FINANCIAL STATEMENTS WITH
REPORT OF INDEPENDENT AUDITORS

EAST TEXAS ELECTRIC COOPERATIVE, INC.

December 31, 2017 and 2016

AXLEY & RODE LLP
CERTIFIED PUBLIC ACCOUNTANTS

C O N T E N T S

REPORT OF INDEPENDENT AUDITORS

The Board of Directors
East Texas Electric Cooperative, Inc.
Nacogdoches, Texas

We have audited the accompanying financial statements of East Texas Electric Cooperative, Inc. (the "Cooperative") which comprise the balance sheets as of December 31, 2017 and 2016 and the related statements of revenue and expense, comprehensive income, patronage capital and other equities and cash flows for the years then ended and the related notes to the financial statements.

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 and the standards for financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain 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 Cooperative'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 Cooperative'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 East Texas Electric Cooperative, Inc. as of December 31, 2017 and 2016, and the results of its operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Other Matters

In accordance with *Government Auditing Standards*, we have also issued our report dated April 12, 2018, on our consideration of the Cooperative's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Axley & Rode LLP
CERTIFIED PUBLIC ACCOUNTANTS

Lufkin, Texas
April 12, 2018

EAST TEXAS ELECTRIC COOPERATIVE, INC.
BALANCE SHEETS
December 31, 2017 and 2016

	2017	2016
ASSETS		
Utility Plant:		
Utility plant in service	$ 787 669 276	$ 780 850 676
Construction work in progress	116 448 195	86 550 947
	904 117 471	867 401 623
Less accumulated provision for depreciation	248 587 648	220 452 590
	655 529 823	646 949 033
Investments and Other Assets:		
Investments in associated organizations	33 807 145	34 197 813
Other investments - RUS cushion of credit	30 170 521	28 708 313
Funds held in escrow	27 824 747	47 586 922
	91 802 413	110 493 048
Current Assets:		
Cash and cash equivalents	4 829 081	8 313 617
Accounts receivable from member cooperatives	24 965 409	25 943 574
Accounts receivable - Other	861 619	445 064
Certificates of deposit	5 259 000	5 013 000
Investment securities - Available for sale	3 177 635	3 317 706
Fuel stock	3 434 112	5 463 217
Materials and supplies	10 373 146	9 954 141
Other current assets	1 534 280	3 236 671
	54 434 282	61 686 990
Deferred debits	160 261 080	168 548 132
	$ 962 027 598	$ 987 677 203
EQUITIES AND LIABILITIES		
Equity and Margin:		
Memberships	$ -	$ 15 000
Patronage capital	117 423 533	107 581 406
Accumulated comprehensive income (loss)	(68 623)	(54 246)
	117 354 910	107 542 160
Long-term debt, less current maturities	768 420 529	800 602 786
Current Liabilities:		
Accounts payable - Purchased power	13 079 013	12 545 602
Accounts payable - Other	11 577 525	12 110 830
Accrued expenses	8 394 728	6 594 422
Line of credit - General	5 500 000	11 000 000
Current maturities of long-term debt	37 700 893	37 086 871
	76 252 159	79 337 725
Deferred credits	-	194 532
	$ 962 027 598	$ 987 677 203

The accompanying notes are an integral part of these financial statements.

EAST TEXAS ELECTRIC COOPERATIVE, INC.
STATEMENTS OF REVENUE AND EXPENSE
For the Years Ended December 31, 2017 and 2016

	2017	2016
Operating Revenues:		
Power sales - Members	$ 251 147 269	$ 257 602 818
Other electric revenues	7 909 043	7 609 255
	259 056 312	265 212 073
Operating Expenses:		
Purchased power	61 984 550	62 173 748
Power Generation:		
Fuel	52 743 196	54 087 196
Other production expenses	33 459 237	36 062 343
Transmission	31 477 628	33 388 452
Administrative and general	9 889 395	7 841 593
Depreciation	28 158 574	34 857 525
Amortization of regulatory asset	8 054 539	-
Other deductions - Plant impairment	-	963 546
	225 767 119	229 374 403
OPERATING MARGINS BEFORE INTEREST EXPENSE	33 289 193	35 837 670
Interest expense	28 988 122	30 162 950
OPERATING MARGINS	4 301 071	5 674 720
Nonoperating Margins:		
Other income	48 957	200 000
Interest income	2 957 107	2 504 645
Capital credits and patronage capital allocations	2 534 992	2 049 444
NET MARGINS	$ 9 842 127	$ 10 428 809

The accompanying notes are an integral part of these financial statements.

EAST TEXAS ELECTRIC COOPERATIVE, INC.
STATEMENTS OF COMPREHENSIVE INCOME
For the Years Ended December 31, 2017 and 2016

		2017		2016
NET MARGINS	$	9 842 127	$	10 428 809
Other Comprehensive Income (Loss):				
Unrealized gains (losses) on available for sale securities		(14 377)		(54 246)
Unrealized gains (losses) on cash flow hedge		-		3 467 288
OTHER COMPREHENSIVE INCOME (LOSS)		(14 377)		3 413 042
COMPREHENSIVE INCOME	$	9 827 750	$	13 841 851

The accompanying notes are an integral part of these financial statements.

EAST TEXAS ELECTRIC COOPERATIVE, INC.
STATEMENTS OF PATRONAGE CAPITAL AND OTHER EQUITIES
For the Years Ended December 31, 2017 and 2016

	MEMBERSHIPS	PATRONAGE CAPITAL	ACCUMULATED COMPREHENSIVE INCOME (LOSS)	TOTAL
Balance, December 31, 2015	$ 15 000	$ 97 152 597	$ (3 467 288)	$ 93 700 309
Net margins	-	10 428 809	-	10 428 809
Other comprehensive income (loss)	-	-	3 413 042	3 413 042
Balance, December 31, 2016	15 000	107 581 406	(54 246)	107 542 160
Net margins	-	9 842 127	-	9 842 127
Memberships	(15 000)	-	-	(15 000)
Other comprehensive income (loss)	-	-	(14 377)	(14 377)
Balance, December 31, 2017	$ -	$ 117 423 533	$ (68 623)	$ 117 354 910

The accompanying notes are an integral part of these financial statements.

