

Heartland Consumers Power District

Independent Auditor's Reports and Financial Statements

December 31, 2016 and 2015



Heartland Consumers Power District
December 31, 2016 and 2015

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Independent Auditor's Report

Board of Directors
Heartland Consumers Power District
Madison, South Dakota

We have audited the accompanying financial statements of Heartland Consumers Power District (the District), as of and for the years ended December 31, 2016 and 2015, and the related notes to the financial statements, which collectively comprise the District's basic financials 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 audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Heartland Consumers Power District as of December 31, 2016 and 2015, and the changes in its financial position and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis and the pension information listed in the table of contents be presented to supplement the basic financial statements. Such information, although not 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 audits were conducted for the purpose of forming an opinion on the financial statements that collectively comprise the District's basic financial statements. The schedules of transmission operation and maintenance expenses and of administrative and general expenses as listed in the table of contents, are presented for purposes of additional analysis and are not a required part of the basic financial statements.

The schedules of transmission operation and maintenance expenses and of administrative and general expenses have not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on them.

BKD, LLP

Lincoln, Nebraska
March 29, 2017

MANAGEMENT'S DISCUSSION AND ANALYSIS

This discussion and analysis of Heartland Consumers Power District's (Heartland or HCPD) financial statements provides the reader an overview of the financial activities for 2016, 2015 and 2014. Heartland's financial statements are comprised of three components: (1) Management's Discussion and Analysis, (2) financial statements, and (3) notes to the financial statements. Please read this in conjunction with the audited financial statements and footnotes contained herein.

Overview of Financial Statements

The balance sheets present information on Heartland's assets and deferred outflows of resources, and liabilities and deferred inflows of resources, with the difference reported as net position. Over time, increases or decreases in net position may serve as a useful indicator of whether the financial position of Heartland is improving or deteriorating.

Heartland's overall financial position is summarized below (in thousands). This information is derived from the financial statements and records of Heartland.

	Net Position as of December 31,			Fiscal Year-to-Year Percentage Change	
	2016	2015	2014	From 2015 to 2016	From 2014 to 2015
Current assets	\$ 28,769	\$ 25,552	\$ 19,254	12.6%	32.7%
Capital assets, net	20,402	20,260	19,862	0.7%	2.0%
Other noncurrent assets	5,500	8,601	22,833	(36.1)%	(62.3)%
Total assets	<u>54,671</u>	<u>54,413</u>	<u>61,949</u>	<u>0.5%</u>	<u>(12.2)%</u>
Deferred outflows of resources	<u>675</u>	<u>536</u>	<u>570</u>	<u>25.9%</u>	<u>(5.9)%</u>
Total assets and deferred outflows of resources	<u>\$ 55,346</u>	<u>\$ 54,949</u>	<u>\$ 62,519</u>	<u>0.7%</u>	<u>(12.1)%</u>
Current liabilities	\$ 10,727	\$ 14,464	\$ 16,344	(25.8)%	(11.5)%
Noncurrent liabilities	<u>5,650</u>	<u>12,667</u>	<u>28,980</u>	<u>(55.4)%</u>	<u>(56.3)%</u>
Total liabilities	<u>16,377</u>	<u>27,131</u>	<u>45,324</u>	<u>(39.6)%</u>	<u>(40.1)%</u>
Deferred inflows of resources	<u>1,776</u>	<u>426</u>	<u>1,546</u>	<u>316.9%</u>	<u>(72.4)%</u>
Net investment in capital assets	12,250	4,789	(969)	155.8%	(594.2)%
Restricted for debt service	5,660	6,668	10,660	(15.1)%	(37.4)%
Restricted for pensions	-	370	697	(100.0)%	100.0%
Unrestricted	<u>19,283</u>	<u>15,565</u>	<u>5,261</u>	<u>23.9%</u>	<u>195.9%</u>
Total net position	<u>37,193</u>	<u>27,392</u>	<u>15,649</u>	<u>35.8%</u>	<u>75.0%</u>
Total liabilities, deferred inflows of resources and net position	<u>\$ 55,346</u>	<u>\$ 54,949</u>	<u>\$ 62,519</u>	<u>0.7%</u>	<u>(12.1)%</u>

Heartland's overall net position increased in 2016, 2015 and 2014 by \$9,801,428, \$11,742,652 and \$6,997,741, respectively. In 2016, a decrease in customer contracts and a transfer for rate stabilization lead to a lower increase in net position compared to 2015. Heartland had reductions in power supply contracts in 2015 that resulted in less cost of power and an increase in net position in 2015 compared to 2014

The decrease in customer revenue in 2016 was a result of two of Heartland's long-term contracts ending June 30, 2016, with the most significant being Marshall, MN. Heartland received over 10 years advance notice of the contract termination. The increased customer revenue in 2015 was attributed to an increase in wholesale electric demand and energy rates. The demand and energy rates were increased to meet the costs of power supply generation and maintenance, other operating expenses, debt service, and other financial metrics. Generation and transmission facilities represent 95% of Heartland's total capital assets. The remaining 5% of capital assets includes Heartland's headquarters building, transportation equipment, and office equipment. The level of assets should remain reasonably stable until such time as Laramie River Station (LRS) requires substantial capital improvements.

The statements of revenues, expenses and changes in net position present information showing how Heartland's net position changed during the most recent fiscal year.

Heartland's results for the current and prior two years are summarized in the following table. This information is derived from the financial statements and records of Heartland.

Results of Operations

A summary of revenues and expenses is provided in the table that follows (in thousands except power sales).

	2016	2015	2014	Fiscal Year-to-Year Percentage Change	
	Actual	Actual	Actual	From 2015 to 2016	From 2014 to 2015
Power sales					
Customer energy (MWh)	637,252	855,651	862,805	(25.5)%	(0.8)%
Customer cumulative demand (kW)	1,085,799	1,433,896	1,452,937	(24.3)%	(1.3)%
Revenues					
Customer revenue	\$ 50,071	\$ 62,717	\$ 60,953	(20.2)%	2.9%
Contracted requirements revenue	17,893	12,609	16,462	41.9%	(23.4)%
Surplus sales revenue	2,557	2,976	3,588	(14.1)%	(17.1)%
Other operating revenue	4,041	969	1,079	317.0%	(10.2)%
Transfer for rate stabilization	(1,750)	-	-	100.0%	—%
Total operating revenue	<u>72,812</u>	<u>79,271</u>	<u>82,082</u>	<u>(8.1)%</u>	<u>(3.4)%</u>
Expenses					
LRS production & O&M	7,732	8,470	9,230	(8.7)%	(8.2)%
Cost of power	41,368	46,543	53,153	(11.1)%	(12.4)%
Transmission	6,400	5,439	5,254	17.7%	3.5%
Depreciation	1,323	1,242	1,188	6.5%	4.5%
Taxes	447	199	185	124.6%	7.6%
Administration and general	3,947	4,264	4,021	(7.4)%	6.0%
Amortization	1,108	203	195	445.8%	4.1%
Total operating expenses	<u>62,325</u>	<u>66,360</u>	<u>73,226</u>	<u>(6.1)%</u>	<u>(9.4)%</u>
Operating income	10,487	12,911	8,856	(18.8)%	45.8%
Total nonoperating expenses, net	<u>(686)</u>	<u>(1,168)</u>	<u>(1,858)</u>	<u>(41.3)%</u>	<u>(37.1)%</u>
Change in net position	9,801	11,743	6,998	(16.5)%	67.8%
Net position, beginning of year	<u>27,392</u>	<u>15,649</u>	<u>8,651</u>		
Net position, end of year	<u>\$ 37,193</u>	<u>\$ 27,392</u>	<u>\$ 15,649</u>		

Operating revenues include firm power sales to Heartland's wholesale rate customers, other contracted sales, short-term energy sales on the surplus market, and other revenues. Demand and energy sales for 2016 were 1,086 MW and 637,252 MWh, respectively. The 2016 peak demand of Heartland's long-term wholesale customers was 126.7 MW. Heartland's wholesale customer demand and energy sales for 2015 were 1,443 MW and 855,651 MWh, respectively. Heartland's wholesale customer demand and energy sales for 2014 were 1,453 MW and 862,805 MWh. Heartland's wholesale customer peak demand for 2015 and 2014 were 135.7 MW and 138.3 MW, respectively.

Heartland has other energy sales contracts, in addition to its wholesale customers. The contracted requirements revenue mitigates exposure to the surplus market for excess power and the contracts typically contain fixed pricing and quantities. Many of these contracts are unit contingent and Heartland is not required to provide replacement power. These revenues increased in 2016 due to less scheduled and unscheduled unit outages compared to 2015.

Surplus energy sales are the sales of energy produced by Heartland's resources in excess of the energy required by Heartland's customers and other contracts. These sales are considered short term and non-firm. The quantity of surplus energy and revenue is dependent upon multiple factors including availability of resources, customer and other contract requirements, and market and contractual pricing. Heartland has contracted with other parties for most of its excess energy and the market prices have declined resulting in declining surplus sales revenue.

