

***OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM
&
WATER WORKS SYSTEM
FINANCIAL STATEMENTS
& SUPPLEMENTARY INFORMATION
Years Ended May 31, 2016 and 2015***

(With Independent Auditor's Report Thereon)

CONTENTS

	<u>Pages</u>
Electric Light and Power System:	
Independent Auditor's Report	1-2
Management's Discussion and Analysis	3-6
Financial Statements:	
Statements of Net Position	7-8
Statements of Revenues, Expenses and Changes in Net Position	9
Statements of Cash Flows	10-11
Notes to Financial Statements	12-35
Required Supplementary Information:	
Pension Schedules:	
Schedule of Proportionate Share of the Net Pension Liability	36
Schedule of Contributions	37
Notes to Required Supplementary Information	38
Supplementary Information:	
Schedule of Revenues and Expenses	39-40
Water Works System:	
Independent Auditor's Report	41-42
Management's Discussion and Analysis	43-46
Financial Statements:	
Statements of Net Position	47-48
Statements of Revenues, Expenses and Changes in Net Position	49
Statements of Cash Flows	50-51
Notes to Financial Statements	52-68
Required Supplementary Information:	
Pension Schedules:	
Schedule of Proportionate Share of the Net Pension Liability	69
Schedule of Contributions	70
Notes to Required Supplementary Information	71



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, 2016 and 2015, 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, 2016 and 2015, 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, in 2015 the Electric System adopted new accounting guidance, GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*. Our opinion is not modified with respect to this matter.

As discussed in Note 1, 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, 2016 and 2015, 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, the Schedule of Proportionate Share of the Net Pension Liability on page 36, and the Schedule of Contributions on page 37, 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.

Owensboro, Kentucky
September 6, 2016

Renee Hancock CPAs PSC

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, 2016. 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 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 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.

MANAGEMENT'S DISCUSSION AND ANALYSIS, CONTINUED

Financial Summary

The following table summarizes the financial condition and operations of the Electric System for 2016 and 2015.

Assets and Deferred Outflows of Resources	<u>2016</u>	<u>2015</u>
Utility plant, net	\$ 187,514,699	\$ 187,030,810
Restricted assets	101,281,782	100,276,282
Current assets	52,893,448	58,200,541
Other noncurrent assets	12,977,099	4,374,109
Deferred outflows of resources	<u>12,375,170</u>	<u>10,739,974</u>
	<u>\$ 367,042,198</u>	<u>\$ 360,621,716</u>
Liabilities, Deferred Inflows of Resources, and Net Position		
Net position		
Net investment in capital assets	\$ 7,652,971	\$ 13,697,693
Restricted	68,620,816	61,425,657
Unrestricted	<u>19,674,740</u>	<u>18,208,856</u>
Total net position	95,948,527	93,332,206
Long-term debt	189,212,814	204,022,904
Current liabilities	41,676,030	24,968,266
Other noncurrent liabilities	26,842,964	22,319,437
Deferred inflows of resources	<u>13,361,863</u>	<u>15,978,903</u>
	<u>\$ 367,042,198</u>	<u>\$ 360,621,716</u>
Revenues, Expenses and Changes in Net Position		
Operating revenues	\$ 140,804,689	\$ 139,814,866
Operating expenses	<u>117,976,641</u>	<u>122,183,834</u>
Operating income	<u>22,828,048</u>	<u>17,631,032</u>
Interest and debt expense	(11,527,656)	(10,331,770)
Interest and other income	<u>133,616</u>	<u>940,056</u>
Net nonoperating expenses	<u>(11,394,040)</u>	<u>(9,391,714)</u>
Income before transfers	11,434,008	8,239,318
Transfers out - dividends to City of Owensboro	<u>(8,817,687)</u>	<u>(8,527,030)</u>
Change in net position	<u>\$ 2,616,321</u>	<u>\$ (287,712)</u>

MANAGEMENT'S DISCUSSION AND ANALYSIS, CONTINUED

FINANCIAL HIGHLIGHTS

- Total net position increased \$2.6 million in 2016, or 2.8%, versus a decline of \$287,712 in 2015 as the result of changes in operating revenues, operating expenses, nonoperating revenues/expenses and transfers as discussed below.
- Operating revenues increased \$989,823, or 0.7%, in 2016 when compared to 2015. Although retail sales volumes declined slightly, retail revenues increased by \$18.2 million, or 25%, primarily due to an increase 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. Wholesale energy sales volumes and prices declined in 2016, resulting in a reduction in energy costs recovery from wholesale customers, thus increasing the recovery requirement from retail customers. Wholesale sales volumes declined by approximately 37.9% in 2016, as the Electric System reduced its electric generation due to depressed wholesale energy prices, causing wholesale operating revenues to decline \$17.7 million, or 27.8%.
- Operating expenses in 2016 declined \$4.2 million, or 3.4%, versus 2015, largely the result of reduced production costs. Production costs declined \$9.7 million, or 11.1%, primarily due to decreased fuel costs, which were partially offset by increases in other production costs. Fuel costs declined \$16.4 million, or 24.9%, from decreased power generation as a result of temporary plant shutdowns due to depressed wholesale energy prices, as discussed above, and one scheduled maintenance outage in 2016 versus no scheduled outages in 2015. The increased maintenance cost as a result of the outage caused other production cost to increase \$7.2 million, or 49.7%. Transmission and distribution cost increased \$923,900, or 12.5%, versus 2015, due to general cost increases. General and administrative costs increased \$2.7 million, or 24%, in 2016, versus 2015, primarily due to increases in pension expense, as well as other general cost increases. In addition to the pension contributions recorded by the Electric System in 2016, the CERS annual pension actuarial valuation required an increase in pension expense in 2016, versus a reduction in 2015, due to changes in pension investment earnings, as well as other valuation factors. Finally, depreciation increased \$1.8 million in 2016, or 12.5%, versus 2015, as a result of plant additions as discussed below.
- Nonoperating expenses increased by \$2 million, or 21.3%, in 2016 when compared to 2015. Interest expense increased by \$1.2 million, or 11.6%, primarily the result of discontinuation of interest capitalization on the 2013 Series bonds in January 2015. Interest income increased \$222,753, or 14.7%, in 2016 due to higher rates received on bank balances as a result of a new banking contract executed in 2015 and increased investment in U.S. agency investments. Finally the loss on investment derivatives increased \$976,505 in 2016, primarily due to cancellation of various fuel hedge position. The cancellations were necessary following the Electric System's negotiation of price reductions on existing fuel contracts, projected to reduce fuel cost by \$6.3 million in calendar 2016 and 2017. The new contracts included modified diesel fuel clauses as the result of lower market prices.

MANAGEMENT'S DISCUSSION AND ANALYSIS, CONTINUED

FINANCIAL HIGHLIGHTS, CONTINUED

- Dividend transfers to the City of Owensboro increased by \$290,657 in 2016, or 3.4%, due partially to an increase in actual cash transfers to the City, to increased rates for the free electric service provided to the City and the addition of telecom free service provided to the City beginning in 2016.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

At the end of 2016, the Electric System had \$187.5 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 slight increase of \$483,889 over 2015 due to capital asset additions which exceeded depreciation. In addition to routine capital additions during 2016, the Electric System incurred \$5.4 million on installation of a dry sorbent injection system and environmental design services to comply with enacted EPA mercury compliance rules, \$2.7 million on furnace tube panel replacement and \$712,000 on renovation of the distribution office building. The following table summarizes capital assets, net of accumulated depreciation, at the end of 2016 and 2015:

	<u>2016</u>	<u>2015</u>
Production plant	\$ 108,966,661	\$ 115,030,429
Transmission plant	13,789,168	14,590,022
Distribution plant	35,953,781	33,799,887
General plant	8,219,469	7,877,245
Unclassified plant and construction in progress	<u>20,585,620</u>	<u>15,733,227</u>
	<u>\$ 187,514,699</u>	<u>\$ 187,030,810</u>

Debt

At the end of 2016, the Electric System had \$207.3 million in bonds outstanding versus \$206.8 million in 2015, for an increase of \$476,755, or 0.2%. The increase is attributable to compounding of interest on the 1991-B Series deferred interest bonds which exceeded scheduled principle reductions on other debt.

Outlook

We expect the 2017 net operating results to somewhat improve from 2016 results, with overall revenue increases anticipated to outpace cost increases. Revenues from retail customers are expected to increase as additional energy costs are expected to be passed on to retail customers, due to reduced energy cost recovery from wholesale customers, resulting from continuing softness of wholesale market prices. Costs are also expected to increase due to general cost increases, but to a lesser extent due to cost containment measures by management.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

STATEMENTS OF NET POSITION

May 31, 2016 and 2015

ASSETS AND DEFERRED OUTFLOWS OF RESOURCES	<u>2016</u>	<u>2015</u>
Utility plant, net	\$ 187,514,699	\$ 187,030,810
Restricted assets	<u>101,281,782</u>	<u>100,276,282</u>
Current assets:		
Cash and cash equivalents	27,426,580	38,053,568
Investments	1,899,203	499,620
Receivables:		
Retail accounts receivable, less allowance for doubtful accounts of \$54,904 for 2016 and \$62,172 for 2015	9,333,059	9,407,995
Wholesale accounts receivable	1,829,482	3,457,593
City of Owensboro	148,035	176,731
Other	650,847	537,202
Materials and supplies	3,315,511	3,459,155
Prepayments	373,364	392,973
Other	<u>7,917,367</u>	<u>2,215,704</u>
Total current assets	<u>52,893,448</u>	<u>58,200,541</u>
Other noncurrent assets:		
Unamortized debt expense	1,454,232	1,663,602
Energy cost to be recovered	8,011,523	-
Other noncurrent assets	<u>3,511,344</u>	<u>2,710,507</u>
Total other noncurrent assets	<u>12,977,099</u>	<u>4,374,109</u>
Total assets	<u>354,667,028</u>	<u>349,881,742</u>
Deferred outflows of resources:		
Accumulated decrease in fair value of hedging derivatives	4,338,276	4,985,469
Deferred pension outflows	5,483,103	2,308,965
Unamortized loss on debt refunding	2,545,528	3,255,908
Net unrealized loss on investments	<u>8,263</u>	<u>189,632</u>
Total deferred outflows of resources	<u>12,375,170</u>	<u>10,739,974</u>
 Total assets and deferred outflows of resources	 <u>\$ 367,042,198</u>	 <u>\$ 360,621,716</u>

