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August 13, 2010

PARTIES OF RECORD

Re: Case No. 2009-00465

Attached is a copy of the memorandum which is being filed in the record of the above-referenced case. If you have any comments you would like to make regarding the contents of the informal conference memorandum, please do so within five days of receipt of this letter. If you have any questions, please contact M. Todd Osterloh at 502/564-3940, Extension 439.

Sincerely,

A handwritten signature in black ink, appearing to read "Jeff Derouen".

Jeff Derouen
Executive Director

TO/ew

Attachment

INTRA-AGENCY MEMORANDUM

KENTUCKY PUBLIC SERVICE COMMISSION

TO: Case File
FROM: Todd Osterloh, Staff Attorney
DATE: August 13, 2010
RE: Case No. 2009-00465
Informal Conference of August 12, 2010

On August 12, 2010, Commission Staff ("Staff") held an informal teleconference with the parties to discuss substantive and procedural issues of the case. The following individuals participated in the informal conference:

James Asher	City of Whitesburg
Paul Nesbitt	City of Whitesburg (Nesbitt Engineering)
Abbie Jones	City of Whitesburg (Nesbitt Engineering)
Chris Caudill	City of Whitesburg (Veolia Water)
Jason Pennell	City of Whitesburg (Veolia Water)
Mark Frost	PSC Staff
Jason Green	PSC Staff
Dennis Jones	PSC Staff
Todd Osterloh	PSC Staff
James Rice	PSC Staff

Although Letcher County Water and Sewer District was served with a copy of the Commission's Order of August 6, 2010, it did not participate in the informal teleconference.

Beginning the conference, Staff stated that it would prepare minutes of the conference for the case record, that a copy of the minutes would be provided to all parties, and that all parties would be given an opportunity to submit written comments upon those minutes. Staff also noted that its statements and opinions are not necessarily binding on the Commission.

Staff explained that the Commission and its Staff are concerned that the City of Whitesburg ("Whitesburg") has not provided sufficient or adequate supporting documentation for the Commission to make a determination on whether the proposed rate adjustment is fair, just, and reasonable. There is a particular concern because the ten-month statutory deadline pursuant to KRS 278.190(2) for a Commission decision is September 2, 2010 and, even if appropriate information and documentation were

provided immediately, the Commission may not have time to adequately review the information. It was also noted that the Commission has taken the position that a utility cannot waive the statutory deadline.¹

In light of the impending statutory deadline and lack of adequate information in the record of the case, Staff questioned whether Whitesburg would be willing to withdraw its rate case and request Staff assistance in the preparation of an application for rate adjustment. During a litigated rate case, Staff is prohibited from *ex parte* contacts with a single party. By withdrawing its current case, Whitesburg enables Staff to provide assistance in preparing a rate application. This assistance would include guidance on the appropriate test period and would likely result in a comprehensive application to submit for Commission acceptance.

Whitesburg expressed its concern regarding finances for its utility operations. Although Kentucky law prohibits retroactive rate-making, there is a provision in KRS 278.190(2) that enables rates to become effective during the suspension period of a Commission investigation if the Commission finds that the utility's "credit or operations will be materially impaired or damaged by the failure to permit the rates to become effective during the period." Mr. Osterloh stated that he did not know under what circumstances the Commission had previously allowed such interim rates but that he would research the issue and send information to the parties.²

Mr. Asher stated that Whitesburg would be willing to withdraw its rate case with the understanding that Staff would assist the city in preparing a rate application. He stated that he would file a letter indicating Whitesburg's request to withdraw the case and request Staff assistance in preparing a rate application. The letter would also briefly state the city's concern for expedited assistance, given its financial situation. Staff indicated that the Commission, on receipt of Mr. Asher's letter, would close the case and cancel the hearing that is set for August 19, 2010.

The conference then adjourned.

¹ See Case No. 1990-00019, *Hardin County Water District No. 1* (Ky. PSC Jan. 24, 1991).

² To satisfy this statement, copies of four Commission orders are attached to this memorandum. This is not an exhaustive grouping of cases in which the Commission has ruled on this issue, but the orders provide some insight on what type of information the Commission has previously used in determining whether a utility has met the standard set forth in KRS 278.190. Additional documents related to these cases (and others) may be found on the Commission's website, <http://psc.ky.gov>.

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF HARDIN COUNTY WATER)
DISTRICT NO. 1 FOR (1) ISSUANCE OF)
CERTIFICATE OF PUBLIC CONVENIENCE AND)
NECESSITY; (2) AUTHORIZATION TO BORROW) CASE NO. 2001-211
FUNDS AND TO ISSUE ITS EVIDENCE OF)
INDEBTEDNESS THEREFOR; (3) AUTHORITY TO)
ADJUST RATES; AND (4) APPROVAL TO REVISE)
AND ADJUST TARIFF)

ORDER

Hardin County Water District No. 1 ("Hardin District") has moved for authority to place its proposed rates into effect immediately while its application for rate adjustment is pending. Finding that Hardin District has failed to meet the statutory prerequisites for this relief, we deny the motion.

Hardin District is a water district organized pursuant to KRS Chapter 74. It provides retail water service to approximately 9,000 customers in Hardin and Meade counties and wholesale water service to the city of Vine Grove, Kentucky and Meade County Water District.

On October 16, 2001, Hardin District applied for a Certificate of Public Convenience and Necessity to construct \$4.6 million in water main extension projects, for authority to issue \$4.8 million in 20-year revenue bonds, and for an adjustment in its retail and wholesale rates. Hardin District proposed to place its proposed rates into effect on November 15, 2001. Finding that further investigation into the reasonableness

of the proposed rates was required, the Commission, on November 6, 2001, suspended the proposed rates for 5 months.

On November 20, 2001, Hardin District moved for authority to place its proposed rates into effect immediately. On December 10, 2001, the Commission held a hearing on this motion. Testifying at this hearing were: Jim Bruce, Hardin District's General Manager; Robert Cramer, a financial consultant; and Kevin J. Brian, a professional engineer.