The operating expenses fluctuated in some areas. Production expenses (the cost for coal, transportation, and operations and maintenance at Laramie River Station (LRS)) decreased by 8.7% and 8.2% in 2016 and 2015, respectively. The largest reason for the decrease was a reduction in generation. LRS unit 1 had a long Fall outage for environmental improvements in 2016. LRS unit 1 did not generate as many MWh in 2015 due to maintenance outages and decreased market dispatch compared to 2014.

Heartland purchases power, in addition to its ownership share in LRS, to meet the total contract resource obligations to its customers. The purchased power contracts include base-load resources, renewable generation facilities, short-term purchases during peak conditions or during an outage, and additional capacity purchases required to comply with the resource reserve requirements for maintaining regional reliability.

Heartland is a member of Public Power Generation Agency (PPGA), an interlocal agency created under Nebraska statute to build WEC2, a 220 megawatt coal-fired project near Hastings, Nebraska. Heartland's participation in PPGA is for 80 megawatts. PPGA financed construction of WEC2 directly, rather than obtaining funding from its members. Heartland has a contract with Hastings Utilities for an additional share of WEC2. This contract decreases annually. Heartland also has a contract with North Iowa Municipal Electric Cooperative Association (NIMECA) in which NIMECA purchases output of WEC2 for the life of the unit. NIMECA's contract includes all owners' costs and increases annually until 2019. The combination of the Hastings Utilities contract reduction and the NIMECA contract increases resulted in reduced cost of power in 2016 and 2015. Also attributing to the reduction in the cost of power was a short-term power supply contract that corresponded with the end date of Marshall's contract.

The nonoperating revenues/expenses include interest on bonds, investment income, and amortization of costs recoverable from future billings. Heartland's debt service coverage (as defined in the senior bond resolution which includes other available sources) for 2016 and 2015 was 2.72 and 3.21, respectively. The debt service coverage was 5.22 in 2014.

Heartland made principal payments of \$5,750,000 on its Electric System Second Lien Revenue Bonds, Series 2011 in 2016, and also paid down \$1,700,000 on its operating line related to the previously outstanding Electric System Second Lien Revenue Note, Series 2010. Heartland called the Electric System Second Lien Revenue Note, Series 2010, in 2015 and the remaining balance was moved to Heartland's line of credit. This allowed Heartland to take advantage of the lower short-term interest rates on the line of credit compared to the 4.29% of the Series 2010 Note.

In March 2015, Heartland completed a transaction to defease the remainder of its Electric System Revenue Bonds, Series 1992. Heartland used fully funded reserve accounts, previously established, to pay the final two years of debt service of the Series 1992 bonds, to defease the remaining \$9,760,000. In addition to the defeasance, Heartland made payments of \$4,645,590 on revenue bonds and notes. Principal payments in 2014 were \$703,401. Additions to plant in service were primarily the result of improvements to the Missouri Basin Power Project, which includes LRS and various associated transmission facilities. There were no significant additions in 2016, 2015, or 2014.

Fitch assigned an underlying rating of A- to Heartland, Moody's assigned A3, and Standard & Poor's has assigned an issuer credit rating of BBB+ to Heartland.

Contact Information

This financial report is designed to provide a general overview of Heartland's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to Micheal Malone, P.O. Box 248, Madison, SD 57042.

Heartland Consumers Power District

Balance Sheets

December 31, 2016 and 2015

Assets and Deferred Outflows of Resources

	<u>2016</u>	<u>2015</u>
Current Assets		
Cash and cash equivalents	\$ 7,965,003	\$ 4,030,999
Restricted cash and cash equivalents	5,810,693	6,951,367
Short-term investments	1,977,173	2,387,702
Accounts receivable	7,777,416	8,082,970
Notes receivable, current portion	435,732	427,767
Plant operation assets	4,769,254	3,560,089
Prepaid expenses and other current assets	33,279	111,072
Total current assets	<u>28,768,550</u>	<u>25,551,966</u>
Noncurrent Assets		
Notes receivable, net of allowance of \$343,781 for 2016 and \$326,774 for 2015	2,743,898	2,816,366
Long-term investments	273,044	2,327,533
Capital assets, net	20,402,110	20,260,272
Costs recoverable from future billings	1,388,285	2,792,435
Net pension asset	-	370,005
Other noncurrent assets	1,095,000	295,000
Total noncurrent assets	<u>25,902,337</u>	<u>28,861,611</u>
Deferred Outflows of Resources		
Deferred outflows for pensions	674,873	429,423
Deferred loss on debt defeasance	-	106,244
Total deferred outflows of resources	<u>674,873</u>	<u>535,667</u>
Total assets and deferred outflows of resources	<u>\$ 55,345,760</u>	<u>\$ 54,949,244</u>

Liabilities, Deferred Inflows of Resources and Net Position

	<u>2016</u>	<u>2015</u>
Current Liabilities		
Current maturities of long-term debt	\$ 5,873,946	\$ 6,023,832
Accounts payable	4,197,886	6,548,434
Accrued expenses	500,361	412,409
Accrued interest payable	155,312	287,531
Unearned revenue	-	1,191,877
	<u>10,727,505</u>	<u>14,464,083</u>
Noncurrent Liabilities		
Line of credit	2,300,000	4,000,000
Long-term debt, net	2,783,366	8,432,331
Net pension liability	296,707	-
Other noncurrent liabilities	269,750	235,065
	<u>5,649,823</u>	<u>12,667,396</u>
Total noncurrent liabilities	<u>5,649,823</u>	<u>12,667,396</u>
Total liabilities	<u>16,377,328</u>	<u>27,131,479</u>
Deferred Inflows of Resources		
Deferred inflows for pensions	21,891	350,782
Deferred gain on refunding	-	75,533
Reductions of future billings	1,753,663	-
	<u>1,775,554</u>	<u>426,315</u>
Total deferred inflows of resources	<u>1,775,554</u>	<u>426,315</u>
Net Position		
Net investment in capital assets	12,250,422	4,789,036
Restricted for debt service	5,659,735	6,667,805
Restricted for pensions	-	370,005
Unrestricted	19,282,721	15,564,604
	<u>37,192,878</u>	<u>27,391,450</u>
Total net position	<u>37,192,878</u>	<u>27,391,450</u>
Total liabilities, deferred inflows of resources and net position	<u>\$ 55,345,760</u>	<u>\$ 54,949,244</u>

Heartland Consumers Power District
Statements of Revenues, Expenses and
Changes in Net Position
Years Ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Operating Revenues		
Customer requirements	\$ 50,070,249	\$ 62,716,984
Other contracted requirements	17,893,259	12,609,096
Surplus sales revenue	2,557,198	2,976,217
Other operating revenue	4,041,568	968,729
Transfer for rate stabilization	(1,750,000)	-
Total operating revenues	<u>72,812,274</u>	<u>79,271,026</u>
Operating Expenses		
Cost of power	49,099,837	55,013,347
Depreciation and amortization	2,430,760	1,445,041
Transmission	6,400,660	5,439,290
Other	4,394,270	4,462,499
Total operating expenses	<u>62,325,527</u>	<u>66,360,177</u>
Operating Income	<u>10,486,747</u>	<u>12,910,849</u>
Nonoperating Revenues (Expenses)		
Investment income	133,171	149,080
Interest expense	(386,639)	(802,421)
Amortization expense	(238,825)	(205,969)
Grant revenue	-	300,000
Other	(193,026)	(608,887)
Net nonoperating expenses	<u>(685,319)</u>	<u>(1,168,197)</u>
Change in Net Position	9,801,428	11,742,652
Net Position, Beginning of Year	<u>27,391,450</u>	<u>15,648,798</u>
Net Position, End of Year	<u>\$ 37,192,878</u>	<u>\$ 27,391,450</u>

Heartland Consumers Power District
Statements of Cash Flows
Years Ended December 31, 2016 and 2015

