Southern Maryland Electric Cooperative, Inc.
and SMECO Solar LLC
Financial Statements
December 31, 2013 and 2012

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Financial Statements

Supplementary Information

ADAMS, JENKINS AND CHEATHAM
CERTIFIED PUBLIC ACCOUNTANTS AND BUSINESS CONSULTANTS

Independent Auditor's Report

The Board of Directors
Southern Maryland Electric Cooperative, Inc.
and SMECO Solar LLC

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Southern Maryland Electric Cooperative, Inc. and SMECO Solar LLC ("SMECO") which comprise the balance sheets as of December 31, 2013 and 2012 and the related statements of revenues, expenses and patronage capital and comprehensive income and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated 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 audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to SMECO'S preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of SMECO'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 consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

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Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of SMECO as of December 31, 2013 and 2012, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Other Regulatory Requirements

In accordance with *Government Auditing Standards*, we have also issued our report dated March 16, 2014, on our consideration of SMECO's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our 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* in considering SMECO's internal control over financial reporting and compliance.

Adams, Jenkins & Cheatham

Richmond, Virginia
March 16, 2014

Southern Maryland Electric Cooperative, Inc.
and SMECO Solar LLC
Consolidated Balance Sheets
December 31, 2013 and 2012

	2013	2012
Assets		
Utility Plant, at Original Cost (Notes 2, 3 and 19)	$ 967,303,113	$ 867,087,477
Less: Accumulated Depreciation and Amortization	(310,109,692)	(299,217,682)
Net utility plant	657,193,421	567,869,795
Nonutility Property (net)	1,228,443	1,245,530
Investments (Note 2):		
Investments in associated organizations, at cost (Note 4)	13,375,698	12,927,687
Investment in an unconsolidated entity (Note 5)	1,180,555	1,152,947
Other investments	8,755,037	1,893,104
Total investments	23,311,290	15,973,738
Current Assets (Note 2):		
Cash and cash equivalents	5,292,624	3,428,080
Accounts receivable, net of allowance for doubtful accounts of $1,200,000 and $1,700,000 respectively	59,973,942	48,121,318
Grant receivable (Note 19)	-	5,921,036
Materials and supplies inventory	11,976,698	12,936,169
Prepaid expenses	5,496,995	6,199,087
Current portion of direct financing lease (Note 6)	4,276,896	3,742,527
Other current assets	13,116,670	10,309,340
Total current assets	100,133,825	90,657,557
Noncurrent Portion of Direct Financing Lease (Note 6)	4,887,563	9,164,459
Regulatory Assets (Notes 2 and 7)	87,154,753	68,200,617
Deferred Charges and Other (Note 2)	9,795,246	18,734,389
Total assets	$ 883,704,541	$ 771,846,085
Equities and Liabilities		
Equities (Note 9):		
Patronage capital	$ 197,113,366	$ 180,480,809
Other equities	7,756,615	7,319,199
Accumulated other comprehensive (loss)	(42,883,991)	(67,432,603)
Total equities	161,985,990	120,367,405
Long-Term Debt, Less Current Maturities (Notes 10 and 14)	395,784,690	346,378,365
Current Liabilities:		
Accounts payable	39,971,033	42,374,587
Current maturities of long-term debt (Note 10)	16,924,219	15,964,417
Notes payable (Note 10)	130,500,000	92,051,313
Current portion of obligations under capital lease (Note 11)	2,270,981	1,563,428
Customer deposits	5,938,626	5,581,828
Other current liabilities	13,308,699	13,598,757
Total current liabilities	208,913,558	171,134,330
Accrued Pension and Postretirement Benefits (Note 8)	42,228,015	71,144,444
Noncurrent Portion of Obligations Under Capital Lease (Note 11)	7,630,783	5,855,760
Deferred Credits	5,935,841	8,291,196
Derivative Liabilities (Notes 2 and 15)	61,225,664	48,674,585
Commitments and Contingencies (Notes 12 and 13)	-	-
Total equities and liabilities	$ 883,704,541	$ 771,846,085

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

Southern Maryland Electric Cooperative, Inc.
and SMECO Solar LLC
Consolidated Statements of Revenue, Expenses and Patronage Capital
Years Ended December 31, 2013 and 2012

	2013	2012
Operating Revenue:		
Sales of electricity	$ 438,346,363	$ 403,170,680
Lease income (Note 6)	1,538,359	2,005,961
Other	19,475,805	13,316,654
Total operating revenue	459,360,527	418,493,295
Operating Expenses:		
Purchased power (Note 12)	297,747,235	275,256,422
Power production	177,683	2,167
Transmission	3,893,596	3,684,194
Distribution - operations	9,732,884	8,315,945
Distribution - maintenance	18,466,029	16,829,638
Customer accounts	10,140,122	9,253,741
Customer service and information	15,694,102	11,007,022
Administrative and general	32,859,833	30,078,841
Depreciation and amortization	26,134,423	26,487,914
Taxes	12,152,377	12,589,731
Other	382,440	317,770
Total operating expenses	427,380,724	393,823,385
Operating margins	31,979,803	24,669,910
Interest Expense:		
Interest on long-term debt	16,039,006	16,098,719
Other interest	1,630,428	865,966
Total interest expenses	17,669,434	16,964,685
Net Operating Margins	14,310,369	7,705,225
Other Patronage Allocations	1,763,339	1,398,309
Total operating margins	16,073,708	9,103,534
Nonoperating Margins (Note 18)	1,926,791	3,755,426
Net margins	$ 18,000,499	$ 12,858,960
Patronage Capital, Beginning of Year	$ 180,480,809	$ 170,117,158
Net Margins	18,000,499	12,858,960
Distribution of Capital Credits	(1,367,942)	(2,495,309)
Patronage capital, end of year	$ 197,113,366	$ 180,480,809

Consolidated Statements of Comprehensive Income
Years Ended December 31, 2013 and 2012

	2013	2012
Net Margins	$ 18,000,499	$ 12,858,960
Other Comprehensive Income (Loss):		
Net gain (loss) during period	22,156,985	(23,148,188)
Amortization of net gain	2,391,627	2,913,417
Other comprehensive income (loss)	24,548,612	(20,234,771)
Comprehensive Income (Loss)	$ 42,549,111	$ (7,375,811)

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

Southern Maryland Electric Cooperative, Inc. and SMECO Solar LLC
Consolidated Statements of Cash Flows
Years Ended December 31, 2013 and 2012

	2013	2012
Cash Flows From Operating Activities:		
Net margins	$ 18,000,499	$ 12,858,960
Adjustments to reconcile net margins to net cash provided by operating activities:		
Depreciation and amortization	26,134,423	26,487,914
(Earnings) loss in unconsolidated entities	(27,608)	(13,595)
Other patronage allocations	(1,763,339)	(1,398,309)
Gain on sale of assets	-	(3,066,740)
Change in operating assets and liabilities:		
Accounts receivable, net	(11,852,624)	2,356,372
Prepaid expenses	702,092	(1,651,729)
Other current assets	(2,807,330)	3,726,934
Deferred charges and other	8,939,143	531,267
Regulatory assets	(18,954,136)	(21,421,318)
Accounts payable	(2,403,554)	13,687,083
Customer deposits	356,798	584,731
Other current liabilities	(290,058)	(7,641,518)
Deferred credits	(2,355,355)	(1,331,165)
Derivative liabilities	12,551,079	14,098,902
Accrued pension and postretirement benefits	(4,367,817)	(1,199,378)
Net cash provided by operating activities	21,862,213	36,608,411
Cash Flows From Investing Activities:		
Construction of utility plant	(114,323,767)	(111,544,628)
Plant removal cost	(2,775,500)	(2,713,916)
Proceeds from the salvage of utility plant	804,106	1,457,761
Contributions in aid of construction	3,801,862	3,864,668
Capitalized interest	781,587	494,086
Grants receivable	5,921,036	-
Materials and supplies inventory	959,471	(1,080,265)
Disposition of nonutility property	17,087	(101,130)
Receivable from related party	-	3,210,193
Net change in other investments	(6,861,933)	1,523,269
Net redemption of capital term certificates	51,937	53,183
Net sale of associated investments	1,263,391	1,044,099
Net investment in direct financing lease	3,742,527	3,274,925
Net cash used in investing activities	(106,618,196)	(100,517,755)
Cash Flows From Financing Activities:		
Advances on long-term debt	66,372,000	47,000,000
Payments of long-term debt	(16,005,873)	(15,297,038)
Advances under line of credit agreements	271,839,098	312,364,047
Payments under line of credit agreements	(233,390,411)	(276,012,734)
Obligations under capital lease	(930,526)	(446,612)
Distribution of capital credits	(1,263,761)	(2,178,586)
Net cash provided by financing activities	86,620,527	65,429,077
Net Increase in Cash and Cash Equivalents	1,864,544	1,519,733
Cash and Cash Equivalents, Beginning of Year	3,428,080	1,908,347
Cash and cash equivalents, end of year	$ 5,292,624	$ 3,428,080
Non-cash Investing Activity:		
Capital lease	$ 3,746,337	$ 3,563,420