Hardin District argues that its credit and operations will be materially damaged if the proposed rates are not immediately placed into effect. It projects that its operations for calendar year 2001 will suffer a loss of \$350,000. Hardin District states that its bond covenants require its net revenues to be equal to at least 1.2 times its average net annual debt service requirements. It projects its revenues for calendar year 2001 to be only 0.64 times its net annual debt service requirements. It is, therefore, technically in default on its bond covenants and will likely have its credit rating lowered by credit rating services. Such a rating, Hardin District argues, will likely increase its debt costs and limit its ability to access credit markets.

Mr. Bruce testified that Hardin District's operations were also suffering. The water district has cancelled several capital projects, limited employee travel, and postponed several customer service projects. It has also reduced its materials inventory to below normal levels. Mr. Bruce also testified that the water district has had severe cash flow problems, requiring extraordinary cash management efforts. These efforts and the delay expenditures have, Mr. Bruce testified, adversely affected employee morale.

KRS 278.190(2) permits the Commission to suspend the operation of a proposed rate schedule for a 5 months to hold a hearing and make a decision on the reasonableness of that schedule. It further provides that

if the commission, at any time, during the suspension period, finds that **the company's credit or operations will be materially impaired or damaged by the failure to permit the rates to become effective during the period**, the commission may, after any hearing or hearings, permit all or a portion of the rates to become effective under terms and conditions as the commission may, by order, prescribe.

Id. (emphasis added). Accordingly, a utility seeking to place its proposed rates in effect during the suspension period must demonstrate that the failure to place proposed rates into effect will materially impair or damage its credit or operations.

We find that continued suspension of the proposed rates will not materially impair Hardin District's credit. The damage created by the operating losses has already been done. Hardin District's witnesses concede that, even if the proposed rates were allowed to become effective, the water district would fall short of its debt service coverage requirements and would still be considered in default. Moreover, while a rate adjustment that permanently increases the water district's revenues is likely to allay the concerns of the bond rating agencies and restore the water district's standing, an interim increase subject to refund is not.

Hardin District witness Robert Cramer testified that the timing of a final decision on the proposed rates is the crucial factor to Hardin District's credit rating. No default occurs until the issuance of an independent auditor's report of Hardin District's financial statements for calendar year 2001. Hardin District expects such a report to be issued in late March 2002. If permanent rates that restore Hardin District's net revenues to the

proper levels are in effect when the report is issued, Mr. Cramer testified, then the financial community's reaction to the audit results and the effect on Hardin District's credit rating should be minimal. We fully expect to issue a final Order in this proceeding no later than March 8, 2002.

The Commission further finds no evidence that the suspension will materially impair the water district's operations. While Hardin District is experiencing some cash flow problems, the record clearly shows the utility has the ability to remedy these problems without an interim rate adjustment. Hardin District currently has \$1.4 million in certificates of deposit that could be used as security for short-term financing to meet immediate cash needs. While subject to some financial penalty, it could also redeem those certificates to obtain needed cash.

The record also contains no evidence that the water district is currently experiencing any reductions in operations or quality of service. Hardin District has not eliminated any employee positions in the last 3 years. It has not reduced salaries or wages. In fact, in January 2001, it implemented a new benefit program for its employees. While some maintenance programs have been reduced or improvements postponed, Hardin District acknowledges that no tangible reduction in services has occurred.

In light of Hardin District's failure to demonstrate that its credit or operations will be materially affected by the continued suspension of the proposed rates, the Commission finds that Hardin District's motion should be denied. While we recognize that Hardin District's current financial condition limits its flexibility and presents some

challenges to management, it does not justify the immediate imposition of the proposed rates.

Hardin District officials must recognize their responsibility for the water district's present financial conditions. Hardin District officials concede that its current financial condition stems from the loss of Hardin County Water District No. 2 ("District No. 2") as a wholesale customer. The record indicates that Hardin District officials have known since 1991 that District No. 2 would cease purchasing water from the water district in 2001. Despite this knowledge, they did not act to adjust rates until District No. 2's departure. This failure to act in a timely manner is the principal cause of Hardin District's current condition.

IT IS THEREFORE ORDERED that Hardin District's motion for authority to place its proposed rates into effect immediately is denied.

Done at Frankfort, Kentucky, this 14th day of January, 2002.

By the Commission

ATTEST:


Executive Director

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF SALT RIVER WATER)	
DISTRICT OF BULLITT COUNTY, KENTUCKY)	CASE NO. 90-143
FOR APPROVAL TO INCREASE ITS RATES)	

O R D E R

On May 18, 1990, Salt River Water District ("Salt River") filed an application before the Public Service Commission requesting authority to increase its rates approximately \$170,000 annually over test-year revenues. On October 19, 1990, Salt River filed an application for emergency rate relief due to the imminent financial failure of the Salt River due to a bonded indebtedness payment due December 1, 1990 in the sum of \$63,697.47. Salt River has represented to the Commission in its application that with existing revenues and estimated expenses the district will fall \$54,723.78 short of meeting this debt payment. Salt River has further stated in its application that there are no reserves set aside to meet the contractual requirements of the district's bonded indebtedness nor are there any reserves for meeting general operating expenses. Included in the application for emergency rate relief was a cash flow statement, bond payment schedules for 1962 and 1988 bond issuances, and the projected and actual 1990 budget for Salt River with actual figures supplied through September of 1990.

After consideration of the request for an interim Order authorizing immediate rate relief, the record in this proceeding, and being otherwise sufficiently advised, the Commission finds the following:

The rates initially proposed by Salt River in its May 18, 1990 filing were to take effect on July 1, 1990. However, the Commission, pursuant to KRS 278.190, suspended those rates for five months on and after the proposed effective date. Thus, the rates proposed by Salt River may be placed into effect by the district, pursuant to KRS 278.190, for service rendered on and after December 1, 1990.

KRS 278.190(2) provides that:

[I]f the commission, at any time, during said five (5) months' suspension period, finds that the company's credit or operations will be materially impaired or damaged by the failure to permit said rates to become effective during said five (5) months' period, said commission may, after any hearing or hearings, permit all or a portion of said rates to become effective under such terms and conditions as the commission may, by order, prescribe.