	2016	2015
Operating Activities		
Receipts from customers	\$ 51,349,152	\$ 63,084,525
Receipts from others	23,518,676	15,766,286
Payments to suppliers	(63,773,731)	(66,958,232)
Payments to employees	(1,422,534)	(1,345,693)
	<u>9,671,563</u>	<u>10,546,886</u>
Net cash provided by operating activities		
Noncapital Financing Activities		
Advances on revolving line of credit	-	1,615,718
Payments on revolving line of credit	(1,700,000)	(2,064,544)
Federal grants received	-	300,000
Proceeds from issuance of promissory notes	225,000	1,225,000
Payments on promissory notes	(273,851)	(175,158)
Remittance of BNSF settlement funds	-	(628,380)
Other nonoperating payments	(176,020)	-
	<u>(1,924,871)</u>	<u>272,636</u>
Net cash provided by (used in) noncapital financing activities		
Capital and Related Financing Activities		
Purchase of capital assets	(1,365,219)	(1,606,250)
Payments on revenue bonds and notes	(5,750,000)	(4,645,590)
Net payments for debt defeasance and refunding	-	(10,050,000)
Interest paid	(488,147)	(1,280,182)
	<u>(7,603,366)</u>	<u>(17,582,022)</u>
Net cash used in capital and related financing activities		
Investing Activities		
Proceeds from sales and maturities of investment securities	7,183,717	13,830,000
Purchases of investment securities	(4,756,393)	(5,324,586)
Issuance of notes receivable	(436,407)	(1,600,000)
Repayments of notes receivable	483,903	546,847
Investment income received	175,184	188,975
	<u>2,650,004</u>	<u>7,641,236</u>
Net cash provided by investing activities		
Change in Cash and Cash Equivalents	<u>2,793,330</u>	<u>878,736</u>
Cash and Cash Equivalents, Beginning of Year	<u>10,982,366</u>	<u>10,103,630</u>
Cash and Cash Equivalents, End of Year	<u>\$ 13,775,696</u>	<u>\$ 10,982,366</u>
Composition of Cash and Cash Equivalents		
Cash and cash equivalents	\$ 7,965,003	\$ 4,030,999
Restricted cash and cash equivalents	5,810,693	6,951,367
	<u>\$ 13,775,696</u>	<u>\$ 10,982,366</u>
Total	<u>\$ 13,775,696</u>	<u>\$ 10,982,366</u>

Heartland Consumers Power District
Statements of Cash Flows - Continued
Years Ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Reconciliation of Operating Income to Net Cash		
Provided by Operating Activities		
Operating income	\$ 10,486,747	\$ 12,910,849
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation and amortization	2,430,760	1,445,041
Amortization of advance payment received under energy purchase contract	(1,191,877)	(2,404,062)
Changes in balance sheet operating items		
Accounts receivable	305,554	(418,990)
Plant operation assets	(1,209,165)	35,440
Prepaid expenses and other assets	(665,175)	(18,775)
Net pension asset (liability)	666,712	327,289
Deferred outflows for pensions	(245,450)	141,133
Accounts payable	(2,450,289)	(1,052,200)
Accrued liabilities	122,637	37,963
Deferred inflows for pensions	(328,891)	(456,802)
Deferred inflows for rate stabilization	1,750,000	-
Net Cash Provided by Operating Activities	<u>\$ 9,671,563</u>	<u>\$ 10,546,886</u>
Supplemental Cash Flows Information		
Capital asset acquisitions included in accounts payable	\$ 251,688	\$ 151,947
Increase in allowance for notes receivable	\$ 17,007	\$ 10,358

Heartland Consumers Power District

Notes to Financial Statements

December 31, 2016 and 2015

Note 1: Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations

Heartland Consumers Power District (Heartland) is a public corporation and a political subdivision of the State of South Dakota created under the Consumers Power District Law for the purpose of supplying electric energy. Heartland is empowered by the Consumers Power District Law to finance, own, and operate, either singly or jointly with others and anywhere within or without the boundaries of Heartland or the State of South Dakota, any electric light and power plants, lines, and systems or interest therein for the generation and transmission of electric power and energy. Heartland has firm power customers in the four-state region of Minnesota, Kansas, Iowa and South Dakota.

Rates for wholesale electric service are set by the Heartland Board of Directors. Neither the South Dakota Public Utilities Commission nor any other commission has jurisdiction over Heartland with respect to Heartland's rates and charges for power sales to its customers.

Reporting Entity

In evaluating how to define the District for financial reporting purposes, management has considered all potential component units for which financial accountability may exist. The determination of financial accountability includes consideration of a number of criteria, including: (1) the District's ability to appoint a voting majority of another entity's governing body and to impose its will on that entity, (2) the potential for that entity to provide specific financial benefits to or impose specific financial burdens on the District and (3) the entity's fiscal dependency on the District. Based upon the above criteria, Heartland has determined that it has no reportable component units.

Basis of Accounting

Heartland's activities are accounted for on the flow of economic resources measurement focus and use the accrual basis of accounting. Heartland's accounting records are maintained in accordance with accounting principles generally accepted in the United States of America for regulated utilities and generally follow the Uniform System of Accounts for Public Utilities and Licenses prescribed by the Federal Energy Regulatory Commission (FERC). Heartland prepares its financial statements as a business-type activity in conformity with applicable pronouncements of the Governmental Accounting Standards Board (GASB).

Heartland's accounting policies also follow the regulated operations provisions of GASB Statement No. 62, which permits an entity 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 rates charged to its customers. This method includes the philosophy that debt service requirements, as opposed to depreciation or amortization, are a cost for rate making purposes.

Heartland Consumers Power District

Notes to Financial Statements

December 31, 2016 and 2015

Note 1: Nature of Operations and Summary of Significant Accounting Policies - Continued

Use of 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, liabilities and deferred inflows and outflows of resources and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues, expenses and other changes in net position during the reporting period. Actual results may differ from those estimates.

Cash Equivalents

Heartland considers all highly liquid investments with an original maturity of three months or less at the date of purchase to be cash equivalents. At December 31, 2016 and 2015, cash equivalents consisted of money market funds.

Investments and Investment Income

Heartland maintains various debt service reserve accounts that are available for debt service obligations. The reserve accounts consist of bank deposits and investments. Investments in money market mutual funds are carried at cost, which approximates fair value. Investments in U.S. Treasury securities and U.S. agency obligations are carried at fair value. Fair value is determined based on quoted market prices or yields currently available on comparable securities of issuers with similar credit ratings.

Investment income consists of interest income and realized and unrealized gains.

Accounts and Notes Receivable

Accounts receivable are stated at the amount billed to customers. Accounts receivable are ordinarily due 20 days after the issuance of the invoice. Delinquent receivables are charged off as they are deemed uncollectible. Management does not believe an allowance for doubtful accounts is necessary for accounts receivable at December 31, 2016 and 2015, as there were no delinquent accounts. Notes receivable relate to Heartland's economic development program (see Note 3), and amounts due generally follow amortization schedules contained within the related note agreements. Management has established an allowance for doubtful accounts for notes receivable of \$343,781 and \$326,774 at December 31, 2016 and 2015, respectively.

Plant Operation Assets

The operation of the Missouri Basin Power Project (MBPP) requires the establishment of certain operating assets, primarily fuel inventories, supplies, and operating cash. These assets are managed by the operating agent for MBPP and are stated at cost.

Heartland Consumers Power District

Notes to Financial Statements

December 31, 2016 and 2015

Note 1: Nature of Operations and Summary of Significant Accounting Policies - Continued

Capital Assets

Capital assets are recorded at cost at the date of acquisition. Depreciation is computed using the straight-line method over the estimated useful life of each asset, which is normally 20 - 30 years for utility plant, 5 - 10 years for vehicles, furniture, and various office equipment and 40 years for buildings.

Compensated Absences

Employees earn vacation days at varying rates depending on years of service. In the event of termination, an employee is reimbursed for accumulated vacation time, with no maximum accumulation. Expense and the related liability are recognized when earned and vacation benefits are redeemable as time off or in cash. Employees earn sick leave at the rate of approximately one day per month. Upon normal retirement, an employee can use any accumulated sick time to pay for certain qualified medical expenses. Expense and the related liability for sick leave benefits are recognized when earned to the extent the employee is expected to realize the benefit in cash determined using the termination payment method. Compensated absences expected to be used during the next fiscal year are classified as a current liability in accrued expenses. The remaining balance is reflected as a noncurrent liability.

Regulated Operations

Rates for the District's regulated operations are established and approved by the Board of Directors. The District applies the regulated operations provisions of GASB Statement No. 62, which provide for the deferral of expenses which are expected to be recovered through customer rates over some future period (costs recoverable from future billings) and reductions in earnings to cover future expenditures (reductions of future billings). Costs recoverable from future billings are primarily comprised of charges incurred in relation to the District's bond issuances and costs incurred by the District for initial payments made on long-term capacity contracts. These costs are being amortized in future rate periods when such costs are included in the revenue requirements to establish electric rates. Reductions of future billings are comprised of the unrealized net gains on investments and a Board approved transfer for rate stabilization.

Pensions

For purposes of measuring the net pension asset and liability, deferred outflows of resources and deferred inflows of resources related to pensions, and pension revenue and expense, information about the fiduciary net position of the South Dakota Retirement System (SDRS) and additions to/deductions from SDRS's fiduciary net position have been determined on the same basis as they are reported by SDRS. The District's contributions and net pension asset and liability are recognized on the accrual basis of accounting.

