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April 12 2005

Ms. Elizabeth O'Donnell
Executive Director
Public Service Commission of Kentucky
Post Office Box 615
Frankfort, Kentucky 40601

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APR 14 2005
PUBLIC SERVICE
COMMISSION

Re: Kenergy Corp.
Case No. 2004-00446

Dear Ms. O'Donnell:

Enclosed for filing are Kenergy's audited financial statements as of and for the period ended December 31, 2004. This is provided in response to Item 2 of KIUC's Initial Data Request.

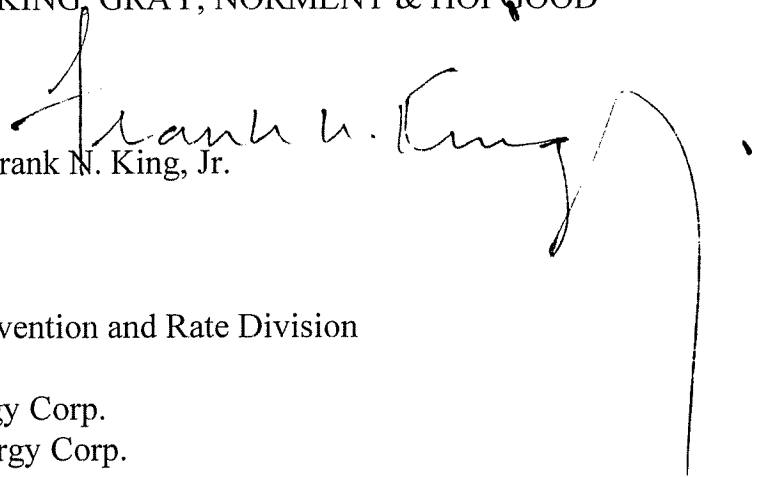
Your assistance in this matter is appreciated.

Very truly yours,

DORSEY, KING, GRAY, NORMENT & HOPGOOD

By

Frank N. King, Jr.



FNKJr/cds

Encls.

Copy/w/encl.: Attorney General, Utility Intervention and Rate Division
Michael L. Kurtz, Esq.

Copy/w/o/encl.: Mr. Mark A. Bailey, Kenergy Corp.
Mr. Steve Thompson, Kenergy Corp.

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***KENTUCKY 65 HENDERSON
KENERGY CORP.
HENDERSON, KENTUCKY***

FINANCIAL STATEMENTS

Years Ended December 31, 2004 and 2003

(With Independent Auditors' Report Thereon)

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INDEPENDENT AUDITORS' REPORT

Board of Directors
Kenergy Corp.
Henderson, Kentucky

We have audited the accompanying balance sheets of Kenergy Corp. (Kenergy) as of December 31, 2004 and 2003, and the related statements of revenue and expenses, changes in members' equities and cash flows for the years then ended. These financial statements are the responsibility of Kenergy's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards 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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Kenergy as of December 31, 2004 and 2003, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated February 24, 2005, on our consideration of Kenergy's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Riney, Hancock & Co., PSC

Owensboro, Kentucky
February 24, 2005

KENERGY CORP.

