges:		
Pension costs	13,348	14,526
Other	1,956	1,727
Total deferred charges	15,304	16,253
Total assets	$ 897,920	$ 891,757
Equities and Liabilities		
Equities:		
Patronage capital	$ 391,670	$ 379,767
Accumulated other comprehensive income (loss)	18	(157)
Total equities	391,688	379,610
Long-term debt, excluding current installments	420,852	434,538
Current liabilities:		
Current installments of long-term debt	14,237	13,562
Line of credit	3,200	—
Amounts due to power suppliers	25,331	25,304
Accounts payable	7,514	7,455
Consumer deposits	7,804	7,969
Other	6,866	6,530
Total current liabilities	64,952	60,820
Other noncurrent liabilities:		
Postretirement benefit obligation	1,252	1,508
Deferred credits-other	17,697	13,736
Other	1,479	1,545
Total other noncurrent liabilities	20,428	16,789
Total equities and liabilities	$ 897,920	$ 891,757

See Independent Auditor's Report and Notes to Financial Statements

RAPPAHANNOCK ELECTRIC COOPERATIVE

Statements of Operations

Years ended December 31, 2017, 2016 and 2015

	2017	2016	2015
		(In thousands)	
Operating revenues	$ 373,837	$ 418,165	$ 461,867
Operating expenses:			
Cost of power/cost of goods sold	243,983	290,744	337,007
Transmission	786	877	1,125
Distribution – operations	16,224	15,381	16,112
Distribution – maintenance	24,574	23,460	20,892
Consumer accounts	13,611	12,757	12,950
Consumer service	3,044	2,920	2,854
Sales, administrative, and general	16,666	16,595	15,079
Total	318,888	362,734	406,019
Other expenses:			
Depreciation	30,704	30,470	29,190
Interest on long-term debt	17,572	18,272	17,652
Other	597	1,065	677
Total other expenses	48,873	49,807	47,519
Total expenses	367,761	412,541	453,538
Operating margins	6,076	5,624	8,329
Nonoperating margins:			
Patronage capital assigned	10,000	7,334	5,427
Interest income	592	904	645
Other income, net	1,095	1,113	868
Total nonoperating margins	11,687	9,351	6,940
Net margins	$ 17,763	$ 14,975	$ 15,269

Statements of Comprehensive Income

Years ended December 31, 2017, 2016 and 2015

	2017	2016	2015
		(In thousands)	
Net Margins	$ 17,763	$ 14,975	$ 15,269
Other Comprehensive Income:			
Actuarial change	175	4	19
Amortization of prior service costs	—	4	7
Total other comprehensive income	175	8	26
Comprehensive Income	$ 17,938	$ 14,983	$ 15,295

See Independent Auditor's Report and Notes to Financial Statements

RAPPAHANNOCK ELECTRIC COOPERATIVE

Statements of Cash Flows

Years ended December 31, 2017, 2016 and 2015

	2017	2016	2015
		(In thousands)	
Cash flows from operating activities:			
Net margins	$ 17,763	$ 14,975	$ 15,269
Adjustments:			
Depreciation	30,704	30,470	29,190
Noncash capital credit allocations	(10,151)	(7,334)	(5,427)
Special equipment installation costs	(996)	(909)	(914)
Cushion of credit interest expense applied	10,172	10,524	11,498
Loss on sale of assets	169	27	177
(Increase) decrease in assets:			
Other investments	(1)	31	(6)
Accounts and unbilled receivables	(9,521)	(3,791)	1,775
Other current assets	(2,326)	(23)	(89)
Deferred charges	949	410	2,015
Increase (decrease) in liabilities:			
Accounts payable	86	(2,256)	(3,834)
Other current liabilities	319	413	(334)
Deferred credits	3,962	3,806	1,217
Other noncurrent liabilities	(147)	(76)	(15)
Net cash provided by operating activities	40,982	46,267	50,522
Cash flows from investing activities:			
Extension and replacement of plant	(47,014)	(34,880)	(44,140)
Contributions in aid of construction	4,182	6,352	4,435
Plant removal costs	(1,402)	(9,298)	(4,361)
Retirement of CTC's	47	47	51
Purchases/receipts of investments	(201,266)	(258,533)	(375,680)
Maturities of investments	223,688	275,769	338,975
Net cash used in investing activities	(21,765)	(20,543)	(80,720)
Cash flows from financing activities:			
Net change in memberships	—	(80)	(3)
Net change in consumer deposits	(165)	(790)	87
Proceeds from patronage capital retired	4,948	2,966	1,026
Retirements of patronage capital	(5,860)	(3,062)	(2,867)
Cushion of credit payments	(16,266)	(16,650)	(17,200)
Proceeds from long-term debt	457	—	54,197
Payments on long-tem debt	(7,374)	(7,083)	(6,348)
Proceeds from line of credit	3,200	—	—
Net cash provided by (used in) financing activities	(21,060)	(24,699)	28,892
Net increase (decrease) in cash and cash equivalents	(1,843)	1,025	(1,306)
Cash and cash equivalents, beginning of year	4,546	3,521	4,827
Cash and cash equivalents, end of year	$ 2,703	$ 4,546	$ 3,521
Supplemental disclosure:			
Cash paid for interest	$ 17,668	$ 18,453	$ 17,555

