

***OWENSBORO MUNICIPAL UTILITIES
ELECTRIC LIGHT AND POWER SYSTEM
&
WATER WORKS SYSTEM
FINANCIAL STATEMENTS
& SUPPLEMENTARY INFORMATION
Years Ended May 31, 2018 and 2017***

(With Independent Auditor's Report Thereon)

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Riney Hancock CPAs
PSC

INDEPENDENT AUDITOR'S REPORT

City Utility Commission
City of Owensboro, Kentucky

Report on the Financial Statements

We have audited the accompanying financial statements of the Owensboro Municipal Utilities Electric Light and Power System (Electric System) a component unit of the City of Owensboro, Kentucky, as of and for the years ended May 31, 2018 and 2017, 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 and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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, 2018 and 2017, 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.

Changes in Accounting Principles

As discussed in Note 10 to the financial statements, in 2018 the Electric System adopted new accounting guidance, GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*. Also, as discussed in Note 1 to the financial statements, in 2018 the Electric System adopted the provisions of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance in Pre-November 30, 1989 FASB and AICPA Pronouncements*, as it relates to rate-regulated entities, for reporting pension and other postemployment benefits. Our opinion is not modified with respect to these matters.

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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 and the Pension and Other Post-Employment Benefits (OPEB) Schedules on pages 38 through 42, 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.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated September 11, 2018, on our consideration of Electric System's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Electric System's internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Electric System's internal control over financial reporting and compliance.

Riney Hancock CPAs PSC

Owensboro, Kentucky
September 11, 2018

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, 2018. Please read it in conjunction with the Electric System's financial statements, which begin on page 7.

Overview of the Financial Statements

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

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

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

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

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

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

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

MANAGEMENT'S DISCUSSION AND ANALYSIS, CONTINUED

Financial Summary

The following table summarizes the financial condition and operations of the Electric System for 2018 and 2017.

Assets and Deferred Outflows of Resources	<u>2018</u>	<u>2017</u>
Utility plant, net	\$ 165,243,209	\$ 175,221,640
Restricted assets	99,729,633	99,383,755
Current assets	54,604,302	52,822,451
Other noncurrent assets	19,981,509	14,392,124
Deferred outflows of resources	58,706,826	12,071,027
	<u>\$ 398,265,479</u>	<u>\$ 353,890,997</u>
Liabilities, Deferred Inflows of Resources, and Net Position		
Net position		
Net investment in capital assets	\$ 7,000,058	\$ 7,929,669
Restricted	72,405,502	70,338,515
Unrestricted	57,509,187	26,478,211
Total net position	136,914,747	104,746,395
Long-term debt	164,629,594	173,404,723
Current liabilities	42,489,058	38,433,377
Other noncurrent liabilities	48,261,807	31,393,460
Deferred revenues	666,966	1,072,751
Deferred inflows of resources	5,303,307	4,840,291
	<u>\$ 398,265,479</u>	<u>\$ 353,890,997</u>
Revenues, Expenses and Changes in Net Position		
Operating revenues	\$ 150,223,995	\$ 147,495,908
Operating expenses	124,967,802	120,196,927
Operating income	25,256,193	27,298,981
Interest and debt expense	(9,733,843)	(11,149,966)
Interest and other income	2,311,169	1,770,169
Net nonoperating expenses	(7,422,674)	(9,379,797)
Income before transfers	17,833,519	17,919,184
Transfers out - dividends to City of Owensboro	(9,209,935)	(9,121,316)
Change in net position	<u>\$ 8,623,584</u>	<u>\$ 8,797,868</u>

MANAGEMENT'S DISCUSSION AND ANALYSIS, CONTINUED

FINANCIAL HIGHLIGHTS

- Total net position increased \$8.6 million in 2018, or 8.2%, versus an increase of \$8.8 million in 2017 as the result of changes in operating revenues, operating expenses, nonoperating revenues/expenses and transfers as discussed below.
- Operating revenues increased \$2.7 million, or 1.8%, in 2018 when compared to 2017. Retail revenues increased \$6.9 million, or 7.2%, in 2018 primarily due to increased 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. The primary cause of the retail energy cost increase was a decline in wholesale energy sales volumes in 2018 as the Electric System had two scheduled maintenance outages and also curtailed power generation at its Elmer Smith Generating Station (ESGS) during periods of projected low wholesale prices, primarily during nights and weekends, resulting in a reduction in energy cost recovery from wholesale customers and increasing the recovery requirement from retail customers. A secondary cause was an increase in maintenance cost, also a component of energy cost, at ESGS due to the planned maintenance outages on both of the generating units in 2018 versus none in 2017. Conversely, wholesale revenues declined \$4.3 million, or 8.6%, in 2018 primarily resulting from the decreased wholesale energy sales volumes, as discussed above. Finally, telecommunication revenues were up \$180,738, or 11.8%, due to increases in commercial telecommunication services, as well as additional residential services through the new Fiber-to-the-Home program.
- Operating expenses in 2018 increased \$4.8 million, or 4.0%, versus 2017, largely the result of an overall increase in power production cost of \$5.0 million, or \$6.3%. The planned maintenance outages mentioned above was the primary cause for the increase in power production cost. The outages led to an increase in maintenance cost, included in other production cost, which increased by \$6.0 million, or 36.9%. The outages also increased purchased power requirements as the units were not available for power generation during the outage duration, resulting in an increase in purchased power of \$3.9 million, or 57.5%. Thirdly, fuel cost declined \$4.9 million, or 8.6%, as less fuel was required due to decreased power generation during the outage period, offsetting a portion of the other production cost increases. General and administrative expense decreased \$1.4 million, or 14.4%, due primarily to an accounting principle change which, if applied in 2017, would have decreased pension expense, a component of general and administrative expense, by \$2.2 million. Partially offsetting that decrease was an increase in administrative payroll expense due primarily to various personnel changes in 2018, as well as various general cost increases. Finally, depreciation expense increased \$933,826, or 5.1%, as a result of plant additions as discussed below and accelerating depreciation on production plant assets.
- Nonoperating expenses decreased by \$2 million, or 20.9%, in 2018 when compared to 2017. Interest expense decreased by \$1.4 million, or 12.7%, primarily the result of scheduled principal payments on debt, lower rates on debt refunded by the 2017 series bonds and capitalization of interest on the newly issued portion of the 2017 series bonds, as discussed below. Interest income increased by \$523,563, or 29.9%, primarily due to higher rates received on bank and investment balances.
- Dividend transfers to the City of Owensboro increased by \$88,619 in 2018, or 1.0%, due primarily to an increase in actual cash transfers to the City.

MANAGEMENT'S DISCUSSION AND ANALYSIS, CONTINUED

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

At the end of 2018, the Electric System had \$165.2 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 decrease of \$10.0 million over 2017 due to depreciation which exceeded capital asset additions. In addition to other routine capital additions during 2018 the Electric System incurred \$2.1 million on the Fiber-to-the-Home program to deliver high speed internet service to residential customers, \$698,000 to extend electric service in the Gateway Commons commercial development and \$685,000 on routine pole change-outs. The following table summarizes capital assets, net of accumulated depreciation, at the end of 2018 and 2017:

	<u>2018</u>	<u>2017</u>
Production plant	\$ 91,084,738	\$ 97,729,914
Transmission plant	12,192,575	13,006,573
Distribution plant	37,497,817	37,652,576
General plant	6,985,758	7,791,166
Unclassified plant and construction in progress	17,482,321	19,041,411
	<u>\$ 165,243,209</u>	<u>\$ 175,221,640</u>

Debt

At the end of 2017, the Electric System had \$183.4 million in bonds outstanding versus \$191.7 million in 2017, for a decrease of \$8.3 million, or 4.3%. During 2018 the Electric System issued the 2017 Series Electric Light and Power System Bonds that totaled \$49.7 million. The 2017 Bonds were issued to provide \$6.0 million to fund construction of a residential fiber optic distribution network with the ability to provide ultrahigh speed internet access to approximately 6,500 dwellings and to refund the 2010-C series bonds in the amount of \$8.9 million and certain 2013-B series bonds totaling \$36.2 million. However, scheduled debt repayments on existing debt and the debt refunded exceeded the new debt issuance, which resulted in the overall decline in outstanding debt. The Electric System bonds carry ratings of "A" (stable outlook) and "A3" (stable outlook) as assigned by S&P Global Ratings and Moody's Investors Services, Inc., respectively.

Outlook

We expect the 2019 net operating results to decline somewhat from 2018 results, with overall cost increases anticipated to outpace increased revenues. Wholesale revenues are anticipated to increase moderately as increased generation is expected at ESGS, partially due to only one maintenance outage planned in 2019, as well as fewer anticipated night and weekend production curtailments. Revenues from retail customers are also expected to increase slightly as additional energy costs are anticipated to be passed on to retail customers, due to increased power generation and reduced energy cost recovery from wholesale customers. However cost increases associated with the additional power generation are expected to outpace the increased revenue.

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

STATEMENTS OF NET POSITION

May 31, 2018 and 2017

**ASSETS AND DEFERRED OUTFLOWS OF
RESOURCES**

	<u>2018</u>	<u>2017</u>
Utility plant, net	\$ 165,243,209	\$ 175,221,640
Restricted assets	<u>99,729,633</u>	<u>99,383,755</u>
Current assets:		
Cash and cash equivalents	13,588,619	28,142,820
Investments	20,291,469	6,039,228
Receivables:		
Retail accounts receivable, less allowance for doubtful accounts of \$49,121 for 2018 and \$41,251 for 2017	10,335,325	9,428,215
Wholesale accounts receivable	4,310,526	2,144,123
City of Owensboro	176,858	222,420
Other	639,800	327,742
Materials and supplies inventories	4,209,585	3,281,502
Prepayments	370,856	394,326
Other	<u>681,264</u>	<u>2,842,075</u>
Total current assets	<u>54,604,302</u>	<u>52,822,451</u>
Other noncurrent assets:		
Unamortized debt expense	1,088,248	1,244,861
Energy cost to be recovered	18,807,748	11,521,754
Other noncurrent assets	<u>85,513</u>	<u>1,625,509</u>
Total other noncurrent assets	<u>19,981,509</u>	<u>14,392,124</u>
Total assets	<u>339,558,653</u>	<u>341,819,970</u>
Deferred outflows of resources:		
Accumulated decrease in fair value of hedging derivatives	1,935,210	2,285,656
Deferred pension outflows	11,749,933	7,668,097
Deferred other postemployment benefit outflows	3,330,004	-
Deferred pension obligation	27,845,013	-
Deferred postemployment benefit obligation	9,604,755	-
Unamortized loss on debt refunding	3,136,433	1,835,148
Net unrealized loss on investments	<u>1,105,478</u>	<u>282,126</u>
Total deferred outflows of resources	<u>58,706,826</u>	<u>12,071,027</u>
Total assets and deferred outflows of resources	\$ <u>398,265,479</u>	\$ <u>353,890,997</u>

See Notes to Financial Statements

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

	<u>2018</u>	<u>2017</u>
Net position:		
Net investment in capital assets	\$ 7,000,058	\$ 7,929,669
Restricted for capital projects, net of related debt	5,553,650	5,318,510
Restricted for debt service	15,505,673	13,782,076
Restricted for other purposes	51,346,179	51,237,929
Unrestricted	<u>57,509,187</u>	<u>26,478,211</u>
Total net position	<u>136,914,747</u>	<u>104,746,395</u>
Long-term debt	<u>164,629,594</u>	<u>173,404,723</u>
Current liabilities (payable from restricted assets):		
Current maturities of long-term debt	18,791,838	18,251,851
Accrued interest payable	2,808,784	2,931,410
Accounts payable	<u>3,869,184</u>	<u>4,057,888</u>
	<u>25,469,806</u>	<u>25,241,149</u>
Current liabilities (payable from current assets):		
Accounts payable	8,102,975	4,914,914
Other	<u>8,916,277</u>	<u>8,277,314</u>
	<u>17,019,252</u>	<u>13,192,228</u>
Total current liabilities	<u>42,489,058</u>	<u>38,433,377</u>
Other noncurrent liabilities:		
Net pension liability	35,787,099	30,858,179
Net other postemployment benefit liability	12,291,225	-
Other	<u>183,483</u>	<u>535,281</u>
Total other noncurrent liabilities	<u>48,261,807</u>	<u>31,393,460</u>
Commitments and contingencies (Note 9)		
Deferred revenues	<u>666,966</u>	<u>1,072,751</u>
Total liabilities	<u>256,047,425</u>	<u>244,304,311</u>
Deferred inflows of resources:		
Accumulated increase in fair value of hedging derivatives	851,926	4,485,606
Deferred pension inflows	3,807,847	354,685
Deferred other postemployment benefit inflows	<u>643,534</u>	<u>-</u>
Total deferred inflows of resources	<u>5,303,307</u>	<u>4,840,291</u>
Total liabilities, deferred inflows of resources, and net position	\$ <u>398,265,479</u>	\$ <u>353,890,997</u>

