

Phyllis K. Fong  
Inspector General  
United States Department of Agriculture  
Room 117-W Jamie Whitten Bldg  
1400 Independence Avenue SW  
Washington DC 20250

August 9, 2010

Dear Ms. Fong,

We write to bring your attention to a recent management audit conducted under the auspices of the Kentucky Public Service Commission (KPSC) by Liberty Consulting Services (LCS) of the East Kentucky Power Cooperative (EKPC) (see attached). The audit, conducted by an independent, well-regarded member of the professional energy community confirms and supplements with additional facts and analysis many of the issues raised in a prior correspondence on February 23, 2010 and offers further commentary on the continuing severe deterioration of the cooperative's financial and management structure.

We believe the findings and conclusions in this audit are so serious that they warrant the immediate revocation of the lien accommodation granted to EKPC by RUS on July 31, 2009. The audit makes clear the depth of financial and management dysfunction of the cooperative and EKPC's persistent efforts to proceed with its almost \$1 billion investment in a new coal-burning power plant continue to put its members at risk. There is clear and convincing evidence that the financial authority granted by RUS to EKPC under the lien accommodation is being managed imprudently, or worse.

As such, we believe anything short of revoking EKPC's lien accommodation for the Smith plant will only perpetuate the poor management structure and further compound the Rural Utility Service's lax oversight of the cooperative.

### **The Audit Found Significant Lapses in RUS Oversight of EKPC**

The audit points to several instances, during the last decade at least, when the Rural Utility Service effectively enabled EKPC to adopt and carry out a series of financial and management actions that eroded the cooperative's credit position and weakened its ability to provide proper and reliable service to the people and businesses of Kentucky. Such policies and practices on the part of RUS are present and continuing.

- On July 31, 2009, RUS granted EKPC a lien accommodation for the cooperative to proceed with the Smith coal-burning power plant. This coal-burning plant:
  - a) has been denied funding by RUS;
  - b) has been the subject of skeptical reviews by the Kentucky Public Service Commission (KPSC);
  - c) is a project for which the cooperative has not produced firm financial commitments from unimpaired (see below) private banking institutions;

- d) has been litigated against by local organizations;
  - e) has been criticized by the mainstream press in Kentucky;
  - f) has been subject to astronomical cost increases; and
  - g) has had its application to KPSC for financing approval revoked by its sponsor, EKPC. Additionally, the original lien accommodation application to RUS was replete with statements of questionable consistency and content.
- The audit shows how RUS, faced with a “technical” default by EKPC of its credit covenants, took no substantive action. These so-called technical violations had to do with the fact that the cooperative was failing to demonstrate that it was a creditworthy institution (a matter of substantive and urgent concern in this audit). The audit points out that RUS did not declare default and implies that such an action would have triggered cross default provisions of EKPC’s \$650 million privately financed line of credit. The audit offers no indication that RUS provided any written cautionary warnings, required a plan of corrective action, or exercised any other prudent oversight.
  - It is also apparent from the audit that since 2005 RUS continued to approve new debt for several projects despite the cooperative’s worsening revenue picture. The audit highlights how RUS’s credit standards are low as a matter of financial policy, enabling a lax credit environment at EKPC.
  - The audit provides details of other audit reports (including an audit LCS performed in 2001) and several management studies, to which RUS may or may not have been privy, pointing out a growing management crisis in the agency. Despite RUS’s significant financial stake in the organization, and obligation to protect assets of the United States government, the audit does not note any significant action taken by RUS in response to any of these oversight reports.

**The Audit makes clear that the Smith plant is the ripe question for debate regarding financial dysfunction. And, the lien accommodation is the arena for action for RUS to correct the situation now.**

Adding to the concerns stated above, the audit further concludes that the current board of directors and management is “unlikely” to be able or willing to implement a thoroughgoing plan of reform. While the lack of willingness on the part of management to implement reform is painstakingly detailed on pages 55-76, we call your attention to a discussion of the frighteningly poor quality of the financial managers on page 22-24. This team is unprepared to address EKPC’s current financial needs.

