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## **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, 2014 and 2013 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.

## 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, 2014 and 2013, 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 10, 2015, 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.

A handwritten signature in cursive script that reads "Adams, Jenkins & Cheatham".

Richmond, Virginia  
March 10, 2015

**Southern Maryland Electric Cooperative, Inc.  
and SMECO Solar LLC  
Consolidated Balance Sheets  
December 31, 2014 and 2013**

	<u>2014</u>	<u>2013</u>
<b>Assets</b>		
Utility Plant, at Original Cost (Notes 2 and 3)	\$ 1,027,563,938	\$ 967,303,113
Less: Accumulated Depreciation and Amortization	(324,260,523)	(310,109,692)
Net utility plant	<u>703,303,415</u>	<u>657,193,421</u>
Nonutility Property (net)	<u>2,024,867</u>	<u>1,228,443</u>
Investments (Note 2):		
Investments in associated organizations, at cost (Note 4)	12,273,378	13,375,698
Investment in an unconsolidated entity (Note 5)	1,183,868	1,180,555
Other investments	11,944,069	8,755,037
Total investments	<u>25,401,315</u>	<u>23,311,290</u>
Current Assets (Note 2):		
Cash and cash equivalents	6,644,148	5,292,624
Accounts receivable, net of allowance for doubtful accounts of \$900,000 and \$1,200,000 respectively	54,689,447	59,973,942
Materials and supplies inventory	13,208,763	11,976,698
Prepaid expenses	10,088,632	5,496,995
Current portion of direct financing lease (Note 6)	4,504,717	4,276,896
Other current assets	7,731,019	13,116,670
Total current assets	<u>96,866,726</u>	<u>100,133,825</u>
Noncurrent Portion of Direct Financing Lease (Note 6)	-	4,887,563
Regulatory Assets (Notes 2 and 7)	77,186,544	87,154,753
Deferred Charges and Other (Note 2)	10,162,439	9,795,246
Derivative Assets (Notes 2 and 15)	5,591,119	-
Total assets	<u>\$ 920,536,425</u>	<u>\$ 883,704,541</u>
<b>Equities and Liabilities</b>		
Equities (Note 9):		
Patronage capital	\$ 204,255,833	\$ 197,113,366
Other equities	8,139,540	7,756,615
Accumulated other comprehensive (loss)	(84,809,741)	(42,883,991)
Total equities	<u>127,585,632</u>	<u>161,985,990</u>
Long-Term Debt, Less Current Maturities (Notes 10 and 14)	<u>416,774,088</u>	<u>395,784,690</u>
Current Liabilities:		
Accounts payable	31,673,187	39,971,033
Current maturities of long-term debt (Note 10)	19,075,025	16,924,219
Notes payable (Note 10)	158,000,000	130,500,000
Current portion of obligations under capital lease (Note 11)	2,850,590	2,270,981
Customer deposits	6,258,136	5,938,626
Other current liabilities	13,773,338	13,308,699
Total current liabilities	<u>231,630,276</u>	<u>208,913,558</u>
Accrued Pension and Postretirement Benefits (Note 8)	79,673,204	42,228,015
Noncurrent Portion of Obligations Under Capital Lease (Note 11)	7,822,887	7,630,783
Deferred Credits	9,241,381	5,935,841
Derivative Liabilities (Notes 2 and 15)	47,808,957	61,225,664
Commitments and Contingencies (Notes 12 and 13)	-	-
Total equities and liabilities	<u>\$ 920,536,425</u>	<u>\$ 883,704,541</u>