BALANCE SHEETS

December 31, 2004 and 2003

ASSETS	<u>2004</u>	<u>2003</u>
Utility plant, net	\$ <u>160,793,532</u>	\$ <u>155,118,670</u>
Investments	<u>8,334,802</u>	<u>7,516,929</u>
Current assets:		
Cash and cash equivalents	848,890	5,533,454
Accounts receivable, less allowance for doubtful accounts: 2004, \$261,059; 2003, \$413,808		
Billed	19,621,371	20,565,923
Unbilled	7,236,156	6,285,812
Materials and supplies	1,758,483	1,707,516
Other current assets	<u>687,363</u>	<u>166,778</u>
Total current assets	<u>30,152,263</u>	<u>34,259,483</u>
Other assets	<u>359,959</u>	<u>422,025</u>
Total assets	\$ <u><u>199,640,556</u></u>	\$ <u><u>197,317,107</u></u>
 MEMBERS' EQUITIES AND LIABILITIES		
Members' equities:		
Memberships	\$ 275,470	\$ 291,875
Patronage capital	54,826,732	54,017,459
Other	<u>2,858,224</u>	<u>2,409,075</u>
	<u>57,960,426</u>	<u>56,718,409</u>
Long-term debt	<u>107,902,571</u>	<u>106,177,762</u>
Current liabilities:		
Note payable	1,000,000	-
Accounts payable	21,623,443	22,738,712
Consumer deposits	2,272,175	2,340,002
Current maturities of long-term debt	3,757,222	3,926,165
Other current and accrued liabilities	<u>1,381,938</u>	<u>1,248,158</u>
Total current liabilities	<u>30,034,778</u>	<u>30,253,037</u>
Other noncurrent liabilities	<u>2,946,383</u>	<u>3,431,301</u>
Deferred credits	<u>796,398</u>	<u>736,598</u>
Total members' equities and liabilities	\$ <u><u>199,640,556</u></u>	\$ <u><u>197,317,107</u></u>

See Notes to Financial Statements

KENERGY CORP.**STATEMENTS OF REVENUE AND EXPENSES**

Years Ended December 31, 2004 and 2003

	<u>2004</u>	<u>2003</u>
Operating revenue	\$ <u>281,710,528</u>	\$ <u>279,674,782</u>
Operating expenses:		
Cost of power	254,634,344	253,749,545
Distribution operation	3,301,838	3,222,427
Distribution maintenance	7,680,715	5,757,949
Customer accounts	2,559,692	2,472,214
Consumer service and information	162,956	122,462
Sales	146,846	175,078
Administrative and general	2,487,686	2,417,134
Depreciation	5,589,176	5,274,279
Taxes	275,720	289,036
Other deductions	78,148	53,977
	<u>276,917,121</u>	<u>273,534,101</u>
Operating margin before interest expense	4,793,407	6,140,681
Interest on long-term debt	3,118,978	3,364,565
Interest charged to construction	(55,479)	(109,745)
Other interest expense	118,202	162,610
	<u>1,611,706</u>	<u>2,723,251</u>
Operating margin	1,611,706	2,723,251
Nonoperating margin:		
Investment income	836,782	906,188
Other income (expense)	(21,223)	(64,296)
	<u>2,427,265</u>	<u>3,565,143</u>
Net margin before operating margin assigned	2,427,265	3,565,143
Operating margin assigned by associated organizations	131,689	61,484
	<u>131,689</u>	<u>61,484</u>
Net margin	\$ <u><u>2,558,954</u></u>	\$ <u><u>3,626,627</u></u>

See Notes to Financial Statements

KENERGY CORP.

STATEMENTS OF CHANGES IN MEMBERS' EQUITIES

Years Ended December 31, 2004 and 2003

	<u>Member- ships</u>	<u>Patronage Capital</u>	<u>Other</u>	<u>Total</u>
Balance, January 1, 2003	\$ 300,820	\$ 53,209,965	\$ 2,531,652	\$ 56,042,437
Net refund of membership fees	(8,945)	-	-	(8,945)
Net margin	-	3,626,627	-	3,626,627
Accumulated other comprehensive loss: Increase in additional minimum pension liability	-	-	(458,065)	(458,065)
Patronage capital retired	-	(2,819,133)	-	(2,819,133)
Retired capital credits - gain	-	-	334,479	334,479
Other changes	-	-	1,009	1,009
Balance, December 31, 2003	<u>291,875</u>	<u>54,017,459</u>	<u>2,409,075</u>	<u>56,718,409</u>
Net refund of membership fees	(16,405)	-	-	(16,405)
Net margin	-	2,558,954	-	2,558,954
Accumulated other comprehensive income: Decrease in additional minimum pension liability	-	-	163,136	163,136
Patronage capital retired	-	(1,749,681)	-	(1,749,681)
Retired capital credits - gain	-	-	285,500	285,500
Other changes	-	-	513	513
Balance, December 31, 2004	<u>\$ 275,470</u>	<u>\$ 54,826,732</u>	<u>\$ 2,858,224</u>	<u>\$ 57,960,426</u>

See Notes to Financial Statements

KENERGY CORP.

