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OFFICE OF THE ATTORNEY GENERAL

JACK CONWAY  
ATTORNEY GENERAL

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November 21, 2008

Ms. Stephanie Stumbo  
Executive Director  
Kentucky Public Service Commission  
211 Sower Boulevard  
Frankfort, KY 40601

Re: Big Rivers Electric Unwind Hearing Date  
Case No. 2007-00455

Dear Ms. Stumbo:

Please find attached hereto the supplemental direct testimony of David Brevitz on behalf of the Attorney General. This testimony was also served upon all parties to the matter as indicated in the certificate of service.

I thank you in advance for your attention to this matter.

Sincerely,

  
Dennis G. Howard, II  
Acting Director  
Office of Rate Intervention



BEFORE THE PUBLIC SERVICE COMMISSION OF KENTUCKY

CASE NO. 2007-00455

SUPPLEMENTAL DIRECT TESTIMONY OF  
DAVID BREVITZ

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1 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

2 A. My name is David Brevitz. My business address is 3623 SW Woodvalley Terrace,  
3 Topeka, Kansas.

4 Q. BY WHOM AND IN WHAT CAPACITY ARE YOU EMPLOYED?

5 A. I am an independent consultant serving state regulatory commissions, Attorney General's  
6 Offices, and consumer organizations. I am testifying on behalf of the Attorney General  
7 of Kentucky.

8 Q. HAVE YOU PREVIOUSLY FILED TESTIMONY IN THIS MATTER?

9 A. Yes, I filed Direct Testimony on April 3, 2008. That filing of testimony was immediately  
10 preceded by the First Amendment and Supplement to the Application by Joint  
11 Applicants. However, as the Commission is aware the scheduled hearing was postponed  
12 due to subsequent events. By the time the presently rescheduled hearing in this matter  
13 occurs, it will have been pending before the Commission for almost a year as it has been  
14 amended and supplemented a number of times.

15 Q. WHAT WAS THE CAUSE OF THAT POSTPONEMENT, AND WHAT EVENTS  
16 HAVE OCCURRED SUBSEQUENT TO THAT POSTPONEMENT?

17 A. The general cause of the postponement was the developing negative conditions in the  
18 financial markets which interfered with Big Rivers Electric Company ("BREC")'s  
19 original plans to issue public debt and later became more severe with BREC's loss of the  
required credit enhancement (of its leases) of AMBAC due to AMBAC's ratings

1 downgrade. As a result, the Joint Applicants have made Second and Third Amendments  
2 and supplements to the original filing, and have filed or provided several other pleadings  
3 or documents since the time of the originally scheduled hearing. The information  
4 provided includes subsequent updated runs of the Unwind Financial Model in June 2008  
5 and October 2008.

6 **Q. HAVE YOU REVIEWED AND CONSIDERED THE INFORMATION WHICH**  
7 **HAS BEEN FILED OR PROVIDED BY JOINT APPLICANTS AND OTHER**  
8 **PARTIES SUBSEQUENT TO THE FILING OF YOUR DIRECT TESTIMONY?**

9 A. Yes. I have reviewed each filing of information in this matter, including additional  
10 *discovery responses*, and have participated via teleconference in periodic informal  
11 conference meetings among the parties.

12 **Q. WHAT WAS YOUR RECOMMENDATION IN YOUR ORIGINAL DIRECT**  
13 **TESTIMONY?**

14 A. Due to the fact there were a number of items unknown at that time, I made “a provisional  
15 recommendation that the Commission approve the transactions, but with limited  
16 enthusiasm, and with certain conditions and understandings”.<sup>1</sup> The conditions were  
17 designed to address concerns with the proposed transaction and its projected impacts  
18 based on the facts and circumstances as they existed at that time. I was explicit that “this  
19 testimony must be considered as preliminary until the record has been supplemented by  
20 the Joint Applicants to include and address these crucial areas, which are demonstrably  
21 and materially incomplete.”<sup>2</sup> Those four “crucial areas” were lack of complete  
22 information and documentation on planned financing, lack of credit ratings, lack of  
23 *required consents including the City of Henderson, and lack of a completed due diligence*

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<sup>1</sup> Direct Testimony of David Brevitz, page 50, lines 14-16.

