

Public Power
North America
Credit Analysis

PowerSouth Energy Cooperative

Ratings

Outstanding Debt
The Industrial Development
Board of the Town of Chatom
Gulf Opportunity Zone Bonds
(Alabama Electric Cooperative,
Inc. Projects) A-

Rating Outlook

Stable

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Key Utility Statistics

(Fiscal Year Ended 12/31/07)

System Type	Wholesale
No. of Customers	20
Annual Revenues (\$ Mil.)	632.1
Top User (% of Revenues)	6.1
Primary Fuel Source	Coal
Peak Demand (MW)	1,991
Energy Growth (%)	2.21
Debt-Service Coverage (x)	1.02
Days Operating Cash	39
Equity/Capitalization (%)	10

Rating Rationale

- The rating upgrade to 'A-' from 'BBB+' reflects PowerSouth Energy Cooperative's (PowerSouth) improved financial performance over the past few years as a result of management's increased cash flow, liquidity and equity targets; the members' support of past and future planned rate increases to recover costs on a timely basis and to meet the utility's higher financial targets; and greater clarity associated with the utility's power resource plan, which incorporates a good mix of owned and purchased power, as well diversified fuel sources.
- The underpinnings of the rating include PowerSouth's status as an all-requirements provider of power and energy to its 20 members, through contracts extending through 2050. There is territorial protection with the members who each serve captive retail markets. The customer base is primarily residential, with interruptible contracts for the largest industrial users.
- While there are still sizable future debt plans associated with power needs, the magnitude has been downsized over the last year, and timing of PowerSouth's financial commitments are more manageable and supportive of the 'A-' rating level.
- The rating also takes into account PowerSouth's stable and experienced management team, which has constructed a solid business plan and hedging program.

Key Rating Drivers

- The Stable Outlook reflects Fitch's expectation that PowerSouth will continue to implement timely rate increases to assure bondholder protection is maintained at targeted levels. These targets include increasing equity by \$193 million by 2016, (more than \$50 million has been raised to date), increasing liquidity and maintaining cash flow sufficient to produce debt-service coverage of approximately 1.25 times (x).
- The slower economy and housing downturn should reduce growth pressures on the PowerSouth system; the offset is that it could weaken the financial health of certain distribution customers, which collectively tend to show below-average economic indicators. Growth in kilowatt-hour (kWh) sales is currently estimated at 2.61% annually through 2013. Fitch anticipates that financial operations will be sustainable, even with a small drop in kWh sales.
- As with all systems with fossil fuel generation, particularly coal units, there are risks associated with the potential cost impacts associated with greenhouse gas regulation. Fitch will monitor this issue and its impact on PowerSouth's financial profile relative to neighboring utilities and its peer group going forward.

Credit Summary

PowerSouth (formerly known as Alabama Electric Cooperative Inc.) is a not-for-profit generation and transmission (G&T) cooperative that provides wholesale electric service to 16 retail electric distribution cooperatives and four municipal electric systems in the southern U.S. More than one million people are served by PowerSouth's members, with

Rating History

Rating	Action	Outlook/ Watch	Date
A-	Upgrade	Stable	4/07/09
BBB+	Affirmed	Stable	7/22/08
BBB+	Initial	Stable	4/08/07

about 80% of energy sales coming from its Alabama members (in central and south Alabama), and the remainder derived from its northwest Florida systems.

PowerSouth’s generation portfolio is reasonably diverse, as it owns one coal facility and has an interest in another coal plant, three natural gas facilities and two hydro facilities, for an aggregate capacity of 1,726 megawatts (MW), 670 MW of which is coal fired. In addition, since 2003, PowerSouth has purchased an average of 36% of its total power needs. In 2007, purchases amounted to 40% of total energy requirements. PowerSouth provides electricity to customers in 39 Alabama counties and 10 Florida counties, covering 37,000 square miles. PowerSouth’s members serve a customer base of 408,088, of which 69% are classified as residential, 16% as commercial and 15% as industrial.

Management/Governance

PowerSouth is governed by a 40 member board, with two trustees from each of the 20 members. The board operates through a committee structure, including a risk management oversight committee that makes all hedging decisions and determines the level of risk exposure through financial instruments. Day-to-day operations are managed by the president/CEO, who, along with the other members of the senior management team, has experience both in the electric industry and in other sectors. Fitch views the management team as having significant depth and a positive working relationship with its members as well as a proven track record of meeting operating and financial targets. Over the last two years, management has established new financial targets to support the utility’s future power resource strategy, and the board has shown its strong support of these changes.