**LIABILITIES, DEFERRED INFLOWS OF
RESOURCES, AND NET POSITION**

	<u>2016</u>	<u>2015</u>
Net position:		
Net investment in capital assets	\$ 7,652,971	\$ 13,697,693
Restricted for capital projects, net of related debt	5,622,502	5,323,512
Restricted for debt service	12,487,762	12,468,189
Restricted for other purposes	50,510,552	43,633,956
Unrestricted	<u>19,674,740</u>	<u>18,208,856</u>
Total net position	<u>95,948,527</u>	<u>93,332,206</u>
Long-term debt	<u>189,212,814</u>	<u>204,022,904</u>
Current liabilities (payable from restricted assets):		
Current maturities of long-term debt	18,066,845	2,780,000
Accrued interest payable	3,009,471	3,082,909
Accounts payable	<u>4,784,763</u>	<u>5,545,120</u>
	<u>25,861,079</u>	<u>11,408,029</u>
Current liabilities (payable from current assets):		
Accounts payable	5,755,257	4,111,595
Other	<u>10,059,694</u>	<u>9,448,642</u>
	<u>15,814,951</u>	<u>13,560,237</u>
Total current liabilities	<u>41,676,030</u>	<u>24,968,266</u>
Other noncurrent liabilities:		
Net pension liability	26,254,442	20,520,943
Other	<u>588,522</u>	<u>1,798,494</u>
Total other noncurrent liabilities	<u>26,842,964</u>	<u>22,319,437</u>
Commitments and contingencies (Note 9)		
Total liabilities	<u>257,731,808</u>	<u>251,310,607</u>
Deferred inflows of resources:		
Accumulated increase in fair value of hedging derivatives	11,295,112	4,798,482
Deferred pension inflows	589,339	2,290,634
Deferred revenue	1,477,412	1,886,549
Deferred energy cost adjustment	<u>-</u>	<u>7,003,238</u>
Total deferred inflows of resources	<u>13,361,863</u>	<u>15,978,903</u>
Total liabilities, deferred inflows of resources, and net position	<u>\$ 367,042,198</u>	<u>\$ 360,621,716</u>

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET POSITION

Years Ended May 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Operating revenues:		
Charges for services:		
Residential	\$ 30,131,855	\$ 24,650,499
Commercial	7,005,427	5,828,846
Industrial	52,603,819	41,309,466
Water Works System	999,908	787,580
City of Owensboro	2,195,241	2,071,206
Supplemental power	1,199,388	1,495,293
Other wholesale	44,907,850	62,351,667
Build America Bond subsidy	539,243	540,256
Other	1,221,958	780,053
	<u>140,804,689</u>	<u>139,814,866</u>
Total operating revenues		
Operating expenses:		
Production:		
Fuel for electric generation	49,267,137	65,620,480
Purchased power	6,847,091	7,409,652
Other	21,792,325	14,554,570
Transmission and distribution	8,321,746	7,397,846
Customer service and information	1,475,606	1,465,083
General and administrative	13,786,217	11,115,142
Telecommunications	510,469	417,088
Depreciation	15,976,050	14,203,973
	<u>117,976,641</u>	<u>122,183,834</u>
Total operating expenses		
Operating income	<u>22,828,048</u>	<u>17,631,032</u>
Nonoperating revenues (expenses):		
Interest and debt expense	(11,527,656)	(10,331,770)
Interest income on investments	1,739,614	1,516,861
Loss on investment derivatives	(1,691,427)	(714,922)
Other, net	85,429	138,117
Net increase in fair value of investments	181,369	307,705
Deferred net change in fair value of investments	(181,369)	(307,705)
	<u>(11,394,040)</u>	<u>(9,391,714)</u>
Total nonoperating revenues (expenses)		
Income before transfers	11,434,008	8,239,318
Transfers out - dividends to City of Owensboro	(8,817,687)	(8,527,030)
Change in net position	<u>2,616,321</u>	<u>(287,712)</u>
Net position, beginning of year, before restatement	93,332,206	114,996,717
Cumulative effect of change in accounting principle	-	(21,376,799)
Net position, beginning of year, as restated	<u>93,332,206</u>	<u>93,619,918</u>
Net position, end of year	<u>\$ 95,948,527</u>	<u>\$ 93,332,206</u>

See Notes to Financial Statements

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

STATEMENTS OF CASH FLOWS

Years Ended May 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Cash flows from operating activities:		
Receipts from customers, including collections as agent for third parties	\$ 150,418,582	\$ 161,505,836
Customer remittances to third parties	(22,909,643)	(19,145,549)
Payments to suppliers	(92,540,756)	(94,581,656)
Payments to employees	<u>(13,252,322)</u>	<u>(13,031,945)</u>
Net cash provided by operating activities	<u>21,715,861</u>	<u>34,746,686</u>
Cash flows from noncapital financing activities:		
Transfers out - dividends to City of Owensboro	<u>(8,817,687)</u>	<u>(8,527,030)</u>
Cash flows from capital and related financing activities:		
Capital expenditures	(16,337,146)	(10,844,768)
Payments on long-term debt	(2,780,000)	(2,610,000)
Interest paid on long-term debt	<u>(7,424,589)</u>	<u>(7,599,144)</u>
Net cash used in capital and related financing activities	<u>(26,541,735)</u>	<u>(21,053,912)</u>
Cash flows from investing activities:		
Purchase of investments	(25,400,927)	(6,414,922)
Proceeds from sale and maturities of investments	12,200,000	6,341,653
Interest on investments	<u>1,693,136</u>	<u>1,523,764</u>
Net cash provided by (used in) investing activities	<u>(11,507,791)</u>	<u>1,450,495</u>
Net increase (decrease) in cash and cash equivalents	(25,151,352)	6,616,239
Cash and cash equivalents, beginning of year	<u>103,670,199</u>	<u>97,053,960</u>
Cash and cash equivalents, end of year	<u>\$ 78,518,847</u>	<u>\$ 103,670,199</u>
Included in the following balance sheet captions:		
Restricted assets	\$ 51,092,267	\$ 65,616,631
Cash and cash equivalents	<u>27,426,580</u>	<u>38,053,568</u>
	<u>\$ 78,518,847</u>	<u>\$ 103,670,199</u>

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

STATEMENTS OF CASH FLOWS, Concluded

Years Ended May 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 22,828,048	\$ 17,631,032
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	16,243,973	14,466,717
Other revenues	85,429	138,117
Change in assets and liabilities:		
Decrease (increase) in assets:		
Restricted assets:		
Fuel inventory	(5,216,217)	2,741,376
Other	20,853	15,313
Receivables	1,662,784	(1,764,007)
Materials and supplies	143,644	81,892
Prepayments	19,609	(38,914)
Other current assets	(369,087)	-
Other noncurrent assets	(7,986,146)	451,700
Deferred outflow of resources	(3,174,138)	230,702
Increase (decrease) in liabilities:		
Accounts payable	451,167	(1,905,130)
Other current liabilities	386,113	767,863
Other noncurrent liabilities	5,733,499	(3,395,523)
Deferred inflow of resources	(9,113,670)	5,325,548
Net cash provided by operating activities	<u>\$ 21,715,861</u>	<u>\$ 34,746,686</u>
Noncash investing, capital and financing activities:		
Accretion of interest expense on long-term debt	<u>\$ 3,613,549</u>	<u>\$ 3,374,931</u>
Amortization of debt premium and expense and deferred loss on debt defeasance	<u>\$ 562,956</u>	<u>\$ 545,761</u>
Deferred gain (loss) on hedging derivatives	<u>\$ 6,956,836</u>	<u>\$ (186,987)</u>

OWENSBORO MUNICIPAL UTILITIES ELECTRIC LIGHT AND POWER SYSTEM

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

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.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

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 2016 and 2015 was approximately 3.3% and 3.4%, 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.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

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. The Electric System categorizes the fair value measurements of its investments based on the hierarchy established by generally accepted accounting principles. U.S. government obligations and agency securities are stated at fair values based upon externally developed models that use rates and prices of similar securities.

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.

Pensions

For purposes of measuring the net pension liability, deferred outflows of resources and deferred inflows of resources related to pensions, and pension expense, information about the fiduciary net position of the County Employees Retirement System (CERS) and additions to/deduction from CERS's fiduciary net position have been determined on the same basis as they are reported by CERS. For this purpose, benefit payments (including refunds of employee contributions) are recognized when due and payable in accordance with the benefit terms. Investments are reported at fair value.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

1. Organization and Summary of Significant Accounting Policies, Continued

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.

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 2015, the Electric System adopted GASB Statement No. 68, "Accounting and Financial Reporting for Pensions" (GASB 68). GASB 68 establishes standards for measuring and recognizing liabilities, deferred outflows of resources, and deferred inflows of resources, and expense/expenditures. For defined benefit pensions, GASB 68 identifies the methods and assumptions that should be used to project benefit payments, discount projected benefit payments to their actuarial present value, and attribute that present value to periods of employee service.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

2. Utility Plant

Electric utility plant activity for the year ended May 31, 2016, was as follows:

	<u>Beginning Balance</u>	<u>Additions</u>	<u>Retirements</u>	<u>Ending Balance</u>
Utility plant:				
Production plant	\$ 309,045,620	\$ 5,631,370	\$ -	\$ 314,676,990
Transmission plant	31,538,986	134,762	(45,198)	31,628,550
Distribution plant	77,809,254	4,822,860	(1,721,484)	80,910,630
General plant	20,377,879	1,358,025	(612,536)	21,123,368
Unclassified plant in service	8,091,835	7,935,091	-	16,026,926
Total, at original cost	<u>446,863,574</u>	<u>19,882,108</u>	<u>(2,379,218)</u>	<u>464,366,464</u>
Accumulated depreciation:				
Production plant	(194,015,191)	(11,695,138)	-	(205,710,329)
Transmission plant	(16,948,964)	(935,615)	45,197	(17,839,382)
Distribution plant	(44,009,367)	(2,598,596)	1,651,114	(44,956,849)
General plant	(12,500,634)	(1,014,624)	611,359	(12,903,899)
Total accumulated depreciation	<u>(267,474,156)</u>	<u>(16,243,973)</u>	<u>2,307,670</u>	<u>(281,410,459)</u>
Construction in progress	<u>7,641,392</u>	<u>(3,082,698)</u>	<u>-</u>	<u>4,558,694</u>
Utility plant, net	<u>\$ 187,030,810</u>	<u>\$ 555,437</u>	<u>\$ (71,548)</u>	<u>\$ 187,514,699</u>