<sup>2</sup> Id., page 5, lines 21-23.

1 report.<sup>3</sup> I also observed that “the Commission could reasonably hold this proceeding in  
2 abeyance until these matters have been accomplished”.<sup>4</sup>

3 **Q. HAVE THESE FOUR AREAS BEEN COMPLETED AND ADDRESSED IN THE**  
4 **INTERVENING SIX MONTHS?**

5 A. No. There is no real finality on any of these issues.

- 6 • The circumstances regarding financing have changed from one unknown to another.  
7 Previously, public capital markets were planned to be used for debt proceeds in  
8 concert with closing the proposed transaction, but specifics were lacking. Now,  
9 BREC proposes to access public capital markets three times, in 2011, 2015 and  
10 2018.<sup>5</sup> The borrowing in 2015 is referenced as being for \$200 million. Obviously, the  
11 specifics regarding these debt offerings are both distant and unknown at this time.
- 12 • BREC has not yet sought credit ratings from credit ratings entities, and plans to do so  
13 after the Commission’s action on this matter.
- 14 • The required consent of the City of Henderson still has not been obtained, and as  
15 discussed below, the same impasse as before appears to exist on two material issues.
- 16 • There is a lack of finality to “due diligence”, as there is no due diligence report, and  
17 due diligence will evidently occur up to the point of closing the proposed transaction.  
18 This implies that there could be future items which arise in due diligence review with  
19 a cost impact.

20 **Q. GIVEN THE EVENTS IN THIS MATTER (OR LACK THEREOF)**  
21 **SUBSEQUENT TO THE FILING OF YOUR DIRECT TESTIMONY, IS YOUR**  
22 **RECOMMENDATION TO THE COMMISSION THE SAME?**

23 A. No. Under the current circumstances and the proposed transaction as amended, I am not  
24 able to recommend that the Commission approve the proposed transaction at this time.

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<sup>3</sup> Id., lines 1-20.

<sup>4</sup> Id., page 47, line 29.

<sup>5</sup> Supplemental Direct Testimony of Robert S. Mudge, Exhibit 98, Page 7, Line 12-17.

1 The concerns expressed in my previous Direct Testimony should be read together and  
2 harmonized with the concerns expressed in this Supplemental Direct Testimony.

3 **Q. WHY ARE YOU NOT ABLE TO RECOMMEND THAT THE COMMISSION**  
4 **APPROVE THE PROPOSED TRANSACTION UNDER ITS PRESENT**  
5 **STRUCTURE AND CIRCUMSTANCES?**

6 A. The effect of subsequent events on the proposed transaction in concert with the lack of  
7 finality on the issues noted above yield three primary reasons why I am not able to  
8 recommend approval of the proposed transaction. They are:

- 9 1. Substantial further rate increases for residential customers are indicated over  
10 and above the rate increases which were projected in the Unwind Financial  
11 Model which was the subject of my Direct Testimony; and,
- 12 2. The required consent from the City of Henderson has not yet been obtained by  
13 the Joint Applicants, and the cost impact of obtaining such consent is  
14 unknown at this time but clearly more than is incorporated in the current  
15 (October 2008) Unwind Financial Model.
- 16 3. Despite numerous iterations of the Model and the passage of approximately  
17 six more months, the Application is still incomplete at this time including the  
18 lack of resolution on the City of Henderson's required consent.

19 Projected Further Rate Increases

20 **Q. PLEASE SUMMARIZE THE EXTENT OF INDICATED FURTHER RATE**  
21 **INCREASES FOR RESIDENTIAL (RURAL) RATES.**

22 A. Projected rates from the different runs of the Unwind Financial Model—February 2008  
23 vs. October 2008—can be compared to yield percentage rate increases as follows:

	<u>Additional Increase over Feb Model</u>					
	2009	2010	2011	2012	2013	2014
Rural Rates	3.13%	8.75%	11.79%	17.46%	8.49%	10.79%

1 This is the projected increase to rural rates which has occurred due to changed  
 2 circumstances and events since the Unwind Financial Model run addressed by my  
 3 original Direct Testimony.