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

Note 1: Description of Business

Southern Maryland Electric Cooperative, Inc. (SMECO) is an electric distribution cooperative that was initially formed as Southern Maryland Tri-County Cooperative Association on February 5, 1937. In 1942, the members voted to change the form of the organization from an association to a cooperative, nonprofit membership corporation under the Maryland Electric Cooperative Act and adopted the current name. SMECO serves about 157,000 customers in a 1,150 square-mile area in Southern Maryland comprised of Calvert, Charles, Prince George's and St. Mary's counties.

SMECO Solar LLC, a wholly-owned subsidiary that constructed and owns a solar project with a capacity of approximately 5.5 megawatts and can produce nearly 8,700 megawatt-hours of energy annually, was established by SMECO on June 21, 2011. Producing solar renewable energy will help SMECO fulfill its renewable portfolio obligation as required by the state (see Note 2).

Note 2: Summary of Significant Accounting Policies

A. System of Accounts and Regulation - The accounting records are maintained in accordance with the Uniform System of Accounts for Electric Borrowers prescribed by the Rural Utilities Service (RUS). SMECO is subject to regulation by the Maryland Public Service Commission (PSC). The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The consolidated financial statements reflect the ratemaking policies of the PSC in conformity with guidance set forth by the Financial Accounting Standards Board (FASB) as it relates to certain types of regulated industries. This standard allows SMECO to record certain regulatory assets and liabilities, which will be included in future rates and would not be recorded under GAAP for nonregulated entities in the United States (see Note 7).

If portions of SMECO's operations no longer become subject to the provisions as set forth by FASB, a write-off of any related regulatory assets or liabilities would be required unless some form of transition cost recovery continues through rates established and collected for the remaining regulated operations. In addition, a determination of any impairment to the carrying costs of deregulated plant and inventory assets would be required.

B. Consolidation - The consolidated financial statements include the accounts and results of operations of SMECO and its wholly-owned subsidiary. All significant intercompany transactions have been eliminated in consolidation.

C. Estimates - The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of revenues, expenses, assets, liabilities and disclosure of contingencies as of the date of the consolidated financial statements. Actual results could differ from those estimates and assumptions.

D. Utility Plant - Utility plant is stated at cost which includes the cost of labor, material and applicable indirect costs. When a retirement unit of property is replaced or removed, the cost of such property is deducted from utility plant and such cost, together with the cost of removal less salvage, is charged to accumulated depreciation. Expenditures for additions and replacements that are not considered units of property, as well as routine repairs and maintenance, are expensed as incurred.

SMECO periodically evaluates long-lived assets such as utility plant when events or changes in circumstances indicate that the carrying value of these assets may not be recoverable. The determination of whether impairment has occurred is based on an estimate of undiscounted cash flows attributable to these assets, as compared to the carrying value of the assets.

E. Depreciation - For financial reporting purposes, depreciation is computed on a straight-line composite basis using the estimated useful service lives of the depreciable property.

F. Investments - The investment in an unconsolidated entity is accounted for under the equity method. SMECO records its proportionate share of equity in earnings or loss of the unconsolidated entity in the Statements of Revenue, Expenses and Patronage Capital under Nonoperating Margins (see Note 5).

G. Cash and Cash Equivalents - Cash and cash equivalents are considered to be highly liquid investments with an original maturity of three months or less.

H. Accounts Receivable - Credit is extended to customers for electric service received as customers are billed on a monthly basis after the service is rendered and the electric meter is read. These readings occur as nearly as practicable every 30 days. Bills are payable within 20 days of rendering. If not paid timely, late payment charges may be applied. In compliance with the rules and regulations of the PSC, SMECO may require both residential and nonresidential customers to make and maintain cash deposits to secure the payment of final bills. The allowance for doubtful accounts is calculated as a percentage of sales. Accounts are reviewed periodically to determine collectability. Bad debts are written off automatically throughout the year after one year of nonpayment.

I. Materials and Supplies Inventory - Materials and supplies inventory is generally used for construction or maintenance of operations. Inventory is recorded using the lower of market or average cost and issued items are charged to construction or operations at the recorded average cost.

J. Derivative Instruments - SMECO uses various methods to manage the commodity and financial risks associated with meeting its power supply requirements, such as forward purchase contracts, option contracts, financial swaps and commodity swaps. SMECO accounts for the aforementioned contracts in accordance with guidance as set forth by FASB as it relates to derivative instruments and hedging activities, which requires all derivatives, subject to certain exceptions, to be accounted for at fair value. According to FASB guidance, the majority of SMECO's forward purchase contracts and option contracts qualify for the normal purchase and normal sales exception. As a result, these contracts are not recorded at fair value. Since all of SMECO's power supply related costs are subject to rate recovery, changes in the fair value of financial and commodity swaps are periodically reflected as derivative assets and regulatory liabilities or derivative liabilities and regulatory assets, respectively, under the provisions as set forth by FASB (see Note 2A). As of December 31, 2013, the fair value of SMECO's derivative instruments, excluding contracts accounted for as normal purchase/normal sale were as follows:

Derivatives	Balance Sheet Location	Fair Value
Financial Gas	Regulatory assets and Derivative liabilities	$ (7,202,861)
Financial Energy	Regulatory assets and Derivative liabilities	(52,545,972)
Financial Transmission Rights	Regulatory assets and Derivative liabilities	(1,476,831)
Total		$ (61,225,664)

At December 31, 2013, total derivative contracts in a gross asset and gross liability position amounted to approximately $1.0 million and $62.2 million, respectively.

As of December 31, 2012, the fair value of SMECO's derivative instruments, excluding contracts accounted for as normal purchase/normal sale were as follows:

Derivatives	Balance Sheet Location	Fair Value
Financial Gas	Regulatory assets and Derivative liabilities	$ (15,160)
Financial Energy	Regulatory assets and Derivative liabilities	(46,917,663)
Financial Transmission Rights	Regulatory assets and Derivative liabilities	(1,741,762)
Total		$ (48,674,585)

At December 31, 2012, total derivative contracts in a gross asset and gross liability position amounted to approximately $440,000 and $49,114,000, respectively.

Net gains and losses on financial and commodity swaps and Financial Transmission Rights are reflected in cost of power at the time they are settled. For the year ended December 31, 2013, the realized loss on these transactions was as follows:

Derivatives	Realized Loss Recognized in Purchased Power
Financial Gas	$ -
Financial Energy	(1,705,926)
Financial Transmission Rights	(2,331,110)
Total	$ (4,037,036)

For the year ended December 31, 2012, the realized loss on these transactions was as follows:

Derivatives	Realized Loss Recognized in Purchased Power
Financial Gas	$ (4,685,354)
Financial Energy	(4,910,315)
Financial Transmission Rights	(5,699,971)
Total	$ (15,295,640)

As of December 31, 2013 and 2012, SMECO had entered into commitments for options totaling $900,000 and $16.5 million, respectively.

