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Summary:

Arkansas River Power Authority, Colorado; Wholesale Electric

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Table Of Contents

Summary:

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Credit Profile		
Arkansas River Pwr Auth		
Long Term Rating	BBB/Stable	Affirmed
Arkansas River Pwr Auth pwr		
Unenhanced Rating	BBB(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings affirmed its 'BBB' long-term and underlying ratings on Arkansas River Power Authority (ARPA), Colo.'s power revenue bonds outstanding. The outlook is stable.

The rating reflects our view of the authority's:

- High member rates, at about 30% above state averages, although management projects that rate increases over the next several years will be minimal;
- Very high debt ratios; and
- Participating member municipalities' limited service area economies, with adequate, but below-average, income indicators and employment bases that generally revolve around agribusiness, or are generally rural economies.

Partially offsetting these credit weaknesses, in our view, are the following factors:

- ARPA's recent resolution of member discord and associated litigation, which has eliminated much uncertainty surrounding the authority's operational and financial stability;
- A purchased power agreement that will provide replacement power for the Lamar Repowering Project (LRP) at a competitive rate through at least 2024;
- Cost certainty, given that most expenses are known and fixed for the next several years; and
- The monopolistic position of each of member city as well as rate autonomy, which insulate each from competitive pressures, given the above-average retail rates and load profiles of some members.

A first lien on net revenue of the ARPA system, which sells power to member municipalities on an all-requirements basis, net of any generation that each individual municipality chooses to produce, secures the authority's bonds outstanding. ARPA's governing board can adjust rates as necessary, effectively creating an unlimited step-up provision. Accordingly, we base our rating on the confluence of members' credit quality. We believe it would support a default of the balance of members, which in our view comprises Lamar and La Junta's pledges. In our view, Lamar's ability to withstand a default of ARPA's other members is stronger than La Junta's. We have also considered the authority's weak balance sheet and operations, where a substantial portion of members' revenues support a plant that is not operational, resulting in a high wholesale rate and high member rates compared with state averages.

The Lamar, Colo.-based joint action agency had about $139 million in long-term debt as of December 2018.

ARPA provides wholesale power to six member municipalities in southeastern Colorado:

- Lamar (32% of fiscal 2017 operating revenue)
- La Junta (31%)
- Trinidad (20%)
- Las Animas (9%)
- Springfield (4%)
- Holly (3%)

A few years ago, the City of Raton, N.M., negotiated its exit from the authority. This represented 2% of operating revenue in 2013, down from 14% in 2012, as the city temporary purchased power contract wound down throughout 2013. As part of a 2009 settlement, Raton relinquished its membership with ARPA but agreed to purchase all of its power needs from the authority above a defined generation source at a fixed price for three years, in an effort to provide ARPA time to seek additional member municipalities and stabilize system sales and rates. The authority has not found a replacement for Raton, and we believe it will be unlikely to do so in the near term.

The LRP was a joint effort by the authority, the Lamar Utilities Board (LUB), and the City of Lamar to repower the LUB's existing 25-megawatt (MW) steam generating unit to coal-fired from natural-gas-fired operation. The new coal-fired boiler, in conjunction with the existing LUB steam turbine and a new condensing steam turbine, increased the capacity of steam generation to 44 MW. The decision to convert the plant came at a time when natural gas prices were high and the board had identified a need for access to additional base load generation.

The LRP was to provide about two-thirds of the authority's energy requirements, with the remainder coming primarily from ARPA's Western Area Power Administration federal hydropower allocation. However, cost and timeline overruns, boiler design issues, and the inability to meet emissions requirements plagued the project. Because of this, it has not operated since November 2011. Although the plant came online in 2010, problems with the boiler led to the plant's shutdown in December 2010 for major modifications and to ensure air permit compliance. The boiler manufacturer funded modifications in part as part of its contract obligations, but the plant remains offline. ARPA management believes that the boiler is the root cause of the plant's noncompliance with its air permits, which occurred when the plant ran above a certain level.

In February 2014, the authority filed a lawsuit against Babcock & Wilcox Power Generation Group Inc. (B&W), which supplied the coal-fired steam boiler for the LRP. The boiler was never able to meet its emissions guarantees. As a result, ARPA has been unable to operate the plant and has incurred substantial losses, including funds spent to resolve the operating deficiencies, fines and penalties for emission exceedance, and legal fees for environmental litigation.