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

	<u>2016</u>	<u>2015</u>
Electric utility plant	\$ 15,798,581	\$ 14,025,582
Telecommunications	<u>177,469</u>	<u>178,391</u>
	15,976,050	14,203,973
Transportation and stores depreciation charged to construction activities or other operating expenses	<u>267,923</u>	<u>262,744</u>
	<u>\$ 16,243,973</u>	<u>\$ 14,466,717</u>

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

3. Restricted Assets

Restricted assets at May 31 consists of the following:

	<u>2016</u>	<u>2015</u>
Cash and cash equivalents	\$ 51,092,267	\$ 65,616,631
Investments	37,427,652	27,135,748
Accrued interest receivable	391,379	348,783
Fuel and other inventories, at cost	11,662,577	6,446,360
Other	<u>707,907</u>	<u>728,760</u>
	<u>\$ 101,281,782</u>	<u>\$ 100,276,282</u>

The above balances are contained in the following funds:

	<u>2016</u>	<u>2015</u>
Operation and Maintenance Fund	\$ 14,021,740	\$ 8,753,163
Construction Fund	7,956,499	19,762,324
Depreciation Fund	5,325,505	4,967,714
Sinking Funds	31,253,257	24,660,860
Facility Charge Fund	7,856,374	7,550,669
Reserve and Contingency Fund	<u>34,868,407</u>	<u>34,581,552</u>
	<u>\$ 101,281,782</u>	<u>\$ 100,276,282</u>

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 gains of \$181,369 and \$307,705 for the years ended May 31, 2016 and 2015, 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 gains for the years ended May 31, 2016 and 2015, have been deferred.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

3. Restricted Assets, Continued

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

	<u>2016</u>	<u>2015</u>
Net realized gains (losses) on sales of investments	\$ -	\$ -
Net unrealized gains (losses) on investments	<u>181,369</u>	<u>307,705</u>
	<u>\$ 181,369</u>	<u>\$ 307,705</u>

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:

	<u>2016</u>	<u>2015</u>
Deposits in financial institutions	\$ 78,518,847	\$ 103,670,199
Investments other than deposits	<u>39,326,855</u>	<u>27,635,368</u>
	<u>\$ 117,845,702</u>	<u>\$ 131,305,567</u>

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

	<u>2016</u>	<u>2015</u>
Cash and cash equivalents	\$ 27,426,580	\$ 38,053,568
Temporary investments	1,899,203	499,620
Restricted assets:		
Cash and cash equivalents	51,092,267	65,616,631
Investments	<u>37,427,652</u>	<u>27,135,748</u>
	<u>\$ 117,845,702</u>	<u>\$ 131,305,567</u>

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.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

4. Cash Deposits and Investments, Continued

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, 2015, \$78,865,216 of the Electric System's bank balance of \$79,122,516 was exposed to custodial credit risk as follows:

Uninsured and uncollateralized	\$ -
Uninsured with collateral held by pledging bank's agent	<u>78,865,216</u>
Total	<u>\$ 78,865,216</u>

Investments are measured at fair value on a recurring basis. *Recurring* fair value measurements are those that Governmental Accounting Standards Board (GASB) Statements require or permit in the statement of net position at the end of each reporting period. Fair value measurements are categorized based on the valuation inputs used to measure an asset's fair value: Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs. The Electric System's investments consist primarily of U.S. agency securities, which utilize Level 2 inputs for fair value measurements. Fair values is based upon externally developed models that use rates and prices of similar securities, due to the limited market activity of the securities.

As of May 31, 2016, the Electric System had the following investments, which are reported at fair value, with the exception of repurchase agreements, which are reported at cost.

<u>Investments</u>	<u>Maturities</u>	
Repurchase agreements	12/31/2019	\$ 8,900,000
Federal Farm Credit Bank – Callable	12/18/2017 thru 06/22/2021	6,992,761
Federal Home Loan Bank – Callable	09/24/2018 thru 01/30/2023	<u>23,434,094</u>
		<u>\$ 39,326,855</u>

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.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

4. Cash Deposits and Investments, Continued

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, 2016.

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 and fuel swap and futures contracts (hedging transactions). Hedging transactions are measured at fair value on a recurring basis. The Electric System utilizes Level 2 inputs (see investment footnote for definition of fair value inputs) for fair value measurements of hedging transactions.

The Electric System enters into electricity and fuel hedging transactions at various fixed prices and notional amounts. Each electricity short 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 short hedge position by entering into a long hedging transaction to pay a fixed price, and for the contract counterparty to pay a floating price for a 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 4,304,145 and 1,238,180 MWh in 2016 and 2015, respectively. Hedging transactions with notional amounts totaling 3,259,980 and 3,734,900 MWh were settled in 2016 and 2015, respectively, with a resulting gain (loss) of \$6,814,041 and \$(757,980) in 2016 and 2015, respectively, which are reflected in other wholesale revenue. At May 31, 2016, the Electric System's outstanding electricity hedging swap transactions were as follows:

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

5. Hedging Transactions, Continued

Execution Date Range	Maturity Date	Notional Amount (MWh)	Fair Market Value
Short Hedge Positions:			
Fiscal 2014-2016	Fiscal 2017	1,542,765	\$ 6,933,674
Fiscal 2015-2016	Fiscal 2018	708,295	2,268,745
Fiscal 2016	Fiscal 2019	<u>231,165</u>	<u>545,581</u>
		<u>2,482,225</u>	<u>9,748,000</u>
Long Hedge Positions:			
Fiscal 2015-2016	Fiscal 2017	711,635	(2,752,945)
Fiscal 2016	Fiscal 2018	<u>34,535</u>	<u>(50,468)</u>
		<u>746,170</u>	<u>(2,803,413)</u>
		<u>3,228,395</u>	<u>\$ 6,944,587</u>

Additionally, at May 31, 2016, the Electric System had outstanding put and call options with notional amounts totaling 340,800 MWh, which expire from July 2016 through December 2017. The Electric System paid \$452,240 upon execution of the options and the total fair value of the options at May 31, 2016, was \$463,464.

The Electric System entered into fuel hedging transactions with notional amounts totaling 924,000 and 5,334,000 gallons in 2016 and 2015, respectively. Hedging transactions with notional amounts totaling 4,284,000 and 3,108,000 gallons were settled in 2016 and 2015, respectively, with resulting losses of \$2,471,107 and \$1,242,216 in 2016 and 2015, respectively. The above losses resulted primarily from significant declines in the price of diesel, which led to corresponding price reductions on coal shipments that partially offset the losses, as well as allowing the Electric System to negotiate price reductions on existing fuel contracts in 2016. The resulting losses, which will be offset by a significant reduction in fuel costs, are reflected in the statements of revenues, expenses and changes in net position as follows:

	<u>2016</u>	<u>2015</u>
Fuel for electric generation (effective hedges)	\$ (779,680)	\$ (572,501)
Loss on hedging derivatives (ineffective hedges)	<u>(1,691,427)</u>	<u>(669,715)</u>
	<u>\$ (2,471,107)</u>	<u>\$ (1,242,216)</u>

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

5. Hedging Transactions, Continued

Additionally, the Electric System entered into derivative natural gas transactions with notional amounts totaling 1,480,000 million British thermal units (MMBTU) in 2015. These transactions, which also settled in 2015, resulted in losses of \$45,207, which is included in loss on investment derivatives.

At May 31, 2016, the Electric System had outstanding heating oil average priced call options, with rights to purchase 42,000 gallons (long position) per month for the months from June 2016 through January 2017. The total cost of the call options was \$5,120 and the fair value at May 31, 2016, was \$6,146.

The electricity and fuel hedging transactions are settled by cash payments that are equal to the difference 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, 2016 and 2015 statements of net position. 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, 2016 and 2015. The Electric System's electricity hedging transactions settle and are valued at the AEP-Dayton Hub, the PJM West 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 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 \$7,408,051 and \$1,076,154 at May 31, 2016 and 2015, respectively. The fuel hedging transactions had a fair value of \$6,146 and (\$1,263,051) at May 31, 2016 and 2015, 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, 2016, 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 one counterparty that was not rated but had provided a letter of credit for the purpose of establishing credit for the counterparty.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

5. Hedging Transactions, Continued

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 aggregate fair value of outstanding Hedging Transactions in asset positions with counterparties that the Electric System had a net asset position with at May 31, 2016, was \$11,664,530. The asset positions represent the maximum loss that would be incurred at the reporting date if all counterparties failed to perform as contracted. This maximum exposure is reduced by \$2,700,000 of collateral held and \$4,250,333 of outstanding Hedging Transactions in a liability position included in netting arrangements with those counterparties, resulting in a net exposure to credit risk of \$4,714,197.

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 Hub, PJM West Hub or Indiana 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 (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

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

5. Hedging Transactions, Continued

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, 2016, the Electric System would have not been required to post collateral with its counterparties.

6. Long-Term Debt

Long-term debt activity for the year ended May 31, 2016, was as follows:

	<u>Beginning Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending Balance</u>	<u>Amounts Due Within One Year</u>
Bonds payable:					
Series of 1991-B	\$ 51,105,243	\$ 3,613,549	\$ -	\$ 54,718,792	\$ 15,111,845
Series of 2002-A	15,765,000	-	(2,780,000)	12,985,000	2,955,000
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	-
	<u>203,275,243</u>	<u>3,613,549</u>	<u>(2,780,000)</u>	<u>204,108,792</u>	<u>18,066,845</u>
Add unamortized debt premium (discount)	<u>3,527,661</u>	<u>-</u>	<u>(356,794)</u>	<u>3,170,867</u>	<u>-</u>
Total long-term debt	<u>\$ 206,802,904</u>	<u>\$ 3,613,549</u>	<u>\$ (3,136,794)</u>	<u>\$ 207,279,659</u>	<u>\$ 2,780,000</u>

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

	<u>2016</u>	<u>2015</u>
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, 2016, was \$10,269,998)	\$ 54,718,792	\$ 51,105,243
Series of 2002-A:		
6.34% due 2020, subject to annual pro rata sinking fund redemption from 2017 to 2020	12,985,000	15,765,000
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

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

6. Long-Term Debt, Continued

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	8,875,000
Series of 2013-B:		
Current interest bonds, 3.00% to 5.00%, due from 2022 to 2027	<u>77,100,000</u>	<u>77,100,000</u>
Total long-term debt	204,108,792	203,275,243
Less current maturities	(18,066,845)	(2,780,000)
Add unamortized debt premium (discount)	<u>3,170,867</u>	<u>3,527,661</u>
	<u>\$189,212,814</u>	<u>\$204,022,904</u>

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

<u>Year Ending May 31:</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
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	19,275,000	6,624,551	25,899,551
2021	18,550,000	6,399,481	24,949,481
2022 – 2026	106,665,000	18,072,582	124,737,582
2027 – 2031	<u>11,190,000</u>	<u>447,600</u>	<u>11,637,600</u>
	<u>\$ 212,290,000</u>	<u>\$ 52,638,634</u>	<u>\$ 264,928,634</u>

The scheduled principal maturities include \$8,181,208 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.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

6. Long-Term Debt, Continued

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.