4 **Q. PLEASE SUMMARIZE THE EXTENT OF INDICATED RATE INCREASES**  
 5 **FOR RESIDENTIAL (RURAL) RATES FROM THE PROPOSED UNWIND**  
 6 **TRANSACTION VERSUS CURRENT RATES RESULTING FROM THE LEASE**  
 7 **AGREEMENT.**

8 A. The projected increase in the October 2008 Unwind Financial Model, over the effective  
 9 2008 rate is:

	2008	2009	2010	<u>Increase vs. Current Rates</u>			
				2011	2012	2013	2014
<u>Rural Rates</u>							
Increase \$/MWH	35.33	1.89	3.86	5.67	7.71	10.59	13.47
% Increase Over Current		5.34%	10.90%	16.01%	21.77%	29.92%	38.03%

10 This shows that significant increases in rates are projected to occur year after year,  
 11 without consideration of further unforeseeable circumstances, and also without resolution  
 12 of the City of Henderson consent which when quantified in the model could translate to  
 13 even more increases.

14 **Q. WHAT ARE THE FACTORS OR ELEMENTS THAT CONTRIBUTE TO THE**  
 15 **INCREASED RATES PROJECTED IN THE CURRENT MODEL VERSUS THE**  
 16 **FEBRUARY 2008 VERSION, UPON WHICH YOUR PREVIOUS TESTIMONY**  
 17 **WAS BASED?**

18 A. Projected increased operating expenses, increased interest costs, and increased capital  
 19 expenditures appear to be the primary drivers of the increased rates projected in the  
 20 Unwind Financial Model, when comparing February 2008 to the most current version of  
 21 the model—October 2008. Projected increased operating costs appear to be predominant  
 22 among those items. These increases are displayed below:

	Calendar Year	2009	2010	2011	2012	2013	Total
Oct. 08	Total Disbursements	451.56	498.30	530.34	565.80	599.33	
Feb. 08	Total Disbursements	393.33	407.73	436.07	438.75	460.48	
	Difference	58.23	90.57	94.27	127.05	138.85	508.98
	%	14.80%	22.21%	21.62%	28.96%	30.15%	
Oct. 08	Total Expenses	564.13	581.69	619.81	658.67	689.33	
Feb. 08	Total Expenses	473.33	486.42	519.12	524.36	538.24	
	Difference	90.79	95.27	100.69	134.31	151.09	572.15
	%	19.18%	19.59%	19.40%	25.61%	28.07%	
Oct. 08	Total Capital Expenditures	93.47	51.30	63.67	42.23	50.11	
Feb. 08	Total Capital Expenditures	76.01	58.58	56.26	53.85	35.54	
	Difference	17.46	-7.29	7.41	-11.62	14.56	20.52
	%	22.97%	-12.44%	13.17%	-21.58%	40.97%	

2 **Q. WHY DOES THE INCREASING EXTENT OF PROJECTED RESIDENTIAL**  
3 **RATE INCREASES CONCERN YOU?**

4 A. There are several reasons why growing projected residential rate increases in the Unwind  
5 Financial Model are of sufficient concern that I cannot recommend that the Commission  
6 approve the Unwind Transaction as proposed.

7 1. BREC is a relatively small organization that is not diversified on either a  
8 geographic or product basis. But it proposes to resume full exposure (outside  
9 the current lease agreement) to future capital expenditure and expense  
10 requirements under the proposed transaction. As stated by BREC before a  
11 meeting of the Board of Commissioners of the City of Henderson:

12 This is a very complex transaction. Yes, it involves a lot of money, but it  
13 involves tremendous risks coming back to Big Rivers to operate these  
14 power plants and provide the volume of energy that goes to not only  
15 Alcan, but to Century and that is a load that no other electric generation

1 and transmission cooperative, nor utility that I am aware of, has to support  
2 in this country, that is two large smelters and a 98% load factor.<sup>6</sup>