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, 2014 and 2013**

	<u>2014</u>	<u>2013</u>
Operating Revenue:		
Sales of electricity	\$ 460,931,055	\$ 438,346,363
Lease income (Note 6)	621,144	1,538,359
Other	21,625,695	19,475,805
Total operating revenue	<u>483,177,894</u>	<u>459,360,527</u>
Operating Expenses:		
Purchased power (Note 12)	321,683,773	297,747,235
Power production	216,386	177,683
Transmission	4,016,843	3,893,596
Distribution - operations	10,227,779	9,732,884
Distribution - maintenance	18,794,091	18,466,029
Customer accounts	10,970,143	10,140,122
Customer service and information	17,929,786	15,694,102
Administrative and general	33,219,602	32,859,833
Depreciation and amortization	29,450,913	26,134,423
Taxes	13,860,042	12,152,377
Other	361,564	382,440
Total operating expenses	<u>460,730,922</u>	<u>427,380,724</u>
Operating margins	<u>22,446,972</u>	<u>31,979,803</u>
Interest Expense:		
Interest on long-term debt	17,535,136	16,039,006
Other interest	1,877,250	1,630,428
Total interest expenses	<u>19,412,386</u>	<u>17,669,434</u>
Net Operating Margins	3,034,586	14,310,369
Other Patronage Allocations	2,372,848	1,763,339
Total operating margins	<u>5,407,434</u>	<u>16,073,708</u>
Nonoperating Margins	3,020,993	1,926,791
Net margins	<u>\$ 8,428,427</u>	<u>\$ 18,000,499</u>
Patronage Capital, Beginning of Year	\$ 197,113,366	\$ 180,480,809
Net Margins	8,428,427	18,000,499
Distribution of Capital Credits	(1,285,960)	(1,367,942)
Patronage capital, end of year	<u>\$ 204,255,833</u>	<u>\$ 197,113,366</u>

**Consolidated Statements of Comprehensive Income  
Years Ended December 31, 2014 and 2013**

	<u>2014</u>	<u>2013</u>
Net Margins	\$ 8,428,427	\$ 18,000,499
Other Comprehensive (Loss) Income:		
Net (loss) gain during period	(40,247,028)	22,156,985
Amortization of net (loss) gain	(1,678,722)	2,391,627
Other comprehensive (loss) income	<u>(41,925,750)</u>	<u>24,548,612</u>
Comprehensive (Loss) Income	<u>\$ (33,497,323)</u>	<u>\$ 42,549,111</u>

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









**Southern Maryland Electric Cooperative, Inc.  
and SMECO Solar LLC  
Notes to Consolidated Financial Statements  
December 31, 2014 and 2013**

**Note 3: Utility Plant**

The major classes of utility plant in service as of December 31, 2014 and 2013 are as follows:

	<u>2014</u>	<u>2013</u>
Distribution	\$ 567,915,807	\$551,064,311
Transmission	250,030,735	209,581,880
Generation	14,681,335	14,676,905
General	<u>148,303,053</u>	<u>145,241,190</u>
	980,930,930	920,564,286
Construction work in progress	<u>46,633,008</u>	<u>46,738,827</u>
	1,027,563,938	967,303,113
Less: Accumulated depreciation and amortization	<u>(324,260,523)</u>	<u>(310,109,692)</u>
Net utility plant	<u>\$ 703,303,415</u>	<u>\$657,193,421</u>

The provision for depreciation, stated as a percentage of the average balance of related properties, approximated the following percentages during 2014 and 2013:

	<u>2014</u>	<u>2013</u>
Distribution	3.40%	3.42%
Transmission	3.11%	2.93%
General	2.46%-10.54%	2.46%-10.54%
Composite rate	3.35%	3.29%
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 \$7.7 million and \$3.6 million for the years ended December 31, 2014 and 2013, 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, 2014 and 2013:

	<u>2014</u>	<u>2013</u>
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%	720,411	1,516,525
Noninterest bearing	299,057	340,042

Member capital securities	-	1,000,000
Patronage capital certificates	1,662,285	1,568,856
CFC membership	<u>1,000</u>	<u>1,000</u>
	6,848,186	8,591,856

Federated Rural Electric Insurance Corporation	859,772	685,675
CoBank, ACB (CoBank)	4,344,956	3,872,903
Other	<u>220,464</u>	<u>225,264</u>
	<u>\$12,273,378</u>	<u>\$13,375,698</u>

**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). SMECO's proportionate share of ACES earnings was \$3,313 in 2014 and \$27,608 in 2013. As of December 31, 2014 and 2013, the carrying value of the investment was \$1,183,868 and \$1,180,555, 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, 2014 and 2013:

	<u>2014</u>	<u>2013</u>
Total minimum FCC payments receivable	\$ 4,812,610	\$10,062,730
Estimated residual value of FCC property	<u>-</u>	<u>-</u>
Gross investment in FCC	4,812,610	10,062,730
Less: Unearned income	<u>(307,893)</u>	<u>(898,271)</u>
Net investment in FCC Agreement	<u>\$ 4,504,717</u>	<u>\$ 9,164,459</u>

**Southern Maryland Electric Cooperative, Inc.  
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Current portion	\$ 4,504,717	\$ 4,276,896
Noncurrent portion	<u>-</u>	<u>4,887,563</u>
Net investment in FCC Agreement	<u>\$ 4,504,717</u>	<u>\$ 9,164,459</u>

Future minimum FCC receivables due under this direct financing lease as of December 31, 2014 are as follows:

2015	\$ 4,812,610
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**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 \$24,311,600 and \$21,311,620 as of December 31, 2014 and 2013, 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, 2014 and 2013, the regulatory assets for these projects totaled \$5,065,987 and \$4,617,469, respectively.