EAST TEXAS ELECTRIC COOPERATIVE, INC.
STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2017 and 2016

	2017	2016
Operating Activities:		
Net margins	$ 9 842 127	$ 10 428 809
Adjustments to Reconcile Net Margins to Net Cash Provided by Operating Activities:		
Depreciation	28 158 574	34 857 525
Amortization	8 054 539	-
Patronage capital credits - Non-cash	(941 812)	(790 139)
Impairment loss	-	963 545
Reinvested dividends on investment securities	(17 737)	(13 923)
Cash Provided by (Used for) the Change in:		
Accounts receivable - Members	978 165	(5 134 648)
Accounts receivable - Other	(416 555)	30 842
Fuel stock	2 029 105	1 768 829
Materials and supplies	(419 005)	(80 775)
Other current assets	1 736 040	(528 078)
Deferred debits	175 350	(4 188 779)
Accounts payable	533 411	5 181 733
Accounts payable - Other	132 018	(266 043)
Accrued expenses	1 800 304	(1 601 231)
Deferred credits	(194 532)	194 532
NET CASH PROVIDED BY OPERATING ACTIVITIES	51 449 992	40 822 199
Investing Activities:		
Capital expenditures (including interest capitalized)	(37 381 171)	(28 151 546)
Redemption of CFC loan certificates	1 332 480	2 436 575
RUS cushion of credit	(1 462 208)	(15 833 405)
Funds held in escrow	19 762 175	16 057 195
Certificates of deposit	(246 000)	609 102
Other investments	143 431	284 705
NET CASH USED BY INVESTING ACTIVITIES	(17 851 293)	(24 597 374)
Financing Activities:		
Loan advances - RUS	-	12 002 264
Loan advances - Others	-	46 535 625
Loan payments to RUS	(18 696 064)	(17 535 798)
Loan payments - Others	(16 360 236)	(11 171 761)
Memberships	(15 000)	-
Clean Renewable Energy Bonds	(7 523 214)	(7 523 212)
Loan payoff - Others	-	(42 083 333)
Net activity - Syndicated facility/lines of credit	5 511 279	5 904 755
NET CASH USED BY FINANCING ACTIVITIES	(37 083 235)	(13 871 460)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(3 484 536)	2 353 365
Cash and cash equivalents, beginning of year	8 313 617	5 960 252
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 4 829 081	$ 8 313 617
Supplemental Disclosures of Cash Flow Information:		
Cash paid for interest	$ 30 023 583	$ 32 169 664

EAST TEXAS ELECTRIC COOPERATIVE, INC.
STATEMENTS OF CASH FLOWS - CONTINUED
For the Years Ended December 31, 2017 and 2016

		2017		2016
Supplemental Schedule of Non-Cash Investing and Financing Activities:				
Utility plant transferred to deferred debits as a regulatory asset	$	-	$	164 888 857
Unrealized loss on investment available for sale	$	(14 377)	$	(54 246)
Increase (decrease) in accounts payable for capital expenditures	$	7 197 415	$	7 862 738

The accompanying notes are an integral part of these financial statements.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations:

East Texas Electric Cooperative, Inc. ("Cooperative") is an electric generating and transmission cooperative formed and operating pursuant to the Texas Electric Cooperative Corporation Act. The Cooperative was created by, and on behalf of, its members, Northeast Texas Electric Cooperative, Inc. ("NTEC"), Sam Rayburn G & T Electric Cooperative, Inc. ("SRG&T"), and Tex-La Electric Cooperative of Texas, Inc. ("Tex-La") ("Members") for the purpose of providing wholesale electric service to the Members. The Cooperative supplies a portion of each Member's power needs. Each of the Members in turn provides wholesale electric power to its member distribution cooperatives.

Use of Estimates:

The preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities. The estimates and assumptions used in the accompanying financial statements are based upon management's evaluation of the relevant facts and circumstances as of the date of the financial statements. Actual results may differ from the estimates and assumptions used in preparing the accompanying financial statements.

System of Accounts:

The Cooperative maintains its accounting records in accordance with the Federal Energy Regulatory Commission's ("FERC") Uniform System of Accounts as adopted by the USDA Rural Development's Rural Utilities Service ("RUS"), which conforms with U.S. generally accepted accounting principles in all material respects. The more significant accounting policies are described below.

Revenue Recognition:

Revenues from the sale of electricity are recorded based on billings to Members.

Cash Flows Statement:

For purposes of reporting cash flows, cash and cash equivalents consist of cash and temporary cash investments with original maturities of three months or less.

Accounts Receivable:

Accounts receivable from member cooperatives are recorded from the billings of the sale of electricity to the Members. The Cooperative considers accounts receivable to be fully collectible; accordingly, no allowance for doubtful accounts has been established. If accounts become uncollectible, they will be charged to operations when that determination is made. No accounts receivable from Member Cooperatives were past due more than 90 days at December 31, 2017 and 2016.

Utility Plant:

The utility plant is stated at original cost. The cost of additions to the electric plant includes contracted work, direct labor, materials, allocable overhead and interest on debt used for construction. The cost of retirements, replacements, or betterments are removed from utility plant and, in accordance with industry practice, the cost of the unit and its removal cost, less salvage, are charged to accumulated depreciation. Maintenance and repairs are charged to operating expenses as incurred.

Depreciation of the utility plant is provided on the composite straight-line method over the estimated useful lives of the various components. The method and rates are prescribed by RUS or as approved for rate-making purposes. The annual depreciation rates are:

Transmission	2.75%
Production plant	3.226% - 6.67%
Load dispatching equipment	6.67%

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - CONTINUED

In accordance with Financial Accounting Standards Board ("FASB") ASC Topic 360-10, *Impairment of Long-Lived Assets,* the Cooperative evaluates, when indicators of impairment are identified, the carrying amount of its long-lived assets. Recoverability is determined by comparing the projected undiscounted net cash flows of the long-lived assets against their respective carrying amounts. The amount of impairment, if any, is measured based upon the excess of the carrying value over the fair value. During the year ended December 31, 2016, the Cooperative recorded an impairment charge in the amount of $164,888,857 related to its Hilton Lively Renewable Power Project (Note 2).

Investments in Associated Organizations:

Investments in patronage capital credits of associated organizations are accounted for under the equity method. Patronage capital is recorded at the stated amount of the certificate when allocated by the associated organization.

Investment Securities:

The Cooperative's investment securities are classified as available for sale. These securities are carried at estimated fair value with any unrealized gains or losses excluded from net margin and reported in accumulated other comprehensive income (loss), which is reported as a separate component of members' equity.

Premiums and discounts on securities available for sale are recognized in interest income using a method approximating the interest method over the period to expected maturity. Purchases and sales of securities are accounted for on a trade date basis on a specific identification basis.

Declines in the estimated fair value of individual securities below their cost that are other-than-temporary are accounted for as a write-down of the individual securities to their fair value. Any related write-downs are included in earnings as realized losses.

Unrealized holding gains and losses on securities available for sale are reported in other comprehensive income. Realized gains and losses on securities available for sale are included in gains and losses on sale of available for sale securities in the statement of operations and, when applicable, are reported as a reclassification adjustment in other comprehensive income. Gains and losses on the sale of securities are determined using the specific-identification method.

Fair Value Measurements:

The fair value of financial assets and liabilities is measured according to the *Fair Value Measurements and Disclosure* topic of FASB Accounting Standards Codification. Fair Value is required to be evaluated and adjusted according to the following valuation techniques.

Level 1 - Fair value is determined using quoted market prices in active markets for identical assets and liabilities.