The exhibits filed with the most recent application amply demonstrate that the district's operations will be materially impaired or damaged by the failure to permit the rates to become effective within the five month suspension period. In fact, it appears that revenues are grossly insufficient to meet even normal operating expenses. The Commission, therefore, finds that Salt River should be allowed to place its proposed rates into effect for services rendered on and after the date of this Order, subject to refund.

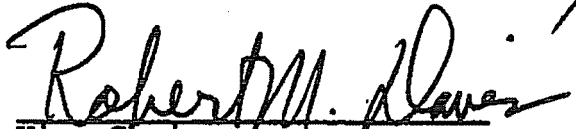
IT IS THEREFORE ORDERED that the application for emergency rate relief by Salt River be and it hereby is approved and Salt River shall be permitted to place its proposed rates into effect, subject to refund, on and after the date of this Order.

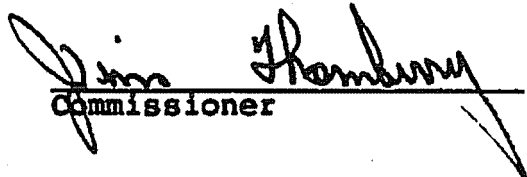
IT IS FURTHER ORDERED that Salt River shall maintain its books and accounts in such a manner as to be able to determine the appropriate amount to be refunded in the event the Commission determines that refunds should be made.

Done at Frankfort, Kentucky, this 30th day of October, 1990.

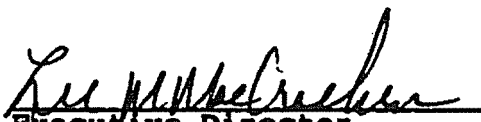
PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:


Executive Director

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

GENERAL ADJUSTMENT OF ELECTRIC)
RATES OF EAST KENTUCKY POWER) CASE NO. 2006-00472
COOPERATIVE, INC.)

INTERIM ORDER

This matter is before the Commission on the application of East Kentucky Power Cooperative, Inc. ("EKPC") for an increase in base rates during the suspension period of EKPC's pending application for a general adjustment of electric rates. For the reasons set forth herein, the Commission will grant EKPC interim rate relief on the terms and conditions set forth herein.

PROCEDURAL BACKGROUND

EKPC submitted for filing its application for an adjustment of electric rates with the Commission on January 29, 2007. Deficiencies were noted and, upon the resolution of those deficiencies, the application was deemed filed as of February 6, 2007. Kentucky Industrial Utility Customers, Inc. ("KIUC") and the Attorney General, by and through his Office of Rate Intervention ("AG"), were granted status as intervenors on February 19, 2007. The Cumberland Chapter of the Sierra Club ("Sierra Club") was granted intervention from the bench on March 6, 2007.¹ On February 20, 2007, the Commission issued its second data request relating principally to EKPC's request that it

¹ An Order granting intervention to the Sierra Club was issued on March 21, 2007.

be granted interim rate relief in the amount of \$43.3 million during the suspension period. Also on that date, the AG issued his initial set of data requests to EKPC. EKPC filed its responses to both data requests on February 27, 2007.

A hearing scheduled for March 6, 2007 was continued when EKPC failed to provide timely public notice of the hearing. In place of the hearing, however, representatives of EKPC, KIUC, the AG, and the Sierra Club engaged in settlement discussions and arrived at a settlement in principle.² In an Order entered on March 16, 2007, the Commission noted that despite the terms of any settlement the parties might be able to reach, EKPC ultimately had the burden to demonstrate that the statutory criteria set forth in KRS 278.190(2) were satisfied as a prerequisite to any interim rate relief award.

On March 22, 2007, a hearing was held in the Commission's offices in Frankfort for the purpose of providing testimony on EKPC's request for interim rate relief. Upon the conclusion of the hearing, EKPC agreed to file additional information with the Commission no later than March 27, 2007. Parties were also invited to file briefs on or before March 27, 2007. The Sierra Club, EKPC, and the AG availed themselves of the opportunity to do so.

DISCUSSION

As a general matter, prudently managed utilities will not willingly place themselves in a position where interim rate relief during the suspension period is necessary to avoid a material impairment of the utility's credit or operations. This is especially true of rural electric cooperative corporations. KRS 279.095 provides that a

² Sierra Club subsequently refused to sign the settlement agreement.

cooperative "shall be operated on a nonprofit basis for the mutual benefit of its members and patrons." While low rates are desirable, this must be balanced against the necessity that a cooperative remain financially and operationally viable. With the shadow of Big Rivers Electric Corporation's bankruptcy only recently receding in the memory of Kentucky utility jurisprudence, all directors and officers of jurisdictional utilities should take note that the extraordinary relief authorized under KRS 278.190(2) is just that – extraordinary. In other words, only where the financial or operational condition of a utility has deteriorated to a perilous extent has the General Assembly authorized the Commission to utilize the procedures of KRS 278.190(2), which states in relevant part:

[I]f the commission, at any time, during the suspension period, finds that the company's credit or operations will be materially impaired or damaged by the failure to permit the rates to become effective during the period, the commission may, after any hearing or hearings, permit all or a portion of the rates to become effective under terms and conditions as the commission may, by order, prescribe.

In measuring the record against the statutory criteria, we will examine each element of the statute in turn – first EKPC's potential credit impairment and then EKPC's potential operational impairment.

Credit Impairment

EKPC has a two-tiered debt structure. Approximately \$1.7 billion of EKPC's existing debt is subject to a 2004 Restated and Consolidated Mortgage and Security Agreement (the "Mortgage Agreement") with the Rural Utilities Service ("RUS").³ The total allowable debt under the Mortgage Agreement is \$3 billion. Additionally, EKPC

³ EKPC Notes to Consolidated Financial Statements December 31, 2006 and 2005, Note 5-Long-Term Debt.

has a 2005 \$650 million Unsecured Credit Agreement (the "Credit Facility") with a consortium of lenders led by the National Rural Utilities Cooperative Finance Corporation ("CFC"). At this time, EKPC has drawn all but approximately \$195 million of the unsecured credit line.⁴ Both agreements have cross-default provisions.

