OWENSBORO MUNICIPAL UTILITIES

ELECTRIC LIGHT AND POWER SYSTEM
&
WATER WORKS SYSTEM

FINANCIAL STATEMENTS
& SUPPLEMENTARY INFORMATION
Years Ended May 31, 2014 and 2013

(With Independent Auditor's Report Thereon)

C O N T E N T S

Riney Hancock CPAs PSC

INDEPENDENT AUDITOR'S REPORT

City Utility Commission
City of Owensboro, Kentucky

We have audited the accompanying financial statements of the Owensboro Municipal Utilities Electric Light and Power System (Electric System) of the City of Owensboro, Kentucky, as of and for the years ended May 31, 2014 and 2013, and the related notes to the financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Owensboro Municipal Utilities Electric Light and Power System of the City of Owensboro, Kentucky, as of May 31, 2014 and 2013, and the changes in financial position and cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

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Emphasis of Matter

As discussed in Note 1 to the financial statements, the financial statements present only the Electric System, an enterprise fund of the City of Owensboro, Kentucky, and do not purport to, and do not, present fairly the financial position of the City of Owensboro, Kentucky, as of May 31, 2014 and 2013, and the changes in its financial position or, where applicable, its cash flows, for the years then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 3 through 6 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The schedule of revenues and expenses is presented for purposes of additional analysis and is not a required part of the financial statements.

The Schedule of Revenues and Expenses is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the schedule of revenues and expenses is fairly stated in all material respects, in relation to the financial statements as a whole.

Riney Hancock CPAs PSC

Owensboro, Kentucky
September 4, 2014

MANAGEMENT'S DISCUSSION AND ANALYSIS

Our discussion and analysis of the Owensboro Municipal Utilities Electric Light and Power System (Electric System) financial performance provides an overview of the Electric System's financial activities for the fiscal year ended May 31, 2014. Please read it in conjunction with the Electric System's financial statements, which begin on page 7.

Overview of the Financial Statements

This annual report consists of three parts: Management's Discussion and Analysis, Financial Statements, and Supplementary Information.

Management's Discussion and Analysis (MD&A) serves as an introduction to the basic financial statements and supplementary information. The MD&A represents management's examination and analysis of the Electric System's financial condition and performance.

The financial statements report information using accounting methods similar to those used by private sector companies. The financial statements include a Statement of Net Position; a Statement of Revenues, Expenses, and Changes in Net Position; a Statement of Cash Flows; and Notes to the Financial Statements.

The Statement of Net Position presents the financial position of the Electric System and thus provides information about the nature and amount of resources and obligations at year-end.

The Statement of Revenues, Expenses, and Changes in Net Position presents the results of the business activities over the course of the fiscal year and information as to how the net position changed during the year. All changes in net position are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of the related cash flow.

The Statement of Cash Flows presents changes in cash and cash equivalents resulting from operational, financing and investing activities. This statement presents cash receipts and cash disbursements information, without consideration of the earnings event or when an obligation arises.

The Notes to the Financial Statements provide required disclosures and other information that are essential to a full understanding of material data provided in the statements. The notes present information about the Electric System's accounting policies, significant account balances and activities, material risks, obligations, commitments, contingencies and subsequent events, if any.

Financial Summary

The following table summarizes the financial condition and operations of the Electric System for 2014 and 2013.

Assets and Deferred Outflows of Resources	**2014**	**2013**
Utility plant, net	$ 191,109,570	$ 174,639,040
Restricted assets	110,332,631	73,319,343
Current assets	44,664,771	37,467,326
Other noncurrent assets	7,321,304	10,716,087
Deferred outflows of resources	21,440,542	5,100,843
	$ 374,868,818	$ 301,242,639
Liabilities, Deferred Inflows of Resources, and Net Position		
Net position		
Net investment in capital assets	$ 37,246,490	$ 40,787,888
Restricted	52,245,528	39,009,725
Unrestricted	25,504,699	34,136,705
Total net position	114,996,717	113,934,318
Long-term debt	203,784,767	141,181,277
Current liabilities	33,667,373	41,026,545
Other noncurrent liabilities	8,267,252	1,601,229
Deferred inflows of resources	14,152,709	3,499,270
	$ 374,868,818	$ 301,242,639
Revenues, Expenses and Changes in Net Position		
Operating revenues	$ 137,401,276	$ 142,294,779
Operating expenses	119,647,751	123,056,364
Operating income	17,753,525	19,238,415
Interest and debt expense	(9,546,328)	(10,472,877)
Interest and other income	1,269,665	861,401
Net nonoperating expenses	(8,276,663)	(9,611,476)
Income before transfers	9,476,862	9,626,939
Transfers out - dividends to City of Owensboro	(8,414,463)	(8,631,197)
Change in net position	$ 1,062,399	$ 995,742

FINANCIAL HIGHLIGHTS

- Net assets increased by $1,062,399 in 2014 versus $995,742 in 2013 as the result of changes in operating revenues, operating expenses, interest and transfers as discussed below.

- Operating revenues decreased $4.9 million, or 3.5%, in 2014 when compared to 2013. Wholesale revenues, including supplemental power, increased by $3.1 million, or 5.0%, primarily as a result of increased market prices, largely due to increased demand for electric power and natural gas as a result of the extreme cold triggered by the Arctic polar vortex in 2014. The increase in wholesale market prices more than offset decreased wholesale sales volumes resulting from reduced power generation, as discussed below. That increase offset a decrease in revenues from retail customers of $7.3 million, or 1.0%, primarily due to a decrease in recovery of energy costs from retail customers through the energy cost adjustment. The adjustment provides for the Electric System to adjust charges to its retail customers for fluctuations in energy costs. Due to increased wholesale revenues, more energy cost was recovered from wholesale customers in 2014, thus reducing the recovery requirement from retail customers.

- Operating expenses in 2014 decreased $3.4 million, or 2.8%, versus 2013, largely the result of decreases in production costs. Production costs decreased $1.9 million, or 5.2%, primarily due to reductions in fuel costs, which were partially offset by increases in purchased power and other production costs. Fuel costs increased $7.3 million, or 10.9%, from reduced power generation as a result of two scheduled maintenance outages in 2014 versus no scheduled outages in 2013. The outages resulted in increased purchased power of $2.5 million, or 38.4%, and increased maintenance costs of $2.9 million, or 22.5%. Transmission and distribution costs decreased by $684,920, or 8.6%, partially due to reduced wholesale transmission requirements from reduced wholesale sales volumes, as mentioned above. Depreciation expense also decreased $1.2 million, or 8.2%, primarily from decreased depreciation of ESGS assets as a result of the debt refinancing, discussed below, which extended the depreciable lives of certain ESGS assets.

- Nonoperating revenues and expenses decreased by $1.3 million, or 13.9%, in 2014 when compared to 2013. Interest expense decreased by $926,549, or 8.8%, as a result of the debt refinancing and the capitalization of interest on the new debt issued, as discussed below, as well as scheduled principal reduction on existing debt. Interest income increased $236,321 or 29.0%, primarily as a result of higher rates received from investment in U.S. agency securities in 2014.

- Dividend transfers to the City of Owensboro decreased by $216,734 in 2014, or 2.5%, due to a decrease in the valuation of free services provided to the City.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

At the end of 2014, the Electric System had $191.1 million invested in a broad range of assets, including power plant facilities and equipment, substation facilities and equipment, transformers, poles, wiring, street lighting, traffic signal equipment, communication equipment, fiber optic cable and equipment, buildings and other equipment. This represents a net increase, after depreciation, of $16.5 million over 2013, or 9.4%. In addition to routine capital additions during 2014, OMU incurred $23.2 million in production plant capital improvements primarily resulting from two scheduled maintenance outages during 2014. The following table summarizes capital assets, net of accumulated depreciation, at the end of 2014 and 2013:

	2014	2013
Production plant	$ 123,799,596	$ 109,109,471
Transmission plant	14,353,461	14,719,805
Distribution plant	33,505,649	32,107,192
General plant	7,834,403	7,544,537
Unclassified plant and construction in progress	11,616,461	11,158,035
	$ 191,109,570	$ 174,639,040

Debt

At the end of 2014, the Electric System had $206.4 million in bonds outstanding versus $158.7 million in 2013, for an increase of 30.0%. The increase is attributable to issuance of the 2013 Series Electric Light and Power System Bonds that totaled $86 million. The bonds were issued to fund various capital improvement expenditures for the Electric System and to refund $42.6 million of 1991-B Series bonds. The Electric System bonds are insured and carry ratings of "AA-" (stable outlook) and "A2" (stable outlook) as assigned by Standard & Poor's Rating Services and Moody's Investors Services, Inc., respectively.

Outlook

We expect the 2015 net operating results to decline somewhat from 2014 results, with overall revenue increases to be outpaced by cost increases. Wholesale revenues are anticipated to increase as ESGS has no maintenance outages scheduled in 2014, which is expected to result in increased production volumes, leading to increased surplus energy available for sale to wholesale customers. Revenues from retail customers are also expected to increase slightly, but less than initially anticipated due to mild summer temperatures during the first two months of fiscal 2015 which has reduced energy demand. Production costs are anticipated to increase as increased energy production volumes will require additional fuel costs. The increase in fuel costs are anticipated to be partially offset by decreases in plant maintenance costs as a result of no scheduled maintenance outages. Transmission costs are also anticipated to increase as a result of increased wholesale sales volumes which will require additional transmission.

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OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM

STATEMENTS OF NET POSITION

May 31, 2014 and 2013

ASSETS AND DEFERRED OUTFLOWS OF RESOURCES	2014	2013
Utility plant, net	$ 191,109,570	$ 174,639,040
Restricted assets	110,332,631	73,319,343
Current assets:		
Cash and cash equivalents	24,977,368	21,053,713
Receivables:		
Retail accounts receivable, less allowance for doubtful accounts of $47,903 for 2014 and $79,576 for 2013	8,895,341	7,527,748
Wholesale accounts receivable	2,280,438	3,458,839
City of Owensboro	593,216	703,267
Other	449,438	489,594
Materials and supplies	3,541,047	3,628,384
Prepayments	354,059	229,842
Other	3,573,864	375,939
Total current assets	44,664,771	37,467,326
Other noncurrent assets:		
Unamortized debt expense	1,855,777	1,309,385
Energy costs to be recovered	-	8,264,739
Other noncurrent assets	5,465,527	1,141,963
Total other noncurrent assets	7,321,304	10,716,087
Total assets	353,428,276	296,141,796
Deferred outflows of resources:		
Accumulated decrease in fair value of hedging derivatives	16,976,917	4,713,917
Unamortized loss on debt refunding	3,966,288	126,403
Net unrealized loss on investments	497,337	260,523
Total deferred outflows of resources	21,440,542	5,100,843
Total assets and deferred outflows of resources	$ 374,868,818	$ 301,242,639