Demographics

Members have legislatively mandated monopoly retail markets. In the state of Alabama, utilities have defined service territories for existing customers and for new customers, with small loads. State statute in Florida protects the service areas for existing customers, and the statute requires that new customers are to be provided service by the least-costly facility additions. However, once a provider is selected, it cannot be switched.

In 2007, combined the 20 members served 408,759 customers. Baldwin EMC (Summerdale, Ala.) has the largest base, serving 63,791 customers, followed by CHELCO (DeFuniak Springs, Fla.), with 42,326 customers. There is diversity in the member retail sales, and overall, 69% of kWh sales were made to residential customers, followed by 16% commercial and 15% industrial.

There is no Alabama Public Service Commission (PSC) regulation of cooperatives. Florida regulation of cooperatives is limited to rate structure, territorial agreements and disputes, and reliability of the coordinated transmission grid. According to PowerSouth, there are no electric restructuring initiatives in Alabama or Florida.

Largely dependent on manufacturing, Alabama’s economy grew more slowly than the nation over the past decade. Despite this, PowerSouth’s sales growth has been steady. Overall, the cooperative experienced annual energy growth from 2003 through 2007 of 2.60% per year and customer growth of 1.93% per year. Most of PowerSouth’s growth in the recent past has been derived from new residential development in beach communities in both Alabama and the northwest panhandle of Florida. However, growth in this area has subsided due to the current economic downturn.

Management projects that growth in energy sales will remain fairly stable, growing 2.61% annually through 2013, then declining to a growth rate of 2.09% through 2018,

and then showing an annual growth rate of 1.88% through 2027. Given the ongoing recession, Fitch feels that near-term growth estimates may be slightly inflated. However, Fitch believes that given the staggered addition of new power resources over the next 10 years, and that annual market purchases are required to meet the system's reserve requirement, reduced growth rates over the next few years should not pose a material credit risk.

In terms of revenue, the largest industrial customer, Alabama River Newsprint (ARN), whose parent company is Abitibi Bowater (in the newspaper and recycling business), is a customer of Southern Pine EC and provided revenues of \$40.1 million in 2007. On April 16, 2009, the parent company filed for bankruptcy. As ARN is billed for energy at an average cost rate and the demand is discounted under an interruptible rate, the impact on PowerSouth's margin will be nominal. This conclusion is based on actual activity through March 31, 2009, and estimates through Dec. 31, 2009. As ARN is an interruptible load that is served from PowerSouth's power reserves, not serving the ARN load will not require dispatch of higher-cost generation. Per Southern Pine management, there will be only a nominal impact to its margin.

Shaw Industries was the next largest customer, at \$14.54 million, and is a customer of the City of Andalusia. Overall, the largest loads all have interruptible rates, and the 10 largest customers combined contributed \$68.74 million, or 11% of revenues in 2007.

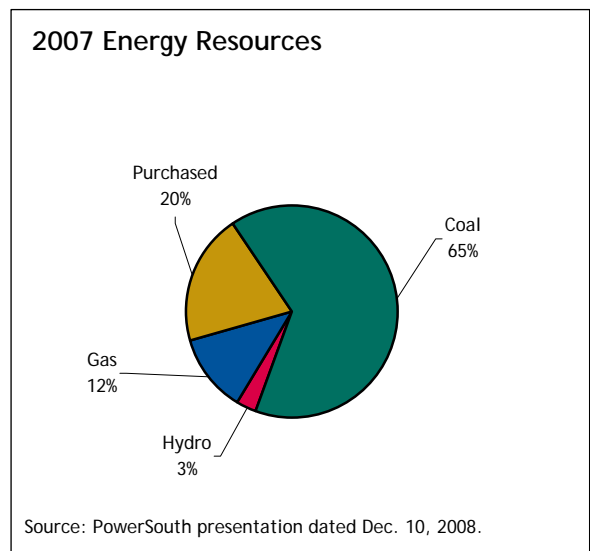
During the 2008–2009 period, eight new large customers in aggregate are expected to come on line. Combined, these customers are expected to contribute 112,489 kWh sales and add additional jobs to the region.

