S&P Global
Ratings

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Summary:

Arkansas River Power Authority, Colorado; Wholesale Electric

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Summary:

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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; however, we note that the credit quality of the balance of the authority's members suppresses the rating. 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 $127 million in long-term debt as of December 2020.

Credit overview

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

- Lamar (33% of fiscal 2020 operating revenue)
- La Junta (30%)
- 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; however, member rates should moderate somewhat given ARPA's projected decreases in power costs;

- 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 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 January 2025, with an additional contract secured that will provide ARPA power through 2043 at similarly competitive rates;
- Cost certainty, given that most expenses are known and fixed for the next several years;
- Discretionary defeasance of debt that, combined with projected declines in power costs, should provide some rate relief to members; 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

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. However, ARPA indicated its long-term power supply contract that will take effect in 2025 has provisions that ensure the authority will meet all renewable portfolio requirements, which offsets this risk, in our view.

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 writeoffs but has not observed members experiencing liquidity challenges or late payments to date due to the COVID-19 pandemic or related recessionary pressures. 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. 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 by an additional 3.6% in 2020. In total, ARPA reports current all-in costs are 4.5% lower when compared with 2018 costs.

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 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 January 2025 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 5.5 cents per kWh for fiscal 2020. Power under this contract comes from a diverse mix of fuel and accounts for about 64% of ARPA's total energy supply.

ARPA secured a long-term, fixed-price purchase power contract with Guzman Energy LLC., that will take effect in 2025 and extends through 2043. Management indicated that the contract has performance guarantees, as well as a responsibility on behalf of Guzman to ensure ARPA meets Colorado renewable requirements. In addition, Guzman sources its power from a diverse fleet of owned and purchase assets. However, we note that there are provisions in the contract which could lead Guzman to require ARPA to post collateral, which could stress the authority's liquidity position.

Lamar, ARPA's largest member, provides power to about 5,000 customers. The utility's revenue stream is diverse, with more than 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 72% of U.S. levels in 2020. Lamar has a solid track record of passing through costs, as demonstrated by its fixed cost coverage (FCC), which has averaged 1.33x over the past three years. The city also maintains extremely strong liquidity, at $10.6 million or more than 313 days' worth of operating expenses in 2020. 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 fixed charge coverage, which incorporates certain fixed capacity payments made by the authority as debt-like, averaged 1.18x over the past three years, and is projected to remain between 1.2x-1.4x 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 $17.8 million at fiscal year-end 2020; however, it declined to about $5 million in 2021, given ARPA's retirement of its 2010 bonds. The retirement provided the authority with annual debt

service savings of about $1.2 million. The authority also has a $1.5 million line of credit, 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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