See Notes to Financial Statements

LIABILITIES, DEFERRED INFLOWS OF RESOURCES, AND NET POSITION	2014	2013
Net position:		
Net investment in capital assets	$ 37,246,490	$ 40,787,888
Restricted for capital projects, net of related debt	4,933,791	4,345,538
Restricted for debt service	12,448,714	16,687,320
Restricted for other purposes	34,863,023	17,976,867
Unrestricted	25,504,699	34,136,705
Total net position	114,996,717	113,934,318
Long-term debt	203,784,767	141,181,277
Current liabilities (payable from restricted assets):		
Current maturities of long-term debt	2,610,000	17,566,845
Accrued interest payable	3,151,857	1,633,485
Accounts payable	6,455,229	6,541,058
	12,217,086	25,741,388
Current liabilities (payable from current assets):		
Accounts payable	7,084,692	6,674,317
Other	14,365,595	8,610,840
	21,450,287	15,285,157
Total current liabilities	33,667,373	41,026,545
Other noncurrent liabilities	8,267,252	1,601,229
Commitments and contingencies (Note 9)		
Total liabilities	245,719,392	183,809,051
Deferred inflows of resources:		
Accumulated increase in fair value of hedging derivatives	8,297,836	802,314
Deferred revenue	2,292,598	2,696,956
Deferred energy cost adjustment	3,562,275	-
Total deferred inflows of resources	14,152,709	3,499,270
Total liabilities, deferred inflows of resourses, and net position	$ 374,868,818	$ 301,242,639

See Notes to Financial Statements

OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET POSITION

Years Ended May 31, 2014 and 2013

	2014	2013
Operating revenues:		
Charges for services:		
Residential	$ 22,995,721	$ 25,569,752
Commercial	5,500,947	5,730,964
Industrial	40,239,608	44,783,817
Water Works System	719,708	844,106
City of Owensboro	2,116,223	2,486,697
Supplemental power	2,700,565	1,709,220
Other wholesale	61,877,554	59,800,009
Build America Bond subsidy	532,827	557,863
Other	718,123	812,351
Total operating revenues	137,401,276	142,294,779
Operating expenses:		
Production:		
Fuel for electric generation	59,449,211	66,708,167
Purchased power	9,048,348	6,535,616
Other	15,575,734	12,717,231
Transmission and distribution	7,295,393	7,980,313
Customer service and information	1,385,522	1,321,943
General and administrative	12,865,935	12,737,385
Telecommunications	545,158	370,743
Depreciation	13,482,450	14,684,966
Total operating expenses	119,647,751	123,056,364
Operating income	17,753,525	19,238,415
Nonoperating revenues (expenses):		
Interest and debt expense	(9,546,328)	(10,472,877)
Interest income on investments	1,052,320	815,999
Other, net	217,345	45,402
Net decrease in fair value of investments	(236,814)	(260,523)
Deferred net change in fair value of investments	236,814	260,523
Total nonoperating revenues (expenses)	(8,276,663)	(9,611,476)
Income before transfers	9,476,862	9,626,939
Transfers out - dividends to City of Owensboro	(8,414,463)	(8,631,197)
Change in net position	1,062,399	995,742
Net position, beginning of year	113,934,318	112,938,576
Net position, end of year	$ 114,996,717	$ 113,934,318

See Notes to Financial Statements

OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM

STATEMENTS OF CASH FLOWS

Years Ended May 31, 2014 and 2013

	2014	2013
Cash flows from operating activities:		
Receipts from customers, including collections as agent for third parties	$ 168,145,388	$ 154,966,755
Customer remittances to third parties	(19,075,866)	(17,623,769)
Payments to suppliers	(96,182,970)	(93,654,419)
Payments to employees	(14,472,621)	(12,981,008)
Net cash provided by operating activities	38,413,931	30,707,559
Cash flows from noncapital financing activities:		
Transfers out - dividends to City of Owensboro	(8,414,463)	(6,149,600)
Cash flows from capital and related financing activities:		
Capital expenditures	(26,075,889)	(9,374,030)
Payments on long-term debt	(2,455,000)	(18,035,000)
Interest paid on long-term debt	(5,932,524)	(4,066,826)
Issuance of debt	46,732,097	-
Refunding bonds issued	42,848,278	-
Payment to refunded bond escrow agent	(46,877,988)	-
Debt issuance cost	(873,039)	(40,389)
Net cash provided by (used in) capital and related financing activities	7,365,935	(31,516,245)
Cash flows from investing activities:		
Purchase of investments	(15,302,995)	(20,725,000)
Proceeds from sale and maturities of investments	8,961,342	7,500,000
Interest on investments	1,066,016	749,295
Net cash used in investing activities	(5,275,637)	(12,475,705)
Net increase (decrease) in cash and cash equivalents	32,089,766	(19,433,991)
Cash and cash equivalents, beginning of year	64,964,194	84,398,185
Cash and cash equivalents, end of year	$ 97,053,960	$ 64,964,194
Included in the following balance sheet captions:		
Restricted assets	$ 72,076,592	$ 43,910,481
Cash and cash equivalents	24,977,368	21,053,713
	$ 97,053,960	$ 64,964,194

See Notes to Financial Statements

OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM

STATEMENTS OF CASH FLOWS, Concluded

Years Ended May 31, 2014 and 2013

	2014	2013
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 17,753,525	$ 19,238,415
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	13,719,456	14,915,624
Other revenues	217,345	45,402
Noncash operating revenues from City of Owensboro	-	(2,481,597)
Change in assets and liabilities:		
Decrease (increase) in assets:		
Restricted assets:		
Fuel inventory	(2,734,675)	(980,238)
Other	(4,625)	42,565
Receivables	(411,991)	(599,714)
Materials and supplies	87,337	(37,902)
Prepayments	(124,217)	127,815
Other deferred charges	8,204,593	(2,190,680)
Increase (decrease) in liabilities:		
Accounts payable	(1,642,691)	2,721,386
Other current liabilities	191,957	321,559
Deferred revenue	3,157,917	(415,076)
Net cash provided by operating activities	$ 38,413,931	$ 30,707,559
Noncash investing, capital and financing activities:		
Accretion of interest expense on long-term debt	$ 3,341,820	$ 6,357,592
Amortization of debt premium (discount) and expense and deferred loss on debt defeasance	$ 544,200	$ 109,482
Noncash dividends to City of Owensboro	$ -	$ 2,481,597
Deferred gain (loss) on hedging derivatives	$ (4,753,550)	$ (3,911,603)

See Notes to Financial Statements

1. Organization and Summary of Significant Accounting Policies

General Information

In 1940, the City of Owensboro, Kentucky (City), established the City Utility Commission to manage, control and operate Owensboro Municipal Utilities (OMU). City officials appoint the five individuals who comprise the City Utility Commission. OMU consists of the Electric Light and Power System (Electric System) and the Water Works System (Water System), which are separate enterprise funds of the City. Accordingly, the Electric System and the Water System are part of the financial reporting entity of the City. The accompanying financial statements present only the Electric System and are not intended to present fairly the financial position of the City and the changes in its financial position or, where applicable, its cash flows, in conformity with accounting principles generally accepted in the United States of America. The Electric System is subject to regulation by the City, including approval of rates charged for utility services, as set forth in applicable City ordinances.

The Electric System provides electric power to approximately 26,000 residential, commercial and industrial customers in Owensboro, Kentucky. The Electric System also sells electric power into regional wholesale power markets and to other wholesale customers.

The Electric System consists of the original generating station, the transmission and distribution plant and the Elmer Smith Generating Station (ESGS). ESGS is operated, including subsequent additions, as a separate division.

System of Accounts and Basis of Accounting

The Electric System's accounts are maintained substantially in accordance with the Uniform System of Accounts of the Federal Energy Regulatory Commission and in conformity with accounting principles generally accepted in the United States of America using the economic resources measurement focus and the accrual basis of accounting, including the application of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 980, *Regulated Operations*, as the standard relates to the deferral of revenues and expenses to future periods in which the revenues are earned or the expenses are recovered through the rate-making process.

The Electric System considers electric and telecommunications revenues and costs that are directly related to generation, purchase, transmission, and distribution of electricity and telecommunications services to be operating revenues and expenses. Revenues and expenses related to financing and other activities are reflected as nonoperating.

1. Organization and Summary of Significant Accounting Policies, Continued

System of Accounts and Basis of Accounting, Continued

The Electric System accrues revenues as services are rendered to utility customers. In addition, the Electric System's present electric rate ordinance provides for an energy cost adjustment and environmental control cost adjustment to be made to customer bills, except bills rendered to the City, to reflect changes in the price of fuel and maintenance costs and environmental compliance costs to generate electricity. The Electric System estimates and records amounts to be billed or refunded under the energy cost adjustment on a monthly basis.

Utility Plant and Depreciation

Utility plant is stated at original cost, which includes the cost of contracted services, materials, labor, and labor-related expenditures, administrative and general costs, and an allowance for borrowed funds used during construction.

Replacements of depreciable property units, except minor replacements, are charged to utility plant. Property units replaced or retired, including cost of removal net of any salvage, are charged to accumulated depreciation. Routine maintenance, repairs and minor replacement costs are charged to expense as incurred.

Allowance for borrowed funds used during construction includes capitalized interest during the construction period less any interest income on construction fund investments from bond proceeds during such period. Capitalization of interest is discontinued when the project is completed and the related utility plant is placed in service.

Depreciation of utility plant and unclassified plant in service is provided using the straight-line composite rate method over the estimated service lives of the depreciable assets of the Electric System, excluding ESGS, and on the sinking fund method for ESGS depreciable assets. Estimated service lives of assets depreciated using the composite method range from 5 to 60 years. The sinking fund method was adopted for ESGS as a result of the terms of a power sale contract. Depreciation expense during 2014 and 2013 was approximately 3.3% and 3.7%, respectively, of the average original cost of depreciable utility plant in service.

Restricted Assets

The City ordinances that authorized the Electric Light and Power Revenue Bonds require that certain amounts from bond proceeds and payments by customers for services provided be deposited into designated funds and be used only for the specified purposes of the funds. The Electric System's policy is to first apply restricted resources when an expense is incurred for purposes for which both restricted and unrestricted net assets are available.

1. Organization and Summary of Significant Accounting Policies, Continued

Cash and Investments

Cash deposits are reported at carrying amounts. Certificates of deposit and long-term repurchase agreements are reported at cost. U.S. government obligations and agency securities are stated at fair values based upon currently quoted market rates.

The Electric System considers all highly liquid investments (including restricted assets) with a maturity of three months or less when purchased to be cash equivalents. Unrestricted investments with initial maturities exceeding three months, consisting of certificates of deposit and U.S. agency securities, are classified as temporary investments.

Inventories

Inventories consisting of materials and supplies and fuel inventory (included in restricted assets) are valued at the lower of weighted average cost or market. Fuel for electric generation is charged to expense as used.

Bond Issuance Costs

Premiums and discounts arising from various bond issues are deferred and amortized using the straight-line method over the lives of the bond issues.

The Electric System's rate making methodology allows for future recovery of debt costs, including bond issuance costs, in its rate making process. Accordingly, under FASB ASC 980, *Regulated Operations,* debt issuance costs are deferred and amortized using the straight-line method over the lives of the bond issues.

The difference between the reacquisition price and the net carrying amount of defeased bond issues has been deferred and is being amortized using the straight-line method over the lives of the refunding bond issues.

Income Taxes

The Electric System is exempt from federal and state income taxes and, accordingly, the financial statements include no provision for such taxes.