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.

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.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

6. Long-Term Debt, Continued

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 2016 and 2015 was \$539,243 and \$540,256, respectively. Remaining interest subsidies scheduled through maturities of the bonds, before budget sequestration reductions, are as follows:

Year Ending May 31:

2017	\$ 578,846
2018	578,846
2019	578,846
2020	578,846
2021	578,846
2022 – 2026	<u>1,371,848</u>
	<u>\$ 4,266,078</u>

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

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

6. Long-Term Debt, Continued

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.

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 \$22,455,000 at May 31, 2016), 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 (\$10,877,596 at May 31, 2016) and amounts in the Facility Charge Fund (\$7,856,374 at May 31, 2016) 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 \$8,817,687 and \$8,527,030 for 2016 and 2015, respectively.

8. Pension Plan

Plan Description

The Electric System contributes to the County Employees Retirement System (CERS), which is a cost-sharing multiple-employer defined benefit pension plan administered by Kentucky Retirement Systems (KRS) that covers all regular full-time members employed in nonhazardous positions of each participating county, city, and school board, and any additional eligible local agencies electing to participate in CERS. Kentucky Revised Statute

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

8. Pension Plan, Continued

Plan Description, Continued

Section 61.645 assigns the authority to establish and amend benefit provisions to the Board of Trustees of Kentucky Retirement Systems (Board). CERS issues a publicly available financial report that can be obtained at www.kyret.ky.gov.

Benefits Provided

CERS provides for retirement, disability, and death benefits to system members through its pension fund. Retirement benefits may be extended to beneficiaries of members under certain circumstances. Retirement benefits are determined using a formula which considers the member's final compensation; benefit factors set by statute which vary depending upon the type / amount of service, participation date, and retirement date; and years of service. Plan members with a participation date prior to September 1, 2008, are eligible to retire with full benefits at any time with 27 or more years of service credit, or at age 65 with at least 48 months of service credit. Plan members with a participation date on or after September 1, 2008, are eligible to retire with full benefits at age 57 if the member's age and years of service equal 87, or at age 65 with at least 60 months of service credit. Plan members with a participating date on or after January 1, 2014, are eligible for retirement benefits under the provisions established for a hybrid Cash Balance Plan.

CERS also provides for retiree medical benefits through its insurance fund. Generally accepted accounting and financial reporting principles do not currently require recognition and reporting of the liabilities, deferred outflows of resources, deferred inflows of resources, and expense associated with this postemployment benefit. Therefore, such information has not been reflected in these financial statements.

Contributions

Per Kentucky Revised Statutes Section 78.545(33), contribution requirements of the active employees and the participating employers are established and may be amended by the KRS Board. Plan members who began participating in CERS prior to September 1, 2008, are required to contribute 5% of their annual creditable compensation to the pension fund. For Plan members who began participating in CERS on or after September 1, 2008, the contribution rate is 6%, of which 1% is contributed to the insurance fund. The Electric System's actuarially determined contribution rate as of May 31, 2016, was 17.06% of annual creditable compensation, of which 12.42% and 4.64% was contributed to the pension and insurance funds within CERS, respectively. Contributions to CERS pension fund by the Electric System were \$2,263,989 for the year ended May 31, 2016.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

8. Pension Plan, Continued

Pension Liabilities, Pension Expense, Deferred Outflows of Resources, and Deferred Inflows of Resources Related to Pensions

At May 31, 2016, the Electric System reported a liability of \$26,254,442 for its proportionate share of the net pension liability. The net pension liability was measured as of June 30, 2015, and the total pension liability used to calculate the net pension liability was determined by an actuarial valuation as of that date. The Electric System's proportion of the net pension liability was based on a projection of the Electric System's long-term share of contributions to the pension plan relative to the projected contributions of all participating entities, actuarially determined. At the June 30, 2015, measurement date, the Electric System's proportion was 0.610636%, a decrease of 0.021872% from its proportion measured as of June 30, 2014, of 0.632508%

For the year ended May 31, 2016, the Electric System recognized pension expense of \$3,122,055. At May 31, 2016, the Electric System reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

	<u>Deferred Outflows of Resources</u>	<u>Deferred Inflows of Resources</u>
Differences between expected and actual experience	\$ 218,184	\$ -
Changes of assumptions	2,647,473	-
Changes in proportion and differences between contributions and proportionate share of contributions	-	589,339
Net difference between projected and actual earnings on plan investments	235,350	-
Pension contributions subsequent to the measurement date	<u>2,382,096</u>	<u>-</u>
Total	<u>\$ 5,483,103</u>	<u>\$ 589,339</u>

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

8. Pension Plan, Continued

The \$2,382,096 of deferred outflows of resources resulting from the Water System's contributions subsequent to the measurement date will be recognized as a reduction of the net pension liability in the year ending May 31, 2017. Other amounts reported as deferred outflows (inflows) outflows of resources will be recognized in pension expense as follows:

Year ending May 31,	
2017	\$ 822,350
2018	822,350
2019	377,972
2020	<u>488,996</u>
	<u>\$ 2,511,668</u>

Actuarial Assumptions

The total pension liability in the June 30, 2014, actuarial valuation was determined using the following actuarial assumptions, applied to all periods included in the measurement:

Inflation	3.5 %
Salary increases	4.0 average, including inflation
Investment rate of return	7.5%, net of pension plan investment expense, including inflation

The mortality table used for active members is RP-2000 Combined Mortality Table projected with Scale BB to 2013 (multiplied by 50% for males and 30% for females). For healthy retired members and beneficiaries, the mortality table used is the RP-2000 Combined Mortality Table projected with Scale BB to 2013 (set-back one year for females). For disabled members, the RP-2000 Combined Disabled Mortality Table projected with Scale BB to 2013 (set back four years for males) is used for the period after disability retirement.

The actuarial assumptions used in the June 30, 2015, valuation were based on the results of an actuarial experience study for the period July 1, 2008 – June 30, 2013.

Discount Rate

The discount rate used to measure the total pension liability was 7.50%, a decrease of 0.25% from the prior year rate of 7.75%. The discount rate does not use a municipal bond rate.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

8. Pension Plan, Continued

Projected Cash Flows

The projection of cash flows used to determine the discount rate assumed that local employers would contribute the actuarially determined contribution rate of projected compensation over the remaining 28 year amortization period of the unfunded actuarial accrued liability. The actuarial determined contribution rate is adjusted to reflect the phase in of anticipated gains on actuarial value of assets over the first four years of the projection period.

Long-Term Rate of Return

The long-term expected return on plan assets is reviewed as part of the regular experience studies prepared every five years for CERS. The most recent analysis, performed for the period covering fiscal years 2008 through 2013 is outlined in a report dated April 30, 2014. Several factors are considered in evaluating the long-term rate of return assumption including long-term historical data, estimates inherent in current market data, and a log-normal distribution analysis in which best-estimate ranges of expected future real rates of return (expected return, net of investment expense and inflation) were developed by the investment consultant for each major asset class. These ranges were combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and then adding expected inflation. The capital market assumptions developed by the investment consultant are intended for use over a 10-year horizon and may not be useful in setting the long-term rate of return for funding pension plans which covers a longer timeframe. The assumption is intended to be a long-term assumption and is not expected to change absent a significant change in the asset allocation, a change in the inflation assumption, or a fundamental change in the market that alters expected returns in future years.

Periods of Projected Benefit Payments

Projected future benefit payments for all current plan members were projected through 2117.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

8. Pension Plan, Continued

Assumed Asset Allocation

The target allocation and best estimates of arithmetic real rates of return for each major asset class are summarized in the following table:

Asset Class	Target Allocation	Long-Term Expected Real Rate of Return
Combined equity	44%	5.40%
Combined fixed income	19	1.50
Real return (diversified inflation strategies)	10	3.50
Real estate	5	4.50
Absolute return (diversified hedge funds)	10	4.25
Private equity	10	8.50
Cash equivalents	2	-0.25
Total	<u>100%</u>	

Sensitivity of the Electric System's Proportionate Share of the Net Pension Liability to Changes in the Discount Rate

The following presents the Electric System's proportionate share of the net pension liability calculated using the discount rate of 7.50%, as well as what the Electric System's proportionate share of the net pension liability would be if it were calculated using a discount rate that is 1-percentage-point lower (6.50%) or 1-percentage-point higher (8.50%) than the current rate:

	Discount rate	Electric System's proportionate share of net pension liability
1% decrease	6.5%	\$33,575,029
Current discount rate	7.5%	\$26,254,442
1% increase	8.5%	\$19,985,007

Plan Fiduciary Net Position

Detailed information about the CERS fiduciary net position is available in the separately issued Kentucky Retirement Systems Comprehensive Annual Financial Report.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

8. Pension Plan, Continued

Payables to the Pension Plan

At May 31, 2016, the Electric System reported a payable of \$253,944 for the outstanding amount of contributions due to CERS for the year.

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:

2017	\$ 49,783,915
2018	55,039,653
2019	41,098,871
2020	<u>11,932,958</u>
	<u>\$ 157,855,397</u>

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.