Heartland Consumers Power District

Notes to Financial Statements

December 31, 2016 and 2015

Note 1: Nature of Operations and Summary of Significant Accounting Policies - Continued

Net Position Classification

Net position is required to be classified into three components – net investment in capital assets; restricted; and unrestricted. These classifications are defined as follows:

Net investment in capital assets- This component of net position consists of capital assets, net of accumulated depreciation, reduced by the outstanding balances of any bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets. Deferred outflows of resources and deferred inflows of resources that are attributable to the acquisition, construction, or improvement of those assets or related debt are included in this component of net position. If there are significant unspent related debt proceeds at year-end, the portion of the debt attributable to the unspent proceeds is not included in the calculation of net investment in capital assets.

Restricted - This component of net position consists of constraints placed on net position use through external constraints imposed by creditors (such as through debt covenants), contributors, or law or regulations of other governments or constraints imposed by law through constitutional provisions or enabling legislation.

Unrestricted - This component of net position consists of the net amount of the assets, liabilities and deferred inflows and outflows of resources that do not meet the definition of “restricted” or “net investment in capital assets.”

When both restricted and unrestricted resources are available for use, it is Heartland’s policy to use restricted resources first, then unrestricted as they are needed.

Classification of Revenues

Operating revenues and expenses generally result from providing services in connection with Heartland’s ongoing operations. The principal operating revenues are charges to customers for services. Operating expenses include the cost of service, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

Income Taxes

Heartland is exempt from federal income taxes as it is a political subdivision of the state of South Dakota. Heartland may be subject to franchise taxes in states in which it operates. Tax expense was \$9,840 and \$9,660 in 2016 and 2015, respectively.

Heartland Consumers Power District

Notes to Financial Statements

December 31, 2016 and 2015

Note 1: Nature of Operations and Summary of Significant Accounting Policies - Continued

Reclassifications

Certain reclassifications were made to the 2015 financial statements to conform to the 2016 financial statement presentation. These reclassifications had no effect on the change in net position.

Implementation of New Accounting Principles

In 2016, the District implemented the provisions of the following accounting principles:

GASB Statement No. 72, *Fair Value Measurement and Application*. This Statement provides guidance for determining a fair value measurement for financial reporting purposes as well as applying fair value to certain investments and the disclosure related to all fair value measurements.

GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*. The objective of this Statement is to identify – in the context of the current governmental financial reporting environment – the hierarchy of generally accepted accounting principles (GAAP). This statement reduces the GAAP hierarchy to two categories of authoritative GAAP and addresses the use of authoritative and nonauthoritative literature in the event that the accounting treatment for a transaction or other event is not specified within a source of authoritative GAAP.

The implementation of GASB Statements No. 72 and 76 did not have a significant impact on the financial statements of the District.

Note 2: Deposits, Investments and Investment Return

Heartland's investing is performed in accordance with the investment policy adopted by its Board of Directors and applicable state statutes. Heartland may invest in certificates of deposit, time deposits, repurchase agreements, and various U.S. Treasury securities and U.S. agency obligations.

Deposits

State statutes require banks either to give bond or to pledge government securities to Heartland in the amount of Heartland's deposits. The District's cash deposits, including certificates of deposit, are insured up to \$250,000 by the Federal Deposit Insurance Corporation (FDIC). Any cash deposits or certificates of deposit in excess of the \$250,000 FDIC limits are covered by collateral held in a Federal Reserve Bank pledge account or by an agent for the District and thus, no custodial risk exists. No legal opinion has been obtained regarding the enforceability of any collateral arrangements.

Heartland Consumers Power District
Notes to Financial Statements
December 31, 2016 and 2015

Note 2: Deposits, Investments and Investment Return - Continued

Investments

At December 31, 2016 and 2015, Heartland had the following investments and maturities:

	Carrying Value	Maturities in Years			More Than 10	Credit Ratings (Moody's)
		Less Than 1	1-5	6-10		
December 31, 2016						
Money market mutual funds	\$ 12,257,085	\$ 12,257,085	\$ -	\$ -	\$ -	Aaa-mf
U.S. Treasury securities	2,002,110	-	2,002,110	-	-	N/A
U.S. agency obligations	248,107	-	-	248,107	-	Aaa
	<u>\$ 14,507,302</u>	<u>\$ 12,257,085</u>	<u>\$ 2,002,110</u>	<u>\$ 248,107</u>	<u>\$ -</u>	
December 31, 2015						
Money market mutual funds	\$ 9,694,910	\$ 9,694,910	\$ -	\$ -	\$ -	Aaa-mf
U.S. Treasury securities	4,382,433	2,385,013	1,997,420	-	-	N/A
U.S. agency obligations	332,800	-	-	-	332,800	Aaa
	<u>\$ 14,410,143</u>	<u>\$ 12,079,923</u>	<u>\$ 1,997,420</u>	<u>\$ -</u>	<u>\$ 332,800</u>	

Disclosures About Fair Value of Assets and Liabilities

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value measurements must maximize the use of observable inputs and minimize the use of unobservable inputs. There is a hierarchy of three levels of inputs that may be used to measure fair value:

- Level 1** Quoted prices in active markets for identical assets or liabilities
- Level 2** Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities
- Level 3** Unobservable inputs supported by little or no market activity and are significant to the fair value of the assets or liabilities

The District's investments in money market mutual funds are carried at cost and thus are not included within the fair value hierarchy. The District's investments in U.S. Treasury securities and U.S. agency obligations are measured at fair value on a recurring basis, and are classified within Level 2 of the fair value hierarchy at December 31, 2016 and 2015.

Heartland Consumers Power District
Notes to Financial Statements
December 31, 2016 and 2015

Note 2: Deposits, Investments and Investment Return - Continued

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Heartland's investment policy provides limitations on the maturities of the various types of investments as a means of managing its exposure to fair value losses arising from interest rate fluctuations.

Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. Heartland's investment policy establishes requirements for all investment securities to be in compliance with ratings established in bond indentures, for which substantially all investments are held.

Custodial Credit Risk

For an investment, custodial credit risk is the risk that, in the event of a failure of the counterparty, Heartland would not be able to recover the value of its investment securities that are in the possession of an outside party. The District's investments in U.S. agency obligations are held in a book entry system in an account designated as a customer account at the Federal Reserve and the custodian's internal records identify the District as owner.

Concentration of Credit Risk

Concentration of credit risk is the risk associated with the amount of investments Heartland has with any one issuer that exceeds 5% or more of its total investments. Investments issued or explicitly guaranteed by the U.S. Government are excluded from this requirement. Heartland's investment policy limits the amount of its investment portfolio that may be invested in any one issuer, other than U.S. government securities, to 10%. No investments at December 31, 2016 or 2015 exceeded 5%.

Heartland Consumers Power District
Notes to Financial Statements
December 31, 2016 and 2015

Note 2: Deposits, Investments and Investment Return - Continued

Summary of Carrying Values

The carrying values of deposits and investments shown above are included in the balance sheets at December 31, 2016 and 2015 as follows:

	<u>2016</u>	<u>2015</u>
Carrying value		
Deposits	\$ 1,518,611	\$ 1,287,458
Investments	<u>14,507,302</u>	<u>14,410,143</u>
	<u>\$ 16,025,913</u>	<u>\$ 15,697,601</u>

Included in the following balance sheet captions:

	<u>2016</u>	<u>2015</u>
Current Assets		
Cash and cash equivalents		
Operating funds	\$ 545,812	\$ 297,163
General reserve funds	3,715,507	2,531,755
Revolving loan fund program accounts	1,122,798	1,140,292
Rate stabilization fund	<u>2,580,886</u>	<u>61,789</u>
Total	<u>7,965,003</u>	<u>4,030,999</u>
Restricted cash and cash equivalents		
Energy efficiency and incentive grant fund	59,730	59,577
Wessington PPA collateral account	-	850,000
Debt service funds	<u>5,750,963</u>	<u>6,041,790</u>
Total	<u>5,810,693</u>	<u>6,951,367</u>
Short-term investments - rate stabilization fund	<u>1,977,173</u>	<u>2,387,702</u>
Noncurrent Assets		
Long-term investments - rate stabilization fund	<u>273,044</u>	<u>2,327,533</u>
	<u>\$ 16,025,913</u>	<u>\$ 15,697,601</u>

Investment Return

Investment return for the years ended December 31, 2016 and 2015 consisted of interest income and realized gains of \$92,257 and \$115,807, respectively. Unrealized gains and losses on restricted investments are deferred and reported as reductions of future billings shown as a deferred inflow of resources in accordance with the regulated operations provisions of GASB Statement No. 62.

