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PUBLIC SERVICE COMMISSION

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

GENERAL ADJUSTMENT OF ELECTRIC RATES	)	
OF EAST KENTUCKY POWER	)	**CASE NO.**
COOPERATIVE, INC.	)	**2006-00472**

INTERIM RATE RELIEF HEARING BRIEF OF
EAST KENTUCKY POWER COOPERATIVE, INC

Pursuant to the directives of the Public Service Commission (the "Commission") at the hearing held in this case on March 22, 2007, the Applicant, East Kentucky Power Cooperative, Inc. ("EKPC") hereby submits this post-hearing brief on the following questions:

Question 1: How should the Commission interpret the language in KRS §278.190, which authorizes the Commission to permit suspended rates to become effective based on a finding that an Applicant's "credit or operations will be materially impaired or damaged by the failure to permit the rates to become effective during the period"?

ARGUMENT

The subject language in KRS 278.190 (2), referencing the discretion of the Commission to allow interim rate relief if it finds the Applicant's "credit or operations will be materially impaired or damaged by the failure to permit the rates to become effective during the period" is not more specifically defined in KRS Chapter 278, and no Commission regulation appears to address this subject. It is EKPC's position that a reasonable interpretation of this language would be that the statute requires a finding of substantial evidence for the Commission to conclude that, absent the requested interim rate relief, there would be a significant adverse impact on the Applicant's cost of debt, or its ability to raise necessary funds, or its ability to operate its system in a reasonable and reliable manner, and that such adverse impact would affect the Applicant's rates or service. EKPC notes that nothing in the subject phrase indicates that such adverse impacts must be shown to occur within the rate suspension period in question. EKPC also contends that the Commission should analyze such adverse impacts differently for a cooperative, compared to an investor owned utility, since the cooperative's member ratepayers are the only entities affected by such financial events.

Question 2: Has sufficient evidence of material impairment of EKPC's credit or operations been presented to the Commission to justify interim rate relief?

ARGUMENT

EKPC contends that adequate evidence has been submitted to the Commission in this case to support its request for interim rate relief. That evidence is summarized as follows:

1. EKPC has urgent cash flow needs for calendar year 2007- David Eames, EKPC Vice President- Finance, testified that if EKPC does not secure additional cash flow in 2007 through rate relief, including the requested interim relief, it will run out of available funds by the end of the year. (Eames Cross-examination, March 22, 2007 Transcript p. 108) EKPC established an unsecured revolving Credit Facility in the amount of $650 million in 2005 through the National Rural Utilities Cooperative Finance Corporation ("CFC") for interim financing of general operations and capital construction, until long term construction loan funds are available from the Rural Utilities Service ("RUS") (Eames Direct Testimony, Application Exhibit G-2. p. 3) Mr. Eames testified that EKPC only had approximately $195 million in available funds under its Credit Facility, and that those funds would satisfy EKPC's projected cash needs only through the end of 2007. (Eames CE, Tr. p. 108)

EKPC has failed to generate sufficient margins to meet its minimum Debt Service Coverage ("DSC") requirement under its RUS/CFC Mortgage for the past three years, largely as a result of an unanticipated forced outage in 2004, and an accounting reserve established in regard to litigation with the Environmental Protection Agency in 2005. (Robert Marshall Direct Testimony, Application Exhibit G-1, p. 2-4; March 22, 2007 Hearing, Applicant's Exhibit 2) New cash flow needs have arisen, even since the initiation of this case, in the form of an estimated $25 million in construction costs at EKPC's Cooper Power Station to prevent potential plant operational disruptions resulting from repairs to the Wolf Creek Dam. (Eames CE, Tr. p. 97) Mr. Frank Oliva, EKPC Manager of Finance and Risk Management, testified that EKPC's lack of cash flow could mean that it would need to use advances from its Credit Facility to make its quarterly $25 million debt service payment to the Federal Financing Bank in September of this year, effectively raising the cost of financing for that amount by 125 to 150 basis points. (Oliva CE, Tr. p. 169-170)

2. EKPC's credit position is threatened and deteriorating- Mr. Jonathon Andrew Don, CFC's Vice President of Capital Market Member Products, testified that EKPC's credit had deteriorated from a level of BBB to BBB- at the time that the Credit Facility was established, to a level below investment grade, and that at least 3 or 4 banks participating in the Credit Facility have placed EKPC on credit watch status, which entails a higher risk rating and quarterly evaluations of EKPC's credit position. (Don CE, Tr. p. 141-144) Mr. Don testified that major Credit Facility participating banks would not be likely to lend any additional amounts to EKPC until its credit position showed improvement, and that any additional private financing that EKPC might be able to obtain would cost an additional 50 basis points, if it could be obtained at all. (Id., Tr. p. 143)

This situation is of extreme concern to EKPC at a time when it needs to increase the amount of its Credit Facility by as much as $200 million and, due to the delays involved in obtaining RUS loan funds, must also consider more expensive private project financing for the Smith CFB Unit 1. (Eames Re-direct, Tr. p. 108, 115, 119) The Credit Facility agreement could also be in jeopardy if EKPC does not maintain its members' equity above the $90 million minimum level. (Application Exhibit G-1, p. 4)

