BOEHM, KURTZ & LOWRY
ATTORNEYS AT LAW
36 EAST SEVENTH STREET
SUITE 1510
CINCINNATI, OHIO 45202
TELEPHONE (513) 421-2255

TELECOPIER (513) 421-2764

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December 30, 2008

Stephanie Stumbo Executive Director,
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40602

Re: **Case No. 2007-00455**

Dear Ms. Stumbo:

Please find enclosed the original and twelve (12) copies of the sworn BRIEF OF ALCAN PRIMARY PRODUCTS CORPORATION AND CENTURY ALUMINUM OF KENTUCKY GENERAL PARTNERSHIP in the above-referenced matter.

By copy of this letter, all parties listed on the attached Certificate of Service been served. Please place these documents of file.

Very Truly Yours,

Michael L. Kurtz, Esq.
BOEHM, KURTZ & LOWRY

MLKkew
Attachment
cc: David C. Brown, Esq.
Certificate of Service

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing was served by mailing a true and correct copy, by regular U.S. mail (unless otherwise noted) to all parties on the 30TH day of December, 2008.

Michael L. Kurtz, Esq.

Honorable Douglas L Beresford
Attorney At Law
Hogan & Hartson, L.L.P.
555 Thirteenth Street, N.W.
Washington, DC 20004-1109

C William Blackburn
Big Rivers Electric Corporation
201 Third Street
P. O. Box 24
Henderson, KY 42420

David Brown
Stites & Harbison, PLLC
1800 Providian Center
400 West Market Street
Louisville, KY 40202

George F Hobday. Jr
Hogan & Hartson, L.L.P.
555 Thirteenth Street, N.W.
Washington, DC 20004-1109

Honorable Dennis G Howard II
Assistant Attorney General
Office of the Attorney General Utility & Rate
1024 Capital Center Drive
Suite 200
Frankfort, KY 40601-8204

Honorable John N Hughes
Attorney at Law
124 West Todd Street
Frankfort, KY 40601

Honorable Frank N King, Jr.
Attorney at Law
Dorsey, King, Gray, Norment & Hopgood
318 Second Street
Henderson, KY 42420

Honorable Don Meade
Attorney at Law
Priddy, Cutler, Miller & Meade
800 Republic Bldg.
429 W. Muhammad Ali Blvd.
Louisville, KY 40202

Honorable James M Miller
Attorney at Law
Sullivan, Mountjoy, Stainback & Miller, PSC
100 St. Ann Street
P.O. Box 727
Owensboro, KY 42302-0727

Gary Osborne
President
International Brotherhood of Electrical Workers -
Local Union 101
2911 W. Parrish Avenue
Owensboro, KY 42301

Honorable Kendrick R Riggs
Attorney at Law
Stoll Keenon Ogden, PLLC
2000 PNC Plaza
500 W Jefferson Street
Louisville, KY 40202-2828

Honorable Allyson K Sturgeon
Attorney at Law
E.ON U.S. Services, Inc.
220 West Main Street
Louisville, KY 40202

Melissa D Yates
Attorney
Denton & Keuler, LLP
555 Jefferson Street
P. O. Box 929
Paducah, KY 42002-0929

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION OF KENTUCKY

THE APPLICATIONS OF BIG RIVERS ELECTRIC CORPORATION FOR (I) APPROVAL OF WHOLESALE TARIFF ADDITIONS FOR BIG RIVERS ELECTRIC CORPORATION, (II) APPROVAL OF TRANSACTIONS, (III) APPROVAL TO ISSUE EVIDENCES OF INDEBTEDNESS, AND (IV) APPROVAL OF AMENDMENTS TO CONTRACTS; AND OF E.ON U.S., LLC, WESTERN KENTUCKY ENERGY CORP. AND LG&E ENERGY MARKETING) INC. FOR APPROVAL OF TRANSACTIONS	:	**Case No. 2007-00455**

BRIEF SUBMITTED BY CENTURY ALUMINUM OF KENTUCKY GENERAL PARTNERSHIP AND ALCAN PRIMARY PRODUCTS CORPORATION

Century Aluminum of Kentucky General Partnership ("Century") and Alcan Primary Products Corporation ("Alcan"), backed by their respective parent organizations, Century Aluminum Company and Rio Tinto Alcan, strongly support the Unwind Transaction and urge the Commission to approve the Joint Application, as amended, because it is required by the public interest.

INTRODUCTION

The Commission is well aware that without the Unwind, Century and Alcan have limited prospects for operating their Smelters beyond 2010-11 because they would lose a competitively priced source of energy which primarily determines whether a smelter can compete in the worldwide aluminum market.[1] Professor Paul Coomes of the University of Louisville School of Business explains that a Smelter shutdown has dire economic consequences beyond the loss of Smelter jobs themselves:

> "Shutting down the smelting operations would jeopardize the viability of related business activities, both upstream and downstream. Among the supporting industries that would be affected are river barges (that bring in alumina), electricity producers, and the various vendors to the smelting plants. Downstream, the Smelters supply raw aluminum to rolling and extruding mills in the region, which are clustered to support wiring plants, auto parts plants, can factories, and other heavy aluminum users in the region."[2]

Professor Coomes projects that a shutdown of the Smelters would mean not only a loss of the 1,400 direct Smelters jobs but over 5,000 total jobs and a total of $193,000,000 in annual payroll and $16,700,000 in annual tax revenue to state and local government.[3] The economy of the Commonwealth is in no shape to allow this to happen. While the Unwind may entail some risks, those risks pale in comparison to losing the aluminum industry of Western Kentucky.

