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Standard & Poor's Evaluates Big Rivers Electric Corp.'s Potential Credit Quality After Proposed Lease Termination

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Standard & Poor's Ratings Evaluation Letter To BREC

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In 1998, Big Rivers Electric Corp. (BREC or the company) leased its eight power plants to LG&E Energy Marketing Inc. (LEM) for 25 years and LEM agreed to sell energy to BREC and its customers at specified prices. LEM's successor, E.ON-U.S. LLC, negotiated a buyout arrangement with BREC that will terminate the lease 15 years early because of poor lease economics.

BREC asked Standard & Poor's Ratings Services to evaluate the credit rating implications of implementing the proposed termination scenario through its Rating Evaluation Service. Based on our review of materials that the company furnished and other information, we concluded that we could assign the \$865 million of senior secured debt that it is projecting following debt reduction and restructuring a 'BBB-' rating with a stable outlook if it completes the unwind transaction on the specified terms.

Whether we will rate BREC's senior secured debt 'BBB-' hinges on the final terms of the lease termination conforming to the assumptions that the company presented to us. There are numerous preconditions to closing the transaction. E.ON must pay BREC about \$500 million of cash compensation for taking back the generating assets and terminating the power supply arrangements. E.ON must also release BREC from certain financial obligations related to the lease that together with other noncash compensation totals \$315 million. Additional conditions include:

- Obtaining necessary state and federal regulatory approvals;
- Exchanging payments;
- Obtaining favorable opinions covering the transaction's tax implications;
- Assessing the costs of environmental exposures and the status of environmental remediation projects;
- Exchanging releases extinguishing legal claims;
- Executing power supply agreements between BREC's leading distribution cooperative and its two largest customers; and
- Extending the tenor of the wholesale power supply contracts between the company and its three distribution cooperatives.

A complete list of the issues and conditions underlying the outcome of Standard & Poor's ratings evaluation are delineated in the letter we prepared for BREC.

Standard & Poor's Ratings Evaluation Letter To BREC

April 23, 2009

Mr. C. William Blackburn, CMA

Chief Financial Officer

Vice President of Financial Services and Power Supply

201 Third Street

P.O. Box 24

Henderson, KY 42419-0024

Dear Mr. Blackburn:

Thank you for requesting that Standard & Poor's Ratings Services (Standard & Poor's, we, or us) provide Big Rivers Electric Corporation (BREC, the issuer, or you) with feedback on the credit rating implications of implementing the proposed scenario described below through its Rating Evaluation Service. Standard & Poor's has reviewed the scenario provided. The following is a summary analysis reflecting our Rating Evaluation committee's response.

Existing rating

BREC is not currently rated by Standard & Poor's.

Ratings evaluation scenario

As part of its 1998 Chapter 11 bankruptcy reorganization, BREC entered into an operating lease with LG&E Energy Marketing (LEM) covering its eight power plants. LEM leased BREC's generating assets for 25 years and agreed to sell energy to BREC and its customers at specified prices.

LEM's successor E.ON-U.S., LLC (E.ON) negotiated a buyout arrangement with BREC because of poor lease economics. The buyout allows the companies to terminate the lease fifteen years early. The parties negotiated a buyout that proposes that E.ON pay BREC about \$500 million of cash compensation for taking back the generating assets and terminating the power supply arrangements. E.ON will also release BREC from another \$315 million of financial obligations related to the lease.

There are numerous preconditions to closing the transaction. They include obtaining necessary state and federal regulatory approvals, exchanging payments, obtaining favorable opinions covering the transaction's tax implications, assessing the costs of environmental exposures and the status of environmental remediation projects, exchanging releases extinguishing legal claims, achieving specified credit rating thresholds, executing power supply agreements between BREC's leading distribution cooperative and its two largest customers, and extending the tenor of the wholesale power supply contracts between BREC and its three distribution cooperatives.