Heartland Consumers Power District
Notes to Financial Statements
December 31, 2016 and 2015

Note 3: Notes Receivable

Type of Notes	2016				Due Within One Year
	January 1,	Additions	Reductions	December 31,	
4.0% to 4.5% notes in connection with Heartland's economic development program, payable in annual installments through December 2018	\$ 161,218	\$ 2,657	\$ 24,040	\$ 139,835	\$ 9,461
3.0% to 6.25% notes in connection with the Intermediary Relending Program Promissory Note (see Note 13), due in monthly installments through January 2024	842,593	433,750	150,308	1,126,035	116,715
Interest-free notes in connection with the Rural Economic Development Loan Agreement and Rural Economic Development Grant Agreement (see Note 13), due in monthly installments through November 2028	2,567,096	-	309,555	2,257,541	309,556
Allowance for notes receivable	(326,774)	(17,007)	-	(343,781)	-
Total notes receivable, net	<u>\$ 3,244,133</u>	<u>\$ 419,400</u>	<u>\$ 483,903</u>	<u>\$ 3,179,630</u>	<u>\$ 435,732</u>
	2015				
4.0% to 4.5% notes in connection with Heartland's economic development program, payable in annual installments through December 2018	\$ 224,078	\$ -	\$ 62,860	\$ 161,218	\$ 24,044
3.0% to 6.25% notes in connection with the Intermediary Relending Program Promissory Note (see Note 13), due in monthly installments through January 2024	847,024	300,000	304,431	842,593	94,169
Interest-free notes in connection with the Rural Economic Development Loan Agreement and Rural Economic Development Grant Agreement (see Note 13), due in monthly installments through November 2028	1,446,652	1,300,000	179,556	2,567,096	309,554
Allowance for notes receivable	(316,416)	(10,358)	-	(326,774)	-
Total notes receivable, net	<u>\$ 2,201,338</u>	<u>\$ 1,589,642</u>	<u>\$ 546,847</u>	<u>\$ 3,244,133</u>	<u>\$ 427,767</u>

Interest income on these notes totaled \$40,914 and \$33,273 for 2016 and 2015, respectively, and is included within investment income on the statements of revenues, expenses and changes in net position.

Heartland Consumers Power District
Notes to Financial Statements
December 31, 2016 and 2015

Note 4: Capital Assets

Capital assets at December 31, 2016 and 2015 consisted of the following:

	2016	2015
Depreciable assets		
Missouri Basin Power Project	\$ 56,029,934	\$ 54,555,764
Transmission Project I (TP I)	1,085,293	1,085,293
Transmission Project II (TP II)	-	6,752,305
Groton substation (TP III)	408,641	408,641
Heartland headquarters building	2,837,333	2,837,333
General plant	811,285	759,685
Total depreciable assets	<u>61,172,486</u>	<u>66,399,021</u>
Nondepreciable assets		
Land	80,402	80,402
Construction in progress	1,030,796	1,280,756
Total nondepreciable assets	<u>1,111,198</u>	<u>1,361,158</u>
	<u>\$ 62,283,684</u>	<u>\$ 67,760,179</u>

Capital assets activity for 2016 and 2015 was:

	2016				Ending Balance
	Beginning Balance	Additions	Retirements	Transfers	
Missouri Basin Power Project	\$ 54,555,764	\$ 66,704	\$ (189,150)	\$ 1,596,616	\$ 56,029,934
Transmission Project I (TP I)	1,085,293	-	-	-	1,085,293
Transmission Project II (TP II)	6,752,305	-	(6,752,305)	-	-
Groton substation (TP III)	408,641	-	-	-	408,641
Heartland headquarters building	2,837,333	-	-	-	2,837,333
General plant	759,685	51,600	-	-	811,285
Land	80,402	-	-	-	80,402
Construction in progress	1,280,756	1,346,656	-	(1,596,616)	1,030,796
Total capital assets	<u>67,760,179</u>	<u>1,464,960</u>	<u>(6,941,455)</u>	<u>-</u>	<u>62,283,684</u>
Less accumulated depreciation	<u>(47,499,907)</u>	<u>(1,323,122)</u>	<u>6,941,455</u>	<u>-</u>	<u>(41,881,574)</u>
Capital assets, net	<u>\$ 20,260,272</u>	<u>\$ 141,838</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 20,402,110</u>

Heartland Consumers Power District
Notes to Financial Statements
December 31, 2016 and 2015

Note 4: Capital Assets - Continued

	2015				Ending Balance
	Beginning Balance	Additions	Retirements	Transfers	
Missouri Basin Power Project	\$ 54,566,157	\$ 1,742	\$ (712,368)	\$ 700,233	\$ 54,555,764
Transmission Project I (TP I)	1,085,293	-	-	-	1,085,293
Transmission Project II (TP II)	6,752,305	-	-	-	6,752,305
Groton substation (TP III)	408,641	-	-	-	408,641
Heartland headquarters building	2,837,333	-	-	-	2,837,333
General plant	752,277	70,925	(63,517)	-	759,685
Land	80,402	-	-	-	80,402
Construction in progress	412,892	1,568,097	-	(700,233)	1,280,756
Total capital assets	66,895,300	1,640,764	(775,885)	-	67,760,179
Less accumulated depreciation	(47,033,390)	(1,242,402)	775,885	-	(47,499,907)
Capital assets, net	<u>\$ 19,861,910</u>	<u>\$ 398,362</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 20,260,272</u>

Heartland is a 24% of 75% (total of 18%) owner of TP I, which consists of approximately eight miles of 115 kv transmission line and associated switching equipment.

TP II consists of 3 115/69 kv substations, certain improvements to three East River Electric Power Cooperative (East River) 69/12.5 kv substations, three microwave towers and associated facilities, and approximately 51 miles of additions to East River 115 kv and 69 kv transmission lines, the additions owned jointly by Heartland and East River as tenants in common. Heartland holds a 99% ownership interest and East River a 1% ownership interest in those additions. East River has 100% use of this East River Section of TP II and purchases 100% of the total capacity of this section on a take-or-pay basis. In accordance with the terms of the agreement described in Note 7, East River executed its option to acquire Heartland's interest in TP II during 2016.

TP III consists of a 345/115 kv substation located near Groton, South Dakota; a 115 kv tie line between the Groton substation and the substation owned by Western Area Power Administration (WAPA); and a 115 kv circuit breaker in addition to the WAPA Groton substation for the termination of the tie line. Heartland owns a 3.9% share in TP III.

Heartland is also a 3% co-owner of the Missouri Basin Power Project, which includes Laramie River Station (LRS), a three-unit, 1,650 MW, coal-fired power supply station in eastern Wyoming, and a related transmission system.

LRS project participants, including Heartland, filed a rate case in 2004 with the federal Surface Transportation Board (STB) challenging the reasonableness of the freight rates charged by the Burlington Northern Santa Fe (BNSF) railroad for coal deliveries to LRS.

Heartland Consumers Power District
Notes to Financial Statements
December 31, 2016 and 2015

Note 4: Capital Assets - Continued

In early 2009, the STB issued its decision and awarded the LRS project participants a favorable decision estimated by the STB at approximately \$345 million in rate relief. The STB awarded \$119 million to the LRS participants for past freight overcharges plus an expectation of present value rate benefits of approximately \$245 million due to a new tariff the STB ordered to be charged through 2024. Of this total award, BNSF remitted approximately \$3.6 million to Heartland.

On January 28, 2015, Western Fuels and Burlington Northern Santa Fe (BNSF) filed a joint petition with the Surface Transportation Board (STB) asking the STB to hold the rate proceeding in abeyance due to the fact that the parties had reached a settlement that called for dismissal of the case and vacation of the rate prescription ordered by STB. In accordance with the settlement terms, Heartland remitted approximately \$600,000 back to BNSF during 2015.

Note 5: Credit Facilities

Line of Credit

In March 2015, Heartland entered into a revolving credit agreement with a financial institution that provides for borrowings up to \$25,000,000; secured by a subordinate lien on the revenues of Heartland's electric system. The agreement expires on March 23, 2018, and can be extended at the option of Heartland. Borrowings under the credit agreement bear interest at varying rates, and cannot exceed a maximum rate, as defined in the agreement (1.41% and 1.17% at December 31, 2016 and 2015, respectively). The agreement also provides for standby letters of credit, not to exceed \$5,000,000 in the aggregate. The amount available under Heartland's revolving credit agreement is reduced by the amount of any issued standby letters of credit. Heartland had outstanding borrowings of \$2,300,000 and \$4,000,000 on this line at December 31, 2016 and 2015, respectively. District management has created an internal loan amortization schedule to document their intent of repayment of the outstanding balance on the line of credit by February 2019. This internal amortization schedule shows principal repayments of \$600,000, \$1,200,000 and \$500,000 in 2017, 2018 and 2019, respectively.

Letter of Credit

As financial security for Heartland's performance under certain financial transmission rights and transmission congestion rights in regional transmission organizations in which Heartland participates, Heartland has obtained a standby letter of credit for \$1.5 million at December 31, 2016 and 2015. The letter of credit expires September 30, 2017, and can be renewed for an additional one-year term.