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

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET POSITION

Years Ended May 31, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Operating revenues:		
Charges for services:		
Residential	\$ 33,157,106	\$ 31,097,720
Commercial	7,774,118	7,116,947
Industrial	56,759,947	52,944,090
Water Works System	1,327,367	1,101,570
City of Owensboro and Schools	3,174,786	2,825,192
Supplemental power	1,495,309	1,405,095
Other wholesale	44,539,462	48,981,965
Build America Bond subsidy	540,498	538,954
Other	1,455,402	1,484,375
Total operating revenues	<u>150,223,995</u>	<u>147,495,908</u>
Operating expenses:		
Production:		
Fuel for electric generation	51,802,072	56,664,811
Purchased power	10,646,435	6,758,909
Other	22,205,081	16,221,380
Transmission and distribution	9,796,278	9,690,171
Customer service and information	1,945,780	1,922,102
General and administrative	8,470,867	9,898,923
Telecommunications	932,771	805,939
Depreciation	19,168,518	18,234,692
Total operating expenses	<u>124,967,802</u>	<u>120,196,927</u>
Operating income	<u>25,256,193</u>	<u>27,298,981</u>
Nonoperating revenues (expenses):		
Interest and debt expense	(9,733,843)	(11,149,966)
Interest income on investments	2,275,618	1,752,055
Other, net	35,551	18,114
Net decrease in fair value of investments	(823,352)	(273,862)
Deferred net change in fair value of investments	823,352	273,862
Total nonoperating revenues (expenses)	<u>(7,422,674)</u>	<u>(9,379,797)</u>
Income before transfers	17,833,519	17,919,184
Transfers out - dividends to City of Owensboro	<u>(9,209,935)</u>	<u>(9,121,316)</u>
Change in net position	<u>8,623,584</u>	<u>8,797,868</u>
Net position, beginning of year, before restatement	104,746,395	95,948,527
Cumulative effect of a change in accounting principle	<u>23,544,768</u>	<u>-</u>
Net position, beginning of year, as restated	<u>128,291,163</u>	<u>95,948,527</u>
Net position, end of year	<u>\$ 136,914,747</u>	<u>\$ 104,746,395</u>

See Notes to Financial Statements

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

STATEMENTS OF CASH FLOWS

Years Ended May 31, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Cash flows from operating activities:		
Receipts from customers, including collections as agent for third parties	\$ 167,491,656	\$ 169,275,518
Customer remittances to third parties	(24,544,920)	(25,392,395)
Payments to suppliers	(91,107,328)	(85,797,852)
Payments to employees	(14,240,265)	(13,729,573)
Net cash provided by operating activities	<u>37,599,143</u>	<u>44,355,698</u>
Cash flows from noncapital financing activities:		
Transfers out - dividends to City of Owensboro	<u>(9,209,935)</u>	<u>(9,121,316)</u>
Cash flows from capital and related financing activities:		
Capital expenditures	(9,266,326)	(6,936,122)
Payments on long-term debt	(18,865,000)	(18,680,000)
Interest paid on long-term debt	(6,687,469)	(7,251,361)
Proceeds from bond issuance	55,128,550	-
Payment to refunded bond agent	(48,782,141)	-
Debt issuance cost	(215,858)	-
Net cash used in capital and related financing activities	<u>(28,688,244)</u>	<u>(32,867,483)</u>
Cash flows from investing activities:		
Purchase of investments	(27,282,467)	(34,150,289)
Proceeds from sale and maturities of investments	2,347,000	24,318,334
Interest on investments	2,117,365	1,672,408
Net cash used in investing activities	<u>(22,818,102)</u>	<u>(8,159,547)</u>
Net decrease in cash and cash equivalents	(23,117,138)	(5,792,648)
Cash and cash equivalents, beginning of year	<u>72,726,199</u>	<u>78,518,847</u>
Cash and cash equivalents, end of year	<u>\$ 49,609,061</u>	<u>\$ 72,726,199</u>
Included in the following Statements of Net Position captions:		
Restricted assets	\$ 36,020,442	\$ 44,583,379
Cash and cash equivalents	<u>13,588,619</u>	<u>28,142,820</u>
	<u>\$ 49,609,061</u>	<u>\$ 72,726,199</u>

See Notes to Financial Statements

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

STATEMENTS OF CASH FLOWS, Concluded

Years Ended May 31, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 25,256,193	\$ 27,298,981
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	19,436,442	18,502,615
Other revenues	35,551	18,114
Change in assets and liabilities:		
Decrease (increase) in assets:		
Restricted assets:		
Fuel inventory	1,226,808	854,520
Other	(182,990)	20,906
Receivables	(3,261,592)	(125,203)
Materials and supplies	(928,083)	34,009
Prepayments	23,470	(20,962)
Other current assets	-	5,075,292
Other noncurrent assets	(7,218,868)	(1,624,396)
Deferred outflows of resources	-	(132,374)
Increase (decrease) in liabilities:		
Accounts payable	2,980,385	(865,099)
Other current liabilities	637,612	(1,782,380)
Other noncurrent liabilities	-	4,550,496
Deferred revenues	(405,785)	(404,661)
Deferred inflows of resources	-	(7,044,160)
Net cash provided by operating activities	<u>\$ 37,599,143</u>	<u>\$ 44,355,698</u>
Noncash investing, capital and financing activities:		
Accretion of interest expense on long-term debt	<u>\$ 2,543,198</u>	<u>\$ 3,413,709</u>
Amortization of debt premium and expense and deferred loss on debt defeasance	<u>\$ 464,333</u>	<u>\$ 562,957</u>
Deferred gain (loss) on hedging derivatives	<u>\$ (1,083,284)</u>	<u>\$ 2,199,950</u>

OWENSBORO MUNICIPAL UTILITIES ELECTRIC LIGHT AND POWER SYSTEM

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

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 component units 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.

The financial statements are prepared in accordance with generally accepted accounting principles and follow accounting guidance provided by the Governmental Accounting Standards Board (GASB) in the regulated operations provisions of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, which permit certain entities with cost-based rates to defer certain costs or income that would otherwise be recognized when incurred to the extent that the rate-regulated entity is recovering or expects to recover such amounts in

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

1. Organization and Summary of Significant Accounting Policies, Continued

System of Accounts and Basis of Accounting, Continued

future rates charged to its customers. Regulatory assets are the deferral of costs expected to be recovered in future customer rates and regulatory liabilities represent current recovery of expected future costs.

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.

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.

Change in Accounting Principle

In 2018, the Electric System adopted the provisions of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements* (GASBS No. 62), as it relates to rate-regulated entities, for reporting pension and other postemployment benefits. As discussed above, GASBS No. 62 allows the Electric System to defer certain costs to the extent that it will be able to recover such costs from future rates charged to its customers. Certain pension costs previously recognized as expense are now reported as a regulatory asset. The change was made to better match revenues and expenses. The cumulative effect of this change resulted in a restatement of beginning net position of \$23,544,768 and a corresponding increase to deferred outflows of resources. The effect of the change in accounting principle on change in net position for 2018 was an increase of \$4,300,245.

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.

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

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. 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 2018 and 2017 was approximately 4.2% and 4.1%, 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.

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, treasury coupon securities, and U.S. government and agency securities, are classified as temporary investments.

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

1. Organization and Summary of Significant Accounting Policies, Continued

Inventories

Inventories consisting of materials and supplies and fuel inventory (included in restricted assets) are valued at the lower of weighted average cost or net realizable value. 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 GASBS No. 62, 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.

Pension and Other Postemployment Benefits

For purposes of measuring the net liabilities, the deferred outflows of resources and deferred inflows of resources and expense related to pensions and other postemployment benefits (OPEB), information about the fiduciary net position of the pension/OPEB plans, and additions to/deductions from the pension/OPEB plans' fiduciary net position have been determined on the same basis as they are reported by the pension/OPEB plans. For this purpose, revenues are recognized when earned. Contributions are recognized when due, pursuant to legal (or statutory) requirements. Benefit payments (including refunds of employee contributions) are recognized when due and payable in accordance with the benefit terms. Plan investments are reported at fair value.

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.

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

1. Organization and Summary of Significant Accounting Policies, Continued

Hedging Derivative Instruments

The Electric System has adopted GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments* (GASBS No. 53). GASBS No. 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 GASBS No. 53. The Electric System utilized one of the three quantitative methods required by GASBS No. 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 GASBS No. 53.

2. Utility Plant

Electric utility plant activity for the year ended May 31, 2018, was as follows:

	<u>Beginning Balance</u>	<u>Additions</u>	<u>Retirements</u>	<u>Ending Balance</u>
Utility plant:				
Production plant	\$ 316,820,964	\$ 7,764,196	\$ (409,514)	\$ 324,175,646
Transmission plant	31,823,935	171,100	(209,402)	31,785,633
Distribution plant	84,767,626	2,802,138	(428,442)	87,141,322
General plant	21,682,874	278,285	(198,927)	21,762,232
Unclassified plant in service	12,091,574	809,773	-	12,901,347
Total, at original cost	<u>467,186,973</u>	<u>11,825,492</u>	<u>(1,246,285)</u>	<u>477,766,180</u>
Accumulated depreciation:				
Production plant	(219,091,050)	(14,409,372)	409,514	(233,090,908)
Transmission plant	(18,817,362)	(985,098)	209,402	(19,593,058)
Distribution plant	(47,115,050)	(2,958,279)	429,824	(49,643,505)
General plant	(13,891,708)	(1,083,693)	198,927	(14,776,474)
Total accumulated depreciation	<u>(298,915,170)</u>	<u>(19,436,442)</u>	<u>1,247,667</u>	<u>(317,103,945)</u>
Construction in progress	<u>6,949,837</u>	<u>(2,368,863)</u>	<u>-</u>	<u>4,580,974</u>
Utility plant, net	<u>\$ 175,221,640</u>	<u>\$ (9,979,813)</u>	<u>\$ 1,382</u>	<u>\$ 165,243,209</u>

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

2. Utility Plant, Continued

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

	<u>2018</u>	<u>2017</u>
Electric utility plant	\$ 18,957,548	\$ 18,059,961
Telecommunications	<u>210,970</u>	<u>174,731</u>
	19,168,518	18,234,692
Transportation and stores depreciation charged to construction activities or other operating expenses	<u>267,924</u>	<u>267,923</u>
	<u>\$ 19,436,442</u>	<u>\$ 18,502,615</u>

It is the Electric System's policy to capitalize interest on funds borrowed to finance the construction of utility plant. For the years ended May 31, 2018 and 2017, total interest cost incurred was \$9,919,478 and \$11,149,966, respectively. In 2018, \$185,635 of interest was capitalized in connection with construction in progress while no interest was capitalized in 2017.