Level 2 - Fair value is determined using quoted market prices in active markets for similar assets and liabilities, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant inputs are observable in the market for substantially the full term of the assets or liabilities.

Level 3 - Fair value is determined using inputs that are generally unobservable and typically reflect management's estimates of assumptions that market participants would use in pricing the asset or liability. The market for assets and liabilities using Level 3 measures is typically inactive.

Inventories:

Inventory consists of fuel stock (primarily coal) for operation of the electric plants. Fuel inventory is carried at weighted average cost. Materials and supplies inventory used for the operation of the electric plants is valued at average cost and is stated at the lower of average cost or net realizable value (NRV), with NRV determined to be the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. Cost is determined using the average cost method and includes all costs related to acquisition.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - CONTINUED

Allowance for Borrowed Funds Used During Construction:

The Cooperative capitalizes the carrying costs on certain significant construction and development projects while in progress. Interest is capitalized based on the debt specifically borrowed to finance projects during construction and is reflected as a credit to interest expense in the Statement of Revenue and Patronage Capital. For the years ended December 31, 2017 and 2016, capitalized interest was approximately $1,016,093 and $1,823,000, respectively.

Income Taxes:

The Cooperative is exempt from Federal income tax under the provisions of Section 501(c)(12) of the Internal Revenue Code of 1986.

Uncertain Tax Positions:

Financial Accounting Standards Board Codification Section 740 requires recognition, measurement and disclosure of uncertain tax positions. The Cooperative currently accounts for uncertain tax positions based on the estimated likelihood of assessment and has not determined that any tax positions require an accrual based on current standards of accounting. For federal income tax purposes the tax returns essentially remain open for possible examination for a period of three years after the date on which those returns are filed.

Comprehensive Income:

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net margin. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities and cash flow hedges are reported as a separate component of the equity section of the balance sheet, such items, along with net margin, are components of comprehensive income.

Deferred Debits/Credits:

In accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 980: *Regulated Operations* (formerly FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*), certain costs have been capitalized as deferred debits that would otherwise be charged to expense. Such deferred debits are recorded when it is probable that future revenue in an amount at least equal to the capitalized costs will result from inclusion of those costs in future rates. Accordingly, certain obligations have been accrued as deferred credits that would otherwise be charged to income. Such deferred credits are recorded when it is probable that future expenses in an amount at least equal to the accrued liabilities will result from inclusion of those revenues in future rates.

Derivative Instruments:

The Cooperative is exposed to various market risks in the course of its business activities, including changes in interest rate. Management has established risk management policies and strategies to reduce the potentially adverse effects that the volatility of the markets may have on its operations. These policies and strategies include the use of derivative instruments in the form of interest rate swaps for the purpose of hedging volatility in interest rates. The Cooperative's policy is that derivatives are to be used only for hedging purposes and Management does not engage in transactions unrelated to the underlying financial exposures. The Cooperative does not enter into derivative financial instruments for trading purposes.

Regional Transmission Organizations:

The Cooperative is a member and participates in both the Midcontinent Independent System Operator (MISO) Regional Transmission Organization (RTO) Southwest Power Pool (SPP) RTO. Both RTO's operate wholesale electric markets and are responsible for moving electricity over large interstate areas. They also coordinate, control and monitor the electric transmission grid within their areas. As a result of this, the Cooperative now sells all plant generation into the RTO markets and purchases power to serve a large portion of its load from markets. The Cooperative records RTO transactions on an hour-to-hour basis. Transactions within each individual hour are netted to a single purchase or sale based on actual load and net megawatt-hour generation.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - CONTINUED

Subsequent Events:

Management has evaluated subsequent events through April 12, 2018 the date the financial statements were available to be issued. Subsequent to the year-ended December 31, 2017, two of the Cooperative's Members, SRG&T and Tex-La, were merged with and into the Cooperative. The Cooperative will continue its electric cooperative corporation existence under the Texas Electric Cooperative Corporation Act as the surviving entity in the merger, and the separate existence of SRG&T and Tex-La will cease (Note 18).

NOTE 2 - UTILITY PLANT

The following summarizes utility plant at December 31, 2017 and 2016:

	2017	2016
Utility Plant, at Cost:		
Transmission	$ 60 315 788	$ 58 164 419
Production plant	726 757 291	722 125 869
Load dispatching equipment	221 251	221 251
Office equipment	374 946	339 137
	787 669 276	780 850 676
Construction work in progress	116 448 195	86 550 947
	904 117 471	867 401 623
Less accumulated depreciation	248 587 648	220 452 590
	$ 655 529 823	$ 646 949 033

The Cooperative has an undivided ownership in and is responsible for providing its share of the costs for its jointly owned and other power plant facilities. The Cooperative's share of each facility at December 31, 2017, is as follows:

Nelson Unit 6 (50Mw)	9.10%
Independence Steam Electric Station Unit 2 ("ISES 2") (60Mw)	7.13%
Plum Point Energy Station ("Plum Point") (50Mw)	7.52%
John W. Turk Power Plant("Turk") (50Mw)	8.33%
Harrison County Power Project ("HCPP") (248Mw)	45.00%
Hardin County Units 1 and 2 (150Mw)	100.00%
San Jacinto Units 1 and 2 (150Mw)	100.00%
Hilton Lively Renewable Power Project (49Mw)	100.00%

In addition to the above plants that are currently in operation, the Cooperative has additional significant investments in the following power plant project under construction or development:

R.C. Thomas Hydroelectric Project (24Mw) (under construction)	100.00%

The Cooperative is constructing, in cooperation with the Trinity River Authority of Texas ("Authority") and the City of Houston, Texas, a hydropower facility with an installed capacity of approximately 24Mw to be located at the Lake Livingston Dam. The estimated total cost to construct the hydropower facility is $149,500,000. The project is under construction as of December 31, 2017. The Cooperative has been approved for and has issued a total of $106,355,693 in Clean Renewable Energy Bonds (CREBS) (Note 9). The Cooperative intends to finance the project with the use of allocated CREBS related to the project and to use RUS funds for their remaining financing needs.

During the year ended December 31, 2016, the Cooperative elected to temporarily suspend operations at the Hilton Lively Renewable Power Project. Due to several operational challenges including steep declines in natural gas prices and lower wholesale energy prices in the MISO market, the Project was determined to no longer be economically viable to operate under current conditions. During the suspension of commercial operations, the Project is being maintained in a condition such that commercial operations could be resumed in a matter of months, if economic conditions warrant. Economic conditions that could change and make the Project more competitive includes increased cost of natural gas and wholesale electricity market prices, increased loads, increased congestion in the region directly adjacent to the Project, and increased cost of the generation of electricity from resources emitting carbon dioxide.

