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Ratings

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Summary:

Arkansas River Power Authority; Wholesale Electric

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Table Of Contents

Credit Highlights

Outlook

Credit Opinion

Related Research

Summary:

Arkansas River Power Authority; Wholesale Electric

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 outlook is stable.

Security

A first lien on net revenue of the 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. 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, effectively creating an unlimited step-up provision in the event of one or more members' default. The authority's outstanding electric revenue debt totaled $105 million as of Dec. 31, 2022.

Credit overview

In our view, ARPA's credit quality is based on our modified strong-link approach that assesses the strongest member within a subset of members that are capable of full covering all costs after step-up scenario. While ARPA's financial metrics remain healthy and after the analysis of the authority's overall credit characteristics, we believe the general credit characteristics of the membership base and ARPA's high debt position as limiting factors. We believe the rating is supported by the authority's financial profile and by Lamar Utilities' Board (LUB) creditworthiness (the city represents about one-third of the allocated debt service requirements).

The rating also reflects improved member relations, a decline in the authority's debt service requirements, a forecast that indicates stable fixed-charge coverage (FCC) and liquidity, and the potential for reduced wholesale rates in coming years that could also lessen rate pressures at the member level. However, key rating risks center around a lack of depth and diversity in the rural service area economy, weak income levels, and a high debt burden for the authority. Historically, a substantial portion of member revenue supported the Lamar Repowering Project (LRP) that was never operational, yielding 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 (32% of fiscal 2023 operating revenue),
- La Junta (30%),
- Trinidad (20%),
- Las Animas (10%),
- Springfield (5%),
- Holly (3%).

The rating further reflects our view of the authority's high member rates for the two largest members, at about 58% above the state average. However, we believe member rates should moderate somewhat beginning in 2025, given ARPA's projected decrease in power costs as it begins a new contract with Guzman Energy. In our view, 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 significantly limits the authority's rate-raising flexibility.

Partially offsetting ARPA's credit weaknesses, in our view, are the following factors:

- A purchased power agreement with Guzman Energy that has been secured and will provide ARPA power through 2043 at competitive rates, given the energy price with Guzman is fixed through the life of the contract.
- ARPA lowered rates by 2.0% in 2019, and by an additional 3.6% in 2021. With the advent of the new contract, ARPA plans to decrease rates by 3.0% in 2025, 3.0% in 2026, and 3.0% in 2027. The authority is currently in the process of conducting a formal cost of service study and will approve rate decreases year-to-year.
- The monopolistic position of each member city as well as full rate autonomy, which insulate each from competitive pressures and helps offset the above-average retail rates and limited load profiles of some members.
- 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.

In our view, LUB's credit strengths include:

- The presence of a discretionary purchased cost adjustment (PCA) mechanism that recovers costs over 12 months.
- Stable financial metrics marked by good FCC metrics during the past three years, averaging 1.4x, and, in our view, could improve as power costs decrease. Liquidity has been relatively stable, with unrestricted cash of $10 million, which accounts for just more than 300 days' cash as of fiscal year-end 2022.
- Minimal debt burden (less than 2% debt-to-capitalization) with no formalized debt plans in the near term.

Environmental, social, and governance

Social capital risk factors are elevated in our view as we consider electric member rates to be high, and associate moderate negative social risk with the authority because of its members' weak income levels, which in our view constrain the authority's rate-raising capacity and financial flexibility.

We continue to monitor the strength and stability of wholesale electric utilities' revenue streams for evidence of delinquent payments or other revenue erosion. Inflation (as measured by the consumer price index or CPI) has remained above 3% in recent months, and S&P Global Economics forecasts elevated interest rates persisting through

the first half of 2024, with moderate softening through the remainder of the year. (See "U.S. Economic Forecast Update: A Sturdy Job Market Keeps Growth Going," published Feb. 21, 2024, on RatingsDirect.) In addition, Bureau of Labor Statistics data shows that electricity price inflation continues to outpace the overall CPI. The amalgam of material increases in delinquent consumer, credit card, and auto loans, along with October's resumption of student loan payments and drawdowns of household savings garnered during the pandemic, will likely compound the financial pressures facing electricity consumers.

We believe the authority faces reduced environmental exposure related to the energy transition given that under its supply contract with Guzman Energy, Guzman will not serve the authority with coal once the contract begins in 2025, which is an improvement from ARPA's current fuel mix via Xcel Energy, and a credit positive. In addition, ARPA indicates its long-term power supply contract with Guzman has provisions that ensure the authority will meet all renewable portfolio requirements, which somewhat offsets this risk, in our view. Furthermore, Guzman's fuel mix is 30%-32% natural gas, which we view as a moderate portion, with the balance comprising solar, wind, and battery power. 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 view ARPA's governance factors as credit neutral. We believe the authority has robust formal financial policies and practices in place, but note that if there is evidence of member discord or if members depart from the authority, it could negatively affect the rating.

Outlook

The stable outlook reflects ARPA's maintenance of healthy coverage metrics, which we project will continue, and that member rates will remain relatively steady or decline, given the authority's long-term power supply contracts.

Downside scenario

We could lower the rating if ARPA is unable to maintain sufficient cost recovery, fails to accomplish projected coverage 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 limited, if any, rate flexibility; the authority's high debt burden; and members' weak service area demographics, elevated rates, and varied financial metrics.

Credit Opinion

The LRP was a joint effort by the authority, 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 ARPA had

identified a need for access to additional base load generation. 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, and ARPA incurred considerable losses and the cities of Lamar and Trinidad filed separate breach of contract lawsuits against ARPA. Both cities have since resolved their disputes, and LRP was demolished in 2021. (For more information, see "Arkansas River Power Authority" published Feb. 22, 2023, on RatingsDirect).

Lamar provides power to about 5,000 customers and has a diverse revenue stream, with about 44% of revenue billed to residential customers. Lamar has a solid track record of passing through costs, as demonstrated by good FCC, which has averaged 1.4x during the past three years. We believe Lamar's solid financial metrics and diverse revenue streams contribute positively 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 on top of already high rates. In our view, the increase in rates would further impair Lamar's rate competitiveness and affordability.

ARPA has secured a long-term, fixed-price purchase power contract with Guzman Energy, that will take effect Feb. 1, 2025 and extend through 2043. Management indicates the contract has performance guarantees, as well as a responsibility on behalf of Guzman to ensure ARPA meets Colorado's renewable requirements. Guzman sources its power from a diverse fleet of owned and purchased assets, and will not serve the authority with coal as part of the contract stipulations.

ARPA's FCC, which incorporates certain fixed capacity payments made by the authority as debt-like, averaged 1.4x during the past three years, and is projected to improve to between 1.4x and 1.5x through 2028. These projected higher levels are due in part to the authority's future lower power costs, and in turn, probable rate decreases for its members beginning in fiscal 2025. We believe these coverage levels provide further 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; in 2021 it declined to about $6.4 million or 98 days' cash, given ARPA's retirement of its 2010 bonds. The retirement provided the authority with about $1.2 million in annual debt service savings. The authority also has a $1.5 million line of credit, currently undrawn, which adds about 30 days' liquidity for operating costs, if needed. ARPA has not made a draw on the line since March 2012, and will keep the line in place indefinitely. Capital needs during the next few years are minimal and the authority does not plan to issue additional debt.

Related Research

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

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