Heartland Consumers Power District
Notes to Financial Statements
December 31, 2016 and 2015

Note 6: Long-term Liabilities

Long-term liabilities at December 31, 2016 consisted of the following:

Type of Debt	2016				Due Within One Year
	January 1,	Additions	Reductions	December 31,	
4.75-5.25% Electric System Second Lien Revenue Bonds, Series 2011, with interest payments due semi-annually and principal payments due on January 1, 2016 and 2017	\$ 11,350,000	\$ -	\$ 5,750,000	\$ 5,600,000	\$ 5,600,000
1.0% Intermediary Relending Program Promissory Note, due annually on October 16 with a final payment due October 16, 2036	599,130	-	25,847	573,283	26,105
1.0% Intermediary Relending Program Promissory Note, due annually on June 25 with a final payment due June 25, 2040	605,518	-	26,196	579,322	26,029
1.0% Intermediary Relending Program Promissory Note, due annually on November 10, beginning in 2020, with a final payment due November 10, 2046; this Note is authorized, and expected, to be drawn to a maximum of \$1,000,000 in 2017	-	225,000	-	225,000	-
0% Rural Economic Development Promissory Note, with principal payments due in monthly installments of \$6,852 through July 31, 2019	294,620	-	82,224	212,396	82,224
0% Rural Economic Development Promissory Note, with principal payments due in monthly installments of \$3,299 through April 30, 2031	606,895	-	39,588	567,307	39,588
0% Rural Economic Development Promissory Note, with principal payments due in monthly installments of \$8,333 through December 31, 2025	1,000,000	-	99,996	900,004	100,000
Total bonds and notes payable	14,456,163	225,000	6,023,851	8,657,312	5,873,946
Compensated absences	327,804	99,682	99,716	327,770	82,572
Total long-term liabilities	<u>\$ 14,783,967</u>	<u>\$ 324,682</u>	<u>\$ 6,123,567</u>	<u>\$ 8,985,082</u>	<u>\$ 5,956,518</u>

Heartland Consumers Power District
Notes to Financial Statements
December 31, 2016 and 2015

Note 6: Long-term Liabilities - Continued

Long-term liabilities at December 31, 2015 consisted of the following:

Type of Debt	2015				Due Within One Year
	January 1,	Additions	Reductions	December 31,	
6.0% Electric System Revenue Bonds, Series 1992, due annually starting on January 1, 2015 with a final payment due January 1, 2017. Outstanding principal of \$9,760,000 was defeased in 2015	\$ 14,225,000	\$ -	\$ 14,225,000	\$ -	\$ -
4.29% Electric System Second Lien Revenue Note, Series 2010, due quarterly on January 1, April 1, July 1, and October 1 with final payment due on July 1, 2020. Callable at Heartland's option on June 1, 2013. Redeemed in full in 2015	4,682,443	-	4,682,443	-	-
4.75-5.25% Electric System Second Lien Revenue Bonds, Series 2011, with interest payments due semi-annually and principal payments due on January 1, 2016 and 2017	11,350,000	-	-	11,350,000	5,750,000
1.0% Intermediary Relending Program Promissory Note, due annually on October 16 with a final payment due October 16, 2036	624,721	-	25,591	599,130	25,847
1.0% Intermediary Relending Program Promissory Note, due annually on June 25 with a final payment due June 25, 2040	408,273	225,000	27,755	605,518	26,173
0% Rural Economic Development Promissory Note, with principal payments due in monthly installments of \$6,852 through July 31, 2019	376,844	-	82,224	294,620	82,224
0% Rural Economic Development Promissory Note, with principal payments due in monthly installments of \$3,299 through April 30, 2031	646,483	-	39,588	606,895	39,588
0% Rural Economic Development Promissory Note, with principal payments due in monthly installments of \$8,333 through December 31, 2025	-	1,000,000	-	1,000,000	100,000
Total bonds and notes payable	32,313,764	1,225,000	19,082,601	14,456,163	6,023,832
Compensated absences	307,773	154,697	134,666	327,804	92,739
Total long-term liabilities	<u>\$ 32,621,537</u>	<u>\$ 1,379,697</u>	<u>\$ 19,217,267</u>	<u>\$ 14,783,967</u>	<u>\$ 6,116,571</u>

Heartland Consumers Power District
Notes to Financial Statements
December 31, 2016 and 2015

Note 6: Long-term Liabilities - Continued

Debt service requirements at December 31, 2016 are as follows:

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2017	\$ 5,873,946	\$ 189,499	\$ 6,063,445
2018	274,483	30,772	305,255
2019	240,734	13,591	254,325
2020	233,512	12,202	245,714
2021	234,457	11,257	245,714
2022-2026	1,021,734	42,084	1,063,818
2027-2031	465,275	24,532	489,807
2032-2036	313,171	9,601	322,772
	<u>\$ 8,657,312</u>	<u>\$ 333,538</u>	<u>\$ 8,990,850</u>

The District has executed three credit agreements with two financial institutions, two for \$740,000 and the other for \$1,000,000, which is renewed annually. The credit agreements allow Heartland to retain drawing capacity at least equal to the issued and outstanding amount of the Rural Economic Development Promissory Notes. There were no amounts outstanding under these credit agreements at December 31, 2016 and 2015.

The principal and interest on the revenue notes and bonds are payable solely from, and secured solely by, a pledge of and lien on: (1) the revenues of Heartland's electric system, subject to prior payments there from of operation and maintenance expense; (2) the proceeds of the sale of the notes or bonds; and (3) all accounts established under the Bond Resolution, including income, if any, from investments thereof. The total principal and interest remaining to be paid on the secured bond is \$5,747,000, with the final payment on January 1, 2017 expecting to require approximately 10% of net revenues in 2017. Principal and interest for the current year and total operating revenues were \$6,180,563 and \$72,812,274, respectively.

Debt Defeasance

In March 2015, Heartland completed a transaction to defease the remaining outstanding balance of the Electric System Revenue Bonds, Series 1992 ("defeased bonds"). Under this transaction, Heartland used a total of \$10,638,621 to purchase U.S. government securities, which were then deposited with an escrow agent to provide for the future principal and interest payments on the defeased bonds. The outstanding balance of the defeased bonds was \$5,030,000 and \$9,760,000 at December 31, 2016 and 2015, respectively.

Heartland Consumers Power District

Notes to Financial Statements

December 31, 2016 and 2015

Note 7: Power Sales Agreements

Heartland is a party to electric power sales agreements with municipalities in South Dakota, Minnesota, Kansas and Iowa, whereby Heartland has undertaken to provide primary power to and to supplement existing power sources of the parties. Rates are established annually by the Board of Directors. The majority of these agreements expire in 2040.

Heartland has a power sales agreement with Northern Electric Cooperative, Inc. (Northern) to provide supplemental electric service to a small portion of Northern's service area under the same terms and conditions as the agreements with Heartland's municipal customers. Heartland also has power sales agreements with the State of South Dakota to provide service to various state institutions.

Heartland has an agreement with East River Electric Power Cooperative whereby East River will pay approximately 95% of the operating expenses of TP II on a take-or-pay basis. The payments are set to underwrite the cost of debt service on the associated bonds along with Heartland's overhead expenses. East River operates and maintains the facilities at its own expense. The contract continued until 2016, at which time East River may acquire Heartland's interest for \$1,000. East River executed this option in 2016 and acquired Heartland's interest.

Heartland entered into power sales agreements with Basin Electric Power Cooperative (Basin) whereby Heartland will sell and deliver approximately 50 MW of power to Basin through May 31, 2021. The agreements provide for a fixed energy rate throughout the term of the contracts.

Note 8: Commitments

Western Area Power Administration (WAPA)

Heartland has a long-term agreement with WAPA whereby WAPA is making available to Heartland the use of a shared transmission system. Effective September 1998, Heartland, WAPA, and Basin Electric Power Cooperative transmission facilities created the Integrated System (IS), which is a combined transmission system operated as a single integrated system by WAPA. The IS has been developed to allow for third-party transmission use consistent with the Federal Energy Regulatory Commission final orders and policies governing open access transmission service.

Public Power Generation Agency (PPGA)

Heartland has entered into an agreement with other utilities, creating an interlocal, PPGA. In connection with PPGA, Heartland has also entered into a long-term participation power agreement whereby the District has agreed to share in the energy output of the Whelan Energy Center Unit 2, a 220 MW coal-fired power plant, which became commercially operational in May 2011. Heartland's commitment is for 36.36%, or 80 MW, of the output of the project, which extends to the later of the life of the project or January 2041, which represents the date of final maturity on the bonds issued by PPGA for the project.