BREC asked us to assume that if it, E.ON and BREC's leading customers meet the several closing conditions, it will use about \$140 million of E.ON's \$500 million termination payment to reduce debt and \$218 million to create rate stabilization accounts benefiting non-smelter customers, which includes \$61 million that the commission's final order directed E.ON to contribute to the rate stabilization accounts. BREC has also advised us that it will set aside about \$35 million of E.ON receipts to mitigate the effects of potential smelter shutdowns and that it plans to hold the approximately \$116 million balance of E.ON's cash payment as unrestricted cash reserves to enhance working capital.

Big Rivers has also asked us to assume that it will restructure debt as part of the lease termination transaction. Big Rivers has about \$140 million of senior secured pollution control bonds and about \$900 million of subordinate secured Rural Utilities Service debt. We are assuming that, at closing, the new indenture will collapse the senior and subordinate liens, converting the subordinate debt to parity senior debt.

Standard & Poor's conclusions are based on our review of the several October 2008 and April 2009 financial forecasts and scenarios prepared by BREC for Standard & Poor's review. We also reviewed the documents BREC submitted to us in October 2008 including, but not limited to, the indenture, wholesale and retail sales agreements, smelter agreements, RUS loan contract and revolving credit agreements. In addition, our evaluation reflects telephone conversations and meetings held between BREC and Standard & Poor's.

Ratings evaluation conclusions

It is Standard & Poor's opinion that the \$865 million of senior secured debt that BREC is projecting following the lease's termination, its debt reduction and debt restructuring, may be assigned a 'BBB-' rating with a stable outlook if BREC completes the unwind transaction on the specified terms. Consistent with the assumptions you have provided, to achieve these ratings BREC would receive the contemplated E.ON payments, reduce debt as projected and convert all of its subordinated RUS notes to senior secured instruments on par with its outstanding senior lien pollution control bonds.

Rationale for rating conclusions

In our opinion, BREC faces several credit exposures that constrain the rating. They include:

A. We believe that BREC's extreme level of customer concentration and its leading customers' credit profiles represent meaningful credit exposures.

Assuming BREC severs its E.ON ties, it will use its power plants to produce and sell wholesale electricity. Its principal customers are its three member distribution cooperatives that will resell the electricity to their nearly 110,000 retail customers. BREC is projecting that only two of the 110,000 customers will account for about 60% of its revenues. These two customers, Rio Tinto Alcan (Alcan; BBB/Negative/--) and Century Aluminum Co. (Century; B/ Negative/--), are aluminum smelters whose operations and financial performance are exposed to extreme commodity price volatility. We believe these companies' economic viability hinges on aluminum prices, among other things. Notably, BREC expects Century's electricity purchases to provide 34% of its revenues, which meaningfully exposes BREC's financial profile to a single speculative grade customer's cash flows.

In recent months, many aluminum smelters curtailed operations following the sharp collapse of aluminum prices. If Alcan or Century ceased operations at their Kentucky facilities, BREC would need to sell surplus electricity in competitive wholesale markets in a bid to recover substantial portions of its fixed costs. If the smelters reduce their operations, BREC will need to sell the resulting surplus energy in the market for the benefit of the smelters. The several agreements signed by BREC, its distribution cooperative member, Kenergy Corp. (Kenergy), and the smelters provide that certain profits from market sales following curtailment inure to the benefit of the smelters. The agreements also provide that the smelters must cover BREC losses resulting from market sales following curtailment. Given Century's weak credit quality, its ability to make up shortfalls is questionable. If the smelters terminate operations, their BREC obligations end. While BREC may retain profits from off-system sales in this scenario it will also bear market the risk of losses.

We believe that selling electricity in wholesale markets to cover debt service presents meaningful credit challenges because wholesale market sales represent speculative and unpredictable revenue streams. Wholesale markets expose utilities to volatile prices, competing market participants, operational uncertainties such as acquiring physical access to transmission capacity, and potentially heightened liquidity needs.