K. Deferred Charges - Costs of preliminary surveys and studies made for the purpose of determining the feasibility of proposed utility projects are recorded as deferred charges. If a project is constructed, such costs are capitalized as part of the cost of the facility. If the plans for a project are subsequently abandoned, the costs are expensed.

L. Revenue Recognition - Revenue is recognized as service is rendered to customers. Recorded revenue includes an estimate of unbilled revenue for utility service rendered but not billed to customers as of year-end. Estimated unbilled revenue was approximately $18.7 million and $15.9 million as of December 31, 2013 and 2012, respectively.

M. Income Taxes - As a not-for-profit, membership cooperative under Section 501(c)(12) of the Internal Revenue Code, SMECO is exempt from federal income taxes. Pursuant to the Maryland Electric Cooperative Act, SMECO is also exempt from state income taxes. Accordingly, no provision for such taxes has been made in the accompanying financial statements.

Certain income earned from other unrelated products and services may require SMECO to pay federal and state income taxes. Should this situation arise, the necessary provisions for income tax liability will be recorded in the consolidated financial statements.

The tax years from 2010 to 2012 remain subject to examination by the taxing authorities.

SMECO Solar LLC is taxed as a corporation and is subject to federal and state income taxes. Deferred tax assets and liabilities are recognized for the expected tax consequences of temporary differences arising between the tax bases of assets and liabilities and their reported amounts in accordance with GAAP. At December 31, 2013 and 2012, there were no deferred tax assets and liabilities reported on the consolidated balance sheets.

N. Accumulated Other Comprehensive Income - This item consists of other gains and losses affecting equity that, under GAAP, are excluded from net income. During 2013 and 2012, such items relate to SMECO's unrecognized actuarial loss and amortization from the adoption of guidance issued by FASB as it relates to the accounting for defined benefit pension and other postretirement plans.

O. Subsequent Events - Subsequent events have been evaluated through March 16, 2014, which is the date the consolidated financial statements were available to be issued.

P. Advertising Costs - Advertising costs are expensed as incurred.

Note 3: Utility Plant

The major classes of utility plant in service as of December 31, 2013 and 2012 are as follows:

	2013	2012
Distribution	$551,527,486	$532,059,631
Transmission	209,581,880	153,519,515
Generation	14,213,730	14,161,685
General	145,241,190	81,573,501
	920,564,286	781,314,332
Construction work in progress	46,738,827	85,773,145
	967,303,113	867,087,477
Less: Accumulated depreciation and amortization	(310,109,692)	(299,217,682)
Net utility plant	$657,193,421	$567,869,795

The provision for depreciation, stated as a percentage of the average balance of related properties, approximated the following percentages during 2013 and 2012:

	2013	2012
Distribution	3.42%	3.63%
Transmission	2.93%	2.79%
General	2.46%-10.54%	2.46%-10.54%
Composite rate	3.29%	4.19%
Generation	5.00%	5.00%

SMECO follows the regulatory principle of intergenerational cost allocation by including net salvage (gross salvage less costs of removal) as a component of depreciation rates. Net salvage is a “non-legal asset retirement obligation,” and as such is not subject to the accounting requirements issued by FASB as it relates to accounting for asset retirement obligations and Federal Energy Regulatory Commission (FERC) Order 631 (as adopted by RUS). SMECO has no legal asset retirement obligations as that term is defined by FASB guidance and FERC Order 631.

In accordance with the reporting requirements of FASB’s guidance on asset retirement obligations and FERC Order 631, SMECO’s accumulated provision for depreciation included a net salvage timing difference of approximately $3.6 million and $4.1 million for the years ended December 31, 2013 and 2012, respectively. This represents the differences in the timing of recognition of the period costs associated with net salvage.

SMECO capitalizes interest cost incurred on funds used to construct utility plant. The capitalized interest is recorded as part of the asset to which it relates and is amortized over the asset’s estimated useful life.

Note 4: Investments in Associated Organizations

Investments in associated organizations, which are recorded at cost (see Note 14), consisted of the following as of December 31, 2013 and 2012:

	2013	2012
National Rural Utilities Cooperative Finance Corporation (CFC):		
Capital Term Certificates		
3%	$ 1,000,650	$ 1,000,650
5%	3,164,783	3,164,783
8.55%	1,516,525	1,516,525
Noninterest bearing	340,042	391,979
Member capital securities	1,000,000	1,000,000
Patronage capital certificates	1,568,856	1,515,908
CFC membership	1,000	1,000
	8,591,856	8,590,845
Federated Rural Electric Insurance Corporation	685,675	604,903
CoBank, ACB (CoBank)	3,872,903	3,504,913
Other	225,264	227,026
	$13,375,698	$12,927,687

Note 5: Equity Method Investments

Effective August 1, 2003, SMECO invested $1,000,000 for a membership and equity investment in Alliance for Cooperative Energy Services Power Marketing, LLC (subsequently renamed ACES). Organized in 1999 and currently comprised of 21 members, ACES provides a number of power supply related professional services including, among others, acting as agent for its members in the procurement and sale of wholesale power supply (see Notes 12 and 13). SMECO’s proportionate share of ACES earnings was $27,608 in 2013 and $13,595 in 2012. As of December 31, 2013 and 2012, the carrying value of the investment was $1,180,555 and $1,152,947 respectively.

Note 6: Net Investment in Facility Capacity Credit Agreement

Pursuant to the Facility and Capacity Credit Agreement (FCC Agreement) entered into with Potomac Electric Power Company (Pepco) in March 1989, SMECO constructed a 77-megawatt combustion turbine generating unit at Pepco’s then-owned Chalk Point Generating Station in Aquasco, Maryland. This facility was placed in commercial operation on December 1, 1990. As part of the FCC Agreement, in exchange for electric capacity and generated energy from the facility, Pepco is obligated to operate and maintain the facility for a period of 25 years, commencing December 1990.

In accordance with SMECO’s concurrence under the Agreement and Consent executed in December 2000, Pepco assigned its rights and obligations under the FCC Agreement to Southern Energy, Inc. (subsequently renamed Mirant Corporation (Mirant)), a Delaware corporation. Mirant subsequently assigned the FCC Agreement to one of its subsidiaries, Mirant Peaker, LLC, which subsequently merged into another Mirant subsidiary, Mirant Chalk Point, LLC. In

December 2010, Mirant merged with RRI Energy, creating GenOn Energy, Inc. (GenOn), in connection with which Mirant Chalk Point, LLC changed its name to GenOn Chalk Point, LLC. The agreement permits GenOn Chalk Point, LLC to operate, dispatch and receive all electricity generated from the facility. GenOn Chalk Point, LLC is now responsible for all costs associated with operating and maintaining the combustion turbine during the remaining term of the FCC Agreement. On December 14, 2012, NRG Energy, Inc. (NRG) acquired all of the ownership interests of GenOn and, accordingly, NRG is now the ultimate corporate parent of GenOn Chalk Point, LLC.

The FCC Agreement is accounted for as a direct financing lease. The current monthly payment is $437,510.

