S&P Global Ratings

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Summary:

Arkansas River Power Authority, Colorado; Wholesale Electric

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Table Of Contents

Credit Highlights

Outlook

Credit Opinion

Related Research

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

Credit Highlights

- S&P Global Ratings affirmed its 'BBB' long-term and underlying rating (SPUR) on Arkansas River Power Authority (ARPA), Colo.'s outstanding electric revenue bonds.
- The authority's outstanding electric revenue debt totaled $108 million as of Dec. 31, 2021.
- The outlook is stable.

Security

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 in the event one or more members default. We believe the rating is supported by the authority's financial profile and by Lamar's creditworthiness (Lamar represents about one-third of the allocated debt service requirements); however, we note that the credit quality of the balance of the authority's members limits the rating.

Credit overview

The rating primarily reflects the credit quality of the authority and its largest participant: the electric utility owned by, and serving, the city of Lamar. The top three members account for 83% of the allocated share of ARPA's debt service requirements. Power sales contracts between the authority and its members represent take-or-pay obligations, and since ARPA's governing board can adjust rates as necessary, we believe this effectively creates an unlimited step-up provision in the event one or more members default. Given the security, in addition to the analysis of the authority's credit characteristics, we reviewed the credit profiles of the leading participating utilities and have determined that the strongest of these is Lamar's, which is one of the main drivers for the rating for ARPA.

The rating also reflects improved member relations, a decline in the authority's debt service requirements, a forecast that indicates improved fixed charge coverage (FCC) and liquidity of the authority, and the potential for reduced wholesale rates in coming years that could also reduce rate pressures at the member level. However, credit limitations include a lack of depth and diversity in the service area economy, low income levels, and the authority's high debt

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burden. Historically, a substantial portion of member revenues have supported a power plant that was never operational, resulting in a high wholesale rate and high member rates compared with state averages.

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

- Lamar (33% of fiscal 2021 operating revenue);
- La Junta (30%);
- Trinidad (20%);
- Las Animas (9%);
- Springfield (4%); and
- Holly (3%).

The rating reflects our view of the authority's:

- Portfolio of member participants in typically smaller and rural areas with lower incomes and a large agricultural customer base;
- High member rates for the two largest members, at about 58% above the state average; however, member rates should moderate somewhat beginning in 2025 given ARPA's projected decreases in power costs. 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 limits the authority's rate-raising flexibility significantly; and
- ARPA's very high debt burden.

Partially offsetting these credit weaknesses, in our view, are the following factors:

- ARPA's resolution of member discord and associated litigation, which has eliminated significant uncertainty surrounding the authority's operational and financial stability;
- A purchased power agreement that has provided replacement power for the Lamar Repowering Project (LRP) at a competitive rate through January 2025, with an additional contract with Guzman Energy secured that will provide ARPA power through 2043 at similarly competitive rates, given the energy price with Guzman is fixed through the life of the contract;
- Recent defeasance of the series 2010 bonds that, combined with projected declines in power costs, should provide some rate relief to members;
- The monopolistic position and full rate autonomy of each member city, which insulate them from competitive pressures and helps offset the above-average retail rates and limited load profiles of some members; and
- Use of a debt-service coverage (DSC) adder that was adopted in 2014, in addition to an energy cost adjuster (ECA) that was adopted to the rate tariff in 2010. The ECA allows the authority to bill an ECA in the event that the actual cost of energy production and purchases exceed the budgeted cost.

In our view, Lamar's credit characteristics include the following weaknesses:

- Below-average household incomes at 59% of the nation's average, paired with rates that we consider significantly above average;

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- High rates, at about 58% above state average; however, member rates should moderate somewhat beginning in 2025 given ARPA's projected decreases in power costs; and
- Lack of financial projections.

In our view, Lamar's partially offsetting credit strengths include:

- The presence of a discretionary purchased cost adjustment (PCA) mechanism that recovers costs over 12 months;
- Good FCC metrics in the past three years, averaging 1.26x, and that could increase as power costs decrease;
- Significant liquidity, with unrestricted cash of $10.6 million, which accounts for just over 300 days' cash as of fiscal year-end 2021; and
- Very low debt burden (less than 4% debt-to-capitalization) with no formalized debt plans in the near term.