In its response to data requests relating to an alleged credit impairment, EKPC asserted that without interim rate relief, it would fail to achieve the required debt service coverage ratio ("DSC") for 2007 and, because of poor financial results in previous years, EKPC would be in a position wherein it is subject to a declaration of default under its Mortgage Agreement with RUS.⁵ EKPC also asserted that while it hoped to achieve a net margin of \$6 million in 2007, \$34 million of its earnings were comprised of the Allowance for Funds Used During Construction ("AFUDC"), which is non-cash earning.⁶ Finally, EKPC asserted in its data request responses that the President's proposed federal budget for 2008 included a provision eliminating RUS funding of loans for generation projects.⁷ In testimony submitted by EKPC's President and Chief Executive Officer, Bob Marshall, EKPC further asserted that the cost of potential penalties and fines to be levied against EKPC by the United States Environmental Protection Agency were a source of potential credit impairment.⁸ Mr. Marshall also asserted that an

⁴ See Transcript of Evidence ("T.E."), March 22, 2007, at 108.

⁵ See EKPC Response to Commission Second Data Request, filed Feb. 27, 2007, Response 6(a).

⁶ See id.

⁷ See id.

⁸ See Testimony of Bob Marshall, filed Feb. 6, 2007, at 3.

increased capital construction budget exposed EKPC to greater interest expense and that this too contributed to its credit impairment.⁹ At the March 22, 2007 hearing, EKPC additionally asserted that any default under the Mortgage Agreement would also trigger a cross-default provision in its Credit Facility. David Eames, EKPC's Vice President of Finance, testified that if sums due and owing under the Mortgage Agreement and Credit Facility were required to be repaid due to a default under either agreement, EKPC would be insolvent.¹⁰

Taken individually, none of these factors would appear to constitute a material impairment of credit as contemplated by the plain and ordinary language of the statute. While EKPC asserts many grounds to support a credit impairment finding, some are simply too remote to be given much credence. For instance, the Commission attaches little significance to EKPC's reliance upon the potential elimination of the RUS generation loan program in the proposed federal budget for 2008. As EKPC concedes, a proposed budget is far removed from an enacted budget,¹¹ and the likelihood of any detrimental impairment of EKPC's credit flowing from the passage of the federal budget is simply too speculative to be given any weight at this time. Likewise, EKPC firmly contends that its decision to reserve \$32 million in 2005 to satisfy potential fines and penalties arising from its environmental litigation is reflective of a prudent business practice and not an admission that the fines and penalties will actually be due and

⁹ See id.

¹⁰ See T.E., March 22, 2007, at 104.

¹¹ See id. at 64-65.

payable at some point in the future.¹² EKPC thereby undercuts its own argument that the \$32 million reserve results in a credit impairment. Accordingly, this factor is also given little weight.

The remaining assertions raised by EKPC are more responsive to the statutory criteria of credit impairment. As demonstrated by the outage of the Spurlock No. 1 unit in 2004, the costs of purchasing power are generally higher than generating power. In the event that EKPC is forced to purchase power in any significant amounts, its credit-worthiness will certainly be an issue.¹³ Likewise, it was the continuing decline in EKPC's Times Interest Earned Ratio ("TIER") that caused the Commission to commence an investigation into EKPC's financial condition in October of 2006.¹⁴ Despite some improvement in EKPC's margin in 2006, Mr. Eames rightly points out that EKPC's overall financial condition has not improved.¹⁵ The positive margin EKPC produced in 2006 is largely a product of its revised depreciation schedule and its AFUDC accounting.¹⁶ When these factors are removed, EKPC posted another substantial deficit for 2006 at a time when its exposure to credit costs were increasing. Given its failure to satisfy the debt covenants contained in the Mortgage Agreement,

¹² See id. at 37.

¹³ See id. at 120.

¹⁴ Case No. 2006-00455, An Investigation into the Financial Condition of East Kentucky Power Cooperative, Inc.

¹⁵ See T.E., March 22, 2007, at 67-68, 71.

¹⁶ See id. at 60-61, 71.

EKPC's financial viability appears at this point to be almost entirely within the discretion and good grace of RUS.

The most compelling evidence, however, comes from the testimony of Jonathan Don, Vice President of Capital Market Member Products for CFC. Mr. Don testified that although the 2006 amendment to the Credit Facility eliminated the immediate danger of EKPC defaulting under the terms of the Credit Facility, EKPC was subject to a declaration of default under the Mortgage Agreement and a subsequent cross-default declaration under the Credit Facility.¹⁷ Mr. Don further stated that EKPC's existing unsecured creditors would be unlikely to enlarge the Credit Facility until such time as EKPC's financial condition improved.¹⁸ EKPC's financial condition has deteriorated to the point, according to Mr. Don, that several of the unsecured lenders have placed EKPC on a credit watch list and have instituted a heightened tracking system of EKPC's financial indicators.¹⁹ Most telling, Mr. Don indicated that EKPC's credit rating had fallen from somewhere in the BBB to BBB- range at the time the Credit Facility was originally entered into, to a current rating in the subinvestment grade or "junk" classification.²⁰ Mr. Don explained that with a subinvestment grade credit rating, EKPC may be simply unable to find a creditor willing to establish an unsecured revolving line of credit.²¹

¹⁷ See id. at 134-35.

¹⁸ See id. at 135.

¹⁹ See id. at 137, 143-144.

²⁰ See id. at 140-141.

²¹ See id. at 141-142.

