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Summary:

Arkansas River Power Authority, Colorado; Wholesale Electric

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Summary:

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Arkansas River Pwr Auth pwr rev imp bnds ser 2008 dtd 07/01/2008 due 10/01/2040		
Long Term Rating	BBB-/Stable	Outlook Revised
Arkansas River Pwr Auth pwr		
Unenhanced Rating	BBB-(SPUR)/Stable	Outlook Revised

Many issues are enhanced by bond insurance.

Rationale

Standard & Poor's Ratings Services revised its outlook to stable from negative affirmed its 'BBB-' long-term rating and underlying rating (SPUR) on the Arkansas River Power Authority (ARPA), Colo.'s power revenue bonds.

The outlook revision reflects our view of ARPA's improved relationships with its member cities and a recently signed purchased power agreement that will provide replacement power for the Lamar Repowering Project (LRP) at a competitive rate through at least 2022. We believe these measures, in combination with improved financial metrics, will provide greater credit stability over at least the next two years.

The rating further reflects our view of ARPA's:

- Continued inability to operate the Lamar Repowering Project (LRP), its flagship facility, as a result of emissions requirements and problems with the boiler design (these issues are unlikely to be addressed, leaving the coal-fired plant dormant or in "cold-storage" for the foreseeable future);
- Very high member rates at about 50% above state averages, although management projects that rate increases over the next few years will be minimal;
- Recent loss of 18% of load represented by the City of Raton, which negotiated an exit largely as a result of the delays in operating the LRP (ARPA is unlikely to find a replacement customer, which adds rate pressure); and
- Participating member municipalities' limited service area economies, with adequate but below-average income indicators and employment bases that generally revolve around agribusiness or rural economies.

Partly offsetting the above weaknesses, in our view, are:

- Debt service coverage (DSC) that has been restored to at least minimally covenanted levels in fiscal years 2011 to 2013, including 1.25x DSC in fiscal 2013;
- Liquidity that has improved to $3.2 million, or 64 days' cash, as of fiscal 2013, up from $1.1 million, or 18 days' cash, in 2011, and that is projected at no less than $2.5 million, or 49 days' operations, by fiscal year-end 2013;
- Unrestricted cash that is bolstered by a $1.5 million line of credit, currently untapped, that adds 30 days of liquidity;
- Cost certainty given that most expenses are known and fixed for the next several years, which reduces uncertainty, and potential upside with regard to ongoing litigation related to the LRP; 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 of the 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. The Lamar, Colo.-based joint action agency had, as of December 2013, about $158 million in long-term debt.

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

- Lamar (31% of operating revenue),
- La Junta (30%),
- Trinidad (20%),
- Las Animas (10%),
- Springfield (5%), and
- Holly (3%).

The City of Raton, N.M., which recently negotiated an exit from the authority, represented 2% of operating revenue in 2013 as its temporary purchased power contract wound down over the course of the year. As part of a 2009 settlement, Raton relinquished its membership with ARPA but agreed to purchase all of its power needs from ARPA 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 (which has not materialized) and stabilize system sales and rates in the long term.

The LRP is a joint effort by ARPA, the Lamar Utilities Board (LUB), and the City of Lamar to repower LUB's existing 25-megawatt (MW) steam generating unit from natural-gas-fired to coal-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 plan came at time when natural gas prices were high and the board had identified a need for access to additional base load generation.

The LRP was intended 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, has been 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. An environmental group later sued ARPA, citing the alleged permit violations. In a separate environmental lawsuit, a federal judge in September 2012 ruled that ARPA violated certain requirements in the federal Clean Air Act. Both of these environmental lawsuits were settled in 2013.

On Feb. 28, 2014, ARPA 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 spent for

environmental litigation resulting from the boiler's failure to meet its emission guarantees. ARPA paid $325,000 in legal fees and $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 $512,455 in 2012 and $734,511 in 2013, and are budgeted at $500,000 (3% of operating expenses) in 2014. ARPA reports that it has provided B&W ample opportunity to remedy the issues with the boiler, but that B&W has not been successful. Several attempts at negotiating a settlement were also attempted but were unsuccessful. The timeline to settle the B&W litigation is uncertain and could take more than one year to resolve, according to ARPA's counsel.

The inability to operate the plant and self-generate power was a major reason that ARPA has entered a contract to purchase power for the next several years. However, with the $150 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. According to management, about 3.5 cents of the member rate of about 11 cents per kilowatt-hour (kWh) is related to the non-operating LRP. However, in our view, the power supply contract that extends through 2022 will allow ARPA to stabilize rates for its members.