This brief does not undertake to review the entire record or to comment on the variety of regulatory issues that may need to be addressed in the Commission's final Order. Suffice it to say the Smelters support Big Rivers and E.ON in all regulatory approvals requested and required to close the transaction. Instead, the Smelters believe it would be most helpful to the Commission to focus this Brief on four core issues:

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[1] Fayne Direct Testimony at p. 4; Coomes Direct Testimony Ex. 2 at p. 1; Hale Direct Testimony at p. 2; Authier Direct Testimony at p. 2.

[2] Coomes Direct Testimony Ex. 2 at p. 1-2.

[3] Coomes Direct Testimony at p. 4.

1. The Commission must be assured that the Unwind is consistent with the public interest, and that is clearly so from a variety of perspectives.

2. It is important for the Commission to understand how the Smelter contracts help produce rates for Rural customers that will be lower than if the Unwind does not occur.

3. The supplemental testimony of Witness Brevitz deserves little weight because it contains erroneous assumptions leading to erroneous conclusions and because it fails to consider the rate implications if the Unwind does not occur.

4. While the Smelters must take steps to manage their businesses responsibly, they would not enter into this transaction unless they intend to operate in Kentucky for the long term; and this transaction provides them reasonable prospects for doing so.

I. THE UNWIND TRANSACTION IS THE BEST SOLUTION FOR ALL CONSTITUENTS AND THE COMMONWEALTH OF KENTUCKY AND IS THEREFORE CONSISTENT WITH THE PUBLIC INTEREST

The legal standard governing the Commission's decision in this case is whether the Unwind transaction is consistent with the public interest. The most relevant statute is KRS 278.218 which concerns the transfer of ownership or control of utility assets. KRS 278.218(1) provides in pertinent part:

> "No person shall acquire or transfer ownership of or control, or the right to control, any assets that are owned by a utility . . . without prior approval of the commission. . . "

In this case the "utility" is Big Rivers which has ownership of the assets and the "Person" transferring control of those assets is Western Kentucky Electric Corp. ("WKE"); hence the transaction is jurisdictional. The legal standard that guides the Commission is KRS 278.218(2):

> "(2) The commission shall grant its approval if the transaction is for a proper purpose and is consistent with the public interest."

If the Commission steps back from the details of the Unwind and looks at the basic building blocks, it can readily see that the transaction is straightforward in design and offers advantages and protections to each of the parties.

- The generating units will be returned to Big Rivers early and in good condition, in 2009 rather than in 2023 when their condition will be uncertain at best.
- The aluminum Smelters will terminate their current contracts with WKE, execute new long-term contracts with Big Rivers/Kenergy, and thus be able to operate and support thousands of jobs beyond 2010-11.
- The employees of WKE who man the units will become employees of Big Rivers. Cash and non-cash compensation, indemnities and post-closing service contracts from E.ON will provide Big Rivers with the resources to operate the units effectively and efficiently upon Closing.
- E.ON will pay Big Rivers total compensation of at least $755.9 million and the 1.24 TIER provided by the Smelters will re-establish Big Rivers as a financially healthy G&T cooperative for the first time in over twenty-five years, with an equity ratio of 26% and the capacity to refinance its pollution control bonds and incur additional debt when and as needed. This new financial health will allow Big Rivers to better promote economic development in Western Kentucky.
- The exposure of the Rural customers to fuel and environmental costs will be mitigated by two factors: (i) $327 million in subsidies provided by the Smelters; and (ii) the Economic Reserve of $157 million.
- Cash paid by E.ON to the Smelters will compensate them for giving up the value of their current contracts through 2010-11 and provide them with multi-year protection against rising fuel costs to allow them to operate well beyond 2010-11 and in turn provide subsidies to the non-Smelter customers.

This is the essence of the Unwind. Although the transaction is complex in its details, the overall picture shows that all parties, including the Commonwealth of Kentucky, are winners.

A. The Public Interest Requires Maintaining the Viability of the Aluminum Industry in Western Kentucky.

The specter of Western Kentucky's loss of the aluminum smelting industry was first brought to the Commission's attention in 2005 in Administrative Case No. 2005-00090 when the Smelters filed comments pointing out that Kentucky's generation resource planning was unprepared for meeting the Smelter load after 2010-11.[4] The Smelters noted that the wholesale power market had failed to evolve as anticipated when the Lease Agreement was approved in 1998 and offered several options that could be explored. The Smelters appeared in this Administrative Case because the Commission previously recognized the importance of maintaining the aluminum smelting industry. In its April 30, 1998 Order conditionally approving the Lease Agreement, the Commission stated:

> "We truly believe that Big Rivers and the Smelters are vital to the economy of western Kentucky and their fortunes have been intertwined for many years. Even though our decisions today sever most of their existing ties, the Smelters' ability to purchase reasonably priced power at fixed costs from LEM is the result of the availability of valuable generating assets on the Big Rivers system."[5]

In the 2005 Administrative Case the Commission was not asked nor was it in a position to take specific steps to resolve the issue. The Commission clearly signaled, however, its belief that something needed to be done.