On the basis of the foregoing, the Commission hereby finds that: (1) beginning with the unplanned outage of the Spurlock No. 1 unit in July of 2004, EKPC's financial condition has steadily and consistently deteriorated and shows no immediate signs of improvement; (2) due to a significant capital construction program, EKPC has incurred increasing levels of interest expense at a time when it is least able to absorb such increasing costs; (3) EKPC's credit-worthiness has deteriorated to the point that its credit score would likely be in the subinvestment grade category; and (4) but for the willingness of RUS to forebear from making any declaration of default under the Mortgage Agreement, which would also trigger the cross-default provisions of the Credit Facility, EKPC would be insolvent. Although the Commission recognizes and appreciates the commitment of EKPC's new management to reduce costs wherever possible, such reductions, at least in the short term, will be insufficient to reverse its credit impairment. The Commission therefore concludes that these findings taken as a whole will result in the credit of EKPC being materially impaired or damaged unless a portion of the general rate increase proposed in EKPC's application is permitted to become effective under the terms and conditions set forth herein.

Operational Impairment

Though it is unnecessary at this point for the Commission to look beyond EKPC's credit impairment, we find additional support for our decision when EKPC's potential for operational impairment is also considered. In its response to data requests relating to an alleged operational impairment, EKPC asserted that without interim rate relief, it would likely be forced to defer maintenance on unidentified generation and transmission

projects, which could potentially affect electric system reliability.²² EKPC also asserted that its construction program could be halted if RUS were to “freeze” future loan advances.²³ At the March 22, 2007 hearing, EKPC stated that without interim rate relief, it would be unable to hire for positions “that need to be filled” resulting in EKPC “falling behind in our construction programs and other programs that affect our operation....”²⁴ Mr. Marshall also testified that while the situation regarding the level of Lake Cumberland had no operational effect on EKPC during the historic test year,²⁵ “certainly it has an effect and is a concern as we move forward.”²⁶ Mr. Eames helped quantify the cost of the potential draw-down of Lake Cumberland by stating that necessary improvements to the John Sherman Cooper Station (“Cooper Station”) would be approximately \$25 million while the costs of purchasing replacement power would be

²² See EKPC's Response to Commission Staff's Second Data Request, Response 6(b). On cross-examination, Mr. Eames elaborated on this response and indicated the referenced deferrals were for overhauls of the turbines at Spurlock No. 2 and Dale No. 3. Specifically, the overhauls would be deferred for 6 months beyond their normal 10-year cycle, which is already beyond industry standards. See T.E., March 22, 2007, at 86, 106.

²³ See EKPC's Response to Commission Staff's Second Data Request, Response 6(b).

²⁴ See T.E., March 22, 2007, at 105.

²⁵ On January 22, 2007, the U. S. Army Corps of Engineers announced plans to lower the Cumberland Lake level at Wolf Creek Dam in Russell County, Kentucky, to 680 feet in response to internal and independent studies that have classified the dam as being at high risk for structural failure. See U.S. Army Corps of Engineers, Nashville District news release 07-01, http://www.orn.usace.army.mil/pao/news_releases/2007%20news%20releases/07-01.pdf. The Corps subsequently announced the lake level could be drawn down to 650 feet.

²⁶ See T.E., March 22, 2007, at 157.

"far in excess of that on an annual basis."²⁷ While EKPC indicated that it was cutting costs by carefully reviewing expenditures and offering qualifying employees early retirement,²⁸ it held out the possibility that layoffs would result if interim rate relief were not granted and additional cost saving measures were not effective.²⁹

While the danger associated with any operational impairment may not be as immediate as EKPC's ongoing credit impairment, there is little doubt that the two are closely related. In the absence of some form of interim rate relief, EKPC is caught in a difficult position – to preserve its financial viability, it would be forced to embark upon an even more aggressive cost-cutting program at the expense of its workforce and perhaps at the expense of its reliability and safety programs. This is, of course, a recipe for disaster. As stated before, while low rates are desirable, this must be balanced against the necessity that a cooperative remains financially and operationally viable. Unless and until EKPC regains a solid financial footing, its operations will be under threat of material impairment.

On the basis of the foregoing, the Commission hereby finds that: (1) the U.S. Army Corps of Engineers' decision to lower the level of Lake Cumberland has placed the continued reliable operation of the Cooper Station at risk; and (2) as a result of its cash shortage, EKPC has decided to defer scheduled maintenance of the Spurlock No. 2 and Dale No. 3 generation units, despite the fact that these units are already beyond industrial standards for maintenance. The Commission therefore concludes

²⁷ See id. at 97.

²⁸ See id. at 160-161.

²⁹ See id. at 89.

that the combination of these factors will result in the operations of EKPC being materially impaired or damaged unless a portion of the general rate increase proposed in EKPC's application is permitted to become effective under the terms and conditions set forth herein.

SCOPE OF SUSPENSION PERIOD RATE RELIEF

In light of the fact that the Commission has determined that a material credit and operational impairment will occur at EKPC unless interim rate relief is granted during the suspension period, we now turn to the scope, terms, and conditions of such rate relief. The Commission notes that all of the parties to the case initially reached a settlement in principle on March 6, 2007. Subsequently, however, the Sierra Club determined to withhold its consent to the proposed settlement agreement. Consequently, the Commission cannot accept the settlement agreement as drafted. However, we have reviewed the proposed settlement agreement and find many of its terms to be a reasonable resolution of the issues associated with the implementation of an interim rate increase for EKPC.

The proposed settlement agreement requests EKPC to be awarded an annualized rate increase of \$19.0 million, commencing on April 1, 2007. Though EKPC itself concedes that this level of relief will be insufficient to satisfy its debt covenants in 2007,³⁰ we will accept EKPC's judgment that this level of interim increase is

³⁰ Mr. Eames testified that even with an annualized \$19.0 million in interim rate relief, "that, as far as meeting our [debt] covenants, we are in a very dire situation." T.E., March 22, 2007, at 113. He later testified that EKPC would still fail to achieve the requisite debt service coverage ratio for 4 years in a row under the Mortgage Agreement. See id. at 116.

reasonable.³¹ The Commission will permit a portion of EKPC's requested increase – \$19.0 million on an annualized basis – to go into effect for service rendered on and after April 1, 2007. This interim rate relief shall be collected subject to refund and, in the event that EKPC ultimately collects more under the rates established in this Order than the Commission authorizes as permanent rates at the conclusion of this proceeding, EKPC shall refund the difference along with interest at the average of the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release.