According to management, given current gas prices, the LRP's per unit cost of power would still be higher than power purchased on the market or from typical combined cycle gas-fired generation. Management reports that the LRP has a heat rate of 13,500 to 14,500 Btu per kWh. The LRP delays eventually cost ARPA one of its original seven members, the City of Raton, which completed negotiations to exit. As part of the 2010 exit agreement, however, Raton remained a purchased power customer through 2012 and part of 2013. The LRP problems also led the City of Trinidad, Colo., to file a breach of contract lawsuit against ARPA in March 2010, apparently in an attempt to also negotiate an exit from the authority. Trinidad has since resolved its disputes with ARPA and no longer plans to relinquish its membership. ARPA reports that the settlement of its disputes with Trinidad will result in annual cost savings of $250,000.

ARPA has replaced LRP power supply with purchased power agreements, first with Municipal Energy Agency of Nebraska, next with Tri-State Generation and Transmission Association, then, effective Feb. 1, 2015, with Twin Eagle. Twin Eagle is an independent power marketer that will help ARPA procure and schedule power through 2022 under a contract by which the cost of power escalates 2.2% annually. The Twin Eagle contract begins on February 2015 and the cost of power under this contract is, in our view, very competitive. Power from Twin Eagle comes from a diverse mix of fuel and it is projected to account for 60% to 65% of ARPA's total supply. Although LRP is not operating, an economic analysis estimated that annual operations and maintenance costs to keep the plant in "cold storage" would be $1.23 million in 2015, escalating to $1.67 million by 2024, or $14.4 million over the 10-year study period.

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, various estimates indicate it could recover $3 million to $8 million from the plant's various components. Despite the unfavorable operating situation, most of ARPA's costs are fixed for the next several years, including debt service.

ARPA restored DSC in fiscal years 2011 to 2013 to a range of 1.25x to 1.59x, with fixed-charge coverage at 1.1x to 1.5x. DSC in fiscal 2013 was 1.25x, with fixed-charge coverage of 1.20x. DSC is estimated near 1.25x in fiscal 2014, and we view the 1.25x rate covenant as very strong for a wholesaler. The rebound in financial performance followed two consecutive years -- 2009 and 2010 -- of DSC's being below its rate covenant. The level was never insufficient 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 did have 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. The goal of these two rate actions was to help restore liquidity. A similar rate adjustment was implemented for fiscal 2011. Management did not implement a rate increase in fiscal years 2012, 2013, or 2014.

ARPA's governing board can adjust rates at any time as necessary, effectively creating an unlimited step-up provision. A consequence of ARPA's continued willingness to adjust rates to maintain its financial integrity has been a rise in member cities' rates, which in 2012 were about 50% more the statewide average system rate revenue, according to the U.S. Energy Information Administration. Given this, decisions on future rate adjustments could be politically difficult. The problems at LRP have also hampered management's ability to find firm takers to replace Raton's load, potentially leaving ARPA in a surplus capacity position if the LRP ever comes back on line, although the prospects for that appear unlikely, in our view. No rate increases are planned, but a 1% to 2% rate increase may occur in 2015, subject to financial and operating conditions later in 2014 and a final board decision. Driving the need for a potential rate increase is ARPA's desire to restore its liquidity position to a range of 90 to 180 days, excluding the line of credit.

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 stabilized and totaled $3.2 million at fiscal year-end 2013, equal to 64 days of operations. Management projects unrestricted cash to total no less than $2.5 million, equal to 49 days of operations, at fiscal year-end 2014. According to management, on Feb. 1, 2015, $825,000 in collateral that ARPA posted for its contract with Tri-State will be refunded as the contract terminates and the Twin Eagle contract begins. There are no collateral requirements with the Twin Eagle contract. ARPA also has a $1.5 million line of credit with Colorado East Bank & Trust, currently undrawn, which adds 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 include $250,000 for a gearbox for ARPA's wind project and another $200,000 for contingencies that ARPA does not anticipate spending. No additional bonds are planned. Debt to capitalization is, in our view, very high at 87%.

Outlook

The stable outlook reflects our view that, during the next two years, member rates and energy demand will remain relatively stable given ARPA'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 that raising rates will be difficult given operational difficulties already imposed on the members in the form of high rates. Upward rating potential is nil given ARPA's very limited, if any, rate flexibility, and its high debt burden. We could lower the rating if ARPA's rate competitiveness erodes further, or if DSC or liquidity fall to materially less than budgeted levels.

Related Criteria And Research

Related Criteria

- USPF Criteria: Electric Utility Ratings, June 15, 2007
- USPF Criteria: Wholesale Utilities, May 24, 2005

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