[4] June 8, 2005 Comments of Alcan Primary Products Corporation and Century Aluminum of Kentucky, LLC, Case No 2005-00090

> "The issues raised by Alcan and Century are both serious and complex. It is true that competitive energy markets have not evolved as Alcan and Century expected. It appears that the discussion in this case of how the smelter loads will be served beyond the expiration dates of their existing contracts has merely scratched the surface of the issues that could impact how this matter may be resolved. We believe that this issue will require further detailed review by numerous parties, including the Commission, the smelters, Big Rivers, Kenergy, LG&E Energy as lessee of Big Rivers' generation, and representative of the state and local governments."[6]

The numerous parties have now done exactly what the Commission envisioned. Everyone recognizes that if Kenergy were required to purchase 100% of the power needed to serve the Smelter load from the wholesale market, in all probability one or both Smelters could not operate economically and would have to close. Closure, as testified to by Professor Coomes, would have a devastating impact on Western Kentucky. As contemplated by the Commission, the Smelters have worked with Big Rivers, Kenergy, Jackson Purchase, Meade County and E.ON for over four years to keep that catastrophe from happening. The parties now need the Commission's affirmation that the solution, agreed upon by all the transaction parties, is in the public interest. While there may be other ways to retain the aluminum industry presence in Western Kentucky, none has surfaced. The Unwind transaction is the surest way to preserve Smelter operations.

It is true that without the Unwind Big Rivers could sell excess power to the Smelters after 2010-11. Though an incomplete solution, it is a path the Smelters would pursue if there is no Unwind. Big Rivers has modeled the impact on Member rates if it sold only part of its excess

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[5] Application of Big Rivers Electric Corporation and Others for Approval of Transaction, PSC Case No. 97-204. Order April 30, 1008 at pp. 41-42.

[6] Kentucky's Electric Infrastructure: Present and Future – An Assessment Conducted By The Kentucky Public Service Commission August 22, 2005, p. 59, attached as Appendix A to the Order in Administrative Case No. 2005 - 00090 dated September 15, 2005

power to the Smelters (200 MW) at the Large Industrial Rate.[7] There are several negatives to that approach. For example, 200 MW would be insufficient to keep both Smelters open, or even one operating at full load. Additionally, a sale of 200 MW at the Large Industrial Rate would result in non-Smelter rates being higher than they would be under the Unwind.[8] Under that approach Big Rivers would have only limited ability to support the Smelters with excess power and that support would create pressure on Member rates well beyond the projected rates under the Unwind.

The Commission should also consider the relatively nominal marginal cost to the Members to enable the aluminum industry to survive and continue to benefit the economy of Western Kentucky. Even before considering a 20% to 25% rate increase discussed below, Big Rivers Redirect Exhibit 4 compares the impact on Member rates of the Unwind versus a no-Unwind scenario in which all excess power is sold off-system rather than to the Smelters (the "arbitrage" case). For the six-year period, 2009 through 2014, the average increase to the Members under the Unwind is $5.51 per MWh (14.79%). The arbitrage or "best case" scenario for the Members necessarily involves the shutdown of the Smelters, and still reflects an increase in the lesser amount of $3.57 per MWh (9.6%) or approximately $4.7 million per year. The choice, therefore, is between shutting down the Smelters and suffering the loss of 5,000 direct and indirect jobs, $193,000,000 in annual payroll and $16,700,000 in tax revenue to state and local government in order to "save" $4.7 million for the Members. Based on the amount of sales to the Rural customers, allowing the Smelters the opportunity to continue operations means an

[7] Amended Application October 9, 2008, Exhibit 100.

[8] Id.

addition of only $2.00[9] to the monthly bill of the average customer who already enjoys some of the lowest electric rates in the nation.

The incremental cost to Rural ratepayers to help save the aluminum industry and also avoid the market pricing risk inherent in the arbitrage case is minimal. This is why the Members believe the Unwind is in the best interest of ratepayers/owners: to preserve the aluminum industry, to give customers a good price for the electricity they buy, and to avoid continuing legal battles (see Section E, page 15 below).[10] The Boards of Directors of the three Member cooperatives that own Big Rivers are duly elected to represent the interests of the ratepayer/owners, and they voted 25-1 in favor of the Unwind.[11] They believe the Unwind "is in the best interest of our customers."[12]

In addition to the Smelters and other transaction parties, the Commonwealth of Kentucky also has a large stake in preserving the aluminum industry. State officials devote their life's work to developing economic engines like the Smelters, and opportunities like this come few and far between. The matter before this Commission is a compelling example of the importance of business retention. It would take years and a considerable amount of good fortune or luck for the Commonwealth to replace the jobs, payroll, income and property tax revenue generated by the Smelters and the upstream and downstream businesses they spawn. We are witnessing today in Frankfort the numbing effects of too little state revenue when compared to the rising costs of education, healthcare, mine safety, retirement funding and many other pressures on the Commonwealth's General Fund. Preserving the jobs and tax revenues that result from the

[9] TE Vol II at 51.

[10] Supplemental Testimony of Burns E. Mercer, p. 4

[11] TE, Vol. I at 237

[12] TE Vol. I at 239

Smelter presence are of utmost concern to the Commonwealth, especially during this recessionary period, and thus in the public interest. Indeed, the Commonwealth's interest in the Unwind is confirmed by the General Assembly's amendment of KRS 279.120 in 2006 to allow for the contingency of Big Rivers exporting the Smelter power without disturbing its legal status as a Kentucky cooperative.

Finally, the Unwind reestablishes jurisdictional control over the generating capacity lost in 1998 which was the price paid for Big Rivers to emerge from bankruptcy. Bringing that capacity back into a healthy Big Rivers with borrowing capacity is the only way Western Kentucky can hope to create economic development because otherwise Big Rivers will have no ability to develop electric infrastructure and keep pace with the rest of the state.[13] Mr. Thompson was candid that if there is no Unwind, WKE will market the power previously sold to the Smelters and seek the maximum price for it in the marketplace. That is not likely to be to the Smelters[14] or, for that matter, any other customer in Kentucky to whom cost based rates are available.