The rate relief awarded herein shall be allocated to the individual sections of EKPC's wholesale rate schedule on the same percentage basis and according to the same rate design methodology as in the proposed tariffs filed in EKPC's application. The rate increase reflected in the proposed tariffs will be adjusted proportionally to reflect the annual increase of \$19.0 million and not the \$43.4 million originally requested. Any refunds required as a result of EKPC's over-collection or a finding that EKPC's proposed tariff is unreasonable shall be passed through to EKPC's member cooperatives, with interest, through the approach required by KRS 278.455(2). The Commission will not impose the provisions contained in paragraphs four and five of the proposed settlement agreement as we find those terms, in this context, to be a disincentive to controlling and containing expenses.

³¹ EKPC contends that it will be able to achieve the financial ratios required by the debt covenants by cutting expenditures. See T.E., March 22, 2007, at 126-127. EKPC also notes, however, that this could require at least an additional 3 to 5 percent reduction in discretionary spending. See id. at 174.

Due to the unique and extraordinary circumstances of this proceeding, the Commission finds it is reasonable to monitor EKPC's financial condition more closely during the pendency of this proceeding. Beginning on April 1, 2007 and ending on the effective date of the Commission's final Order in this case, EKPC will file with the Commission a monthly accounting of its expenses and revenues in both a monthly format and a 12-month ending format to enable the Commission and the parties to monitor EKPC's margins. EKPC will also provide monthly budget information for calendar year 2007 and a calculation of its TIER and DSC as of the 12-month period ending for each month included in this monitoring period. The required financial information will be filed no later than 30 days after the end of the reporting month.

IT IS THEREFORE ORDERED that:

1. EKPC shall be granted an increase in its base rates by the sum of \$19.0 million on an annualized basis for service rendered on and after April 1, 2007. EKPC shall maintain its records in such manner as will allow the proper determination of any amount to be refunded, in the event refund is required, upon final resolution of this matter.

2. This interim rate relief shall be collected subject to refund and, in the event that EKPC ultimately collects more under the rates established in this Order than it is finally allowed to collect under permanent rates established at the end of this proceeding, EKPC shall refund the difference along with interest at the average of the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release. Any refunds required as a result of EKPC's over-collection or a finding that EKPC's proposed tariff is unreasonable shall be passed

through to EKPC's member cooperatives, with interest, through the approach required by KRS 278.455(2).

3. The rate relief awarded herein shall be allocated to the individual sections of EKPC's wholesale rate schedule on the same percentage basis and according to the same rate design methodology as in the proposed tariffs filed in EKPC's application.

4. The rate increase reflected in the proposed tariffs shall be adjusted proportionally to reflect the annualized increase of \$19.0 million and not the \$43.4 million originally requested.

5. Within 10 days of the date of this Order, EKPC shall file its tariffs reflecting the \$19.0 million annualized increase granted herein.

6. Beginning on April 1, 2007 and ending on the effective date of the Commission's final Order in this case, EKPC shall file with the Commission a monthly accounting of its expenses and revenues in a monthly format and a 12-month ending format to enable the Commission and the parties to monitor EKPC's margins. EKPC shall also provide monthly budget information for calendar year 2007 and a calculation of its TIER and DSC as of the 12-month period ending for each month included in this monitoring period. The required financial information shall be filed no later than 30 days after the end of the reporting month.

Done at Frankfort, Kentucky, this 1st day of April, 2007@ 12:04 p.m.

By the Commission

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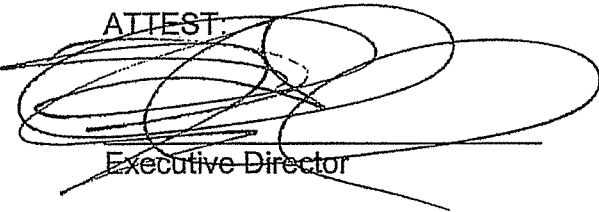
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ATTEST

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Executive Director

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF BIG RIVERS ELECTRIC)	CASE NO.
CORPORATION FOR A GENERAL ADJUSTMENT)	2009-00040
IN RATES)	

INTERIM ORDER

Pending before the Commission is a request by Big Rivers Electric Corporation ("Big Rivers") for an interim increase in base electric rates during the five-month suspension of the rates proposed in its application for a general rate adjustment. Due to Big Rivers' inability to justify its need for this extraordinary relief, the Commission denies Big Rivers' request for interim rate relief.

PROCEDURAL BACKGROUND

Big Rivers is a rural electric cooperative corporation organized pursuant to KRS Chapter 279. It owns electric generation facilities, and purchases, transmits and sells electricity at wholesale. Its principal purpose is to provide wholesale electric service to its three distribution cooperative member-owners, Kenergy Corp., Meade County Rural Electric Cooperative Corporation, and Jackson Purchase Energy Corporation (collectively "Member Coops"). The Member Coops provide retail electric service to approximately 111,000 customers in 22 Western Kentucky counties.¹

¹ Application, Pages 1-2.

On March 2, 2009, Big Rivers submitted an application for filing requesting an adjustment of electric rates in order to produce an additional \$24.9 million in annual revenues, which would be a 21.6 percent increase over normalized test-year sales. Upon request, the Commission granted intervention to the Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention ("AG") and Kentucky Industrial Utility Customers, Inc. ("KIUC").

Anticipating that the Commission would suspend the proposed permanent rates for five months to investigate their reasonableness, Big Rivers requested that its proposed rates become effective on an interim basis for service rendered on and after April 1, 2009. Big Rivers argues that, absent interim rate relief, it will not have adequate cash reserves to make a December 15, 2009 debt payment to Phillip Morris Credit Corporation ("PMCC") in the amount of \$12.4 million and a January 4, 2010 debt payment to Rural Utility Service ("RUS") in the amount of \$15.8 million.²

Big Rivers requested that its proposed permanent rates become effective for service rendered on and after April 1, 2009. To allow time to investigate the reasonableness of Big Rivers' proposed permanent rates, the Commission, by Order dated March 16, 2009, suspended the proposed effective date until September 1, 2009, pursuant to KRS 278.190(2). The Commission also appended two procedural schedules to its March 16, 2009 Order: Appendix A to investigate the request for interim rate relief and Appendix B to investigate the request for permanent rate relief.