B. It is our opinion that the take-or-pay features of the retail power sales contracts between BREC distribution cooperative, Kenergy Corp., and the smelters are weak.

Kenergy is one of BREC's three member distribution cooperatives. The lease unwind provides for Kenergy to resell BREC electricity to the smelters under 14-year power supply contracts. These contracts have take-or-pay elements that require the smelters to pay for specific quantities of energy, irrespective of whether the smelters need the energy. Yet, we believe that these contracts' take-or-pay features are weak and do not provide meaningful credit protections. For example, the smelters can terminate their contracts without penalties if they close their Kentucky facilities. The smelters' parent companies are not backstopping their subsidiaries obligations under the power sales agreements.

C. We believe BREC's financial performance could suffer if the Kentucky Public Service Commission does not provide timely rate relief or disallows costs, particularly if BREC needs to reallocate the smelters' shares of fixed costs to its non-smelter customers.

It is our view that if the smelters close and BREC cannot fully recoup the smelters' share of fixed costs through surplus electricity sales in competitive wholesale markets, BREC's non-smelter retail customers may need to bear substantial additional costs. BREC will not have control over revenues if it needs to sell electricity in competitive wholesale markets to compensate for eroded smelter activity. Moreover, BREC can only recover shortfalls from the non-smelter retail customers if it and its distribution cooperative members can obtain rate relief from the Kentucky PSC.

Unlike many other cooperative utilities, BREC and its member distribution cooperatives cannot autonomously raise rates to respond to increasing costs or to reallocate costs. The Kentucky Public Service Commission (Kentucky PSC) regulates these utilities' wholesale and retail electricity rates. Rate regulation presents credit concerns because rate proceedings can be lengthy and delay cost recovery. Moreover, rate-regulated utilities do not have cost recovery guarantees. Nevertheless, in recent rate proceedings, the Kentucky PSC provided BREC's distribution cooperatives with rate relief that was closely aligned with the utilities' requests. Also, the commission has taken additional steps in connection with the lease termination that we view as supportive of credit quality, including directing E.ON to fund rate stabilization accounts benefitting BREC's members' non-smelter, retail customers. In addition, the average wholesale rates of more than \$72 per megawatt-hour (MWH) the commission recently approved for East Kentucky Power Cooperative (East Kentucky), another generation and transmission cooperative, are substantially higher than BREC's current blended non-smelter rates of about \$35 per MWH. We believe that rates set for East Kentucky indicate there is capacity for further BREC rate increases should they be needed to reallocate costs to BREC's non-smelter customers.

D. It is our view that BREC's few, vintage, coal-fired generation assets present operational exposures that can affect financial performance.

Assuming BREC and E.ON terminate their generation lease, BREC will sell the electricity it produces at its seven owned coal plants and the two coal plants it leases from Henderson, Kentucky's Municipal Power and Light utility. BREC operates and has contractual rights to nearly 1,800 MW of generation capacity. BREC's and Henderson's power plants range in age from 23 to 40 years, with a weighted average age of 32 years, based on contributions to overall generating capacity.

BREC's wholesale electric rates include automatic fuel and purchased power cost adjustment mechanisms that we believe mitigate some of the credit concerns surrounding the ability of the mature fleet to reliably serve native load customers. These true-up mechanisms shift some of the operational risks of operating older units to the smelter and non-smelter customers by making them responsible for replacement power costs if units are not running.

While the fuel adjustment is an automatic, formulaic, monthly adjustment, the purchased power cost adjustment is only automatic for the smelters. Before they are eligible for recovery in rates, the PSC must review the power purchase costs BREC incurs on behalf of its non-smelter customers. All costs recoverable under the adjustment mechanisms are subject to PSC prudence reviews.