3. Restricted Assets

Restricted assets at May 31 consists of the following:

	<u>2018</u>	<u>2017</u>
Cash and cash equivalents	\$ 36,020,442	\$ 44,583,379
Investments	52,753,209	42,841,842
Accrued interest receivable	504,742	463,476
Fuel and other inventories, at cost	9,581,249	10,808,057
Other	<u>869,991</u>	<u>687,001</u>
	<u>\$ 99,729,633</u>	<u>\$ 99,383,755</u>

The above balances are contained in the following funds:

	<u>2018</u>	<u>2017</u>
Operation and Maintenance Fund	\$ 12,107,033	\$ 13,177,786
Construction Fund	7,921,679	7,035,731
Depreciation Fund	5,082,752	4,971,208
Sinking Funds	31,322,946	31,145,787
Facility Charge Fund	7,920,365	7,937,837
Reserve and Contingency Fund	<u>35,374,858</u>	<u>35,115,406</u>
	<u>\$ 99,729,633</u>	<u>\$ 99,383,755</u>

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

3. Restricted Assets, Continued

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* (GASBS No. 31), which requires certain investments to be carried at fair value in the statements of net position and changes in the fair value of investments to be reported in the statements of revenues, expenses and changes in net position. In accordance with GASBS No. 31, OMU recorded unrealized losses of (\$823,352) and (\$273,862) for the years ended May 31, 2018 and 2017, respectively. OMU's rate making methodology does not consider unrealized gains or losses on marketable securities in its rate making process. Accordingly, the unrealized gains for the years ended May 31, 2018 and 2017, have been deferred.

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

	<u>2018</u>	<u>2017</u>
Net realized gains (losses) on sales of investments	\$ -	\$ -
Net unrealized gains (losses) on investments	<u>(823,352)</u>	<u>(273,862)</u>
	<u>\$ (823,352)</u>	<u>\$ (273,862)</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>2018</u>	<u>2017</u>
Deposits in financial institutions	\$ 53,838,141	\$ 73,735,944
Investments other than deposits	<u>68,815,598</u>	<u>47,871,325</u>
	<u>\$ 122,653,739</u>	<u>\$ 121,607,269</u>

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

4. Cash Deposits and Investments, Continued

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

	<u>2018</u>	<u>2017</u>
Cash and cash equivalents	\$ 13,588,619	\$ 28,142,820
Temporary investments	20,291,469	6,039,228
Restricted assets:		
Cash and cash equivalents	36,020,442	44,583,379
Investments	<u>52,753,209</u>	<u>42,841,842</u>
	\$ <u>122,653,739</u>	\$ <u>121,607,269</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.

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, 2018, \$49,649,020 of the Electric System's bank balance of \$54,192,927 was exposed to custodial credit risk as follows:

Uninsured and uncollateralized	\$ -
Uninsured with collateral held by pledging bank's agent	<u>49,649,020</u>
Total	\$ <u>49,649,020</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 value is based upon externally developed models that use rates and prices of similar securities, due to the limited market activity of the securities.

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

4. Cash Deposits and Investments, Continued

As of May 31, 2018, 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	09/20/2018 thru 12/15/2025	23,873,839
Federal Home Loan Bank – Callable	12/14/2018 thru 10/12/2022	33,052,415
Treasury Coupon Securities	12/31/2018 thru 02/15/2019	2,989,344
Negotiable Certificates of Deposit	06/29/2018 thru 05/24/2022	4,229,080
		<u>\$ 73,044,678</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.

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, other than deposits, are in U.S. agency securities, treasury coupon securities and repurchase agreements at May 31, 2018.

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

5. Hedging Transactions

The Electric System is exposed to market price fluctuations on its sale of surplus electricity. To protect itself from wholesale electricity price fluctuations, the Electric System periodically enters into electricity price 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 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. 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 hedging transaction is measured in megawatt hours (MWh), 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 2,095,721 and 1,752,765 MWh in 2018 and 2017, respectively. Hedging transactions with notional amounts totaling 2,661,031 and 3,563,755 MWh were settled in 2018 and 2017, respectively, with a resulting gain of \$360,480 and \$5,977,726 in 2018 and 2017, respectively, which are reflected in other wholesale revenue. At May 31, 2018, the Electric System's outstanding electricity hedging swap transactions were as follows:

<u>Execution Date Range</u>	<u>Maturity Date</u>	<u>Notional Amount (MWh)</u>	<u>Fair Market Value</u>
Short Hedge Positions:			
Fiscal 2015-2016	Fiscal 2019	961,375	\$ (1,232,470)
Fiscal 2016	Fiscal 2020	<u>122,720</u>	<u>(29,672)</u>
		<u>1,084,095</u>	<u>(1,262,142)</u>
Long Hedge Positions:			
Fiscal 2015-2016	Fiscal 2019	93,440	141,035
Fiscal 2016	Fiscal 2020	<u>15,360</u>	<u>37,823</u>
		<u>108,800</u>	<u>178,858</u>
		<u>1,192,895</u>	<u>\$ (1,083,284)</u>

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

5. Hedging Transactions, Continued

The electricity 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 GASBS 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, 2018 and 2017 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, 2018 and 2017. 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 outstanding electricity hedging transactions had a fair value of (\$1,083,284) and \$2,199,950 at May 31, 2018 and 2017, 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, 2018, the Electric System's rated counterparties, or affiliated guarantors, had credit ratings ranging from A to BBB+ as established by a nationally recognized rating organization. The Electric System also had two counterparties that were not rated but had provided a letter of credit for the purpose of establishing credit.

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, 2018, was \$49,775. The asset positions represent the maximum loss that would be incurred at the

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

5. Hedging Transactions, Continued

reporting date if all counterparties failed to perform as contracted. This maximum exposure is reduced by \$46,045 of outstanding Hedging Transactions in a liability position included in netting arrangements with those counterparties, resulting in a net exposure to credit risk of \$3,730.

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 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, 2018, the Electric System would have been required to post collateral with its counterparties in the amount \$908,568.

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

6. Long-Term Debt

Long-term debt activity for the year ended May 31, 2018, 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	\$ 42,407,501	\$ 2,543,198	\$ (15,725,000)	\$ 29,225,699	\$ 15,111,838
Series of 2002-A	10,030,000	-	(3,140,000)	6,890,000	3,340,000
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	-	(36,160,000)	40,940,000	-
Series of 2017	-	49,685,000	-	49,685,000	340,000
	<u>188,842,501</u>	<u>52,228,198</u>	<u>(63,960,000)</u>	<u>177,110,699</u>	<u>18,791,838</u>
Add unamortized debt premium	<u>2,814,073</u>	<u>4,120,499</u>	<u>(623,839)</u>	<u>6,310,733</u>	<u>-</u>
Total long-term debt	<u>\$ 191,656,574</u>	<u>\$ 56,348,697</u>	<u>\$ (64,583,839)</u>	<u>\$ 183,421,432</u>	<u>\$ 18,791,838</u>

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

	<u>2018</u>	<u>2017</u>
Series of 1991-B:		
Deferred interest bonds including interest compounded semi-annually at 6.70% to 6.95%, principal and interest due from 2018 to 2020 (original principal of outstanding bonds at May 31, 2018, was \$4,784,646)	\$ 29,225,699	\$ 42,407,501
Series of 2002-A:		
6.34% due 2020, subject to annual pro rata sinking fund redemption from 2018 to 2020	6,890,000	10,030,000
Series of 2010-A:		
Current interest bonds, 4.88% to 5.03%, due from 2021 to 2022	10,070,000	10,070,000
Series of 2010-B:		
Current interest bonds, 4.88% to 5.58%, due from 2021 to 2025	31,425,000	31,425,000
Series of 2010-C:		
Current interest bonds, 5.00%, due from 2021 to 2022	-	8,935,000

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

6. Long-Term Debt, Continued

Series of 2013-A:

Current interest bonds, 3.40% to 3.65%, due from 2021 to 2022	8,875,000	8,875,000
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Series of 2013-B:

Current interest bonds, 3.00% to 5.00%, due from 2022 to 2027	40,940,000	77,100,000
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Series of 2017:

Current interest bonds, 4.00%, due from 2019 to 2037	<u>49,685,000</u>	<u>-</u>
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Total long-term debt	177,110,699	188,842,501
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Less current maturities	(18,791,838)	(18,251,851)
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Add unamortized debt premium	<u>6,310,733</u>	<u>2,814,073</u>
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	<u>\$164,629,594</u>	<u>\$173,404,723</u>
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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>
2019	\$ 19,405,000	\$ 6,741,082	\$ 26,146,082
2020	19,275,000	6,515,726	25,790,726
2021	17,395,000	6,290,656	23,685,656
2022	18,255,000	5,542,208	23,797,208
2023	20,695,000	4,732,235	25,427,235
2024 – 2028	79,985,000	9,035,414	89,020,414
2029 – 2033	2,095,000	708,400	2,803,400
2034 – 2038	<u>2,230,000</u>	<u>230,000</u>	<u>2,460,000</u>
	<u>\$ 179,335,000</u>	<u>\$ 39,795,721</u>	<u>\$ 219,130,721</u>

The scheduled principal maturities include \$2,224,301 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, 2018 and 2017

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, as well as accrued interest payable of \$164,248 and net of unamortized discount and issuance costs of \$123,543, 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 it's 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, 2018 and 2017

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 33% of the total coupon interest. Interest subsidy received for fiscal years 2018 and 2017 was \$540,498 and \$538,954, respectively. Remaining interest subsidies scheduled through maturities of the bonds, before budget sequestration reductions, are as follows:

Year Ending May 31:

2019	\$ 578,846
2020	578,846
2021	578,846
2022	503,779
2023	424,028
2024 – 2028	<u>444,041</u>
	<u>\$ 3,108,386</u>

The 2010-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. 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, 2018 and 2017

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.

On August 9, 2017, the City issued \$49,685,000 of Electric Light and Power System Revenue Bonds, 2017 Series, each dated August 9, 2017. The 2017 Bonds were issued to fund construction of a residential fiber optic distribution network with the ability to provide ultrahigh speed internet access to approximately 6,500 dwellings and to refund the 2010-C series bonds and certain 2013-B series bonds. The in-substance defeasance of the 2010-C and 2013-B bonds was accomplished by placing \$48,325,931 in proceeds from the 2017 Bonds and \$456,210 in funds from the 2010-C and 2013-B Bond Sinking Funds in an irrevocable escrow fund to be used solely for satisfying scheduled debt service payments of the 2010-C and 2013-B Bonds. Accordingly, the 2010-C Bonds in the amount of \$8,935,000, and certain 2013-B Bonds in the amount of \$36,160,000, as well as accrued interest payable of \$347,104 and unamortized discount and issuance costs of \$1,152,596, were extinguished resulting in the accounting recognition of a loss from defeasance of \$2,187,441, reported in the accompanying financial statements as a deferred outflow. The City advance refunded the 2010-C and 2013-B bonds to reduce the effective rate on the debt. The advance refunding resulted in an economic savings (difference between the present value of the debt service payment on the old and new debt) of \$3,128,648.

The 2017 series bonds maturing on or after January 1, 2028, are subject to redemption prior to maturity in whole or in part on any date on or after January 1, 2027, 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.

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

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 \$25,148,000 at May 31, 2018), 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 (\$11,645,555 at May 31, 2018) and amounts in the Facility Charge Fund (\$7,920,365 at May 31, 2018) 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 \$9,209,935 and \$9,121,316 for 2018 and 2017, respectively.

8. Pension and Other Postemployment Benefits – CERS

Plan Description

The Electric System contributes to the County Employees Retirement System (CERS), which is a cost-sharing multiple-employer defined benefit pension/OPEB plan administered by Kentucky Retirement Systems (KRS) that covers members employed in 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). KRS 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, as well as other postemployment benefits (OPEB) for hospital and medical insurance through its Insurance 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

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

8. Pension and Other Postemployment Benefits – CERS, Continued

Benefits Provided, Continued

benefits at any time with 27 or more years of service credit, or at age 65 with at least 4 years 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 5 years of service credit.

Other postemployment benefits provided by CERS consist of prescribed contributions for whole or partial payments of required premiums to purchase hospital and medical insurance.

Contributions

State statute requires active members to contribute 5% of creditable compensation. For members participating on or after September 1, 2008, an additional 1% of creditable compensation is required. This amount is credited to the Insurance Fund and is non-refundable to the member. Employers contribute at the rate determined by the KRS Board to be necessary for the actuarial soundness of the systems, as required by KRS 61.565 and KRS 61.752.

