



Report of Independent Auditors and
Consolidated Financial Statements with
Supplementary Information for

Kaua'i Island Utility Cooperative

December 31, 2014 and 2013

MOSS-ADAMS_{LLP}

Certified Public Accountants | Business Consultants

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REPORT OF INDEPENDENT AUDITORS

To the Board of Directors
Kaua'i Island Utility Cooperative

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Kaua'i Island Utility Cooperative (the Cooperative), which comprise the consolidated balance sheets as of December 31, 2014 and 2013, and the related consolidated statements of operation, equities and margins, 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 consolidated 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 consolidated 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 consolidated 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 applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated 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 consolidated 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 consolidated financial statements.

REPORT OF INDEPENDENT AUDITORS (continued)

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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Kaua'i Island Utility Cooperative as of December 31, 2014 and 2013, and the consolidated results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated April 28, 2015 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. 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 internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Cooperative's internal control over financial reporting and compliance.

A handwritten signature in blue ink that reads "Moss Adams LLP". The signature is written in a cursive, flowing style.

Portland, Oregon
April 28, 2015

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**KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATED BALANCE SHEETS**

ASSETS

	December 31,	
	<u>2014</u>	<u>2013</u>
UTILITY PLANT		
Electric plant in service	\$ 479,173,682	\$ 435,351,324
Electric plant acquisition cost	54,852,453	54,852,453
Accumulated depreciation and amortization	<u>(253,579,118)</u>	<u>(245,585,999)</u>
Net electric plant in service	280,447,017	244,617,778
Construction work in progress	<u>51,849,468</u>	<u>26,947,426</u>
Net utility plant	<u>332,296,485</u>	<u>271,565,204</u>
OTHER INVESTMENTS		
Investments in associated organizations	791,795	741,259
Rural economic development loans	<u>1,073,313</u>	<u>1,159,935</u>
Total other investments	<u>1,865,108</u>	<u>1,901,194</u>
CURRENT ASSETS		
Cash and cash equivalents	20,028,196	7,898,651
Restricted cash and cash equivalents	1,908,115	310,426
Accounts and notes receivable, less allowance for doubtful accounts of \$592,145 and \$537,627 in 2014 and 2013, respectively	10,399,975	13,221,075
Accrued unbilled revenue	7,091,702	8,039,369
Energy rate adjustment clause	-	158,388
Inventories	14,396,537	15,377,024
Other current and accrued assets	<u>1,218,420</u>	<u>1,263,574</u>
Total current assets	<u>55,042,945</u>	<u>46,268,507</u>
POST-RETIREMENT BENEFIT ASSET	<u>1,113,400</u>	<u>-</u>
DEFERRED DEBITS	<u>7,530,747</u>	<u>7,405,231</u>
Total assets	<u><u>\$ 397,848,685</u></u>	<u><u>\$ 327,140,136</u></u>

**KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATED BALANCE SHEETS**

LIABILITIES, EQUITIES, AND MARGINS

	December 31,	
	2014	2013
EQUITIES AND MARGINS		
Controlling equity interest	\$ 93,019,262	\$ 85,289,477
Non-controlling equity interest	23,928,991	-
Total equities and margins	116,948,253	85,289,477
LONG-TERM DEBT, less current maturities	191,515,093	177,468,620
CONSTRUCTION DEBT	-	5,500,000
POST-RETIREMENT BENEFIT OBLIGATION	-	1,602,600
ASSET RETIREMENT OBLIGATION	1,139,750	-
CURRENT LIABILITIES		
Current maturities of long-term debt	12,556,893	11,291,699
Line of credit	39,000,000	11,311,000
Accounts payable	11,370,869	9,522,670
Energy rate adjustment clause	1,109,770	-
Consumer deposits	1,514,639	1,281,238
Accrued employee compensation	2,655,600	2,387,753
Accrued taxes	9,413,017	9,881,913
Other current and accrued liabilities	107,019	117,380
Total current liabilities	77,727,807	45,793,653
DEFERRED CREDITS	10,517,782	11,485,786
Total liabilities, equities, and margins	\$ 397,848,685	\$ 327,140,136

KAUA'I ISLAND UTILITY COOPERATIVE

CONSOLIDATED STATEMENTS OF OPERATIONS

	Years Ended December 31,				Increase (Decrease)
	2014		2013		
	Amount	%	Amount	%	
OPERATING REVENUES					
Residential	\$ 68,457,684	38.2	\$ 69,870,560	37.9	\$ (1,412,876)
Irrigation	38,762	0.0	82,525	0.0	(43,763)
Commercial and industrial	108,660,247	60.6	112,902,888	61.1	(4,242,641)
Public street and highway lighting	1,594,732	0.9	1,616,931	0.9	(22,199)
Other operating revenues	624,043	0.3	241,384	0.1	382,659
Total operating revenues	<u>179,375,468</u>	<u>100.0</u>	<u>184,714,288</u>	<u>100.0</u>	<u>(5,338,820)</u>
OPERATING EXPENSES					
Power cost	109,348,105	61.0	115,313,248	62.4	(5,965,143)
Transmission – operation	335,826	0.2	334,134	0.2	1,692
Transmission – maintenance	479,856	0.3	576,913	0.3	(97,057)
Distribution – operation	1,346,803	0.8	1,256,350	0.7	90,453
Distribution – maintenance	3,046,602	1.7	2,692,103	1.5	354,499
Customer accounts	2,357,285	1.3	2,514,917	1.4	(157,632)
Customer service and information	527,877	0.3	593,129	0.3	(65,252)
Administrative and general	13,382,811	7.5	15,839,315	8.6	(2,456,504)
Depreciation and amortization	14,789,636	8.2	13,850,874	7.5	938,762
Taxes	15,101,376	8.4	15,540,946	8.4	(439,570)
Other interest expense	550,062	0.3	456,024	0.2	94,038
Total operating expenses	<u>161,266,239</u>	<u>90.0</u>	<u>168,967,953</u>	<u>91.5</u>	<u>(7,701,714)</u>
OPERATING MARGINS, before interest	18,109,229	10.0	15,746,335	8.5	2,362,894
INTEREST ON LONG-TERM DEBT, net of amounts capitalized	<u>7,766,874</u>	<u>4.3</u>	<u>7,760,076</u>	<u>4.2</u>	<u>6,798</u>
OPERATING MARGINS	<u>10,342,355</u>	<u>5.7</u>	<u>7,986,259</u>	<u>4.3</u>	<u>2,356,096</u>
NONOPERATING MARGINS					
Interest income	1,422,736	0.8	1,063,254	0.6	359,482
Capital credits	53,676	0.0	70,012	0.0	(16,336)
Other nonoperating income (expense)	<u>(860,613)</u>	<u>(0.5)</u>	<u>34,530</u>	<u>0.0</u>	<u>(895,143)</u>
Total nonoperating margins	<u>615,799</u>	<u>0.3</u>	<u>1,167,796</u>	<u>0.6</u>	<u>(551,997)</u>
EXTRAORDINARY LOSS (NOTE 15)	<u>(1,509,273)</u>	<u>(0.8)</u>	<u>-</u>	<u>0.0</u>	<u>(1,509,273)</u>
NET MARGINS	<u>9,448,881</u>	<u>5.2</u>	<u>9,154,055</u>	<u>4.9</u>	<u>\$ 294,826</u>
COMPREHENSIVE LOSS					
Non-controlling interest	(1,067,191)		-		
Post-retirement benefit obligation gain (loss)	<u>(207,100)</u>		<u>383,100</u>		
COMPREHENSIVE INCOME	<u>\$ 8,174,590</u>		<u>\$ 9,537,155</u>		

KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATED STATEMENTS OF EQUITIES AND MARGINS