STATEMENTS OF CASH FLOWS

Years Ended December 31, 2004 and 2003

	<u>2004</u>	<u>2003</u>
Cash flows from operating activities:		
Net margin	\$ 2,558,954	\$ 3,626,627
Adjustments to reconcile net margin to net cash provided by operating activities:		
Depreciation charged to operations	6,228,009	5,869,596
Noncash assigned capital credits	(139,630)	(61,485)
Increase in accounts receivable	944,552	1,435,165
Decrease in materials and supplies	(50,967)	(92,048)
Decrease (increase) in other current assets	(1,470,929)	164,877
Decrease in accounts payable	(1,115,269)	(1,802,496)
Increase (decrease) in other current and accrued liabilities	133,782	(397,694)
Other, net	<u>(181,289)</u>	<u>(257,999)</u>
Net cash provided by operating activities	<u>6,907,213</u>	<u>8,484,543</u>
Cash flows from investing activities:		
Capital expenditures, net	(11,847,465)	(11,904,621)
Decrease (increase) in other investments, excluding assigned capital credits	<u>(752,276)</u>	<u>252,981</u>
Net cash used in investing activities	<u>(12,599,741)</u>	<u>(11,651,640)</u>
Cash flows from financing activities:		
Additional memberships, net of refunds	(84,234)	216,434
Net borrowings on note payable	1,000,000	-
Additional long-term debt	5,900,000	16,070,000
Reduction of long-term debt	(4,344,135)	(8,114,439)
Patronage capital retired	<u>(1,463,667)</u>	<u>(2,484,653)</u>
Net cash provided by financing activities	<u>1,007,964</u>	<u>5,687,342</u>
Net increase (decrease) in cash and cash equivalents	(4,684,564)	2,520,245
Cash and cash equivalents, beginning of year	<u>5,533,454</u>	<u>3,013,209</u>
Cash and cash equivalents, end of year	\$ <u><u>848,890</u></u>	\$ <u><u>5,533,454</u></u>
Supplemental disclosure of cash flow information:		
Interest paid, net of amounts capitalized	\$ <u><u>3,149,133</u></u>	\$ <u><u>3,372,412</u></u>

See Notes to Financial Statements

KENERGY CORP.

NOTES TO FINANCIAL STATEMENTS

Years Ended December 31, 2004 and 2003

1. Organization and Summary of Significant Accounting Policies

Nature of Business

Kenergy is a nonprofit electric distribution cooperative association which provides electric power to approximately 53,000 residential, commercial and industrial customers located in fourteen western Kentucky counties.

Basis of Accounting

The accounting policies of Kenergy reflect those prescribed by the United States Department of Agriculture Rural Utilities Service (RUS) and the Kentucky Public Service Commission (KPSC), which conform with accounting principles generally accepted in the United States of America in all material respects.

Revenues

Revenues are accrued when services are rendered based on rates authorized by the KPSC.

Utility Plant

Utility plant is stated at original cost, net of contributions, which is the cost when first dedicated to public service. Kenergy capitalizes supervisory and overhead costs applicable to construction projects.

Maintenance and repairs of property units and renewals of minor items of property are charged to maintenance expense accounts. The costs of replacing complete property units are charged to utility plant accounts and the original cost of distribution plant property units retired and cost of removal, net of salvage value, are charged to accumulated depreciation.

Depreciation

Depreciation is provided on the basis of the estimated useful lives of assets at straight-line rates, which for 2004 and 2003, were as follows:

Distribution plant	3.10% to 6.75%
General plant	2.00% to 15.60%

KENERGY CORP.

NOTES TO FINANCIAL STATEMENTS

Years Ended December 31, 2004 and 2003

1. Organization and Summary of Significant Accounting Policies, Continued

Depreciation, Continued

Kenergy uses the composite method of depreciation for distribution plant and the unit method of depreciation for general plant.