The Electric System's actuarially determined contribution rates and contribution amounts, based on annual creditable compensation, for the year ended May 31, 2018, were as follows:

	<u>Contribution Rates</u>	<u>Contributions</u>
Pension	14.48%	\$ 2,148,899
OPEB	4.70%	697,502
Total	<u>19.18%</u>	<u>\$ 2,846,401</u>

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

The net pension and OPEB liabilities reported as of May 31, 2018, were measured as of June 30, 2017, and the total pension and OPEB liabilities used to calculate the net pension liability was determined by an actuarial valuation as of June 30, 2016. The Electric System's proportion of the liabilities was based on a projection of the Electric System's long-term share of contributions to the plan relative to the projected contributions of all participating entities, actuarially determined. At the June 30, 2017, measurement date, the Electric System's pension and OPEB proportion was 0.611400%, a decrease of (0.015338%) from its proportion measured as of June 30, 2016, of 0.626738%.

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

8. Pension and Other Postemployment Benefits – CERS, Continued

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

The Electric System's pension and OPEB liabilities and expense as of and for the year ended May 31, 2018, were as follows:

	Pension	OPEB
Net Liability	\$ 35,787,099	\$ 12,291,225
Expense	\$ 2,148,899	\$ 697,502

At May 31, 2018, the Electric System reported deferred outflows of resources and deferred inflows of resources related to pensions and OPEB from the following sources:

	Pension		OPEB	
	Deferred Outflows of Resources	Deferred Inflows of Resources	Deferred Outflows of Resources	Deferred Inflows of Resources
Differences between expected and actual experience	\$ 44,387	\$ 908,430	\$ -	\$ 34,138
Changes of assumptions	6,603,690	-	2,674,493	-
Net difference between projected and actual earnings on plan investments	2,834,295	2,391,650	-	580,876
Changes in proportion and differences between contributions and proportionate share of contributions	248,028	507,767	-	28,520
Contributions subsequent to the measurement date	2,019,533	-	655,511	-
Total	\$ 11,749,933	\$ 3,807,847	\$ 3,330,004	\$ 643,534

The \$2,019,533 and \$655,511 of deferred outflows of resources resulting from the Electric System's pension and OPEB contributions subsequent to the measurement date will be recognized as a reduction of the net pension and OPEB liabilities in the year ending May 31, 2019. Other amounts reported as deferred outflows of resources and deferred inflows of resources will be recognized as follows:

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

8. Pension and Other Postemployment Benefits – CERS, Continued

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

Year ending May 31,	Pension	OPEB
2019	\$ 2,636,458	\$ 349,447
2020	2,622,747	349,447
2021	1,122,873	349,447
2022	(459,525)	349,447
2023	-	494,666
2024	-	138,505
	<u>\$ 5,922,553</u>	<u>\$ 2,030,959</u>

Actuarial Assumptions

The total pension/OPEB liabilities in the June 30, 2017, actuarial valuation were determined using the following actuarial assumptions, applied to all periods included in the measurement:

Inflation	2.30%
Salary increases	2.00% average
Investment rate of return	6.25%, net of investment expenses
Healthcare cost trend rates (OPEB)	Initial trend starting at 7.50% for Pre-65, or 5.5% for Post-65, and gradually decreasing to an ultimate trend rate of 5% over a period of 5 years for Pre-65, or 2 years for Post-65

Mortality rates were based on the following assumptions and assume a margin for future mortality improvement:

Pre-retirement mortality: RP-2000 Combined Mortality Table projected with Scale BB to 2013. Male mortality rates are multiplied by 50% and female mortality rates are multiplied by 30%.

Post-retirement mortality (non-disabled): RP-2000 Combined Mortality Table projected with Scale BB to 2013. Female mortality rates are set back one year.

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

8. Pension and Other Postemployment Benefits – CERS, Continued

Actuarial Assumptions, Continued

Post-retirement mortality (disabled): RP-2000 Combined Disabled Mortality Table projected with Scale BB to 2013. Male mortality rates are set back four years.

The actuarial assumptions used in the June 30, 2016, valuation were based on the results of an actuarial experience study for the five-year period ended June 30, 2013.

The long-term expected rate of return was determined by using a building-block method in which best-estimate ranges of expected future real rate of returns are developed for each asset class. The ranges are combined by weighting the expected future real rate of return by the target asset allocation percentage. The target allocation and best estimates of arithmetic real rate of return for each major asset class are summarized in the tables below.

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
US equity	17.50%	5.97%
International equity	17.50%	7.85%
Global bonds	4.00%	2.63%
Global credit	2.00%	3.63%
High yield	7.00%	5.75%
Emerging market debt	5.00%	5.50%
Private credit	10.00%	8.75%
Real estate	5.00%	7.63%
Absolute return	10.00%	5.63%
Real returns	10.00%	6.13%
Private equity	10.00%	8.25%
Cash	2.00%	1.88%
Total	100%	

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

8. Pension and Other Postemployment Benefits – CERS, Continued

Discount Rate

The discount rates used to measure the total pension/OPEB liabilities at the measurement dates and changes since the prior year were as follows:

	<u>Pension</u>	<u>OPEB</u>
Discount rate, June 30, 2016	7.50%	6.89%
Increase (decrease)	<u>(1.25)</u>	<u>(1.05)</u>
Discount rate, June 30, 2017	<u>6.25%</u>	<u>5.84%</u>

The discount rate of 6.25% used to measure the total pension liability was based on the expected rate of return on pension plan investments. The discount rate of 5.84% used to measure the total OPEB liability was based on the expected rate of return on OPEB plan investments of 6.25% and a municipal bond rate of 3.56%, as reported in Fidelity Index's "20-Year Municipal GO AA Index" as of June 30, 2017.

Projected Cash Flows

The projection of cash flows used to determine the discount rates is based on the assumption that each participating employer in CERS will contribute the actuarially determined contribution rates, which are determined using a closed funding period (26 years as of June 30, 2017), as well as the actuarial assumptions and methods adopted by the KRS Board of Trustees. Current assets, future contributions, and investment earnings are projected to be sufficient to pay the projected benefit payments from the system.

Sensitivity of the Electric System's Proportionate Share of the Liabilities to Changes in the Discount Rate

The following presents the Electric System's proportionate share of the net pension/OPEB liabilities, as well as what the Electric System's proportionate share of the net pension/OPEB liabilities would be if they were calculated using a discount rate that is 1-percentage-point lower or 1-percentage-point higher than the current rate:

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

8. Pension and Other Postemployment Benefits – CERS, Continued

Sensitivity of the Electric System's Proportionate Share of the Liabilities to Changes in the Discount Rate, Continued

	Electric System's Proportionate Share			
	Discount Rate	Net pension Liability	Discount Rate	Net OPEB Liability
1% decrease	5.25%	\$ 45,135,267	4.84%	\$ 15,639,902
Current discount rate	6.25%	\$ 35,787,099	5.84%	\$ 12,291,225
1% increase	7.25%	\$ 27,967,427	6.84%	\$ 9,504,599

Sensitivity of the Electric System's Proportionate Share of the Net OPEB Liability to Changes in the Healthcare Cost Trend Rates

The following presents the Electric System's proportionate share of the net OPEB liability, as well as what the Electric System's proportionate share of the net OPB liability would be if it were calculated using healthcare cost trend rates that are 1-percentage-point lower or 1-percentage-point higher than the current rate:

	Healthcare Cost Trend Rate	Electric System's Proportionate Share of Net OPEB Liability
1% decrease	6.5% Pre-65 or 5.5% Post-65 decreasing to 4%	\$ 9,428,002
Current healthcare cost trend rate	7.5% Pre-65 or 5.5% Post-65 decreasing to 5%	\$ 12,291,225
1% increase	8.5% Pre-65 or 5.5% Post-65 decreasing to 6%	\$ 16,013,245

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, 2018 and 2017

8. Pension and Other Postemployment Benefits – CERS, Continued

Payables to the Pension/OPEB Plans

The Electric System reported the following payables for the outstanding amount of pension/OPEB contributions due to CERS for the year ended May 31, 2018.

	<u>Pension</u>		<u>OPEB</u>
\$	<u>169,908</u>	\$	<u>55,150</u>

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:

2019	\$	63,710,739
2020		<u>23,362,368</u>
	\$	<u>87,073,107</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, 2018, 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, 2018 and 2017

10. Impact of Recently Issued Accounting Principles

The following recently issued accounting standard was implemented by the Electric System at May 31, 2018:

In fiscal year 2018, the Electric System implemented GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other than Pensions* (GASBS No. 75), which amends or supersedes the accounting and financial reporting guidance for Postemployment benefits other than pensions (other postemployment benefits or OPEB) provided to the employees of state and local governmental employers. The objective is to improve accounting and financial reporting for OPEB by state and local governments.

Under GASBS No. 75, the liability to be recognized by participating employers is measured as the portion of the present value of projected benefit payments to be provided through the OPEB plan to current active and inactive employees that is attributed to those employees' past periods of service (total OPEB liability), less the amount of the OPEB plan's fiduciary net position. The OPEB expense and deferred outflows of resources and deferred inflows of resources related to OPEB that are required to be recognized by an employer result primarily from changes in the components of the net OPEB liability, as detailed in Note 8 to financial statements. However, the OPEB expense to be recognized currently under GASBS No. 75 has been deferred to future periods under GASBS No. 62 to the extent that the Electric System will be able to recover such costs from future rates charged to its customers.

In the financial statements, the implementation of GASBS No. 75 resulted in an increase in deferred outflows of resources of \$12,934,759 and a corresponding increase in deferred inflows of resources of \$643,534 and other noncurrent liabilities of \$12,291,225. Deferred outflows and inflows related to GASBS No. 75 are disclosed in Note 8 to the financial statements.

The following recently issued accounting standard is expected to impact the financial statements of the Electric System in future periods:

GASBS No. 83 Certain Asset Retirement Obligations

In November of 2016, the GASB issued Statement No. 83 which addresses accounting and financial reporting for certain asset retirement obligations (AROs). An ARO is a legally enforceable liability associated with the future retirement of a tangible capital asset. This Statement establishes criteria for recognition of a liability and a corresponding deferred outflow of resources and related disclosures for AROs. This Statement requires that recognition occur when the liability is both incurred and reasonably estimable and that measurement of the ARO be based on the best estimate of the current value of outlays expected to be incurred. This Statement also requires the current value of a government's AROs to be adjusted for the effects of general inflation or deflation at least annually and to

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

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

10. Impact of Recently Issued Accounting Principles, Continued

evaluate all relevant factors at least annually to determine whether the effects of one or more of the factors are expected to significantly change the estimated asset retirement outlay. This Statement also requires disclosure of information about the nature of a government's AROs, the methods and assumptions used for the estimates of the liabilities, and the estimated remaining useful life of the associated tangible capital assets. This statement will enhance comparability of financial statements among governments by establishing uniform criteria for governments to recognize and measure certain AROs, including obligations that may not have been previously reported and also enhance the decision-usefulness of the information provided to financial statement users requiring disclosures related to those AROs. The statement is effective for fiscal years beginning after June 15, 2018. The Electric System is currently evaluating the impact that the standard will have on its financial statements

11. Subsequent Events

On Friday, June 22, 2018, the City Utility Commission approved the execution of an agreement with another power generating company to purchase most of its future power. The agreement will take effect approximately on June 1, 2020, and run through December 31, 2026.