Heartland Consumers Power District

Notes to Financial Statements

December 31, 2016 and 2015

Note 8: Commitments - Continued

Energy Purchase Contracts

Heartland entered into an energy purchase contract with a national energy company to purchase 30 MW of energy at a fixed price during the period of January 1, 2014 through June 30, 2016. In connection with the agreement, Heartland received a \$6,000,000 advance payment from the energy company in 2012. This advance payment was recorded as unearned revenue and was recognized over the term of the contract as a reduction of the cost of the power purchased under the agreement.

Note 9: Retirement Plans

Defined Benefit Plan

Plan Description

Heartland contributes to the South Dakota Retirement System (the Plan), which is a cost-sharing, multiple-employer, public employee retirement system, providing retirement, disability and survivors benefits. The Plan is a defined benefit plan covering all full-time employees of the District. Authority for establishing, administering and amending plan provisions are found in South Dakota Codified Law 3-12. In accordance with the provisions of GASB Statement No. 68, the District accounts for and reports its participation in the Plan, based on its calculated proportionate share of contributions to the Plan. The Plan issues a publicly available financial report that includes financial statements and required supplementary information for the Plan. That report may be obtained at <http://www.sdrs.sd.gov/publications/> or by writing the South Dakota Retirement System, P.O. Box 1098, Pierre, SD 57501-1098.

Contributions

Covered employees are required by state statute to contribute a percentage of their salary (6%) to the Plan, and Heartland is required to match the employee contribution. Participating employers may also make an additional contribution of 1.50% of compensation for optional spouse coverage. The contribution requirements of plan members and Heartland are established and may be amended by the Plan's board of trustees. Contributions made to the Plan by Heartland were \$103,771 and \$99,453 during 2016 and 2015, respectively, and were in accordance with statutory rates. The employees' contributions during 2016 and 2015 were \$84,452 and \$82,227, respectively, and were in accordance with statutory rates.

Benefits

The Plan provides retirement, disability, and survivor benefits based on an employer's membership class within the Plan. Heartland is a Class A member in the Plan. Class A members who retire after age 65 with three years of service are entitled to an unreduced annual retirement benefit. An unreduced annual retirement benefit is also available after age 55 for Class A members, where the sum of age and credited service is greater than or equal to 85. The annual increase in benefits payable is indexed to the consumer price index annually on July 1st, with further adjustments based on the funded status of the Plan. The right to receive benefits vests after three years of credited service.

Heartland Consumers Power District
Notes to Financial Statements
December 31, 2016 and 2015

Note 9: Pension Plan - Continued

Defined Benefit Plan - Continued

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

At December 31, 2016, the District reported a liability of \$296,707 for its proportionate share of the collective net pension liability for the Plan. At December 31, 2015, the District reported an asset of \$370,005 for its proportionate share of the collective net pension asset for the Plan. The net pension liability and net pension asset were measured as of June 30, 2016 and 2015, respectively, and the total pension liability used to calculate these amounts was determined by an actuarial valuation as of those dates. The District's proportionate share of the net pension liability and net pension asset was based on the District's share of contributions to the Plan relative to all employer contributions to the Plan for the measurement period. At December 31, 2016 and 2015, the District's proportion was 0.088% and 0.087%, respectively.

For the years ended December 31, 2016 and 2015, the District recognized pension expense of \$92,371 and \$11,620, respectively. At December 31, 2016 and 2015, the District reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

	December 31, 2016		December 31, 2015	
	Deferred Outflows of Resources	Deferred Inflows of Resources	Deferred Outflows of Resources	Deferred Inflows of Resources
Differences between expected and actual experience	\$ 103,290	\$ -	\$ 75,760	\$ -
Net difference between projected and actual earnings on pension plan investments	330,039	-	-	319,919
Changes of assumptions	177,714	-	293,390	-
Change in Heartland's proportionate share of Heartland contributions subsequent to the measurement date	-	21,891	-	30,863
	<u>63,830</u>	<u>-</u>	<u>60,273</u>	<u>-</u>
Total	<u>\$ 674,873</u>	<u>\$ 21,891</u>	<u>\$ 429,423</u>	<u>\$ 350,782</u>

The deferred outflows of resources related to pensions resulting from District contributions subsequent to the measurement date will be recognized as a reduction of pension expense in the fiscal year ending December 31, 2017. Other amounts reported as deferred outflows of resources and deferred inflows of resources related to pensions will be recognized in pension expense as follows:

Year Ending December 31,	
2017	\$ 155,907
2018	90,763
2019	205,034
2020	<u>137,448</u>
	<u>\$ 589,152</u>

Heartland Consumers Power District
Notes to Financial Statements
December 31, 2016 and 2015

Note 9: Pension Plan - Continued

Defined Benefit Plan - Continued

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

Actuarial assumptions – The total pension liability in the June 30, 2016 and 2015 actuarial valuations was determined using the following actuarial assumptions, applied to all periods included in the measurement:

Inflation	3.25%
Salary increases	2016 - 5.83% at entry to 3.87% after 30 years of service 2015 - 5.83% at entry to 3.75% after 30 years of service
Discount rate	7.50%, net of pension plan investment expense

Mortality rates were based on the RP-2000 Mortality Table, projected generally with Scale BB and with rates reduced to fit recent experience.

The actuarial assumptions used in the June 30, 2016 and 2015 valuations were based on the results of an actuarial experience study, which covered the five-year period ending June 30, 2011.

The long-term expected rate of return on pension plan investments was determined using a method in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. These ranges are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. 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
December 31, 2016		
Global Equity	58.0%	4.8%
Fixed Income	30.0%	1.8%
Real Estate	10.0%	4.6%
Cash	2.0%	0.7%
Total	100.0%	
December 31, 2015		
Global Equity	61.0%	4.5%
Fixed Income	27.0%	1.8%
Real Estate	10.0%	5.2%
Cash	2.0%	0.0%
Total	100.0%	

Heartland Consumers Power District
Notes to Financial Statements
December 31, 2016 and 2015

Note 9: Pension Plan - Continued

Defined Benefit Plan - Continued

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

Discount rate – The discount rate used to measure the total pension liability was 7.50% for 2016 and 2015. The projection of cash flows used to determine the discount rate assumed that contributions from plan members will be made at the current contribution rate, and that contributions from employers will be made at contractually required rates. Based on those assumptions, the pension plan’s fiduciary net position was projected to be available to make all projected future benefit payments of current plan members. Therefore, the long-term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the total pension liability.

Sensitivity of the District’s proportionate share of the net pension asset (liability) to changes in the discount rate – The following presents the District’s proportionate share of the net pension asset (liability) calculated using the discount rate of 7.50%, as well as what the District’s proportionate share of the net pension asset (liability) would be if it were calculated using a discount rate that is one percentage point lower (6.50%) or one percentage point higher (8.50%) than the current rate.

	1% Decrease (6.50%)	Current Discount Rate (7.50%)	1% Increase (8.50%)
District's proportionate share of the net pension asset (liability) December 31, 2016	\$ (1,660,371)	\$ (296,707)	\$ 815,507

Pension Plan Fiduciary Net Position

Detailed information about the pension plan’s fiduciary net position is available in the separately issued South Dakota Retirement System financial report.

Defined Contribution Plan

In addition to the above retirement plan, Heartland has a savings plan with the National Rural Electric Cooperative Association, which is a defined contribution plan. Employees are eligible to participate in this plan after one month of service. The National Rural Electric Cooperative Association board of directors has the authority to establish and amend provisions to the plan. Heartland matches up to 4% of participating employees’ salaries; employees must contribute a minimum of 1% of their salaries. The contributions made by, and related expense of, Heartland for the years ended December 31, 2016 and 2015 were \$57,691 and \$56,878, respectively. No forfeitures were used to reduce Heartland’s contributions during 2016 and 2015. The contributions made by Heartland employees for the years ended December 31, 2016 and 2015 were \$85,966 and \$82,020, respectively.

Heartland Consumers Power District
Notes to Financial Statements
December 31, 2016 and 2015

Note 10: Significant Estimates and Concentrations

Major Customers

Sales to two customers were approximately 37% and 51% of total operating revenues for the years ended December 31, 2016 and 2015, respectively. Approximately 24% and 57% of total accounts receivable were owed from three customers at December 31, 2016 and 2015, respectively.

Proposed Environmental Standards

In June 1999, the Environmental Protection Agency (EPA) issued final regulations for a Regional Haze Program. The purpose of the regulations is to improve visibility in the form of reduced regional haze in 156 national parks and wilderness areas across the country. The EPA's claim is that haze is formed, in part, from emissions of SO₂ (sulfur dioxide) and NO₂ (nitrogen dioxide). Heartland is impacted by these regulations through its co-ownership of Laramie River Station (LRS) in Wyoming.

As part of the EPA's Clean Air Act regulations, each state is required to submit a state implementation plan (SIP) identifying the emission control technology proposed to comply with the Regional Haze Program. The State of Wyoming submitted its SIP to the EPA in 2011, which included plans for LRS. In January 2014, the EPA issued their final ruling on this SIP, requiring installation of selective catalytic reduction (SCR) NO₂ removal technology for five coal plants in Wyoming, including the three units at LRS. MBPP is currently evaluating the impact of this decision and its options in responding to the decision.