Estimates

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

1. Organization and Summary of Significant Accounting Policies, Continued

Hedging Derivative Instruments

The Electric System has adopted GASB Statement No. 53, "Accounting and Financial Reporting for Derivative Instruments" (GASB 53). GASB 53 requires that hedging derivative instruments (Hedging Transactions) be recorded at fair value and establishes certain requirements for revenue recognition, measurement and disclosure related to Hedging Transactions. The Electric System's Hedging Transactions have been tested for effectiveness under the guidelines prescribed by GASB 53. The Electric System utilized one of the three quantitative methods required by GASB 53, the synthetic instrument method. This method evaluates the effectiveness of a hedge transaction by comparing the relationship of the variable cash flows of the potential hedging item and the hedgeable item. The effectiveness testing of the Electric System's Hedging Transactions demonstrated that the hedges are effective as defined by GASB 53.

Change in Accounting Principle

In 2014, the Electric System adopted GASB Statement No. 65, "Items Previously Reported as Assets and Liabilities" (GASB 65). GASB 65 requires that certain deferred outflows and deferred inflows of resources be reported separately from assets and liabilities. The Electric System has restated its other noncurrent assets and long-term debt to reflect that certain components of those assets and liabilities, as of May 31, 2013, are now reported as deferred outflows of resources in the Statement of Net Position. The effect of this change, as of May 31, 2013, is a decrease of $260,523 in other noncurrent assets, an increase of $386,926 in deferred outflows of resources and an increase in long-term debt of $126,403.

2. Utility Plant

Electric utility plant activity for the year ended May 31, 2014, was as follows:

2. Utility Plant, Continued

	Beginning Balance	Additions	Retirements	Ending Balance
Utility plant:				
Production plant	$ 285,831,688	$ 24,326,038	$ -	$ 310,157,726
Transmission plant	30,154,700	518,939	(222,621)	30,451,018
Distribution plant	72,374,521	4,295,068	(919,553)	75,750,036
General plant	19,272,320	1,105,212	(612,426)	19,765,106
Unclassified plant in service	4,407,008	(800,715)	-	3,606,293
Total, at original cost	412,040,237	29,444,542	(1,754,600)	439,730,179
Accumulated depreciation:				
Production plant	(176,722,217)	(9,635,913)	-	(186,358,130)
Transmission plant	(15,434,895)	(829,747)	167,085	(16,097,557)
Distribution plant	(40,267,329)	(2,455,777)	478,719	(42,244,387)
General plant	(11,727,783)	(798,019)	595,099	(11,930,703)
Total accumulated depreciation	(244,152,224)	(13,719,456)	1,240,903	(256,630,777)
Construction in progress	6,751,027	1,259,141	-	8,010,168
Utility plant, net	$ 174,639,040	$ 16,984,227	$ (513,697)	$ 191,109,570

Depreciation expense for the years ended May 31 was as follows:

	2014	2013
Electric utility plant	$13,309,301	$14,517,707
Telecommunications	173,149	167,259
	13,482,450	14,684,966
Transportation and stores depreciation charged to construction activities or other operating expenses	237,006	230,658
	$13,719,456	$14,915,624

3. Restricted Assets

Restricted assets at May 31 consist of the following:

	2014	2013
Cash and cash equivalents	$72,076,592	$43,910,481
Investments	27,969,316	21,864,477
Accrued interest receivable	354,914	351,876
Fuel and other inventories, at cost	9,187,736	6,453,061
Other	744,073	739,448
	$110,332,631	$73,319,343

3. Restricted Assets, Continued

The above balances are contained in the following funds:

	2014	2013
Operation and Maintenance Fund	$ 11,341,610	$ 8,170,769
Construction Fund	37,118,592	16,134,201
Depreciation Fund	4,313,250	4,119,505
Sinking Funds	25,588,737	25,873,819
Facility Charge Fund	7,292,112	7,315,976
Reserve and Contingency Fund	24,678,330	11,705,073
	$110,332,631	$73,319,343

The terms of the City ordinances authorizing the Electric System's Electric Light and Power Revenue Bonds require all investment income to be credited to the various restricted asset funds.

OMU follows GASB Statement No. 31, "Accounting and Financial Reporting for Certain Investments and for External Investments Pools" (GASB 31), which requires certain investments to be carried at fair value in the balance sheets and changes in the fair value of investments to be reported in the statements of revenues, expenses and changes in fund net position. In accordance with GASB 31, OMU recorded unrealized losses of $236,814 and $260,523 for the years ended May 31, 2014 and 2013, respectively. OMU's rate making methodology does not consider unrealized gains or losses on marketable securities in its rate making process. Accordingly, under FASB ASC 980, *Regulated Operations,* the unrealized losses for the years ended May 31, 2014 and 2013, have been deferred.

The net increase (decrease) in the fair value of investments consists of the following:

	2014	2013
Net realized gains (losses) on sales of investments	$ -	$ -
Net unrealized gains (losses) on investments	(236,814)	(260,523)
	$ (236,814)	$ (260,523)

The calculation of realized gains or losses on sales of investments is independent of the calculation of the net change in the fair value of investments. Realized gains or losses on investments that were held in more than one fiscal year and sold in the current year were included as a net change in the fair value of investments reported in prior years and the current year.

4. Cash Deposits and Investments

At May 31, the carrying amounts of the Electric System's deposits in financial institutions and investments other than deposits were:

	2014	2013
Deposits in financial institutions	$98,395,613	$64,964,194
Investments other than deposits	26,627,663	21,864,477
	$125,023,276	$86,828,371

These amounts are reflected in the statements of net position as:

	2014	2013
Cash and cash equivalents	$24,977,368	$21,053,713
Temporary investments	-	-
Restricted assets:		
Cash and cash equivalents	72,076,592	43,910,481
Investments	27,969,316	21,864,477
	$125,023,276	$86,828,671

Deposit and Investment Policy. The Electric System's deposit and investment policy prescribes to the prudent-person rule: Investments shall be made with applicable law and under prevailing circumstances which persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital, as well as the probable income to be derived.

Custodial Credit Risk. Custodial credit risk is the risk that, in the event of a bank failure, the Electric System's deposits may not be returned to it. The Electric System's deposit and investment policy permits uncollateralized deposits only if issued by institutions ranked in one of the three highest categories by a nationally recognized rating agency. As of May 31, 2014, $98,401,810 of the Electric System's bank balance of $98,676,322 was exposed to custodial credit risk as follows:

Uninsured and uncollateralized	$ -
Uninsured with collateral held by pledging bank's agent	98,401,810
Total	$98,401,810

4. Cash Deposits and Investments, Continued

As of May 31, 2014, the Electric System had the following investments. Investments are reported at fair values with the exception of repurchase agreements, which are reported at cost.

Investments	Maturities	
Repurchase agreements	12/31/2019	$ 8,900,000
Federal Home Loan Bank – Callable	04/17/2019	4,998,835
Federal Home Loan Bank – Callable	11/01/2022	5,451,368
Federal Home Loan Bank – Callable	01/30/2023	7,277,460
		$26,627,663

Interest Rate Risk. As a means of limiting its exposure to fair value losses arising from rising interest rates, the Electric System's deposit and investment policy limits investment maturities based upon provisions of bond ordinances. The bond ordinances limit investments contained in the Operation and Maintenance Fund to five years and limit investments in the Depreciation Fund, Sinking Funds, and Facility Charge Fund to ten years.

Credit Risk. The Electric System's deposit and investment policy authorizes the investment of funds in any manner permitted by bond ordinances and the Kentucky Revised Statutes and does not further limit its investment choices.

Concentration of Credit Risk. Other than the prudent-person rule, the Electric System's deposit and investment policy places no limit on the amount the Electric System may invest in any one issuer. The Electric System's investments are in U.S. agency securities and repurchase agreements at May 31, 2014.

5. Hedging Transactions

The Electric System is exposed to market price fluctuations on its sale of surplus electricity and to market price fluctuations on the price of diesel fuel, due to its long-term coal contracts, many of which contain diesel fuel adjustment clauses. To protect itself from wholesale electricity price fluctuations and diesel fuel price fluctuations, the Electric System periodically enters into electricity price swap and futures contracts and fuel swap contracts (hedging transactions).

The Electric System enters into electricity and fuel hedging transactions at various fixed prices and notional amounts. Each electricity hedging transaction provides for the Electric System to pay a floating price and for the contract counterparty to pay a fixed price, and each fuel hedging transaction provides for the Electric System to pay a fixed price and the contract counterparty to pay a floating price for the notional amount of each type of contract. Furthermore, the Electric System from time to time will remove an electricity hedge position by entering into a hedging transaction to pay a fixed price, and for the contract counterparty to pay a floating price for a

5. Hedging Transactions, Continued

like notional amount as the original hedging transaction. The notional amount of each electricity and fuel hedging transaction is measured in megawatt hours (MWh) and gallons, respectively, with the floating price based on a specific published index (spot price) for the relevant contract month.

The Electric System entered into electricity hedging transactions with notional amounts totaling 4,940,850 and 4,234,375 MWh in 2014 and 2013, respectively. Hedging transactions with notional amounts totaling 2,524,800 and 3,104,775 MWh were settled in 2014 and 2013, respectively, with a resulting loss of $11,959,948 and $1,877,122 in 2014 and 2013, respectively, which are reflected in other wholesale revenue. At May 31, 2014, the Electric System's outstanding electricity hedging transactions were as follows:

Executed	Maturity Date	Notional Quantity (MWh)	Fixed Price ($/MWh)	Fair Value
Hedge Positions:				
10/31/13 – 5/27/14	June 30, 2014- August 31, 2014	120,400	30.40-60.25	$ (820,562)
9/5/13 – 1/21/14	September 30, 2014- November 30, 2014	84,000	40.85-43.60	(477,855)
7/30/12 – 5/15/14	December 31, 2014- February 28, 2015	1,065,750	28.80-61.75	(7,049,181)
2/10/14 – 2/19/14	March 31, 2015- May 31, 2015	51,200	34.30-36.00	(442,657)
1/30/14 – 2/20/14	June 30, 2015- August 31, 2015	52,800	38.35-48.75	(436,712)
2/24/14 – 2/26/14	September 30, 2015- November 30, 2015	33,600	33.90-38.50	(148,834)
9/24/12 – 5/8/14	December 31, 2015- February 28, 2016	978,400	32.25-41.60	(3,051,002)
2/4/14 – 5/13/14	December 31, 2016- February 28, 2017	847,200	32.95-44.55	(4,489,844)
		3,233,350		(16,916,647)

5. Hedging Transactions, Continued

Executed	Maturity Date	Notional Quantity (MWh)	Variable Price ($/MWh)	Fair Value
Hedge Positions Removed:				
8/1/12 – 5/27/14	June 30, 2014- August 31, 2014	206,000	30.50-60.70	1,031,451
8/27/13 – 12/3/13	September 30, 2014- November 30, 2014	84,000	40.20-42.15	584,535
8/14/13 – 5/15/14	December 31, 2014- February 28, 2015	190,000	43.25-62.50	1,910,002
02/26/14	September 30, 2015	16,800	38.25	68,502
2/19/14 - 3/28/14	December 31, 2015- February 28, 2016	489,200	28.25-41.65	2,251,867
3/20/14-3/28/14	December 31, 2016- February 28, 2017	408,000	40.75-46.90	2,424,868
		1,394,000		8,271,225
		4,627,350		$ (8,645,422)