**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>2018</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>
Electric System's proportion of the net pension liability	0.611400%	0.626738%	0.610636%	0.632508%
Electric System's proportionate share of the net pension liability	\$ 35,787,099	\$ 30,858,179	\$ 26,254,442	\$ 20,520,943
Electric System's covered payroll	\$ 14,942,435	\$ 15,035,975	\$ 14,221,628	\$ 14,612,052
Electric System's proportionate share of the net pension liability as a percentage of its covered payroll	239.50%	205.23%	184.61%	140.44%
Plan fiduciary net position as a percentage of the total pension liability	53.32%	55.50%	59.97%	66.80%

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

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

**SCHEDULE OF PENSION CONTRIBUTIONS
COUNTY EMPLOYEES RETIREMENT SYSTEM**

Last 10 Fiscal Years

	<u>2018</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>
Contractually required contributions	\$ 2,148,899	\$ 2,062,855	\$ 1,908,105	\$ 1,820,510
Contributions in relation to the contractually required contributions	<u>(2,148,899)</u>	<u>(2,062,855)</u>	<u>(1,908,105)</u>	<u>(1,820,510)</u>
Contribution deficiency (excess)	\$ <u>-</u>	\$ <u>-</u>	\$ <u>-</u>	\$ <u>-</u>
Electric System's covered payroll	\$ 14,873,999	\$ 14,889,969	\$ 15,097,888	\$ 14,199,426
Contributions as a percentage of covered payroll	14.45%	13.85%	12.64%	12.82%

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

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

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

Last 10 Fiscal Years *

	<u>2018</u>	<u>2017</u>
Electric System's proportion of the net OPEB liability	0.611400%	0.626738%
Electric System's proportionate share of the net OPEB liability	\$ 12,291,225	\$ 9,663,041
Electric System's covered payroll	\$ 14,942,435	\$ 15,035,975
Electric System's proportionate share of the net OPEB liability as a percentage of its covered payroll	82.26%	64.27%
Plan fiduciary net position as a percentage of the total OPEB liability	52.39%	55.24%

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

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

**SCHEDULE OF OPEB CONTRIBUTIONS
COUNTY EMPLOYEES RETIREMENT SYSTEM**

Last 10 Fiscal Years

	<u>2018</u>		<u>2017</u>		<u>2016</u>		<u>2015</u>
Contractually required contributions	\$ 697,502	\$	699,448	\$	712,851	\$	698,185
Contributions in relation to the contractually required contributions	<u>(697,502)</u>		<u>(699,448)</u>		<u>(712,851)</u>		<u>(698,185)</u>
Contribution deficiency (excess)	<u>\$ -</u>	\$	<u>-</u>	\$	<u>-</u>	\$	<u>-</u>
Electric System's covered payroll	\$ 14,873,999	\$	14,889,969	\$	15,097,888	\$	14,199,426
Contributions as a percentage of covered payroll	4.69%		4.70%		4.72%		4.92%

* 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, 2018

Changes of Benefit Terms

None

Changes of Assumptions

For amounts reported in 2018, the assumed investment return was changed from 7.5% to 6.25%, the price inflation assumption was changed from 3.25 to 2.3%, which also resulted in a 0.95 decrease in the salary increase assumption at all years of service, and the payroll growth assumption (applicable for the amortization of unfunded actuarial accrued liabilities) was changed from 4.00% to 2.00% in order to reflect future economic expectations.

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

SCHEDULE OF REVENUES AND EXPENSES

Year Ended May 31, 2018 (with comparative totals for 2017)

	Retail Electric System	Wholesale Power Marketing
Operating revenues:		
Charges for services:		
Residential	\$ 32,995,680	\$ -
Commercial	6,486,714	-
Industrial	56,759,947	-
Water Works System	1,301,107	-
City of Owensboro and Schools	3,118,167	-
Supplemental power	-	1,495,309
Other wholesale	-	44,587,659
Electric Light and Power System	-	-
Build America Bond subsidy	395,937	-
Other	1,577,666	-
	<hr/>	<hr/>
Total operating revenues	102,635,218	46,082,968
Operating expenses:		
Production:		
Fuel for electric generation	-	-
Purchased power	50,482,225	60,871,327
Other	-	-
Transmission and distribution	5,828,595	3,869,199
Customer service and information	1,844,918	-
General and administrative	3,228,667	1,640,094
Telecommunications	-	-
Depreciation	3,980,666	-
	<hr/>	<hr/>
Total operating expenses	65,365,071	66,380,620
Operating income (loss)	<hr/> 37,270,147	<hr/> (20,297,652)
Nonoperating revenues (expenses):		
Interest and debt expense	(1,681,804)	-
Interest income on investments	1,170,287	17,506
Interest income on Elmer Smith Generating Station investments allocated to:		
Electric System	1,036,883	-
Other, net	20,156	-
Net increase (decrease) in fair value of investments	(347,122)	-
Deferred net change in fair value of investments	347,122	-
	<hr/>	<hr/>
Total nonoperating revenues (expenses)	545,522	17,506
Income before transfers	37,815,669	(20,280,146)
Transfers out - dividends to City of Owensboro	(9,209,935)	-
Change in net position	<hr/> \$ 28,605,734	<hr/> \$ (20,280,146)

Elmer Smith Generating Station	Telecommunications	Eliminations	Total	2017 Total
\$ -	\$ 161,426	\$ -	\$ 33,157,106	\$ 31,097,720
-	1,287,404	-	7,774,118	7,116,947
-	-	-	56,759,947	52,944,090
-	26,260	-	1,327,367	1,101,570
-	56,619	-	3,174,786	2,825,192
-	-	-	1,495,309	1,405,095
-	-	(48,197)	44,539,462	48,981,965
100,801,718	184,096	(100,985,814)	-	-
144,561	-	-	540,498	538,954
-	-	(122,264)	1,455,402	1,484,375
<u>100,946,279</u>	<u>1,715,805</u>	<u>(101,156,275)</u>	<u>150,223,995</u>	<u>147,495,908</u>
51,802,072	-	-	51,802,072	56,664,811
142,798	-	(100,849,915)	10,646,435	6,758,909
22,217,261	-	(12,180)	22,205,081	16,221,380
211,818	-	(113,334)	9,796,278	9,690,171
-	100,862	-	1,945,780	1,922,102
3,560,826	177,000	(135,720)	8,470,867	9,898,923
-	977,897	(45,126)	932,771	805,939
14,976,882	210,970	-	19,168,518	18,234,692
<u>92,911,657</u>	<u>1,466,729</u>	<u>(101,156,275)</u>	<u>124,967,802</u>	<u>120,196,927</u>
<u>8,034,622</u>	<u>249,076</u>	<u>-</u>	<u>25,256,193</u>	<u>27,298,981</u>
(8,068,106)	8,015	8,052	(9,733,843)	(11,149,966)
1,054,972	40,905	(8,052)	2,275,618	1,752,055
(1,036,883)	-	-	-	-
15,395	-	-	35,551	18,114
(476,230)	-	-	(823,352)	(273,862)
476,230	-	-	823,352	273,862
<u>(8,034,622)</u>	<u>48,920</u>	<u>-</u>	<u>(7,422,674)</u>	<u>(9,379,797)</u>
-	297,996	-	17,833,519	17,919,184
-	-	-	(9,209,935)	(9,121,316)
<u>\$ -</u>	<u>\$ 297,996</u>	<u>\$ -</u>	<u>\$ 8,623,584</u>	<u>\$ 8,797,868</u>



Riney Hancock CPAs
PSC

**INDEPENDENT AUDITOR'S REPORT
ON INTERNAL CONTROL OVER FINANCIAL
REPORTING AND ON COMPLIANCE AND OTHER
MATTERS BASED ON AN AUDIT OF FINANCIAL
STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS**

City Utility Commission
City of Owensboro, Kentucky

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the Owensboro Municipal Utilities Electric Light and Power System (Electric System) of the City of Owensboro, Kentucky as of and for the year ended May 31, 2018, and the related notes to the financial statements, and have issued our report thereon dated September 11, 2018.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Electric System's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Electric System's internal control. Accordingly, we do not express an opinion on the effectiveness of the Electric System's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

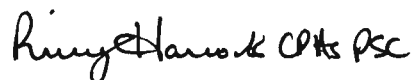
Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Electric System's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

 Ringel Harnock CPA, PSC

Owensboro, Kentucky
September 11, 2018



INDEPENDENT AUDITOR'S REPORT

City Utility Commission
City of Owensboro, Kentucky

Report on the Financial Statements

We have audited the accompanying financial statements of the Owensboro Municipal Utilities Water Works System (Water System) a component unit of the City of Owensboro, Kentucky, as of and for the years ended May 31, 2018 and 2017, 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 and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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, 2018 and 2017, 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.

Change in Accounting Principle

As discussed in Note 10 to the financial statements, in 2018 the Water System adopted new accounting guidance, GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*. Also, as discussed in Note 1 to the financial statements, in 2018 the Water System adopted the provisions of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance in Pre-November 30, 1989 FASB and AICPA Pronouncements*, as it relates to rate-regulated entities, for reporting pension and other postemployment benefits. Our opinion is not modified with respect to these matters.

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 49 through 52 and the Pension and Other Post-Employment Benefits (OPEB) Schedules on pages 78 through 82, 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 Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated September 11, 2018, on our consideration of the Water System's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Water System's internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Water System's internal control over financial reporting and compliance.

 Riney Hancock CPAs PSC

Owensboro, Kentucky
September 11, 2018

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, 2018. Please read it in conjunction with the Water System's financial statements, which begin on page 53.

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 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 2018 and 2017.

Assets and Deferred Outflows of Resources	<u>2018</u>	<u>2017</u>
Utility plant, net	\$ 45,624,644	\$ 45,973,223
Restricted assets	8,812,601	9,857,786
Current assets	7,230,750	7,134,248
Other noncurrent assets	995,513	1,074,073
Deferred outflow of resources	<u>11,315,405</u>	<u>2,281,764</u>
	<u>\$ 73,978,913</u>	<u>\$ 66,321,094</u>
Liabilities, Deferred Inflows of Resources, and Net Position		
Net position		
Net investment in capital assets	\$ 21,626,098	\$ 21,631,568
Restricted	1,173,189	1,149,286
Unrestricted	<u>6,467,617</u>	<u>1,964,817</u>
Total net position	29,266,904	24,745,671
Long-term debt	32,023,009	32,929,079
Current liabilities	1,993,171	2,139,305
Other noncurrent liabilities	9,721,334	6,214,089
Deferred revenues	82,883	222,883
Deferred inflows of resources	<u>891,612</u>	<u>70,067</u>
	<u>\$ 73,978,913</u>	<u>\$ 66,321,094</u>
Revenues, Expenses and Changes in Net Position		
Operating revenues	\$ 11,576,450	\$ 11,522,989
Operating expenses	<u>10,267,839</u>	<u>10,215,665</u>
Operating income	<u>1,308,611</u>	<u>1,307,324</u>
Interest expense	(1,422,174)	(1,525,999)
Interest and other income	<u>190,323</u>	<u>173,992</u>
Net nonoperating expenses	<u>(1,231,851)</u>	<u>(1,352,007)</u>
Income (loss) before contributions and transfers	76,760	(44,683)
Capital contributions	110,948	300,711
Transfers out - dividends to City of Owensboro	<u>(317,565)</u>	<u>(310,382)</u>
Change in net position	<u>\$ (129,857)</u>	<u>\$ (54,354)</u>

MANAGEMENT'S DISCUSSION AND ANALYSIS, CONTINUED

FINANCIAL HIGHLIGHTS

- Net position decreased \$129,857 in 2018, and the income (loss) before contributions and transfers was \$76,760 in 2018 versus \$(44,683) in 2017, as a result of changes in operating revenues, operating expenses and interest as discussed below.
- Operating revenues increased by \$53,461 in 2018 when compared to 2017, or 0.5%. The increase in revenues in 2018 is primarily attributable to an increase in commercial retail revenues which increased \$121,487, or 3.1%, due to increased sales volumes. That increase was partially offset by a slight decrease in residential sales volumes and associated revenues. Wholesale revenues also declined slightly due to a slightly lower average wholesale rate in 2018, as determined by the terms of the rural water districts' contracts.
- Operating expenses increased \$52,174 in 2018 when compared to 2017, or 0.5%. Production and purification cost increased \$255,726 in 2018, or 7.2%, primarily due to increased electricity cost on the wells and treatment plant, due to increased usage and rates, and increased maintenance cost due to a major main break during the year, as well as additional unplanned maintenance requirements. Conversely, general and administrative expense decreased \$269,120, or 14.8%, due primarily to an accounting principle change which if applied in 2017 would have decreased pension expense, a component of general and administrative expense, by \$293,642. Partially offsetting that decrease was an increase in administrative payroll expense, due primarily to various personnel changes in 2018. Finally, depreciation also increased by \$46,342 in 2018, or 1.7%, due to capital asset additions as discussed below.
- Interest expense decreased by \$103,825 in 2017, or 6.8%, due to scheduled debt repayments in 2018. Interest income increased \$48,846, or 34.5%, primarily due to higher rates received on bank balances and investment balances.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

At the end of 2018, the Water System had \$45.6 million invested in a broad range of assets, including wells, treatment facilities and equipment, storage tanks, buildings and water mains. This amount represents a decrease of \$348,579 from 2017 due to depreciation which exceeded capital asset additions. The following table summarizes capital assets, net of accumulated depreciation, at the end of 2018 and 2017.

