COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

BIG RIVERS ELECTRIC CORPORATION S APPLICATION FOR APPROVAL OF A LEVERAGED LEASE OF THREE GENERATING UNITS	)))	CASE NO. 99-450

O R D E R

On November 8, 1999, Big Rivers Electric Corporation (Big Rivers) filed an application seeking authority, if needed, to implement a sale and leaseback transaction (lease transaction) involving certain generating facilities owned by Big Rivers.[1] The application requested the Commission to disclaim jurisdiction over the lease transaction and the documents to be issued in connection with the lease transaction. In the alternative, Big Rivers sought Commission approval of the lease transaction and the documents considered to be evidences of indebtedness, including amendments to the documents approved by the Commission in 1998 in conjunction with the LG&E Energy

[1] Specifically, Big Rivers proposed to consummate a leveraged lease of its ownership interest in the D. B. Wilson Unit No. 1 (Wilson Unit), the Robert D. Green Units No. 1 and 2 (Green Units), and the common facilities owned by Big Rivers that are located at the Green Units site. The Wilson Unit, Green Units, and the common facilities at the Green Units site are referenced as the Facilities.

Corp. lease transaction (LEC transaction).[2] Additionally, Big Rivers requests permission to deviate from the filing requirements of 807 KAR 5:001, Section 11, to the extent its application was not in compliance with that regulation. Finally, due to the complexity and timing of the lease transaction, Big Rivers requests that the Commission expedite its review of the proposed lease transaction and grant the requested approvals no later than November 24, 1999.

The Attorney General, Southwire Company, and Alcan Aluminum Corporation were granted intervention in this proceeding. An informal conference was held at the Commission s offices on October 21, 1999 to provide additional explanations about the proposed transaction.

The Wilson Unit is located in Ohio County, Kentucky, and was placed into commercial operation in November 1986. The Green Units are located in Webster County, Kentucky, and were placed into commercial operation in December 1979 and January 1981. The units are coal-fired steam electric generating stations that are equipped with sulfur dioxide scrubbers. The combined net rated capability of the units is 874 MW.

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[2] Case No. 97-204, The Application of Big Rivers Electric Corporation, Louisville Gas and Electric Company, Western Kentucky Energy Corp., Western Kentucky Leasing Corp., and LG&E Station Two Inc. for Approval of Wholesale Rate Adjustment for Big Rivers Electric Corporation and for Approval of Transaction, final Order dated April 30, 1998, and Case No. 98-267, The Application of Big Rivers Electric Corporation for Approval of the 1998 Amendments to Station Two Contracts Between Big Rivers Electric Corporation and the City of Henderson, Kentucky and the Utility Commission of the City of Henderson, final Order dated July 14, 1998. Under the terms of the LEC transaction, Big Rivers leases its generating assets to subsidiaries or affiliates of LG&E Energy Corp. Big Rivers has been operating under the terms of that agreement since July 15, 1998, the closing date of the LEC transaction.

Big Rivers states in the application that the purpose of the proposed lease transaction is to simultaneously sell and lease back certain ownership rights, and use the net cash benefit from the lease transaction to pay down approximately $70 million of its debt. The proposed lease transaction will consist of up to six sales and leasebacks involving two equity investors and separate undivided interests in Big Rivers ownership interest in the Facilities.

The form of the lease transaction will be a long-term lease (Head Lease) of an undivided interest in the Facilities from Big Rivers to the trustee[3] of a trust estate created for the benefit of the equity investor. The trustee will also lease from Big Rivers an undivided interest in the sites the Facilities are located on for a term identical to that of the Head Lease (Ground Lease). A Participation Agreement will set forth the terms of the closing conditions, the payment of transaction costs, certain covenants and indemnification of the parties, and other general matters relating to the lease transaction.

