S&P Global Ratings

RatingsDirect®

Summary:

Arkansas River Power Authority; Wholesale Electric

Primary Credit Analyst:
Doug Snider, Centennial 303-721-4709; doug.snider@spglobal.com

Secondary Contact:
Scott W Sagen, New York (1) 212-438-0272; scott.sagen@spglobal.com

Table Of Contents

Rationale

Outlook

Summary:

Arkansas River Power Authority; Wholesale Electric

Credit Profile		
Arkansas River Pwr Auth WHLELC		
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 rating and underlying rating (SPUR) on the Arkansas River Power Authority (ARPA), Colo.'s power revenue bonds. The outlook is stable.

The rating reflects our view of ARPA's:

- Inability to operate the Lamar Repowering Project (LRP), its flagship facility, because of emissions requirements and problems with the boiler design, and its subsequent decision to sell the plant or its key subsystems (likely at a substantial loss);
- High member rates, at about 30% above state averages, although management projects that rate increases over the next several years will be minimal;
- Recent loss of about 18% of load represented by the City of Raton, N.M., which negotiated an exit largely because of the delays in operating the LRP (ARPA is unlikely to find a similarly sized replacement customer, which adds rate pressure);
- 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 the above weaknesses, in our view, are:

- Debt service coverage (DSC) that has returned to at least minimally covenanted levels in fiscal years 2011 through 2015;
- Strong liquidity, with $4.8 million, or 93 days' cash, as of fiscal 2015, up from $1.1 million, or 18 days' cash, in 2011. Cash is projected at $5.7 million, or 113 days' operations, by fiscal year-end 2016;
- Unrestricted cash that a $1.5 million line of credit, currently untapped, bolsters by adds roughly 30 days' worth of liquidity;
- A recently signed purchased power agreement that will provide replacement power for the 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 one 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 bonds. While credit quality of the participating members is important, we base the rating primarily on 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 to state averages.

The Lamar, Colo.-based joint action agency had, as of Dec. 2015, about $146 million in long-term debt.

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

- Lamar (32% of fiscal 2015 operating revenue)
- La Junta (32%)
- Trinidad (19%)
- Las Animas (10%)
- Springfield (4%)
- Holly (3%)

A few years ago, Raton negotiated an exit from the authority. It represented 2% of operating revenue in 2013, down from 14% in 2012, as its temporary purchased power contract wound down over the course of 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 in excess of 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 been unable to locate 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 ARPA, 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 from 25 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. The LRP, however, was plagued by cost and timeline overruns, boiler design issues, and the inability to meet emissions requirements. Because of this, it has not been in operation since November 2011. Although the plant came on line 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 modifications were funded, in part, by the boiler manufacturer 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 paid to regulators for emission exceedance, and legal fees on environmental litigation. ARPA paid $450,000 in legal fees, including $125,000 for a supplemental environmental project that is converting community facilities (e.g., libraries and senior centers) lighting in the member communities to LED lighting. Legal fees totaled $734,511 in 2013, $1.0 million in 2014, and $1.24 million (or 7% of operating expenses) in 2015. In November 2016, a federal jury ruled against B&W, awarding ARPA a $4.2 million verdict.

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 $146 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. In our view, the power supply contract that extends through 2024 will allow ARPA to stabilize rates for its members.

The issues at the LRP led both the cities of Lamar and Trinidad to file separate breach of contract lawsuits against the authority. Trinidad has since resolved its disputes with ARPA and no longer plans to relinquish its membership. The lawsuit with Lamar is ongoing; however, the authority met with Lamar in February 2017 and reached a settlement in principle, which is contingent upon the unanimous approval of ARPA's members. Management does not expect the lawsuit's outcome to be materially burdensome. S&P Global Ratings will continue to monitor the Lamar litigation as it unfolds.

The authority has replaced LRP power supply with various purchased power agreements. The current agreement is with Twin Eagle Resource Management, replacing a previous contract with Tri-State. 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, in our view, very competitive, at less than 5 cents per kilowatt-hour (kWh) for 2015-2016. Power comes from a diverse mix of fuel and accounts for roughly 60% of ARPA's total energy supply.

ARPA continues to fully recoup its fuel and purchased power costs from its members, making it more likely to sustain its financial performance even with the relatively high rates. If the LRP is scrapped and sold, the authority could recover some of its losses, or perhaps restructure or reduce its debt. ARPA's auditor provided the board an opinion that the LRP represented an impaired asset; the LRP was subsequently written off in fiscal 2014. In addition, inventories and capital improvements identified as project in process associated with the plant were 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 restored DSC in fiscal years 2011 to 2015 to a range of 1.24x to 1.59x, with fixed-charge coverage at 1.23x to 1.56x. DSC in fiscal 2015 was 1.25x, with fixed-charge coverage of 1.21x. DSC is estimated near 1.44x for fiscal 2016 and 1.35x for fiscal 2017, with fixed-charge coverage at 1.38x and 1.30x, respectively. We view the 1.25x rate covenant as strong for a wholesaler. The rebound in financial performance followed two consecutive years -- 2009 and 2010 -- of DSC falling below ARPA's rate covenant. DSC was never insufficient (less than 1.0x) and the debt service reserve fund, which is currently fully funded with cash, was never used. Management attributes the weaker DSC to below-budgeted revenue and mainly to higher-than-budgeted expenses associated with litigation and LRP fixes; a great deal of the

repairs were later capitalized. ARPA also used virtually all of its available working capital to get the LRP operational. Management had to implement a wholesale rate increase of 0.7 cent per 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 at any time 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.

ARPA's liquidity suffered in 2011, as it used a large portion of its designated reserves in an attempt to expedite LRP repairs. Since then, liquidity has strengthened, and totaled $4.7 million at fiscal year-end 2015, equal to 93 days of operations. Management projects unrestricted cash to total no less than $5.7 million, equal to 142 days of operations, at fiscal year-end 2016. We believe ARPA's 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 roughly 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 no additional bonds are planned.

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 in place 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

Upward rating potential is unlikely over the next two years given ARPA's very limited, if any, rate flexibility, and its very high debt ratios. However, if there is a significant reduction in the authority's debt burden and improvement in rate competitiveness, we could consider a higher rating.

Downside scenario

We could lower the rating if rate pressures increase and further threaten affordability, or if DSC or liquidity fall significantly under budget.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

Copyright © 2017 by Standard & Poor’s Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription) and www.spcapitaliq.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.