Environmental, social, and governance

We believe the authority 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 that 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. S&P Global Ratings will monitor the regulatory landscape and the authority's compliance, as well as additional operational or budgetary pressures it might face.

We consider electric member rates to be high, and associate moderate negative social risk with the authority because of the members' below-average income levels, which in our view constrain the authority's rate-raising capacity and financial flexibility.

S&P Global Ratings projects that the U.S. economy is likely to fall into a shallow recession in 2023, tempered by moderate initial jobless claims and unemployment rates. (See, "Economic Outlook Sees The U.S. Tipping Toward Recession," published Nov. 28, 2022 on RatingsDirect.) Consequently, we continue to monitor the strength and stability of the revenue streams of U.S. Public Finance proprietary enterprises, including combined system issuers, for evidence of delinquent payments or other revenue erosion because rising consumer prices and interest rates are whittling consumers' discretionary income.

We view ARPA's governance factors as credit neutral, given that member discord has subsided and financial policies and practices are in place. However, if there is additional evidence of member discord or efforts to depart from the authority, it could negatively affect the rating.

Outlook

The stable outlook reflects our view that, during the next two years, member rates and energy demand will remain relatively steady or decline, given the authority's long-term power supply contracts. We view additional fracturing of the membership as unlikely, but if cost overruns transpire, we believe raising rates will be difficult given the authority's and members' already-high rates.

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Downside scenario

We could lower the rating if ARPA is unable to execute rate rebates and/or is unable to pass through costs and fails to attain, at a minimum, FCC near the projected materially stronger levels or if liquidity does not increase in line with projections absent improvement in Lamar's credit profile. In addition, any material waning of the membership base and/or economic fundamentals, especially that of Lamar, and the quality of cash flows that they generate, absent offsetting adjustments, could lead to a lower rating.

Upside scenario

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

Credit Opinion

ARPA's member discord has recently been resolved. The Lamar Repowering Project (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 (WAPA) 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 was 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, which include 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 the lighting in community facilities (such as libraries and senior centers) 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 into a contract to purchase power for the next several years. However, with the $149 million (as of 2017) in debt for the plant (not to mention other operating and legal costs) already embedded in member rates, additional replacement power costs have

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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 the ECA pass-through clause to its rates, effective 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 2.0% in 2019, and by an additional 3.6% in 2021. With the advent of the new contract with Guzman in 2025, ARPA plans to decrease rates by 3.0% in 2025 and 2.3% in 2026.

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. Power under this contract comes from a diverse mix of fuel and accounts for just more than 60% 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 extend through 2043. Management indicated that the contract has performance guarantees, as well as a responsibility on behalf of Guzman to ensure ARPA meets Colorado's renewable requirements. In addition, Guzman sources its power from a diverse fleet of owned and purchased assets.

Lamar, ARPA's largest member, provides power to about 5,000 customers and has a diverse revenue stream, with just 33% of revenues billed to residential customers. The city also has below-average income indicators -- median household effective buying income (MHHEBI) was just 59% of U.S. levels in 2021, worsening from 72% as of 2020. Lamar has a solid track record of passing through costs, as demonstrated by good FCC, which has averaged 1.26x during the past three years. The city also maintains extremely strong liquidity at $10.6 million, or more than 300 days' worth of operating expenses in 2021. We believe Lamar's robust financial metrics and diverse revenue stream contribute to ARPA's overall credit quality. However, under a stress scenario, in the event Lamar is required to assume the obligations of all other members, we believe its credit quality would degrade, given a decline in FCC and a necessary rate increase. In our view, the increase in rates would further impair Lamar's rate competitiveness.

ARPA's FCC, which incorporates certain fixed capacity payments made by the authority as debt-like, averaged 1.28x during the past three years, and is projected to improve to between 1.4x and 1.7x through 2027. These projected higher levels are due in part to the authority's future lower power costs. We believe these coverage levels provide additional cushion for the authority, which is especially important given its constrained ratemaking flexibility and weak member credit quality.

Liquidity and reserves have worsened since fiscal year-end 2020, when unrestricted cash totaled $17.9 million or 358 days' cash; it declined to about $6.4 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

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plan to issue additional bonds.

Related Research

Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022

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.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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