- 3 2. Due to this smaller size and undiversified position, BREC is exposed to  
4 unforeseen negative consequences from future events which could exert  
5 substantial pressures to increase expenses and/or capital expenditures. This  
6 has been demonstrated by the past six months and the change in projected  
7 rates over that time period.
- 8 3. Estimated capital expenditures and expenses in the Unwind Financial Model  
9 are subject to some potential for error due to the fact that BREC has not  
10 operated the plants for ten years. As time has elapsed, BREC appears to have  
11 found more required costs which have been included in the Unwind Financial  
12 Model and contribute to projected rate increases.
- 13 4. Required early termination of the leases has diminished BREC's cash from  
14 that which was projected to be available in February 2008. All other things  
15 equal, this contributes to the need to increase rates to generate cash. It does  
16 not appear that BREC has a realistic ability to obtain additional cash financing  
17 from the member cooperatives. Therefore, any additional cash requirements  
18 must be obtained externally—from additional debt borrowings which increase  
19 cash debt service requirements, and ultimately from increased rates. Within  
20 the boundaries of materiality, any additional cash requirements of BREC must  
21 come from increased rates absent opportunities for increased revenues from  
22 other sources or cost cutting.
- 23 5. The issues regarding obtaining the required consent for the proposed  
24 transaction from the City of Henderson are unresolved and cause significant  
25 uncertainty regarding additional costs associated with accomplishing the  
26 proposed transaction.

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<sup>6</sup> BREC Response to OAG Supplemental No. 33, Verbatim transcript of Special Called Commission Meeting, June 27, 2008, at page 3.



1 6. Recommending approval of the proposed transaction with the significantly  
2 increased projected rates implies pre-approval of planned or “required” later  
3 rate increases.

4 Lack of Required Consent from the City of Henderson

5 **Q. IS IT CLEAR THAT THE REQUIRED CONSENT TO THE PROPOSED**  
6 **TRANSACTION FROM THE CITY OF HENDERSON IS IMMINENT?**

7 A. No. It does not appear that such consent is imminent. Copies of communications  
8 between Joint Applicants and the City of Henderson and/or HMP&L were sought via  
9 OAG Supplemental No. 10 to E.ON, and OAG Supplemental No. 33 to BREC, and  
10 requested copies were provided. It appears that some level of communication among the  
11 entities began in the later part of 2005, and continued from time to time, and somewhat  
12 intermittently at times to the current point. The documents I have reviewed suggest to  
13 me that a number of issues may have been resolved over time, but two core issues remain  
14 and there does not appear to be substantive progress on those issues—in fact, matters  
15 currently appear to be at an impasse.

16 **Q. DID YOU HAVE THESE DOCUMENTS AND CORRESPONDENCE**  
17 **AVAILABLE AT THE TIME OF YOUR DIRECT TESTIMONY?**

18 A. No. None of the correspondence up to that point in time was available.

19 **Q. WHAT ARE THE TWO ISSUES WHICH CURRENTLY REMAIN?**

20 A. The August 29, 2008 Status Report identifies two dispute areas impeding the City of  
21 Henderson’s consent to the early termination of the Station Two Agreement in the  
22 BREC/E.ON existing transaction for the Unwind Transaction to be consummated.  
23 Henderson continues to assert as follows:

- 24 1. “Henderson retail customers are subsidizing the profits of WKEC currently, and Big  
25 Rivers in the future, because while Henderson must pay for its share of Station II  
26 capacity, Henderson only receives a margin of \$1.50/MHW for excess energy utilized  
by WKEC and Big Rivers; and,”

1 2. "there are a number of maintenance and repair claims with Station II resulting from  
2 WKEC's operation of the Station Two facility."

3 By its letter dated September 3, 2008, Henderson appears to agree on the identity of the  
4 remaining issues, as follows: "discussions [between the Chairman of the Henderson  
5 Utility Commission and the Chairman of Big Rivers] failed to resolve the two key issues:  
6 Excess Energy sales and Station Two maintenance and repair expenses reflected in the  
7 independent engineering reports."

8 **Q. DID THESE TWO ISSUES ALSO EXIST IN MARCH-APRIL 2008 WHEN THE**  
9 **PROCEDURAL SCHEDULE BECAME PROBLEMATIC AND ULTIMATELY**  
10 **THE HEARING WAS POSTPONED?**

11 A. Yes. My review of the correspondence documents suggests that these issues clearly  
12 existed at that time and prior to it.