NOTE 2 - UTILITY PLANT - CONTINUED

As a result of the temporary suspension, the Cooperative applied the provisions of ASC 360-10, *Impairment of Long-Lived Assets,* and performed an impairment analysis. Under generally accepted accounting principles the determination of an asset's recoverability is based on the probability-weighted net cash flows expected to be generated. The projected net cash flows primarily depend on the status of operations as well as projections of future revenues and costs over the estimated remaining life of the Project. The Cooperative performed the impairment analysis based upon energy and capacity price curves, as applicable, which were developed internally with both observable Level 2 quotations and unobservable Level 3 inputs, as well as management's forecasts of fuel, operating, and capital expenditures. As of December 31, 2016, the estimated fair value of the Project was determined to be $17,766,600, while the carrying value was $182,655,457, resulting in an impairment charge of $164,888,857.

The Cooperative applied for and received approval from RUS to defer $163,925,311 of the impairment charge for future rate recovery as a regulatory asset. The Cooperative will amortize and recover the regulatory asset over a period of twenty-one years beginning January 2017 using a regulatory method based on the bonds outstanding. The remaining net impairment of $963,545 was written-off in 2016 and reported as another deduction in operating expenses on the Statement of Revenues and Expenses.

For the year ended December 31, 2017, the amount amortized and recovered through rates was $8,054,539 and the remaining balance of the regulatory asset is $155,870,772.

Investments in associated organizations at December 31, 2017 and 2016 consisted of the following:

	2017	2016
National Rural Utilities Cooperative Finance Corporation (CFC):		
Patronage capital and Membership	$ 5 924 500	$ 5 308 003
Loan capital term certificates	26 684 773	28 017 253
CoBank:		
Patronage capital and Membership	1 197 872	872 557
	$ 33 807 145	$ 34 197 813

Patronage capital allocations reported in the Statements of Revenue and Expenses in the amount of $2,534,992 and $2,049,444 for the fiscal years ended December 31, 2017 and 2016, respectively, represent patronage capital allocations from CoBank and CFC.

NOTE 4 - OTHER INVESTMENTS - RUS CUSHION OF CREDIT

The Cooperative established a Cushion of Credit Account with RUS. The account represents voluntary payments to RUS in excess of amounts due and is intended to enable the Cooperative to have funds available to make scheduled payments on RUS debt. By law, the account earns five percent interest annually and can only be used to make installments on RUS mortgage notes.

NOTE 5 - INVESTMENT SECURITIES AND FAIR VALUE MEASUREMENTS

Investments securities consisted of investments in fixed income mutual funds and government bonds with an estimated fair value of $3,177,635 and $3,317,706 at December 31, 2017 and 2016, respectively. The amount of unrealized gain or (loss) included in other comprehensive loss is $(68,623) and $(54,246) for the years ended December 31, 2017 and 2016.

Mutual funds are valued at the net asset value (NAV) of shares held which is considered a Level 1 valuation technique.

Government bonds are valued using quoted market prices in active markets for identical assets which is considered a Level 1 valuation technique.

NOTE 5 - INVESTMENT SECURITIES AND FAIR VALUE MEASUREMENTS - CONTINUED

The amortized costs and estimated fair values of investment securities are as follows:

	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	ESTIMATED FAIR VALUE
Securities Available for Sale				
December 31, 2017:				
Money Market Mutual Fund	$ 432 810	$ -	$ -	$ 432 810
U.S. Government Obligations	2 047 665	-	(25 215)	2 022 450
Mutual Fund Bond	765 783	-	(43 408)	722 375
TOTALS	$ 3 246 258	$ -	$ (68 623)	$ 3 177 635

	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	ESTIMATED FAIR VALUE
Securities Available for Sale				
December 31, 2016:				
Money Market Mutual Fund	$ 656 841	$ -	$ -	$ 656 841
U.S. Government Obligations	1 949 328	-	(14 292)	1 935 036
Mutual Fund Bond	765 783	-	(39 954)	725 829
TOTALS	$ 3 371 952	$ -	$ (54 246)	$ 3 317 706

The scheduled maturities of securities to be held to maturity and securities available for sale at December 31, 2017 were as follows:

	AVAILABLE FOR SALE SECURITIES	
	AMORTIZED COST	ESTIMATED FAIR VALUE
Due in one year or less	$ -	$ -
Due from one to five years	2 047 665	2 022 450
Due from five to ten years	-	-
Over ten years	-	-
Money Market Mutual Fund	432 810	432 810
Mutual Fund Bond	765 783	722 375
	$ 3 246 258	$ 3 177 635

Information pertaining to securities with gross unrealized losses at December 31, 2017 and 2016 aggregated by investment category and length of time that individual securities have been in a continuous loss position follows:

2017	LESS THAN 12 MONTHS		12 MONTHS OR GREATER		TOTAL	
Description of Securities:	FAIR VALUE	UNREALIZED LOSSES	FAIR VALUE	UNREALIZED LOSSES	FAIR VALUE	UNREALIZED LOSSES
U.S. Governments	$ 723 948	$ (5 311)	$ 1 014 313	$ (19 904)	$ 1 738 261	$ (25 215)
Mutual Fund Bonds	$ -	$ -	$ 722 375	$ (43 408)	$ 722 375	$ (43 408)

2016	LESS THAN 12 MONTHS		12 MONTHS OR GREATER		TOTAL	
Description of Securities:	FAIR VALUE	UNREALIZED LOSSES	FAIR VALUE	UNREALIZED LOSSES	FAIR VALUE	UNREALIZED LOSSES
U.S. Governments	$ 1 147 912	$ (12 116)	$ 531 108	$ (3 331)	$ 1 679 020	$ (15 447)
Mutual Fund Bonds	$ -	$ -	$ 725 829	$ (39 954)	$ 725 829	$ (39 954)

NOTE 5 - INVESTMENT SECURITIES AND FAIR VALUE MEASUREMENTS - CONTINUED

Management evaluates securities for other-than-temporary impairment on a periodic basis. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Cooperative to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. As the Cooperative has the ability to hold investment securities until maturity, or the foreseeable future, none of the declines are deemed to be other-than-temporary.

At December 31, 2017, the majority of the securities are guaranteed by the U.S. Government, agencies thereof or municipalities. These unrealized losses relate principally to current interest rates for similar types of securities. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer's financial condition. As management has the ability to hold debt securities until maturity, or for the foreseeable future, none of the declines are deemed to be other-than-temporary.

NOTE 6 - FUNDS HELD IN ESCROW

The Cooperative has issued $106,355,693 in CREBS related to the R.C. Thomas Hydroelectric Project. Bond proceeds which have not been utilized in the amount of $27,824,747 are held in escrow by CoBank. As of December 31, 2017, the funds held in escrow are fully available for use on construction for the project.