Investments

As more fully described in Note 3, Kenergy's investment in a generation and transmission corporation is recorded at zero. All other investments of Kenergy are stated at cost, which approximates fair value.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand, money market funds, and investments with an original maturity of three months or less. The carrying amount reported in the balance sheet for cash and cash equivalents approximates fair value.

Materials and Supplies

Materials and supplies inventory are stated at the lower of cost or market using the average cost method.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. Utility Plant

Utility plant at December 31 consists of the following:

	<u>2004</u>	<u>2003</u>
Distribution plant	\$ 178,897,812	\$ 170,380,871
General plant	<u>19,944,776</u>	<u>19,263,150</u>
	198,842,588	189,644,021

KENERGY CORP.

NOTES TO FINANCIAL STATEMENTS

Years Ended December 31, 2004 and 2003

2. Utility Plant, Continued

	<u>2004</u>	<u>2003</u>
Less accumulated depreciation	41,186,755	38,310,950
	157,655,833	151,333,071
Construction in progress	3,137,699	3,785,599
	<u>\$ 160,793,532</u>	<u>\$ 155,118,670</u>

Depreciation expense for the years ended December 31, 2004 and 2003, was \$6,228,009 and \$5,869,596, respectively.

Interest capitalized during 2004 and 2003 related to construction of utility plant was \$55,479 and \$109,745, respectively.

3. Investments

Generation and Transmission Corporation

As discussed in Note 7, Kenergy purchases electric power from Big Rivers, a generation and transmission cooperative association. The membership of Big Rivers is comprised of Kenergy and two other distribution cooperatives.

The following is an audited summary at December 31 of financial information pertaining to Big Rivers:

	<u>2004</u>	<u>2003</u>
	(In Thousands)	
Balance Sheet Data:		
Current assets	\$ 71,403	\$ 32,312
Noncurrent assets	1,149,237	1,150,544
Total assets	<u>1,220,640</u>	<u>1,182,856</u>
Current liabilities	22,537	38,985
Noncurrent liabilities	1,476,359	1,444,152
Total liabilities	<u>1,498,896</u>	<u>1,483,137</u>
Equities (deficit)	<u>\$ (278,256)</u>	<u>\$ (300,281)</u>
Income Statement Data:		
Revenues	\$ 232,530	\$ 215,472

KENERGY CORP.

NOTES TO FINANCIAL STATEMENTS

Years Ended December 31, 2004 and 2003

3. Investments, Continued

Generation and Transmission Corporation, Continued

	<u>2004</u>		<u>2003</u>
Operating margin	\$ 9,622	\$	4,502
Net margin	\$ 22,025	\$	18,349

The above summary was obtained from Big Rivers audited financial statements as of and for the years ended December 31, 2004 and 2003. Big Rivers experienced significant operating losses in prior years and has a net equities deficiency of approximately \$278 million at December 31, 2004. Because the equity of Big Rivers is a deficit at December 31, 2004 and 2003, Kenergy's investment in Big Rivers is carried at zero in accordance with accounting principles generally accepted in the United States of America.

Other Investments

The more significant other investments are as follows:

Capital Term Certificates (CTC's) of the National Rural Utilities Cooperative Finance Corporation are carried at cost, which approximates market. The investment at December 31, 2004 and 2003, totaled \$2,549,782 and \$2,550,544, respectively. The CTC's mature in varying amounts from 2020 through 2080 and bear interest at 0%, 3% and 5% per annum.

Investment in CoBank, an international cooperative bank, is a restricted investment which is carried at cost and totaled \$1,356,882 and \$1,276,590 at December 31, 2004 and 2003, respectively. Under the terms of this Loan Base Capital Plan, Kenergy's investment in CoBank (stock and notified allocated surplus from CoBank) is required to be 11.5% of Kenergy's average loan balance due to CoBank for the past five years.

Kenergy's Retirement Trust totaling \$1,722,189 and \$1,809,794 at December 31, 2004 and 2003, respectively, represents amounts set aside to fund Kenergy's deferred compensation agreements (Note 11) and are stated at fair value.