	Years Ended December 31,	
	2014	2013
CONTROLLING EQUITY INTEREST		
Memberships		
Balance at January 1,	\$ 451	\$ 434
Additions	16	17
Balance at December 31,	467	451
Patronage capital		
Balance at January 1,	84,689,122	78,371,443
Transfer of net margins	9,448,881	9,154,055
Retirement of capital credits, net	(1,610,241)	(2,836,376)
Balance at December 31,	92,527,762	84,689,122
Other equity		
Balance at January 1,	298,104	255,627
Additions	98,229	42,477
Balance at December 31,	396,333	298,104
Post-retirement benefit obligation gain (loss)		
Balance at January 1,	301,800	(81,300)
Gain (loss)	(207,100)	383,100
Balance at December 31,	94,700	301,800
Total controlling equity interest	93,019,262	85,289,477
NON-CONTROLLING EQUITY INTEREST		
A&B KRS II equity in KRS Two		
Balance at January 1,	-	-
Contributions	23,848,609	-
Distributions	(986,809)	-
Non-controlling interest	1,067,191	-
Total non-controlling equity interest	23,928,991	-
Total equities and margins	\$ 116,948,253	\$ 85,289,477

KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31,	
	2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES		
Net margins	\$ 9,448,881	\$ 9,154,055
Adjustments to reconcile net margins to net cash from operating activities		
Depreciation and amortization	15,184,103	14,233,624
Post-retirement benefit obligation	(2,923,100)	(396,700)
Capital credits allocated	(53,676)	(70,012)
Income attributable to non-controlling equity interest	1,067,191	-
Change in assets and liabilities		
Accounts and notes receivable and unbilled revenue	3,768,767	1,534,246
Energy rate adjustment clause	1,268,158	308,656
Inventories and other current and accrued assets	1,025,641	(631,258)
Deferred debits	(125,516)	(318,164)
Accounts payable, consumer deposits and accrued expenses	1,870,190	2,992,714
Deferred credits	(968,004)	(295,456)
Net cash from operating activities	<u>29,562,635</u>	<u>26,511,705</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Additions to utility plant, net	(74,775,634)	(22,542,548)
Rural economic development loans	86,622	(332,450)
Other investments	3,140	2,638
Net cash from investing activities	<u>(74,685,872)</u>	<u>(22,872,360)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Payments on long-term debt	(35,917,333)	(11,069,597)
Borrowings from long-term debt	45,729,000	17,289,000
Net activity on line of credit	27,689,000	(2,867,000)
Contributions from non-controlling equity interest	23,848,609	-
Capital distributions paid to investor	(986,809)	-
Memberships	16	17
Other equity	98,229	42,477
Retirement of patronage capital	(1,610,241)	(2,836,376)
Net cash from financing activities	<u>58,850,471</u>	<u>558,521</u>
CHANGE IN CASH AND CASH EQUIVALENTS	13,727,234	4,197,866
CASH AND CASH EQUIVALENTS, beginning of year	<u>8,209,077</u>	<u>4,011,211</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 21,936,311</u>	<u>\$ 8,209,077</u>

**KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Years Ended December 31,	
	<u>2014</u>	<u>2013</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the year for		
Interest on long-term debt	\$ 7,766,874	\$ 7,760,076
Income taxes	<u>\$ 30,836</u>	<u>\$ 26,421</u>
Noncash investing activities		
Liabilities incurred for asset retirement obligation	<u>\$ 1,139,750</u>	<u>\$ -</u>

KAUA'I ISLAND UTILITY COOPERATIVE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Nature of Organization and Operations

Kaua'i Island Utility Cooperative (KIUC or the Cooperative), a not-for-profit cooperative association pursuant to the provisions of Chapter 421C of the Hawaii Revised Statutes, was formed to purchase and operate the electric utility on the island of Kaua'i, Hawaii. KIUC is the exclusive retail electric service provider for the island of Kaua'i and provides electric generation, transmission and distribution services to approximately 37,000 customers. The Cooperative's headquarters facility is located in Lihue, Hawaii.

On November 1, 2002, the Cooperative acquired substantially all of the assets of Kaua'i Electric (KE), a division of Citizens Communications Company (Citizens). The aggregate purchase price was approximately \$218 million, which included transaction costs incurred in the acquisition, and was financed by lines of credit from the National Rural Utilities Cooperative Finance Corporation (CFC) and loans from the U.S. government.

On October 10, 2011, the Cooperative created a wholly owned subsidiary, KIUC Renewable Solutions One LLC (KRS One). KRS One is a Delaware limited liability company that has elected to be treated as a corporation for federal tax purposes. KRS One was created to construct, own, and operate a photovoltaic (PV) facility for the purpose of selling the renewable energy produced by the PV facility to the Cooperative for use in the Cooperative's operations.

On October 11, 2012, the Cooperative created a wholly owned subsidiary, KIUC Renewable Solutions Two LLC (KRS Two). KRS Two is a Delaware limited liability company that has elected to be treated as a disregarded entity for federal tax purposes. KRS Two was created to construct, own, and operate a PV facility for the purpose of selling the renewable energy produced by the PV facility to the Cooperative for use in the Cooperative's operations. The facility went into commercial operation on September 5, 2014.

On August 1, 2013, the Cooperative created a wholly owned subsidiary, KIUC Renewable Solutions Two Holdings LLC (KRS Two Holdings). KRS Two Holdings is a Delaware limited liability company that initially elected to be treated as a disregarded entity for federal tax purposes. Effective January 1, 2014 KRS Two Holdings has elected to be treated as a corporation for federal tax purposes. KRS Two Holdings was created as a holding company to own KRS Two. On August 28, 2013, KIUC transferred 100% of its membership interests in KRS Two to KRS Two Holdings.

On July 3, 2014, KRS Two Holdings and A&B KRS II LLC (Investor) entered into an Amended and Restated Limited Liability Company Agreement (the LLC Agreement) of KRS Two. On that date, KRS Two Holdings made a capital contribution to KRS Two in exchange for all of the Class A membership interests in KRS Two and the Investor made a capital contribution to KRS Two in exchange for all of the Class B Membership Interests in KRS Two. KRS Two Holdings is the Managing Member of KRS Two. Allocations of profits, losses, contributions, and distributions are made in accordance with the LLC Agreement. In accordance with the LLC Agreement, the "Flip Date" means the date on which Investor achieves an Internal Rate of Return (IRR) equal to the Target IRR, as defined in the LLC Agreement. As of December 31, 2014, the Flip Date had not occurred.

KAUA'I ISLAND UTILITY COOPERATIVE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Nature of Organization and Operations (continued)

The accompanying consolidated financial statements reflect the financial position and results of operations for the Cooperative and its wholly owned subsidiaries KRS One and KRS Two Holdings. See Note 2, principles of consolidation, for further discussion on consolidation.

Note 2 – Summary of Significant Accounting Policies

Principles of consolidation – The consolidated financial statements include the accounts of the Cooperative and its wholly owned subsidiaries, KRS One and KRS Two Holdings. KRS Two Holdings consolidated financial statements include the accounts of KRS Two Holdings wholly owned subsidiary KRS Two. The consolidation of the Cooperative, KRS One, and KRS Two Holdings eliminated all inter-company transactions and balances. The consolidation of KRS Two Holdings and KRS Two eliminated all inter-company transactions and balances. See supplementary information for details on the elimination of inter-company transactions and balances.

Basis of accounting and presentation – The consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America as applied to regulated enterprises, which conform to policies prescribed or permitted by the Hawaii Public Utilities Commission (HPUC) and the United States Department of Agriculture, Rural Utilities Service (RUS).

The accounting records of the Cooperative are maintained in accordance with the Uniform System of Accounts as prescribed by the Federal Energy Regulatory Commission (FERC) for Class A and B electric utilities.