NOTE 7 - DEFERRED DEBITS/CREDITS

The following is a summary of the amounts recorded as deferred debits/credits as of December 31, 2017 and 2016:

	2017	2016
DEFERRED DEBITS		
Debt issuance costs	$ 173 565	$ 198 658
Retirement security plan	176 643	210 290
Prepayment premium on settlement of derivative	4 040 100	4 213 873
Regulatory asset - Impairment (Note 2)	155 870 772	163 925 311
	$ 160 261 080	$ 168 548 132
DEFERRED CREDITS		
Overhead and maintenance	$ -	$ 194 532
	$ -	$ 194 532

Debt issuance costs represent the unamortized costs associated with the issuance of CREBS and refinancing of debt. The costs are being amortized over the life of the bonds and the life of the loan, respectively.

The NRECA Board of Directors approved an option to allow participating cooperatives to make a prepayment and reduce future required contributions to the NRECA Retirement Security Plan ("RS Plan"). The prepayment amount is the Cooperative's share of future contributions required to fund the RS Plan's unfunded value of benefits earned to date using Plan actuarial valuation assumptions. The Cooperative elected to accept the option and made a prepayment to the NRECA RS Plan. The Cooperative recorded the prepayment as a miscellaneous deferred debit and is amortizing the prepayment over ten years as stipulated by RUS.

In connection with the Cooperative's long-term financing for a 50Mw interest in the Turk power plant, the Cooperative entered into an interest rate swap that effectively fixed the interest rate for this loan. The interest rate swap agreement effectively converted floating rates into fixed rates so that the Cooperative could predict with greater assurance what its future interest costs will be and protect itself against increases in floating rates. During 2016, the Cooperative refinanced the debt associated and settled the interest rate swap. The Cooperative incurred a prepayment premium for settling the swap in the amount of $4,344,200. The premium was deferred and is being amortized over the remaining term of the new debt.

NOTE 7 - DEFERRED DEBITS/CREDITS - CONTINUED

The Board of Directors approves the Cooperative's rates, which allows recovery of overhead and maintenance ("O & M") expenses, including administrative and general expenses incurred by the Cooperative on behalf of the Members. Under this provision, the difference in the allowable customer charge computed under the Cooperative's rate and the actual amount of O & M expenses incurred by the Cooperative is to be accumulated by the Cooperative in a deferred account. The allowable customer charge is a monthly average of O & M expenses as budgeted by the Cooperative at the beginning of each twelve-month billing period. Subsequent periods reflect the adjustments between actual and estimated O & M expenses.

NOTE 8 - PATRONAGE CAPITAL

Patronage capital at December 31, 2017 and 2016 consists of the following:

	2017	2016
Assignable patronage capital	$ 9 842 127	$ 10 428 809
Assigned patronage capital	107 581 406	97 152 597
	$ 117 423 533	$ 107 581 406

The by-laws of the Cooperative provide that all amounts received and receivable from the furnishing of electric energy in excess of the sum of operating costs and expenses are to be assigned to Members' patronage capital credit accounts on a patronage basis. The bylaws permit the Cooperative to allocate losses to Members, offset losses with margins from future years, or offset losses with certain nonoperating margins from current or future years.

Pursuant to the RUS mortgage and related loan agreements, until the total of equities and margins equal or exceed 30% of total assets, the distribution of capital contributed by members in each year is limited generally to 25% of patronage capital and margins of the preceding year provided that, after giving effect to such distribution, the total equity will equal or exceed 20% of total assets. The equities and margins of the Cooperative represent 12% of the total assets at the balance sheet date. For the years ending December 31, 2017 and 2016, no patronage capital was retired.

NOTE 9 - LONG-TERM DEBT

Long-term debt at December 31, 2017 and 2016 consisted of the following:

	2017	2016
Federal Financing Bank ("FFB") mortgage notes guaranteed by RUS, fixed rates 1.94% to 5.27%, maturing at various times through 2040	$ 395 566 639	$ 414 262 703
CFC Fixed Rate Notes - 2.45% to 7.15%, maturing at various times from 2018 to 2041	201 092 956	209 399 017
CFC Financing Notes - Capital term certificates, fixed rates from 5.65% to 7.15%, maturing 2024 - 2041	24 745 227	25 978 210
CFC/Regions Syndicated Revolving Credit Facility - variable interest rates, maturing 2021	15 468 974	9 957 694
Clean Renewable Energy Bonds - R.C. Thomas Facility CFC, effective rate of 2.95%, maturing 2024	4 462 501	5 100 000
Clean Renewable Energy Bonds - Hilton Lively Renewable Power Plant, CFC, effective rate of 1.36%, maturing 2035	42 912 088	45 329 670
Clean Renewable Energy Bonds - R.C. Thomas Facility CoBank, effective rate of 1.25%, maturing 2035 - 2040	82 706 372	86 829 030
CoBank Fixed Rate Note - 5.64%, maturing 2041	39 166 665	40 833 333
	806 121 422	837 689 657
Less current maturities	37 700 893	37 086 871
	$ 768 420 529	$ 800 602 786

The Cooperative receives a performance discount rate reduction of 0.125% and a volume discount rate reduction of 0.125% on CFC fixed rate notes. The notes feature a combination of level debt service and level principal payment arrangements.

NOTE 9 - LONG-TERM DEBT - CONTINUED

The Cooperative has secured long-term financing from RUS to finance an ownership interest in several power projects including HCPP, Nelson 6, San Jacinto, Hardin, and the Hilton Lively Renewable Power Project. The RUS mortgage secures existing RUS debt in an amount up to $509,995,264, in the form of eight separate RUS promissory notes. At December 31, 2017, the RUS notes aggregated $395,566,639.

The Cooperative has secured long-term financing from CFC and CoBank to finance its ownership in Plum Point. The long-term financing consists of fixed rate loans with CFC with a balance of $28,191,718 at December 31, 2017 and a fixed rate note with CoBank with a balance of $39,166,665 at December 31, 2017.

The Cooperative has secured long-term financing from CFC to finance its ownership interest in the Turk power plant. The long-term financing consists of fixed rate loans with CFC. At December 31, 2017, the CFC fixed rate notes had a balance of $155,045,753.

During 2011, the Cooperative secured long-term financing with Regions Bank to partially finance the Cooperative's 50Mw interest in the Turk power plant. The long-term financing consisted of a ten year variable rate term loan of $50,000,000 as well as an interest rate swap (Note 10) that effectively fixed the interest rate for this loan at 5.96%. During the year ending December 31, 2016 the Cooperative refinanced this debt with CFC.

On April 11, 2016 the Cooperative replaced an expiring syndicated revolving credit facility with a new syndicated revolving credit facility with CFC, Regions Bank, and BancorpSouth for a five year term. The facility consists of an aggregate commitment of $115,000,000. The facility has been utilized to provide unsecured interim financing for the R.C. Thomas Hydroelectric Project. The Cooperative is continuing to utilize the syndicated facility to provide unsecured interim financing for the R.C. Thomas Hydroelectric Project. The Cooperative had $15,468,974 outstanding on this facility as of December 31, 2017.