	<u>2018</u>	<u>2017</u>
Source of supply plant	\$ 2,832,621	\$ 3,015,671
Pumping plant	339,037	369,327
Water treatment plant	13,162,382	13,577,778
Transmission and distribution plant	21,465,214	21,707,764
General plant	1,055,835	1,158,230
Unclassified plant and construction in progress	<u>6,769,555</u>	<u>6,144,453</u>
	<u>\$ 45,624,644</u>	<u>\$ 45,973,223</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 \$385,649 for design services related to expansion of the Water System's Cavin water treatment plant, to allow for abandonment of its treatment Plant "A" as a result of foundation settlement issues at the aging facility, as well as \$292,111 for improvements to the clear well piping and valves.

Debt

At the end of 2018, the Water System had \$32.9 million in bonds outstanding versus \$33.8 million in 2017, for a decrease of 2.6%. As there was no debt issued in 2018, the decrease is due to scheduled bond payments.

Outlook

In 2019, the Water System will be issuing bonds and commencing construction to expand the treatment capability at the Cavin Water Treatment Plant, as mentioned above. The Water System is anticipating adjusting rates in 2019 to begin recovering the treatment plant expansion cost. As a result, we expect the 2019 results to improve as compared to 2018, largely as a result of this anticipated retail water rate adjustment, as well as corresponding increases in wholesale supply agreements, which will increase overall operating revenues. Overall costs are also expected to increase in 2019, but to a lesser extent than revenues.

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**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

STATEMENT OF NET POSITION

May 31, 2018 and 2017

ASSETS AND DEFERRED OUTFLOWS OF RESOURCES	<u>2018</u>	<u>2017</u>
Utility plant, net	\$ <u>45,624,644</u>	\$ <u>45,973,223</u>
Restricted assets	<u>8,812,601</u>	<u>9,857,786</u>
Current assets:		
Cash and cash equivalents	362,154	1,256,269
Investments	4,269,359	3,269,581
Accounts receivable, less allowance for doubtful accounts of \$5,258 for 2018 and \$4,579 for 2017	1,991,807	1,988,594
Materials and supplies	459,622	499,550
Prepayments	<u>147,808</u>	<u>120,254</u>
Total current assets	<u>7,230,750</u>	<u>7,134,248</u>
Other noncurrent assets	<u>995,513</u>	<u>1,074,073</u>
Total assets	<u>62,663,508</u>	<u>64,039,330</u>
Deferred outflows of resources:		
Deferred pension outflow	2,404,594	1,514,887
Deferred other postemployment benefit outflows	683,580	-
Deferred pension obligation	5,526,277	-
Deferred postemployment benefit obligation	1,907,253	-
Unamortized loss on debt refunding	645,935	723,289
Net unrealized loss on investments	<u>147,766</u>	<u>43,588</u>
Total deferred outflows of resources	<u>11,315,405</u>	<u>2,281,764</u>
Total assets and deferred outflows of resources	\$ <u>73,978,913</u>	\$ <u>66,321,094</u>

See Notes to Financial Statements

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

	<u>2018</u>	<u>2017</u>
Net position:		
Net investment in capital assets	\$ 21,626,098	\$ 21,631,568
Restricted for capital projects, net of related debt	374,610	393,915
Restricted for debt service	798,579	755,371
Unrestricted	<u>6,467,617</u>	<u>1,964,817</u>
Total net position	<u>29,266,904</u>	<u>24,745,671</u>
Long-term debt	<u>32,023,009</u>	<u>32,929,079</u>
Current liabilities (payable from restricted assets):		
Current maturities of long-term debt	890,000	860,000
Accrued interest payable	271,211	274,466
Accounts payable	<u>124,211</u>	<u>700,923</u>
	<u>1,285,422</u>	<u>1,835,389</u>
Current liabilities (payable from current assets):		
Accounts payable	<u>707,749</u>	<u>303,916</u>
Total current liabilities	<u>1,993,171</u>	<u>2,139,305</u>
Other noncurrent liabilities:		
Net pension liability	7,168,159	6,095,910
Net other postemployment benefit liability	2,461,933	-
Customers' advances for construction	<u>91,242</u>	<u>118,179</u>
Total other noncurrent liabilities	<u>9,721,334</u>	<u>6,214,089</u>
Deferred revenues	<u>82,883</u>	<u>222,883</u>
Total liabilities	<u>43,820,397</u>	<u>41,505,356</u>
Deferred inflows of resources:		
Deferred pension inflows	762,712	70,067
Deferred other postemployment benefit inflows	<u>128,900</u>	<u>-</u>
	<u>891,612</u>	<u>70,067</u>
Total liabilities, deferred inflows of resources, and net position	<u><u>\$ 73,978,913</u></u>	<u><u>\$ 66,321,094</u></u>

See Notes to Financial Statements

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET POSITION

Years Ended May 31, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Operating revenues:		
Charges for services:		
Residential	\$ 4,095,678	\$ 4,118,555
Commercial	4,003,927	3,882,440
Water districts	2,322,086	2,344,208
Fire protection	263,104	265,020
City of Owensboro	317,317	310,382
Electric Light and Power System	263,531	320,456
Service revenues	<u>310,807</u>	<u>281,928</u>
Total operating revenues	<u>11,576,450</u>	<u>11,522,989</u>
Operating expenses:		
Production and purification	3,793,470	3,537,744
Transmission and distribution	1,331,834	1,318,956
Customer service and information	790,278	783,930
General and administrative	1,550,507	1,819,627
Depreciation	<u>2,801,750</u>	<u>2,755,408</u>
Total operating expenses	<u>10,267,839</u>	<u>10,215,665</u>
Operating income	<u>1,308,611</u>	<u>1,307,324</u>
Nonoperating revenues (expenses):		
Interest and debt expense	(1,422,174)	(1,525,999)
Interest income on investments	190,323	141,477
Gain on sale of utility plant	-	32,515
Net increase (decrease) in fair value of investments	(104,178)	(43,450)
Deferred net change in fair value of investments	<u>104,178</u>	<u>43,450</u>
Total nonoperating revenues (expenses)	<u>(1,231,851)</u>	<u>(1,352,007)</u>
Income (loss) before contributions and transfers	76,760	(44,683)
Capital contributions	110,948	300,711
Transfers out - dividends to City of Owensboro	<u>(317,565)</u>	<u>(310,382)</u>
Change in net position	<u>(129,857)</u>	<u>(54,354)</u>
Net position, beginning of year, before restatement	24,745,671	24,800,025
Cumulative effect of a change in accounting principle	<u>4,651,090</u>	<u>-</u>
Net position, beginning of year, as restated	<u>29,396,761</u>	<u>24,800,025</u>
Net position, end of year	<u>\$ 29,266,904</u>	<u>\$ 24,745,671</u>

See Notes to Financial Statements

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

STATEMENTS OF CASH FLOWS

Years Ended May 31, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Cash flows from operating activities:		
Receipts from customers	\$ 11,420,537	\$ 11,330,269
Payments to suppliers	(3,956,873)	(4,510,937)
Payments to employees	<u>(2,986,538)</u>	<u>(2,751,157)</u>
Net cash provided by operating activities	<u>4,477,126</u>	<u>4,068,175</u>
Cash flows from noncapital financing activities:		
Transfers out - dividends to City of Owensboro	<u>(316,296)</u>	<u>(310,315)</u>
Cash flows from capital and related financing activities:		
Capital expenditures	(3,006,249)	(2,428,355)
Payments on long-term debt	(860,000)	(770,000)
Interest paid on long-term debt	(1,309,626)	(1,285,117)
Proceeds from bond issuance	-	6,511,882
Payment to refunded bond agent	-	(6,521,094)
Reimbursements of customers' advances	(5,622)	(7,465)
Debt issuance cost	<u>-</u>	<u>(44,050)</u>
Net cash used in capital and related financing activities	<u>(5,181,497)</u>	<u>(4,544,199)</u>
Cash flows from investing activities:		
Purchase of investments	(1,240,255)	(4,911,067)
Proceeds from sale and maturities of investments	200,000	3,004,000
Interest on investments	<u>182,718</u>	<u>128,726</u>
Net cash used in investing activities	<u>(857,537)</u>	<u>(1,778,341)</u>
Net decrease in cash and cash equivalents	(1,878,204)	(2,564,680)
Cash and cash equivalents, beginning of year	<u>8,907,625</u>	<u>11,472,305</u>
Cash and cash equivalents, end of year	<u>\$ 7,029,421</u>	<u>\$ 8,907,625</u>
Included in the following Statements of Net Position captions:		
Cash and cash equivalents, unrestricted	\$ 362,154	\$ 1,256,269
Cash and cash equivalents, restricted	<u>6,667,267</u>	<u>7,651,356</u>
	<u>\$ 7,029,421</u>	<u>\$ 8,907,625</u>

See Notes to Financial Statements

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

STATEMENTS OF CASH FLOWS, Concluded

Years Ended May 31, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 1,308,611	\$ 1,307,324
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	2,867,750	2,845,408
Change in assets and liabilities:		
Decrease (increase) in assets:		
Accounts receivable	1,787	13,546
Materials and supplies	39,928	10,724
Prepayments	(27,554)	(5,435)
Other noncurrent assets	24,041	(136)
Deferred outflows of resources	-	(456,513)
Increase (decrease) in liabilities:		
Accounts payable	402,563	(307,665)
Other noncurrent liabilities	-	896,794
Deferred revenues	(140,000)	(189,233)
Deferred inflows of resources	-	(46,639)
Net cash provided by operating activities	<u>\$ 4,477,126</u>	<u>\$ 4,068,175</u>
Noncash investing, capital and financing activities:		
Noncash contributions in aid of construction	<u>\$ 89,633</u>	<u>\$ 295,443</u>
Unrefunded customers' advances credited to contributions in aid of construction	<u>\$ 21,315</u>	<u>\$ 5,268</u>
Amortization of debt discount and expense and deferred loss on debt defeasance	<u>\$ 115,803</u>	<u>\$ 201,624</u>

OWENSBORO MUNICIPAL UTILITIES WATER WORKS SYSTEM

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

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 component units 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 financial statements are prepared in accordance with generally accepted accounting principles and follow accounting guidance provided by the Governmental Accounting Standards Board (GASB) in the regulated operations provisions of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, which permit certain entities with cost-based rates to defer certain costs or income that would otherwise be recognized when incurred to the extent that the rate-regulated entity is recovering or expects to recover such amounts in future rates charged to its customers. Regulatory assets are the deferral of costs expected to be recovered in future customer rates and regulatory liabilities represent current recovery of expected future costs.

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.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

1. Organization and Summary of Significant Accounting Policies, Continued

System of Accounts and Basis of Accounting, Continued

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.

Change in Accounting Principle

In 2018, the Water System adopted the provisions of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements* (GASBS No. 62), as it relates to rate-regulated entities, for reporting pension and other postemployment benefits. As discussed above, GASBS No. 62 allows the Water System to defer certain costs to the extent that it will be able to recover such costs from future rates charged to its customers. Certain pension costs previously recognized as expense are now reported as a regulatory asset. The change was made to better match revenues and expenses. The cumulative effect of this change resulted in a restatement of beginning net position of \$4,651,090 and a corresponding increase to deferred outflows of resources. The effect of the change in accounting principle on change in net position for 2018 was an increase of \$875,187.

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.

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 2018 and 2017 was approximately 3.4% of the average original cost of depreciable utility plant in service.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

1. Organization and Summary of Significant Accounting Policies, Continued

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. 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, agency securities and negotiable certificates of deposit 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 U.S. agency securities and negotiable certificates of deposit, are classified as temporary investments.

Inventories

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

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 GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, 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.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

1. Organization and Summary of Significant Accounting Policies, Continued

Pensions and Other Postemployment Benefits

For purposes of measuring the net liabilities, deferred outflows of resources and deferred inflows of resources related to pensions and other postemployment benefits (OPEB), information about the fiduciary net position of the pension/OPEB plans, and additions to/deductions from the pension/OPEB plans' fiduciary net position have been determined on the same basis as they are reported by the pension/OPEB plans. For this purpose, revenues are recognized when earned. Contributions are recognized when due, pursuant to legal (or statutory) requirements. Benefit payments (including refunds of employee contributions) are recognized when due and payable in accordance with the benefit terms. Plan 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.