The Electric System entered into fuel hedging transactions with notional amounts totaling 2,982,000 and 504,000 gallons in 2014 and 2013, respectively. Hedging transactions with notional amounts totaling 2,016,000 gallons were settled in 2014, with a resulting loss of $39,249 in 2014 which is reflected in fuel expense. No fuel hedging transactions were settled in 2013. At May 31, 2014, the Electric System's outstanding fuel hedging transactions were as follows:

5. Hedging Transactions, Continued

Executed	Maturity Date	Notional Quantity (Gallons)	Fixed Price ($/Gallon)	Fair Value
Diesel:				
06/11/13 – 08/29/13	6/30/2014	126,000	3.833 – 4.070	$ (9,840)
12/4/2013	7/31/2014	84,000	3.955	(7,384)
12/4/2013	8/31/2014	84,000	3.955	(7,006)
12/4/2013	9/30/2014	84,000	3.955	(6,577)
12/4/2013	10/31/2014	84,000	3.955	(6,997)
12/4/2013	11/30/2014	84,000	3.955	(8,937)
12/4/2013	12/31/2014	84,000	3.955	(9,660)
		630,000		$ (56,401)
Heating Oil:				
05/24/13 – 07/03/13	6/30/2014	84,000	2.888 – 2.981	(3,869)
10/1/2013	7/31/2014	126,000	2.869	3,163
10/1/2013	8/31/2014	126,000	2.869	3,919
10/1/2013	9/30/2014	126,000	2.869	4,435
10/1/2013	10/31/2014	126,000	2.869	4,813
10/1/2013	11/30/2014	126,000	2.869	5,052
10/1/2013	12/31/2014	126,000	2.869	5,229
		840,000		22,742
		1,470,000		$ (33,659)

The electricity and fuel hedging transactions are settled by cash payments that are equal to the differential between the contract price and the settlement price (financially settled). These financially settled hedging transactions are hedging derivative instruments as defined by GASB 53. Accordingly, the Electric System's unrealized gains and losses on its outstanding hedging transactions are reported at fair value in other current assets, other noncurrent assets, other current liabilities and other noncurrent liabilities in its May 31, 2014 and 2013, balance sheets. The fair market value for each of the Electric System's hedging transactions have been determined by computing the difference between the contractual forward price and the published forward price at the respective market's settlement point at market closing as of May 31, 2014 and 2013. The Electric System's electricity hedging transactions settle and are valued at the AEP-Dayton Hub and the Indiana hub, which are settlement hubs in the PJM and MISO energy markets, respectively. The heating oil hedging transactions settle and are valued at the heating

5. Hedging Transactions, Continued

oil futures index of the New York Mercantile Exchange (NYMEX) and the diesel hedging transactions settle and are valued at the NYMEX Energy Information Administrations (EIA) Flat Tax On-Highway Diesel Futures index. The outstanding electricity hedging transactions had a fair value of ($8,645,422) and ($3,897,991) at May 31, 2014 and 2013, respectively. The fuel hedging transactions had a fair value of ($33,659) and ($13,612) at May 31, 2014 and 2013, respectively.

Credit Risk: The Electric System is exposed to credit risk on hedging transactions that are in an asset position. To minimize the Electric System's exposure to loss related to credit risk, the Electric System requires certain counterparties to post collateral equal to all or a portion of the fair value of hedging transactions in asset positions (net of the effect of applicable netting arrangements) should the fair value of the netted contracts exceed contractually agreed upon parameters or if the credit rating of a certain counterparty or, an affiliated guarantor of the counterparty, is at, or falls below, contractually agreed-upon levels. Collateral posted is in the form of a letter of credit or US dollars held by the Electric System. At May 31, 2014, the Electric System's rated counterparties, or affiliated guarantors, had credit ratings ranging from A to BBB+ as established by a nationally recognized rating organization. The Electric System also had two counterparties that were not rated but each had provided a letter of credit for the purpose of establishing credit for the counterparty.

It is the Electric System's practice to enter into netting arrangements whenever it has entered into more than one financially settled forward swap contract transaction with a counterparty. If one party becomes insolvent or defaults on its obligations, closeout netting provisions permit the non-defaulting party to accelerate and terminate all outstanding transactions and net the transactions' fair values so that a single sum will be owed to, or owed by, the non-defaulting party.

The Electric System had no outstanding hedging transactions with counterparties at May 31, 2014, in which the aggregate fair value was in a net asset position. The net asset position represents the maximum loss that would be incurred at the reporting date if all counterparties failed to perform as contracted. Outstanding hedging transactions in a liability positions totaled $8,679,081 at May 31, 3014.

Basis Risk: The Electric System is exposed to basis risk on its hedging transactions because the price of the expected physical commodity sale being hedged will be priced at pricing points (South Import PJM Interface or LG&E MISO Interface), which are different than the pricing points at which the hedging transactions will settle (AEP-Dayton PJM Hub or Indiana MISO Hub). Management believes this risk is not material based on quantitative analysis.

Termination Risk: The Electric System is exposed to termination risk on its hedging transactions because a counterparty may fail to perform under the terms of one or more contracts resulting in the termination of the aggregate contracts with that counterparty. To minimize the Electric System's exposure to loss related to termination risk, the Electric System requires counterparties to post collateral equal to the fair value of hedging transactions in asset positions

5. Hedging Transactions, Continued

(net of the effect of applicable netting arrangements) should the fair value of the netted contracts exceed contractually agreed upon parameters or if the credit rating of a certain counterparty, or an affiliated guarantor of the counterparty, is at, or falls below, contractually agreed-upon levels. If at the time of termination the net position of financially settled power contracts with a terminating party is in an aggregate liability position, the Electric System would be liable to the counterparty for a payment equal to the aggregate liability position, subject to netting arrangements.

Commitments: Hedging transactions provide that the Electric System post collateral in the event that 1) OMU's credit profile falls below contractually agreed-upon parameters or 2) the fair value of the Electric System's hedging transactions are in a liability position (net of the effect of applicable netting arrangements) should the fair value of the netted contracts exceed contractually agreed-upon parameters. When collateral is posted, it is in US dollars in the amount of the fair value of the hedging derivative instruments in liability positions (net of the effect of applicable netting arrangements). If the Electric System does not post collateral, the aggregate outstanding hedging transactions may be terminated by the counterparty. If the collateral posting requirements related to OMU's credit profile had been triggered at May 31, 2014, the Electric System would have been required to post collateral with its counterparties in the amount of $8,645,422.

6. Long-Term Debt

Long-term debt activity for the year ended May 31, 2014, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due Within One Year
Bonds payable:					
Series of 1991-B	$ 86,985,787	$ 3,341,820	$(42,597,295)	$ 47,730,312	$ -
Series of 2002-A	20,830,000	-	(2,455,000)	18,375,000	2,610,000
Series of 2010-A	10,070,000	-	-	10,070,000	-
Series of 2010-B	31,425,000	-	-	31,425,000	-
Series of 2010-C	8,935,000	-	-	8,935,000	
Series of 2013-A	-	8,875,000		8,875,000	
Series of 2013-B	-	77,100,000	-	77,100,000	-
	158,245,787	89,316,820	(45,052,295)	202,510,312	2,610,000
Add unamortized debt premium (discount)	502,335	3,698,189	(316,069)	3,884,455	-
Total long-term debt	$158,748,122	$93,015,009	$(45,368,364)	$206,394,767	$ 2,610,000

6. Long-Term Debt, Continued

Long-term debt at May 31 consists of the following Electric Light and Power Revenue Bonds:

	2014	2013
Series of 1991-B: Deferred interest bonds including interest compounded semi-annually at 6.70% to 6.95%, principal and interest due from 2017 to 2020 (original principal of outstanding bonds at May 31, 2014, was $10,269,998)	$ 47,730,312	$ 86,985,787
Series of 2002-A: 6.34% due 2020, subject to annual pro rata sinking fund redemption from 2014 to 2020	18,375,000	20,830,000
Series of 2010-A: Current interest bonds, 4.88% to 5.03%, due from 2021 to 2022	10,070,000	10,070,000
Series of 2010-B: Current interest bonds, 4.88% to 5.58%, due from 2021 to 2025	31,425,000	31,425,000
Series of 2010-C: Current interest bonds, 5.00%, due from 2021 to 2022	8,935,000	8,935,000
Series of 2013-A: Current interest bonds, 3.40% to 3.65%, due from 2021 to 2022	8,875,000	-
Series of 2013-B: Current interest bonds, 3.00% to 5.00%, due from 2022 to 2027	77,100,000	-
Total long-term debt	202,510,312	158,245,787
Less current maturities	(2,610,000)	(17,566,845)
Add unamortized debt premium (discount)	3,884,455	502,335
	$203,784,767	$141,181,277

6. Long-Term Debt, Continued

Sinking fund requirements and scheduled aggregate maturities of long-term debt are as follows:

Year Ending May 31:	Principal	Interest	Total
2015	$ 2,610,000	$ 7,564,456	$ 10,174,456
2016	2,780,000	7,398,982	10,178,982
2017	18,680,000	7,222,730	25,902,730
2018	18,865,000	7,035,383	25,900,383
2019	19,065,000	6,836,307	25,901,307
2020 – 2024	98,730,000	26,959,435	125,689,435
2025 – 2029	56,950,000	4,584,779	61,534,779
	$217,680,000	$67,602,072	$285,282,072

The scheduled principal maturities include $15,169,688 of interest scheduled to be incurred in future years on deferred interest bonds, which will be compounded and added to the original principal amounts.

The Electric System is subject to certain debt covenants, compliance with which is required by the ordinances authorizing its bond issues. Such ordinances require revenue to be first applied to the Sinking Funds, second to the Operations and Maintenance Fund, third to the Additions and Replacements Fund, fourth to the Depreciation Fund, fifth to the Reserve and Contingency Fund, and finally to the Facility Charge Fund.

On December 6, 1991, the City issued $62,474,359 of Electric Light and Power System Revenue Bonds, 1991-B series, dated December 6, 1991. These deferred interest bonds bear interest at rates ranging from 6.70% to 6.95% which, when compounded semi-annually and added to the original principal amount, will result in compounded amounts at scheduled maturities in 2005 to 2020 of $25,000 per bond.

The 1991-B Bonds were issued to provide construction funds for certain pollution control facilities and equipment, certain solid waste disposal facilities and equipment and related purposes.

The 1991-B series is not subject to redemption prior to maturity.

On February 27, 2002, the City issued $34,905,000 of Electric Light and Power System Revenue Bonds, Taxable 2002-A Series and $12,205,000 of Electric Light and Power System Revenue Bonds, Tax-Exempt 2002-B Series, each dated February 1, 2002.

6. Long-Term Debt, Continued

The 2002-A and B Bonds were issued to provide construction funds for certain pollution control facilities and equipment.

The 2002-A series is subject to scheduled redemption prior to maturity based upon annual pro rata sinking fund redemptions. In addition, the 2002-A series is subject to early redemption, in whole or in part, at any time, at terms specified in the 2002 Official Statement. Certain 2002-B series bonds totaling $3,230,000 due January 1, 2020, are subject to scheduled redemption beginning in 2018 based upon annual pro rata sinking fund redemptions. The 2002-B series is also subject to early redemption in whole or in part on any date on or after January 1, 2009, at redemption prices (expressed as a percentage of principal amount) of 101% for 2009, 100½% for 2010, and 100% thereafter, plus accrued interest to the redemption date.