ARPA paid $450,000 in legal fees, including $125,000 for a supplemental environmental project that is converting community facilities (such as libraries and senior centers) lighting in the member communities to LED lighting. The B&W case was resolved in early 2017, and the authority received $4.2 million in addition to $4.0 million in pre- and post-trial interest.

The inability to operate the plant and self-generate power was a major reason ARPA entered a contract to purchase power for the next several years. However, with the $149 million in debt for the plant (not to mention other operating and legal costs) already embedded in member rates, additional replacement power costs have resulted in even higher power costs and member rates. Because of the LRP's failure, management had to implement a wholesale rate increase of 0.7 cents per kilowatt-hour (kWh; about 9.5%), as well as create an energy cost adjustor pass-through clause to its rates, effective May 1, 2010, in an attempt to restore liquidity. It implemented similar rate adjustments in fiscal 2011, but has not done so since, and doesn't plan on raising rates for the next several years.

ARPA's governing board can adjust rates as necessary, effectively creating an unlimited step-up provision. A consequence of the authority's historical willingness to adjust rates to maintain its financial integrity has been a rise in member cities' rates, which are about 30% more than the statewide average system rate. Given this, decisions on rate adjustments could be politically difficult.

The issues at the LRP led both the cities of Lamar and Trinidad to file separate breach of contract lawsuits against ARPA. Both cities have since resolved their disputes. The authority has agreed to pay Lamar a $2.50 million lump-sum payment (which will be largely covered by the release of $2.25 million funds in escrow by Syncora Guarantee Inc. upon refunding of ARPA's Syncora-insured bonds outstanding), as well as an annual payment of $350,000, payable subordinate to the authority's revenue debt for 26 years. Management expects the debt-service savings from its recently issued refunding bonds and additional planned cash defeasances will exceed this annual payment.

The authority has replaced LRP power supply with various purchased power agreements. The current agreement is with Twin Eagle Resource Management LLC, replacing a previous contract with Tri-State Generation and Transmission Association Inc. Twin Eagle is an independent power marketer that procures and schedules power for ARPA through 2024 under a contract by which the cost of power escalates 2.2% annually. The cost of power under this contract is very competitive, in our view, at just over 5.2 cents per kWh for fiscal 2018. Power comes from a diverse mix of fuel and accounts for about 64% of ARPA's total energy supply.

ARPA's auditor provided the board an opinion that the LRP represented an impaired asset; the project was subsequently written off in fiscal 2014. Inventories and capital improvements identified as project in process associated with the plant were also written off. Total losses for 2014 amounted to $162 million net of depreciation credits and other write-offs. Given the write-offs, ARPA's debt-to-capitalization rose to 770% in 2014 from 87% in 2013. Despite the unfavorable operating situation, most of the authority's costs, including debt service, are fixed for the next several years. ARPA has located a buyer for the LRP, although financing has been delayed to an expected closing in August 2019 from April 2018. Management intends to use these funds, along with the money expected from the B&W settlement, to defease a portion of its bonds outstanding.

ARPA's liquidity suffered in 2011 because it used a large portion of its designated reserves in an attempt to expedite

LRP repairs. Since then, however, liquidity has strengthened, and totaled $6.3 million at fiscal year-end 2017, equal to 108 days of operations. We believe the strong cash position provides a cushion against potential settlement costs with Lamar. The authority also has a $1.5 million line of credit with Colorado East Bank & Trust, currently undrawn, which adds about 30 days' liquidity of operating costs if needed. ARPA has not made a draw on the line since March 2012. Capital needs during the next few years are minimal and the authority does not plan additional bonds.

Outlook

The stable outlook reflects our view that, during the next two years, member rates and energy demand will remain relatively steady given the authority's long-term power supply contracts and the recent easing of member discord. We view additional fracturing of the membership as unlikely, but if cost overruns occur, we believe raising rates will be difficult given the already-high rates.

Upside scenario

We do not expect to raise the rating over the next two years given ARPA's very limited, if any, rate flexibility; its very high debt ratios; and participants' generally weak service area demographics, high rates, and mixed financial metrics.

Downside scenario

We could lower the rating if rate pressures increase and further threaten affordability, member credit quality, especially that of Lamar or La Junta weakens meaningfully; or ARPA's cash or coverage fall meaningfully short relative to historical levels.