Economic development loans represent interest free loans made to qualifying applicants to promote rural economic development. Kenergy borrows monies from RUS (Note 4) pursuant to the Rural Electrification Act of 1936 and in turn loans these monies to

KENERGY CORP.

NOTES TO FINANCIAL STATEMENTS

Years Ended December 31, 2004 and 2003

3. Investments, Continued

Other Investments, Continued

qualifying applicants. The loans are secured by letters of credit, thereby eliminating Kenergy's exposure to loss. Amounts outstanding at December 31, 2004 and 2003, were \$1,851,357 and \$1,123,577, respectively.

4. Long-Term Debt

Long-term debt at December 31 consists of:

	<u>2004</u>	<u>2003</u>
First mortgage notes payable to: RUS in quarterly and monthly installments of varying amounts through 2038:		
2% notes	\$ 144,844	\$ 290,633
5% notes	19,350,270	27,782,826
5.125% notes	2,450,094	2,487,790
1.125% notes	47,143,465	13,450,361
4.625% notes	1,821,594	1,853,738
4.5% notes	1,817,083	1,850,045
1.625% notes	8,101,424	34,959,355
4.000% notes	1,496,062	8,313,835
Unapplied note prepayments – 5%	<u>(11,285,982)</u>	<u>(10,740,136)</u>
	71,038,854	80,248,447
 CoBank in quarterly and monthly installments of varying amounts through 2032 at interest rates varying with the Bank's current rate of interest (currently 2.90% to 4.94%)	 27,769,582	 19,355,732
 Rural Economic Development Zero-Interest Loan payable to RUS in monthly installments of varying amounts through May 2011	 1,851,357	 1,123,577

KENERGY CORP.

NOTES TO FINANCIAL STATEMENTS

Years Ended December 31, 2004 and 2003

4. Long-Term Debt, Continued

	<u>2004</u>	<u>2003</u>
First mortgage notes payable to National Rural Utilities Cooperative Finance Corporation in monthly installments of varying amounts through 2033, including interest at 4.40% (2.65% beginning January 1, 2004)	-	3,376,171
Federal Financing Bank in quarterly installments of varying amounts beginning March 2004 through December 2037, including 2.22% interest	<u>11,000,000</u>	<u>6,000,000</u>
Total long-term debt	111,659,793	110,103,927
Less current maturities	<u>3,757,222</u>	<u>3,926,165</u>
	<u>\$ 107,902,571</u>	<u>\$ 106,177,762</u>

Aggregate annual maturities of long-term debt at December 31, 2004, are:

2005	\$ 3,757,222
2006	3,958,425
2007	3,880,655
2008	3,901,593
2009	3,809,166
Thereafter	<u>92,352,732</u>
	<u>\$ 111,659,793</u>

All assets of Kenergy are pledged as collateral on the long-term debt as previously described. Kenergy has available \$10,355,000 in unadvanced loan funds from Federal Financing Bank at December 31, 2004.

5. Short-Term Borrowings

Kenergy has unsecured line of credit agreements with financial institutions permitting short-term borrowings for general corporate purposes totaling \$35,000,000. Rates for such borrowings are variable. There was \$1,000,000 outstanding under these agreements at December 31, 2004, at 4.05%, and no outstanding borrowings at December 31, 2003.

KENERGY CORP.

NOTES TO FINANCIAL STATEMENTS

Years Ended December 31, 2004 and 2003

6. Major Customers

Operating revenue for 2004 and 2003 includes approximately \$186.5 million and \$184.5 million, respectively, attributable to sales of power to two aluminum smelting customers. Accounts receivable from these customers totaled \$14.0 million and \$15.7 million at December 31, 2004 and 2003, respectively.

Operating revenue also includes sales of power to six other large industrial customers totaling approximately 9.52 % and 10.14% of the Company's operating revenue for 2004 and 2003, respectively.