The following sets forth the components of the net investment in the FCC Agreement as of December 31, 2013 and 2012:

	2013	2012
Total minimum FCC payments receivable	$10,062,730	$15,312,850
Estimated residual value of FCC property	-	-
Gross investment in FCC	10,062,730	15,312,850
Less: Unearned income	(898,271)	(2,405,864)
Net investment in FCC Agreement	$ 9,164,459	$12,906,986
Current portion	$ 4,276,896	$ 3,742,527
Noncurrent portion	4,887,563	9,164,459
Net investment in FCC Agreement	$ 9,164,459	$12,906,986

Future minimum FCC receivables due under this direct financing lease as of December 31, 2013 are as follows:

2014	$ 5,250,120
2015	4,812,610
Total	$10,062,730

Note 7: Regulatory Assets

Regulatory assets consisted of the following:

A. Demand Response (DR) and EmPOWER Maryland Programs - Conservation expenditures pertaining to DR and EmPOWER Maryland programs are recognized as regulatory assets and amortized over a one-year or five-year period in accordance with PSC requirements. Conservation costs are recovered through a rate surcharge approved by the PSC that reflects expenditures and an allowed rate of return. The related amounts of regulatory assets for the DR and EmPOWER Maryland programs were $21,311,620 and $16,394,058 as of December 31, 2013 and 2012, respectively.

B. Advanced Metering Infrastructure (AMI) Implementation - Pursuant to PSC approval, a regulatory asset was established for the costs associated with an AMI staged implementation to determine whether the deployment of AMI in SMECO's service territory would achieve the operational savings anticipated. In 2013, the PSC approved the system-wide deployment of AMI and a regulatory asset was established. As of December 31, 2013 and 2012, the regulatory assets for these projects totaled $4,617,469 and $3,131,974, respectively.

C. Energy and Energy-Related Costs - As of December 31, 2013 and 2012, the regulatory asset pertaining to energy and energy-related costs was $61,225,664 and $48,674,585, respectively (see Note 2).

Note 8: Employee Benefit Plans

A. Pension Plan and Other Postretirement Benefits - SMECO has a qualified, noncontributory, defined benefit pension plan which provides for retirement benefits based upon age, years of service and compensation. The Retirement Annuity Plan for Employees of SMECO was closed effective December 31, 2006, so that employees who were hired or re-hired on or after January 1, 2007, were not eligible to participate (or recommence participation) in the Pension Plan. SMECO continued to maintain the Pension Plan for current employees through December 31, 2010 at which time the Plan was frozen. The net effect was that a participant's benefits under the Pension Plan were calculated as if the participant terminated employment with SMECO on December 31, 2010. As a result of this curtailment, SMECO requested a deferral as available under FASB's regulatory accounting treatment to amortize the prior service costs (benefit cost) of $4.7 million, over an eight-year period. Annual provisions for accrued pension costs are based upon independent actuarial valuations dated as of December 31, 2013 and 2012. SMECO's policy is to fund accrued pension costs in accordance with provisions of the Employee Retirement Income Security Act of 1974 (ERISA). Effective with the 2013 fiscal year, the amortization period has changed from the average expected future working lifetime of active participants to the average life expectancy of all plan participants.

SMECO provides additional retirement benefits to certain employees under a nonqualified plan established in accordance with Section 457 of the Internal Revenue Code. The periodic plan expenses are based on the present value of the retirement benefits earned during the year.

SMECO supplements health care insurance premiums for retirees and covered dependents through their inclusion in the same insurance coverage pool as active employees. The expected cost of these benefits under the unfunded plan is recognized during the years in which employees render service.

The following sets forth the obligations, funded status and periodic costs for the plans and the actuarial assumptions used:

	Pension Benefits	
	2013	2012
Benefit obligation at year end	$124,768,526	$140,042,749
Fair value of plan assets at year end	102,297,066	86,677,351
Funded status	$(22,471,460)	$(53,365,398)

	2013	2012
Amounts recognized in the Balance Sheets:		
Accrued benefit cost	$(22,471,460)	$(53,365,398)
Accumulated other comprehensive loss	35,916,433	60,317,165
Deferred charges	2,367,506	2,604,257
Weighted-average assumptions used to determine benefit obligations as of year end:		
Discount rate	5.50%	4.50%
Benefit cost	$ 1,549,475	$ 2,910,850
Employer contribution	7,804,696	5,216,172
Benefits paid	6,582,233	6,341,372
Weighted-average assumptions used to determine benefit costs:		
Discount rate	4.50%	5.75%
Expected return on plan assets	8.00%	8.00%

Expected contributions for year ending December 31, 2014:	
Employer	$ 4,923,907
Employees	-
Estimated future benefit payments reflecting expected future service for years ending December 31:	
2014	$ 6,608,007
2015	6,855,270
2016	7,118,781
2017	7,324,754
2018	7,461,169
2019-2023	40,994,914
Estimated Loss Amortization for Next Fiscal Year	$ 1,112,950

	2013	2012
Plan Assets:		
Equity Securities (a) (c)	58%	53%
Fixed Income Securities (b) (c)	42%	47%

(a) The portfolio's target asset allocation range is 50% equity with an allowable range of 30% to 60%.
(b) The portfolio's target asset allocation range is 50% fixed income with an allowable range of 30% to 60%.
(c) The portfolio's target asset allocation also allows for up to 20% in cash.

SMECO's investment strategy with respect to pension assets is designed to achieve a moderate level of overall portfolio risk in keeping with its desired risk objective, which is established after careful consideration of plan liabilities, plan funded status and SMECO's overall financial condition. The portfolio's target asset allocation is 50% equity and 50% fixed income with specified allowable ranges around these targets. The equity segment is broadly diversified across growth/value and small-, mid- and large-cap equities. The fixed income segment is diversified by investing in preferred stocks, corporate debt securities and obligations of the U.S. Government and its agencies.

SMECO also sponsors a defined benefit postretirement medical insurance plan that covers substantially all collectively bargained and management employees and their dependents. Employees who reach the age of 55 with 10 years of service (provided active coverage was elected before retirement), become eligible to receive benefits. Participants under the age of 65 are eligible for the PPO Plan or HDHP/HSA Plan and participants of the age 65 and older are eligible for the Medicare Supplemental Plan. The following sets forth the funded status of the Plan reconciled with amounts reported in the balance sheets:

	Other Postretirement Benefits	
	2013	2012
Benefit obligation at year end	$ 19,756,555	$ 17,779,046
Fair value of plan assets at year end	-	-
Funded status	$(19,756,555)	$(17,779,046)
Amounts recognized in the Balance Sheets:		
Accrued benefit cost	$(19,756,555)	$(17,779,046)
Accumulated other comprehensive loss	6,967,558	7,115,438
Deferred charges	312,238	549,215
Weighted-average assumptions used to determine benefit obligations as of year end:		
Discount rate	5.50%	4.50%
Benefit cost	$ 2,617,360	$ 1,686,579
Employer contribution	254,994	263,706
Benefits paid	254,994	263,706
Weighted-average assumptions used to determine benefit costs:		
Discount rate	4.50%	5.75%

Expected contributions for year ending December 31, 2014:	
Employer	$ 560,878
Employees	-
Estimated future benefit payments reflecting expected future service for years ending December 31:	
2014	$ 560,878
2015	633,674
2016	732,611
2017	820,947
2018	913,568
2019-2023	5,474,669
Estimated Amortization for: Next Fiscal Year	$ 574,496

For measurement purposes, a 7.0% annual rate of increase in per capita cost of covered health care benefits was assumed for 2014. The rate is assumed to decrease gradually to 4.5% to 2019 and remain at that level thereafter. A 7.0% annual rate of increase in employee premiums was assumed for 2014. This rate is assumed to gradually decrease to 4.5% to 2019 and remain at that level thereafter.

On December 8, 2003, the President signed into law the Medicare Prescription Drug Improvement and Modernization Act of 2003. This Act introduces a prescription drug benefit under Medicare Part D as well as a federal subsidy to sponsors of retiree healthcare benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. SMECO has not, and does not intend to, apply for this subsidy.