Power Supply

PowerSouth's power supply policy includes maintaining a 15% reserve and holding a portfolio of owned generating resources and purchased power. Purchases are a mix of long-term, intermediate and market purchases. Management strives to maintain a diversified supply mix as it pertains to both the number of resources and fuel mix. Specifically, the current energy supply consists of approximately 69% of system-owned power and 31% of purchased power. Owned capacity is generated from coal-fired, combined-cycle natural gas and simple-cycle natural gas units, for an aggregate of 1,718 MW. PowerSouth also has 8 MW of hydro generation and 199 MW of allocated Southeastern Power Administration Hydro Generation. The other power purchase contracts include a 250-MW contract with Georgia Power coal steam project that runs through 2016, a winter-peaking contract that runs through 2010 that provides 50–200 MW and a 60-MW contract with SMEPA that expires in 2010.

The system peak in 2007 was 1,991 MW, and increased to a peak of 2,059 MW in 2008. The table on the top of page 4 depicts PowerSouth's current generating portfolio.

Member requirements are growing, and it is expected that needs will be met from a combination of sources, including power supplied under a purchase power agreement entered



into with the Municipal Electric Authority of Georgia (MEAG), and PowerSouth management is in ongoing negotiations with Georgia Power personnel to extend a 250-MW contract beyond the 2016 expiration date.

Future Power Supply

PowerSouth has a long-term strategic goal to improve its resource mix to include nuclear, clean coal technology and renewable generation. In the recent past, PowerSouth was contemplating a \$2 billion investment in a coal plant. This decision has subsequently been changed, and PowerSouth now anticipates increasing its resources through the participation/ownership in a number of different facilities, as outlined in the table to the right.

Fitch views this diversification of resources as a positive, as it provides PowerSouth with some flexibility and allows the utility to make adjustments should demand forecasts continue to change.

Fuel Supply

Coal

PowerSouth had problems with two of its coal suppliers in 2008. The stock pile dropped to less than a 20-day supply, versus the 45-day goal. These suppliers stopped making deliveries; therefore, PowerSouth was forced to purchase on the open market, at a price approximately 180% over what was budgeted. Overall, the fuel issues experienced in 2008 resulted in approximately \$90 million of unbudgeted costs. Management acted swiftly, and the board voted to recover \$40 million of the unbudgeted costs in 2008, with an 8 mil/kWh adjustment and expects to recover the remainder by the end of fiscal 2009. Coal costs in 2009 are shown to be lower than the 2008 costs.

Going forward, there will be more focus on quality suppliers, and PowerSouth wants to have contracts with a minimum of three coal suppliers. The strategy is to have a portfolio of fixed price and spot contracts with various terms, both domestic and foreign. Coal contracts are in place through 2010 for 100% of requirements, and for 2011 and 2012, approximately 56% of the requirements are now contracted.

Natural Gas

PowerSouth employs a number of hedges for its natural gas supply. The current practice is to hedge at least 80% of the next three months' requirements, then 50%–80% of the next six months' requirements, and within 12 months, have 25% of requirements hedged. However, should a desirable contract become available and with the approval of the Risk Management Oversight Committee, PowerSouth has the ability to enter into additional hedges. This committee was formed to manage the financial hedging plan for

PowerSouth's Generating Portfolio Components

Facility	Fuel Type	Capacity Owned/ Interest (MW)
Charles R. Lowman Plant	Coal	556
James H. Miller Power Plant	Coal	114
James A. Vann Plant	Natural Gas	539
Maury A. McWilliams Plant	Natural Gas	159
McIntosh Plant	Natural Gas	350
Point A and Gantt Plants	Hydro	8

Future Projects

Year	Project	Capacity (MW)
2011	Two Combustion Turbines (Self-Build) McIntosh 4 and 5 — Peaking	360
2012	Yellow Pine PPA (biomass) — 30-Year Contract	30
2016	SoCo250 (Georgia Power) PPA — 10-Year Contract	250
2016	MEAG PPA — Vogtle Nuclear Project No. 3 — 20-Year Contract	62
2017	MEAG PPA — Vogtle Nuclear Project No. 4 — 20-Year Contract	62
2020	Nuclear Ownership or PPA	250

natural gas.