13 **Q. WAS THE SIX MONTH PERIOD BETWEEN THEN AND NOW USED AND**  
14 **USEFUL TO RESOLVE THESE ISSUES?**

15 A. No. At the end of March 2008, BREC informed the City of Henderson that it had  
16 "nothing further to offer." Discussions appear to have been non-productive after that  
17 point, punctuated mainly by a specially called Henderson City Commission meeting on  
18 June 27, 2008, and three meetings involving the Chairmen of BREC and HMP&L in the  
19 period August 1, 2008 to September 2, 2008. The impasse or stalemate between the  
20 parties was not subject to any material change from these later meetings that I can see. If  
21 anything, positions appear to have hardened.

22 **Q. WHAT DO THE DOCUMENTS BETWEEN BREC, E.ON AND HMP&L**  
23 **ILLUSTRATE REGARDING THE CURRENT STALEMATE OR IMPASSE?**

24 A. There are a number of documents provided in response to OAG Supplemental No. 33 (to  
25 BREC) and OAG Supplemental No. 10 (to E.ON). One is a piece of mail from HMP&L  
26 to its customers regarding the proposed transaction in March 2008 stating its view of the

1 issues.<sup>7</sup> All other things equal, the mailing would tend to harden views regarding consent  
2 to the proposed transaction. Discussions and exchange of correspondence between the  
3 entities were occurring at that time, including a letter from BREC to HMP&L, which  
4 expressed “disappointment” with the HMP&L response to the latest BREC proposal, and  
5 indicated “Big Rivers has nothing further to offer to HMP&L”.<sup>8</sup> Correspondence also  
6 indicates that the Chairmen of BREC and HMP&L met on September 2, 2008 on the  
7 open issues.<sup>9</sup> One concern evident on the part of HMP&L is that Big Rivers would  
8 experience financial problems after the Unwind and potentially file for bankruptcy.  
9 HMP&L proposed contract amendments to deal with this potential circumstance. BREC  
10 was not able or willing to accept HMP&L’s proposal “because it shifts costs to our  
11 Members and substantially changes the Station Two agreement” beyond which it would  
12 “be unacceptable to [BREC] creditors whose approvals would also be required”.<sup>10</sup> It  
13 does not appear to me that agreement between the Joint Applicants and the City of  
14 Henderson on remaining issues pertaining to required consent for the proposed  
15 transaction is imminent.

16 **Q. ARE YOU ABLE TO ASSESS THE FINANCIAL IMPACT TO CONSUMERS IN**  
17 **THE ABSENCE OF THE NECESSARY AGREEMENT BY THE CITY OF**  
18 **HENDERSON TO THE PROPOSED TRANSACTION?**

19 A. No. The financial impact on consumers is not yet known since there is no agreement or  
20 understanding regarding the financial circumstances to obtain the City of Henderson’s  
21 consent. It appears to me that the further any resolution goes toward the City’s position,  
22 the more material an impact would exist for BREC consumers. BREC has only  
23 incorporated the financial impact of its last proposal into the Unwind Financial Model  
24 (October 2008) currently before the Commission.

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<sup>7</sup> BREC Response to OAG Supplemental No. 33.

<sup>8</sup> Id., Letter from Michael Core to Gary Quick, March 28, 2008.

<sup>9</sup> BREC Response to OAG Supplemental No. 33. BREC Supplemental Response to OAG No. 107 indicates that Dr. Smith and Mr. Denton met twice, once on August 1, 2008, then again on September 2, 2008.

<sup>10</sup> BREC Response to OAG Supplemental No. 33, Letter from Mark Bailey to Gary Quick, September 24, 2008.

1 **Q. ARE YOU EXPRESSING ANY VIEW REGARDING THE UNDERLYING**  
2 **FACTS OF THE IMPASSE BETWEEN BREC AND HMP&L?**

3 A. No, nothing in the foregoing should be construed as expressing any opinion regarding the  
4 relative merits of the facts on this issue between BREC and HMP&L. The relevant point  
5 is that the necessary consent to accomplish the proposed transaction has not been  
6 obtained, and obtaining such consent could require further material cost which is not  
7 included in the Unwind Financial Model or its projected rates.