B. <u>The Unwind Transaction Will Place Big Rivers In a Financially Strong Position which is Consistent with the Public Interest</u>

Overnight the Unwind will convert Big Rivers from a cash-strapped, transmission company with virtually no borrowing capacity, a negative equity and limited credit capacity to sell off-system, into a financially healthy generation and transmission utility with deep reserves. This will be the first time Big Rivers has attained this level of financial security since the late 1970's. It will position Big Rivers for the future and is in the public interest.

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[13] TE Vol. I at 200.

At closing E.ON will pay Big Rivers cash and non-cash compensation valued between \$755.9 million[15] and \$842.3 million,[16] depending on how certain asset values are calculated. If Big Rivers can survive without the Unwind, it would resume control of the generating units anyway. But the choice is, should Big Rivers take the units back now in good condition, with a healthy balance sheet and no future liability to WKE, or take them back in 2023 in uncertain condition, owing WKE a Residual Value Payment of \$377 million[17] and owing RUS approximately \$250 million on the ARVP Note.[18] The rather easy answer is to unwind the 1998 Lease Agreement now and reconstitute Big Rivers as a financially sound utility.

It is unlikely that, without the Unwind, Big Rivers can survive and reposition itself to take the units back in 2023 when the Lease Agreement expires. The facts brought out at the hearing are these:

- The June 19, 2008 downgrade of Ambac required Big Rivers to buy out the Bank of America and Philip Morris Capital Corporation leveraged leases at a cost of \$129.4 million before any further participation by E.ON.[19] These payments leave Big Rivers with only about \$12.1 million in cash[20] and a \$15 million line of credit which Mr. Core described as a "drop in the bucket."[21] Big Rivers now faces immediate capital demands for its share of capital improvements required by the 1998 Lease Agreement, including the likelihood of significant costs imposed by environmental mandates, and a \$13 million note payment to PMCC at the end of 2009.
- Due to the subsequent Ambac downgrade, Big Rivers is paying a penalty interest rate of 18% on \$83.3 million of pollution control bonds. To extract itself from this penalty interest rate, it must refinance the pollution control bond issue after

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[14] TE Vol. I at 202-03

[15] Exhibit CWB-15

[16] Revised Exhibit PWT-3

[17] TE Vol. II at 140, 147.

[18] Big Rivers Response to AG Item 43; TE Vol. II at 147

[19] Blackburn Third Supplemental Direct Testimony at p. 10

[20] Exhibit CWB-17.

[21] Big Rivers Response to AG Item 43

the Unwind closes. Without the Unwind, refinancing is not feasible.[22] The interest rate differential of 13% between the penalty rate and the 5% rate contained in the financial model[23] increases interest expense by $10.8 million annually which will diminish the margins Big Rivers could hope to make from off-system sales.

- Big Rivers is unable to meet its capital demands by borrowing from RUS, and, because of its negative net worth, is unable to access the capital markets.[24]
- Big Rivers is unable to fully capitalize on off-system sales with counterparties requiring collateral or other credit resources that Big Rivers cannot offer.[25]

It is fortuitous for Big Rivers that the Unwind transaction can repair the damage caused by Ambac's diminished credit standing. With the Unwind, Big Rivers will receive $61 million from E.ON representing half of the PMCC buyout cost,[26] it will operate under an Indenture and be able to access the capital markets without existing RUS restrictions, and it will have a 26% equity ratio that will allow it to once again satisfy its capital, operating and public interest obligations with greater facility than would be otherwise possible.

C. The Unwind Transaction is the Low Cost Solution for Non-Smelter Ratepayers And Is In the Public Interest

While the Financial Model projects Member rates to increase under the Unwind compared to rates now in effect, the increase will be substantially less than the 20% to 25% increase that by Big Rivers will seek if the Unwind does not take place. Witness Mark Bailey testified that if there is not an Order approving the Unwind by late January, Big Rivers will be forced to file for a rate increase of this magnitude.[27] No such rate increase would be required by

[22] TE Vol. II at 84-85.

[23] Financial Model, Section XIII, line 121.

[24] TE Vol. II at 24

[25] TE Vol. II at 124

[26] Blackburn Third Supplemental Direct Testimony at p. 10

[27] TE Vol. I at 103

the Unwind.[28] On the other hand, under the Unwind, Rural rates are projected to go up by only 14.79% on average over six years.[29] The Smelters do not take a position on whether such a rate increase would be warranted, but make the obvious point that a 20% to 25% rate increase can be avoided by approving the Unwind and that, generally speaking, lower electric utility rates are more consistent with the public interest than higher rates.

Big Rivers also provided the Commission with information that if it sells 200 megawatts of excess energy to the Smelters at the Large Industrial Rate after 2010-11, Rural rates for the six year period 2009-14 would be 6.9% higher on average than under the Unwind.[30] In fact, the 6.9% ($2.57 per megawatt hour) differential is understated if Big Rivers were required to sell <u>all</u> its excess capacity to the Smelters in order to preserve as many jobs and as much of the aluminum industry as possible.

Taking into account both no-Unwind factors – the immediate across the board 20% to 25% rate increase and the likelihood of cost-based sales to the Smelters after 2010-11 – it is clear the projected rates to Big Rivers' non-Smelter customers will be lower with the Unwind than without the Unwind.

D. <u>Big Rivers Financial Risk Will Be Mitigated By The Upgrade To Its Transmission System So It Can Fully Participate in the Wholesale Power Market When and As Needed</u>

As part of the Unwind structure, Big Rivers has received a Certificate of Convenience and Necessity in KPSC Case No. 2007-00177 to construct a thirteen-mile transmission line in Ohio County to connect the switchyard at Plant Wilson to its existing 161 kV transmission line

[28] Big Rivers does not forecast a base rate case under the Unwind until 2017. Exhibit 79 at p. 3, line 12.