**C. Energy and Energy-Related Costs** - As of December 31, 2014 and 2013, the regulatory asset pertaining to energy and energy-related costs was \$47,808,957 and \$61,225,664, 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, 2014 and 2013. 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.

The Retirement Annuity Plan offered Terminated Vested Participants a limited period of time to elect a one-time lump sum distribution option in lieu of a deferred annuity effective September 15, 2014. The forms of payment available during this election period were a lump sum distribution or immediate annuity (as required by law). Qualified Terminated Vested Participants had from September 15 through October 30, 2014 to elect this voluntary lump sum distribution. Benefits were payable as of November 1, 2014 and paid in a single lump sum cash distribution or roll-over, if the lump sum option was elected. If an immediate annuity was elected, the monthly annuity payment was payable beginning November 1, 2014. All participants not making an election by October 30, 2014 remain in the plan as terminated vested participants until their normal retirement date.

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:

	<u>Pension Benefits</u>	
	<u>2014</u>	<u>2013</u>
Benefit obligation at year end	\$154,805,530	\$124,768,526
Fair value of plan assets at year end	<u>105,655,757</u>	<u>102,297,066</u>
Funded status	<u>\$(49,149,773)</u>	<u>\$(22,471,460)</u>
Amounts recognized in the Balance Sheets:		
Accrued benefit cost	\$(49,149,773)	\$(22,471,460)
Accumulated other comprehensive loss	68,994,677	35,916,433
Deferred charges	2,130,756	2,367,506
Weighted-average assumptions used to determine benefit obligations as of year end:		
Discount rate	4.35%	5.50%
Benefit cost	\$ 533,585	\$ 1,627,171
Employer contribution	7,048,398	7,804,696
Benefits paid	9,458,292	6,582,233
Weighted-average assumptions used to determine benefit costs:		
Discount rate	5.50%	4.50%
Expected return on plan assets	8.00%	8.00%
Expected contributions for year ending December 31, 2015:		
Employer	\$5,723,878	
Employees	-	

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Estimated future benefit payments reflecting expected future service for years ending December 31:

2015	\$ 6,909,893
2016	7,228,968
2017	7,418,737
2018	7,618,088
2019	7,992,727
2020-2024	43,262,493

Estimated Loss Amortization for Next Fiscal Year \$ 1,927,594

Plan Assets:

Equity Securities (a) (c)	52%	58%
Fixed Income Securities (b) (c)	48%	42%

- (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 52% equity and 48% 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	
	2014	2013
Benefit obligation at year end	\$ 30,523,431	\$ 19,756,555
Fair value of plan assets at year end	-	-
Funded status	<u>\$(30,523,431)</u>	<u>\$(19,756,555)</u>
Amounts recognized in the Balance Sheets:		
Accrued benefit cost	\$(30,523,431)	\$(19,756,555)
Accumulated other comprehensive loss	15,815,064	6,967,558
Deferred charges	75,261	312,238

Weighted-average assumptions used to determine benefit obligations as of year end:

Discount rate	4.35%	5.50%
Benefit cost	\$ 2,814,546	\$ 2,617,360
Employer contribution	658,199	254,994
Benefits paid	658,199	254,994
Weighted-average assumptions used to determine benefit costs:		
Discount rate	5.50%	4.50%

Expected contributions for year ending December 31, 2015:

Employer	\$ 703,484
Employees	-

Estimated future benefit payments reflecting expected future service for years ending December 31:

2015	\$ 703,484
2016	830,818
2017	938,044
2018	1,063,442
2019	1,136,075
2020-2024	6,805,220

Estimated Amortization for

Next Fiscal Year	\$ 934,763
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For measurement purposes, a 6.5% annual rate of increase in per capita cost of covered health care benefits was assumed for 2015. The rate is assumed to decrease gradually to 4.5% to 2019 and remain at that level thereafter. A 6.5% annual rate of increase in employee premiums was assumed for 2015. 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 for the years ended December 31, 2014 and 2013.