Regulatory accounting – Due to regulation of its rates by the HPUC, the Cooperative follows regulatory accounting requirements. Regulatory accounting requirements recognize that the ratemaking process can result in differences in the application of generally accepted accounting principles between regulated and non-regulated businesses. Such differences generally involve the accounting period in which various transactions enter into the determination of net margins. Accordingly, certain costs and income may be capitalized as a regulatory asset or liability that would otherwise be charged to expense or revenues. Regulatory assets and liabilities are recorded when it is probable that future rates will permit recovery and are approved by the HPUC (see Notes 6 and 10). Such balances are amortized over the period specified by the HPUC.

In accordance with an HPUC Decision & Order, KIUC is allowed recovery of depreciation expense not realized due to the early retirement of an electric plant destroyed in hurricane Iniki. In 1996, the HPUC approved \$7,598,760 as the total amount of Iniki deferred depreciation with an amortization period of 26 years. The annual amortization amount is \$292,260 ending in 2022. The Iniki regulatory asset is amortized to depreciation expense and the offsetting Iniki regulatory liability is amortized to accumulated depreciation.

Memberships – In accordance with KIUC's bylaws, all electricity users can elect whether or not to become a member. Each member is entitled to one vote regardless of billing amounts.

KAUA'I ISLAND UTILITY COOPERATIVE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 – Summary of Significant Accounting Policies (continued)

Patronage capital – Net margins are assigned to individual Cooperative members' capital credit accounts based upon their pro rata use of total Cooperative electricity provided for the year (see Note 7). Capital credits are returned to members in accordance with the Cooperative's policies. Under the provisions of the mortgage agreements, until the equities and margins equal or exceed 30% of the total assets of the Cooperative, the return to patrons of capital contributed by them is limited generally to 25% of the patronage capital or margins received by the Cooperative in the prior calendar year. The equities and margins of the Cooperative represent 29.40% and 26.07% of the total assets at December 31, 2014 and 2013, respectively. Under the provisions of the 2010 HPUC approved rate case, subject to the loan agreements, KIUC is required to return patronage capital for amounts exceeding a 2.00 TIER in a given year.

Electric plant, acquisition cost, depreciation, and maintenance – Electric plant is stated at the original cost of construction, which includes the cost of contracted services, direct labor and materials, and overhead items (see Note 3). Contributions from others toward the construction of electric plant are credited to the applicable plant accounts.

In accordance with RUS accounting regulations, electric plant acquisition cost represents the difference between the purchase price for the acquisition of KE's assets and the carrying value of those assets. This amount is being amortized over the remaining useful life of the assets acquired which was originally estimated to be 25 years.

Provision has been made for depreciation of electric plant at a straight-line composite rate of approximately 2.9% per annum. A depreciation study was conducted in March 2009 and was approved by the HPUC in 2010. The effective date of the new depreciation rates was June 1, 2010. Depreciation for the years ended December 31, 2014 and 2013 was \$15,184,103 and \$14,233,624, respectively, of which \$14,789,636 and \$13,850,874 was charged to depreciation and amortization expense and \$394,467 and \$382,750 was allocated to other accounts, respectively.

When property which represents a retirement unit is replaced or removed, the average cost of such property as determined from the continuing property records is credited to electric plant and such cost, together with cost of removal less salvage, is charged to the accumulated provision for depreciation.

Maintenance and repairs, including the renewal of minor items of plant not comprising a retirement unit, are charged to the appropriate maintenance accounts, except that repairs of transportation and service equipment are charged to clearing accounts and redistributed to operating expense and capital accounts.

Management assesses impairment and the existence of asset retirement obligations annually and as circumstances warrant.

Investments in associated organizations – Investments in associated organizations are carried at cost (see Note 4), which approximates fair value, plus capital credits allocated and not retired.

KAUA'I ISLAND UTILITY COOPERATIVE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 – Summary of Significant Accounting Policies (continued)

Rural economic development loans – The Cooperative has received Rural Economic Development Grants (RED Grant) from the USDA Rural Development (USDA RD) Office in order to provide loans to promote sustainable rural economic development and job creation projects. KIUC is required to match 20% of the RED Grant award. The RED Grant is awarded to KIUC, who in turn loans the funds to the eligible project applicant at 0% interest for a term of up to ten years. When the loan recipient repays the loan, the loan funds are retained and placed into the Revolving Loan Fund (RLF) and then reused to fund new loans to additional projects (RLF Loans). The RLF Loans are made in accordance with the USDA RD approved Revolving Loan Fund Plan Loan Policies and Procedures Manual. Both the RED Grant loans and the RLF loans are stated at cost (see Note 4).

Cash equivalents – The Cooperative considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Restricted cash – Cash restricted for rural economic development loans.

Accounts and notes receivable – Accounts and notes receivable are recorded when invoices are issued and are written off when they are determined to be uncollectible. The allowance for doubtful accounts is estimated considering the Cooperative's historical losses, review of specific problem accounts, existing economic conditions and the financial stability of its customers, currently 0.1% of monthly operating revenues. Generally, the Cooperative considers accounts receivable past due after 44 days.

Inventories – Materials and supplies inventories consist primarily of items for construction and maintenance of electric plant and are valued at average unit cost. Fuel inventories consist of naphtha and diesel fuel for the generation units and are valued at lower of cost or current market (see Note 5).

Preliminary survey and investigation charges – Preliminary Survey and Investigation (PSI) Charges, included under Deferred Debits, include costs for preliminary surveys, plans, and investigations made for the purpose of determining the feasibility of proposed construction projects. The portion pertaining to plant which is actually constructed is charged to Construction Work in Progress. Any portion pertaining to projects that are abandoned is charged to the appropriate operating expense account.

Accrued vacation – The Cooperative accrues accumulated unpaid vacation as the obligation is incurred. Compensated absences are included in "accrued employee compensation."

Customer advances for construction – Customer advances for construction represent advances for construction jobs that the customer requested, such as line extensions. The customer advance is held in a deferred credit account until the requirements have been met, at which time the advance, or applicable proportion of the advance, is refunded. If the requirements are not met within a five-year time period, the advance is forfeited by the customer and credited to electric plant.

Overhaul accounting – In accordance with an HPUC Decision & Order, KIUC accrues for overhaul costs on the generation equipment by charging a proportion of the estimated cost of the overhaul, over the

KAUA'I ISLAND UTILITY COOPERATIVE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 – Summary of Significant Accounting Policies (continued)

period covered by the overhaul cycle, to maintenance expense. The overhaul cycle for the individual generation units vary based on the type of unit and hours of use. For most generation units, the typical overhaul cycle is every two to five years. When the overhaul occurs, the actual costs are charged against the overhaul deferred credit (regulatory liability – scheduled plant maintenance), with any leftover being charged to maintenance expense (see Note 10).

Post-retirement benefits – KIUC sponsors a Retiree Welfare Benefit Plan (the Plan). The Cooperative accounts for the Plan by reporting the current economic status (the overfunded or underfunded status) of the Plan in the balance sheets and measuring the Plan assets and Plan obligations as of the balance sheets date (see Note 14).

Taxes – The Cooperative is exempt from federal income taxes under the provisions of Section 501(c)(12) of the Internal Revenue Code, except to the extent of unrelated business income, if any. The Cooperative's subsidiaries are disregarded entities and corporations that either report activity with that of the Cooperative or have little to no net income activity as of December 31, 2014, therefore, no income tax provision has been recorded. The Cooperative adopted Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 740-10, relating to accounting for uncertain tax positions. As of December 31, 2014 and 2013, the Cooperative does not have any uncertain tax positions. The Cooperative files an exempt organization and unrelated business income tax return in the U.S. federal jurisdiction and the corporate subsidiaries file a corporate return with the U.S. federal and state of Hawaii jurisdictions and are no longer subject to examination by taxing authorities before 2011.