[29] Big Rivers Redirect Exhibit 4.

[30] Big Rivers Redirect Exhibit 4.

in southern Ohio County. This new transmission facility will provide the capability for Big Rivers to export all 850 megawatts of the Smelter load if smelting production went away.[31] The ability of Big Rivers to fund the cost of the new facility is a direct by-product of the Unwind because it provides Big Rivers with the financial resources to support the project.

The electric utility environment has changed in ten years so the risk to Big Rivers of marketing excess power resulting from Smelter closure has been significantly mitigated since 1998 when Big Rivers last operated its power plants. Since 1998, organized wholesale power markets have developed.[32] The entire Smelter load is less than 1% (0.77%) of the wholesale power transactions in the two major markets (MISO and TVA) to which Big Rivers is interconnected and those markets could absorb the capacity without materially affecting price.[33] Prior to 1998 Big Rivers could not physically export the 850 MW Smelter load, but it is no longer restricted in light of the Phase 2 transmission upgrade.[34] Finally, the Kentucky General Assembly's act to amend KRS 279.120 will allow Big Rivers to remarket the power that otherwise would have been sold to the smelters without jeopardizing its cooperative status.[35]

E. Public Interest Favors A Solution That Avoids Litigation

The Unwind resolves important contractual and policy disagreements that now exist or are likely to arise among Big Rivers, Kenergy, E.ON and the Smelters. With no Unwind there will be disputes between E.ON and Big Rivers over interpretation of the 1998 Lease Agreement and related documents. For example, if there is a carbon tax, Big Rivers faces the same relative

[31] Blackburn Third Supplemental Direct Testimony at p. 58.

[32] TE Vol. II at 134

[33] Blackburn Third Supplemental Direct Testimony at p. 61.

[34] TE Vol. II at 135

[35] TE Vol. II at 135-6.

global warming exposure with or without the Unwind, but Big Rivers' interpretation of the Lease Agreement reduces that exposure if there is a cap and trade system.[36] E.ON has a different view. Mr. Thompson testified there will be disputes on this issue, and accordingly they "will not make it good" for Big Rivers and the Members.[37] Moreover, responding to questions from Vice-Chairman Gardner, Mr. Thompson testified that without the Unwind legal disputes between E.ON and Big Rivers are possible with respect to generating plant conditions and transmission rights, as well as environmental issues.[38]

The Smelters and Big Rivers have differing views on Kenergy's right to access Big Rivers' excess power so Kenergy can fulfill its statutory obligation to serve the Smelters with the lowest cost power.[39] That dispute is rendered moot by the Unwind until 2023, but as part of the Unwind, Big Rivers and the Smelters will undertake to resolve the matter by 2015. Failure to approve the Unwind would place the Commission and the courts of Kentucky squarely in the middle of a critical issue necessary to preserve the Western Kentucky economy. For all practical purposes, the Commission's approval of the Unwind makes the issue go away.

As discussed above, a general base rate case in early 2009 seeking a 20% to 25% rate increase is another major piece of litigation that will be avoided by the Unwind.

For these reasons, the Smelters urge the Commission to approve the Unwind transaction, as filed. The parties have reached agreement after four years of arduous negotiations and that agreement clearly serves the public interest.

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[36] TE Vol. I at 253, 263.

[37] TE Vol. I at 201, 226.

[38] TE Vol. I at 227-28.

[39] TE Vol. II at 55.

II. THE SMELTER CONTRACTS DELICATELY BALANCE THE INTERESTS OF BIG RIVERS, THE MEMBERS AND SMELTERS, PROVIDING SUBSIDIES TO THE MEMBERS WHILE MAINTAINING A COST STRUCTURE UNDER WHICH THE SMELTERS CAN OPERATE

A. Smelter Subsidies To The Members Are Substantial

Extensive negotiations among the Smelters, Members, Big Rivers and E.ON have created a unique but complex contract structure in order to accommodate the interests of the parties. Much of that structure is devoted to preserving the value the Members have under the 1998 transaction. Witness Blackburn calculates the value of the Smelter subsidies to the Members at $327 million over the life of the contract.[40] The payments that will be made by the Smelters to the Members and Big Rivers include the following:

- The Smelters have agreed to pay a base rate that includes a $0.25 per megawatt hour premium over the Large Industrial base rate.
- The Smelters have agreed, in addition to a premium over the base rate, to pay an additional charge that will guarantee Big Rivers a 1.24 TIER. This means that if Big Rivers' Net Margin produces a TIER of less than 1.24, the Smelters will pay an additional per megawatt hour charge, subject to the bandwidth, that will produce a 1.24 TIER. The bandwidth ranges from $12.8 million per year in the early years to $34.7 million per year in the later years.[41] For example, the Financial Model projects Net Margins in 2011 of only $100,000 due to higher variable and non-variable fixed O&M costs in that year. Because a 1.24 TIER requires margins of $13,200,000, the Smelters would pay Big Rivers an

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[40] Blackburn Direct Testimony at p. 12

[41] TE Vol. II at 76.

additional $13,100,000.[42] That amount is equal to $1.79 per megawatt hour, an additional charge per megawatt hour that is within the bandwidth.[43]

- The Smelters have agreed to pay two surcharges.

  ✓ The first surcharge is a fixed $0.70 per megawatt hour in 2009-11, $1.00 per megawatt hour in 2012-16, and $1.40 per megawatt hour in 2017-23. The revenue generated by the surcharge for the benefit of the non-Smelter ratepayers ranges from $5.1 million in the first three years to $7.3 million in the middle years to $10.2 million in the final seven years.