See Independent Auditor's Report and Notes to Financial Statements

RAPPAHANNOCK ELECTRIC COOPERATIVE

Statements of Equities

December 31, 2017 and 2016

		Membership Fees		Patronage Capital		Accumulated Other Comprehensive Income (Loss)		Total
				(In thousands)				
Balance, December 31, 2015	$	80	$	367,854	$	(165)	$	367,769
Net Margins		—		14,975		—		14,975
Retirement of Patronage Capital		—		(3,062)		—		(3,062)
Other Comprehensive Income		—		—		8		8
Net Change in Memberships		(80)		—		—		(80)
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
Net Change in Memberships		—		—		—		—
Balance, December 31, 2017	$	—	$	391,670	$	18	$	391,688

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 $117,546,055 in ODEC as of December 31, 2017, is 28.3% 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.

Provision is made for depreciation of sub-transmission and distribution plant on a straight-line basis using composite rates of 2.75% and 3.05% per annum, respectively, except for water heater switches, Supervisory Control and Data Acquisition (SCADA), and Load Management/Two-Way Automated Control System (TWACS) for which rates of 5.00%, 6.65% and 6.65% per annum, respectively, are being used. The premium of electric plant acquisition adjustment is amortized over 32 years which is the remaining useful life of the assets. Provision is made for depreciation of general plant based on straight-line rates per annum as follows:

Structures and improvements	2.50%
Office furniture and other equipment	6.00%
Transportation equipment (large bucket trucks at 100')	6.25%
Communications equipment	6.50%
Heat pumps	6.67%
Transportation equipment (large bucket trucks under 100')	8.33%
Systems software	10.00%
Transportation equipment	15.50%
Power-operated equipment	16.00%
Servers and other system infrastructure	20.00%
Personal computers	25.00%
Standard laptops	25.00%
Mobile laptops	20.00%

(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 2017 and 2016, the Cooperative earned an average rate of 1.65% and 1.16%, 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, 2017 and 2016, the Cooperative had short-term investments of $78,228 and $22,500,662, 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, 2017 and 2016, the Cooperative had allowances of $864,302 and $1,013,429, 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, 2014 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, 2017 and 2016, the Cooperative had a cumulative over collection of power costs totaling $10,564,220 and $6,980,736, 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, 2017, 2016, and 2015.

(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, 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. As of 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.

(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 13, 2018, 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, 2017 and 2016, consists of the following:

		2017		2016
		(In thousands)		
Distribution	$	822,011	$	810,810
Transmission		37,178		37,087
General		104,288		108,702
Acquisition adjustments		54,324		54,324
Utility plant in service		1,017,801		1,010,923
Construction in progress		48,347		32,851
Total utility plant		1,066,148		1,043,774
Less accumulated amortization and depreciation		394,383		386,567
Net utility plant	$	671,765	$	657,207

(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, 2017 and 2016, investments in associated organizations consist of the following:

		2017		2016
		(In thousands)		
ODEC patronage capital assigned	$	117,546	$	113,119
CFC patronage capital certificates		1,772		1,631
CoBank Class E stock		5,166		4,933
Other		2,907		2,656
Investments in associated organizations		127,391		122,339
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		447		494
Member capital securities		500		500
Capital term certificates and member capital securities		4,320		4,367
Total Investments in Associated Organizations	$	131,711	$	126,706

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 maturing 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 and 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, 2017 and 2016 consists of the following:

		2017		2016
		(In thousands)		
Mortgage notes:				
RUS-				
due 2031 through 2045; (2.50% - 4.50%)	$	257,230	$	263,324
CoBank-				
due 2028 through 2045; (3.06% - 6.85%)		102,793		106,882
CFC-				
due 2018 through 2045; (3.40% - 4.90%)		74,609		77,894
CISCO-				
due 2020; (2.40%)		457		—
Total long-term debt		435,089		448,100
Less current installments		14,237		13,562
Long-term debt, excluding current installments	$	420,852	$	434,538

RUS mortgage note balances include advance payments on cushion of credit of approximately $3,000 and $290,000 at December 31, 2017 and 2016, respectively.

Annual maturities of long-term debt for the five years subsequent to December 31, 2017, and thereafter are approximately $14.2 million in 2018, $14.8 million in 2019, $15.4 million in 2020, $15.8 million in 2021, $16.6 million in 2022 and $358.3 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 43.6% and 42.6% of the total assets at December 31, 2017 and 2016, 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 2.0, 1.8, and 1.9 in 2017, 2016 and 2015, respectively. DSC was 2.1, 2.0, and 2.1 in 2017, 2016 and 2015, 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 2015, the Cooperative obtained new debt of $54 million from RUS and refinanced approximately $25 million and $54 million of RUS debt with CoBank and CFC, respectively. These refinancing agreements were noncash and made directly from CoBank and CFC. There was no new debt obtained during 2017 or 2016.