The Head Lease will be considered a sale of the undivided interest in the Facilities for federal income tax purposes because the term of the Head Lease extends beyond the entire expected economic useful life of the Facilities. The trustee will pay all the rent under the Head Lease on the closing date. The trustee will finance the rent

[3] Exhibit 3 of the application identifies the trustee as the State Street Bank and Trust Company of Connecticut, N.A.

payment with a combination of equity from the equity investor and the proceeds of non-recourse loans to the trustee.[4]

The trustee will lease the trust s undivided interest in the Facilities back to Big Rivers under a shorter-term lease (Facilities Lease) for a term that extends beyond the expiration of the LEC transaction.[5] The Facilities Lease will be a conventional triple net lease, under which Big Rivers will have the obligation to maintain and insure the Facilities and will incur the risk of loss with respect to the Facilities. The trustee will also lease the Facilities sites back to Big Rivers for the term of the Facilities Lease (Ground Sublease).

The Facilities Lease will be subject to the terms of the LEC transaction. The lease transaction documents will provide that at the end of the term of the LEC transaction, or its early termination, Big Rivers will be responsible for the operation and maintenance of the Facilities through the end of the Facilities Lease term. At the end of the Facilities Lease, Big Rivers will have the option to either purchase the remaining leasehold interest of the trust under the Head Lease or operate the Facilities on behalf

[4] These non-recourse loans will be secured by the trustee s interest in the Facilities under the Head Lease, the Facilities Lease, the Ground Lease and Sublease, Big Rivers payment of rent, certain investment instruments purchased by Big Rivers and assigned to the trustee, and the trustee s interest in the Big Rivers Mortgage.

[5] The term of the Facilities Lease for the Wilson Unit will be approximately 27 years and for the Green Units approximately 25 years.

of the trust and locate an unrelated, third party to purchase power generated from the Facilities.[6]

Big Rivers will economically defease its periodic rent obligations under the Facilities Lease by using a portion of the rent payment received under the Head Lease on the closing date to purchase investment instruments[7] from affiliates of Ambac Assurance Corporation (Ambac) and another institution. The payments under these investment instruments in the aggregate will be equal in timing and amount to Big Rivers basic rent obligation under the Facilities Lease.[8] In addition, these investments will provide for payment of an amount sufficient to fund Big Rivers right to purchase the trustee s interest in the Facilities at the end of the Facilities Lease term.

Big Rivers will have the option to purchase the equity investor s interest in the trust if either the lease transaction becomes illegal with respect to Big Rivers and cannot be restructured in a manner acceptable to the parties or burdensome indemnities become due by Big Rivers. Big Rivers will pay the trustee a purchase price for the trustee s interest under the Head Lease equal to a specified amount (Termination

[6] Under the purchase option, Big Rivers would pay a fixed purchase price plus unpaid rent. The fixed purchase option price will be economically defeased. Under the continued operations option, the terms and conditions for the operation of the Facilities and the associated power purchase agreement will be governed by two additional documents, an Operating and Support Agreement and a Service Contract.

[7] The investment instruments will take the form of guaranteed investment contracts, prepaid swap agreements, or interest bearing deposits.

[8] In its application, Big Rivers states that the acquisition of the investment instruments will be made by a wholly owned, limited purpose corporate subsidiary of Big Rivers created for this transaction in order to limit the impact of certain state and local taxes. Big Rivers will use a portion of the rent payment under the Head Lease as a capital infusion to the new subsidiary, in order for the subsidiary to acquire these investment instruments.

Value). In addition, involuntary termination of the Facilities Lease can occur in the event of loss or an event of default.[9] Generally, a termination of the Facilities Lease due to an event of loss will require that Big Rivers purchase the equity investor s interest in the trust by payment of an amount equal to the Termination Value plus all unpaid rent. Following an event of default under the Facilities Lease, the equity investor will be entitled to put its beneficial interest in the trust under the Head Lease to an Ambac subsidiary for the full amount of Termination Value. Under the terms of an arrangement called a Lessor Swap, the obligations of the Ambac subsidiary will be guaranteed by Ambac pursuant to a surety bond. The Ambac subsidiary would then be entitled to put this beneficial interest in the trust to Big Rivers for the full amount of the Termination Value or an alternate cash settlement procedure. Under the terms of an arrangement called the Big Rivers Swap, Ambac will guarantee Big Rivers obligations pursuant to a financial guarantee insurance policy.