KIUC is not exempt under Hawaii Revised Statutes from state income taxes; however, margins that are allocated within a specific time period are considered a deduction for state income tax purposes. For the State of Hawaii, KIUC is assessed a 5.885% of gross revenues Public Service Company Tax in lieu of general excise taxes and county real property taxes. Also, KIUC is assessed a 0.5% of gross revenues Public Utility Commission Fee. For the County of Kaua'i, Hawaii, KIUC is assessed a 2.5% franchise fee on gross revenues.

Electric revenues and unbilled revenue – KIUC recognizes revenues based on rates (tariffs) authorized by the HPUC including unbilled revenue, revenue from electric power delivered but not yet billed to the customers.

The Cooperative's tariffs for electric service include energy rate adjustment clauses under which billings to customers are adjusted to reflect changes in the cost of fuel. In order to match power costs and related revenues, under-collected or over-collected power costs to be billed or credited to consumers in subsequent periods is recognized as a current asset or current liability and as an increase or decrease of classified operating revenues on the statement of operations.

KAUA'I ISLAND UTILITY COOPERATIVE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 – Summary of Significant Accounting Policies (continued)

Cushion of credit – RUS established a Cushion of Credit Payment Program, whereby borrowers may make advance payments on their RUS and Federal Financing Bank (FFB) notes. These advance payments earn interest at the rate of 5.0% per annum. The advance payments, plus any accrued interest, can only be used for the payment of principal and interest on the notes. The Cooperative's participation in the Cushion of Credit Payment Program totaled approximately \$12.5 million and \$11.8 million at December 31, 2014 and 2013, respectively, and is recorded as a reduction of RUS long-term debt on the consolidated balance sheets.

Environmental matters – KIUC is subject to federal, state and local environmental laws. These laws regulate the discharge of materials into the environment and may require KIUC to mitigate the effects of a release of a hazardous substance. Environmental matters are recorded when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated. In general, costs related to environmental matters are charged to expense. Environmental costs are capitalized if the costs increase the value of the property and/or prevent or mitigate contamination from future operations. Although the level of future expenditures for environmental matters is difficult to determine, it is management's opinion that such costs when determined will not have a material adverse effect on KIUC's financial condition. Accordingly, no provision has been included in the accompanying consolidated financial statements.

Concentration of credit risk – Financial instruments that are exposed to concentrations of credit risk consist primarily of cash, including other investments, and receivables.

The Cooperative maintains its cash in deposit accounts in various financial institutions and its other investments in highly rated securities. At times these balances exceed federally insured limits.

Credit is extended to customers generally without collateral requirements; however, the Cooperative requires a deposit from some members upon connection, which is applied to unpaid bills and fees in the event of default. The deposit only accrues interest if held longer than the establishment of 12 months of good payment history and is returned along with any accrued interest periodically. In addition, formal shut-off procedures are in place.

Use of estimates – The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates include the allowance for doubtful accounts, unbilled revenue, overhaul deferrals, the post-retirement benefit obligation, asset retirement obligation and depreciation of electric plant. Actual results could differ from those estimates.

Subsequent events – The Cooperative has evaluated subsequent events through April 28, 2015, the date the consolidated financial statements were available to be issued.

KAUA'I ISLAND UTILITY COOPERATIVE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 3 – Electric Plant in Service

The major classes of electric plant in service are as follows at December 31:

	<u>2014</u>	<u>2013</u>
Production plant	\$ 189,062,776	\$ 150,426,475
Transmission plant	76,523,268	76,137,927
Distribution plant	178,209,719	178,114,832
General plant	34,238,169	30,672,090
Asset retirement costs	<u>1,139,750</u>	<u>-</u>
Total electric plant in service	<u><u>\$ 479,173,682</u></u>	<u><u>\$ 435,351,324</u></u>

Note 4 – Other Investments

Other investments consisted of the following at December 31:

	<u>2014</u>	<u>2013</u>
Investments in associated organizations (CFC)		
Capital term certificates, interest from 0% to 7.5% maturing through 2044 or consistent with the related debt (see Note 8)	\$ 579,097	\$ 553,233
Patronage capital	197,137	175,457
Membership/other	<u>15,561</u>	<u>12,569</u>
	<u>791,795</u>	<u>741,259</u>
Rural economic development loans		
YWCA	333,750	360,000
National Tropical Botanical Gardens	121,875	159,375
Island School	140,625	178,125
Tiki Iniki	138,362	160,829
Kauai Brewers LLC	117,085	137,031
JC Linen	101,773	119,623
Kipuni Way	85,127	-
Hale Opio	<u>34,716</u>	<u>44,952</u>
	<u>1,073,313</u>	<u>1,159,935</u>
Total other investments	<u><u>\$ 1,865,108</u></u>	<u><u>\$ 1,901,194</u></u>

KAUA'I ISLAND UTILITY COOPERATIVE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 5 – Inventories

Inventories consisted of the following at December 31:

	<u>2014</u>	<u>2013</u>
Materials and supplies	\$ 12,794,123	\$ 13,225,431
Fuel	<u>1,602,414</u>	<u>2,151,593</u>
Total inventories	<u>\$ 14,396,537</u>	<u>\$ 15,377,024</u>

Note 6 – Deferred Debits

Deferred debits consisted of the following at December 31:

	<u>2014</u>	<u>2013</u>
Regulatory asset – Iniki damage	\$ 2,264,952	\$ 2,557,212
Regulatory asset – demand-side management (DSM) and integrated resource plan (IRP)	(543,776)	(301,036)
Preliminary survey and investigation	3,990,250	3,828,172
Other deferred debits	<u>1,819,321</u>	<u>1,320,883</u>
Total deferred debits	<u>\$ 7,530,747</u>	<u>\$ 7,405,231</u>

Note 7 – Patronage Capital

Patronage capital consisted of the following at December 31:

	<u>2014</u>	<u>2013</u>
Assigned	\$ 106,654,497	\$ 97,500,442
Assignable	<u>9,448,881</u>	<u>9,154,055</u>
	116,103,378	106,654,497
Less: Retired	<u>(23,575,616)</u>	<u>(21,965,375)</u>
Total patronage capital	<u>\$ 92,527,762</u>	<u>\$ 84,689,122</u>

KAUA'I ISLAND UTILITY COOPERATIVE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 8 – Long-Term Debt

The Cooperative has long-term debt due to RUS, CFC, NCSC and FFB. Substantially all assets of the Cooperative are pledged as security for the long-term debt and the notes are subject to certain covenants.

Following is a summary of long-term debt at December 31:

	2014	2013
KIUC		
Fixed and variable notes payable due to RUS in monthly installments of principal and interest with rates ranging from 0.875% to 4.875%, maturing October 31, 2027.	\$ 144,235,878	\$ 152,822,246
Fixed and variable notes payable due to FFB in quarterly installments of principal and interest with rates ranging from 1.341% to 4.430%, maturing December 31, 2023.	19,427,288	21,254,031
Fixed and variable notes payable due to FFB in quarterly installments of principal and interest with rates ranging from 1.574% to 3.334%, maturing December 31, 2042.	32,200,150	21,899,802
Fixed note payable due to CFC in quarterly installments of principal and interest at a rate of 2.425%, maturing September 30, 2023.	4,205,043	4,628,746
RUS/FFB advance payments (cushion of credit)	(12,447,764)	(11,844,506)
KRS Two Holdings Consolidated		
Variable construction loan which is non-amortizing through December 31, 2014. Draws taken through December 31, 2014 were priced at 2.649% to 2.665%, maturing June 30, 2039.	16,451,391	-
Total long-term debt	204,071,986	188,760,319
Less current maturities	(12,556,893)	(11,291,699)
Long-term debt, less current maturities	\$ 191,515,093	\$ 177,468,620

KAUA'I ISLAND UTILITY COOPERATIVE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 8 – Long-Term Debt (continued)

Maturities of long-term debt for the next five years and thereafter are as follows:

2015	\$ 12,556,893
2016	12,972,544
2017	13,433,089
2018	16,648,212
2019	16,060,271
Thereafter	<u>132,400,977</u>
	<u>\$ 204,071,986</u>

The carrying value for variable rate debt is considered fair value due to the frequency of repricing. The fair market value of the Cooperative's fixed rate long-term debt is determined using currently quoted or offered rates for similar issues.