Even if rates are increased (to improve revenue), new plans developed, and some window dressing is undertaken, the same poor power planning policies that are driving the cooperative into bankruptcy and the people and businesses of Kentucky into higher risk and poorly designed energy projects will govern.

In the Liberty Consulting Group audit, the Smith plant case is the poster child for EKPC’s financial mismanagement and imprudent decision making. This proposed \$921 million is the subject of the lien accommodation. The Smith plant is referred to during the

audit as EKPC's "major risk." The audit is clear that the plant is the product of a fatally flawed energy planning process.

Third, Liberty has emphasized that the continued commitment to a build/own/operate approach, and the lack of robust consideration of ownership structuring and market-based alternatives to its next proposed new generation fails to recognize both the opportunities and risks of today's power supply and generation environment. In addition, EKPC's extremely high level of anticipated expenditures and the large rate disparity it already imposes on distribution cooperative member/customers raise real questions about the costs to ultimate users and about the ability to fund and carry through on its long-standing approach to meeting the needs of the ultimate users that it serves.

Nevertheless, EKPC proposes to continue pursuing Smith 1. During the nine months during which it will undertake "risk assessment," EKPC proposes to obtain approval of nearly a billion dollars in permanent financing for a project that may be the biggest risk it will face in many years. EKPC's failure to address this issue, other than as a part of a nine month risk assessment, is a major failing of the EKPC response. Moreover, EKPC has indicated that it is working with the CFC to address this issue. The EKPC board chairman is a director of the CFC and its audit committee's financial expert. The CFC is a cooperative-owned financing entity that has total gross loans and guarantees outstanding of \$21.5 billion and its owners have invested more than \$4.3 billion in CFC securities. It too has close and long-standing relationships with EKPC. Relying solely on its support in this activity thus creates very substantial barriers in EKPC's candid examination or pursuit of alternative approaches. (pps. 69-70)

This rather understated conclusion makes an extremely powerful point. The people and businesses of eastern and central Kentucky are ill-served by a cooperative whose most critical financial decisions are apparently impaired by such conflicts of interest. As this audit plainly shows, the cooperative needs a robust discussion of all the options, as the power planning processes and finances of the cooperative have been skewed by biases that are financially counterproductive, imperiling both the cooperative members and federal assets. We remind you that RUS has denied EKPC financing for the Smith coal plant because the financial risks are too great. Now we learn those very same risks have been ignored by EKPC's internal process.

The attached audit provides far more than this letter can cover. We hope after reading it that you understand our concerns. We ask after reading it, and considering our request, that you immediately revoke the lien accommodation for the Smith plant and work with EKPC, KPSC and the cooperative members to find a better way to get the cooperative back on track to its traditional mission of providing affordable electricity for Kentucky.

We look forward to your response soon.

Sincerely,

Michael Hannon  
248 Apache Dr.  
Paint Lick KY 40461

Blue Grass Energy Member

Hunter Hensley  
Inter-County Energy Member

Barbara and Pate Warner  
Inter-County Energy Members

Ted Withrow  
Grayson RECC Member

Phil Hays  
Taylor County RECC Member

Robin Daugherty  
Jackson Energy Member

Steve Wilkins  
Blue Grass Energy Member

Jim Porter  
Inter-County Energy Member

Erik L. Lewis  
Fleming-Mason Energy Member

Joseph Netherland  
Salt River Electric Member

Teri Blanton  
Blue Grass Energy Member

Doug Doerrfeld  
Grayson RECC Member

Peter Hille  
Blue Grass Energy Member

Robin Reed  
Jackson Energy Member

Janet & Dick Futrell  
Blue Grass Energy Members

John Capillo  
Blue Grass Energy Member

Lois Kleffman  
Jackson Energy Member

Hunter Purdy  
Inter-County Energy Member

Colleen Ambrose  
Blue Grass Energy Member

Matt Poole  
Clark Energy Member

Billy Edwards  
Clark Energy Member