**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 \$7.0 million in 2014 and \$6.2 million in 2013. Provisions for claims incurred but not reported have been made based on claim experience and approximated \$245,000 and \$462,000 as of December 31, 2014 and 2013, 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. 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

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**Notes to Consolidated Financial Statements**  
**December 31, 2014 and 2013**

base pay. During 2014 and 2013, SMECO recorded 401(k) plan-related expenses of approximately \$3.9 million and \$3.3 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 2014 and 2013, SMECO made aggregated contributions to the trust of \$570,000 and \$490,000, respectively. At December 31, 2014 and 2013, the trust had estimated net assets available for benefits of \$200,208 and (\$32,984), 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, 2014 and 2013 consisted of the following:

	<u>2014</u>	<u>2013</u>
Assignable	\$ 8,417,636	\$ 18,002,711
Assigned to date	<u>283,326,618</u>	<u>265,313,116</u>
	291,744,254	283,315,827
Less: Retirements to date	<u>(87,488,421)</u>	<u>(86,202,461)</u>
Patronage capital	<u>\$204,255,833</u>	<u>\$197,113,366</u>

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, 2014 and 2013:

Lender	Interest Rates	Maturity (Year)	<u>2014</u>	<u>2013</u>
RUS	3.44–5.19%	2034-41	\$114,760,656	\$117,157,280
CFC	3.35–9.50%	2015-30	16,771,782	19,289,738
CoBank	2.85–6.44%	2017-40	68,417,813	74,187,106
NCSC	7.25%	2015	3,345,964	6,459,950
FFB	2.34–8.07%	2025-46	<u>232,552,898</u>	<u>195,614,835</u>
Total debt outstanding			435,849,113	412,708,909
Less: Current maturities			<u>19,075,025</u>	<u>16,924,219</u>
Long-term debt			<u>\$416,774,088</u>	<u>\$395,784,690</u>

At December 31, 2014, the required principal payments of the long-term debt are as follows:

2015	\$ 19,075,025
2016	14,790,994
2017	15,329,596
2018	14,842,256
2019	15,440,038
Thereafter	<u>356,371,204</u>
Total	<u>\$435,849,113</u>

Cash paid for interest totaled approximately \$20.7 million and \$18.4 million for the years ended December 31, 2014 and 2013, respectively. Unadvanced loan funds totaled \$40.7 million as of December 31, 2013.

SMECO has received requisite approvals from RUS and the PSC to buy out of the RUS loan program and refinance approximately \$330 million in long term debt, currently outstanding with RUS and FFB, with CoBank and CFC. Final settlement of the refinance is anticipated in early 2015. Future long term debt will be financed through CoBank, CFC and the private placement market.

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 March 31, 2015. 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, 2014, SMECO had authorized lines of credit of \$175 million with CFC and \$125 million with CoBank. Pursuant to limitations on total unsecured debt of \$200 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 \$200 million until March 30, 2015.

As of December 31, 2014 and 2013, SMECO had outstanding letters of credit totaling \$15.4 million and \$17.7 million, respectively.

The outstanding balances for CoBank lines of credit and their respective interest rates as of December 31, 2014 were \$75.0 million at 1.78% and \$50.0 million at 2.72% and for 2013 were \$45.0 million at 1.76% and \$25.0 million at 2.73%. The outstanding balances for CFC lines of credit and their respective interest rates as of December 31, 2014 were \$33.0 million at 2.9% and as of December 31, 2013 were \$60.5 million at 2.9%.

**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 2024. The future minimum lease payments required under the capital leases and the present value of the net minimum lease payments as of December 31, 2014, are as follows:

2015	\$ 3,165,677
2016	2,460,614
2017	2,097,163
2018	1,566,109
2019	1,056,317
Thereafter	<u>2,338,819</u>
Total minimum lease payments	12,684,699
Less: Amount representing interest	<u>(2,011,222)</u>
Present value of minimum lease payments	10,673,477
Less: Current obligations	<u>(2,850,590)</u>
Long-term capital lease obligation	<u>\$ 7,822,887</u>

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

	<u>2014</u>	<u>2013</u>
Distribution	\$ 9,852,280	\$7,551,930
General	<u>6,513,246</u>	<u>5,009,407</u>
	16,365,526	12,561,337
Less: Accumulated depreciation	<u>(1,464,815)</u>	<u>(1,038,390)</u>
	<u>\$14,900,711</u>	<u>\$11,522,947</u>

Interest paid on the capital lease obligations for the years ended December 31, 2014 and 2013 was \$374,733 and \$310,180, 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, 2014 and 2013 relating to these assets was \$614,287 and \$459,556, 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 2019. 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 \$2,027,659 and \$1,882,175 in 2014 and 2013, respectively.