	<u>Carrying Value</u>	<u>Fair Value</u>
December 31, 2014	<u>\$ 216,519,749</u>	<u>\$ 135,897,970</u>
December 31, 2013	<u>\$ 200,604,822</u>	<u>\$ 123,159,296</u>

During 2013 KRS Two established a loan with the National Cooperative Services Corporation (NCSC), an affiliate of the National Rural Utilities Cooperative Finance Corporation (CFC), to provide construction and permanent financing for the solar project. The loan has a maximum loan commitment of \$41,166,000, a draw period until the earlier of the Commercial Operation date or December 31, 2014, is non-amortizing through December 31, 2014, and matures June 30, 2039. Substantially all assets of KRS Two are pledged as security for the loan and the loan is subject to financial covenants. At certain measurement periods during the year ended December 31, 2014, the Company was out of compliance with certain required covenants. A waiver from NCSC has been received by the Company for the covenants. The Cooperative has provided NCSC with a guaranty of the indebtedness of KRS Two to NCSC.

As of December 31, 2014 KRS Two had drawn \$16,451,391 from the loan for solar project construction expenditures and reached the end of the draw period, therefore there is no remaining credit commitment. Draws against the loan were priced at variable rates tied to a published index, which had resulted in all draws taken through December 31, 2014 being priced at 2.649% to 2.665%. Interest was capitalized as part of the solar project costs until commercial operation.

Effective January 1, 2015, KRS Two converted the construction loan to permanent financing. The interest rate is fixed at 4.650% until the loan's maturity at June 30, 2039.

KAUA'I ISLAND UTILITY COOPERATIVE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 9 – Line of Credit

The Cooperative has a perpetual \$60,000,000 disaster line of credit, a perpetual \$5,000,000 line of credit for short-term financing, a 3-year \$20,000,000 line of credit for construction financing with CFC, and a 3-year non-revolving line of credit with CFC in the amount of \$70,000,000 to finance construction of KRS One, all at a variable interest rate. The lines are secured by substantially all Cooperative assets and subject to termination provisions and certain covenants. The total balance outstanding was \$39,000,000 and \$11,311,000 at December 31, 2014 and 2013.

Note 10 – Deferred Credits

Deferred credits consisted of the following:

	<u>2014</u>	<u>2013</u>
Rural economic development grant	\$ 1,245,057	\$ 1,230,295
Hydro security deposit	1,500,000	-
Customer advances for construction	653,485	2,112,830
Regulatory liability – Iniki	2,264,952	2,557,212
Regulatory liability – scheduled plant maintenance	<u>4,854,288</u>	<u>5,585,449</u>
	<u>\$ 10,517,782</u>	<u>\$ 11,485,786</u>

Note 11 – Asset Retirement Obligation

For the year ended December 31, 2014, KRS Two completed an asset retirement obligation (ARO) calculation with the assumption that the assets will be in service through the year 2044. The useful life expectations used in the calculations of the ARO are based on the assumption that operations will continue without deviation from historical trends.

As of December 31, 2014, the ARO capitalized asset and the offsetting ARO liability were established at present value. The ARO asset will be depreciated through 2044 on a straight line basis and the ARO liability will be accreted through 2044 using a discount rate and effective interest method.

KAUA'I ISLAND UTILITY COOPERATIVE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 12 – Litigation, Commitments, and Contingencies

Litigation – In the normal course of business, the Cooperative is a party to claims and matters of litigation. The ultimate outcome of these matters cannot presently be determined; however, in the opinion of management of the Cooperative, the resolution of these matters will not have a material adverse effect on the Cooperative's financial position, results of operations or liquidity.

Fuel contract – As a result of the purchase of KE assets, Citizens assigned to KIUC a fuel supply contract with an international oil refining company that is renewable for 12-month periods unless terminated by KIUC or the supplier; 99.9% of KIUC's fuel is obtained through this supply contract. The price is adjusted monthly to equal a published price, as defined, plus other defined costs such as terminal and freight costs. Fuel costs under this contract for the years ended December 31, 2014 and 2013 were \$84,725,250 and \$91,782,510, respectively. The contract was renegotiated and signed December 2011, with an effective date of April 1, 2012.

Power supply – Most of KIUC's power is generated using diesel and naphtha generating units. In addition, KIUC maintains various power supply agreements to purchase power from hydroelectric and photovoltaic projects. The terms of the agreements vary and include termination provisions.

In 2011, the Cooperative created a wholly owned subsidiary, KIUC Renewable Solutions One LLC (KRS One). KRS One is developing a 12 MW solar photovoltaic facility with an integrated Battery Energy Storage System and associated interconnection facilities on a 55-acre parcel of land leased from the State of Hawaii, Department of Hawaiian Home Lands located in Anahola, Kauai, Hawaii. The output of the project is expected to provide 12 MW of peak power for the electric system on Kauai, an amount that represents about 5% of total energy consumption and would power approximately 4,000 homes. The solar project is being built for KRS One under an Engineering Procurement and Construction contract with REC Solar, Inc. and is expected to be placed in service in the third quarter of 2015. This project is estimated to have a 25-year life.

In 2011, the Cooperative signed an agreement with Green Energy Team LLC, to purchase power from its proposed 6.7 MW biomass-to-energy facility located near Koloa. The biomass-to-energy plant will contribute firm capacity to KIUC's system and will provide more than 11% of Kauai's energy needs. The biomass plant will supply enough electricity to power 8,500 homes, annually replacing about 3.7 million gallons of imported fossil fuel. This project is the first closed-loop biomass-to-energy plant in the United State and is considered to be carbon neutral. The project will maximize the use of natural fertilization processes, including intercropping with alternate rows of nitrogen-fixing trees and the use of fertilizers created as a byproduct of the plant combustion cycle. The biomass fuel will be supplied primarily by more than 2,500 acres of short-rotation crops grown on Kauai. In 2013, construction began on the facility and is expected to be placed in service the second quarter of 2015. This contract has a term of 20 years.

In 2012, the Cooperative created a wholly owned subsidiary, KIUC Renewable Solutions Two LLC (KRS Two). KRS Two developed a 12 MW solar photovoltaic facility with an integrated Battery Energy Storage System and associated interconnection facilities on a 67-acre parcel of land leased from Grove Farm Co., Inc. near Koloa, Kauai, Hawaii. The output of the project provides 12 MW of peak power for the electric

KAUA'I ISLAND UTILITY COOPERATIVE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 12 – Litigation, Commitments, and Contingencies (continued)

system on Kauai, an amount that represents about 5% of total energy consumption and would power approximately 4,000 homes. The solar project was built for KRS Two under an Engineering Procurement and Construction contract with SolarCity and was placed in service in September 2014. The project is expected to have a 25-year life.

In 2014, the Cooperative signed an agreement with Gay & Robinson Inc., to continue to purchase power from its existing 1.25 MW hydroelectric generating facility and to purchase power from its proposed 6 MW expansion hydroelectric generating facility, which is anticipated to be constructed in 2018 / 2019. This contract has an initial term of 25 years once it is in commercial operation.