8 Investment Grade Credit Rating

9 **Q. DID YOU ADDRESS THE SUBJECT OF CREDIT RATINGS IN YOUR**  
10 **PREVIOUS TESTIMONY?**

11 A. Yes, see pages 34-37 of that testimony.

12 **Q. DO YOU HAVE ANYTHING TO ADD TO THAT DISCUSSION?**

13 A. Yes. In addition I note that the Commission has as much to do with the investment grade  
14 credit rating as the innate nature of the proposed transaction for BREC. An investment  
15 grade credit rating has some circularity with Commission approval. Credit rating entities  
16 will rely on the Commission's approval of the proposed transaction as implicit  
17 commitment to increase rates to the extent necessary to maintain BREC's financial  
18 viability and ensure timely debt service payments.

19 Conditions

20 **Q. YOUR DIRECT TESTIMONY CONTAINED RECOMMENDED CONDITIONS**  
21 **AT PAGES 50-52. HOW DOES THE FACT THAT YOU CAN NO LONGER**  
22 **RECOMMEND APPROVAL OF THE PROPOSED TRANSACTION IMPACT**  
23 **THESE RECOMMENDED CONDITIONS?**

24 A. If the Commission decides to approve the proposed transaction, the direction of the  
previously proposed conditions is still valid and the Commission should consider them.

1 In its decision, the Commission should address each proposed condition and incorporate  
2 each one as updated and modified by subsequent events. In particular, the first proposed  
3 condition would require additional contribution to economic reserve funds to mitigate the  
4 residential increased rates projected by the October 2008 modeling subsequent to the  
5 February 2008 modeling upon which my Direct Testimony was based. The third  
6 proposed condition could be addressed in part by agreement between BREC, the City of  
7 Henderson, and E.ON regarding the condition of generating facilities and sites.

8 **Q. ARE YOU NOT CONCERNED ABOUT THE POTENTIAL LOSS OF JOBS IF**  
9 **THIS TRANSACTION IS NOT APPROVED AND ULTIMATELY**  
10 **CONSUMMATED?**

11 A. I am very much concerned about this issue and the Attorney General has advised me that  
12 he is as well. However, even if the Commission approves the application and the  
13 proposed transaction occurs, there is no guarantee that the smelters will continue their  
14 operations in Kentucky. In fact, the smelters have negotiated terms which would allow  
15 them to terminate their contracts as soon as 2011<sup>11</sup> and would allow the closing of a pot-  
16 line depending on the market for a period of up to 12 months and then re-selling the  
17 electricity that would have otherwise been used.<sup>12</sup> Obviously the possibility of a loss of  
18 jobs exists regardless of the Commission's actions in this matter. Accordingly, because  
19 the smelters have this agreement in place, it appears self-evident that the smelters  
20 anticipate the possibility, if not the likelihood that there will be a loss of jobs.

21 **Q. DOES THIS CONCLUDE YOUR SUPPLEMENTAL TESTIMONY?**

22 A. Yes.

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<sup>11</sup> Direct testimony of C. William Blackburn, Exhibit 10, Page 65-66

<sup>12</sup> Direct testimony of C. William Blackburn, Exhibit 10, Page 45-46. Under this circumstance, current projections indicate the smelter would earn approximately \$14 million. BREC Response to OAG Supplemental No. 34. This figure will be different depending on market conditions at the time.



## CERTIFICATE OF SERVICE AND NOTICE OF FILING

I hereby give notice that this the 21<sup>st</sup> day of November, 2008, I have filed the original and ten copies of the foregoing with the Kentucky Public Service Commission at 211 Sower Boulevard, Frankfort, Kentucky, 40601 and certify that this same day I have served the parties by mailing a true copy of same, postage prepaid, to those listed below.

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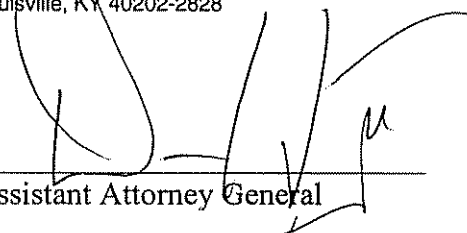
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