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.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

2. Utility Plant

Water utility plant activity for the year ended May 31, 2018, was as follows:

	Beginning Balance	Additions	Retirements	Ending Balance
Utility plant:				
Source of supply plant	\$ 5,466,430	\$ 4,789	\$ -	\$ 5,471,219
Pumping plant	1,177,901	-	-	1,177,901
Water treatment plant	29,768,870	334,120	-	30,102,990
Transmission and distribution plant	39,221,624	1,400,228	(10,871)	40,610,981
General plant	4,714,817	154,932	(14,974)	4,854,775
Unclassified plant in service	1,753,902	2,730,079	-	4,483,981
Total, at original cost	<u>82,103,544</u>	<u>4,624,148</u>	<u>(25,845)</u>	<u>86,701,847</u>
Accumulated depreciation:				
Source of supply plant	(2,450,759)	(187,839)	-	(2,638,598)
Pumping plant	(808,574)	(30,290)	-	(838,864)
Water treatment plant	(16,191,092)	(749,516)	-	(16,940,608)
Transmission and distribution plant	(17,513,860)	(1,642,778)	10,871	(19,145,767)
General plant	(3,556,587)	(257,327)	14,974	(3,798,940)
Total accumulated depreciation	<u>(40,520,872)</u>	<u>(2,867,750)</u>	<u>25,845</u>	<u>(43,362,777)</u>
Construction in progress	<u>4,390,551</u>	<u>(2,104,977)</u>	<u>-</u>	<u>2,285,574</u>
Utility plant, net	<u>\$ 45,973,223</u>	<u>\$ (348,579)</u>	<u>\$ -</u>	<u>\$ 45,624,644</u>

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

	<u>2018</u>	<u>2017</u>
Water utility plant	\$ 2,801,750	\$ 2,755,408
Transportation depreciation charged to construction activities or other operating expenses	<u>66,000</u>	<u>90,000</u>
	<u>\$ 2,867,750</u>	<u>\$ 2,845,408</u>

3. Restricted Assets

Restricted assets at May 31 consist of the following:

	<u>2018</u>	<u>2017</u>
Cash and cash equivalents	\$ 6,667,267	\$ 7,651,356
Investments	2,127,636	2,188,732
Accrued interest receivable	<u>17,698</u>	<u>17,698</u>
	<u>\$ 8,812,601</u>	<u>\$ 9,857,786</u>

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

3. Restricted Assets, Continued

The above balances are contained in the following funds:

Sinking Fund	\$ 3,144,197	\$ 3,183,700
Renewal and Replacement Fund	544	338
Construction Fund	<u>5,667,860</u>	<u>6,673,748</u>
	<u>\$ 8,812,601</u>	<u>\$ 9,857,786</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 \$567,000 at May 31, 2018), 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* (GASBS No. 31), which requires certain investments to be carried at fair value in the statements of net position and changes in the fair value of investments to be reported in the statements of revenues, expenses and changes in net assets. In accordance with GASBS No. 31, the Water System recorded unrealized losses of (\$104,178) and (\$43,450) for the years ended May 31, 2018 and 2017, respectively. The Water System's rate making methodology does not consider unrealized gains or losses on marketable securities in its rate making process. Accordingly, under GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, as it relates to rate-regulated entities, the unrealized losses for the years ended May 31, 2018 and 2017, have been deferred.

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

	<u>2018</u>	<u>2017</u>
Net realized gains (losses) on sales of investments	\$ -	\$ -
Net unrealized gains (losses) on investments	<u>(104,178)</u>	<u>(43,450)</u>
	<u>\$ (104,178)</u>	<u>\$ (43,450)</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.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

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>2018</u>	<u>2017</u>
Deposits in financial institutions	\$ 7,685,771	\$ 9,379,521
Investments other than deposits	<u>5,740,645</u>	<u>4,986,417</u>
	<u>\$ 13,426,416</u>	<u>\$ 14,365,938</u>

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

	<u>2018</u>	<u>2017</u>
Cash and cash equivalents	\$ 362,154	\$ 1,256,269
Investments	4,269,359	3,269,581
Restricted assets:		
Cash and cash equivalents	6,667,267	7,651,356
Investments	<u>2,127,636</u>	<u>2,188,732</u>
	<u>\$ 13,426,416</u>	<u>\$ 14,365,938</u>

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, 2018, \$6,999,250 of the Water System's bank balance of \$7,705,344 was exposed to custodial credit risk as follows:

Uninsured and uncollateralized	\$ -
Uninsured with collateral held by pledging bank's agent	<u>6,999,250</u>
Total	<u>\$ 6,999,250</u>

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

4. Cash Deposits and Investments, Continued

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, 2018, the Water System had the following investments, which are reported at fair value:

<u>Investments</u>	<u>Maturities</u>	
Federal Home Loan Bank – Callable	12/28/2018 thru 10/27/2022	\$ 2,191,351
Federal Farm Credit Bank – Callable	09/20/2018 thru 12/16/2024	3,549,294
Negotiable Certificates of Deposit	06/30/2020 thru 05/24/2022	<u>656,350</u>
		<u>\$ 6,396,995</u>

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, other than deposits, are in U.S. agency securities at May 31, 2018.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

5. Long-Term Debt

Long-term debt activity for the year ended May 31, 2018, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due Within One Year
Bonds payable:					
Series of 2009	\$ 13,265,000	\$ -	\$ -	\$ 13,265,000	\$ 475,000
Series of 2014	8,270,000	-	(750,000)	7,520,000	295,000
Series of 2015	5,350,000	-	(30,000)	5,320,000	35,000
Series of 2016	6,590,000	-	(80,000)	6,510,000	85,000
	<u>33,475,000</u>	<u>-</u>	<u>(860,000)</u>	<u>32,615,000</u>	<u>890,000</u>
Add unamortized debt premium	<u>314,079</u>	<u>-</u>	<u>(16,070)</u>	<u>298,009</u>	<u>-</u>
Total bonds payable	<u>\$ 33,789,079</u>	<u>\$ -</u>	<u>\$ (876,070)</u>	<u>\$ 32,913,009</u>	<u>\$ 890,000</u>

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

	<u>2018</u>	<u>2017</u>
Series of 2009:		
5.0% to 5.25%, due serially September 15, 2018 to 2035	\$ 13,265,000	\$ 13,265,000
Series of 2014:		
1.75% to 3.9%, due serially September 15, 2018 to 2038	7,520,000	8,270,000
Series of 2015:		
3.0% to 4.0%, due serially September 15, 2018 to 2041	5,320,000	5,350,000
Series of 2016:		
2.0% to 3.0%, due serially September 15, 2018 to 2035	<u>6,510,000</u>	<u>6,590,000</u>
Total long-term debt	32,615,000	33,475,000
Less current maturities	(890,000)	(860,000)
Add unamortized debt premium	<u>298,009</u>	<u>314,079</u>
	<u>\$ 32,023,009</u>	<u>\$ 32,929,079</u>

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

5. Long-Term Debt, Continued

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>
2019	\$ 890,000	\$ 1,285,020	\$ 2,175,020
2020	915,000	1,253,320	2,168,320
2021	950,000	1,222,508	2,172,508
2022	985,000	1,189,533	2,174,533
2023	1,015,000	1,154,920	2,169,920
2024 – 2028	5,710,000	5,147,114	10,857,114
2029 – 2033	7,025,000	3,838,641	10,863,641
2034 – 2038	8,830,000	2,127,711	10,957,711
2039 – 2043	6,295,000	367,248	6,662,248
	<u>\$ 32,615,000</u>	<u>\$ 17,586,015</u>	<u>\$ 50,201,015</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.

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.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

5. Long-Term Debt, Continued

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.

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.

On June 8, 2016, the City issued \$6,590,000 of Water Revenue Refunding Bonds, Series 2016, dated June 8, 2016. The 2016 Bonds were issued to refund a portion of the outstanding Series 2009 Bonds. The in-substance defeasance of the 2009 Bonds was accomplished by placing \$6,417,071 in proceeds from the 2014 Bonds and \$104,023 in funds from the 2009 Bond Sinking Fund in an irrevocable escrow fund to be used solely for satisfying scheduled debt service payments of the 2009 Bonds. Accordingly, 2009 Bonds in the amount of \$5,895,000, net of unamortized discount and issuance costs of \$129,024 and accrued interest payable of \$69,133, were extinguished resulting in the accounting recognition of a loss from defeasance of \$685,985, reported in the accompanying financial

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

5. Long-Term Debt, Continued

statements as a deferred outflow of resources. The City advance refunded the 2009 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 \$771,709.

The Series 2016 Bonds maturing on and after September 15, 2025, are subject to redemption in whole or in part on September 15, 2024, 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 and Other Postemployment Benefits – CERS

Plan Description

The Water System contributes to the County Employees Retirement System (CERS), which is a cost-sharing multiple-employer defined benefit pension/OPEB plan administered by Kentucky Retirement Systems (KRS) that covers members employed in 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). KRS 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, as well as other postemployment benefits (OPEB) for hospital and medical insurance through its Insurance 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

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

6. Pension and Other Postemployment Benefits – CERS, Continued

Benefits Provided, Continued

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 4 years 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 5 years of service credit.

Other postemployment benefits provided by CERS consist of prescribed contributions for whole or partial payments of required premiums to purchase hospital and medical insurance.

Contributions

State statute requires active members to contribute 5% of creditable compensation. For members participating on or after September 1, 2008, an additional 1% of creditable compensation is required. This amount is credited to the Insurance Fund and is non-refundable to the member. Employers contribute at the rate determined by the KRS Board to be necessary for the actuarial soundness of the systems, as required by KRS 61.565 and KRS 61.752.

The Water System's actuarially determined contribution rates and contribution amounts, based on annual creditable compensation, for the year ended May 31, 2018, were as follows:

	<u>Contribution Rates</u>		<u>Contributions</u>
Pension	14.48%	\$	484,778
OPEB	4.70%		157,352
Total	19.18%	\$	642,130

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

The net pension and OPEB liabilities reported as of May 31, 2018, were measured as of June 30, 2017, and the total pension and OPEB liabilities used to calculate the net pension liability was determined by an actuarial valuation as of June 30, 2016. The Water System's

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

6. Pension and Other Postemployment Benefits – CERS, Continued

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

proportion of the liabilities was based on a projection of the Water System's long-term share of contributions to the plan relative to the projected contributions of all participating entities, actuarially determined. At the June 30, 2017, measurement date, the Water System's pension and OPEB proportion was 0.122463%, a decrease of (0.001347%) from its proportion measured as of June 30, 2016, of 0.123810%.