Some of BREC's plants have high heat rates. Its fleet's heat rates range from 10,600 BTU per kilowatt-hour (KWH) to 13,382 BTU per KWH with a weighted average heat rate of 11,100, reflecting the small percentage of the fleet with the highest heat rates. We are concerned that portions of the fleet may not dispatch to support market sales that compensate for losses of smelter sales.

BREC projects using coal to produce 95% of the electricity it sells, exposing the utility and its customers to potentially higher operating costs as the regulation of carbon and other emissions progresses. The plants' heat rates contribute to carbon intensity in the range of 1.1 tons of coal per MWH. The plants' ages, heat rates and carbon intensity raise questions about their ability to compete against potentially more efficient and less carbon-intensive units in wholesale markets if the smelters reduce or end their BREC electric purchases. It is our view that the extent of carbon regulation will determine the effects of this level of carbon intensity on BREC's production facilities' economics.

Because aluminum smelting is a carbon intensive process, we believe a combination of costly carbon constraints on aluminum production and carbon charges levied on the smelters' electricity purchases could impair the smelters' operations and heighten the likelihood that BREC's generating assets may have to compete in wholesale markets.

E. Although BREC is adding transmission capacity for physical access to wholesale markets, we believe it lacks the certainty of firm contractual transmission arrangements that can facilitate surplus power sales.

BREC advised us that it is adding transmission capacity to facilitate power sales to others if the smelters reduce operations or close. The Kentucky PSC approved the transmission capacity additions and BREC projects they will cost a moderate \$5.3 million. Yet, we believe BREC's ability to remarket the smelters' power still presents credit concerns.

BREC's transmission additions could provide sufficient physical interconnections with wholesale markets. However, BREC lacks firm contractual access rights that could ensure that it can move power across others' transmission systems, including, the Tennessee Valley Authority (TVA) system. BREC only has contracts for 100 MW of firm transmission capacity across the TVA system. BREC's management views the high cost of securing firm transmission access for a contingent exposure as unwarranted. BREC has physical interconnections with other power markets beyond TVA, such as the Midwest ISO and the Southwest Power Pool. However, BREC's electricity needs to cross TVA's transmission system to access key markets such as Southern Company and Entergy. Lack of transmission access due to fully loaded lines during peak periods could frustrate BREC's ability to capture the most robust power prices for surplus power it may need to sell if it loses smelter loads.

These strengths temper the preceding credit exposures:

A. BREC advised us that it plans to reduce debt and build equity with transaction proceeds.

BREC plans to use about \$140 million of E.ON's termination payments to reduce debt by nearly 16% and plans to use \$218 million to create rate stabilization accounts benefitting its non-smelter customers. BREC plans to hold the balance of E.ON's cash payment as unrestricted cash reserves to enhance working capital. E.ON will also cancel some lease-related obligations, which will further reduce long-term debt. These actions will reduce debt to \$872

million following the transaction from \$1.035 billion immediately prior to the transaction. Also, reducing debt and increasing cash balances will improve debt to capitalization to a sound 70% from a very weak 116%.

B. BREC projects funding its 2009-2013 capital needs from operating cash flow.

BREC projects \$300 million of 2009-2013 capital spending to add environmental controls to generation plants and enhancing its transmission system. BREC believes that it will only need modest amounts of incremental debt if it has to sell the smelters' power in wholesale markets at depressed prices. It is our view that market sales at depressed prices could require meaningful additional debt. Market prices for surplus power sales and the Kentucky PSC's wholesale and retail rate adjustments for BREC and its member cooperatives will determine the precise amount of debt that could be needed.

C. It is our opinion that the long-term wholesale power contracts between BREC and its three member distribution cooperatives provide a measure of revenue stream security.

It is our understanding that terms of wholesale power contracts between BREC and its members require BREC's three member distribution cooperatives to purchase their electricity needs from BREC. BREC and its member distribution cooperatives must extend their wholesale power sales contracts by twenty years to 2043 in connection with the lease termination. This long tenor contributes to credit quality. Furthermore, the members have exclusive rights to sell electricity within defined service territories, which shields BREC and its members from competition for their electric loads.