(Continued)

(b) Lines of Credit

The Cooperative has unsecured line-of-credit agreements with two banks in the amounts of $80 million each. 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. 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. There were zero balances on both lines of credit as of December 31, 2016.

(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, 2017, the Cooperative had approximately $4.8 million of uninsured deposits.

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 70% 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 30% 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, 2017 are as follows:

Year ending December 31:		(In thousands)
2018	$	307
2019		203
2020		183
Thereafter		1
Total minimum lease payments	$	694

Rental expense of $328,145, $162,010 and $163,454 was recognized in 2017, 2016 and 2015, 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 $10,492,411 and $4,417,009 at December 31, 2017 and 2016, 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 2017 and in 2016 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 $6,786,342 and $6,494,697 in 2017 and 2016, respectively. There have been no significant changes that affect the comparability of 2017 and 2016 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, 2017 and over 80 percent funded on January 1, 2016 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 $615,036, $602,775 and $581,253 for the years ended December 31, 2017, 2016 and 2015, 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 $35,000, $86,000 and $107,000, as of December 31, 2017, 2016 and 2015, respectively, and are included in other liabilities. The expense under these agreements amounted to $4,076, $50,557 and $9,362 in 2017, 2016 and 2015, 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 $630,000, $667,000 and $704,000, as of December 31, 2017, 2016 and 2015, respectively, and are included in other liabilities. The expense under these agreements amounted to $35,997, $37,714 and $39,353, in 2017, 2016 and 2015, 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 \$3,251,078. As of December 31, 2017 and 2016, the cash surrender values of these policies were \$978,439 and \$974,834, 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, 2017 and 2016, the balance of the deferred compensation held for the benefit of the directors of the board was \$32,025 and \$144,075, respectively. For the years ended December 31, 2017 and 2016, the balance of the deferred compensation held for the benefit of the key employees was \$352,538 and \$243,133, respectively.

(d) 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 \$153,559, \$189,632 and \$200,561, in 2017, 2016 and 2015, 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, 2017 and 2016:

	2017	2016
	(In thousands)	
Change in benefit obligation:		
Benefit obligation at beginning of year	$ 1,508	$ 1,613
Interest cost	51	62
Actuarial change	(175)	(4)
Medicare Part D subsidy received	22	26
Benefits paid	(154)	(189)
Benefit obligation at end of year	1,252	1,508
Fair value of plan assets at end of year	—	—
Funded status	$ (1,252)	$ (1,508)

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

	2017	2016
	(In thousands)	
Net actuarial gain/(loss)	$ 18	$ (157)
Total	$ 18	$ (157)

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	Estimated Net Benefit Payment
		(In thousands)	
2018	$ 172	$ 21	$ 151
2019	166	20	146
2020	160	19	141
2021	152	18	134
2022	142	17	125
2023-2027	$ 553	$ 65	$ 488

The average discount rate used in determining the accumulated postretirement benefit obligation was 4.00% for 2017 and 2016. 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 $51,306, $66,167 and $74,163 in 2017, 2016 and 2015, respectively. The 2017 expense was based on an estimated medical inflation rate of 8.0% in 2017 and decreasing to 5% by 2024. Estimated amortization amounts in the following year are $0 and $820 at 2017 and 2016, respectively. The measurement date for the actuarial data included above is within reports dated December 31, 2017 and 2016, respectively.

(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 $223,687,591, $272,097,892 and $337,012,565 in 2017, 2016 and 2015, 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 $23,085,439 and $14,976,496 in 2017 and 2016, respectively.

The Cooperative has binding contracts for substation work to be done. The balance of these contract commitments are $4,886,787 as of December 31, 2017.

(10) Related Party Transactions

The Cooperative has long-term loans with both CFC and CoBank at market interest rates. At December 31, 2017, liabilities were $74,609,637 and $102,792,708, respectively. At December 31, 2016, liabilities were $77,894,428 and $106,881,520, 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 2.74% and 3.06% for the years ending December 31, 2017 and 2016, 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, 2017 and 2016 are as follows:

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

2016	Carrying Value	Fair Value
	(In thousands)	
Capital term certificates (CFC)	$ 3,867	$ 5,100
Member capital securities	500	700
Long-term debt	448,100	473,800

(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, 2017 and 2016, and the related statements of operations, comprehensive income, cash flows and equities for the years ended December 31, 2017, 2016 and 2015, and the related notes to the financial statements, and have issued our report thereon dated April 13, 2018.

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.

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 13, 2018.

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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 13, 2018

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, 2017 and 2016, and the related statements of operations, comprehensive income, cash flows and equities for the years ended December 31, 2017, 2016, and 2015, and the related notes to the financial statements, and have issued our report thereon dated April 13, 2018. In accordance with *Government Auditing Standards*, we have also issued a report dated April 13, 2018 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;

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- Maintain adequate control over materials and supplies;
- 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 13, 2018