B. Health Insurance - SMECO is self-insured for medical and dental claims of its current employees and retirees and their covered dependents. SMECO is liable for claims of up to $150,000 per occurrence for medical claims and $2,000 per year per participant for dental claims. Catastrophic coverage is maintained to pay claims in excess of these amounts. Claims paid under this plan approximated $6.2 million in 2013 and $6.0 million in 2012. Provisions for claims incurred but not reported have been made based on claim experience and approximated $462,000 and $433,000 as of December 31, 2013 and 2012, respectively.

C. 401(k) Plans - SMECO maintains 401(k) plans for its management and bargaining unit employees. All full-time employees are eligible to participate in the plans after meeting minimum service requirements. SMECO matches employee contributions to the management plan up to 6% of annual compensation. SMECO contributed a non-elective, 3% contribution for all eligible employees for 2010. Effective with the freeze of the Pension Plan (see Note 8A), the amount of SMECO's non-elective employer contribution for compensation earned on or after January 1, 2011, varies based on length of service. For employees with 0 - 4 years of service, the contribution will be 3% of base pay; 5 - 20 years of service, 7% of base pay; and more than 20 years of service, 9% of base pay. During 2013 and 2012, SMECO recorded 401(k) plan-related expenses of approximately $3.3 million and $3.1 million, respectively.

D. Workers' Compensation Trust - SMECO is self-insured for workers' compensation insurance through a separate trust which was established to pay workers' compensation claims. Contributions to the trust are based upon an actuarial valuation and SMECO maintains excess liability insurance coverage of up to $2 million per incident for claims exceeding the net assets available for benefits in the trust. Transactions within the trust are not reflected in the accompanying consolidated financial statements. During 2013 and 2012, SMECO made aggregated contributions to the trust of $490,000 and $455,000, respectively. At December 31, 2013 and 2012, the trust had estimated net assets available for benefits of ($32,984) and ($191,015), respectively.

Note 9: Patronage Capital and Other Equities

Assigned patronage capital consists of net margins that have been allocated to individual member patronage accounts. Patronage capital is applied against unpaid accounts receivable when customers leave SMECO. Patronage capital retirements to date represent amounts that have been paid to individual members. Patronage capital activity as of December 31, 2013 and 2012 consisted of the following:

	2013	2012
Assignable	$ 18,002,711	$ 12,849,331
Assigned to date	265,313,116	252,465,997
	283,315,827	265,315,328
Less: Retirements to date	(86,202,461)	(84,834,519)
Patronage capital	$197,113,366	$180,480,809

Other equities consist of donated capital from members and nonrefundable membership fees that were previously collected from new members upon joining SMECO.

Note 10: Long-Term Debt

SMECO has obtained long-term debt from RUS; CFC; CoBank; National Cooperative Services Corporation (NCSC), a wholly-owned subsidiary of CFC; and Federal Financing Bank (FFB). SMECO is subject to various loan covenants under its master mortgage and substantially all assets are pledged as collateral for the long-term debt. The covenants include maintaining certain minimum debt service and equity to assets ratio requirements. SMECO Solar LLC has obtained long-term debt from FFB, which has been guaranteed by SMECO. The following debt was outstanding as of December 31, 2013 and 2012:

Lender	Interest Rates	Maturity (Year)	2013	2012
RUS	3.44-5.19%	2034-41	$117,157,280	$119,447,786
CFC	3.35-9.50%	2014-30	19,289,738	21,876,434
CoBank	2.85-6.44%	2017-40	74,187,106	79,817,513
NCSC	7.25%	2015	6,459,950	9,358,045
FFB	2.34-8.07%	2025-46	195,614,835	131,843,004
Total debt outstanding			412,708,909	362,342,782
Less: Current maturities			16,924,219	15,964,417
Long-term debt			$395,784,690	$346,378,365

At December 31, 2013, the required principal payments of the long-term debt are as follows:

2014	$ 16,924,219
2015	18,372,284
2016	13,344,458
2017	14,268,567
2018	14,985,666
Thereafter	334,813,715
Total	$412,708,909

Cash paid for interest totaled approximately $18.4 million and $17.0 million for the years ended December 31, 2013 and 2012, respectively. Unadvanced loan funds totaled $40.7 million and $92.5 million as of December 31, 2013 and 2012, respectively.

Effective October 2013, SMECO authorized the repricing with CFC for a loan with an outstanding balance of $5.5 million at a rate of 3.65% for four years.

SMECO maintains unsecured revolving line of credit agreements at variable interest rates with CoBank and CFC for its short-term borrowing needs. The CoBank agreement expires June 30, 2014. The CFC agreement automatically renews each March unless CFC or SMECO provides written notice not to renew at least 90 days in advance of the renewal date.

As of December 31, 2013, SMECO had authorized lines of credit of $100 million with CFC and $85 million with CoBank. Pursuant to limitations on total unsecured debt of $150 million, amounts borrowed from either CFC or CoBank may reduce the amounts available from the other party. SMECO received a temporary waiver on limitations of unsecured debt of $150 million until December 31, 2015.

As of December 31, 2013 and 2012, SMECO had outstanding letters of credit totaling $17.7 million and $31.3 million, respectively.

The outstanding balances for CoBank lines of credit and their respective interest rates as of December 31, 2013 were $45.0 million at 1.76% and $25.0 million at 2.73% and for 2012 were $45.0 million at 1.86% and $26.0 million at 2.76%. The outstanding balances for CFC lines of credit and their respective interest rates as of December 31, 2013 were $60.5 million at 2.9% and as of December 31, 2012 were $6.3 million at 2.9% and $14.8 million at variable interest rates ranging from 2.04% - 2.30%.

Note 11: Leases

SMECO is obligated under long-term capital leases for utility equipment, office furniture and equipment and vehicles that expire at various dates through 2023. The future minimum lease payments required under the capital leases and the present value of the net minimum lease payments as of December 31, 2013, are as follows:

2014	$ 2,525,354
2015	2,499,209
2016	1,933,295
2017	1,709,901
2018	1,255,063
Thereafter	1,866,883
Total minimum lease payments	11,789,705
Less: Amount representing interest	(1,887,941)
Present value of minimum lease payments	9,901,764
Less: Current obligations	(2,270,981)
Long-term capital lease obligation	$ 7,630,783

The assets under capital leases are included in the consolidated balance sheets as part of net utility plant as follows:

	2013	2012
Distribution	$ 7,551,930	$5,251,580
General	5,009,407	3,563,420
	12,561,337	8,815,000
Less: Accumulated depreciation	(1,038,390)	(578,834)
	$11,522,947	$8,236,166

Interest paid on the capital lease obligations for the years ended December 31, 2013 and 2012 was $310,180 and $174,738, respectively. The capital leases are collateralized by the assets leased under the agreements, which are recorded in the accompanying consolidated balance sheet. Depreciation expense at December 31, 2013 and 2012 relating to these assets was $459,556 and $192,733, respectively.

SMECO leases many of its vehicles and power-operated equipment for various terms under long-term, operating lease agreements. The leases expire at various dates through 2018. At the expiration of the scheduled lease term, SMECO can either purchase the equipment at fair market value, have the lessor sell the equipment on its behalf or renew the lease for twelve or twenty-four months. Operating lease expense amounted to $1,882,175 and $1,522,280 in 2013 and 2012, respectively.

The future minimum rental payments required under the operating lease agreements as of December 31, 2013, are as follows:

2014	$1,645,112
2015	1,323,108
2016	863,081
2017	461,742
2018	69,433
Total	$4,362,476

Pursuant to a 50-year operating lease, SMECO is obligated to rent the parcel of land on which SMECO's combustion turbine is located at the Chalk Point Generating Station (see Note 6). SMECO makes annual rental payments of $5,000 under the lease agreement that expires in 2039.

Note 12: Commitments and Contingencies

SMECO contracts with various suppliers for energy and energy-related products to serve its native load requirements. As of December 31, 2013, SMECO had forward purchase commitments with multiple parties through December 2032 covering a significant portion of SMECO's power supply needs.