3. EKPC is in default of its financial covenants under its Mortgage to the RUS and CFC, and this situation threatens all of EKPC's financing- Mr. Eames has presented documentation concerning EKPC's failure to meet its RUS/CFC Mortgage Section 4.15 loan covenants of 1.05 for Times Interest Earned Ratio ("TIER") for 2004 and 2005, and 1.0 for DSC for 2004-2006. (March 22, 2007 Hearing, Applicant's Exhibit 2) Although EKPC met the TIER requirement for 2006, due to the retroactive application of new depreciation rates approved by the Commission and RUS late in that year, it failed to meet the DSC requirement for the third straight year, and its 2006 TIER level was not sufficient to prevent EKPC's failure to meet the requirement of Section 4.15 (b) of the RUS/CFC Mortgage that the average TIER and DSC levels for the best two of the last three years must remain at or above the required levels. (Eames CE, Tr. p. 47) This failure triggered notice requirements to RUS and CFC, and requires EKPC to submit a plan to RUS specifying actions that will be taken to achieve the specified TIER and DSC levels on a timely basis (RUS/CFC Mortgage Section 4.15 (b) (3)-(4)).

EKPC's application in this case, which seeks interim rate relief, is a critical element of its plan of correction, along with continuing cost reductions. (Eames CE, Tr. p. 46-50) EKPC's compliance with the three year average test for TIER and DSC levels is evaluated on a calendar year basis, and EKPC's request for interim rate relief is essential to avoid the default of this requirement for a second time, based on calendar year 2007 financial results. (Eames CE, Tr. p. 77, 92)

<u>4. EKPC compliance with its RUS/CFC Mortgage covenants in 2007 is virtually impossible without interim rate relief, and failure to do so would compound all of EKPC's cash flow and financing problems</u>- Mr. Eames testified that EKPC's projections for 2007 show that it cannot meet the RUS/CFC Mortgage three year test for TIER and DSC without the interim rate relief provided for in the Settlement Agreement, reached among EKPC, the Attorney General, and Kentucky Industrial Utility Customers, Inc. ("KIUC"), even if the Commission grants the full increase requested by EKPC in this case effective September 1, 2007. (Eames CE, Tr. p. 101-103) Even with interim relief and the full overall rate increase, EKPC must achieve cost reductions resulting in approximately $5 million in additional margins, above its 2007 budget projections, to meet the Mortgage covenants. (Id., Tr. p. 125) These additional savings will be difficult to accomplish, since EKPC has already reduced its expenses for operations by $17.6 million in 2006, and has deferred plant maintenance normally scheduled for 2007. (Application Exhibit G-1, p. 5; Eames CE, Tr. p. 86-88) EKPC would need to defer hiring of necessary personnel, defer additional maintenance, and might have to resort to layoffs if sufficient revenues are not forthcoming. (Eames CE, Tr. p. 86, 89-90) If interim rate relief is not granted by the Commission, EKPC's plan of correction will almost certainly fail to achieve its objectives. (Eames CE, Tr. p. 102)

Should RUS find EKPC's plan of correction insufficient, it could declare an event of default pursuant to Section 5.01 of the RUS/CFC Mortgage, suspend any further advances of loan funds, and take other more drastic measures to compel EKPC to correct its default. (Eames Re-direct, Tr. p. 111) A declaration of Mortgage default by the RUS would invoke a cross-default provision in EKPC's Credit Facility agreement, and would lead to a freeze on any further advances under that unsecured financing. (Don CE, Tr. p. 134-135) This would leave EKPC without adequate funds to purchase power, to make required payments to construction contractors, to pay for system maintenance, and to service its debt. (Eames CE, Tr. p. 90, 120) Demands that EKPC repay it outstanding loans would lead to insolvency. (Id., Tr. p. 104-105)

Mr. Eames testified that RUS evaluates credit for a power supply cooperative borrower, like EKPC, differently than the financial markets, and that RUS looks for positive developments, such as the granting of interim rate relief, in evaluating the sufficiency of a borrower's corrective actions. (Id., Tr. p. 62-63, 117) Mr. Don testified that the Credit Facility banks were looking for positive developments to allay their concerns about EKPC's credit position. (Don CE, Tr. p. 135) If EKPC is granted the requested interim rate relief, the likelihood that RUS will accept the plan of compliance is significantly improved, and CFC would be more likely to work with EKPC to arrange additional needed financing. (Id., Tr. p. 117-118)

CONCLUSION

EKPC's current financial crisis must be addressed in calendar year 2007. EKPC has not increased its rates since 1983, and this request for interim rate relief is solely motivated by its obligations to take necessary corrective actions to address its current loan covenant default, and the urgency of avoiding a second consecutive default in those covenants, which would cause further deterioration of its credit position and jeopardize its ability to satisfactorily resolve this situation. All parties to this case agree that EKPC faces the prospect of material impairment of its credit and operations without interim rate relief, although EKPC objects to the improper proposal of the Sierra Club to tie such relief to the revocation of the Smith CFB Unit 1 construction certificate. The best, and possibly only, opportunity to resolve EKPC's current financial difficulties before they become more urgent and lenders impose greater costs and burdens on EKPC, will be lost if the requested interim relief is not granted.

Respectfully submitted:

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CERTIFICATE OF SERVICE

This is to certify that an original and 10 copies of the Interim Rate Relief Hearing Brief of East Kentucky Power Cooperative, Inc. in PSC Case No. 2006-00472 were delivered to the office of Elizabeth O'Donnell, Executive Director of the Public Service Commission, 211 Sower Boulevard, Frankfort, KY 40601, and copies were mailed to the parties listed below, this 27th day of March, 2007.

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