On November 18, 2010, the City issued $10,070,000 of Electric Light and Power System Revenue Bonds, Taxable 2010-A Series, $31,425,000 of Electric Light and Power System Revenue Bonds, Taxable 2010-B Series (Build America Bonds) and $8,935,000 of Electric Light and Power System Refunding Revenue Bonds, Tax-Exempt 2010-C Series, each dated November 4, 2010. The 2010 Bonds were issued to fund various capital improvement expenditures for the Electric System and to refund the 2002-B series bonds. The in-substance defeasance of the 2002-B Bonds was accomplished by placing approximately $9,274,976 in proceeds from the 2010-C Bonds and $170,826 in funds from the 2002-B Bond Sinking Fund in an irrevocable escrow fund to be used solely for satisfying scheduled debt service payments of the 2002-B Bonds. Accordingly, the 2002-B Bonds in the amount of $9,230,000, net of unamortized discount and issuance costs of $123,543 and accrued interest payable of $164,248, were extinguished resulting in the accounting recognition of a loss from defeasance of $175,097, reported in the accompanying financial statements as a reduction of long-term debt. The City advance refunded the 2002-B bonds to extend the repayment period of the bond, reduce its near term annual debt payments and reduce the effective rate on the debt. The advance refunding resulted in an economic gain (difference between the present value of the debt service payment on the old and new debt) of $558,382.

The 2010-B Series bonds (Build America Bonds – Direct Payment) were issued in connection with the American Recovery and Reinvestment Act of 2009 (Act). Under the Act, state and local governments were authorized to issue taxable bonds to finance capital expenditures for which they could otherwise issue tax-exempt bonds, and receive from the IRS a direct interest subsidy totaling 35% of the total coupon interest paid to investors. Due to current federal budget sequestration, the direct interest subsidy is currently reduced to 32% of the total coupon interest. Interest subsidy received for fiscal years 2014 and 2013 was $532,827 and $557,863, respectively. Remaining interest subsidies scheduled through maturities of the bonds, before budget sequestration reductions, are as follows:

6. Long-Term Debt, Continued

Year Ending May 31:

2015	$ 578,846
2016	578,846
2017	578,846
2018	578,846
2019	578,846
2020 – 2024	2,378,085
2025 – 2029	151,455
	$5,423,770

The 2010-A, B and C series are subject to redemption prior to maturity in whole or in part on any date on or after January 1, 2020, at the redemption price (expressed as a percentage of principal amount to be redeemed) of 100%, plus accrued interest to the redemption date. Furthermore, the 2010-B series (Build America Bonds) may be subject to redemption prior to maturity in whole or in part upon the occurrence of an Extraordinary Event, as defined in the Official Statement. As discussed above, Build America Bonds involve a payment to the issuer from the United States Treasury for a portion of the interest payable on such bonds. If the associated payment from the United States Treasury is reduced or eliminated through no fault of the issuer (Extraordinary Event), the bonds will become redeemable, at the option of the issuer, at a potentially reduced redemption price, as defined in the Official Statement.

On June 25, 2013, the City issued $8,875,000 of Electric Light and Power System Revenue Bonds, Taxable 2013-A Series and $77,100,000 of Electric Light and Power System Revenue Bonds, Tax-Exempt 2013-B Series, each dated June 25, 2013. The 2013 Bonds were issued to fund various capital improvement expenditures for the Electric System and to refund certain 1991-B series bonds. The in-substance defeasance of the 1991-B Bonds was accomplished by placing $40,325,905 in proceeds from the 2013-B Bonds and $6,552,083 in funds from the 1991-B Bond Sinking Fund in an irrevocable escrow fund to be used solely for satisfying scheduled debt service payments of the 1991-B Bonds. Accordingly, the 1991-B Bonds in the amount of $42,597,295, net of unamortized discount and issuance costs of $211,974, were extinguished resulting in the accounting recognition of a loss from defeasance of $4,492,667, reported in the accompanying financial statements as a deferred outflow. The City advance refunded the 1991-B bonds to extend the repayment period of the bond and reduce its near term annual debt payments. The advance refunding resulted in an economic loss (difference between the present value of the debt service payment on the old and new debt) of $2,993,589.

The 2013-A and B series are subject to redemption prior to maturity in whole or in part on any date on or after January 1, 2020, at the redemption price (expressed as a percentage of principal amount to be redeemed) of 100%, plus accrued interest to the redemption date.

6. Long-Term Debt, Continued

All bonds are secured by a pledge of and are payable from the gross revenues derived from the operation of the Electric System and are secured by a statutory mortgage lien as provided and authorized by the Kentucky Revised Statutes.

7. Dividends - City of Owensboro

Under the terms of City ordinances authorizing the Electric System bonds, whenever all specified or required transfers and payments have been set aside and paid into the restricted asset funds and there is a balance in excess of the amount to be set aside and paid into the restricted asset funds during the next succeeding two months (approximately $20,758,000 at May 31, 2014), the City Utility Commission may withdraw and transfer from such excess to the general fund of the City in any fiscal year an amount not to exceed 10% of the value of the City's ownership (net assets) exclusive of interest accumulated on deposits in the Reserve and Contingency Fund ($10,457,955 at May 31, 2014) and amounts in the Facility Charge Fund ($7,292,112 at May 31, 2014) as shown on the Electric System's books on the first day of the fiscal year. The Ordinance also allows for the transfer to the City of a sum equal to the dollar value of services purchased by the City from the Electric System in the fiscal year, not to exceed, however, $700,000 for the fiscal year ended June 30, 1985, and thereafter increasing at a compound rate of 5% per annum. Transfers to the City under this ordinance and agreement were $8,414,463 and $8,631,197 for 2014 and 2013, respectively.

8. Pension Plan

OMU participates in the County Employees Retirement System (CERS) of the Commonwealth of Kentucky and the City of Owensboro City Employees Pension Fund (CEPF), which are both cost-sharing multiple-employer defined benefit pension plans. The plans provide retirement, disability and death benefits to plan members. The CERS provides for annual cost-of-living adjustments as enacted by the Kentucky legislature in 1996. Participation in the CEPF is limited to participants as of October 1, 1986, who elected to remain in the CEPF rather than enter the CERS.

The Kentucky Revised Statutes assign the administrative authority of the CERS to the Board of Trustees of the Kentucky Retirement Systems. The Kentucky Retirement Systems issues a publicly available financial report that includes financial statements and required supplementary information for the CERS. That report may be obtained by writing to Kentucky Retirement Systems, Perimeter Park West, 1260 Louisville Road, Frankfort, KY 40601 or by calling 502-564-4646.

8. Pension Plan, Continued

The administrative authority of the CEPF is assigned to the Board of Trustees of the CEPF. The CEPF issues a publicly available financial report that includes financial statements and required supplementary information for the CEPF. That report may be obtained by writing to the Finance Director, City of Owensboro, P.O. Box 10003, Owensboro, KY 42302 or by calling 270-687-8534.

Plan members participating in CERS on or before August 31, 2008, are required to contribute 5% of their annual creditable compensation and plan members who began participating in CERS on or after September 1, 2008, are required to contribute 6%. OMU is required to contribute at an actuarially determined rate. The current rate is 18.89% of annual covered payroll. Such contributions are determined by the Board of Trustees of the Kentucky Retirement Systems each biennium. The Electric System's contributions to the CERS totaled approximately $2,752,000, $2,744,000 and $2,547,000 for the years ended May 31, 2014, 2013, and 2012, respectively, equal to the required contributions for each year. At May 31, 2014 and 2013, the Electric System had no active employees participating in the CEPF and, accordingly, made no contributions to the plan.

9. Commitments and Contingencies

The Electric System has entered into contracts to purchase fuel and related products for electric generation. Although contracts have termination provisions, minimum future payments on these contracts for the years ending May 31 are estimated to be as follows:

2015	$ 55,376,986
2016	50,350,821
2017	41,244,125
2018	25,240,042
2019	2,276,042
	$174,488,016

OMU is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. OMU manages its risks through coverages provided by private insurance carriers for various risks of losses to which it is exposed, including directors and officers, employee dishonesty, boiler and machinery, workers' compensation and other property risks. The boiler and machinery policy contains a deductible of $500,000 and excludes acts of terrorism from its coverage. OMU is self-insured for group health and limits its risks of loss by purchasing reinsurance coverage.

OMU has been identified by the United States Environmental Protection Agency as one of numerous parties that may be liable for damages under federal law with respect to a superfund hazardous waste site. Through May 31, 2014, OMU has paid $57,500, plus legal costs, related to this matter. Based upon the opinion of its outside legal counsel, management does not anticipate additional costs to be material, however, the ultimate resolution of this matter and the related financial impact on OMU, if any, cannot be determined at this time.

9. Commitments and Contingencies, Continued

There are a number of other pending legal actions involving OMU. Management believes that the outcome of such legal actions and claims will not have a material effect on OMU's financial position or results of operations.

10. Rate Matters

Effective June 1, 2013, the Electric System discontinued billing credits for retail customers associated with environmental costs at ESGS which was anticipated to increase retail revenues by approximately 6%.

11. Reclassifications

Certain amounts on the prior year financial statements have been reclassified in order to conform to the current year's presentation.

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OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM

SCHEDULE OF REVENUES AND EXPENSES

Year Ended May 31, 2014 (with comparative totals for 2013)

	Retail Electric System	Wholesale Power Marketing
Operating revenues:		
Charges for services:		
Residential	$ 22,995,721	$ -
Commercial	4,618,667	-
Industrial	40,239,608	
Water Works System	684,114	-
City of Owensboro	2,111,123	-
Supplemental power	-	2,700,565
Other wholesale	-	61,952,540
Electric Light and Power System	-	-
Build America Bond subsidy	395,930	-
Other	818,933	-
Total operating revenues	71,864,096	64,653,105
Operating expenses:		
Production:		
Fuel for electric generation	-	-
Purchased power	50,495,359	58,472,326
Other	-	-
Transmission and distribution	4,175,882	3,072,812
Customer service and information	1,351,566	-
General and administrative	4,567,726	1,485,150
Telecommunications	-	-
Depreciation	3,332,907	-
Total operating expenses	63,923,440	63,030,288
Operating income (loss)	7,940,656	1,622,817
Nonoperating revenues (expenses):		
Interest and debt expense	(1,308,845)	-
Interest income on investments	224,879	-
Interest income on Elmer Smith Generating Station investments allocated to:		
Electric System	827,441	-
Other, net	-	-
Net decrease in fair value of investments	-	-
Deferred net change in fair value of investments	-	-
Total nonoperating revenues (expenses)	(256,525)	-
Income before transfers	7,684,131	1,622,817
Transfers out - dividends to City of Owensboro	(8,414,463)	-
Change in net position	$ (730,332)	$ 1,622,817