The procedural schedule to investigate the request for interim rates provided for one round of discovery on Big Rivers' interim rate request, an evidentiary hearing on

² Application, Exhibit 46, Page 6.

March 26, 2009, and an opportunity for intervenors to present testimony at the hearing. The only intervenor to present testimony was KIUC. Big Rivers, the AG and KIUC filed simultaneous briefs on April 8, 2009 as directed by the Commission.

The Commission's findings and rulings in this Order apply only to Big Rivers' request for interim rate relief. The Commission will continue to process Big Rivers' request for a permanent rate increase in accordance with the procedural schedule adopted as Appendix B to the March 16, 2009 Order.

LEGAL STANDARD

The statutory basis for interim rate relief is set forth in KRS 278.190(2). That statute provides, in relevant part, as follows:

[I]f the commission, at any time, during the suspension period, finds that the company's credit or operations will be materially impaired or damaged by the failure to permit the rates to become effective during the [suspension] period, the commission may, after any hearing or hearings, permit all or a portion of the rates to become effective under terms and conditions as the commission may, by order, prescribe.

As the applicant, Big Rivers has the burden to demonstrate that its credit or operations will be materially impaired or damaged in the absence of interim rate relief.

DISCUSSION

Big Rivers has stated that this rate application will be withdrawn if it is able to reacquire operational control of its generating assets in conjunction with the "Unwind

Transaction”³ approved in Case No. 2007-00455.⁴ If the Unwind Transaction closes, Big Rivers expects to recognize cash and non-cash benefits of \$755.9 million,⁵ resulting in a significantly improved financial position and eliminating the need for this request for a rate increase.

To support its claim of insufficient cash to pay \$15.8 million to RUS on January 4, 2010, Big Rivers analyzed its historic and projected cash receipts and disbursements.⁶ That analysis shows a negative \$13.8 million cash balance on January 5, 2010 absent a rate increase and a positive \$2.8 million cash balance if the proposed rates go into effect for service rendered on and after April 1, 2009. Even with the rate increase, Big Rivers states that it will be required to defer 2009 budgeted expenditures for incremental right-of-way clearing, expanded energy efficiency programs and certain capital expenditures in order to meet the projected cash balance.⁷

Big Rivers explains that, until recently, it has maintained adequate cash reserves, but that reserve was greatly depleted on September 20, 2008, when it made a \$109.3

³ Application, Page 3, Lines 4 - 6.

⁴ The Applications of Big Rivers Electric Corporation for: (1) Approval of Wholesale Tariff Additions for Big Rivers Electric Corporation, (2) Approval of Transactions, (3) Approval to Issue Evidences of Indebtedness, and (4) 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 (Ky. PSC March 6, 2009).

⁵ See Commission’s Final Order dated March 6, 2009 in Case No. 2007-00455.

⁶ Application, Exhibit 47, Pages 40 and 41.

⁷ Id. at 42.

million cash payment to PMCC to terminate a leveraged lease.⁸ This payment, coupled with recent debt principal and interest payments and capital expenditures, reduced Big Rivers' cash balance to \$25.7 million at the time it filed this application.⁹

Big Rivers' application states that it has no ability to borrow long-term funds due to its weak financial condition and its primary lender, RUS, has refused to lend additional funds or subordinate its security interest.¹⁰ According to Big Rivers, its only source of cash, other than cash on hand, is a \$15 million line of credit with National Rural Utilities Cooperative Finance Corporation ("CFC"), which must be paid down to a zero balance at least once a year.¹¹ This line of credit is needed by Big Rivers to "meet margin calls required by its power trading counterparties" and is the "sole backstop for any new cash need, including unanticipated costs."¹² (Emphasis in original). Therefore, Big Rivers argues that it would not be prudent to rely on this line of credit for daily cash working capital requirements.

⁸ Big Rivers entered into a leveraged lease with PMCC in 2000. Ambac Assurance Corporation ("Ambac") provided credit support for the leveraged lease. When Ambac's credit rating was downgraded, Big Rivers was obligated to either buy out the leveraged lease or provide alternative credit support. Big Rivers determined that its least costly option was a buy out, consisting of an immediate cash payment of \$109.3 million and a December 15, 2009 payment of \$13.4 million. See Commission's Final Order in Case No. 2007-00455 dated March 6, 2009, Page 8.

⁹ Application, Exhibit 47, Page 39.

¹⁰ Id. at 39 and 40.

¹¹ Id. at 40.

¹² Big Rivers' Brief, Page 9.

For these reasons, Big Rivers requests that its proposed rates be made effective on an interim basis for services rendered on and after April 1, 2009 in order to generate \$16.6 million in additional revenue by January 4, 2010. Big Rivers maintains that any delay in implementing its proposed rates will necessitate higher interim rates to generate the same \$16.6 million in additional revenue it believes is needed by January 4, 2010.

At the March 26, 2009 hearing, Big Rivers updated its financial information to show that implementing its proposed rates on April 1, 2009 results in a cash balance of \$8.5 million, not the previously projected \$2.8 million, after the RUS payment on January 4, 2010. The higher cash balance is achieved through additional cost reductions.¹³ Big Rivers argues that this higher balance of \$8.5 million is necessary to offset the uneven nature of its cash receipts and disbursements and to have sufficient cash to pay daily operating expenses from January 5, 2010, to January 20, 2010.¹⁴

KIUC recognizes that Big Rivers' cash reserves were "depleted" by the PMCC leveraged lease buy-out,¹⁵ but it does not believe that rate relief is needed on April 1, 2009, in order for Big Rivers to make its RUS payment on January 4, 2010. KIUC states that the low point in Big Rivers' projected cash balance will be on January 5, 2010—the day after making the RUS payment.¹⁶ KIUC notes that Big Rivers originally

¹³ Big Rivers' Brief, Page 6.