The future minimum rental payments required under the operating lease agreements as of December 31, 2014, are as follows:

2015	\$1,972,128
2016	1,500,122
2017	995,756
2018	489,249
2019	<u>43,689</u>
Total	<u>\$5,000,944</u>

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, 2014, SMECO had forward purchase commitments with multiple parties through May 2035 covering a significant portion of SMECO's power supply needs.

At December 31, 2014 and 2013, SMECO had made commitments for capital expenditures of approximately \$13.6 million and \$38.9 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.

Under Maryland's Electric Customer Choice and Competition Act and the Electric and Gas Utility Tax Reform Act, electric customers residing in Maryland are entitled to select or choose their electric energy supplier. As of December 31, 2014, SMECO had 2,081 customers served by an alternative electricity supplier. SMECO continues to provide distribution service to all of its customers.

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. SMECO places its cash on deposit with financial institutions located in the United States of America, which are insured by the Federal Deposit Insurance Corporation (FDIC). The FDIC provides insurance coverage for up to \$250,000 of cash held by SMECO in each separate FDIC insured bank and savings institution. From time to time, SMECO may have amounts on deposit in excess of the insured limits. As of December 31, 2014, SMECO had approximately \$4.8 million of deposits that exceeded the insured limits. SMECO grants credit to customers, substantially all of whom are local residents of SMECO's four-county service area. In 2014, SMECO obtained 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 expects to buy out of the RUS loan program in 2015 and refinance its existing RUS and FFB debt with CoBank and CFC. Current expectations are that future long-term debt will be financed using various sources such as CoBank, CFC and the private placement market.

**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

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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 2.75% and 3.96% as of December 31, 2014 and 2013, 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 5.40% and 6.50% as of December 31, 2014 and 2013, 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:

	<u>Carrying Value</u>		<u>Fair Value</u>	
	<u>2014</u>	<u>2013</u>	<u>2014</u>	<u>2013</u>
	(000 Omitted)		(000 Omitted)	
<u>Assets:</u>				
Capital Term				
Certificates	\$ 5,185	\$ 7,022	\$ 7,470	\$ 8,605
<u>Liabilities:</u>				
Long-term Debt	(435,849)	(412,709)	(406,263)	(343,846)

**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:

	<u>December 31, 2014</u>			
	<u>(000 Omitted)</u>			
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
<u>Assets:</u>				
Derivative				
Assets, net	\$ 5,591	\$ -	\$ 5,591	\$ -
<u>Liabilities:</u>				
Derivative				
Liabilities, net (\$47,809)	\$ -	(\$47,809)	\$ -	\$ -
	<u>December 31, 2013</u>			
	<u>(000 Omitted)</u>			
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Derivative				
Liabilities, net (\$61,266)	\$ -	(\$61,226)	\$ -	\$ -

The fair value of derivative liabilities is comprised of forward trades, power and gas 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 constant heat rate projections, 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 AEP Dayton - Dominion Zone, Brandywine, PJM East or PJM West and the gas positions are valued using NYMEX Henry Hub or TRANSCO Zone 6 Non-NY pricing. FTRs are marked-to-market based on data from the most recent FTR auction.

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**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 \$283,100 and \$392,600 in 2014 and 2013, respectively, on investments with CFC. During years 2014 and 2013, SMECO paid interest expense of approximately \$7.5 million and \$7.4 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 \$1.0 million and \$978,000 for such services during 2014 and 2013, 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 \$97,000 and \$29,000 for such services in 2014 and 2013, respectively. Additionally, SMECO paid NRCO approximately \$65,000 in 2013 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 2014 and 2013, SMECO purchased approximately \$704,000 and \$227,000, 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 2014 and 2013, SMECO purchased insurance from Federated totaling about \$809,000 and \$838,000, respectively.