The EPA's final rule is expected to impose significant future costs at LRS, as a result of the extensive renovations at these facilities, the high capital cost of the SCR equipment and dramatically increased operating costs associated with SCRs. Although initial estimates of these costs have been calculated, the level of regulatory and legal uncertainty related to these facilities makes it impractical to quantify the specific potential financial impacts at this time.

Note 11: Risk Management

Heartland 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 others; and natural disasters. Heartland carries commercially available insurance, subject to certain limits and deductibles, to reduce the financial impact for claims arising from such matters. Claims have not exceeded this commercial coverage in any of the three preceding years.

Heartland Consumers Power District

Notes to Financial Statements

December 31, 2016 and 2015

Note 12: Statutory Reporting Requirement

Section 3 of Chapter 49-38 of the South Dakota Codified Laws requires that certain information be set forth in the annual reports of consumer power districts. Additional information, as required, is as shown below:

	<u>2016</u>	<u>2015</u>
Employees (unaudited)	12	12
Total salaries	\$ 1,422,500	\$ 1,377,344
Maintenance expense	\$ 220,820	\$ 301,994
Total kilowatt hours sold (unaudited)	1,282,757,118	1,497,663,374

Note 13: Segment Information

In accordance with the provisions of the Intermediary Relending Program Loan Agreements, Rural Economic Development Loan Agreement and Rural Economic Development Grant Agreement, Heartland is required to create and maintain a revolving loan fund. Heartland administers this revolving loan fund as a division within its District operations. Condensed 2016 and 2015 financial information for the revolving loan fund is presented below:

Condensed Balance Sheet

	<u>2016</u>	<u>2015</u>
Current assets	\$ 1,551,824	\$ 1,545,902
Other assets	2,613,527	2,679,193
Total assets	<u>\$ 4,165,351</u>	<u>\$ 4,225,095</u>
Liabilities		
Current liabilities	\$ 278,623	\$ 277,802
Noncurrent liabilities	2,783,367	2,832,331
Total liabilities	3,061,990	3,110,133
Net Position	<u>1,103,361</u>	<u>1,114,962</u>
Total liabilities and net position	<u>\$ 4,165,351</u>	<u>\$ 4,225,095</u>

Heartland Consumers Power District

Notes to Financial Statements

December 31, 2016 and 2015

Note 13: Segment Information - Continued

Condensed Statement of Revenues, Expenses and Changes in Net Position

	<u>2016</u>	<u>2015</u>
Nonoperating revenues (expenses)		
Investment income	\$ 37,871	\$ 28,668
Interest expense	(12,017)	(10,885)
Bad debt recoveries (expense)	(17,007)	(10,358)
Other	(20,448)	292,120
Capital contributions	<u>-</u>	<u>75,000</u>
Increase (Decrease) in Net Position	(11,601)	374,545
Net Position, Beginning of Year	<u>1,114,962</u>	<u>740,417</u>
Net Position, End of Year	<u><u>\$ 1,103,361</u></u>	<u><u>\$ 1,114,962</u></u>

Condensed Statement of Cash Flows

Net cash provided by (used in)		
Noncapital financing activities	\$ (80,608)	\$ 1,331,632
Investing activities	<u>63,114</u>	<u>(1,013,035)</u>
Increase (Decrease) in Cash	(17,494)	318,597
Beginning of year	<u>1,140,292</u>	<u>821,695</u>
End of year	<u><u>\$ 1,122,798</u></u>	<u><u>\$ 1,140,292</u></u>

Required Supplementary Information

Heartland Consumers Power District
Schedule of Heartland's Proportionate Share of the Net Pension Asset (Liability)
South Dakota Retirement System
December 31, 2016

	2016	2015	2014
Heartland's proportion of the net pension asset (liability)	0.088%	0.087%	0.097%
Heartland's proportionate share of the net pension asset (liability)	\$ (296,707)	\$ 370,005	\$ 697,294
Heartland's covered-employee payroll	\$ 1,394,520	\$ 1,390,734	\$ 1,404,232
Heartland's proportionate share of the net pension asset (liability) as a percentage of its covered-employee payroll	-21.28%	26.61%	49.66%
Plan fiduciary net position as a percentage of the total pension liability	96.89%	104.10%	107.29%

Note: This schedule is presented to illustrate the requirement to show information for 10 years. However, until a full 10-year trend is compiled, the District will present information for only those years for which information is available. Information presented in this schedule has been determined as of the District's measurement date (June 30) of the collective net pension asset (liability) in accordance with GASB 68.

Heartland Consumers Power District
Schedule of Heartland Contributions
South Dakota Retirement System
December 31, 2016

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Statutorily required contribution	\$ 103,771	\$ 99,453	\$ 97,153
Contributions in relation to the statutorily required contribution	<u>(103,771)</u>	<u>(99,453)</u>	<u>(97,153)</u>
Contribution deficiency (excess)	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
Heartland's covered-employee payroll	\$ 1,422,500	\$ 1,377,344	\$ 1,414,132
Contributions as a percentage of covered-employee payroll	7.29%	7.22%	6.87%

Note: This schedule is presented to illustrate the requirement to show information for 10 years. However, until a full 10-year trend is compiled, the District will present information for only those years for which information is available. Information presented in this schedule has been determined as of the District's most recent fiscal year-end (December 31) in accordance with GASB 68.

Other Information

Heartland Consumers Power District
Schedule of Transmission Operation and Maintenance Expenses
FERC Uniform System of Accounts Classification
Year Ended December 31, 2016

	Amount
Operation	
560 – Operation Supervision and Engineering	\$ 50,061
561 – Load Dispatching	-
561.1 – Load Dispatch – Reliability	-
561.2 – Load Dispatch – Monitor and Operate Transmission System	-
561.3 – Load Dispatch – Transmission Service and Scheduling	-
561.4 – Scheduling, System Control and Dispatch Services	-
561.5 – Reliability, Planning and Standards Development	-
561.6 – Transmission Service Studies	-
561.7 – Generation Interconnection Studies	-
561.8 – Reliability, Planning and Standards Development Service	-
562 – Station Expenses	34,159
563 – Overhead Lines Expenses	32,879
564 – Underground Lines Expenses	-
565 – Transmission of Electricity by Others	6,244,932
566 – Miscellaneous Transmission Expenses	21,230
567 – Rents	-
Total Operation Expense	6,383,261
Maintenance	
568 – Maintenance Supervision and Engineering	-
569 – Maintenance of Structures	-
569.1 – Maintenance of Computer Hardware	-
569.2 – Maintenance of Computer Software	-
569.3 – Maintenance of Communication Equipment	-
569.4 – Maintenance of Miscellaneous Regional Transmission Plant	-
570 – Maintenance of Station Equipment	(40,106)
571 – Maintenance of Overhead Lines	26,893
572 – Maintenance of Underground Lines	-
573 – Maintenance of Miscellaneous Transmission Plant	30,612
Total Maintenance Expense	17,399
Total Transmission O&M Expense	\$ 6,400,660

Heartland Consumers Power District
Schedule of Administrative and General Expenses
FERC Uniform System of Accounts Classification
Year Ended December 31, 2016

	Amount
Customer Accounts Expenses	
901 – Supervision	\$ -
902 – Meter Reading Expenses	-
903 – Customer Records and Collection Expenses	-
904 – Uncollectible Accounts	-
905 – Miscellaneous Customer Accounts Expenses	-
	-
Total Customer Accounts Expense	-
Customer Service and Informational Expenses	
907 – Supervision	214,893
908 – Customer Assistance Expenses	287,214
909 – Informational and Instructional Expenses	-
910 – Miscellaneous Customer Service and Informational Expenses	-
	-
Total Customer Service and Informational Expenses	502,107
Sales Expenses	
911 – Supervision	-
912 – Demonstrating and Selling Expenses	-
913 – Advertising Expenses	-
916 – Miscellaneous Sales Expenses	-
	-
Sales Expenses	-
Administrative and General Expenses	
920 – Administrative and General Salaries	1,220,477
921 – Office Supplies and Expenses	181,055
922 – Administrative Expenses Transferred Credit	-
923 – Outside Services Employed	420,853
924 – Property Insurance	8,050
925 – Injuries and Damages	14,625
926 – Employee Pension and Benefits	553,495
927 – Franchise Requirements	-
928 – Regulatory Commission Expenses	50,920
929 – Duplicate Charges Credit	-
930.1 – General Advertising Expenses	31,857
930.2 – Miscellaneous General Expenses	669,189
931 – Rents	-
935 – Maintenance of General Plant	196,565
	196,565
Administrative and General Expenses	3,347,086
Total	\$ 3,849,193