Elmer Smith Generating Station	Telecommunications	Eliminations	Total	2013 Total
$ -	$ -	$ -	$ 22,995,721	$ 25,569,752
-	882,280	-	5,500,947	5,730,964
-	-	-	40,239,608	44,783,817
-	35,594	-	719,708	844,106
-	5,100	-	2,116,223	2,486,697
-	-	-	2,700,565	1,709,220
-	-	(74,986)	61,877,554	59,800,009
99,837,954	148,139	(99,986,093)	-	-
136,897	-	-	532,827	557,863
-	-	(100,810)	718,123	812,351
99,974,851	1,071,113	(100,161,889)	137,401,276	142,294,779
59,409,962	-	39,249	59,449,211	66,708,167
32,852	-	(99,952,189)	9,048,348	6,535,616
15,600,544	-	(24,810)	15,575,734	12,717,231
150,949	-	(104,250)	7,295,393	7,980,313
-	33,956	-	1,385,522	1,321,943
6,784,012	148,936	(119,889)	12,865,935	12,737,385
-	545,158	-	545,158	370,743
9,976,394	173,149	-	13,482,450	14,684,966
91,954,713	901,199	(100,201,138)	119,647,751	123,056,364
8,020,138	169,914	39,249	17,753,525	19,238,415
(8,237,483)	-	-	(9,546,328)	(10,472,877)
827,441	-	-	1,052,320	815,999
(827,441)	-	-	-	-
217,345	-	-	217,345	45,402
(236,814)	-	-	(236,814)	(260,523)
236,814	-	-	236,814	260,523
(8,020,138)	-	-	(8,276,663)	(9,611,476)
-	169,914	39,249	9,476,862	9,626,939
-	-	-	(8,414,463)	(8,631,197)
$ -	$ 169,914	$ 39,249	$ 1,062,399	$ 995,742

INDEPENDENT AUDITOR'S REPORT

City Utility Commission
City of Owensboro, Kentucky

We have audited the accompanying financial statements of the Owensboro Municipal Utilities Water Works System (Water System) of the City of Owensboro, Kentucky, as of and for the years ended May 31, 2014 and 2013, and the related notes to the financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

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Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Owensboro Municipal Utilities Water Works System of the City of Owensboro, Kentucky, as of May 31, 2014 and 2013, and the changes in financial position and cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note 1 to the financial statements, the financial statements present only the Water System, an enterprise fund of the City of Owensboro, Kentucky, and do not purport to, and do not, present fairly the financial position of the City of Owensboro, Kentucky, as of May 31, 2014 and 2013, and the changes in its financial position or, where applicable, its cash flows, for the years then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 36 through 39 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Riney Hancock CPAs PSC

Owensboro, Kentucky
September 4, 2014

MANAGEMENT'S DISCUSSION AND ANALYSIS

Our discussion and analysis of the Owensboro Municipal Utilities Water Works System (Water System) financial performance provides an overview of the Water System's financial activities for the fiscal year ended May 31, 2014. Please read it in conjunction with the Water System's financial statements, which begin on page 40.

Overview of the Financial Statements

This annual report consists of two parts: Management's Discussion and Analysis and the Financial Statements.

Management's Discussion and Analysis (MD&A) serves as an introduction to the basic financial statements. The MD&A represents management's examination and analysis of the Water System's financial condition and performance.

The financial statements report information using accounting methods similar to those used by private sector companies. The financial statements include a Statement of Net Position; a Statement of Revenues, Expenses, and Changes in Fund Net Position; a Statement of Cash Flows; and Notes to the Financial Statements.

The Statement of Net Position presents the financial position of the Water System and thus provides information about the nature and amount of resources and obligations at year-end.

The Statement of Revenues, Expenses, and Changes in Net Position presents the results of the business activities over the course of the fiscal year and information as to how the net position changed during the year. All changes in net position are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of the related cash flow.

The Statement of Cash Flows presents changes in cash and cash equivalents resulting from operational, financing and investing activities. This statement presents cash receipts and cash disbursements information, without consideration of the earnings event or when an obligation arises.

The Notes to the Financial Statements provide required disclosures and other information that are essential to a full understanding of material data provided in the statements. The notes present information about the Water System's accounting policies, significant account balances and activities, material risks, obligations, commitments, contingencies and subsequent events, if any.

Financial Summary

The following table summarizes the financial condition and operations of the Water System for 2014 and 2013.

Assets and Deferred Outflows of Resources	**2014**	**2013**
Utility plant, net	$ 44,824,333	$ 44,721,538
Restricted assets	3,759,026	4,412,855
Current assets	4,279,701	4,542,057
Other noncurrent assets	822,373	876,375
Deferred outflow of resources	469,197	539,253
	$ 54,154,630	$ 55,092,078
Liabilities, Deferred Outflows of Resources, and Net Position		
Net position		
Net investment in capital assets	$ 24,845,499	$ 24,798,195
Restricted	610,971	663,773
Unrestricted	3,202,519	3,496,065
Total net position	28,658,989	28,958,033
Long-term debt	23,272,389	23,907,022
Current liabilities	1,708,106	1,616,383
Other noncurrent liabilities	250,574	276,895
Deferred inflows of resources	264,572	333,745
	$ 54,154,630	$ 55,092,078
Revenues, Expenses and Changes in Net Position		
Operating revenues	$ 9,469,396	$ 9,948,355
Operating expenses	8,892,534	8,809,175
Operating income	576,862	1,139,180
Interest expense	(1,321,748)	(1,345,753)
Interest income	41,592	27,223
Net nonoperating expenses	(1,280,156)	(1,318,530)
Income (loss) before contributions and transfers	(703,294)	(179,350)
Capital contributions	567,566	141,409
Transfers out - dividends to City of Owensboro	(163,316)	(167,913)
Change in net position	$ (299,044)	$ (205,854)

FINANCIAL HIGHLIGHTS

- Net position decreased by $299,044 in 2014, and the loss before contributions and transfers was $703,294 in 2014 versus $179,350 in 2013, as a result of changes in operating revenues, operating expenses and interest as discussed below.

- Operating revenues decreased by $478,959 in 2014 when compared to 2013, or 4.8%. The decrease in revenues in 2014 is primarily attributable to a slight decrease in sales volumes, partially the result of increased rainfall totals in the area, as well as expanding use of consumer products that promote water conservation.

- Operating expenses increased $83,359 in 2014 when compared to 2013, or 0.9%, largely due to general increases in most expense categories. Production and purification increased 86,178, or 3.2%, partially due to increased well maintenance cost; customer service and information increased $45,753, or 8.3%, partially due to increased fees for customer usage of charge cards for bill payment; and depreciation increased by $32,300, or 1.4%, primarily from routine additions to capital assets, as discussed below. Partially offsetting these cost increases was a reduction in transmission and distribution of $88,629, or 9.3%, partially due to a reduction in required water main maintenance.

- Interest expense decreased by $24,005, or 1.8%, due to a reduction in debt as a result of scheduled maturities, and interest income increased $14,369, due primarily to higher rates received from investment in U.S. agency securities in 2014.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

At the end of 2014, the Water System had $44.8 million invested in a broad range of assets, including wells, treatment facilities and equipment, storage tanks, buildings and water mains. This amount represents a slight increase from 2013 due to capital asset additions. The following table summarizes capital assets, net of accumulated depreciation, at the end of 2014 and 2013.

	2014	2013
Source of supply plant	$ 2,277,728	$ 1,964,142
Pumping plant	395,295	403,692
Water treatment plant	15,368,814	15,362,777
Transmission and distribution plant	22,801,267	22,786,078
General plant	1,571,841	1,419,367
Unclassified plant and construction in progress	2,409,388	2,785,482
	$ 44,824,333	$ 44,721,538

CAPITAL ASSET AND DEBT ADMINISTRATION, CONTINUED

Capital Assets, Continued

In addition to the Water System's routine additions and replacement of distribution plant, the Water System incurred $251,000 on treatment plant filter structure analysis and improvements, $128,000 toward treatment plant secondary turbine improvements, $111,000 as its share of the OMU Enterprise system implementation and $111,000 on construction of a replacement well.

Debt

At the end of 2014, the Water System had $23.9 million in bonds outstanding versus $24.5 million in 2013, for a decrease of 2.5%. As there was no new debt issued during 2014, this decrease is due to scheduled bond payments.

The Water System issued $9.7 million in revenue and refunding bonds on July 1, 2014 to provided funding for various Water System improvements and to refinance $3.8 million of existing debt.

Outlook

We expect the 2015 results to improve as compared with 2014, with anticipated increases in revenues partially offset by slight cost increases. The Water System implemented a rate adjustment effective June 1, 2014, which is expected to increase retail operating revenues by approximately 12% from 2014. The increased revenues will be partially offset by overall general costs increases, as well as an increase in interest expense as a result of the additional borrowing discussed above.

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OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM

STATEMENT OF NET POSITION

May 31, 2014 and 2013

ASSETS AND DEFERRED OUTFLOWS OF RESOURCES	2014	2013
Utility plant, net	$ 44,824,333	$ 44,721,538
Restricted assets	3,759,026	4,412,855
Current assets:		
Cash and cash equivalents	1,957,220	2,230,088
Accounts receivable, less allowance for doubtful accounts of $8,644 for 2014 and $8,684 for 2013	1,710,604	1,607,977
Materials and supplies	487,713	585,839
Prepayments	124,164	118,153
Total current assets	4,279,701	4,542,057
Other noncurrent assets	822,373	876,375
Total assets	53,685,433	54,552,825
Deferred outflows of resources:		
Unamortized loss on debt refunding	384,359	501,126
Net unrealized loss on investments	84,838	38,127
Total deferred outflows of resources	469,197	539,253
Total assets and deferred outflows of resources	$ 54,154,630	$ 55,092,078

See Notes to Financial Statements

LIABILITIES, DEFERRED INFLOWS OF RESOURCES, AND NET POSITION	2014	2013
Net position:		
Net investment in capital assets	$ 24,845,499	$ 24,798,195
Restricted for capital projects, net of related debt	93,052	92,063
Restricted for debt service	517,919	571,710
Unrestricted	3,202,519	3,496,065
Total net position	28,658,989	28,958,033
Long-term debt	23,272,389	23,907,022
Current liabilities (payable from restricted assets):		
Current maturities of long-term debt	620,000	595,000
Accrued interest payable	242,918	248,015
Accounts payable	-	52,801
	862,918	895,816
Current liabilities (payable from current assets):		
Accounts payable	789,748	720,567
Other	55,440	-
	845,188	720,567
Total current liabilities	1,708,106	1,616,383
Other noncurrent liabilities:		
Customers' advances for construction	250,574	276,895
Total liabilities	25,231,069	25,800,300
Deferred inflows of resources:		
Deferred revenues	264,572	333,745
Total liabilities, deferred inflows of resources, and net position	$ 54,154,630	$ 55,092,078

See Notes to Financial Statements

OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET POSITION

Years Ended May 31, 2014 and 2013

	2014	2013
Operating revenues:		
Charges for services:		
Residential	$ 3,331,432	$ 3,596,626
Commercial	3,285,868	3,392,550
Water districts	2,004,710	2,102,849
Fire protection	198,703	192,830
City of Owensboro	163,316	167,913
Electric Light and Power System	303,146	269,679
Service revenues	182,221	225,908
Total operating revenues	9,469,396	9,948,355
Operating expenses:		
Production and purification	2,750,733	2,664,555
Transmission and distribution	862,382	951,011
Customer service and information	594,840	549,087
General and administrative	2,363,823	2,356,066
Depreciation	2,320,756	2,288,456
Total operating expenses	8,892,534	8,809,175
Operating income	576,862	1,139,180
Nonoperating revenues (expenses):		
Interest and debt expense	(1,321,748)	(1,345,753)
Interest income on investments	41,592	27,223
Net decrease in fair value of investments	(46,711)	(38,127)
Deferred net change in fair value of investments	46,711	38,127
Total nonoperating revenues (expenses)	(1,280,156)	(1,318,530)
Loss before contributions and transfers	(703,294)	(179,350)
Capital contributions	567,566	141,409
Transfers out - dividends to City of Owensboro	(163,316)	(167,913)
Change in net position	(299,044)	(205,854)
Net position, beginning of year	28,958,033	29,163,887
Net position, end of year	$ 28,658,989	$ 28,958,033