**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, 2014 and 2013, and our report thereon dated March 10, 2015, 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, 2012, 2011, and 2010, 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 10, 2015

**Southern Maryland Electric Cooperative, Inc.  
and SMECO Solar LLC  
Consolidating Balance Sheets  
December 31, 2014**

	SMECO	SMECO Solar LLC	Eliminations	Total
<b>Assets</b>				
Utility Plant, at Original Cost (Notes 2 and 3)	\$ 1,013,345,778	\$ 14,218,160	\$ -	\$ 1,027,563,938
Less: Accumulated Depreciation and Amortization	(322,783,965)	(1,476,558)	-	(324,260,523)
Net utility plant	<u>690,561,813</u>	<u>12,741,602</u>	<u>-</u>	<u>703,303,415</u>
Nonutility Property (net)	2,024,867	-	-	2,024,867
Investments (Note 2):				
Investments in associated organizations, at cost (Note 4)	12,273,378	-	-	12,273,378
Investment in an unconsolidated entity (Note 5)	1,183,868	-	-	1,183,868
Investment in SMECO Solar LLC (Note 2)	148,549	-	(148,549)	-
Other investments	11,944,069	-	-	11,944,069
Total investments	<u>25,549,864</u>	<u>-</u>	<u>(148,549)</u>	<u>25,401,315</u>
Current Assets (Note 2):				
Cash and cash equivalents	5,024,218	1,619,930	-	6,644,148
Accounts receivable, net of allowance for doubtful accounts of \$900,000 and \$1,200,000 respectively	54,689,447	-	-	54,689,447
Materials and supplies inventory	13,186,594	22,169	-	13,208,763
Prepaid expenses	10,025,401	63,231	-	10,088,632
Current portion of direct financing lease (Note 6)	4,504,717	-	-	4,504,717
Intercompany receivables	196,566	62,183	(258,749)	-
Other current assets	7,731,019	-	-	7,731,019
Total current assets	<u>95,357,962</u>	<u>1,767,513</u>	<u>(258,749)</u>	<u>96,866,726</u>
Regulatory Assets (Notes 2 and 7)	77,186,544	-	-	77,186,544
Deferred Charges and Other (Note 2)	10,162,439	-	-	10,162,439
Derivative Assets (Notes 2 and 15)	5,591,119	-	-	5,591,119
Total assets	<u>\$ 906,434,608</u>	<u>\$ 14,509,115</u>	<u>\$ (407,298)</u>	<u>\$ 920,536,425</u>
<b>Equities and Liabilities</b>				
Equities (Note 9):				
Patronage capital	\$ 204,255,833	\$ -	\$ -	\$ 204,255,833
Other equities	8,139,540	148,549	(148,549)	8,139,540
Accumulated other comprehensive (loss)	(84,809,741)	-	-	(84,809,741)
Total equities	<u>127,585,632</u>	<u>148,549</u>	<u>(148,549)</u>	<u>127,585,632</u>
Long-Term Debt, Less Current Maturities (Notes 10 and 14)	<u>403,168,494</u>	<u>13,605,594</u>	<u>-</u>	<u>416,774,088</u>
Current Liabilities:				
Accounts payable	31,673,187	-	-	31,673,187
Current maturities of long-term debt (Note 10)	18,516,619	558,406	-	19,075,025
Notes payable (Note 10)	158,000,000	-	-	158,000,000
Current portion of obligations under capital lease (Note 11)	2,850,590	-	-	2,850,590
Customer deposits	6,258,136	-	-	6,258,136
Intercompany payables	62,183	196,566	(258,749)	-
Other current liabilities	13,773,338	-	-	13,773,338
Total current liabilities	<u>231,134,053</u>	<u>754,972</u>	<u>(258,749)</u>	<u>231,630,276</u>
Accrued Pension and Postretirement Benefits (Note 8)	79,673,204	-	-	79,673,204
Noncurrent Portion of Obligations Under Capital Lease (Note 11)	7,822,887	-	-	7,822,887
Deferred Credits	9,241,381	-	-	9,241,381
Derivative Liabilities (Notes 2 and 15)	47,808,957	-	-	47,808,957
Commitments and Contingencies (Notes 12 and 13)	-	-	-	-
Total equities and liabilities	<u>\$ 906,434,608</u>	<u>\$ 14,509,115</u>	<u>\$ (407,298)</u>	<u>\$ 920,536,425</u>