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.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

10. Rate Matters

Effective June 1, 2015, the Electric System enacted a electric base rate increase for retail customers which was anticipated to increase retail revenues by approximately 10%.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

**SCHEDULE OF PROPORTIONATE SHARE OF THE NET PENSION LIABILITY
COUNTY EMPLOYEES RETIREMENT SYSTEM**

Last 10 Fiscal Years *

	<u>2016</u>	<u>2015</u>
Electric System's proportion of the net pension liability	0.610636%	0.632508%
Electric System's proportionate share of the net pension liability	\$ 26,254,442	\$ 20,520,943
Electric System's covered-employee payroll	\$ 14,221,628	\$ 14,612,052
Electric System's proportionate share of the net pension liability as a percentage of its covered employee payroll	184.61%	140.44%
Plan fiduciary net position as a percentage of the total pension liability	59.97%	66.80%

* Presented for those years for which the information is available.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

**SCHEDULE OF CONTRIBUTIONS
COUNTY EMPLOYEES RETIREMENT SYSTEM**

Last 10 Fiscal Years *

	<u>2016</u>	<u>2015</u>
Contractually required contributions	\$ 1,908,105	\$ 1,820,510
Contributions in relation to the contractually required contributions	<u>(1,908,105)</u>	<u>(1,820,510)</u>
Contribution deficiency (excess)	\$ <u>-</u>	\$ <u>-</u>
 Electric System's covered-employee payroll	 \$ 15,097,888	 \$ 14,199,426
Contributions as a percentage of covered-employee payroll	12.64%	12.82%

* Presented for those years for which the information is available.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

**NOTES TO REQUIRED SUPPLEMENTARY INFORMATION
COUNTY EMPLOYEES RETIREMENT SYSTEM**

Year Ended May 31, 2016

Changes of Benefit Terms

None

Changes of Assumptions

The assumed investment rate of return was decreased from 7.75% to 7.50%.

The assumed rate of inflation was reduced from 3.50% to 3.25%.

The assumed rate of wage inflation was reduced from 1.00% to 0.75%.

Payroll growth assumption was reduced from 4.50% to 4.00%.

The mortality table used for active members is RP-2000 Combined Mortality Table projected with Scale BB to 2013 (multiplied by 50% for males and 30% for females).

For healthy retired members and beneficiaries, the mortality table used is the RP-2000 Combined Mortality Table projected with Scale BB to 2013 (set back one year for females). For disabled members, the RP-2000 Combined Disabled Mortality Table projected with Scale BB to 2013 (set back four years for males) is used for the period after disability retirement. There is some margin in the current mortality tables for possible future improvement in mortality rates and that margin will be reviewed again when the next experience investigation is conducted.

The assumed rates of Retirement, Withdrawal and Disability were updated to more accurately reflect experience.

**OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM**

SCHEDULE OF REVENUES AND EXPENSES

Year Ended May 31, 2016 (with comparative totals for 2015)

	Retail Electric System	Wholesale Power Marketing
Operating revenues:		
Charges for services:		
Residential	\$ 30,131,855	\$ -
Commercial	5,987,652	-
Industrial	52,603,819	-
Water Works System	973,648	-
City of Owensboro	2,149,863	-
Supplemental power	-	1,199,388
Other wholesale	-	44,933,149
Electric Light and Power System	-	-
Build America Bond subsidy	395,018	-
Other	1,325,948	-
	<u>93,567,803</u>	<u>46,132,537</u>
Operating expenses:		
Production:		
Fuel for electric generation	-	-
Purchased power	51,433,037	54,932,746
Other	-	-
Transmission and distribution	4,760,457	3,527,902
Customer service and information	1,416,967	-
General and administrative	5,410,659	1,729,384
Telecommunications	-	-
Depreciation	3,612,136	-
	<u>66,633,256</u>	<u>60,190,032</u>
Operating income (loss)	<u>26,934,547</u>	<u>(14,057,495)</u>
Nonoperating revenues (expenses):		
Interest and debt expense	(1,738,282)	-
Interest income on investments	743,055	10,589
Interest income on Elmer Smith Generating Station investments allocated to:		
Electric System	967,634	-
Loss on investment derivative instruments	-	(1,691,427)
Other, net	32,746	-
Net increase (decrease) in fair value of investments	(1,337)	-
Deferred net change in fair value of investments	1,337	-
	<u>5,153</u>	<u>(1,680,838)</u>
Income before transfers	<u>26,939,700</u>	<u>(15,738,333)</u>
Transfers out - dividends to City of Owensboro	(8,817,687)	-
Change in net position	<u>\$ 18,122,013</u>	<u>\$ (15,738,333)</u>

Elmer Smith Generating Station	Telecommunications	Eliminations	Total	2015 Total
\$ -	\$ -	\$ -	\$ 30,131,855	\$ 24,650,499
-	1,017,775	-	7,005,427	5,828,846
-	-	-	52,603,819	41,309,466
-	26,260	-	999,908	787,580
-	45,378	-	2,195,241	2,071,206
-	-	-	1,199,388	1,495,293
-	-	(25,299)	44,907,850	62,351,667
99,524,551	168,256	(99,692,807)	-	-
144,225	-	-	539,243	540,256
-	-	(103,990)	1,221,958	780,053
<u>99,668,776</u>	<u>1,257,669</u>	<u>(99,822,096)</u>	<u>140,804,689</u>	<u>139,814,866</u>
49,267,137	-	-	49,267,137	65,620,480
31,158	-	(99,549,850)	6,847,091	7,409,652
21,804,505	-	(12,180)	21,792,325	14,554,570
176,007	-	(142,620)	8,321,746	7,397,846
-	58,639	-	1,475,606	1,465,083
6,485,169	278,451	(117,446)	13,786,217	11,115,142
-	510,469	-	510,469	417,088
12,186,445	177,469	-	15,976,050	14,203,973
<u>89,950,421</u>	<u>1,025,028</u>	<u>(99,822,096)</u>	<u>117,976,641</u>	<u>122,183,834</u>
<u>9,718,355</u>	<u>232,641</u>	<u>-</u>	<u>22,828,048</u>	<u>17,631,032</u>
(9,789,374)	-	-	(11,527,656)	(10,331,770)
985,970	-	-	1,739,614	1,516,861
(967,634)	-	-	-	-
-	-	-	(1,691,427)	(714,922)
52,683	-	-	85,429	138,117
182,706	-	-	181,369	307,705
(182,706)	-	-	(181,369)	(307,705)
<u>(9,718,355)</u>	<u>-</u>	<u>-</u>	<u>(11,394,040)</u>	<u>(9,391,714)</u>
-	232,641	-	11,434,008	8,239,318
-	-	-	(8,817,687)	(8,527,030)
<u>\$ -</u>	<u>\$ 232,641</u>	<u>\$ -</u>	<u>\$ 2,616,321</u>	<u>\$ (287,712)</u>



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, 2016 and 2015, 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 Water Works System of the City of Owensboro, Kentucky, as of May 31, 2016 and 2015, 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, in 2015 the Water System adopted new accounting guidance, GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*. Our opinion is not modified with respect to this 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, 2016 and 2015, 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 43 through 46, the Schedule of Proportionate Share of the Net Pension Liability on page 69, and the Schedule of Contributions on page 70, 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.

Renee Hancock CPAs PSC

Owensboro, Kentucky
September 6, 2016

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, 2016. Please read it in conjunction with the Water System's financial statements, which begin on page 47.

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.

MANAGEMENT'S DISCUSSION AND ANALYSIS, CONTINUED

Financial Summary

The following table summarizes the financial condition and operations of the Water System for 2016 and 2015.

Assets and Deferred Outflows of Resources	<u>2016</u>	<u>2015</u>
Utility plant, net	\$ 45,939,585	\$ 45,845,286
Restricted assets	11,616,260	7,958,238
Current assets	6,082,987	4,696,392
Other noncurrent assets	1,188,283	1,003,828
Deferred outflow of resources	<u>1,259,350</u>	<u>839,529</u>
	<u>\$ 66,086,465</u>	<u>\$ 60,343,273</u>
 Liabilities, Deferred Inflows of Resources, and Net Position		
Net position		
Net investment in capital assets	\$ 23,014,448	\$ 24,246,494
Restricted	984,200	728,685
Unrestricted	<u>801,377</u>	<u>(402,166)</u>
Total net position	24,800,025	24,573,013
Long-term debt	33,163,477	28,525,188
Current liabilities	2,264,113	2,121,749
Other noncurrent liabilities	5,330,028	4,303,826
Deferred inflows of resources	<u>528,822</u>	<u>819,497</u>
	<u>\$ 66,086,465</u>	<u>\$ 60,343,273</u>
 Revenues, Expenses and Changes in Net Position		
Operating revenues	\$ 11,175,649	\$ 10,253,198
Operating expenses	<u>9,418,420</u>	<u>8,597,576</u>
Operating income	<u>1,757,229</u>	<u>1,655,622</u>
Interest expense	(1,520,179)	(1,431,994)
Interest and other income	<u>142,778</u>	<u>93,038</u>
Net nonoperating expenses	<u>(1,377,401)</u>	<u>(1,338,956)</u>
Income (loss) before contributions and transfers	379,828	316,666
Capital contributions	143,222	39,673
Transfers out - dividends to City of Owensboro	<u>(296,038)</u>	<u>(169,469)</u>
Change in net position	<u>\$ 227,012</u>	<u>\$ 186,870</u>

MANAGEMENT'S DISCUSSION AND ANALYSIS, CONTINUED

FINANCIAL HIGHLIGHTS

- Net position increased \$227,012 in 2016, and the income before contributions and transfers was \$379,828 in 2016 versus \$316,666 in 2015, as a result of changes in operating revenues, operating expenses and interest as discussed below.
- Operating revenues increased by \$922,451 in 2016 when compared to 2015, or 9%. The increase in revenues in 2016 is primarily attributable to the second step of a retail rate increase effective June 1, 2015, which consisted of a volume-based increase and an increase in the monthly customer charge.
- Operating expenses increased \$820,844 in 2016 when compared to 2015, or 9.5%, primarily due to an increase in general and administrative costs of \$485,841, or 24.4%, and an increase in depreciation of \$247,224, or 10.2%. General and administrative expenses increased primarily due to increases in pension expense, as well as other general cost increases. In addition to the pension contributions recorded by the Water System in 2016, the CERS annual pension actuarial valuation required an increase in pension expense in 2016, versus a reduction in 2015, due to changes in pension investment earnings, as well as other valuation factors. Depreciation increased as a result of plant additions as discussed below.
- Interest expense increased by \$88,185, or 6.2%, due to issuance of the 2015 Series bonds as discussed below, and interest income increased \$28,891, or 34.6%, due to higher rates received on bank balances as a result of a new banking contract executed in 2015, increased investment in U.S. agency investments and from increased construction funds as a result of the 2015 Series bond issue.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

At the end of 2016, the Water System had \$45.9 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 2015 due to capital asset additions. The following table summarizes capital assets, net of accumulated depreciation, at the end of 2016 and 2015.

	<u>2016</u>	<u>2015</u>
Source of supply plant	\$ 3,152,205	\$ 2,257,589
Pumping plant	398,557	417,836
Water treatment plant	14,327,428	14,817,625
Transmission and distribution plant	21,889,750	21,704,749
General plant	1,360,079	1,444,111
Unclassified plant and construction in progress	4,811,566	5,203,376
	<u>\$ 45,939,585</u>	<u>\$ 45,845,286</u>

MANAGEMENT'S DISCUSSION AND ANALYSIS, CONTINUED

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 \$1.2 million on three tank refurbishment projects in 2016.