7. Cost of Power

Kenergy presently purchases all of its power and energy requirements from Big Rivers Electric Corporation (Big Rivers) under wholesale power contracts which expire in 2023 with the exception of the power and energy requirements of its two major customers, which is supplied by LG&E Energy Marketing, Inc. and other suppliers under power purchase agreements expiring annually through December 31, 2011. Accounts payable under such contracts were \$8.2 million and \$12.1 million, respectively, at December 31, 2004, and \$8.1 million and \$13.6 million, respectively, at December 31, 2003.

8. Pension Plans

Kenergy has various pension plans covering its employees.

Noncontributory Defined Benefit Plan

Kenergy has a noncontributory defined benefit pension plan covering former Green River Electric Corporation (GREC) employees who were members of the plan on January 1, 1987. Employees with an original date of hire on or after January 1, 1987, are not eligible to join the defined benefit plan. The benefits are based on years of service and the employee's highest average monthly compensation for three consecutive years of service.

Kenergy amended the defined benefit plan effective January 1, 1987, to offset benefits accruing after January 1, 1987, by the benefits provided by the defined contribution plan discussed below. Kenergy has adopted the provisions of Statement of Financial Accounting Standards No. 87, "Employer's Accounting for Pensions," as amended by Statement of Financial Accounting Standards No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits."

KENERGY CORP.

NOTES TO FINANCIAL STATEMENTS

Years Ended December 31, 2004 and 2003

8. Pension Plans, Continued

Noncontributory Defined Benefit Plan, Continued

Net pension cost (income) for 2004 and 2003 included the following components:

	<u>2004</u>	<u>2003</u>
Service cost	\$ 51,837	\$ 62,665
Interest cost on projected benefit obligation	150,430	145,397
Expected return on plan assets	(160,353)	(149,694)
Net amortization and deferral	<u>43,889</u>	<u>56,483</u>
Pension expense (income)	\$ <u>85,803</u>	\$ <u>114,851</u>

The following table sets forth the plan's funded status and the amount recognized in Kenergy's balance sheet at December 31:

	<u>2004</u>	<u>2003</u>
Accumulated benefit obligation:		
Vested	\$ <u>2,179,297</u>	\$ <u>2,074,881</u>
Projected benefit obligation	\$ 2,757,641	\$ 2,783,372
Plan assets at fair value	<u>2,048,827</u>	<u>2,010,302</u>
Deficiency of plan assets over projected benefit obligation	(708,814)	(773,070)
Unrecognized net loss	971,998	1,128,309
Unrecognized prior service cost	33,821	52,136
Unrecognized net transition asset	<u>-</u>	<u>(24,567)</u>
Net amount recognized	\$ <u>297,005</u>	\$ <u>382,808</u>
Amounts recognized consist of:		
Accrued pension liability	\$ (130,470)	\$ (64,579)
Intangible asset	33,821	52,136
Accumulated other comprehensive income	<u>393,654</u>	<u>395,251</u>
Net amount recognized	\$ <u>297,005</u>	\$ <u>382,808</u>

KENERGY CORP.

NOTES TO FINANCIAL STATEMENTS

Years Ended December 31, 2004 and 2003

8. Pension Plans, Continued

Noncontributory Defined Benefit Plan, Continued

In determining the actuarial present value of the projected benefit obligation, the weighted average discount rate used was 5.50% and 6.00% for the periods ended December 31, 2004 and 2003, respectively, and the rate of increase in future compensation levels was 4.00% for 2004 and 2003. The expected long-term rate of return on assets was 8.00%. Plan assets consist of investments in a guaranteed investment contract and pooled separate accounts. There were no employer or employee contributions for the years ended December 31, 2004 and 2003, and the Kenergy does not expect to contribute to this pension plan for the year ending December 31, 2005. Benefits paid totaled \$13,736 for the years ended December 31, 2004 and 2003, and there were no settlements for the years ended December 31, 2004 and 2003.

At December 31, 2004, the investment allocation was 36% equity, 50% debt, and 14% other securities. A narrative description of investment policies and strategies and the basis used to determine the overall expected long-term rate-of-return-on-assets assumption is not available.