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, 2014**

	SMECO	SMECO Solar LLC	Eliminations	Total
Operating Revenue:				
Sales of electricity	\$ 460,931,055	\$ 1,435,427	\$ (1,435,427)	\$ 460,931,055
Lease income (Note 6)	692,591	-	(71,447)	621,144
Other	21,625,695	-	-	21,625,695
Total operating revenue	<u>483,249,341</u>	<u>1,435,427</u>	<u>(1,506,874)</u>	<u>483,177,894</u>
Operating Expenses:				
Purchased power (Note 12)	323,119,200	-	(1,435,427)	321,683,773
Power production	5,000	282,833	(71,447)	216,386
Transmission	4,016,843	-	-	4,016,843
Distribution - operations	10,227,779	-	-	10,227,779
Distribution - maintenance	18,794,091	-	-	18,794,091
Customer accounts	10,970,143	-	-	10,970,143
Customer service and information	17,929,786	-	-	17,929,786
Administrative and general	33,167,400	52,202	-	33,219,602
Depreciation and amortization	28,740,398	710,515	-	29,450,913
Taxes	13,751,458	108,584	-	13,860,042
Other	361,564	-	-	361,564
Total operating expenses	<u>461,083,662</u>	<u>1,154,134</u>	<u>(1,506,874)</u>	<u>460,730,922</u>
Operating margins	<u>22,165,679</u>	<u>281,293</u>	<u>-</u>	<u>22,446,972</u>
Interest Expense:				
Interest on long-term debt	17,082,879	452,257	-	17,535,136
Other interest	1,877,250	-	-	1,877,250
Total interest expenses	<u>18,960,129</u>	<u>452,257</u>	<u>-</u>	<u>19,412,386</u>
Net Operating Margins (Loss)	3,205,550	(170,964)	-	3,034,586
Other Patronage Allocations	2,372,848	-	-	2,372,848
Total operating margins (loss)	<u>5,578,398</u>	<u>(170,964)</u>	<u>-</u>	<u>5,407,434</u>
Nonoperating Margins	2,850,029	73,950	97,014	3,020,993
Net margins (loss)	<u>\$ 8,428,427</u>	<u>\$ (97,014)</u>	<u>\$ 97,014</u>	<u>\$ 8,428,427</u>
Patronage Capital & Other Equities, Beginning of Year	\$ 197,113,366	\$ 245,563	\$ (245,563)	\$ 197,113,366
Net Margins (Loss)	8,428,427	(97,014)	97,014	8,428,427
Distribution of Capital Credits	(1,285,960)	-	-	(1,285,960)
Patronage capital & other equities, end of year	<u>\$ 204,255,833</u>	<u>\$ 148,549</u>	<u>\$ (148,549)</u>	<u>\$ 204,255,833</u>

**Consolidating Statements of Comprehensive Income  
Year Ended December 31, 2014**

	SMECO	SMECO Solar LLC	Eliminations	Total
Net Margins (Loss)	\$ 8,428,427	\$ (97,014)	\$ 97,014	\$ 8,428,427
Other Comprehensive (Loss):				
Net (loss) during period	(40,247,028)	-	-	(40,247,028)
Amortization of net (loss)	(1,678,722)	-	-	(1,678,722)
Other comprehensive (loss)	<u>(41,925,750)</u>	<u>-</u>	<u>-</u>	<u>(41,925,750)</u>
Comprehensive (Loss) Income	<u>\$ (33,497,323)</u>	<u>\$ (97,014)</u>	<u>\$ 97,014</u>	<u>\$ (33,497,323)</u>