Debt

At the end of 2016, the Water System had \$33.9 million in bonds outstanding versus \$29.3 million in 2015, for an increase of 16%. The increase is attributable to issuance of the 2015 Series Water System Revenue and Improvements Bonds that totaled \$5.4 million. The bonds were issued to provide funds for various capital improvement expenditures. The Water System's bonds are insured and as a result Standard and Poor's Rating Services has assigned a rating of "AA-" and Moody's Investors Service has assigned an underlying rating of "A1" to the bonds.

Outlook

We expect the 2017 results to be down as compared to 2016, largely as a result of general cost increases. The Water System is anticipating revenue growth to be flat in 2017, while general cost increases are expected to lead to increased operating costs across the board.

In 2017, the Water System will also be finalizing plans to expand the treatment capability at the Cavin Water Treatment Plant, in order to abandon its treatment Plant A as a result of foundation settlement issues at the aging facility. The Water System is anticipating adjusting rates and issuing additional debt near the end of 2017, to fund the treatment plant expansion.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

STATEMENT OF NET POSITION

May 31, 2016 and 2015

**ASSETS AND DEFERRED OUTFLOWS OF
RESOURCES**

	<u>2016</u>	<u>2015</u>
Utility plant, net	\$ <u>45,939,585</u>	\$ <u>45,845,286</u>
Restricted assets	<u>11,616,260</u>	<u>7,958,238</u>
Current assets:		
Cash and cash equivalents	2,084,825	2,241,669
Investments	1,370,862	-
Accounts receivable, less allowance for doubtful accounts of \$6,196 for 2016 and \$8,982 for 2015	2,002,207	1,826,500
Materials and supplies	510,274	506,004
Prepayments	<u>114,819</u>	<u>122,219</u>
Total current assets	<u>6,082,987</u>	<u>4,696,392</u>
Other noncurrent assets	<u>1,188,283</u>	<u>1,003,828</u>
Total assets	<u>64,827,115</u>	<u>59,503,744</u>
Deferred outflows of resources:		
Deferred pension outflow	1,058,374	461,522
Unamortized loss on debt refunding	200,838	330,222
Net unrealized loss on investments	<u>138</u>	<u>47,785</u>
Total deferred outflows of resources	<u>1,259,350</u>	<u>839,529</u>
 Total assets and deferred outflows of resources	 <u>\$ 66,086,465</u>	 <u>\$ 60,343,273</u>

See Notes to Financial Statements

**LIABILITIES, DEFERRED INFLOWS OF
RESOURCES, AND NET POSITION**

	<u>2016</u>	<u>2015</u>
Net position:		
Net investment in capital assets	\$ 23,014,448	\$ 24,246,494
Restricted for capital projects, net of related debt	323,675	124,420
Restricted for debt service	660,525	604,265
Unrestricted	<u>801,377</u>	<u>(402,166)</u>
Total net position	<u>24,800,025</u>	<u>24,573,013</u>
Long-term debt	<u>33,163,477</u>	<u>28,525,188</u>
Current liabilities (payable from restricted assets):		
Current maturities of long-term debt	770,000	725,000
Accrued interest payable	304,342	266,066
Accounts payable	<u>578,189</u>	<u>491,876</u>
	<u>1,652,531</u>	<u>1,482,942</u>
Current liabilities (payable from current assets):		
Accounts payable	<u>611,582</u>	<u>638,807</u>
Total current liabilities	<u>2,264,113</u>	<u>2,121,749</u>
Other noncurrent liabilities:		
Net pension liability	5,199,116	4,101,776
Customers' advances for construction	<u>130,912</u>	<u>202,050</u>
Total other noncurrent liabilities	<u>5,330,028</u>	<u>4,303,826</u>
Total liabilities	<u>40,757,618</u>	<u>34,950,763</u>
Deferred inflows of resources:		
Deferred pension inflows	116,706	457,857
Deferred revenues	<u>412,116</u>	<u>361,640</u>
	<u>528,822</u>	<u>819,497</u>
Total liabilities, deferred inflows of resources, and net position	<u>\$ 66,086,465</u>	<u>\$ 60,343,273</u>

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET POSITION

Years Ended May 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Operating revenues:		
Charges for services:		
Residential	\$ 4,190,006	\$ 3,782,632
Commercial	3,838,455	3,540,692
Water districts	2,020,162	1,938,608
Fire protection	258,514	229,530
City of Owensboro	296,038	169,469
Electric Light and Power System	313,655	411,031
Service revenues	<u>258,819</u>	<u>181,236</u>
Total operating revenues	<u>11,175,649</u>	<u>10,253,198</u>
Operating expenses:		
Production and purification	2,687,840	2,666,739
Transmission and distribution	989,454	922,390
Customer service and information	602,164	602,550
General and administrative	2,478,448	1,992,607
Depreciation	<u>2,660,514</u>	<u>2,413,290</u>
Total operating expenses	<u>9,418,420</u>	<u>8,597,576</u>
Operating income	<u>1,757,229</u>	<u>1,655,622</u>
Nonoperating revenues (expenses):		
Interest and debt expense	(1,520,179)	(1,431,994)
Interest income on investments	112,429	83,538
Gain on sale of utility plant	30,349	9,500
Net increase in fair value of investments	47,647	37,053
Deferred net change in fair value of investments	<u>(47,647)</u>	<u>(37,053)</u>
Total nonoperating revenues (expenses)	<u>(1,377,401)</u>	<u>(1,338,956)</u>
Income before contributions and transfers	379,828	316,666
Capital contributions	143,222	39,673
Transfers out - dividends to City of Owensboro	<u>(296,038)</u>	<u>(169,469)</u>
Change in net position	<u>227,012</u>	<u>186,870</u>
Net position, beginning of year, before restatement	24,573,013	28,658,989
Cumulative effect of change in accounting principle	<u>-</u>	<u>(4,272,846)</u>
Net position, beginning of year, as restated	<u>24,573,013</u>	<u>24,386,143</u>
Net position, end of year	<u>\$ 24,800,025</u>	<u>\$ 24,573,013</u>

See Notes to Financial Statements

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

STATEMENTS OF CASH FLOWS

Years Ended May 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Cash flows from operating activities:		
Receipts from customers	\$ 11,036,718	\$ 10,217,177
Payments to suppliers	(3,930,411)	(3,928,279)
Payments to employees	(2,598,059)	(2,505,367)
	<u>4,508,248</u>	<u>3,783,531</u>
Cash flows from noncapital financing activities:		
Transfers out - dividends to City of Owensboro	(285,337)	(169,091)
Cash flows from capital and related financing activities:		
Capital expenditures	(2,647,203)	(3,064,695)
Payments on long-term debt	(725,000)	(620,000)
Interest paid on long-term debt	(1,319,329)	(1,202,185)
Proceeds from bond issuance	5,300,652	9,635,538
Payment to refunded bond agent	-	(3,876,502)
Reimbursements of customers' advances	(8,864)	(8,851)
Debt issuance cost	(111,203)	(114,768)
	<u>489,053</u>	<u>748,537</u>
Cash flows from investing activities:		
Purchase of investments	(1,819,400)	-
Proceeds from sale and maturities of investments	-	243,860
Interest on investments	110,230	83,640
	<u>(1,709,170)</u>	<u>327,500</u>
Net cash provided by (used in) investing activities	<u>(1,709,170)</u>	<u>327,500</u>
Net increase in cash and cash equivalents	3,002,794	4,690,477
Cash and cash equivalents, beginning of year	<u>8,469,511</u>	<u>3,779,034</u>
Cash and cash equivalents, end of year	<u>\$ 11,472,305</u>	<u>\$ 8,469,511</u>
Included in the following balance sheet captions:		
Cash and cash equivalents, unrestricted	\$ 2,084,825	\$ 2,241,669
Cash and cash equivalents, restricted	<u>9,387,480</u>	<u>6,227,842</u>
	<u>\$ 11,472,305</u>	<u>\$ 8,469,511</u>

See Notes to Financial Statements

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

STATEMENTS OF CASH FLOWS, Concluded

Years Ended May 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 1,757,229	\$ 1,655,622
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	2,750,514	2,513,290
Change in assets and liabilities:		
Decrease (increase) in assets:		
Accounts receivable	(175,707)	(115,989)
Materials and supplies	(4,270)	(18,291)
Prepayments	7,400	2,695
Other noncurrent assets	1,195	(1,198)
Deferred outflows of resources	(596,852)	(461,522)
Increase (decrease) in liabilities:		
Accounts payable	(37,926)	(119,491)
Other current liabilities	-	(55,440)
Other noncurrent liabilities	1,097,340	(171,070)
Deferred inflows	(290,675)	554,925
Net cash provided by operating activities	\$ <u>4,508,248</u>	\$ <u>3,783,531</u>
Noncash investing, capital and financing activities:		
Noncash contributions in aid of construction	\$ <u>80,948</u>	\$ <u>-</u>
Unrefunded customers' advances credited to contributions in aid of construction	\$ <u>62,274</u>	\$ <u>39,673</u>
Amortization of debt discount and expense and deferred loss on debt defeasance	\$ <u>162,574</u>	\$ <u>159,178</u>

OWENSBORO MUNICIPAL UTILITIES WATER WORKS SYSTEM

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

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.

OWENSBORO MUNICIPAL UTILITIES WATER WORKS SYSTEM

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

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 2016 and 2015 was approximately 3.4% and 3.1%, respectively, 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. The Water System categorizes the fair value measurements of its investments based on the hierarchy established by generally accepted accounting principles. U.S. government obligations and agency securities are stated at fair values based upon externally developed models that use rates and prices of similar securities.

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.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

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.

Pensions

For purposes of measuring the net pension liability, deferred outflows of resources and deferred inflows of resources related to pensions, and pension expense, information about the fiduciary net position of the County Employees Retirement System (CERS) and additions to/deduction from CERS's fiduciary net position have been determined on the same basis as they are reported by CERS. For this purpose, benefit payments (including refunds of employee contributions) are recognized when due and payable in accordance with the benefit terms. Investments are reported at fair value.

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.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

1. Organization and Summary of Significant Accounting Policies, Continued

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.