Union contract – KIUC has an agreement with one union. As of December 31, 2014, 59% of the positions and 60% of the employees were covered by the union contract. The agreement expires in December 2015.

Operating lease – KIUC leases their headquarters under a non-cancelable operating lease which expires in 2020 and contains options to extend the term up to an additional 25 years. The lease also includes an option to purchase the landlord's interest, as defined, in the year 2025.

KRS Two leases the land upon which their solar facility is located under a non-cancelable operating lease which expires in 2039 and contains an option to extend the term an additional 5 years.

As of December 31, 2014, the future minimum rental commitments under these leases are as follows:

2015	\$ 1,130,773
2016	1,074,649
2017	1,076,299
2018	1,077,998
2019	1,079,747
Thereafter	<u>2,682,444</u>
	<u>\$ 8,121,910</u>

In addition to the amounts above, the Cooperative is responsible for common area maintenance costs, real property taxes and other reimbursable operating expenses. Rent expense for the years ended December 31, 2014 and 2013 was \$1,341,582 and \$1,313,679, respectively.

KAUA'I ISLAND UTILITY COOPERATIVE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 13 – Pension Benefits

Effective November 1, 2002, the Cooperative adopted a retirement program available for all employees meeting length of service requirements. The program is a multi-employer plan administered by the National Rural Electric Cooperative Association (NRECA) and includes a non-contributory defined benefit pension and a contributory defined contribution 401(k) plan. Approximately 1,000 rural electric systems participate in each of these plans. Withdrawal from the plan may result in the Cooperative having a significant obligation to the program. The Cooperative does not currently intend to withdraw from the plan and, accordingly, no provision has been included in the accompanying financial statements.

RS Plan Disclosure Information for the Retirement Security Plan

The National Rural Electric Cooperative Association (NRECA) Retirement Security Plan (RS Plan) is 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.

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.

Plan Information

The Cooperative's contributions to the RS Plan in 2014 and in 2013 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 \$3,094,771 in 2014 and \$3,213,548 in 2013. There have been no significant changes that affect the comparability of 2014 and 2013 contributions.

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 Retirement Security Plan was over 80% funded at January 1, 2014 and 2013, based on the PPA funding target and 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.

KAUA'I ISLAND UTILITY COOPERATIVE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 13 – Pension Benefits (continued)

Disclosure Information for the NRECA 401(K) Plan

The NRECA 401(k) permits elective contributions up to 100% of the participant's salary to a maximum of \$17,500. These limits do not include certain catch-up provisions and provides the Cooperative will match 50% of the first 8% of employee base pay contributions. The Cooperative employer portion of the 401(k) plan contributions for 2014 and 2013 totaled \$509,599 and \$495,180, respectively.

Note 14 – Post-Retirement Benefits

The KIUC Retiree Welfare Benefit Plan (the Plan) and its associated trust, the KIUC Retiree Welfare Benefit Trust (the Trust), were adopted effective January 1, 2003. The Plan provides certain non-contributory medical (which includes a dollar cap, for which retirees pay back KIUC for amounts exceeding the cap), dental, vision and life insurance benefits for retired employees, their beneficiaries, and covered dependents. Benefits are paid on behalf of retirees and are a function of medical insurance costs and number of retirees. Benefits paid for the years ended December 31, 2014 and 2013 were \$254,635 and \$297,794, respectively. The measurement date for the current valuation is December 31, 2014.

KAUA'I ISLAND UTILITY COOPERATIVE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 14 – Post-Retirement Benefits (continued)

Assumptions:

The actuarial cost method used for the valuation is the projected unit credit cost method.

Weighted-average assumptions used to determine the net periodic benefit cost for the year ended December 31, 2014:

- Discount rate: 4.5%
- Expected long-term return on plan assets: 4.0% (based on the ten-year performance of the funds, weighted by market value as of December 31, 2013)
- Health care cost trend rate assumed for next year: 7.5%
- Rate to which the cost trend rate is assumed to decline (the ultimate trend rate): 5.0% in 2017

	2014	2013
I) Net post-retirement benefit cost		
Interest cost	\$ 144,300	\$ 221,800
Expected return on plan assets	(168,100)	(200,900)
Net post-retirement benefit cost	\$ (23,800)	\$ 20,900
II) Accumulated post-retirement benefit obligation (APBO)		
APBO balance at the beginning of year	\$ (5,806,200)	\$ (6,002,000)
Net actuarial gain (loss) and other	2,174,765	(152,379)
Net post-retirement benefit cost	23,800	(20,900)
Benefits paid	254,635	369,079
Net post-retirement benefit obligation at year-end	\$ (3,353,000)	\$ (5,806,200)
III) Reconciliation of funded status		
APBO	\$ (3,353,000)	\$ (5,806,200)
Assets funded	4,466,400	4,203,600
Accrued post-retirement funded status	\$ 1,113,400	\$ (1,602,600)
IV) Accumulated other comprehensive gain		
Unrecognized prior service cost	\$ (301,800)	\$ 81,300
Other comprehensive (gain) loss	207,100	(383,100)
Accumulated other comprehensive gain	\$ (94,700)	\$ (301,800)

KAUA'I ISLAND UTILITY COOPERATIVE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 14 – Post-Retirement Benefits (continued)

The following benefit payments, which reflect expected future service as appropriate, are expected to be paid:

2015	\$ 298,900
2016	283,600
2017	263,800
2018	281,700
2019	268,500
2020 – 2024	1,073,600

The Plan has been fully funded as of December 31, 2014. The Plan assets are held in the Trust and are invested in the Central Pacific Bank's Trust Division at December 31, 2014.

The Plan assets are managed by a trustee and are authorized to be held in various equity and fixed income investments and cash equivalents. The trustee is not allowed to invest in real estate or any other investment other than those noted in the investment policy. The investing strategy is long-term with a focus on moderate volatility and moderate growth investments. All investments at December 31, 2014 and 2013 were level one investments as outlined in the fair value hierarchy as they have quoted prices in active markets for identical assets. The following table shows the investment allocation for Plan assets:

	2014		2013	
Cash and other accrued income	\$ 3,269	0%	\$ 5,707	0%
Mutual funds	3,991,122	89%	3,815,860	91%
Bonds	472,009	11%	382,033	9%
	\$ 4,466,400		\$ 4,203,600	

Note 15 – Extraordinary Loss

Xtreme Power Systems, LLC Bankruptcy – On October 11, 2013, KRS Two entered into an agreement with Xtreme Power Systems, LLC (Xtreme) to engineer, manufacture, and install a battery energy storage system (BESS) at Koloa next to KRS Two's solar farm. During 2013, KRS Two made 3 milestone payments to Xtreme totaling \$1,503,483. No payments have been made in 2014. On January 22, 2014, Xtreme, along with its affiliated entities, filed voluntary petitions for bankruptcy under chapter 11 of title 11 of the United States Code in the United States Bankruptcy Court. On February 28, 2014, Xtreme and its affiliates filed a motion in the United States Bankruptcy Court to sell the assets of the company through a bidding process. On April 10, 2014, Xtreme and its affiliates filed an Asset Purchase Agreement in the United States Bankruptcy Court. According to the Asset Purchase Agreement the potential buyer has excluded the contract with KRS Two from the purchase, as such, the battery will not be obtained by KRS Two. The Asset Purchase Agreement was approved and finalized in 2014, resulting in an extraordinary loss of \$1,509,273 for KRS Two.