BREC's long-term wholesale power contracts also contribute to credit quality because they extend twenty years beyond its debt's 2023 final maturity. BREC is contemplating restructuring and extending some debt to achieve level debt service. The 2043 expiration date accommodates debt restructuring. However, because the smelters contracts expire in 2023, debt extensions beyond 2023 would lead to maturities beyond the expiration of the smelters' contracts and debt service on debt maturing after 2023 may need to be supported by wholesale market revenues.

Generally, lengthy requirements contracts, such as BREC's, provide meaningful revenue predictability and credit support. However, BREC's members' substantial reliance on two industrial loads that are vulnerable to commodity price cycles erodes the contracts' credit support and distinguishes BREC from most other cooperative utilities. Rate regulation also dilutes the benefits of the long-term wholesale power contracts since BREC, unlike most other cooperatives, cannot unilaterally levy additional costs on its captive customers, which could frustrate a reallocation of fixed costs if it loses smelter loads. Also, BREC lacks control over prices for market sales it may need to make if the smelters' operations falter, tempering the wholesale power contracts' benefits.

D. It is our view that BREC's members' retail rates are highly competitive and they could contribute to financial flexibility.

Energy Information Administration data shows that BREC's members' retail rates compare very favorably with average rates for the residential, commercial and industrial sectors in Kentucky. Members' 2007 average residential rates were 13% below the state's average. Members' average commercial and industrial rates were 10% and 23% below the state's respective average rates for these classes.

We believe the smelters' high load factors are likely contributors to the favorable level of rate competitiveness because their consistently high electricity consumption provides a robust platform for spreading fixed costs over many megawatt hours. Here too, the exposure to the smelters can become a liability if commodity prices or economic conditions compromise the smelters' operations.

E. BREC projects sound debt service coverage, but we believe losing the smelters could impair financial performance.

BREC projects debt service coverage of 1.35x or greater over the next decade. These coverage levels are stronger than those of many other generation and transmission cooperatives. Yet, these coverage levels do not enhance the rating because we believe that BREC needs robust coverage as a financial cushion against the vagaries of its aluminum smelter customers' performance.

BREC's base case financial forecast assumes that the smelters' operations are not impaired by either economic conditions or commodity prices.

BREC further assumes that its debt service coverage can strengthen if it loses the smelters' loads. BREC believes competitive wholesale markets can provide opportunities to earn revenues that are higher than the rates the smelters pay because the negotiated smelter rates yield low margins.

While we agree that wholesale markets may at times provide opportunities to reap windfalls, we believe that, on the whole, competitive wholesale market sales can erode financial margins. BREC faces considerable risks in wholesale market activity. If BREC must compete in wholesale markets to sell a meaningful amount of its power plants' capability to recover fixed costs, BREC, like other merchant generators, will need to find purchasers that can buy sufficient electricity to recoup the smelters' share of fixed costs. BREC must also secure enough transmission access to support such sales. During hours when coal is on the margin, BREC may face depressed market prices. The recent collapse of natural gas prices also places downward pressure on electricity prices. Furthermore, transmission constraints during peak periods may frustrate BREC's ability to obtain the best prices for its electricity.

We evaluated a number of stress scenarios with regard to potential financial results. These scenarios indicate that BREC's financial performance remains vulnerable to depressed market power prices if it loses the smelters. To preserve its rating in such scenarios, the utility would likely need regulatory approval for substantially higher rates for its non-smelter customers to shore up financial performance. The regulator will play an important role in determining future credit quality if BREC needs to look to its non-smelter customers to absorb fixed costs previously borne by the smelters. Here, we believe that East Kentucky's significantly higher wholesale rates could be cited in support of a BREC request for rate relief for cost recovery.

Sincerely yours,

Standard & Poor's Ratings Services

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