Change in Accounting Principle

In 2015, the Water System adopted GASB Statement No. 68, "Accounting and Financial Reporting for Pensions" (GASB 68). GASB 68 establishes standards for measuring and recognizing liabilities, deferred outflows of resources, and deferred inflows of resources, and expense/expenditures. For defined benefit pensions, GASB 68 identifies the methods and assumptions that should be used to project benefit payments, discount projected benefit payments to their actuarial present value, and attribute that present value to periods of employee service.

2. Utility Plant

Water utility plant activity for the year ended May 31, 2016, was as follows:

	<u>Beginning Balance</u>	<u>Additions</u>	<u>Retirements</u>	<u>Ending Balance</u>
Utility plant:				
Source of supply plant	\$ 4,490,632	\$ 1,045,729	\$ (117,679)	\$ 5,418,682
Pumping plant	1,166,763	10,487	-	1,177,250
Water treatment plant	29,459,811	282,368	-	29,742,179
Transmission and distribution plant	36,544,604	1,638,028	(82,082)	38,100,550
General plant	4,532,382	246,505	(120,001)	4,658,886
Unclassified plant in service	1,884,614	(344,700)	-	1,539,914
Total, at original cost	<u>78,078,806</u>	<u>2,878,417</u>	<u>(319,762)</u>	<u>80,637,461</u>
	<u>Beginning Balance</u>	<u>Additions</u>	<u>Retirements</u>	<u>Ending Balance</u>
Accumulated depreciation:				
Source of supply plant	(2,233,043)	(164,619)	(131,185)	(2,266,477)
Pumping plant	(748,927)	(29,766)	-	(778,693)
Water treatment plant	(14,642,186)	(772,565)	-	(15,414,751)
Transmission and distribution plant	(14,839,855)	(1,453,027)	(82,082)	(16,210,800)
General plant	(3,088,271)	(330,537)	(120,001)	(3,298,807)
Total accumulated depreciation	<u>(35,552,282)</u>	<u>(2,750,514)</u>	<u>(333,268)</u>	<u>(37,969,528)</u>
Construction in progress	<u>3,318,762</u>	<u>(47,110)</u>	<u>-</u>	<u>3,271,652</u>
Utility plant, net	<u>\$ 45,845,286</u>	<u>\$ 80,793</u>	<u>\$ 13,506</u>	<u>\$ 45,939,585</u>

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

2. Utility Plant, Continued

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

	<u>2016</u>	<u>2015</u>
Water utility plant	\$ 2,660,514	\$ 2,413,290
Transportation depreciation charged to construction activities or other operating expenses	<u>90,000</u>	<u>100,000</u>
	<u>\$ 2,750,514</u>	<u>\$ 2,513,290</u>

3. Restricted Assets

Restricted assets at May 31 consist of the following:

	<u>2016</u>	<u>2015</u>
Cash and cash equivalents	\$ 9,387,480	\$ 6,227,842
Investments	2,223,395	1,727,215
Accrued interest receivable	<u>5,385</u>	<u>3,181</u>
	<u>\$ 11,616,260</u>	<u>\$ 7,958,238</u>

The above balances are contained in the following funds:

Sinking Fund	\$ 3,171,622	\$ 2,817,586
Renewal and Replacement Fund	7	182
Construction Fund	<u>8,444,631</u>	<u>5,140,470</u>
	<u>\$ 11,616,260</u>	<u>\$ 7,958,238</u>

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 \$614,000 at May 31, 2016), all or any part of such excess may be used for any lawful purpose related to the Water System.

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 gains of \$47,647 and \$37,053 for the years ended May 31, 2016 and 2015, respectively. The

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

3. Restricted Assets, Continued

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, 2016 and 2015, have been deferred.

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

	<u>2016</u>	<u>2015</u>
Net realized gains (losses) on sales of investments	\$ -	\$ -
Net unrealized gains (losses) on investments	<u>47,647</u>	<u>37,053</u>
	<u>\$ 47,647</u>	<u>\$ 37,053</u>

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:

	<u>2016</u>	<u>2015</u>
Deposits in financial institutions	\$ 11,472,305	\$ 8,469,511
Investments other than deposits	<u>3,594,257</u>	<u>1,727,215</u>
	<u>\$ 15,066,562</u>	<u>\$ 10,196,726</u>

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

	<u>2016</u>	<u>2015</u>
Cash and cash equivalents	\$ 2,084,825	\$ 2,241,669
Investments	1,370,862	
Restricted assets:		
Cash and cash equivalents	9,387,480	6,227,842
Investments	<u>2,223,395</u>	<u>1,727,215</u>
	<u>\$ 15,066,562</u>	<u>\$ 10,196,726</u>

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

4. Cash Deposits and Investments, Continued

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, 2016, \$11,440,465 of the Water System's bank balance of \$11,472,305 was exposed to custodial credit risk as follows:

Uninsured and uncollateralized	\$ -
Uninsured with collateral held by pledging bank's agent	<u>11,440,465</u>
Total	<u>\$ 11,440,465</u>

Investments are measured at fair value on a recurring basis. *Recurring* fair value measurements are those that Governmental Accounting Standards Board (GASB) Statements require or permit in the statement of net position at the end of each reporting period. Fair value measurements are categorized based on the valuation inputs used to measure an asset's fair value: Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs. The Water System's Investments consist of U.S. agency securities, which utilize Level 2 inputs for fair value measurements. Fair value is based upon externally developed models that use rates and prices of similar securities, due to the limited market activity of the securities.

As of May 31, 2016, the Water System had the following U.S. agency securities:

<u>Securities</u>	<u>Maturities</u>	
Federal Home Loan Bank – Callable	09/24/2018	\$ 1,000,592
Federal Home Loan Bank – Callable	05/17/2019	320,400
Federal Home Loan Bank – Callable	11/26/2019	270,000
Federal Farm Credit Bank – Callable	12/30/2019	229,319
Federal Home Loan Bank – Callable	11/01/2022	<u>1,773,946</u>
		<u>\$ 3,594,257</u>

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

4. Cash Deposits and Investments, Continued

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.

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, 2016.

5. Long-Term Debt

Long-term debt activity for the year ended May 31, 2016, was as follows:

	<u>Beginning Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending Balance</u>	<u>Amounts Due Within One Year</u>
Bonds payable:					
Series of 2009	\$ 19,160,000	\$ -	\$ -	\$ 19,160,000	\$ -
Series of 2014	9,730,000	-	(725,000)	9,005,000	735,000
Series of 2015	<u>-</u>	<u>5,385,000</u>	<u>-</u>	<u>5,385,000</u>	<u>35,000</u>
	28,890,000	5,385,000	(725,000)	33,550,000	770,000
Add unamortized debt premium	<u>360,188</u>	<u>41,219</u>	<u>(17,930)</u>	<u>383,477</u>	<u>-</u>
Total bonds payable	\$ <u>29,250,188</u>	\$ <u>5,426,219</u>	\$ <u>(742,930)</u>	\$ <u>33,933,477</u>	\$ <u>770,000</u>

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

5. Long-Term Debt, Continued

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

	<u>2016</u>	<u>2015</u>
Series of 2009:		
5.0% to 5.25%, due serially		
September 15, 2018 to 2035	\$ 19,160,000	\$ 19,160,000
Series of 2014:		
1.75% to 3.9%, due serially		
September 15, 2015 to 2038	9,005,000	9,730,000
Series of 2015:		
3.0% to 4.0%, due serially		
September 15, 2016 to 2040	<u>5,385,000</u>	<u>-</u>
Total long-term debt	33,550,000	28,890,000
Less current maturities	(770,000)	(725,000)
Add unamortized debt premium	<u>383,477</u>	<u>360,188</u>
	<u>\$ 33,163,477</u>	<u>\$ 28,525,188</u>

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

<u>Year Ending May 31:</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2017	\$ 770,000	\$ 1,453,884	\$ 2,223,884
2018	780,000	1,439,915	2,219,915
2019	805,000	1,416,959	2,221,959
2020	835,000	1,384,309	2,219,309
2021	870,000	1,349,734	2,219,734
2022 – 2026	4,965,000	6,141,581	11,106,581
2027 – 2031	6,315,000	4,794,569	11,109,569
2032 – 2036	8,100,000	3,006,656	11,106,656
2037 – 2041	<u>10,110,000</u>	<u>993,718</u>	<u>11,103,718</u>
	<u>\$ 33,550,000</u>	<u>\$ 21,981,325</u>	<u>\$ 55,531,325</u>

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.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

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.

On June 12, 2014, the City issued \$9,730,000 of Water Revenue Refunding and Improvement Bonds, Series 2014, dated July 31, 2014. The 2014 Bonds were issued to refund all 1999 and 2003 series bonds due after September 15, 2014, and to fund various capital improvement expenditures for the Water System. The in-substance defeasance of the 1999 and 2003 Bonds was accomplished by placing \$3,835,802 in proceeds from the 2014 Bonds and \$40,700 in funds from the 1999 and 2003 Bond Sinking Funds in an irrevocable escrow fund to be used solely for satisfying scheduled debt service payments of the 1999 and 2003 Bonds. Accordingly, 1999 and 2003 Bonds in the amount of \$1,305,000 and \$2,510,000, respectively, net of unamortized discount and issuance costs of \$60,176 and accrued interest payable of \$47,483, were extinguished resulting in the accounting recognition of a loss from defeasance of \$74,195, reported in the accompanying financial statements as a deferred outflow of resources. The City advance refunded the 1999 and 2003 bonds to 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 \$252,617.

The Series 2014 Bonds maturing on and after September 15, 2023, are subject to redemption prior to maturity in whole or in part on September 15, 2022, and on any date thereafter, at the redemption price of 100% of the principal amount redeemed, plus accrued interest to the redemption date.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

5. Long-Term Debt, Continued

On December 16, 2015, the City issued \$5,385,000 of Water Revenue Improvement Bonds, Series 2015, dated December 1, 2015. The 2015 Bonds were issued to provide funds for the various capital improvement expenditures for the Water System and to fully fund the Bond Reserve Account. The Series 2015 Bonds maturing on and after September 15, 2024, are subject to redemption in whole or in part on September 15, 2023, 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 defeased bond issues.

6. Pension Plan

Plan Description

The Water System contributes to the County Employees Retirement System (CERS), which is a cost-sharing multiple-employer defined benefit pension plan administered by Kentucky Retirement Systems (KRS) that covers all regular full-time members employed in nonhazardous positions of each participating county, city, and school board, and any additional eligible local agencies electing to participate in CERS. Kentucky Revised Statute Section 61.645 assigns the authority to establish and amend benefit provisions to the Board of Trustees of Kentucky Retirement Systems (Board). CERS issues a publicly available financial report that can be obtained at www.kyret.ky.gov.