See Notes to Financial Statements

OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM

STATEMENTS OF CASH FLOWS

Years Ended May 31, 2014 and 2013

	2014	2013
Cash flows from operating activities:		
Receipts from customers	$ 9,284,038	$ 9,554,196
Payments to suppliers	(3,811,730)	(4,111,906)
Payments to employees	(2,459,700)	(2,454,594)
Net cash provided by operating activities	3,012,608	2,987,696
Cash flows from noncapital financing activities:		
Transfers out - dividends to City of Owensboro	(157,686)	-
Cash flows from capital and related financing activities:		
Capital expenditures	(1,988,345)	(2,397,884)
Payments on long-term debt	(595,000)	(570,000)
Interest paid on long-term debt	(1,178,239)	(1,201,915)
Customers' advances	-	1,500
Reimbursements of customer' advances	(14,934)	(15,587)
Debt issuance cost	(40)	-
Net cash used in capital and related financing activities	(3,776,558)	(4,183,886)
Cash flows from investing activities:		
Purchase of investments	(709,446)	(2,370,373)
Proceeds from sale and maturities of investments	1,060,959	-
Interest on investments	41,662	24,190
Net cash provided by investing activities	393,175	(2,346,183)
Net decrease in cash and cash equivalents	(528,461)	(3,542,373)
Cash and cash equivalents, beginning of year	4,307,495	7,849,868
Cash and cash equivalents, end of year	$ 3,779,034	$ 4,307,495
Included in the following balance sheet captions:		
Cash and cash equivalents, unrestricted	$ 1,957,220	$ 2,230,088
Cash and cash equivalents, restricted	1,821,814	2,077,407
	$ 3,779,034	$ 4,307,495

See Notes to Financial Statements

OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM

STATEMENTS OF CASH FLOWS, Concluded

Years Ended May 31, 2014 and 2013

	2014	2013
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 576,862	$ 1,139,180
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	2,420,756	2,377,841
Noncash operating revenues from City of Owensboro	-	(167,913)
Change in assets and liabilities:		
Decrease (increase) in assets:		
Accounts receivable	(102,685)	(68,813)
Materials and supplies	98,126	(22,635)
Prepayments	(6,761)	(3,722)
Other noncurrent assets	8,320	(7,369)
Increase (decrease) in liabilities:		
Accounts payable	31,723	(72,039)
Other current liabilities	55,440	(57,862)
Deferred inflows	(69,173)	(128,972)
Net cash provided by operating activities	$ 3,012,608	$ 2,987,696
Noncash investing, capital and financing activities:		
Noncash contributions in aid of construction	$ 556,179	$ 24,944
Unrefunded customers' advances credited to contributions in aid of construction	$ 11,387	$ 116,465
Amortization of debt discount and expense and deferred loss on debt defeasance	$ 148,606	$ 148,606
Noncash dividends to City of Owensboro	$ -	$ 167,913

1. Organization and Summary of Significant Accounting Policies

General Information

In 1940, the City of Owensboro, Kentucky (the City) established the City Utility Commission to manage, control and operate Owensboro Municipal Utilities (OMU). City officials appoint the five individuals who comprise the City Utility Commission. OMU consists of the Electric Light and Power System (Electric System) and the Water Works System (Water System), which are separate enterprise funds of the City. Accordingly, the Electric System and the Water System are part of the financial reporting entity of the City. The accompanying financial statements present only the Water System and are not intended to present fairly the financial position of the City and changes in its financial position or, where applicable, its cash flows, in conformity with accounting principles generally accepted in the United States of America. The Water System is subject to regulation, including approval of rates charged for utility services, by the City, as set forth in the applicable city ordinances.

The Water System provides water to approximately 24,000 residential, commercial and industrial customers in Owensboro, Kentucky. The Water System also furnishes water to three rural water districts in Daviess County, Kentucky, under wholesale supply agreements.

System of Accounts and Basis of Accounting

The Water System's accounts are maintained substantially in accordance with the Uniform System of Accounts for water companies developed by the National Association of Regulatory Utility Commissioners and in conformity with accounting principles generally accepted in the United States of America using the economic resources measurement focus and the accrual basis of accounting.

The Water System considers water revenues and costs that are directly related to production, purification, transmission, and distribution of water to be operating revenues and expenses. Revenues and expenses related to financing and other activities are reflected as nonoperating. The Water System accrues revenues as services are rendered to utility customers.

Utility Plant and Depreciation

Utility plant is stated at original cost, which includes the cost of contracted services, materials, labor, labor-related expenditures, general and administrative costs and an allowance for borrowed funds used during construction.

1. Organization and Summary of Significant Accounting Policies, Continued

Utility Plant and Depreciation, Continued

Replacements of depreciable property units, except minor replacements, are charged to utility plant. In addition, the costs of refurbishments of water tanks are charged to utility plant. Property units replaced or retired, including cost of removal net of any salvage, are charged to accumulated depreciation. Routine maintenance, repairs and minor replacement costs are charged to expense as incurred.

Allowance for borrowed funds used during construction includes capitalized interest during the construction period less any interest income on construction fund investments from bond proceeds during such period. Capitalization of interest is discontinued when the project is completed and the related utility plant is placed in service.

Depreciation of utility plant and unclassified plant in service is provided using the straight-line composite rate method over the estimated service lives of the depreciable assets. Estimated service lives of assets range from 5 to 80 years. Depreciation expense during 2014 and 2013 was approximately 3.1% of the average original cost of depreciable utility plant in service.

Restricted Assets

The City ordinances that authorized the Water Revenue Bonds require that certain amounts from bond proceeds and payments by customers for services provided be deposited into designated funds and be used only for the specified purposes of the funds. The Water System's policy is to first apply restricted resources when an expense is incurred for purposes for which both restricted and unrestricted net assets are available.

Cash and Investments

Cash deposits are reported at carrying amounts. Certificates of deposit and long-term repurchase agreements are reported at cost. U.S. government obligations and agency securities, are stated at fair values based upon currently quoted market rates.

The Water System considers all highly liquid investments (including restricted assets) with a maturity of three months or less when purchased to be cash equivalents. Unrestricted investments with initial maturities exceeding three months, consisting of certificates of deposit and U.S. agency securities, are classified as temporary investments.

1. Organization and Summary of Significant Accounting Policies, Continued

Inventories

Inventories consisting of materials and supplies are valued at the lower of weighted average cost or market.

Bond Issuance Costs

Premiums and discounts arising from various bond issues are deferred and amortized using the straight-line method over the lives of the bond issues.

The Water System's rate making methodology allows for future recovery of debt costs, including bond issuance costs, in its rate making process. Accordingly, under FASB ASC 980, *Regulated Operations,* debt issuance costs are deferred and amortized using the straight-line method over the lives of the bond issues.

The difference between the reacquisition price and the net carrying amount of defeased bond issues has been deferred and is being amortized using the straight-line method over the lives of the refunding bond issues.

Customers' Advances for Construction

Customers' advances for construction are refundable to depositors over a 10-year period. Refund amounts under the contracts are based on annual revenues from the extensions. Unrefunded balances at the end of the contract period are credited to contributions in aid of construction and are no longer refundable.

Contributions of Contributed Property and Equipment

The donor cost or appraised value of contributed property and equipment is included in contributions.

Income Taxes

The Water System is exempt from federal and state income taxes and, accordingly, the financial statements include no provision for such taxes.

Estimates

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

1. Organization and Summary of Significant Accounting Policies, Continued

Change in Accounting Principle

In 2014, the Water System adopted GASB Statement No. 65, "Items Previously Reported as Assets and Liabilities" (GASB 65). GASB 65 requires that certain deferred outflows and deferred inflows of resources be reported separately from assets and liabilities. The Water System has restated its other noncurrent assets and long-term debt to reflect that certain components of those assets and liabilities, as of May 31, 2013, are now reported as deferred outflows of resources in the Statement of Net Position. The effect of this change, as of May 31, 2013, is a decrease of $38,127 in other noncurrent assets, an increase of $539,253 in deferred outflow of resources and an increase in long-term debt of $501,126.

2. Utility Plant

Water utility plant activity for the year ended May 31, 2014, was as follows:

	Beginning Balance	Additions	Retirements	Ending Balance
Utility plant:				
Source of supply plant	$ 3,920,406	$ 447,043	$ -	$ 4,367,449
Pumping plant	1,095,763	19,492	-	1,115,255
Water treatment plant	28,684,355	655,964	-	29,340,319
Transmission and distribution plant	36,001,103	1,222,818	(941,724)	36,282,197
General plant	3,935,625	437,313	-	4,372,938
Unclassified plant in service	606,709	566,273	-	1,172,982
Total, at original cost	74,243,961	3,348,903	(941,724)	76,651,140
Accumulated depreciation:				
Source of supply plant	(1,956,264)	(133,457)	-	(2,089,721)
Pumping plant	(692,071)	(27,889)	-	(719,960)
Water treatment plant	(13,321,578)	(649,927)	-	(13,971,505)
Transmission and distribution plant	(13,215,025)	(1,324,644)	1,058,739	(13,480,930)
General plant	(2,516,258)	(284,839)	-	(2,801,097)
Total accumulated depreciation	(31,701,196)	(2,420,756)	1,058,739	(33,063,213)
Construction in progress	2,178,773	(942,367)	-	1,236,406
Utility plant, net	$ 44,721,538	$ (14,220)	$ 117,015	$ 44,824,333

2. Utility Plant, Continued

Depreciation expense for the years ended May 31 was as follows:

	2014	2013
Water utility plant	$ 2,320,756	$ 2,288,456
Transportation depreciation charged to construction activities or other operating expenses	100,000	89,385
	$ 2,420,756	$ 2,377,841

3. Restricted Assets

Restricted assets at May 31 consist of the following:

	2014	2013
Cash and cash equivalents	$ 1,821,814	$ 2,077,407
Investments	1,934,022	2,332,246
Accrued interest receivable	3,190	3,202
	$ 3,759,026	$ 4,412,855

The above balances are contained in the following funds:

Sinking Fund	$ 2,450,024	$ 2,484,232
Renewal and Replacement Fund	395	280
Construction Fund	1,308,607	1,928,343
	$ 3,759,026	$ 4,412,855

Under the terms of the Water Revenue Bond ordinances, interest income from the temporary investment of the Water System's restricted assets must be credited to the various restricted asset funds. In addition, whenever all specified and required payments and transfers into the restricted asset funds have been made as provided in the Water Revenue Bond ordinances and there is a balance in excess of the estimated amounts required to pay current month operation and maintenance costs (approximately $483,000 at May 31, 2014), all or any part of such excess may be used for any lawful purpose related to the Water System.

