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Summary:

Arkansas River Power Authority, Colorado; Wholesale Electric

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Credit Profile

Arkansas River Pwr Auth pwr

Unenhanced Rating

BBB-(SPUR)/Stable

Affirmed

Rationale

Standard & Poor's Ratings Services 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:

- Continued inability to operate the Lamar Repowering Project (LRP), its flagship facility, as a result of emissions requirements and problems with the boiler design, and its subsequent recent decision to sell the plant or its key subsystems (likely at a substantial loss);
- 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 about 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 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 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 2014, including 1.28x DSC in fiscal 2014;
- Good liquidity, with \$2.8 million, or 56 days' cash, as of fiscal 2014, up from \$1.1 million, or 18 days' cash, in 2011, and that is projected at \$4.4 million, or 87 days' operations, by fiscal year-end 2015;
- Unrestricted cash that is bolstered by a \$1.5 million line of credit, currently untapped, that adds 30 days of liquidity;
- ARPA's improved relationships with its member cities, including the recent settlement of litigation with member city Trinidad;
- 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, 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. While credit quality of the participating members is important, the rating is based primary on ARPA'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 very high member rates.

The Lamar, Colo.-based joint action agency had, as of December 2014, about \$150 million in long-term debt.

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

- Lamar (32% of fiscal 2014 operating revenue),
- La Junta (31%),
- Trinidad (20%),
- Las Animas (10%),
- Springfield (4%), and
- Holly (3%).

A few years ago, the city of Raton, N.M., negotiated an exit from the authority, representing 2% of operating revenue in 2013, down from 14% in 2012 as its temporary purchased power contract wound down over the course of the year (2013). 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 was 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 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 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, 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, 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, \$734,511 in 2013, and \$1.0 million (6% 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 years to resolve.

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 3.8 cents of the member rate of about 10.6 cents per kilowatt-hour (kWh) is related to the nonoperating LRP. However, in our view, the power supply contract that extends through 2024 will allow ARPA to stabilize rates for its members. 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 has replaced LRP power supply with various purchased power agreements. The current agreement, effective Feb. 1, 2015, is with Twin Eagle Resource Management, replacing a previous contract with Tri-State. Twin Eagle is an independent power marketer that will help ARPA procure and schedule power 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 kWh for 2015-2016. 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.

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, ARPA could recover some of its losses, or perhaps restructure or reduce its debt. ARPA's auditor provided the ARPA Board an opinion that the LRP represented an impaired asset and, given this, was written off the books in fiscal 2014. In addition, inventories and capital improvements identified as project in process associated with the plant were written down as well. 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 ARPA's costs are fixed for the next several years, including debt service.

ARPA restored DSC in fiscal years 2011 to 2014 to a range of 1.24x to 1.59x, with fixed-charge coverage at 1.23x to 1.56x. DSC in fiscal 2014 was 1.28x, with fixed-charge coverage of 1.24x. DSC is estimated near 1.28x in fiscal 2015 and 1.46x in fiscal 2016, with fixed-charge coverage at 1.24x and 1.40x, respectively, and 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's being below its 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 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, 2014, or 2015, and doesn't plan on raising rates for at least the next two years.

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 are about 50% more the statewide average system rate revenue. 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.

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 \$2.8 million at fiscal year-end 2014, equal to 56 days of operations. Management projects unrestricted cash to total no less than \$4.4 million, equal to 87 days of operations, at fiscal year-end 2015. According to management, on March 2, 2015, \$825,000 in collateral that ARPA posted for its contract with Tri-State was refunded as the contract terminated and the Twin Eagle contract began. 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 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 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.

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 ARPA's debt burden or improvement in the authority's rate competitiveness, as a result of successful litigation or otherwise, 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 to materially less than budgeted levels.

Related Criteria And Research

Related Criteria

- USPF Criteria: Electric And Gas Utility Ratings, Dec. 16, 2014
- USPF Criteria: Wholesale Utilities, May 24, 2005
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

Ratings Detail (As Of December 30, 2015)

Arkansas River Pwr Auth WHLELC

Long Term Rating

BBB-/Stable

Affirmed

Many issues are enhanced by bond insurance.

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