Big Rivers will issue a promissory note to the trustee to evidence its obligation to pay the Termination Value under the Facilities Lease and to the Ambac subsidiary to pay the Termination Value under the Big Rivers Swap. Big Rivers will also grant to the trustee, the equity investor, the Ambac subsidiary, and the lenders, a mortgage and security agreement in Big Rivers ownership interest in all of its property that is subject to the Big Rivers Mortgage to secure the performance of its obligations to pay certain contractual, tort, and other indemnities under the lease transaction. This mortgage and

[9] An event of loss refers to either the physical destruction of the assets without rebuilding, condemnation by eminent domain, or public utility regulation of the equity investor by reason of the lease transaction. An event of default refers to performance defaults by various parties to the lease transaction agreements or the downgrading of Ambac. See the Response to the Commission s November 16, 1999 Order, Item 14.

security agreement will be subject and subordinate to the Big Rivers Mortgage, the Head Lease, the Facilities Lease, the Ground Lease and Sublease, the LEC transaction, and Big Rivers arrangements with the city of Henderson, Kentucky (Henderson).

The lease transaction will not affect the operation and maintenance of the Facilities by Western Kentucky Energy Corp. (WKEC) pursuant to the LEC transaction. The affiliates of LG&E Energy Corp. associated with the LEC transaction (LG&E Parties) have raised 11 specific concerns about the proposed lease transaction. Based on the information provided and statements made by Big Rivers, the LG&E Parties have stated that they have no objection to Big Rivers proceeding with the development of the proposed lease transaction.[10]

The LG&E Parties required as a condition to consenting to the proposed lease transaction that the parties to the transaction agree to subordinate their interest under the Head Lease to the interests of the LG&E Parties under the LEC transaction. In consideration for the subordination of interest, and in order for the equity investor and the associated lenders to enjoy the full economic benefit of the investments and loans, Big Rivers will partially assign the Power Purchase Agreement between Big Rivers and LG&E Energy Marketing, Inc. to the trustee. Big Rivers will also assign the right to receive a portion of the rent paid by WKEC under the lease of the Facilities in the LEC transaction to the trustee. The trustee will reassign these interests back to Big Rivers in

[10] The LG&E Parties have reserved the right to withhold their final approval of the transaction until such time as the transaction documentation has been finalized and the concerns of the LG&E Parties have been satisfactorily addressed. See Response to the Commission s November 16, 1999 Order, Item 9.

the lease transaction for the term of the Facilities Lease and the trustee will have no rights or obligations under this assignment unless the Facilities Lease is terminated under specific circumstances.

The common facilities located at the Green Units site are used jointly in the operation of the Green Units and the Station Two Facility owned by Henderson. The proposed lease transaction will not affect the continued access to these common facilities by Henderson or the LG&E Energy Corp. affiliate that operates the Station Two Facility under the LEC transaction. No consents or approvals will be required from Henderson for the proposed transaction.

Based on current information, Big Rivers has estimated that as a result of the lease transaction, it will receive approximately $913 million. Payments to establish the debt and equity defeasance instruments are estimated to cost approximately $825 million. Enhancement fees and expenses for legal, advisory, appraisal, and miscellaneous services are estimated to cost approximately $18 million.[11] This results in a net cash benefit of $70 million.[12] The final amount of the net cash benefit will vary based upon the interest rate obtained on the closing date for the defeasance deposits and changes in other assumptions.

Big Rivers accumulated net operating losses will be used to offset federal income taxes that would be recognized on the net gain realized by Big Rivers as a

[11] The estimated proceeds and associated costs are shown in the Response to the Commission s November 16, 1999 Order, Item 14.

[12] Big Rivers has indicated that it will record the net cash benefit in Account No. 253 Other Deferred Credits, and amortize the amount on a straight-line basis over the expected lease term of 27 years. See Response to the Commission s November 16, 1999 Order, Item 3.

result of the transaction. The total amount of the net cash benefit will be paid to the Rural Utilities Service (RUS) and applied to the RUS New Note as a condition of receiving RUS consent to the lease transaction. The RUS New Note debt service schedule will be recalculated to reflect the lower principal balance.[13] Big Rivers anticipates that this recalculation will reduce its annual debt service by approximately $5 million. The Big Rivers board of directors has deferred a decision on the use of the savings until the transaction is completed and the annual debt service savings can be accurately determined.