At December 31, 2013 and 2012, SMECO had made commitments for capital expenditures of approximately $38.9 million and $34.3 million, respectively.

SMECO is involved in legal proceedings in the normal course of business. Management is of the opinion that the final disposition of these proceedings will not have a material adverse effect on SMECO's financial position, results of operations or cash flows.

Note 13: Concentration of Risk

The electric utility industry continues to be subject to increasing competitive pressures, consolidation and restructuring. Federal and state legislatures and regulators, including the United States Congress, Maryland General Assembly and PSC, and large industrial electricity consumers are working to reshape the industry through legislative and regulatory initiatives that increase electric competition at the generation, transmission and distribution levels.

In 1999, Maryland enacted the Electric Customer Choice and Competition Act and the Electric and Gas Utility Tax Reform Act. Under Maryland law, electric customers residing in Maryland are entitled to select or choose their electric energy supplier, the company that generates or supplies the commodity of electricity. The law required electric cooperatives to offer this choice on or before July 1, 2003. In accordance with that law and a settlement approved by the PSC, SMECO elected to begin offering customer choice in 2001. Under customer choice, SMECO provides "standard offer service" for customers who do not select an alternative electricity supplier. SMECO continues to provide distribution service to all of its customers. Only a very limited number of customers have elected to be served by an alternative electricity supplier in

SMECO's service territory. As of December 31, 2013, SMECO had 2,994 customers served by an alternative electricity supplier.

The outcome of these initiatives and their impact on SMECO is uncertain. Customer choice and the resulting retail competition will likely continue to affect the entire industry.

With the assistance of ACES (see Notes 5 and 12), SMECO has developed a more diversified market strategy to meet future power supply needs, including reduced dependence on a single supplier and varied contract termination dates. This approach represents a significant departure from the traditional cooperative model of multiple year contracts with a sole supplier. Given the changes in the wholesale power market in recent years, SMECO has concluded that it is no longer operationally or economically prudent to engage in the traditional full-requirements contract with one supplier.

In order to meet its power supply requirements for its standard offer service customers, SMECO has executed numerous Master Power Purchase and Sale Agreements with a number of counterparties. Such agreements stipulate credit limits and other information pertaining to the establishment of trading relationships. Accordingly, SMECO is subject to the normal market, credit and performance risks inherent in these arrangements. To monitor and mitigate such risk exposure, SMECO continues to work closely with ACES personnel, has created and implemented related trading and credit policies and has established Board and internal risk oversight committees that meet frequently to address pertinent matters.

Financial instruments that subject SMECO to concentration of credit risks include customer accounts receivable and the RUS loan programs. All of SMECO's depository accounts are in institutions insured by the Federal Deposit Insurance Corporation. SMECO grants credit to customers, substantially all of whom are local residents of SMECO's four-county service area. SMECO currently obtains 100% of its new debt under the RUS loan program. The RUS loan program is subject to federal legislative changes which could affect the interest rates and availability of future loans under the program. SMECO's current unadvanced loan funds are available through FFB and the loan is guaranteed by RUS.

Note 14: Fair Value of Financial Instruments

SMECO has accounted for all financial instruments, classified as derivatives, at fair market value. SMECO has accounted for all other financial instruments based on the carrying amount (book value) in the financial statements in accordance with GAAP. According to guidance set forth by FASB, SMECO is required to disclose the fair value of those 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.

Cash and Cash Equivalents

The carrying amount of cash and cash equivalents approximates fair value due to the short maturity of these instruments.

Accounts Receivable

The carrying amount of accounts receivable approximates fair value due to the short period of time amounts are outstanding.

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 long-term treasury rate of 3.96% and 2.95% as of December 31, 2013 and 2012, respectively. The fair value of patronage capital is not determinable since no legal obligation exists to retire capital credits. The fair value of the equity method investment is 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.

Accounts Payable

The carrying amount of accounts payable approximates fair value due to the short period of time amounts are outstanding.

Long-Term Debt

The carrying amount of SMECO's fixed long-term debt includes certain interest rates that are below quoted market prices for the same or similar issues. Therefore, the fair value of fixed long-term debt is estimated based on current market prices for the same or similar issues offered for debt of the same and remaining maturities which was 6.50% and 5.55% as of December 31, 2013 and 2012, respectively.

The carrying amount of lines of credit approximates fair value due to the short maturity of these instruments.

Consumer Deposits

The carrying amount approximates fair value due to the relatively short maturity of the deposits.

The estimated fair value of SMECO's financial instruments, reported at cost, is as follows:

	Carrying Value		Fair Value	
	2013	2012	2013	2012
	(000 Omitted)		(000 Omitted)	
Assets:				
Capital Term Certificates	$ 7,022	$ 7,074	$ 8,605	$ 10,256
Liabilities:				
Long-term Debt	(412,709)	(362,343)	(343,846)	(351,509)

Note 15: Fair Value Measurements

SMECO follows the guidance issued by FASB as it relates to the accounting and disclosure requirements for financial instruments reported as assets and liabilities at fair value. This guidance also establishes a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability. Inputs may be observable or unobservable and refer broadly to the assumptions that market participants would use in pricing the asset or liability. Observable inputs reflect the assumptions market participants would use in pricing the asset or liability based on market data obtained from sources independent of the reporting entity. Unobservable inputs reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

The three levels of the fair value hierarchy are described as follows:

Level 1 - Quoted prices in active markets for identical assets or liabilities.

Level 2 - Other significant observable inputs, including quoted prices for similar assets or liabilities in markets that are not active.

Level 3 - Significant unobservable inputs, which are generally based on SMECO's own assumptions.

The following table summarizes the financial liabilities measured at fair value:

	December 31, 2013 (000 Omitted)			
	Total	Level 1	Level 2	Level 3
Derivative Liabilities, net	($61,226)	$ -	($61,226)	$ -

	December 31, 2012 (000 Omitted)			
	Total	Level 1	Level 2	Level 3
Derivative Liabilities, net	($48,675)	$ -	($48,675)	$ -

The fair value of derivative liabilities is comprised of forward trades, power positions and Financial Transmission Rights (FTRs). The fair value of all forward trades is calculated by a third party, ACES, using market prices when possible and modeled forward prices including supply-demand simulation generated values, inflation escalated market prices, or a blend of these sources when market prices are not available. The power positions are valued at PJM West, and the gas positions are valued using NYMEX Henry Hub pricing. FTRs are marked-to-market based on data from the most recent FTR auction.

Note 16: Related Party Transactions

SMECO is a member of CFC, NCSC and CoBank. Pursuant to the member relationships, SMECO has invested in CFC and CoBank, entered into various loan agreements with the three organizations and maintains unsecured lines of credit with CFC and CoBank (see Notes 4 and 10). SMECO earned interest income of about $392,600 and $393,100 in 2013 and 2012, respectively, on investments with CFC. During years 2013 and 2012, SMECO paid interest expense of approximately $7.4 million and $6.5 million, respectively, on aggregated loans from CFC, NCSC and CoBank.

As a customer, NRG is a member of SMECO. SMECO has entered into a direct financing lease with NRG (see Note 6).

SMECO invested in and became a member of ACES during 2003 to engage ACES' professional assistance in meeting future power supply needs (see Note 5). In addition to the membership fee, SMECO paid ACES approximately $978,000 and $1.0 million for such services during 2013 and 2012, respectively.

SMECO invested in and became a member of National Renewables Cooperative Organization (NRCO) during 2008 to utilize NRCO's services in the analysis of renewable projects in which SMECO may choose to participate in order to fulfill the Maryland Renewable Portfolio Standard obligations (see Note 4). SMECO paid NRCO approximately $28,900 and $26,200 for such services in 2013 and 2012, respectively. Additionally, SMECO paid NRCO approximately $65,000 and $181,000 in 2013 and 2012, respectively for their consulting services relating to the establishment of SMECO Solar LLC.