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, 2014 - 2010**

	<u>2014</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>	<u>2010</u>
Operating Revenue:					
Sales of electricity	\$ 460,931,055	\$ 438,346,363	\$ 403,170,680	\$ 435,200,226	\$ 482,248,410
Lease income	621,144	1,538,359	2,005,961	2,415,140	2,773,195
Other	21,625,695	19,475,805	13,316,654	11,854,049	7,646,339
Total operating revenue	<u>483,177,894</u>	<u>459,360,527</u>	<u>418,493,295</u>	<u>449,469,415</u>	<u>492,667,944</u>
Operating Expenses:					
Purchased power	321,683,773	297,747,235	275,256,422	312,274,549	354,885,238
Power production	216,386	177,683	2,167	-	-
Transmission	4,016,843	3,893,596	3,684,194	3,184,075	3,246,566
Distribution - operations	10,227,779	9,732,884	8,315,945	8,110,012	7,264,686
Distribution - maintenance	18,794,091	18,466,029	16,829,638	16,209,398	16,521,451
Customer accounts	10,970,143	10,140,122	9,253,741	8,579,949	8,202,811
Customer service and information	17,929,786	15,694,102	11,007,022	7,894,534	4,557,947
Administrative and general	33,219,602	32,859,833	30,078,841	27,868,433	28,422,330
Depreciation and amortization	29,450,913	26,134,423	26,487,914	24,982,801	27,174,659
Taxes	13,860,042	12,152,377	12,589,731	9,787,305	10,253,691
Other	361,564	382,440	317,770	340,144	340,448
Total operating expenses	<u>460,730,922</u>	<u>427,380,724</u>	<u>393,823,385</u>	<u>419,231,200</u>	<u>460,869,827</u>
Operating margins	<u>22,446,972</u>	<u>31,979,803</u>	<u>24,669,910</u>	<u>30,238,215</u>	<u>31,798,117</u>
Interest Expense:					
Interest on long-term debt	17,535,136	16,039,006	16,098,719	16,099,488	15,295,576
Other interest	1,877,250	1,630,428	865,966	937,993	2,414,624
Total interest expense	<u>19,412,386</u>	<u>17,669,434</u>	<u>16,964,685</u>	<u>17,037,481</u>	<u>17,710,200</u>
Net Operating Margins	3,034,586	14,310,369	7,705,225	13,200,734	14,087,917
Other Patronage Allocations	2,372,848	1,763,339	1,398,309	1,226,017	1,369,027
Total operating margins	<u>5,407,434</u>	<u>16,073,708</u>	<u>9,103,534</u>	<u>14,426,751</u>	<u>15,456,944</u>
Nonoperating Margins	3,020,993	1,926,791	3,755,426	686,035	1,596,952
Net margins	<u>\$ 8,428,427</u>	<u>\$ 18,000,499</u>	<u>\$ 12,858,960</u>	<u>\$ 15,112,786</u>	<u>\$ 17,053,896</u>
Patronage Capital, Beginning of Year	\$ 197,113,366	\$ 180,480,809	\$ 170,117,158	\$ 158,811,239	\$ 142,658,535
Net Margins	8,428,427	18,000,499	12,858,960	15,112,786	17,053,896
Distribution of Capital Credits	(1,285,960)	(1,367,942)	(2,495,309)	(3,806,867)	(901,192)
Patronage capital, end of year	<u>\$ 204,255,833</u>	<u>\$ 197,113,366</u>	<u>\$ 180,480,809</u>	<u>\$ 170,117,158</u>	<u>\$ 158,811,239</u>
Electric Revenue:					
Residential	\$ 302,538,996	\$ 293,263,234	\$ 268,659,885	\$ 279,647,444	\$ 308,894,513
General service	134,650,211	122,594,208	112,813,667	120,531,733	124,854,802
Large power	17,543,851	16,954,218	16,813,427	18,599,089	22,663,254
Street lights	2,414,335	2,324,151	2,215,760	2,047,584	1,841,175
Transmission	3,762,725	3,207,636	2,667,941	14,374,376	23,994,666
Solar facility services	20,937	2,916	-	-	-
Total	<u>\$ 460,931,055</u>	<u>\$ 438,346,363</u>	<u>\$ 403,170,680</u>	<u>\$ 435,200,226</u>	<u>\$ 482,248,410</u>
Megawatt-Hour Sales:					
Residential	2,159,553	2,135,838	2,043,774	2,113,645	2,216,406
General service	1,127,834	1,106,967	1,111,438	1,017,715	956,418
Large power	151,599	165,767	184,385	176,605	179,828
Street lights	6,986	6,947	6,703	6,241	5,897
Transmission	41,329	33,137	29,763	123,363	204,230
Solar facility services	60	12	-	-	-
Total	<u>3,487,361</u>	<u>3,448,668</u>	<u>3,376,063</u>	<u>3,437,569</u>	<u>3,562,779</u>
Customers at Year End (Billings)	<u>160,213</u>	<u>156,533</u>	<u>154,346</u>	<u>152,730</u>	<u>150,152</u>

See Independent Auditor's Report on Supplementary Information.



**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, 2014 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, 2014, and the related notes to the financial statements, and have issued our report thereon dated March 10, 2015.

**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 10, 2015.

**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.

*Allama, Jenkins & Cheatham*

Richmond, Virginia  
March 10, 2015



**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, 2014, 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 10, 2015. In accordance with *Government Auditing Standards*, we have also issued a report dated March 10, 2015 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;

- 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 10, 2015