The Water System's pension and OPEB liabilities and expense as of and for the year ended May 31, 2018, were as follows:

	Pension	OPEB
Net Liability	\$ 7,168,159	\$ 2,461,933
Expense	\$ 484,778	\$ 157,352

At May 31, 2018, the Water System reported deferred outflows of resources and deferred inflows of resources related to pensions and OPEB from the following sources:

	Pension		OPEB	
	Deferred Outflows of Resources	Deferred Inflows of Resources	Deferred Outflows of Resources	Deferred Inflows of Resources
Differences between expected and actual experience	\$ 8,891	\$ 181,958	\$ -	\$ 6,838
Changes of assumptions	1,322,719	-	535,701	-
Net difference between projected and actual earnings on plan investments	567,710	479,048	-	116,350
Changes in proportion and differences between contributions and proportionate share of contributions	49,680	101,706	-	5,712
Contributions subsequent to the measurement date	455,594	-	147,879	-
Total	\$ 2,404,594	\$ 762,712	\$ 683,580	\$ 128,900

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

6. Pension and Other Postemployment Benefits – CERS, Continued

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

The \$455,594 and \$147,879 of deferred outflows of resources resulting from the Water System's pension and OPEB contributions subsequent to the measurement date will be recognized as a reduction of the net pension and OPEB liabilities in the year ending May 31, 2019. Other amounts reported as deferred outflows of resources and deferred inflows of resources will be recognized as follows:

Year ending May 31,	<u>Pension</u>	<u>OPEB</u>
2019	\$ 528,083	\$ 69,994
2020	525,337	69,994
2021	224,911	69,994
2022	(92,043)	69,994
2023	-	99,082
2024	-	27,743
	<u>\$ 1,186,288</u>	<u>\$ 406,801</u>

Actuarial Assumptions

The total pension/OPEB liabilities in the June 30, 2016, actuarial valuation were determined using the following actuarial assumptions, applied to all periods included in the measurement:

Inflation	2.30%
Salary increases	2.00% average
Investment rate of return	6.25%, net of investment expenses
Healthcare cost trend rates (OPEB)	Initial trend starting at 7.50% for Pre-65, or 5.5% for Post-65, and gradually decreasing to an ultimate trend rate of 5% over a period of 5 years for Pre-65, or 2 years for Post-65

Mortality rates were based on the following assumptions and assume a margin for future mortality improvement:

Pre-retirement mortality: RP-2000 Combined Mortality Table projected with Scale BB to 2013. Male mortality rates are multiplied by 50% and female mortality rates are multiplied by 30%.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

6. Pension and Other Postemployment Benefits – CERS, Continued

Actuarial Assumptions, Continued

Post-retirement mortality (non-disabled): RP-2000 Combined Mortality Table projected with Scale BB to 2013. Female mortality rates are set back one year.

Post-retirement mortality (disabled): RP-2000 Combined Disabled Mortality Table projected with Scale BB to 2013. Male mortality rates are set back four years.

The actuarial assumptions used in the June 30, 2016, valuation were based on the results of an actuarial experience study for the five-year period ended June 30, 2013.

The long-term expected rate of return was determined by using a building-block method in which best-estimate ranges of expected future real rate of returns are developed for each asset class. The ranges are combined by weighting the expected future real rate of return by the target asset allocation percentage. The target allocation and best estimates of arithmetic real rate of return for each major asset class are summarized in the tables below.

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
US equity	17.50%	5.97%
International equity	17.50%	7.85%
Global bonds	4.00%	2.63%
Global credit	2.00%	3.63%
High yield	7.00%	5.75%
Emerging market debt	5.00%	5.50%
Private credit	10.00%	8.75%
Real estate	5.00%	7.63%
Absolute return	10.00%	5.63%
Real returns	10.00%	6.13%
Private equity	10.00%	8.25%
Cash	2.00%	1.88%
Total	100%	

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

6. Pension and Other Postemployment Benefits – CERS, Continued

Discount Rate

The discount rates used to measure the total pension/OPEB liabilities at the measurement dates and changes since the prior year were as follows:

	<u>Pension</u>	<u>OPEB</u>
Discount rate, June 30, 2016	7.50%	6.89%
Increase (decrease)	(1.25)%	(1.05)%
Discount rate, June 30, 2017	<u>6.25%</u>	<u>5.84%</u>

The discount rate of 6.25% used to measure the total pension liability was based on the expected rate of return on pension plan investments. The discount rate of 5.84% used to measure the total OPEB liability was based on the expected rate of return on OPEB plan investments of 6.25% and a municipal bond rate of 3.56%, as reported in Fidelity Index's "20-Year Municipal GO AA Index" as of June 30, 2018.

Projected Cash Flows

The projection of cash flows used to determine the discount rates is based on the assumption that each participating employer in CERS will contribute the actuarially determined contribution rates, which are determined using a closed funding period (26 years as of June 30, 2017), as well as the actuarial assumptions and methods adopted by the KRS Board of Trustees. Current assets, future contributions, and investment earnings are projected to be sufficient to pay the projected benefit payments from the system.

Sensitivity of the Water System's Proportionate Share of the Liabilities to Changes in the Discount Rate

The following presents the Water System's proportionate share of the net pension/OPEB liabilities, as well as what the Water System's proportionate share of the net pension/OPEB liabilities would be if they were calculated using a discount rate that is 1-percentage-point lower or 1-percentage-point higher than the current rate:

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

6. Pension and Other Postemployment Benefits – CERS, Continued

Sensitivity of the Water System's Proportionate Share of the Liabilities to Changes in the Discount Rate, Continued

	Water System's Proportionate Share			
	Discount Rate	Net pension Liability	Discount Rate	Net OPEB Liability
1% decrease	5.25%	\$ 9,040,597	4.84%	\$ 3,132,673
Current discount rate	6.25%	\$ 7,168,159	5.84%	\$ 2,461,933
1% increase	7.25%	\$ 5,601,878	6.84%	\$ 1,903,772

Sensitivity of the Water system's Proportionate Share of the Net OPEB Liability to Changes in the Healthcare Cost Trend Rates

The following presents the Water System's proportionate share of the net OPEB liability, as well as what the Water System's proportionate share of the net OPB liability would be if it were calculated using healthcare cost trend rates that are 1-percentage-point lower or 1-percentage-point higher than the current rate:

	Healthcare Cost Trend Rate	Water System's Proportionate Share of Net OPEB Liability
1% decrease	6.5% Pre-65 or 5.5% Post-65 decreasing to 4%	\$ 1,888,429
Current healthcare cost trend rate	7.5% Pre-65 or 5.5% Post-65 decreasing to 5%	\$ 2,461,933
1% increase	8.5% Pre-65 or 5.5% Post-65 decreasing to 6%	\$ 3,207,454

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
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

6. Pension and Other Postemployment Benefits – CERS, Continued

Payables to the Pension/OPEB Plans

The Water System reported the following payables for the outstanding amount of pension/OPEB contributions due to CERS for the year ended May 31, 2018.

	<u>Pension</u>		<u>OPEB</u>
\$	<u>38,330</u>	\$	<u>12,441</u>

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 \$2,322,000 and \$2,344,000 for 2018 and 2017, respectively.

9. Risk Management

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

10. Impact of Recently Issued Accounting Principles

The following recently issued accounting standard was implemented by the Water System at May 31, 2018:

In fiscal year 2018, the Water System implemented GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other than Pensions* (GASBS No. 75), which amends or supersedes the accounting and financial reporting guidance for Postemployment benefits other than pensions (other postemployment benefits or OPEB) provided to the employees of state and local governmental employers. The objective is to improve accounting and financial reporting for OPEB by state and local governments.

**OWENSBORO MUNICIPAL UTILITIES
WATER WORKS SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Years Ended May 31, 2018 and 2017

10. Impact of Recently Issued Accounting Principles, Continued

Under GASBS No. 75, the liability to be recognized by participating employers is measured as the portion of the present value of projected benefit payments to be provided through the OPEB plan to current active and inactive employees that is attributed to those employees' past periods of service (total OPEB liability), less the amount of the OPEB plan's fiduciary net position. The OPEB expense and deferred outflows of resources and deferred inflows of resources related to OPEB that are required to be recognized by an employer result primarily from changes in the components of the net OPEB liability, as detailed in Note 6 to financial statements. However, the OPEB expense to be recognized currently under GASBS No. 75 has been deferred to future periods under GASBS No. 62 to the extent that the Water System will be able to recover such costs from future rates charged to its customers.

In the financial statements, the implementation of GASBS No. 75 resulted in an increase in deferred outflows of resources of \$2,590,833 and a corresponding increase in deferred inflows of resources of \$128,900 and other noncurrent liabilities of \$2,461,933. Deferred outflows and inflows related to GASBS 75 are disclosed in Note 6 to the financial statements.

11. Subsequent Events

On June 22, 2018, the City Utility Commission approved contract amendments with the Southeast and West Daviess County Water Districts and the East Daviess County Water Association effective June 1, 2018, for the purpose of establishing a proportionate allocated share of the fixed costs for the expanded water treatment facility.

On August 21, 2018, the City Commission approved a bond issue not to exceed \$69 million for water improvements and refunding of existing debt and also an increase in retail water rates of 20% and 12% effective October 1, 2018, and June 1, 2019, respectively.

**OWENSBORO MUNICIPAL UTILITIES
WATER SYSTEM**

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

Last 10 Fiscal Years *

	<u>2018</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>
Water System's proportion of the net pension liability	0.122463%	0.123810%	0.120923%	0.126427%
Water System's proportionate share of the net pension liability	\$ 7,168,159	\$ 6,095,910	\$ 5,199,116	\$ 4,101,776
Water System's covered payroll	\$ 2,923,793	\$ 2,869,077	\$ 2,803,919	\$ 2,920,692
Water System's proportionate share of the net pension liability as a percentage of its covered payroll	245.17%	212.47%	185.42%	140.44%
Plan fiduciary net position as a percentage of the total pension liability	53.32%	55.50%	59.97%	66.80%

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

**OWENSBORO MUNICIPAL UTILITIES
WATER SYSTEM**

**SCHEDULE OF PENSION CONTRIBUTIONS
COUNTY EMPLOYEES RETIREMENT SYSTEM**

Last 10 Fiscal Years

	<u>2018</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>
Contractually required contributions	\$ 484,778	\$ 407,575	\$ 355,884	\$ 363,125
Contributions in relation to the contractually required contributions	<u>(484,778)</u>	<u>(407,575)</u>	<u>(355,884)</u>	<u>(363,125)</u>
Contribution deficiency (excess)	\$ <u>-</u>	\$ <u>-</u>	\$ <u>-</u>	\$ <u>-</u>
Water System's covered payroll	\$ 3,355,482	\$ 2,941,934	\$ 2,815,932	\$ 2,838,215
Contributions as a percentage of covered payroll	14.45%	13.85%	12.64%	12.79%

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

**OWENSBORO MUNICIPAL UTILITIES
WATER SYSTEM**

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

Last 10 Fiscal Years *

	<u>2018</u>	<u>2017</u>
Water System's proportion of the net OPEB liability	0.122463%	0.123810%
Water System's proportionate share of the net OPEB liability	\$ 2,461,933	\$ 1,908,895
Water System's covered payroll	\$ 2,923,793	\$ 2,869,077
Water System's proportionate share of the net OPEB liability as a percentage of its covered payroll	84.20%	66.53%
Plan fiduciary net position as a percentage of the total OPEB liability	52.39%	55.24%

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

**OWENSBORO MUNICIPAL UTILITIES
WATER SYSTEM**

**SCHEDULE OF OPEB CONTRIBUTIONS
COUNTY EMPLOYEES RETIREMENT SYSTEM**

Last 10 Fiscal Years

	<u>2018</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>
Contractually required contributions	\$ 157,352	\$ 138,196	\$ 132,955	\$ 139,262
Contributions in relation to the contractually required contributions	<u>(157,352)</u>	<u>(138,196)</u>	<u>(132,955)</u>	<u>(139,262)</u>
Contribution deficiency (excess)	\$ <u>-</u>	\$ <u>-</u>	\$ <u>-</u>	\$ <u>-</u>
Water System's covered payroll	3,355,482	2,941,934	2,815,932	2,838,215
Contributions as a percentage of covered payroll	4.69%	4.70%	4.72%	4.91%

* 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, 2018

Changes of Benefit Terms

None

Changes of Assumptions

For amounts reported in 2018, the assumed investment return was changed from 7.5% to 6.25%, the price inflation assumption was changed from 3.25 to 2.3%, which also resulted in a 0.95 decrease in the salary increase assumption at all years of service, and the payroll growth assumption (applicable for the amortization of unfunded actuarial accrued liabilities) was changed from 4.00% to 2.00% in order to reflect future economic expectations.



Riney Hancock CPAs
PSC

**INDEPENDENT AUDITOR'S REPORT
ON INTERNAL CONTROL OVER FINANCIAL
REPORTING AND ON COMPLIANCE AND OTHER
MATTERS BASED ON AN AUDIT OF FINANCIAL
STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS**

City Utility Commission
City of Owensboro, Kentucky

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the Owensboro Municipal Utilities Water Works System (Water System) of the City of Owensboro, Kentucky as of and for the year ended May 31, 2018, and the related notes to the financial statements, and have issued our report thereon dated September 11, 2018.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Water System's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Water System's internal control. Accordingly, we do not express an opinion on the effectiveness of the Water System's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Water System's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

 Riney Hannon CPASPSC

Owensboro, Kentucky
September 11, 2018