SMECO is a member of Electric Research and Manufacturing Cooperative (ERMCO) and purchases materials and supplies from them (see Note 4). During 2013 and 2012, SMECO purchased approximately $227,000 and $15,000, respectively, of materials and supplies from ERMCO.

SMECO is a member of Federated Rural Electric Insurance Corporation (Federated) and purchases general liability and property insurance from them (see Note 4). During 2013 and 2012, SMECO purchased insurance from Federated totaling about $838,000 and $758,000, respectively.

Note 17: Storm Loss

Significant storms struck SMECO's service territory in 2012 causing significant system damage totaling about $3.7 million. The Federal Emergency Management Agency (FEMA) funded approximately $2.3 million, which has been offset against the storm costs in the accompanying financial statements.

Note 18: Sale of Utility Property

In 2012, SMECO sold an office building located on a 10.02 acre parcel of land. The land was purchased in July 1966 at a purchase price of $58,526 and the office building was constructed in July 1968 at a cost of $1,352,446. The book value at the time of the sale, including legal fees, taxes and improvements to and depreciation of the building was $93,260. The property sold for $3,160,000, a gain of $3,066,740. This gain is included in Nonoperating Margins on the Consolidated Statement of Revenue, Expenses and Patronage Capital for the year ended December 31, 2012.

Note 19: Federal Award

SMECO Solar LLC received approval from the United States Department of the Treasury for grant funding of $5.9 million for Specified Energy Property in Lieu of Tax Credits under *Section 1603 of Division B of the American Recovery and Reinvestment Act of 2009*. The purpose of the grant is to reimburse for a portion of the cost of constructing a solar farm, which qualifies as specified energy property under the grant. The funds were received in early 2013 and have been offset against Utility Plant in the Consolidated Balance Sheet as of December 31, 2012.

ADAMS, JENKINS AND CHEATHAM
CERTIFIED PUBLIC ACCOUNTANTS AND BUSINESS CONSULTANTS

Independent Auditor's Report on Supplementary Information

To the Board of Directors of
Southern Maryland Electric Cooperative, Inc.
and SMECO Solar LLC

We have audited the consolidated financial statements of Southern Maryland Electric Cooperative, Inc. and SMECO Solar LLC ("SMECO") for the years ended December 31, 2013 and 2012, and our report thereon dated March 16, 2014, which expressed an unmodified opinion on those consolidated financial statements appears on pages 1 and 2. Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating financial information and comparative summary of operations is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual entities, and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. Such information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the supplementary information is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

We also have previously audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheets of SMECO as of December 31, 2011, 2010, and 2009, and the related statements of revenue, expenses and patronage capital and comprehensive income, and cash flows for each of the three years then ended (none of which is presented herein), and we expressed unmodified opinions on those financial statements. In our opinion, the comparative summary of operations is fairly stated in all material respects in relation to the basic consolidated financial statements from which it has been derived.

Adams, Jenkins & Cheatham

Richmond, Virginia
March 16, 2014

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Southern Maryland Electric Cooperative, Inc.
and SMECO Solar LLC
Consolidating Balance Sheets
December 31, 2013

	SMECO	SMECO Solar LLC	Eliminations	Total
Assets				
Utility Plant, at Original Cost (Notes 2, 3 and 19)	$ 953,089,383	$ 14,213,730	$ -	$ 967,303,113
Less: Accumulated Depreciation and Amortization	(309,342,346)	(767,346)	-	(310,109,692)
Net utility plant	643,747,037	13,446,384	-	657,193,421
Nonutility Property (net)	1,228,443	-	-	1,228,443
Investments (Note 2):				
Investments in associated organizations, at cost (Note 4)	13,375,698	-	-	13,375,698
Investment in an unconsolidated entity (Note 5)	1,180,555	-	-	1,180,555
Investment in SMECO Solar LLC (Note 2)	245,563	-	(245,563)	-
Other investments	8,755,037	-	-	8,755,037
Total investments	23,556,853	-	(245,563)	23,311,290
Current Assets (Note 2):				
Cash and cash equivalents	4,352,869	939,755	-	5,292,624
Accounts receivable, net of allowance for doubtful accounts of $1,200,000 and $1,700,000 respectively	59,973,942	-	-	59,973,942
Materials and supplies inventory	11,950,811	25,887	-	11,976,698
Prepaid expenses	5,484,046	12,949	-	5,496,995
Current portion of direct financing lease (Note 6)	4,276,896	-	-	4,276,896
Intercompany receivables	82,911	67,766	(150,677)	-
Other current assets	13,116,670	-	-	13,116,670
Total current assets	99,238,145	1,046,357	(150,677)	100,133,825
Noncurrent Portion of Direct Financing Lease (Note 6)	4,887,563	-	-	4,887,563
Regulatory Assets (Notes 2 and 7)	87,154,753	-	-	87,154,753
Deferred Charges and Other (Note 2)	9,795,246	-	-	9,795,246
Total assets	$ 869,608,040	$ 14,492,741	$ (396,240)	$ 883,704,541
Equities and Liabilities				
Equities (Note 9):				
Patronage capital	$ 197,113,366	$ 245,563	$ (245,563)	$ 197,113,366
Other equities	7,756,615	-	-	7,756,615
Accumulated other comprehensive (loss)	(42,883,991)	-	-	(42,883,991)
Total equities	161,985,990	245,563	(245,563)	161,985,990
Long-Term Debt, Less Current Maturities (Notes 10 and 14)	381,620,690	14,164,000	-	395,784,690
Current Liabilities:				
Accounts payable	39,970,766	267	-	39,971,033
Current maturities of long-term debt (Note 10)	16,924,219	-	-	16,924,219
Notes payable (Note 10)	130,500,000	-	-	130,500,000
Current portion of obligations under capital lease (Note 11)	2,270,981	-	-	2,270,981
Customer deposits	5,938,626	-	-	5,938,626
Intercompany payables	67,766	82,911	(150,677)	-
Other current liabilities	13,308,699	-	-	13,308,699
Total current liabilities	208,981,057	83,178	(150,677)	208,913,558
Accrued Pension and Postretirement Benefits (Note 8)	42,228,015	-	-	42,228,015
Noncurrent Portion of Obligations Under Capital Lease (Note 11)	7,630,783	-	-	7,630,783
Deferred Credits	5,935,841	-	-	5,935,841
Derivative Liabilities (Notes 2 and 15)	61,225,664	-	-	61,225,664
Commitments and Contingencies (Notes 12 and 13)				-
Total equities and liabilities	$ 869,608,040	$ 14,492,741	$ (396,240)	$ 883,704,541

See Independent Auditor's Report on Supplementary Information

Southern Maryland Electric Cooperative, Inc.
and SMECO Solar LLC
Consolidating Statements of Revenue, Expenses and Patronage Capital
Year Ended December 31, 2013