Expected retiree pension benefit payments projected to be required during the years following 2004 are as follows:

2005	\$	917,277
2006		10,481
2007		120,521
2008		554,859
2009		7,655
Years 2010 - 2014		1,361,427

Savings and Retirement Plan

Effective January 1, 1987, Kenergy adopted a defined contribution savings and retirement plan. This plan is available to all former GREC employees and all newly hired employees of Kenergy on or after July 1, 1999, excluding temporary employees, with six months of service, who work at least 1,000 hours during each twelve-month period following their date of employment. Under this plan, Kenergy contributes 6% of each employee's annual compensation. In addition, Kenergy will provide matching contributions equal to 50% of each employee's contribution; however, Kenergy's matching contribution will not exceed 5% of each employee's compensation. Employer contributions under this plan totaled \$521,636 and \$524,552 for the years ended December 31, 2004 and 2003, respectively.

KENERGY CORP.

NOTES TO FINANCIAL STATEMENTS

Years Ended December 31, 2004 and 2003

8. Pension Plans, Continued

NRECA Retirement and Security Program

All eligible employees of the former Henderson Union Cooperative Corporation (HUEC) participate in the NRECA Retirement and Security Program (Program), a defined benefit pension plan qualified under Section 401 and tax-exempt under Section 501(a) of the Internal Revenue Code. Kenergy makes annual contributions to the Program equal to the amounts accrued for pension expense. Non-SERP contributions were \$389,562 and \$361,840 for 2004 and 2003, respectively. In this multi-employer plan, which is available to all member cooperatives of NRECA, the accumulated benefits and plan assets are not determined or allocated separately by individual employer.

Retirement Savings Plan

The Retirement Savings Plan is available for all eligible former HUEC employees. The plan allows participants to make contributions by salary reduction, pursuant to Section 401(k) of the Internal Revenue Code. Kenergy will match the contributions of each participant, up to 3% of the participant's base compensation. Kenergy contributed \$89,311 and \$90,398 for 2004 and 2003, respectively. Participants vest immediately in their contributions and the contributions of Kenergy.

9. Postretirement Benefits

In conjunction with a Special Early Retirement Program, Kenergy is obligated to pay postretirement benefits. Twenty-two individuals who elected early retirement December 31, 1999, are provided medical benefits for the lessor of five years or until age 65, with Kenergy paying for 100% of health care premiums up to a maximum of \$600 per month per retiree. Seven individuals who retired December 31, 2002, in conjunction with a change in policy whereby payment of health insurance for disabled employees would be discontinued, will be provided medical benefits for the lessor of five years or until age 65. The funding policy is to pay the related premiums as they become due. Accrued postretirement benefit costs at December 31, 2004 and 2003, were approximately \$230,356 and \$395,986, respectively, and are included in other current and accrued liabilities.

No other postretirement benefits are provided to Kenergy employees or directors with the exception of allowing retirees (non-SERP) to participate in the Kenergy health care program while paying 100% of their own premiums.

KENERGY CORP.

NOTES TO FINANCIAL STATEMENTS

Years Ended December 31, 2004 and 2003

10. Financial Instruments

Statement of Financial Accounting Standards No. 107, "Disclosures about Fair Value of Financial Instruments," requires Kenergy to disclose estimated fair values of its financial instruments. Fair value estimates, methods, and assumptions are set forth below for Kenergy's financial instruments:

The carrying amounts of cash and cash equivalents, accounts receivable, other current assets, accounts payable, and other current liabilities approximate fair value because of the short-term maturity of those instruments.

In management's opinion, the carrying value of long-term debt also approximates fair value.

Kenergy's financial instruments that are exposed to concentrations of credit risk consist primarily of cash and trade accounts receivable. Kenergy had cash deposits in a financial institution in excess of the amount insured by the Federal Depository Insurance Corporation (FDIC) at December 31, 2004 and 2003. The risk is managed by maintaining all deposits in high quality institutions. Kenergy routinely assesses the financial strength of its customers and, as a consequence, believes that its trade accounts receivable credit risk exposure is limited.