The Cooperative has been allocated and has issued a total of $106,355,693 in CREBS in coordination with R.C. Thomas Hydroelectric Project. The initial issue of CREBS was in the amount of $10,200,000 and was issued by CFC. The Cooperative utilized the funds to finance the initial stages of development of the hydropower facility. At December 31, 2017, the balance of the CREBS amounted to $5,100,000. The Cooperative applied for and was approved for three issuances of CREBS. The three separate CREBS allocations were issued in coordination with CoBank in the total amount of $96,155,693. The funds have been utilized to finance the continued construction or are being held in escrow and are currently available for use on construction of the hydropower facility (Note 6). At December 31, 2017, the balance of the CREBS amounted to $82,706,372.

The Cooperative has an approved commitment from RUS in the amount of $73,000,000 for the permanent financing of the R.C. Thomas Hydroelectric Project.

The Cooperative also received an allocation and CFC issued $55,000,000 of CREBS related to the Hilton Lively Renewable Power Project. The funds have been utilized to finance the construction of the facility and had a balance of $42,912,088 at December 31, 2017.

The long-term debt agreements with lenders contain certain restrictive covenants and restrictions on payment of patronage capital. The covenants require the Cooperative to maintain certain annual minimum financial ratios. The restrictions on payment of patronage capital are related in general to the Cooperative's equity and assets as defined in the agreements. For the years ended December 31, 2017 and 2016, the Cooperative was in compliance with all restrictive covenants.

Substantially all owned assets of the Cooperative are pledged as collateral for the above-mentioned secured debt.

NOTE 9 - LONG-TERM DEBT - CONTINUED

The approximate annual maturities of long-term debt for the next five years that are not expected to be refinanced are as follows:

2018	$	37 700 893
2019	$	38 294 479
2020	$	38 970 467
2021	$	37 178 819
2022	$	37 876 752

The Cooperative has a $12,000,000 line of credit with CFC that matures on March 31, 2020. At December 31, 2017 and 2016, no funds were advanced or owed under this line of credit.

The Cooperative also has an additional line of $12,000,000 with CoBank that matures on July 31, 2018. At December 31, 2017 and 2016, no funds were advanced or owed under this line of credit.

The Cooperative established an additional line of credit with Bank of America for amounts up to $11,000,000 that matures October 12, 2018. At December 31, 2017, the Cooperative has $5,500,000 on the Bank of America line of credit.

NOTE 10 - OPERATING LEASES AND FACILITIES AGREEMENTS

The Cooperative has accepted an assignment of a transmission lease obligation between one of its Members, NTEC, and a distribution cooperative, Wood County Electric Cooperative, Inc., in connection with a 5Mw load served by the Cooperative. The annual lease payments are based upon an estimate using various factors. An annual true-up of this estimate is performed once actual amounts have been determined. This lease obligation has no fixed term, but will remain in effect until terminated by the mutual agreement of both parties. For the years ended December 31, 2017 and 2016, the total transmission lease payments were $140,626 and $118,702, respectively. Estimated lease payments for each of the next five (5) years will approximate $150,000.

NOTE 11 - POWER CONTRACTS

The Cooperative has entered into Wholesale Power Contracts (the "Contracts") with each of its Members extending through December 31, 2044. Pursuant to the Contracts, the Cooperative has agreed to serve all of the Members' power needs, except for the power supply responsibility that is specifically retained in the Contracts by the Members. The Cooperative's Board of Directors, as well as the Cooperative's lenders, have approved amendments to the Contracts permitting the Members to purchase renewable distributed generation resources in an amount not to exceed one percent of the Member's annual summer peak purchases from the Cooperative.

The Cooperative has a Power Supply Agreement with SWEPCO, whereby SWEPCO agrees to provide the Cooperative's requirements at certain points of delivery. SWEPCO, the Cooperative and NTEC entered into an agreement dated November 2, 2009, that replaced an agreement among those parties that expired on December 31, 2009. The new agreement has a twenty (20) year term and provides for the sale of partial requirements service for the first five years and 80Mw for the remaining fifteen years.

NOTE 12 - RETIREMENT PLANS

All employees of the Cooperative participate in the NRECA RS Plan, a defined benefit pension plan qualified under section 401 and tax-exempt under section 501(a) of the Internal Revenue Code. It is a multiemployer plan under the accounting standards. The plan sponsor's Employer identification Number is 53-0116145 and the Plan Number is 333.

NOTE 12 - RETIREMENT PLANS - CONTINUED

A unique characteristic of a multiemployer plan compared to a single employer plan is that all plan assets are available to pay benefits of any plan participant. Separate asset accounts are not maintained for participating employers. This means that assets contributed by one employer may be used to provide benefits to employees of other participating employers. The Cooperative's contributions to the RS Plan in 2017 represented less than 5 percent of the total contributions made to the plan by all participating employers. The Cooperative made contributions to the plan of $124,098 and $145,871 in 2017 and 2016, respectively.

In the RS Plan, a "zone status" determination is not required, and therefore not determined, under the Pension Protection Act ("PPA") of 2006. In addition, the accumulated benefit obligations and plan assets are not determined or allocated separately by individual employer. In total, the RS Plan was over 80 percent funded on January 1, 2017 based on the PPA actuarial value of assets on those dates.

Because the provisions of the PPA do not apply to the RS Plan, funding improvement plans and surcharges are not applicable. Future contribution requirements are determined each year as part of the actuarial valuation of the plan and may change as a result of plan experience.

The Cooperative also participates in a 401(k) plan offered to similar cooperatives by the NRECA. The Cooperative matches certain employee contributions. Such matching contributions amounted to $21,699 and $19,321 in 2017 and 2016, respectively.

NOTE 13 - RELATED PARTY TRANSACTIONS

The Cooperative, Tex-La and SRG&T share personnel. Tex-La and SRG&T reimburse the Cooperative for their proportionate share of payroll related expenses. Tex-La's share of costs for the years ended December 31, 2017 and 2016 was $211,081 and $236,489, respectively. SRG&T's share of costs for the years ended December 31, 2017 and 2016 was $150,403 and $168,164, respectively. At December 31, 2017and 2016, $33,938 and $35,353, respectively, was due from Tex-La and SRG&T for payroll related expenses.

The Cooperative and Tex-La share certain facilities and administrative costs. The Cooperative reimburses Tex-La for their proportionate share of the related expenses. The Cooperative's share of cost for the years ended December 31, 2017 and 2016 was $33,167 and $42,763, respectively.

The Cooperative has various electrical facilities operating agreements with its Members' distribution cooperative members for the operation and maintenance of certain transmission facilities.

NOTE 14 - RATE MATTERS

In 1999, the Texas Legislature approved Senate Bill 7, which provided, among other things, that the Cooperative's rates for the sale of wholesale power are no longer regulated by the Public Utility Commission of Texas ("PUCT"). Similarly, the rates of the Members for the sale of electricity are no longer regulated by the PUCT. The law permits cooperatives' boards of directors to set rates.