¹⁴ Id. at 7.

¹⁵ KIUC's Brief, Page 3.

¹⁶ Id. at 6.

projected this low point to be \$2.8 million if the proposed rates were made effective on April 1, 2009, but Big Rivers later revised this amount to \$8.5 million. KIUC argues that, based upon Big Rivers' revised cash projections, the effective date for interim rates can be delayed by three months and still result in a projected cash balance of \$2.5 million on January 5, 2010.¹⁷ KIUC continues by stating that, if Big Rivers' cash projections are incorrect and adequate funds are not available on January 5, 2010, Big Rivers could temporarily borrow against its CFC line of credit to meet short-term cash needs.¹⁸ Also, KIUC suggests that based upon Big Rivers' "tremendously strong income statement",¹⁹ it may be able to borrow \$10 million to \$15 million²⁰ in unsecured loans from its general purpose banking provider, Old National Bank. Big Rivers acknowledges that it has not contacted Old National Bank to discuss the possibility of obtaining any unsecured loans.²¹

KIUC also questions the reasonableness of Big Rivers' cash projections since they are based on proposed pro forma adjustments that significantly reduce test-year

¹⁷ Id. at 5.

¹⁸ Id. at 9.

¹⁹ March 26, 2009 Hearing Transcript, Page 173.

²⁰ Id. at 186.

²¹ Id. at 64.

Non-Tariff Energy Sales.²² KIUC claims that these adjustments are contrary to Big Rivers' internal budget reports and may be inconsistent with other adjustments which increase wholesale purchased power costs.²³ Noting the significance of these adjustments to Big Rivers' overall revenue deficiency, KIUC states that if any or all of these adjustments ultimately prove to be unfounded and are ultimately rejected by the Commission in its final Order in this case, then Big Rivers' interim rate relief would be unneeded.²⁴

The AG supports KIUC's arguments and also asserts that Big Rivers has taken sufficient cost-deferral and cost-containment actions to delay implementing interim rates until it is known whether or not the Unwind Transaction will close. The AG recommends delaying interim rates until at least June 30, 2009 to allow the Unwind Transaction to close.²⁵

FINDINGS

The Commission finds that Big Rivers' cash reserves were depleted by the \$109 million cash buyout of the PMCC leveraged lease; that Big Rivers' current financial position is poor as evidenced by its negative equity position; and that a base rate

²² In its Application, Exhibit 46, Seelye-2, Schedule 1.11, Big Rivers shows a reduction to Accounts 447.171-447.299 in the amount of \$21,712,149, which is a 26 percent decrease to the amount reported in these accounts during the test year of \$82,316,867 as shown in Big Rivers' Response to Commission Staff's First Data Request, Item 19. a., Page 6.

²³ KIUC's Brief, Page 10.

²⁴ Id. at 11.

²⁵ AG's Brief, Pages 3 - 5.

increase may be necessary if the Unwind Transaction does not close. However, if the Unwind Transaction does close, Big Rivers should have a more reasonable level of cash reserves; its equity balance should be significantly improved; and it will request to withdraw its application for interim and permanent rate relief. Big Rivers is optimistic that the Unwind Transaction will close after May 19, 2009 and has been diligently working to do so.²⁶ Nevertheless, Big Rivers filed this rate application to increase its cash balance in the event the Unwind Transaction does not close.

The 21.6 percent interim rate increase sought by Big Rivers is based upon its projected pro forma annual cash revenue deficiency of \$24.9 million as of the March 2, 2009 filing date. Big Rivers argues that interim rate relief is needed on April 1, 2009 to generate \$16.6 million in additional revenue by January 4, 2010 so it will be able to pay its RUS debt. Big Rivers states that any delay in the effective date beyond April 1, 2009 will result in the need for a higher percentage rate increase. The Commission finds that Big Rivers' position is not supported by the updated cash balance projections it provided at the March 26, 2009 hearing. This updated information shows that Big Rivers would have a positive cash balance after making the RUS debt payment on January 4, 2010 if the effective date of a 21.6 percent increase were delayed until August 1, 2009.²⁷

The Commission recognizes that a possible 21.6 percent increase made effective for services rendered on and after August 1, 2009 could result in a projected

²⁶ See letter from Big Rivers and E.ON U.S. LLC filed on May 14, 2009 in Case No. 2007-00455.

²⁷ \$8.5 million cash balance with April 1 effective date / \$2.075 million monthly increase from 21.6 percent increase = up to 4.1 month delay from April 1 and cash balance remains positive after RUS payment on January 4.

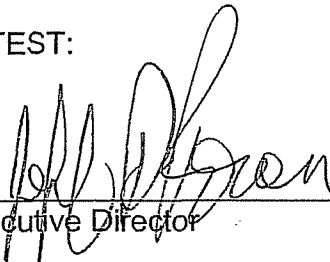
cash balance that is even lower than Big Rivers requested. While the Commission shares many of Big Rivers' concerns regarding its level of cash reserves, it has not demonstrated that interim rate relief is its only available source of working capital. Big Rivers may be able to use the \$15 million CFC line of credit on a temporary basis to meet short-term cash working capital needs, a fact reinforced by Big Rivers' acknowledgement that the CFC line of credit is a backstop for new cash needs.²⁸ In addition, Big Rivers has not pursued the use of short-term, unsecured borrowings through Old National Bank.

Based upon the evidence of record, the Commission finds that Big Rivers has not shown that interim rate relief is needed at this time to avoid a material impairment or damage to its credit or operations. Thus, the request for interim rate relief is denied at this time without prejudice.

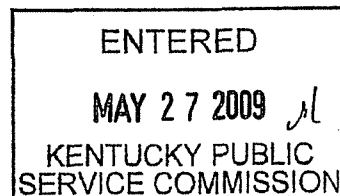
IT IS THEREFORE ORDERED that Big Rivers' request to place its proposed rates into effect on an interim basis for service rendered on and after April 1, 2009 is denied without prejudice.

By the Commission

ATTEST:



Executive Director



²⁸ Big Rivers' Brief, Page 9.