As another means of hedging its fuel costs, by 2011, PowerSouth will have expanded its storage capacity from 800,000 Mcf to 1,300,000 Mcf.

Transmission

PowerSouth owns 2,233 miles of transmission lines, 40 switching substations and 249 distribution substations. In addition, there are 300 distribution points. Management has developed a reliability-centered maintenance program, which is reviewed monthly with the members. According to management, the most-recent audit reflected 100% compliance with the self-determined reliability measures and outage ratios, and indicators exceeded industry averages.

During 2007, PowerSouth invested more than \$30 million on maintenance and new transmission projects to accommodate growth and enhance reliability.

Renewables

PowerSouth has begun diversifying into some small renewable projects, including a 20-MW wind project and a 30-MW biomass project. As part of this effort, the cooperative is a member of the National Renewables Cooperative Organization (NRCO), which is a group of generation and transmission cooperatives that attempts to aggregate renewable power resources to achieve some economies of scale. There is no renewable portfolio standard (RPS) in either Alabama or Florida, to date. However, there are renewable reporting requirements in Florida.

Capital Plan

Over the past few years, PowerSouth's capital plan focused on financing system improvements to meet environmental compliance standards, in addition to financing two peaking units. Going forward, the capital plan focuses on meeting generating resource needs, driven by growth and expiring purchase power contracts. PowerSouth expects to acquire about 500 MW of baseload generating assets by 2016, which will likely require additional base rate increases. A significant portion of this generation is needed to replace the 250-MW contract with Georgia Power that expires in 2016. As mentioned earlier, efforts are currently underway by PowerSouth management to negotiate with Georgia Power personnel on the extension of this contract beyond 2016. Additional requirements are expected to be met with a purchase power agreement entered into with MEAG for power generated from the Vogtle nuclear expansion project. This project encompasses two nuclear units that are anticipated to come online in 2016 and 2017, respectively. (For more information, see the Financial Position section on page 6.)

Rates

PowerSouth's wholesale rates are in line with other regional providers and are set annually by the board of trustees. The rates are set to fully recover operating costs, debt service and a margin. The board has typically approved timely increases in rates and the pass-through of fuel charges. The rate structure is reviewed monthly and may be adjusted at any time at the discretion of the board. Margin requirements are covered through the demand charge component of rates, while the energy charge is used to pass through fuel and related costs.

In August 2008, the members increased rates by 8 mills per kWh, in order to begin to recover \$90 million in excess fuel costs that resulted from increased market coal purchases, as mentioned above.

Cost-of-Service Comparison — Southeast G&Ts

(Mills per kWh)

	2003	2004	2005	2006	2007
PowerSouth	50.68	53.92	57.09	64.18	68.22
SMEPA	46.64	50.22	60.19	65.89	67.17
Seminole	52.17	56.67	64.83	68.54	69.40
East Kentucky	37.33	46.54	55.17	53.90	56.26

Note: The location of the coal mines contributes to the low cost of service shown above for East Kentucky.
Source: PowerSouth presentation book dated Dec. 10, 2008.

The members' average residential rates ranged from a low of 9.81 cents per kWh to a high of 13.70 per kWh in 2007. The highest rate was charged by Pioneer, which was affected by losses on propane operations; however, their board has subsequently made system and management changes and anticipates that, going forward, the rates will be more in line with the average rate.

Overall, PowerSouth's members' residential rates are fairly comparable to the national average in 2007 of 10.64 per kWh, and somewhat higher than Alabama Power's residential rate of 9.70 per kWh. The PowerSouth member rate for residential customers in 2007 was 10.83 cents kWh, as compared with the commercial and industrial rates of 9.88 per kWh and 6.24 per kWh, respectively.

Financial Position

PowerSouth has historically set rates to cover its annual operating budget and a margin for interest (MFI) target of 1.065x. Over the past five years, annual debt-service coverage has been managed to a low level of approximately 1.0x. The cooperative has a fuel and purchased power adjustment clause to permit adjustment of rates, partially mitigating the narrow MFI.

In 2007, PowerSouth updated its business model, which now targets and manages to a higher level of annual net margins — closer to \$25 million annually, from less than \$10 million a year earlier in the decade. There is an internal policy to fund new projects with at least 9%–10% internal funds and to build liquidity. The goal is to build liquidity and increase equity to approximately \$193 million by 2016.