11. Deferred Compensation

Included in other investments and other noncurrent liabilities is \$1,722,189 and \$1,809,794 at December 31, 2004 and 2003, respectively, relating to deferred compensation agreements. The deferred compensation plan was frozen in 1999. Benefits are being paid out and the obligation is being relieved over a period of ten years through approximately 2012.

12. Related Party Transactions

Big Rivers (Note 3) provides billing, safety training, and other services to its three distribution cooperative members for which it is not reimbursed. Big Rivers reimburses its members for economic development costs. Kenergy is also reimbursed for marketing personnel who provide services for all three of Big Rivers' members. Such services requested for reimbursement from Big Rivers during the years ended December 31, 2004 and 2003, totaled \$506,942 and \$341,175, respectively, of which \$51,242 and \$96,608, respectively, was included in accounts receivable.

KENERGY CORP.

NOTES TO FINANCIAL STATEMENTS

Years Ended December 31, 2004 and 2003

13. **Income Tax Status**

Kenergy is exempt from federal and state income taxes under Section 501(c)(12) of the Internal Revenue Code and, accordingly, the accompanying financial statements include no provision for such taxes.

14. **Limitation on Distributions**

Without the prior written approval of RUS, Kenergy shall not in any calendar year make any Distributions (exclusive of any Distributions to the estates of deceased natural patrons) to its members, stockholders or consumers except as follows:

If, after giving effect to any such Distribution, the Equity of the Borrower shall be greater than or equal to 30% of its Total Assets; or

If, after giving effect to any such Distribution, the Equity of the Borrower shall be greater than or equal to 20% of its Total Assets and the aggregate of all Distributions made during the calendar year when added to such Distribution shall be less than or equal to 25% of the prior year's margins.

Provided however, that in no event shall Kenergy make any Distributions if there is unpaid, when due, any installment of principal of (premium, if any) or interest on any of its payment obligations secured by the Mortgage, if the Borrower is otherwise in default hereunder or if, after giving effect to any such Distribution, the Borrower's current and accrued assets would be less than its current and accrued liabilities.

15. **Risk Management**

Kenergy is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. Kenergy carries commercial insurance for all risks of loss, including workers' compensation, general liability and property loss insurance. As is customary in the utility industry, Utility Plant is not insured with the exception of substations. Settled claims resulting from these risks have not exceeded commercial insurance coverage in 2004 or 2003.

KENERGY CORP.

NOTES TO FINANCIAL STATEMENTS

Years Ended December 31, 2004 and 2003

16. Rate Matters

Kenergy received an order on April 22, 2004 reducing the rates of the five largest industrials \$144,600 per year, and directing Kenergy to file a rate application no later than December 31, 2004, to either extend the 4% consolidation rider to all customers or propose an alternative methodology to pass the earnings to all ratepayers. Kenergy was also directed to begin to address the disparity between customer classes and cost of service.

The 4% consolidation credit automatically expired on September 2, 2004. Kenergy filed the rate application on December 15, 2004, requesting an overall reduction in revenues of \$528,491 along with proposed rate changes to begin addressing customer class disparity and certain grandfathered rates. The final order is expected around June 1, 2005.

17. Reclassifications

Certain accounts in the prior year financial statements have been reclassified for comparative purposes to conform to the presentation in the current year financial statements. These reclassifications had no effect on total assets or net margin.



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

Board of Directors
 Kenergy Corp.
 Henderson, Kentucky

We have audited the financial statements of Kenergy Corp. (Kenergy) as of and for the year ended December 31, 2004, and have issued our report thereon dated February 24, 2005. We conducted our audit 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.

Compliance

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

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Kenergy's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted other matters involving the internal control over financial reporting that we have reported to the management of Kenergy in a separate letter dated February 24, 2005.

This report is intended solely for the information and use of the Board of Directors, management, and the Rural Utilities Service and supplemental lenders and is not intended to be and should not be used by anyone other than these specified parties.

Riney, Hancock + Co., PSC

Owensboro, Kentucky
 February 24, 2005