  ✓ The second surcharge is comprised of a) a fixed $0.60 per MWh in all years, subject to a $200,000 monthly credit for the first ninety-six months; and b) an additional $0.60 per MWh contingent on actual fuel costs exceeding a baseline. The Financial Model shows this surcharge being worth over $110 million to the Members.[44]

- The Smelters have agreed to permit Big Rivers to take $75 million of its own funds and create the Economic Reserve for the purpose of mitigating future rate increases to all of the Members' retail customers except the Smelters (the additional E.ON contribution bringing the Economic Reserve to $157 million) and another $35 million to create the Transitional Reserve. This $110 million would otherwise be available to Big Rivers to reduce its debt which would reduce

[42] While final calculation of the TIER Adjustment Charge is made at the end of each year, the Smelters pay the estimated Tier Adjustment Charge each month, with the monthly amount recalculated on a quarterly basis (cite).

[43] Exhibit 79 at p. 4, line 89

interest expense which would in turn reduce the Smelters' Tier Adjustment Charge. In essence, the Smelters have agreed to pay the interest cost on the amount of the two reserves plus up to an additional 24% of that cost.

In exchange for these subsidies above and beyond what any other customer pays, the Smelters sought the right to take reasonable steps to manage their businesses if Big Rivers' cost profile dramatically changes or if the cyclical price of aluminum should fall to depressed levels or if a plant suffers physical damage. In any of these cases it would be fundamentally unfair to expect the Smelters to be locked into continuing operations without the ability to manage around those developments. For that reason Big Rivers and the Members agreed to certain well defined exceptions to the Smelters' general commitment.

These Smelters' contractual rights, as set forth in the Retail Agreements, are at three levels. Level One allows the Smelters, in a variety of scenarios, to curtail (not terminate) their operations temporarily in order to avoid operating losses that would otherwise jeopardize the life of the remaining plant. The most notable provision is Potline Reduction Sales pursuant to Section 10.3 of the Retail Agreement. This provision permits each Smelter to curtail 115 megawatts, essentially one potline,[45] for up to forty-eight months and to direct Kenergy and Big Rivers to sell the curtailed power. The curtailing Smelter would receive the Net Proceeds from those sales to mitigate the cost of operating the remaining potlines and thereby prevent a total closure of the Smelter. Similarly, pursuant to Section 10.2 of the Retail Agreement, if a Smelter under certain defined circumstances experiences damage to the Smelter that prevents normal

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[44] TE Vol II at 75

[45] 20% of Century's production and 33% of Alcan's.

smelting operations, the Smelter's power will be sold off-system and the Smelter will receive the Net Proceeds for as long as nine months until plant operations can be restored.

Level Two allows a Smelter to shut down more than one potline, even total operations, but not terminate the Agreement. In such event the Smelter directs Kenergy and Big Rivers to sell the unused power as Surplus Sales pursuant to Section 10.1 of the Agreement and receives a portion of Net Proceeds equal to the contract price of power. Net Proceeds above the contract price are retained by Big Rivers. The purpose of Level Two is to protect the Smelter against a prolonged slump in the economy but without excusing the Smelter from paying the contract price to Big Rivers.

Level Three is the remedy of last resort. If either a curtailment or a temporary cessation of Smelter operations cannot overcome the economic reality of permanent closure, a Smelter may terminate the Retail Agreement but only on one year's notice and not before January 1, 2011.

The Staff has expressed concern that since the Smelters did not agree to a longer lock-in period, the Smelters could exit the Big Rivers' system earlier rather than later and leave Big Rivers as a merchant operator. The Smelters cannot commit to a longer lock-in period. Any attempt to force this change on the Smelters would jeopardize the transaction. Instead, the operating presumption should be that the Smelters will remain in Kentucky long-term for the following reasons:

- Just as Big Rivers maintained positions that were essentially non-negotiable, the right to terminate on one year's notice but no sooner than January 1, 2011 was a core principle for the Smelters throughout the negotiations. The principle is based on need for flexibility so the Smelters can manage their businesses in a changing world and because of the significant subsidies they are making to the system. In prior years a Smelter could agree to a long-term take-or-pay contract, but at fixed rates. Big Rivers has not been in a position to offer fixed rates or rates based strictly on cost, and the Smelters are not in a position to guarantee rates with these premiums beyond the agreed period.

- The Smelters have a long history of operating in Kentucky and that history includes making operating adjustments when prudently dictated by business conditions. Alcan, for example, was a two line operation from 1994 to 2000.

- Big Rivers is located near plentiful supplies of Illinois basin coal and should be the lowest cost producer of power compared to coal-fired generation serving other Smelters.

- The Smelters have huge investments in their plants and are continuing to make capital improvements that will increase the efficiency of smelting operations.[46] Companies do not lightly make decisions to write off huge investments. Physically, the life of a smelter is fifty to seventy years, and managements know how to live though changing economic conditions and the cyclical nature of commodity prices.[47] The fifth potline at Century is the last smelter facility built in the United States.[48]

- A complete termination of the Retail Agreement and a permanent shut-down of a Smelter is a very expensive proposition.

- Finally, the Smelters' ultimate fate lies as much in the hands of Big Rivers and this Commission as with themselves. Big Rivers has both the power and the responsibility to control its operating and capital costs, to manage budgets in a way so that higher than expected expenses in one area can be offset by expense reductions in others. The Smelters have confidence in Mark Bailey as CEO not to operate Big Rivers with a blank check but to operate judiciously so the Smelters

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[46] TE Vol. I at 156-7.

[47] TE Vol. I at 151

[48] <u>Id</u>

can survive for the long term. The Commission's continuing jurisdiction over the Big Rivers' cost of service provides another level of electric rate protection.

