S&P Global
Ratings

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Summary:

Arkansas River Power Authority, Colorado; Wholesale Electric

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Unenhanced Rating	BBB(SPUR)/Stable	Affirmed
Arkansas River Pwr Auth		
Long Term Rating	BBB/Stable	Affirmed
Many issues are enhanced by bond insurance.		

Rating Action

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.

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. We believe the rating is supported by Lamar's creditworthiness. We have also considered the authority's weak balance sheet and operations, where a substantial portion of member 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 $128 million in long-term debt as of December 2019.

Credit overview

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

- Lamar (32% of fiscal 2019 operating revenue)
- La Junta (31%)
- Trinidad (20%)
- Las Animas (9%)
- Springfield (4%)
- Holly (3%)

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 mainly 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 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.

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.

Environmental, social, and governance factors

We believe the utility faces moderate environmental exposures according to our environmental, social, and governance risk factors (ESG), and as the national focus on reducing greenhouse gas emissions advances. These pressures will likely be indirect, with the costs being initially borne by ARPA's power suppliers, but ultimately passed through in the form of purchased power expenses.

We believe the authority's social factors (including health and safety issues related to COVID-19) are in line with other wholesale utilities that we rate. However, we note that above-average member rates could pose an affordability challenge, especially given suppressed income indicators. Management has reported a very modest increase in write-offs, but has not observed members experiencing liquidity challenges or late payments to date. Nevertheless, we will continue to monitor the effects on member cash flows and delinquencies.

We do not view ARPA's governance factors as an elevated risk. However, if there is additional evidence of member discord or efforts to depart from the authority, we would likely revise our assessment.

Stable Outlook

Downside scenario

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

Upside scenario

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

financial metrics.

Credit Opinion

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% higher than the statewide average system rate.

ARPA has reported only modest disruption at the authority and among its members stemming from the COVID-19 pandemic. Weather-normalized sales are slightly up for the first six months of 2020 compared with 2019, and local unemployment has remained generally low among member cities. Management reported that there were very few disconnects among member utilities, with no cash flow disruptions or significant write-offs. Nevertheless, members' above-average rates coupled with the pandemic and recessionary pressures could further constrain the authority's ratemaking ability.

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 some modifications 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 raised rates since. ARPA lowered rates by about 2% in 2019, and management indicated the authority may lower rates again in 2021 following savings from potential refunding opportunities.

The issues at the LRP led 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 $2.5 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 more than exceed this annual payment.

The authority has replaced LRP power supply with various purchased power agreements. The current agreement is with the Public Service Company of Colorado (PSCo). PSCo is a subsidiary of Xcel Energy 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 5.4 cents per kWh for fiscal 2019. Power under this contract 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 projects 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 various pieces of equipment from the plant, and is drafting bids for the demolition of the remaining plant.

Lamar, ARPA's largest member, provides power to about 5,000 customers. The utility's revenue stream is diverse, with over 35% of revenues billed to residential customers, and no single customer accounting for more than 3% of total retail revenue. This is offset, in our view, by the city's below-average income indicators--median household effective buying income was just 75% of U.S. levels in 2019. Lamar has a solid track record of passing through costs, as demonstrated by its fixed cost coverage (FCC), which has averaged 1.23x over the past three years. The city also maintains extremely strong liquidity, at $10.5 million or over 290 days' worth of operating expenses in 2019. We believe Lamar's robust financial metrics and diverse revenue stream contribute to ARPA's overall credit quality. In the event Lamar were required to assume the obligations of all other members, we believe its credit quality would be affected, given a decline in FCC and an increase in rates. The increase in rates would reduce Lamar's competitiveness.

ARPA's debt service coverage averaged 1.25x over the past three years, and is projected to remain around 1.3x through 2024. We believe these coverage levels provide additional cushion for the authority, which is especially important given its constrained ratemaking flexibility.

Liquidity has strengthened in recent years, totaling $16 million at fiscal year-end 2019, equal to 340 days' of

operations, up from $6.2 million or 131 days in fiscal 2017. Management indicated it plans to retire the authority's 2010 bonds at the end of this year, which will result in cash declining to about $4.1 million or 80 days' worth, while also providing annual debt service savings of about $1.2 million. The authority also has a $1.5 million line of credit with Frontier Bank 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 to issue additional bonds.

Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

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