3. Restricted Assets, Continued

The Water System follows GASB Statement No. 31, "Accounting and Financial Reporting for Certain Investments and for External Investments Pools" (GASB 31), which requires certain investments to be carried at fair value in the balance sheets and changes in the fair value of investments to be reported in the statements of revenues, expenses and changes in fund net assets. In accordance with GASB 31, the Water System recorded unrealized losses of $46,711 and $38,127 for the years ended May 31, 2014 and 2013, respectively. The Water System's rate making methodology does not consider unrealized gains or losses on marketable securities in its rate making process. Accordingly, under FASB ASC 980, *Regulated Operations,* the unrealized losses for the years ended May 31, 2014 and 2013, have been deferred.

The net increase (decrease) in the fair value of investments consists of the following:

	2014	2013
Net realized gains (losses) on sales of investments	$ -	$ -
Net unrealized gains (losses) on investments	(46,711)	(38,127)
	$ (46,711)	$ (38,127)

The calculation of realized gains or losses on sales of investments is independent of the calculation of the net change in the fair value of investments. Realized gains or losses on investments that were held in more than one fiscal year and sold in the current year were included as a net change in the fair value of investments reported in prior years and the current year.

4. Cash Deposits and Investments

At May 31, the carrying amounts of the Water System's deposits in financial institutions and investments other than deposits were:

	2014	2013
Deposits in financial institutions	$ 4,022,894	$ 4,902,868
Investments other than deposits	1,690,162	1,736,873
	$ 5,713,056	$ 6,639,741

4. Cash Deposits and Investments, Continued

These amounts are reflected in the statements of net position as:

	2014	2013
Cash and cash equivalents	$ 1,957,220	$ 2,230,088
Restricted assets:		
Cash and cash equivalents	1,821,814	2,077,407
Investments	1,934,022	2,332,246
	$ 5,713,056	$ 6,639,741

Deposit and Investment Policy. The Water System's deposit and investment policy prescribes to the prudent-person rule: Investments shall be made with applicable law and under prevailing circumstances which persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital, as well as the probable income to be derived.

Custodial Credit Risk. Custodial credit risk is the risk that, in the event of a bank failure, the Water System's deposits may not be returned to it. The Water System's deposit and investment policy permits uncollateralized deposits only if issued by institutions ranked in one of the three highest categories by a nationally recognized rating agency. As of May 31, 2014, $4,013,024 of the Water System's bank balance of $4,022,894 was exposed to custodial credit risk as follows:

Uninsured and uncollateralized	$ -
Uninsured with collateral held by pledging bank's agent	4,013,024
Total	$ 4,013,024

As of May 31, 2014, the Water System had the following investments. Investments are reported at fair values.

Investments	Maturities	
Federal Home Loan Bank – Callable	11/01/2022	$ 1,690,162

Interest Rate Risk. As a means of limiting its exposure to fair value losses arising from rising interest rates, the Water Works System's deposit and investment policy limits investment maturities based upon provisions of bond ordinances.

Credit Risk. The Water System's deposit and investment policy authorizes the investment of funds in any manner permitted by bond ordinances and the Kentucky Revised Statutes and does not further limit its investment choices.

4. Cash Deposits and Investments, Continued

Concentration of Credit Risk. Other than the prudent-person rule, the Water System's deposit and investment policy places no limit on the amount the Water System may invest in any one issuer. All of the Water System's investments are in U.S. agency securities at May 31, 2014.

5. Long-Term Debt

Long-term debt activity for the year ended May 31, 2014, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due Within One Year
Bonds payable:					
Series of 1999	$ 2,080,000	$ -	$ (380,000)	$ 1,700,000	$ 395,000
Series of 2003	2,950,000	-	(215,000)	2,735,000	225,000
Series of 2009	19,160,000	-	-	19,160,000	-
	24,190,000	-	(595,000)	23,595,000	620,000
Add unamortized debt premium	312,022	-	(14,633)	297,389	-
Total bonds payable	$ 24,502,022	$ -	$ (609,633)	$ 23,892,389	$ 620,000

Long-term debt at May 31 consists of the following Water Revenue Bonds:

	2014	2013
Series of 1999: 4.0% to 4.75%, due serially September 15, 2014 to 2017	$ 1,700,000	$ 2,080,000
Series of 2003: 2.0% to 4.25%, due serially September 15, 2014 to 2023	2,735,000	2,950,000
Series of 2009: 5.0% to 5.25%, due serially September 15, 2018 to 2035	19,160,000	19,160,000
Total long-term debt	23,595,000	24,190,000
Less current maturities	(620,000)	(595,000)
Add unamortized debt premium	297,389	312,022
	$ 23,272,389	$ 23,907,022

5. Long-Term Debt, Continued

Sinking fund requirements and scheduled aggregate maturities of long-term debt are as follows:

Year Ending May 31:	Principal	Interest	Total
2015	$ 620,000	$ 1,152,091	$ 1,772,091
2016	650,000	1,123,619	1,773,619
2017	680,000	1,093,831	1,773,831
2018	710,000	1,062,694	1,772,694
2019	740,000	1,029,019	1,769,019
2020 – 2024	4,305,000	4,561,000	8,866,000
2025 – 2029	5,485,000	3,375,375	8,860,375
2030 – 2034	7,040,000	1,814,012	8,854,012
2035 – 2039	3,365,000	178,894	3,543,894
	$ 23,595,000	$ 15,390,535	$ 38,985,535

The Water System is subject to certain debt covenants, compliance with which is required by the ordinances authorizing its bond issues. Such ordinances require revenue to be first applied to the Sinking Fund, next to the Operations and Maintenance Fund and finally to the Renewal and Replacement Fund.

On January 12, 1999, the City issued $26,410,000 of Water Revenue Refunding and Improvement Bonds, Series 1999, dated January 1, 1999. The 1999 Bonds were issued to refund, at a lower cost, all outstanding 1991 and 1992 series bonds and to provide funds for the cost of extensions and improvements to the Water System. The in-substance defeasance of the 1991 and 1992 Bonds was accomplished by placing approximately $23,271,892 in proceeds from the 1999 Bonds and $3,117,030 in funds from the 1991 and 1992 Bonds Sinking Funds in an irrevocable escrow fund to be used solely for satisfying scheduled debt service payments of the 1991 and 1992 Bonds.

The Series 1999 Bonds maturing on and after September 15, 2009, are subject to redemption prior to maturity in whole or in part on March 15, 2009, and on any date thereafter, at the redemption price of 100% of the principal amount redeemed, plus accrued interest to the redemption date.

On May 29, 2003, the City issued $4,500,000 of Water Revenue Improvement Bonds, Series 2003, dated May 15, 2003. The 2003 Bonds were issued to provide funds for the cost of extensions and improvements to the Water System. The Series 2003 Bonds maturing on and after September 15, 2013, are subject to redemption in whole or in part on September 15, 2012, and on any date thereafter, at the redemption price of 100% of the principal amount redeemed, plus accrued interest to the redemption date.

5. Long-Term Debt, Continued

On February 5, 2009, the City issued $19,160,000 of Water Revenue Refunding and Improvement Bonds, Series 2009, dated February 5, 2009. The 2009 Bonds were issued to refund a portion of the 1999 series bonds, to fund various capital improvement expenditures for the Water System and to fully fund the Bond Reserve Account. The in-substance defeasance of the 1999 Bonds was accomplished by placing approximately $11,803,854 in proceeds from the 2009 Bonds and $591,666 in funds from the 1999 Bond Sinking Fund in an irrevocable escrow fund to be used solely for satisfying scheduled debt service payments of the 1999 Bonds. Accordingly, 1999 Bonds in the amount of $12,120,000, net of unamortized discount and issuance costs of $181,145 and accrued interest payable of $214,591, were extinguished resulting in the accounting recognition of a loss from defeasance of $242,074, reported in the accompanying financial statements as a reduction of long-term debt. The City advance refunded the 1999 bonds to extend the repayment period of the bonds and reduce its near term annual debt payments. The advance refunding resulted in an economic loss (difference between the present value of the debt service payment on the old and new debt) of $476,174.

The Series 2009 Bonds maturing on and after September 15, 2019, are subject to redemption prior to maturity in whole or in part on September 15, 2018, and on any date thereafter, at the redemption price of 100% of the principal amount redeemed, plus accrued interest to the redemption date.

All bonds are secured by a pledge of and are payable from the gross revenues derived from the operation of the Water System and are secured by the statutory mortgage lien as provided and authorized by the Kentucky Revised Statutes.

The difference between the reacquisition price and the net carrying amount of defeased bond issues has been deferred and is being amortized using the straight-line method over the lives of the refunding bond issues.

6. Pension Plan

OMU participates in the County Employees Retirement System (CERS) of the Commonwealth of Kentucky and the City of Owensboro City Employees Pension Fund (CEPF), which are both cost-sharing multiple-employer defined benefit pension plans. The plans provide retirement, disability and death benefits to plan members. The CERS provides for annual cost-of-living adjustments as enacted by the Kentucky legislature in 1996. Participation in the CEPF is limited to participants as of October 1, 1986, who elected to remain in the CEPF rather than enter the CERS.

6. Pension Plan, Continued

The Kentucky Revised Statutes assign the administrative authority of the CERS to the Board of Trustees of the Kentucky Retirement Systems. The Kentucky Retirement Systems issues a publicly available financial report that includes financial statements and required supplementary information for the CERS. That report may be obtained by writing to Kentucky Retirement Systems, Perimeter Park West, 1260 Louisville Road, Frankfort, KY 40601 or by calling 502-564-4646.

The administrative authority of the CEPF is assigned to the Board of Trustees of the CEPF. The CEPF issues a publicly available financial report that includes financial statements and required supplementary information for the CEPF. That report may be obtained by writing to the Finance Director, City of Owensboro, P.O. Box 10003, Owensboro, KY 42302 or by calling 270-687-8534.

Plan members participating in CERS on or before August 31, 2008, are required to contribute 5% of their annual creditable compensation and plan members who began participating in CERS on or after September 1, 2008, are required to contribute 6%. OMU is required to contribute at an actuarially determined rate. The current rate is 18.89% of annual covered payroll. Such contributions are determined by the Board of Trustees of the Kentucky Retirement Systems each biennium. The Water System's contributions to the CERS totaled approximately $552,000, $552,000, and $498,000 for the years ended May 31, 2014, 2013, and 2012, respectively, equal to the required contributions for each year. At May 31, 2014 and 2013, the Water System had no active employees participating in the CEPF and, accordingly, made no contributions to the plan.

7. Dividends - City of Owensboro

The Water System transfers to the City each year a sum equal to the dollar value of services purchased by the City from the Water System.

8. Major Customers

Water revenues from three rural water district customers in Daviess County, Kentucky, under wholesale supply agreements totaled approximately $2,005,000 and $2,103,000 for 2014 and 2013, respectively.

9. Risk Management

OMU is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. OMU manages its risks through coverages provided by private insurance carriers for various risks of losses to which it is exposed, including directors and officers, employee dishonesty, workers' compensation and other property risks. OMU is self-insured for group health and limits its risks of loss by purchasing reinsurance coverage.

10. Rate Matters

During 2014, the City Commission approved a two-step rate increase for retail customers. The first step is effective June 1, 2014, and the second step is effective June 1, 2015. These steps, each of which consists of a volume-based increase and an increase in the monthly customer charge, are anticipated to increase retail operating revenues by approximately 12% and 9%, respectively.

11. Subsequent Events

On July 1, 2014, OMU issued $9,730,000 in revenue bonds to provide funding for various Water System improvements and to refinance $3,815,000 in existing debt.