Big Rivers is seeking a written determination from the Kentucky Revenue Cabinet (Revenue Cabinet) concerning certain state tax issues. As of the filing of its application, Big Rivers had not received this determination. In addition, Big Rivers member cooperatives must approve the lease transaction. The proposed lease transaction will be submitted to the member cooperatives between November 8 and 20, 1999.

Big Rivers included with its application a motion requesting the Commission to disclaim jurisdiction over the proposed leveraged lease transaction. The motion states that the transaction is not a financing subject to Commission jurisdiction because no securities or evidences of indebtedness will be issued. Big Rivers asserts that, although it will execute two notes, an amendment to its existing mortgage, and a new subordinated mortgage, such documents only secure its performance under the

[13] In its application, Big Rivers indicated it anticipated that RUS would also allow Big Rivers to receive a reduction in debt service costs that RUS would realize by using the net cash benefit it received to prepay high interest notes to the Federal Financing Bank on the underlying RUS debt. However, no written verification of this benefit has been received by Big Rivers.

leveraged lease and do not evidence current new or refinanced debt or securities. Alternatively, Big Rivers claims that the transaction falls within the exemption to the Commission s financing authority under KRS 278.300(10) because the financing is subject to the control of an agency of the federal government, the RUS.

The Commission finds no merit in this motion. Even though the purpose of the two new notes is to secure Big Rivers performance of certain contractual obligations, the notes are evidences of indebtedness that require prior Commission approval under KRS 278.300(1). Furthermore, the mortgage amendment and new subordinated mortgage to be executed by Big Rivers must also be approved since they are modifications to documents previously reviewed and approved by the Commission.

Although the Commission has previously disclaimed jurisdiction over financings that are subject to the control of a federal agency, such as RUS, the leverage lease proposed here is not under the control of RUS. The terms and conditions of the transaction are not being established by RUS, but by private banks and non-governmental investors. The participation of RUS has been limited to granting requisite approval of the transaction and lien accommodations, activities that do not rise to the level of control that exists when RUS is the lender for the transaction.

In addition, the proposed transaction will require modifications to many of the documents previously approved by the Commission in conjunction with Big Rivers 1998 lease of its generating assets to a subsidiary of LG&E Energy Corp.[14] As such, these modifications to previously approved documents will need Commission approval.

[14] Case No. 98-267, final Order dated July 14, 1998.

Big Rivers also included a motion for expedited consideration, stating that the Commission will need to approve the transaction by November 24, 1999 for a closing to be held by the end of the year. If the transaction does not close by the end of 1999, the benefits to Big Rivers and its members will be reduced by an estimated $6-$8 million. While this potential reduction in benefits amounts to only approximately 10 percent of the total estimated benefits, the absolute amount is very significant, particularly in light of Big Rivers financial condition and its debt service requirements.

Based on the significant benefit reduction if a decision is not issued by November 24, 1999, the Commission has given this application a high priority status to ensure that a final decision is issued by that date. The Commission notes that at the suggestion of its Staff, an informal conference was held at our offices on October 21, 1999 to allow Big Rivers an opportunity to explain the details of the transaction to Staff and intervenors. The application was then filed on November 8, 1999, giving the Commission and intervenors only 16 days to investigate a highly complex and detailed financial transaction.

While Big Rivers maintains that its application could not have been filed earlier because the transaction was susceptible to change and in flux,[15] the record demonstrates that on September 1, 1999, Big Rivers provided the Revenue Cabinet with a very detailed, written description of the proposed transaction.[16] Had such a description been provided to the Commission at that time, our investigation would have been greatly facilitated and our attention would not have had to be diverted from other

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[15] Response to the Commission s November 16, 1999 Order, Item 7.

[16] Id., Item 6.

pending cases. The Commission admonishes Big Rivers that such dilatory conduct will not be tolerated in the future. Big Rivers is put on notice that time-sensitive applications must be filed as early as possible, not weeks after the major parameters of the transaction are known with reasonable certainty.

