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February 5, 2013

**Via Federal Express**

Mr. Jeff DeRouen  
Executive Director  
Public Service Commission  
211 Sower Boulevard, P.O. Box 615  
Frankfort, Kentucky 40602-0615

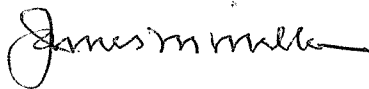
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Re: *In the Matter of: The Application of Big Rivers Electric Corporation for Approval to Issue Evidences of Indebtedness*, PSC Case No. 2012-00492

Dear Mr. DeRouen:

Enclosed are an original and ten copies of a supplemental response of Big Rivers Electric Corporation to Item No. 9 of Kentucky Industrial Utility Customers, Inc., Initial Request for Information. That response is supplemented by adding the enclosed document as an attachment to that response. I certify that copies of this letter and enclosures have been served on each person shown on the attached service list.

Sincerely yours,



James M. Miller

JMM/ej  
Enclosures

cc: Billie J. Richert

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# RatingsDirect®

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## Summary:

# Big Rivers Electric Corp., Kentucky Ohio County; Rural Electric Coop

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## Summary:

# Big Rivers Electric Corp., Kentucky Ohio County; Rural Electric Coop

### Credit Profile

Big Rivers Electric Corp. ICR

*Long Term Rating*

BB-/Negative

Downgraded

#### **Ohio Cnty, Kentucky**

Big Rivers Electric Corp., Kentucky

Ohio Cnty (Big Rivers Electric Corp.) poll ctrl rfdg rev bnds (Big Rivers Elec Corp Proj) ser 2010A

*Long Term Rating*

BB-/Negative

Downgraded

## Rationale

Standard & Poor's Ratings Services has lowered to 'BB-' from 'BBB-' its rating on Big Rivers Electric Corp., Ky., (BREC) and Ohio County, Ky.'s \$83.3 million pollution control refunding revenue bonds, series 2010A (Big Rivers Electric Corp. Project) issued for Big Rivers' benefit. The outlook is negative.

The downgrade reflects our assessments of the issuer's obligations' heightened vulnerability to nonpayment after the following developments that we view as eroding the strength and stability of the utility's revenue stream:

- In August 2012, BREC's leading customer issued a 12-month notice to terminate its contract. The notice covers Century Aluminum Co.'s Hawesville, Ky., smelter. During the 12 months, Century is required to pay a base energy charge that covers its share of Big Rivers' fixed and variable costs. If it does not operate the plant during the notice period, it must still pay its share of fixed costs. The utility has accepted the termination notice. Century accounted for 36% of BREC's 2012 operating revenues.
- After the utility filed a rate case with the Kentucky Public Service Commission (KPSC) Jan. 15, 2013, and requested rate relief that would, among other things, reallocate costs borne by Century to its remaining customers, a second smelter, Rio Tinto Alcan Inc. (Alcan), issued a 12-month notice to terminate its power contract with BREC. Alcan's Jan. 31, is effective January 2014. The notice covers the company's Sebree smelter, which accounted for 28% of BREC's 2012 operating revenues. BREC's rate filing proposed raising Alcan's rates 16%.
- We believe that losing these two loads will deprive the utility of the substantial anchors that have supported much of its fixed costs. Moreover, we view the extent to which the KPSC will approve reallocating costs to remaining customers as uncertain.
- We believe it might be too onerous for remaining customers to assume the fixed costs that the smelters have historically borne, particularly because many of the counties that BREC serves have income levels that are 20%-30% below the national median household effective buying income.
- If BREC looks to competitive market sales to mitigate load losses, it is our view that sales in competitive wholesale markets could expose the utility to substantial price and volume uncertainty, which is inconsistent with sound credit quality. Moreover, BREC depends almost exclusively on coal units, which also could constrain market sales opportunities. Coal has accounted for close to 90% of its power sales and its coal units are not as economical as competing natural gas-fired resources that are benefiting from the fuel's low prices.

- Although the utility has about \$60 million of unexpended bond proceeds available to retire its \$58.5 million of pollution control bonds that are maturing in June, an eroding customer base might frustrate access to capital markets to replenish those funds. The utility reports the speculative grade rating will not lead to an acceleration of obligations outstanding.
- Big Rivers reports it deferred maintenance in 2012 to control expenses. Although it does not plan to defer maintenance in 2013, it is revisiting its capital program pending more certainty as to the timing and extent of rate relief.

Henderson, Ky.-based Big Rivers is a generation and transmission cooperative that produces and procures electricity for sale to three distribution cooperative members and their 112,900 retail customers. One member, Kenergy Corp., serves the two smelters. In 2011, Kenergy's 9.4 million megawatt-hour (MWh) sales were 8x greater than the sum of the other two members' MWh sales. About 86% of Kenergy's 2011 MWh sales were to industrial customers. Nearly three-quarters of its sales were to the two smelters. They accounted for more than 70% of Kenergy's operating revenues. BREC's other member distribution cooperatives--Jackson Purchase Energy and Meade County Rural Electric Cooperative--principally serve residential customers.