Investor-owned utilities in the Electric Reliability Council of Texas ("ERCOT") were required to allow their retail customers to select generation suppliers of electricity as of January 2002. The law gives cooperatives' boards of directors sole authority to allow, or not allow, generating suppliers to attempt to sell electricity to retail customers of a cooperative. Allowing retail customer choice is called "opting in". Even if a cooperative's board decides to opt in, retail customers will continue to use the transmission and distribution facilities of the Cooperative's Members. The Cooperative monitors whether any of its Members will decide to opt in and thus evaluate the potential effects of a change in generation sales. The law allows the Cooperative to recover stranded costs if it experiences a loss of load which would impair payment of debt service and payment of purchased power fixed charges. As of December 31, 2017, none of the distribution cooperatives who are served by the Cooperative's Members have elected to opt in.

NOTE 15 - COMMITMENTS AND CONTINGENCIES

General

In the normal course of business the Cooperative has ongoing disputes with some of its power suppliers. Additionally, some of the billings received by the Cooperative for purchased power are subject to adjustment based on the actual costs of the seller.

The Cooperative was a defendant in a lawsuit brought by a contractor for a delay claim. In February 2017, the Cooperative settled the delay claim with the execution of a binding Memorandum of Understanding. In order to settle the claim, ETEC agreed to make a payment of $3,000,000 once the settlement agreement is executed. The settlement agreement was executed on May 11, 2017 and payment was subsequently made as agreed.

Power Supply Resources and Investments in Utility Plant Projects

To ensure adequate power supplies for its Members, the Cooperative enters into purchase commitments with electric energy suppliers. These contracts have various terms covering minimum required megawatts of power to be purchased, prices to be paid and period covered. On an ongoing basis, the Cooperative evaluates its power supply requirement obligations to its Members. The Cooperative continues to evaluate projects including renewable power and further ownership in natural gas-fired generation. The Cooperative is also evaluating purchase power agreements with various power suppliers.

See Note 2 for a description of the utility plant projects that were in progress as of December 31, 2017. At that date, the Cooperative had commitments of approximately the following amounts, excluding debt service, related to completion of construction for the jointly-owned and other power plant projects that were in progress:

	Total Commitment	Cost as of December 31, 2017	Remaining Commitment
R.C. Thomas Hydroelectric Project	$ 149 500 000	$ 111 384 000	$ 38 116 000

Entergy Texas is in the process of constructing a 993Mw combined-cycle generating unit in Montgomery County, Texas. The current estimated cost of the Montgomery County Power Station ("MCPS") is $937 million. The Cooperative and Entergy Texas have agreed to allow the Cooperative to purchase a 75Mw interest in the MCPS. As part of the agreement, the Cooperative will sale Hardin Units 1 and 2 to Entergy Texas at the Cooperative's net book value as of closing. MCPS has a proposed commercial operation date of June 1st, 2021 and the scheduled sell of the Hardin units will occur no later than that time. The Cooperative is currently seeking RUS approval for this transaction. At this time, no definitive agreements have been negotiated or executed.

The Cooperative has entered into a purchase power agreement with Grant Wind, LLC, a subsidiary of Southern Renewable Energy, Inc., to purchase 50Mw of output from a wind-powered generating facility for a fixed price. The facility has a total of 150Mw of installed capacity and was completed in April 2016. The agreement is for a 20-year term.

The Cooperative has also entered into a purchase power agreement with Redbed Plains Wind Farm, LLC, a subsidiary of EDP Renewables, to purchase 50Mw of output from a wind-powered generating facility for a fixed price. The facility has a total of 100Mw of installed capacity and was completed in October 2017. The agreement is for a 20-year term.

SWEPCO Wind Catcher - PUCT

On July 31, 2017, SWEPCO filed an application at the PUCT requesting approval to build a 2,000Mw wind farm and 250-380 mile transmission line. The total cost of the project is estimated to be $4.5 billion. The Cooperative filed testimony taking the position that the project contains risks with speculative benefits and should therefore be rejected as not in the public interest. Management believes the project could have a significant impact on the Cooperative's Power Supply Agreements with SWEPCO. Subsequent to the year ended December 31, 2017, the Cooperative reached a settlement in principle with SWEPCO. While the total impact of the proposed project on the Cooperative's Power Supply Agreements is uncertain, Management believes the settlement mitigates the overall risk. The PUCT case continues to be litigated by PUCT Staff and intervenors who predominantly oppose the project.

NOTE 15 - COMMITMENTS AND CONTINGENCIES - CONTINUED

FERC Complaints

On June 5, 2017, the Cooperative filed a formal complaint at the FERC that states the base return on common equity used by American Electric Power ("AEP") western transmission subsidiaries (including SWEPCO) in calculating formula transmission rates under the SPP tariff is excessive. In November 2017, a FERC order set the matter for hearing, but held the proceeding in abeyance so the parties could have settlement discussions. If the complaint cannot be settled, the issue with will be set for hearing.

On August 31, 2017, the Cooperative and one of the Cooperative's member, NTEC, filed a complaint at the FERC that states the base return on common equity used by SWEPCO in calculating their power supply formula rates is excessive. In November 2017, a FERC order set the matter for hearing, but held the proceeding in abeyance so the parties could have settlement discussions. SWEPCO has subsequently made a number of concessions, including lowering the return on equity to 10.1%. Subsequent to the year ended December 31, 2017, the parties have reached a settlement in principle, which will result in a reduction to SWEPCO's return on equity to 10.1% and will require amending the Power Supply Agreements.

Environmental Regulation

The Cooperative's facilities and operations are subject to regulation by various governmental authorities having jurisdiction over air quality, water quality, control of toxic substances and hazardous and solid wastes, and other environmental matters. Management believes that the Cooperative is in substantial compliance with environmental regulations currently applicable to its facilities and operations. Because environmental regulations are subject to change, future compliance requirements and costs cannot be precisely estimated.

There have been significant efforts in the United States to regulate greenhouse gas emissions through regulatory changes. These efforts culminated in the issuance by the Environmental Protection Agency of a final rule for both new and existing power plants in August 2015 (the "Clean Power Plan"). The Clean Power Plan provided standards and guidelines for the development of state implementation plans that would reduce carbon emissions from existing power plants. The standards and guidelines have been challenged by several dozen states as well as industry groups and other stakeholders. In February 2016, the US Supreme Court issued a stay on implementation of the rule, including all of the deadlines for submission of initial or final state plans. In 2017, the Federal EPA issued a proposal to repeal the Clean Power Plan and an advance notice of proposed rulemaking seeking information that should be considered in the development of new emission guidelines.

Reduced carbon emission standards could result in increases in capital expenditures and operating costs and could impact the dates for retirement of Cooperative coal-fired power plants. The Cooperative is currently unable to predict with any degree of certainty when (or if) a comprehensive regulatory scheme for greenhouse gases will be in place.

NOTE 16 - CONCENTRATIONS OF CREDIT RISK

The Cooperative's financial instruments that are exposed to concentrations of credit risk consist primarily of cash equivalents and accounts receivable.