Big Rivers and the Members are not rate-disadvantaged by the closure of a Smelter With completion of the new transmission facility, Big Rivers will have the capability to export all 850 megawatts if one or both Smelters were to close. While an element of market pricing risk would be involved, the market price of wholesale power is currently projected to be higher at all times than Smelter rates.[49] Additionally, the closure of one Smelter would tend to drive down costs to the remaining Smelter through lower TIER Adjustment charges resulting from more off-system sales. Therefore, if one Smelter were forced to close the likelihood of the other continuing to operate would improve. Finally, based on Big Rivers positive off-system sales history in recent years, the margins it will earn under the Unwind, even with the Smelter subsidies, are actually limited because it can never earn more than a 1.24 TIER. If both Smelters are forced to terminate and go away, so does the 1.24 TIER, and Big Rivers' more robust Net Margins resulting from greater off-system sales should result in lower rates for the Members.

III. THE ATTORNEY GENERAL'S TESTIMONY HAS LITTLE VALUE WHEN THE ENTIRE CIRCUMSTANCES OF THE UNWIND ARE CONSIDERED

The Attorney General witness, David Brevitz, filed direct testimony on April 3, 2008, making a "provisional" recommendation approving the Unwind, then filed supplemental testimony on November 21, 2008 stating that he could not recommend the Commission approve the transaction.[50] On cross-examination Mr. Brevitz stated he did not oppose the transaction.[51]

[49] Exhibit CWB-19

[50] Brevitz Supplemental Direct Testimony at 4

[51] TE Vol. II at 279

Mr. Brevitz listed three primary reasons why he was not able to recommend approval of the Unwind.[52] Each is addressed below.

First, he argued that Rural customers would suffer rate increases substantially greater than those projected at the time his original testimony was filed. The Table on page five of his supplemental testimony purported to show the percentage increases resulting from Unwind, comparing the rates projected in the October 2008 Unwind Financial Model with the "current rates." As the smelters pointed out on cross-examination, however, Mr. Brevitz had based his analysis on an erroneous assumption that "current rates" include the MRDA credit that expired in August 2008. By failing to recognize that the MRDA credit had expired, Mr. Brevitz understated the current rates and thus overstated the percentage increases resulting from the Unwind. Mr. Brevitz stubbornly refused to concede this obvious computational error.

More importantly, Mr. Brevitz looked at the Unwind in a vacuum and did not compare rural rates in the Unwind to the rural rates in any no-Unwind scenario. Big Rivers Redirect Exhibit 4 shows that the Unwind results in lower rates for the Rural customers if it is assumed that 200 MW of Big Rivers surplus power is sold to the Smelters in an effort to avoid economic calamity in Western Kentucky. Even in the "arbitrage" scenario where all of Big Rivers excess power is sold off-system (at the expense of 5,000 jobs) residential customers only "save" about $2 per month.[53] Mr. Brevitz' flawed analysis cannot be the basis for valid public policy of the Commonwealth.

Second, Mr. Brevitz cited the lack of consent by the City of Henderson. The Applicants have represented to the Commission on numerous occasions that the Station Two Agreements

[52] Brevitz Supplemental Direct Testimony at p. 4

filed as Exhibit 87 to the Amended Application of October 9, 2008 are in the form that the Applicants are willing to execute and that they hope and believe the City of Henderson will ultimately agree to execute, but that any modification of those agreements resulting from negotiations with the City of Henderson would be resubmitted to the Commission so that both the Commission and the Attorney General could consider the impact of such modifications. The concept could not be clearer. The Smelters urge the Commission to approve the Unwind conditioned upon the resolution of issues with the City of Henderson and the Applicants' re-filing representations.

The Smelters join Big Rivers and the Members in their concern that a resolution of the City's issues not affect Big Rivers' October 9, 2008 financial projections. In that regard, the Smelters will be adamant that the City of Henderson closing condition as set forth in the Termination Agreement, and any other closing condition of a material nature contained in the Termination Agreement, not be waived or modified at closing without Smelter concurrence. As the financial underwriters of the Big Rivers system, the Smelters are relying on the protections contained in the Termination Agreement as much as Big Rivers.

Third, Mr. Brevitz cited the fact that the Application is incomplete since many closing conditions still exist. This is a classic "chicken and egg" problem. Without Commission approval, the transaction cannot close, but in order for the other closing conditions to be satisfied, the Commission must act first. The simple answer is this. The Commission should approve the Unwind contingent on all of the closing conditions being satisfied. This transaction should not die because of the Commission's failure to act.

[53] TE Vol. II at 51.

We also note a fundamental inconsistency between Mr. Brevitz' position of neither supporting nor opposing the Unwind and the legal position of the Attorney General. In its April 17, 2008 response to Staff Item 1, the Attorney General described in compelling detail the dire consequences that would result if the Unwind does not occur.

> "In this proceeding, the record is replete with evidence that . . . there are grave concerns about BREC's ongoing financial viability in the event one or both smelters leave the Commonwealth; . . . and, most importantly, that without the unwind transaction "the worst that can happen is BREC is obliterated through bankruptcy due to its inability to respond to some unanticipated financial and/or legal event." Thus, there is evidence of a clear threat to the continuation of utility service at reasonable rates. . . . Without these contracts (or mechanisms / treatments, as variously referred to), it is highly doubtful that BREC could once again become a viable utility."

Mr. Brevitz' testimony in refusing to consider the consequences if there is no Unwind is at odds with the Attorney General's fear that a second bankruptcy may be imminent for Big Rivers if the Unwind is not supported.