	SMECO	SMECO Solar LLC	Eliminations	Total
Operating Revenue:				
Sales of electricity	$ 438,346,363	$ 1,480,436	$ (1,480,436)	$ 438,346,363
Lease income (Note 6)	1,529,224	-	9,135	1,538,359
Other	19,475,805	-	-	19,475,805
Total operating revenue	459,351,392	1,480,436	(1,471,301)	459,360,527
Operating Expenses:				
Purchased power (Note 12)	299,227,671	-	(1,480,436)	297,747,235
Power production	5,000	163,548	9,135	177,683
Transmission	3,893,596	-	-	3,893,596
Distribution - operations	9,732,884	-	-	9,732,884
Distribution - maintenance	18,466,029	-	-	18,466,029
Customer accounts	10,140,122	-	-	10,140,122
Customer service and information	15,694,102	-	-	15,694,102
Administrative and general	32,784,109	75,724	-	32,859,833
Depreciation and amortization	25,426,084	708,339	-	26,134,423
Taxes	12,151,827	550	-	12,152,377
Other	382,440	-	-	382,440
Total operating expenses	427,903,864	948,161	(1,471,301)	427,380,724
Operating margins	31,447,528	532,275	-	31,979,803
Interest Expense:				
Interest on long-term debt	15,892,797	146,209	-	16,039,006
Other interest	1,630,428	324,860	(324,860)	1,630,428
Total interest expenses	17,523,225	471,069	(324,860)	17,669,434
Net Operating Margins	13,924,303	61,206	324,860	14,310,369
Other Patronage Allocations	1,763,339	-	-	1,763,339
Total operating margins	15,687,642	61,206	324,860	16,073,708
Nonoperating Margins	2,312,857	-	(386,066)	1,926,791
Net margins	$ 18,000,499	$ 61,206	$ (61,206)	$ 18,000,499
Patronage Capital, Beginning of Year	$ 180,480,809	$ 184,357	$ (184,357)	$ 180,480,809
Net Margins	18,000,499	61,206	(61,206)	18,000,499
Distribution of Capital Credits	(1,367,942)	-	-	(1,367,942)
Patronage capital, end of year	$ 197,113,366	$ 245,563	$ (245,563)	$ 197,113,366

Consolidating Statements of Comprehensive Income
Year Ended December 31, 2013

	SMECO	SMECO Solar LLC	Eliminations	Total
Net Margins	$ 18,000,499	$ 61,206	$ (61,206)	$ 18,000,499
Other Comprehensive Income:				
Net gain during period	22,156,985	-	-	22,156,985
Amortization of net gain	2,391,627	-	-	2,391,627
Other comprehensive income	24,548,612	-	-	24,548,612
Comprehensive Income	$ 42,549,111	$ 61,206	$ (61,206)	$ 42,549,111

See Independent Auditor's Report on Supplementary Information.

Southern Maryland Electric Cooperative, Inc. and SMECO Solar LLC
Comparative Summary of Operations
Years Ended December 31, 2013 - 2009

	2013	2012	2011	2010	2009
Operating Revenue:					
Sales of electricity	$ 438,346,363	$ 403,170,680	$ 435,200,226	$ 482,248,410	$ 453,921,008
Lease income	1,538,359	2,005,961	2,415,140	2,773,195	3,086,513
Other	19,475,805	13,316,654	11,854,049	7,646,339	5,651,547
Total operating revenue	459,360,527	418,493,295	449,469,415	492,667,944	462,659,068
Operating Expenses:					
Purchased power	297,747,235	275,256,422	312,274,549	354,885,238	349,494,626
Power production	177,683	2,167	-	-	-
Transmission	3,893,596	3,684,194	3,184,075	3,246,566	2,697,089
Distribution - operations	9,732,884	8,315,945	8,110,012	7,264,686	6,535,916
Distribution - maintenance	18,466,029	16,829,638	16,209,398	16,521,451	16,298,261
Customer accounts	10,140,122	9,253,741	8,579,949	8,202,811	7,054,081
Customer service and information	15,694,102	11,007,022	7,894,534	4,557,947	2,446,057
Administrative and general	32,859,833	30,078,841	27,868,433	28,422,330	25,506,305
Depreciation and amortization	26,134,423	26,487,914	24,982,801	27,174,659	25,127,517
Taxes	12,152,377	12,589,731	9,787,305	10,253,691	9,964,859
Other	382,440	317,770	340,144	340,448	315,829
Total operating expenses	427,380,724	393,823,385	419,231,200	460,869,827	445,440,540
Operating margins	31,979,803	24,669,910	30,238,215	31,798,117	17,218,528
Interest Expense:					
Interest on long-term debt	16,039,006	16,098,719	16,099,488	15,295,576	15,670,654
Other interest	1,630,428	865,966	937,993	2,414,624	533,834
Total interest expense	17,669,434	16,964,685	17,037,481	17,710,200	16,204,488
Net Operating Margins	14,310,369	7,705,225	13,200,734	14,087,917	1,014,040
Other Patronage Allocations	1,763,339	1,398,309	1,226,017	1,369,027	1,324,959
Total operating margins	16,073,708	9,103,534	14,426,751	15,456,944	2,338,999
Nonoperating Margins	1,926,791	3,755,426	686,035	1,596,952	910,283
Net margins	$ 18,000,499	$ 12,858,960	$ 15,112,786	$ 17,053,896	$ 3,249,282
Patronage Capital, Beginning of Year	$ 180,480,809	$ 170,117,158	$ 158,811,239	$ 142,658,535	$ 140,353,817
Net Margins	18,000,499	12,858,960	15,112,786	17,053,896	3,249,282
Distribution of Capital Credits	(1,367,942)	(2,495,309)	(3,806,867)	(901,192)	(944,564)
Patronage capital, end of year	$ 197,113,366	$ 180,480,809	$ 170,117,158	$ 158,811,239	$ 142,658,535
Electric Revenue:					
Residential	$ 293,263,234	$ 268,659,885	$ 279,647,444	$ 308,894,513	$ 296,721,707
General service	122,594,208	112,813,667	120,531,733	124,854,802	114,173,552
Large power	16,954,218	16,813,427	18,599,089	22,663,254	20,507,162
Street lights	2,324,151	2,215,760	2,047,584	1,841,175	1,828,498
Transmission	3,207,636	2,667,941	14,374,376	23,994,666	20,690,089
Solar facility services	2,916	-	-	-	-
Total	$ 438,346,363	$ 403,170,680	$ 435,200,226	$ 482,248,410	$ 453,921,008
Megawatt-Hour Sales:					
Residential	2,099,817	2,043,774	2,113,645	2,216,406	2,051,179
General service	1,106,252	1,111,438	1,017,715	956,418	930,007
Large power	165,767	184,385	176,605	179,828	179,573
Street lights	6,947	6,703	6,241	5,897	5,415
Transmission	33,137	29,763	123,363	204,230	199,172
Solar facility services	12	-	-	-	-
Total	3,411,932	3,376,063	3,437,569	3,562,779	3,365,346
Customers at Year End (Billings)	156,533	154,346	152,730	150,152	148,612

See Independent Auditor's Report on Supplementary Information.

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
Southern Maryland Electric Cooperative, Inc.
and SMECO Solar LLC

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 consolidated financial statements of Southern Maryland Electric Cooperative, Inc. and SMECO Solar LLC ("SMECO"), which comprise the consolidated balance sheets as of December 31, 2013 and the related consolidated statements of revenue, expenses, and patronage capital and comprehensive income and the consolidated statements of cash flows as of and for the year ended December 31, 2013, and the related notes to the financial statements, and have issued our report thereon dated March 16, 2014.

Internal Control Over Financial Reporting

In planning and performing our audits of the consolidated financial statements, we considered SMECO's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of SMECO's internal control. Accordingly, we do not express an opinion on the effectiveness of SMECO'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 consolidated financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or 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 over financial reporting 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 SMECO's consolidated 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 consolidated financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, 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 SMECO in a separate letter dated March 16, 2014.

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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 SMECO's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering SMECO's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Adams, Jenkins & Cheatham

Richmond, Virginia
March 16, 2014

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
Southern Maryland Electric Cooperative, Inc.
and SMECO Solar LLC

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 Southern Maryland Electric Cooperative, Inc. and SMECO Solar LLC ("SMECO"), which comprise the balance sheet as of December 31, 2013, and the related statements of revenue, expenses, patronage capital and comprehensive income and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated March 16, 2014. In accordance with *Government Auditing Standards*, we have also issued a report dated March 16, 2014 on our consideration of SMECO's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. No reports other than the reports referred to above 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 SMECO 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 SMECO'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 SMECO's accounting and records to indicate that SMECO 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;

Prepare accurate and timely Financial and Operating Reports;

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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
March 16, 2014