As of fiscal year-end 2008, there was approximately \$1.38 billion of debt outstanding, of which about 75% was fixed rate. Approximately \$115 million of the variable-rate debt is currently in the auction-rate mode, with associated swaps. Given the outcome of recent auctions, there are no plans to refund the ARS at this time, and there have not been any collateral postings required on the swaps.

Financial results in 2008 were good, with debt-service coverage of 1.32x, up from 1.02x achieved in 2007. At the same time, days liquidity on hand improved, reaching 184 days, versus the category average of 149.

Liquidity

RUS has approved a \$335 million, 30-year loan for the Lowman Air Quality Control project and combustion turbines project, which PowerSouth will draw down during the period 2008 through 2011. As of April 3, 2009, \$255 million remains available to be drawn upon. There is

Current Liquidity Position

(\$ Mil.)

Source	Amount Drawn	Amount Available
Cash	—	52.5
RUS Loan	80.0	255.0
CFC Revolver	225.0	0.0
Regions Bank	25.0	25.0

also a five-year syndicated revolving credit agreement for \$225 million which is fully drawn down, with National Rural Utilities Cooperative Finance Corporation (CFC) and four other banks. In addition, PowerSouth has an additional \$50 million line of credit with Regions Bank that is renewed annually. In terms of cash, to date, \$52.5 million of cash has been raised, as part of PowerSouth's plan to increase its equity position.

Cooperative Propane Business

The cooperative propane business is a small non-related part of the G&T that has not produced surpluses in recent years. In 2006, the loss was \$240,000 and declined to \$61,000 in 2007. However, 2008 showed net income of \$379,835. PowerSouth has no plans to enter into any other non-electric enterprises, and this enterprise has no material impact on PowerSouth's financial performance. PowerSouth plans on selling this enterprise.

MEAG Purchase Power Agreement

MEAG is the owner of a 22.7% interest in two additional nuclear generating units to be constructed by 2016 and 2017, respectively, at the existing Plant Vogtle in Burke County, Ga. On May 12, 2008, PowerSouth entered into a 20-year PPA with MEAG to purchase approximately 125 MW of firm capacity from these two additional Vogtle units, beginning in 2016. During the term of the PPA, PowerSouth will be responsible for its portion of the demand costs and energy charges related to these two units.

Financial Summary — PowerSouth Electric Cooperative

(\$000, Fiscal Years Ended Dec. 31)

	2008	2007	2006	2005	2004	2003
Cash Flow (x)						
Debt-Service Coverage	1.32	1.02	1.15	1.14	1.06	1.08
Adjusted Debt-Service Coverage with General Fund Transfer	1.32	1.02	1.15	1.14	1.06	1.08
Coverage of Full Obligations	1.18	1.01	1.09	1.08	1.04	1.06
Liquidity						
Days Cash On Hand	51	39	52	40	47	102
Days Liquidity On Hand	184	175	169	82	98	159
Leverage (%)						
Debt/Funds Available for Debt Service	10.5	10.8	9.0	8.5	9.1	10.1
Equity/Capitalization	10	10	11	11	10	9
Equity/Adjusted Capitalization	7	7	7	7	7	7
Other (%)						
General Fund Transfer/Total Revenue	0.0	0.0	0.0	0.0	0.0	0.0
Variable-Rate Exposure/Capitalization	24.5	9.2	0.0	3.0	3.0	6.9
Income Statement						
Total Operating Revenues	750,390	632,172	628,614	522,974	445,235	410,882
Total Operating Expenses	668,982	576,237	571,409	469,769	396,076	363,173
Operating Income						
Adjustment to Operating Income for Debt-Service Coverage	50,795	45,452	44,441	42,677	41,744	39,790
Funds Available for Debt Service	132,203	101,387	101,646	95,882	90,903	87,499
Total Annual Debt Service	100,263	99,494	88,266	84,380	85,582	80,681
Balance Sheet						
Unrestricted Funds	87,497	56,910	76,116	47,134	46,149	91,143
Restricted Funds	52,046	18,734	877	724	520	0
Total Cash	139,543	75,644	76,993	47,858	46,669	91,143
Total Debt	1,384,754	1,094,370	915,447	812,900	826,482	882,655
Equity and/or Retained Earnings	150,630	122,267	110,467	96,821	88,156	83,851

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