IV. THE SMELTERS INTEND TO DO BUSINESS IN KENTUCKY FOR THE LONG TERM

There is nothing guaranteed in this world, and that is universally true for businesses producing a worldwide commodity such as aluminum. That reality prompted Witness Henry Fayne to testify that the Smelters are "cautiously optimistic" that Big Rivers' rates will be affordable for the long term.[54] The caution is driven by experience but, on the other hand, the Smelters continue to believe they can sustain operations for the long term and would not otherwise enter into this transaction notwithstanding the current market price of aluminum. As Mr. Fayne stated on cross-examination:

> "The important issue here is to recognize that aluminum is cyclical. These companies have all survived circumstances in the '80's or '90's where the aluminum price bottomed out where they struggled through a brief period of time. This is an issue of long-term outlook and what the expectation is around the outlook around aluminum, which is the only reason that we could support going forward with this transaction, and both companies have looked at this transaction under the current circumstances and with the long-term outlook and believe they have a reasonable opportunity to continue to survive."[55]

The same pressures that are causing a recession in the global economy should also impact the cost profile of Big Rivers by reducing the cost of raw materials such as fuel and reagent as well as steel and labor which comprise the significant portion of its capital expenditures. The Smelters also have contract alternatives, as described on pages 17-18 above, that give them an opportunity to mitigate costs by causing Big Rivers and Kenergy to sell certain of the Smelters' energy into the wholesale market. Big Rivers and the Smelters have also introduced the concept of a Coordinating Committee which, with representatives of the Members, will review annual operating and capital budgets, criteria for evaluating maintenance programs, depreciation studies, the timing and terms of refinancing debt, fuel procurement, load forecasts and other activities.[56] The Members and Smelters have a common interest in maintaining costs as low as possible consistent with reliability, and the Smelters have high expectations that Big Rivers will carry out its commitment to making the Coordinating Committee a useful and important interface between the Smelters and the Big Rivers Board of Directors.

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[54] Fayne Supplemental Testimony, p. 3.

[55] TE Vol. II at 174. As the Commission may be aware, Century Aluminum, in response to the significant decline in aluminum prices, announced its plans to reduce production at its Ravenswood Plant in West Virginia effective December 20, 2008 and issued a WARN notice indicating that it might shut down the plant in 60 days. The Company is working with State officials and its various suppliers to try to find a solution to permit continued operations. The Company believes that the long term fundamentals of the aluminum market would support the operation of the Ravenswood Plant over the long term. The Ravenswood Plant is an older, smaller, less efficient, and higher-cost facility than the Hawesville Plant

[56] Coordination Agreement, section 4

CONCLUSION

The Unwind is both a delicate and sensible balance among Big Rivers, the Smelters and the Members and is made possible by significant funding from E.ON.[57] E.ON is making these funds available to avoid future losses under the status quo. Fortunately, Big Rivers will be spared these losses once it resumes control of the units because of the Smelter subsidies, the willingness of the rural customers to pay marginally higher rates to avoid future risk, the willingness of the Smelters to pay higher rates to secure their future, the benefit of the new transmission facility and the E.ON funds themselves. This is an opportunity of enormous upside and almost no downside.

The Smelters therefore urge the Commission to strongly endorse the Unwind which will move it closer to reality. The Commission's strong endorsement will send a signal to the rating agencies that the Commission stands behind the restructured Big Rivers and will help resolve remaining issues and contingencies that are necessary to close the transaction.

Respectively Submitted,

David C. Brown, Esq.
STITES & HARBISON
1800 Aegon Century
400 West Market Street
Louisville, Kentucky 40202
Ph. (502) 681-0421
E-Mail: dbrown@stites.com

Michael L. Kurtz, Esq.
BOEHM, KURTZ & LOWRY
36 East Seventh Street, Suite 1510
Cincinnati, Ohio 45202
Ph. (513 421-2255
E-Mail: mkurtz@BKLlawfirm.com

[57] Confidential TE at 7

CERTIFICATE OF SERVICE

I hereby certify that a true copy of the foregoing Post-Hearing Brief was served via U.S. mail, first-class, postage prepaid, this 30th day of December, 2008, upon the following persons:

C. William Blackburn
Big Rivers Electric Corporation
201 Third Street
P. O. Box 24
Henderson, KY 42420

John N. Hughes
Attorney at Law
124 West Todd Street
Frankfort, KY 40601

Kendrick Riggs
Deborah T. Eversole
Sarah K. M. Adams
Stoll Keenon & Ogden
2000 PNC Plaza
500 West Jefferson Street
Louisville, Kentucky 40202
Telephone (502) 333-6000

Douglas L. Beresford
George F. Hobday, Jr.
Hogan & Hartson, LLP
555 Thirteenth Street, N.W.
Washington, DC 20004-1109

Frank N. King, Jr
Dorsey, King, Gray, Norment & Hopgood
318 Second Street
Henderson, KY 42420

James M. Miller
Sullivan, Mountjoy, Stainback & Miller, PSC
100 St. Ann Street
P.O. Box 727
Owensboro, KY 42302-0727

Don C. Meade
Priddy Cutler Miller & Meade
800 Republic Building
429 West Muhammad Ali Blvd.
Louisville, Kentucky 40202

Melissa D. Yates
Denton & Keuler, LLP
555 Jefferson Street
P. O. Box 929
Paducah, KY 42002-0929

David Brevitz
Brevitz Consulting Services
3623 Southwest Wood Valley Terrace
Topeka, KS 66614

Allyson Sturgeon
Senior Corporate Attorney
E.ON U.S. LLC
220 West Main street
Louisville, Kentucky 40202

Counsel for Century Aluminum of Kentucky General Partnership and Alcan Primary Products Corporation,

AL080:0AL19:712853:8:LOUISVILLE