Benefits Provided

CERS provides for retirement, disability, and death benefits to system members through its pension fund. Retirement benefits may be extended to beneficiaries of members under certain circumstances. Retirement benefits are determined using a formula which considers the member's final compensation; benefit factors set by statute which vary depending upon the type / amount of service, participation date, and retirement date; and years of service. Plan members with a participation date prior to September 1, 2008, are eligible to retire with full benefits at any time with 27 or more years of service credit, or at age 65 with at least 48 months of service credit. Plan members with a participation date on or after September 1, 2008, are eligible to retire with full benefits at age 57 if the member's age and years of

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

6. Pension Plan, Continued

Benefits Provided, Continued

service equal 87, or at age 65 with at least 60 months of service credit. Plan members with participation date on or after January 1, 2014, are eligible for retirement benefits under the provisions established for a hybrid Cash Balance Plan.

CERS also provides for retiree medical benefits through its insurance fund. Generally accepted accounting and financial reporting principles do not currently require recognition and reporting of the liabilities, deferred outflows of resources, deferred inflows of resources, and expense associated with this postemployment benefit. Therefore, such information has not been reflected in these financial statements.

Contributions

Per Kentucky Revised Statutes Section 78.545(33), contribution requirements of the active employees and the participating employers are established and may be amended by the KRS Board. Plan members who began participating in CERS prior to September 1, 2008, are required to contribute 5% of their annual creditable compensation to the pension fund. For Plan members who began participating in CERS on or after September 1, 2008, the contribution rate is 6%, of which 1% is contributed to the insurance fund. The Water System's actuarially determined contribution rate as of May 31, 2016, was 17.06% of annual creditable compensation, of which 12.42% and 4.64% was contributed to the pension and insurance funds within CERS, respectively. Contributions to CERS pension fund by the Water System were \$355,884 for the year ended May 31, 2016.

Pension Liabilities, Pension Expense, Deferred Outflows of Resources, and Deferred Inflows of Resources Related to Pensions

At May 31, 2016, the Water System reported a liability of \$5,199,116 for its proportionate share of the net pension liability. The net pension liability was measured as of June 30, 2015, and the total pension liability used to calculate the net pension liability was determined by an actuarial valuation as of that date. The Water System's proportion of the net pension liability was based on a projection of the Water System's long-term share of contributions to the pension plan relative to the projected contributions of all participating entities, actuarially determined. At the June 30, 2015, measurement date, the Water System's proportion was 0.120923%, a decrease of 0.005504% from its proportion measured at June 30, 2014 of 0.126427%.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

6. Pension Plan, Continued

Pension Liabilities, Pension Expense, Deferred Outflows of Resources, and Deferred Inflows of Resources Related to Pensions, Continued

For the year ended May 31, 2016, the Water System recognized pension expense of \$515,220. At May 31, 2016, the Water System reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

	<u>Deferred Outflows of Resources</u>	<u>Deferred Inflows of Resources</u>
Differences between expected and actual experience	\$ 43,206	\$ -
Changes of assumptions	524,274	-
Changes in proportion and differences between contributions and proportionate share of contributions	-	116,706
Net difference between projected and actual earnings on plan investments	46,606	-
Pension contributions subsequent to the measurement date	444,288	-
Total	<u>\$ 1,058,374</u>	<u>\$ 116,706</u>

The \$444,288 of deferred outflows of resources resulting from the Water System's contributions subsequent to the measurement date will be recognized as a reduction of the net pension liability in the year ending May 31, 2017. Other amounts reported as deferred outflows (inflows) of resources will be recognized in pension expense as follows:

Year ending May 31,

2017	\$ 162,848
2018	162,848
2019	74,849
2020	96,835
	<u>\$ 497,380</u>

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

6. Pension Plan, Continued

Actuarial Assumptions

The total pension liability in the June 30, 2015, actuarial valuation was determined using the following actuarial assumptions, applied to all periods included in the measurement:

Inflation	3.5%
Salary increases	4.0% average, including inflation
Investment rate of return	7.5%, net of pension plan investment expense, including inflation

The mortality table used for active members is RP-2000 Combined Mortality Table projected with Scale BB to 2013 (multiplied by 50% for males and 30% for females). For healthy retired members and beneficiaries, the mortality table used is the RP-2000 Combined Mortality Table projected with Scale BB to 2013 (set-back one year for females). For disabled members, the RP-2000 Combined Disabled Mortality Table projected with Scale BB to 2013 (set back four years for males) is used for the period after disability retirement.

The actuarial assumptions used in the June 30, 2015, valuation were based on the results of an actuarial experience study for the period July 1, 2008 – June 30, 2013.

Discount Rate

The discount rate used to measure the total pension liability was 7.50%, a decrease of 0.25% from the prior year rate of 7.75%. The discount rate does not use a municipal bond rate.

Projected Cash Flows

The projection of cash flows used to determine the discount rate assumed that local employers would contribute the actuarially determined contribution rate of projected compensation over the remaining 28 year amortization period of the unfunded actuarial accrued liability. The actuarial determined contribution rate is adjusted to reflect the phase in of anticipated gains on actuarial value of assets over the first four years of the projection period.

Long-Term Rate of Return

The long-term expected rate of return on pension plan investments is reviewed as part of the regular experience studies prepared every five years. The most recent analysis, performed for the period covering fiscal years 2005 through 2008, is outlined in a report dated August

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

6. Pension Plan, Continued

Long-Term Rate of Return, Continued

25, 2009. Several factors are considered in evaluating the long-term rate of return assumption including long-term historical data, estimates inherent in current market data, and a log-normal distribution analysis in which best-estimate ranges of expected future real rates of return (expected return, net of investment expense, and inflation) were developed by the investment consultant for each major asset class. These ranges were combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and then adding expected inflation. The capital market assumptions developed by the investment consultant are intended for use over a 10-year horizon and may not be useful in setting the long-term rate of return for funding pension plans which cover a longer time frame. The assumption is intended to be a long-term assumption and is not expected to change absent a significant change in the asset allocation, a change in the inflation assumption, or a fundamental change in the market that alters expected returns in future years.

Periods of Projected Benefit Payments

Projected future benefit payments for all current plan members were projected through 2117.

Assumed Asset Allocation

The target allocation and best estimates of arithmetic real rates of return for each major asset class are summarized in the following table:

Asset Class	Target Allocation	Long-Term Expected Real Rate of Return
Combined equity	44%	5.40%
Combined fixed income	19	1.50
Real return (diversified inflation strategies)	10	3.50
Real estate	5	4.50
Absolute return (diversified hedge funds)	10	4.25
Private equity	10	8.50
Cash equivalents	2	-0.25
Total	100%	

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

6. Pension Plan, Continued

Sensitivity of the Water System's Proportionate Share of the Net Pension Liability to Changes in the Discount Rate

The following presents the Water System's proportionate share of the net pension liability calculated using the discount rate of 7.50%, as well as what the Water System's proportionate share of the net pension liability would be if it were calculated using a discount rate that is 1-percentage-point lower (6.50%) or 1-percentage-point higher (8.50%) than the current rate:

	<u>Discount rate</u>	<u>Water System's proportionate share of net pension liability</u>
1% decrease	6.50%	\$6,648,798
Current discount rate	7.50%	\$5,199,116
1% increase	8.50%	\$3,957,592

Plan Fiduciary Net Position

Detailed information about the CERS fiduciary net position is available in the separately issued Kentucky Retirement Systems Comprehensive Annual Financial Report.

Payables to the Pension Plan

At May 31, 2016, the Water System reported a payable of \$56,788 for the outstanding amount of contributions due to CERS for the year.

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 \$2,020,000 and \$1,939,000 for 2016 and 2015, respectively.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2016 and 2015

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 was effective June 1, 2014, and the second step was effective June 1, 2015. These steps, each of which consists of a volume-based increase and an increase in the monthly customer charge, were anticipated to increase retail operating revenues by approximately 12% and 9%, respectively.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

**SCHEDULE OF PROPORTIONATE SHARE OF THE NET PENSION LIABILITY
COUNTY EMPLOYEES RETIREMENT SYSTEM**

Last 10 Fiscal Years *

	<u>2016</u>	<u>2015</u>
Water System's proportion of the net pension liability	0.120923%	0.126427%
Water System's proportionate share of the net pension liability	\$ 5,199,116	\$ 4,101,776
Water System's covered-employee payroll	\$ 2,803,919	\$ 2,920,692
Water System's proportionate share of the net pension liability as a percentage of its covered employee payroll	185.42%	140.44%
Plan fiduciary net position as a percentage of the total pension liability	59.97%	66.80%

* Presented for those years for which the information is available.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

**SCHEDULE OF CONTRIBUTIONS
COUNTY EMPLOYEES RETIREMENT SYSTEM**

Last 10 Fiscal Years *

	<u>2016</u>	<u>2015</u>
Contractually required contributions	\$ 355,884	\$ 363,125
Contributions in relation to the contractually required contributions	<u>(355,884)</u>	<u>(363,125)</u>
Contribution deficiency (excess)	\$ <u>-</u>	\$ <u>-</u>
Water System's covered-employee payroll	\$ 2,815,932	\$ 2,838,215
Contributions as a percentage of covered-employee payroll	12.64%	12.79%

* Presented for those years for which the information is available.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

**NOTES TO REQUIRED SUPPLEMENTARY INFORMATION
COUNTY EMPLOYEES RETIREMENT SYSTEM**

Year Ended May 31, 2016

Changes of Benefit Terms

None

Changes of Assumptions

The assumed investment rate of return was decreased from 7.75% to 7.50%.

The assumed rate of inflation was reduced from 3.50% to 3.25%.

The assumed rate of wage inflation was reduced from 1.00% to 0.75%.

Payroll growth assumption was reduced from 4.50% to 4.00%.

The mortality table used for active members is RP-2000 Combined Mortality Table projected with Scale BB to 2013 (multiplied by 50% for males and 30% for females).

For healthy retired members and beneficiaries, the mortality table used is the RP-2000 Combined Mortality Table projected with Scale BB to 2013 (set back one year for females). For disabled members, the RP-2000 Combined Disabled Mortality Table projected with Scale BB to 2013 (set back four years for males) is used for the period after disability retirement. There is some margin in the current mortality tables for possible future improvement in mortality rates and that margin will be reviewed again when the next experience investigation is conducted.

The assumed rates of Retirement, Withdrawal and Disability were updated to more accurately reflect experience.