The Cooperative places its cash and cash equivalents on deposit with financial institutions in the United States. The Federal Deposit Insurance Corporation (FDIC) provides coverage to $250,000 for substantially all depository accounts, per depositor, per depository institution. At various times during the year, cash balances may exceed insured limits. The Cooperative has not experienced any losses in such accounts.

The Cooperative's accounts receivable are subject to concentration of credit risk due to the Cooperative's customer base. Substantially all of the accounts receivable balance is due from the Cooperative's three Members. The Cooperative believes the risk of loss related to this credit risk is remote.

NOTE 17 - DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amount of the Cooperative's cash and cash equivalents, investment securities available for sale, certificates of deposit, trade receivables and payables approximates their fair value because of the short maturities of these financial instruments. Which is considered a Level 1 valuation technique.

Due to restrictions on repricing of the Cooperative's long-term debt and related assumptions, the fair value of these financial instruments is estimated by management to approximate the carrying value, which is considered a Level 1 valuation technique.

The investments in associated organizations are valued using the equity method which represents the Cooperative's ownership portion of the net assets of the associated organization and approximates fair value. The valuation method is considered to be a Level 2 valuation technique.

The fair value of derivative instruments are measured using Level 2 observable inputs other than quoted prices in active markets for identical assets and liabilities, as defined in fair value guidance. Inputs for interest rate derivatives include LIBOR interest rates and interest rate futures contracts. Interest rate derivatives are standard over-the-counter financial products valued using the market approach.

NOTE 18 - MERGER

During the year ended December 31, 2016, the Cooperative began exploring the possibility of merging operations with SRG&T and Tex-La. After further evaluation, the Board of Directors determined the merger was mutually beneficial for the three Cooperatives by consolidating operations and reducing duplicative costs. In April 2017, the Board of Directors approved the merging with SRG&T and Tex-La, with the Cooperative being the surviving entity. The Cooperatives filed a Certificate of Merger with the Texas Secretary of State and received approval of the merger by all regulatory authorities with jurisdiction over the Cooperative. The merger is effective beginning January 1, 2018. All real estate and other properties, rights, powers and franchises of both SRG&T and Tex-La now vest in the Cooperative and all debts, liabilities obligations and duties of the SRG&T and Tex-La became the debts, liabilities, obligations and duties of the Cooperative.

Effective with the merger, the former members of SRG&T and Tex-La now become members of the Cooperative. The Cooperative's members will consist of one electric generating and transmission cooperative, NTEC, and seven distribution cooperatives, Cherokee County Electric Cooperative Association, Deep East Texas Electric Cooperative, Inc., Houston County Electric Cooperative, Inc., Jasper-Newton Electric Cooperative, Inc., Rusk County Electric Cooperative, Inc., Sam Houston Electric Cooperative, Inc. and Wood County Electric Cooperative, Inc.

The Cooperative entered into Amended and Restated Wholesale Power Contracts with all members, which became effective on the merger effective date and extend to December 31, 2044. Pursuant to the Contracts, the Cooperative has agreed to serve all of the members' power needs, except for the power supply responsibility that is specifically retained in the Contracts by the members.

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

The Board of Directors
East Texas Electric Cooperative, Inc.
Nacogdoches, Texas

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 East Texas Electric Cooperative, Inc. which comprise the balance sheets as of December 31, 2017 and 2016 and the related statements of revenue and expenses, comprehensive income, patronage capital and cash flows for the years then ended and the related notes to the financial statements and have issued our report thereon dated April 12, 2018.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Cooperative'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 opinion on the financial statements, but not for the purpose of expressing an opinion of the effectiveness of the Cooperative's internal control. Accordingly, we do not express an opinion on the effectiveness of the Cooperative'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 the internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in the 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 considered to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance

As part of obtaining reasonable assurance about whether East Texas Electric Cooperative, Inc.'s financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, 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 that are required to be reported under *Government Auditing Standards*.

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Cooperative'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 Cooperative's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Axley & Rode LLP
CERTIFIED PUBLIC ACCOUNTANTS

Lufkin, Texas
April 12, 2018

INDEPENDENT AUDITORS' REPORT ON COMPLIANCE WITH ASPECTS OF CONTRACTUAL AGREEMENTS AND REGULATORY REQUIREMENTS FOR RUS ELECTRIC BORROWERS

AXLEY&RODE LLP
CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITORS' REPORT

Board of Directors
East Texas Electric Cooperative, Inc.
Nacogdoches, Texas

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of East Texas Electric Cooperative, Inc. (the Cooperative), which comprise the balance sheet as of December 31, 2017 and the related statements of revenue and expenses, patronage capital and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated April 12, 2018. In accordance with *Government Auditing Standards*, we have also issued our report dated April 12, 2018, on our consideration of the Cooperative's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. No reports other than the reports referred to above and our schedule of findings and recommendation related to our audit have been furnished to management.

In connection with our audit, nothing came to our attention that caused us to believe that the Cooperative failed to comply with the terms, covenants, provisions or conditions of their loan, grant, and security instruments as set forth in 7 CFR Part 1773, *Policy on Audits of Rural Utilities Service Borrowers*, section 1773.33 and clarified in RUS policy memorandum dated February 7, 2014, insofar as they relate to accounting matters as enumerated below. However, our audit was not directed primarily toward obtaining knowledge of noncompliance. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding the Cooperative's noncompliance with the above-referenced terms, covenants, provisions, or conditions of the contractual agreements and regulatory requirements, insofar as they relate to accounting matters. In connection with our audit, we noted no matters regarding the Cooperative's accounting and records to indicate that the Cooperative did not:

Maintain adequate and effective accounting procedures;

Utilize adequate and fair methods of accumulating and recording labor, material, and overhead costs, and the distribution of these costs to construction, retirement, and maintenance or other expenses accounts;

Reconcile continuing property records to the controlling general ledger plant accounts;

Clear construction accounts and accrue depreciation on completed construction;

Record and properly price the retirement of plant;

Seek approval of the sale, lease or transfer of capital assets and disposition of proceeds for the sale or lease of plant, material or scrap;

Maintain adequate control over materials and supplies;

Prepare accurate and timely Financial and Operating Reports;

Obtain written RUS approval to enter into any contract for the management, operation, or maintenance of the borrower's system if the contract covers all or substantially all of the electric system;

Disclose material related party transactions in the financial statements, in accordance with requirements for related parties in generally accepted accounting principles;

Record depreciation in accordance with RUS requirements (See RUS Bulletin 183-1, Depreciation Rates and Procedures);

Comply with the requirements for the detailed schedule of deferred debits and deferred credits; and

Comply with the requirements for the detailed schedule of investments.

This report is intended solely for the information and use of the board of directors, management, and the RUS and supplemental lenders and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Axley & Rode LLP
CERTIFIED PUBLIC ACCOUNTANTS

Lufkin, Texas
April 12, 2018