The smelters entered take-or-pay power contracts with Kenergy. However, the contracts allow the smelters to terminate their obligations to the distribution utility and BREC without penalty if they provide one-year's notice and cease operations.

Because the KPSC must approve requests for rate adjustments, the utility and its member distribution cooperatives are distinguishable from many other cooperative utilities that have autonomous ratemaking authority. The KPSC also regulates BREC's members' rates.

The utility is evaluating idling power plants as part of its response to losing loads. Closing plants could reduce costs, reduce market exposure and mitigate the financial impact on remaining customers. Big Rivers might also temper the burdens of cost reallocation if it can remarket some or all of the generation output that had been sold to the smelters. However, market or contract demand and prices would need to be sufficient to recoup the smelters' share of costs. We believe that market sales could transform the utility into a principally merchant generator that faces the risks inherent in being subject to market demand and prices.

BREC sells electricity to the smelters under contracts at prices that are about 30% above the 3.3 cents it earned from sales of surplus energy in wholesale markets in 2011. It sold 3 million MWh of surplus wholesale power into the market for \$100.4 million in 2011.

Big Rivers' concentration in coal resources also expose the utility to potentially higher production costs as Environmental Protection Agency (EPA) regulation of power plant emissions progresses. A recent appellate decision that vacated the EPA's Cross-State Air Pollution rule could provide the utility with at least a temporary reprieve from emissions-related capital spending while the EPA revisits its rules.

The utility reported \$794 million of debt as of June 30, 2012. Debt consisted of Rural Utilities Service loans and the Ohio County bonds. Big Rivers closed a \$537 million loan with CoBank ACB and National Rural Utilities Cooperative Finance Corp. in July. In addition to replenishing \$35 million of transition reserve funds, proceeds restructured a portion of the utility's RUS borrowing to eliminate some of the spikes in debt service requirements.

The debt portfolio exhibits uneven amortization. BREC repaid \$14.2 million of principal in 2010. In 2011, it was required to repay \$7.3 million of principal, but also used \$35.0 million of transition reserve money to accelerate principal reduction. The utility replenished the transition reserve in 2012 with proceeds of July's borrowing from CoBank and National Rural Utilities. Loan proceeds also facilitated debt restructuring that reduced 2012's \$72.1 million scheduled maturity to \$12.1 million, with the remaining \$60 million to be amortized later. However, 2013's maturity remains at \$79.3 million, and that will likely need to be restructured. The utility forecasts about \$22 million of 2014 and 2015 principal payments.

Ohio County sold bonds for the benefit of BREC, which used bond proceeds to refund auction rate securities. We understand that the financing structure obligates the utility to unconditionally pay the county's bonds' debt service. Big Rivers issued a note to the county that provides it with a security interest in the utility's assets under its mortgage indenture. The county's bonds' security interest is on par with the utility's senior-secured debt.

Debt service coverage of 1.45x in 2010 and 1.65x in 2011 was strong for a cooperative utility, in our opinion. We believe strong excess coverage margins provide a cushion against the potential for revenue stream variability.

The strength of 2011's coverage ratio partially reflects the year's very low scheduled principal payment of \$7.3 million. We calculated the ratio using scheduled debt service in the denominator, compared to the \$46 million of principal the utility elected to repay.

The utility maintains \$152.6 million of reserves that it uses for rate stabilization to reduce rates. Because it already projects depleting these reserves by the first quarter of 2018 under a steady-state scenario, we do not view these reserves as adding value under a scenario in which the smelters close.

## Outlook

The negative outlook reflects our view that the largest customers' termination notices could degrade BREC's financial performance and credit quality during our one-year outlook horizon. We believe there is significant uncertainty vis-à-vis the extent and timeliness of rate relief, particularly as substantial blocks of fixed costs need to be reallocated. We will monitor the progress of the rate case to assess whether further rating action is appropriate. We believe the customers' notice could expose the utility to the vicissitudes of merchant markets and creates the potential for substantial cost shifting to remaining customers, who might resist such efforts or find that reallocated costs are too onerous to absorb. If these risks, whether in isolation or combination, weaken BREC's business risk profile and erode financial metrics, including the strong debt service coverage that compensated for business risks in recent years, we could further lower the ratings. We do not expect to raise the ratings during our outlook period.

## Related Criteria And Research

USPF Criteria: Applying Key Rating Factors To U.S. Cooperative Utilities, Nov. 21, 2007

Temporary telephone contact information: David Bodek (917-992-6466); Jeffrey Panger (646-369-4067).

*Summary: Big Rivers Electric Corp., Kentucky Ohio County; Rural Electric Coop*

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