KAUA'I ISLAND UTILITY COOPERATIVE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 16 – Subsequent Event

RUS FFB C8 Note – On September 24, 2010, The RUS approved a loan guarantee commitment for the Cooperative in the amount of \$109,968,000 to finance system extensions and additions. Under this commitment, RUS will guarantee a loan of \$109,968,000 to the Cooperative from the FFB. As required by Hawaii Revised Statutes (HRS) §269, all financing and security arrangements by the Cooperative must be approved by the HPUC. On August 25, 2011, the HPUC issued their Decision and Order approving the Cooperative to enter into the financing and security arrangements with RUS for purpose of securing a loan in the amount of \$41,968,000. On March 9, 2012, the fully executed and recorded RUS and FFB loan documents for the \$41,968,000 loan were submitted to RUS and CFC for finalization of the loan closing process. The remaining \$68,000,000 of the RUS loan guarantee commitment was to be documented as a separate loan at a later date. On July 14, 2014 RUS approved an additional loan, from the previously approved RUS loan guarantee commitment, in the amount of \$42,579,000. On November 18, 2014, the HPUC issued their Decision and Order approving a waiver from any requirement that the Cooperative obtain approval from the HPUC in order to enter into and effectuate its proposed RUS loan in the amount of \$42,579,000. On March 10, 2015, the fully executed RUS and FFB loan documents for the \$42,579,000 loan were submitted to RUS for finalization of the loan closing process. The remaining \$25,421,000 of the RUS loan guarantee commitment expires September 30, 2015 and therefore will not be used.

SUPPLEMENTARY INFORMATION

REPORT OF INDEPENDENT AUDITORS ON SUPPLEMENTARY INFORMATION

To the Board of Directors
Kaua'i Island Utility Cooperative

We have audited the consolidated financial statements of Kaua'i Island Utility Cooperative (the Cooperative) as of and for the years ended December 31, 2014 and 2013 and have issued our report thereon dated April 28, 2015. The audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The supplementary information, which comprise the consolidating balance sheets as of December 31, 2014 and 2013, and the related consolidated statements of operation, for the years then ended are presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.



Portland, Oregon
April 28, 2015

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**KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATING BALANCE SHEETS
DECEMBER 31, 2014**

	As of December 31, 2014				
	KIUC	KRS One	KRS Two Holdings Consolidated	Eliminations	KIUC Consolidated
UTILITY PLANT					
Electric plant in service	\$ 439,694,424	\$ -	\$ 39,479,258	\$ -	\$ 479,173,682
Electric plant acquisition cost	54,852,453	-	-	-	54,852,453
Accumulated depreciation and amortization	(253,404,524)	-	(174,594)	-	(253,579,118)
Net electric plant in service	241,142,353	-	39,304,664	-	280,447,017
Construction work in progress	7,964,338	43,732,644	152,486	-	51,849,468
Net utility plant	249,106,691	43,732,644	39,457,150	-	332,296,485
OTHER INVESTMENTS					
Investments in subsidiary companies	37,873,426	-	-	(37,873,426)	-
Investments in associated organizations	791,795	-	-	-	791,795
Rural economic development loans	1,073,313	-	-	-	1,073,313
Total other investments	39,738,534	-	-	(37,873,426)	1,865,108
CURRENT ASSETS					
Cash and cash equivalents	18,765,556	399,289	863,351	-	20,028,196
Restricted cash and cash equivalents	1,908,115	-	-	-	1,908,115
Accounts and notes receivable, less allowance for doubtful accounts of \$592,145 and \$537,627 in 2014 and 2013, respectively	10,172,953	-	227,022	-	10,399,975
Accrued unbilled revenue	7,091,702	-	-	-	7,091,702
Inventories	14,396,537	-	-	-	14,396,537
Other current and accrued assets	1,161,840	25,000	31,580	-	1,218,420
Total current assets	53,496,703	424,289	1,121,953	-	55,042,945
POST-RETIREMENT BENEFIT ASSET	1,113,400	-	-	-	1,113,400
DEFERRED DEBITS	7,530,747	-	-	-	7,530,747
Total assets	\$ 350,986,075	\$ 44,156,933	\$ 40,579,103	\$ (37,873,426)	\$ 397,848,685

KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATING BALANCE SHEETS
DECEMBER 31, 2014

	As of December 31, 2014				
	KIUC	KRS One	KRS Two Holdings Consolidated	Eliminations	KIUC Consolidated
EQUITIES AND MARGINS					
Controlling equity interest	\$ 93,019,262	\$ (19,466)	\$ (1,505,018)	\$ 1,524,484	93,019,262
Non-controlling equity interest	-	-	23,928,991	-	23,928,991
Total equities and margins	<u>93,019,262</u>	<u>(19,466)</u>	<u>22,423,973</u>	<u>1,524,484</u>	<u>116,948,253</u>
LONG-TERM DEBT, less current maturities	<u>175,433,686</u>	<u>39,048,949</u>	<u>16,342,659</u>	<u>(39,310,201)</u>	<u>191,515,093</u>
ASSET RETIREMENT OBLIGATION	<u>-</u>	<u>-</u>	<u>1,139,750</u>	<u>-</u>	<u>1,139,750</u>
CURRENT LIABILITIES					
Current maturities of long-term debt	12,186,909	-	369,984	-	12,556,893
Line of credit	39,000,000	-	-	-	39,000,000
Accounts payable	6,036,260	5,033,039	301,570	-	11,370,869
Energy rate adjustment clause	1,109,770	-	-	-	1,109,770
Consumer deposits	1,514,639	-	-	-	1,514,639
Accrued employee compensation	2,655,600	-	-	-	2,655,600
Accrued taxes	9,406,315	6,702	-	-	9,413,017
Other current and accrued liabilities	<u>105,852</u>	<u>87,709</u>	<u>1,167</u>	<u>(87,709)</u>	<u>107,019</u>
Total current liabilities	<u>72,015,345</u>	<u>5,127,450</u>	<u>672,721</u>	<u>(87,709)</u>	<u>77,727,807</u>
DEFERRED CREDITS	<u>10,517,782</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>10,517,782</u>
Total liabilities and equities	<u>\$ 350,986,075</u>	<u>\$ 44,156,933</u>	<u>\$ 40,579,103</u>	<u>\$ (37,873,426)</u>	<u>\$ 397,848,685</u>

**KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATING STATEMENT OF OPERATIONS
YEAR ENDED DECEMBER 31, 2014**

	As of December 31, 2014				
	KIUC	KRS One	KRS Two Holdings Consolidated	Eliminations	KIUC Consolidated
OPERATING REVENUES					
Residential	\$ 68,457,684	\$ -	\$ -	\$ -	\$ 68,457,684
Irrigation	38,762	-	-	-	38,762
Commercial and industrial	108,660,247	-	-	-	108,660,247
Public street and highway lighting	1,594,732	-	-	-	1,594,732
Sale for resale - RUS borrower	-	-	1,270,298	(1,270,298)	-
Other operating revenues	624,043	-	-	-	624,043
Total operating revenues	179,375,468	-	1,270,298	(1,270,298)	179,375,468
OPERATING EXPENSES					
Power cost	110,589,054	-	29,349	(1,270,298)	109,348,105
Transmission – operation	335,826	-	-	-	335,826
Transmission – maintenance	479,856	-	-	-	479,856
Distribution – operation	1,346,803	-	-	-	1,346,803
Distribution – maintenance	3,046,602	-	-	-	3,046,602
Customer accounts	2,357,285	-	-	-	2,357,285
Customer service and information	527,877	-	-	-	527,877
Administrative and general	13,353,108	8,288	21,415	-	13,382,811
Depreciation and amortization	14,615,042	-	174,594	-	14,789,636
Taxes	15,095,024	-	6,352	-	15,101,376
Other interest expense	550,062	530,459	-	(530,459)	550,062
Total operating expenses	162,296,539	538,747	231,710	(1,800,757)	161,266,239
OPERATING MARGINS, before interest	17,078,929	(538,747)	1,038,588	530,459	18,109,229
INTEREST ON LONG-TERM DEBT	7,362,128	-	404,746	-	7,766,874
OPERATING MARGINS	9,716,801	(538,747)	633,842	530,459	10,342,355
NONOPERATING MARGINS					
Interest income	1,120,510	530,459	302,226	(530,459)	1,422,736
Capital credits	53,676	-	-	-	53,676
Other nonoperating income	(1,442,106)	-	(928,951)	1,510,444	(860,613)
Total nonoperating margins	(267,920)	530,459	(626,725)	979,985	615,799
EXTRAORDINARY LOSS	-	-	(1,509,273)	-	(1,509,273)
NET MARGINS	9,448,881	(8,288)	(1,502,156)	1,510,444	9,448,881
COMPREHENSIVE EXPENSE					
Non controlling interest	-	-	(1,067,191)	-	(1,067,191)
Post-retirement benefit obligation gain	(207,100)	-	-	-	(207,100)
COMPREHENSIVE INCOME	\$ 9,241,781	\$ (8,288)	\$ (2,569,347)	\$ 1,510,444	\$ 8,174,590

KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATING BALANCE SHEETS
DECEMBER 31, 2013

	As of December 31, 2013				
	KIUC	KRS One	KRS Two Holdings Consolidated	Eliminations	KIUC Consolidated
UTILITY PLANT					
Electric plant in service	\$ 435,351,324	\$ -	\$ -	\$ -	\$ 435,351,324
Electric plant acquisition cost	54,852,453	-	-	-	54,852,453
Accumulated depreciation and amortization	(245,585,999)	-	-	-	(245,585,999)
Net electric plant in service	244,617,778	-	-	-	244,617,778
Construction work in progress	8,977,876	9,401,157	8,568,393	-	26,947,426
Net utility plant	253,595,654	9,401,157	8,568,393	-	271,565,204
OTHER INVESTMENTS					
Investments in subsidiary companies	9,593,497	-	-	(9,593,497)	-
Investments in associated organizations	741,259	-	-	-	741,259
Rural economic development loans	1,159,935	-	-	-	1,159,935
Total other investments	11,494,691	-	-	(9,593,497)	1,901,194
CURRENT ASSETS					
Cash and cash equivalents	7,342,449	393,950	162,252	-	7,898,651
Restricted cash and cash equivalents	310,426	-	-	-	310,426
Accounts and notes receivable, less allowance for doubtful accounts of \$537,627 and \$468,161 in 2013 and 2012, respectively	13,221,075	-	-	-	13,221,075
Accrued unbilled revenue	8,039,369	-	-	-	8,039,369
Energy rate adjustment clause	158,388	-	-	-	158,388
Inventories	15,377,024	-	-	-	15,377,024
Other current and accrued assets	1,209,786	25,000	28,788	-	1,263,574
Total current assets	45,658,517	418,950	191,040	-	46,268,507
DEFERRED DEBITS	7,405,231	-	-	-	7,405,231
Total assets	\$ 318,154,093	\$ 9,820,107	\$ 8,759,433	\$ (9,593,497)	\$ 327,140,136

KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATING BALANCE SHEETS
DECEMBER 31, 2013

	As of December 31, 2013				
	KIUC	KRS One	KRS Two Holdings Consolidated	Eliminations	KIUC Consolidated
EQUITIES AND MARGINS	\$ 85,289,477	\$ (11,178)	\$ (2,862)	\$ 14,040	\$ 85,289,477
LONG-TERM DEBT, less current maturities	177,468,620	9,531,355	54,348	(9,585,703)	177,468,620
CONSTRUCTION DEBT	-	-	5,500,000	-	5,500,000
POST-RETIREMENT BENEFIT OBLIGATION	1,602,600	-	-	-	1,602,600
CURRENT LIABILITIES					
Current maturities of long-term debt	11,291,699	-	-	-	11,291,699
Line of credit	11,311,000	-	-	-	11,311,000
Accounts payable	6,038,393	278,096	3,206,181	-	9,522,670
Consumer deposits	1,281,238	-	-	-	1,281,238
Accrued employee compensation	2,387,753	-	-	-	2,387,753
Accrued taxes	9,880,147	-	1,766	-	9,881,913
Other current and accrued liabilities	117,380	21,834	-	(21,834)	117,380
Total current liabilities	42,307,610	299,930	3,207,947	(21,834)	45,793,653
DEFERRED CREDITS	11,485,786	-	-	-	11,485,786
Total liabilities and equities	\$ 318,154,093	\$ 9,820,107	\$ 8,759,433	\$ (9,593,497)	\$ 327,140,136

**KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATING STATEMENT OF OPERATIONS
YEAR ENDED DECEMBER 31, 2013**

	As of December 31, 2013				
	KIUC	KRS One	KRS Two Holdings Consolidated	Eliminations	KIUC Consolidated
OPERATING REVENUES					
Residential	\$ 69,870,560	\$ -	\$ -	\$ -	\$ 69,870,560
Irrigation	82,525	-	-	-	82,525
Commercial and industrial	112,902,888	-	-	-	112,902,888
Public street and highway lighting	1,616,931	-	-	-	1,616,931
Other operating revenues	241,384	-	-	-	241,384
Total operating revenues	184,714,288	-	-	-	184,714,288
OPERATING EXPENSES					
Power cost	115,338,248	(25,000)	-	-	115,313,248
Transmission – operation	334,134	-	-	-	334,134
Transmission – maintenance	576,913	-	-	-	576,913
Distribution – operation	1,256,350	-	-	-	1,256,350
Distribution – maintenance	2,692,103	-	-	-	2,692,103
Customer accounts	2,514,917	-	-	-	2,514,917
Customer service and information	593,129	-	-	-	593,129
Administrative and general	15,829,786	6,667	2,862	-	15,839,315
Depreciation and amortization	13,850,874	-	-	-	13,850,874
Taxes	15,540,946	-	-	-	15,540,946
Other interest expense	456,024	247,976	-	(247,976)	456,024
Total operating expenses	168,983,424	229,643	2,862	(247,976)	168,967,953
OPERATING MARGINS, before interest	15,730,864	(229,643)	(2,862)	247,976	15,746,335
INTEREST ON LONG-TERM DEBT	7,737,757	-	22,319	-	7,760,076
OPERATING MARGINS	7,993,107	(229,643)	(25,181)	247,976	7,986,259
NONOPERATING MARGINS					
Interest income	840,696	448,215	22,319	(247,976)	1,063,254
Capital credits	70,012	-	-	-	70,012
Other nonoperating income	250,240	-	-	(215,710)	34,530
Total nonoperating margins	1,160,948	448,215	22,319	(463,686)	1,167,796
NET MARGINS	9,154,055	218,572	(2,862)	(215,710)	9,154,055
COMPREHENSIVE INCOME					
Post-retirement benefit obligation loss	383,100	-	-	-	383,100
COMPREHENSIVE INCOME	\$ 9,537,155	\$ 218,572	\$ (2,862)	\$ (215,710)	\$ 9,537,155

REPORT REQUIRED BY GOVERNMENT AUDITING STANDARDS

REPORT OF INDEPENDENT AUDITORS 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*

To the Board of Directors
Kaua'i Island Utility Cooperative

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 Kaua'i Island Utility Cooperative (the Cooperative), which consist of the consolidated balance sheet as of December 31, 2014 and the consolidated statements of operations, equities and margins and cash flows for the year ended December 31, 2014, and the related notes to the financial statements, and have issued our report thereon dated April 28, 2015.

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

**REPORT OF INDEPENDENT AUDITORS 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* (continued)**

Compliance and Other Matters

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

Purpose of This Report

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

Moss Adams LLP

Portland, Oregon

April 28, 2015