The Commission has concerns about Big Rivers potential financial exposure due to an early termination of the Facilities Lease. Based on the documents and responses in this record, it appears that adequate provisions have been made concerning the potential exposure from an early termination due to an event of loss or event of default. Big Rivers has acknowledged that an early termination at its direction would result in a financial exposure of as much as $218 million.[17]

An example of an early termination initiated voluntarily by Big Rivers would be the situation where under the defeased lease transaction, burdensome indemnities become due by Big Rivers. Such a situation implies that Big Rivers financial condition has deteriorated and it may not possess the financial resources to pay the Termination Value. However, Big Rivers has stated that it could only exercise this option if it possessed sufficient financial resources to pay the Termination Value. Big Rivers notes that the RUS has been kept apprised of all aspects of the proposed lease transaction, and the RUS is well aware that the potential early termination exposure exceeds the upfront net proceeds to be paid to the RUS. Big Rivers has concluded that it would be extremely unlikely RUS would acquiesce to the proposed lease transaction if it perceived there to be a significant possibility of an early termination of the Facilities

[17] Id., Item 4.

Lease.[18] Given Big Rivers statements and assurances of the RUS s understanding of the potential exposure, the Commission finds this potential exposure to be reasonably addressed.

The Commission, after consideration of the evidence of record and being otherwise sufficiently advised, finds that Big Rivers should be authorized to proceed with the proposed transaction. Based on the description of the proposed transaction, the primary benefit of the proposed lease transaction is the $70 million net cash benefit and the estimated $5 million reduction in Big Rivers debt service obligations to the RUS. The reduction in debt service obligations results from both an additional interest rate reduction and a restructured debt service schedule. The RUS has given verbal assurances in face-to-face meetings with Big Rivers as recently as November 16, 1999 that both the interest rate reduction and the restructured debt service schedule will be reflected in the appropriate documents.[19] The Commission advises Big Rivers that the Commission s approval of the lease transaction is predicated upon the inclusion of both an interest rate reduction and a debt service schedule restructuring.

IT IS THEREFORE ORDERED that:

1. The motion for a disclaimer of jurisdiction over the proposed lease transaction is denied.

2. Big Rivers is authorized to execute a lease of its Wilson and Green Units, along with the associated common facilities at the Green Units site, pursuant to a sale and leaseback transaction as described in the application.

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[18] Id., Item 5.

[19] Id., Item 3(d).

3. Big Rivers shall agree only to such terms, conditions, and prices that are consistent with said parameters as set out in the application.

4. Within 10 days of the date of this Order, Big Rivers shall file with the Commission copies of a letter from its lease counsel that the proposed lease transaction is in compliance with the applicable sections of the Internal Revenue Service Code and any guidelines, rules, or regulations promulgated by the Internal Revenue Service concerning such lease transactions.

5. Big Rivers shall file with the Commission copies of the Revenue Cabinet determination concerning Kentucky tax issues within 10 days of its receipt. If the Revenue Cabinet determination causes Big Rivers to abandon the proposed transaction, notice of that decision should be included with the filing.

6. Big Rivers shall file with the Commission copies of the final approvals of the lease transaction from its member cooperatives, the LG&E Parties, and the RUS within 10 days of their receipt. Any conditions included in the final approvals that were not a part of the record in this proceeding shall be identified and the effect of the conditions summarized.

7. Big Rivers shall, within 30 days of the completion of the sale and leaseback transaction, file two copies of all transaction documentation with the Commission. In addition, Big Rivers shall include an executive summary of the terms and conditions of the finalized transaction. The summary shall note and explain any terms and conditions that are different from those described in the application.

8. Big Rivers shall, in the first monthly financial report filed with the Commission after the booking of the benefits from the sale and leaseback transaction,

include notes to its respective financial statements explaining the determination of the benefits recognized from the transaction. This shall include the disclosure of the final transaction price, the gross up-front benefit amount received by Big Rivers, the total expenses to achieve the transaction, the total amount applied to the RUS New Note, and an explanation of any debt service revisions provided by the RUS.

Done at Frankfort, Kentucky, this 24th day of November, 1999.

By the Commission

ATTEST:

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Executive Director