FitchRatings

FITCH RATES KENTUCKY MUNI ENERGY AGENCY PROJECT OBLIGATIONS AT 'A'; OUTLOOK STABLE

Fitch Ratings-New York-14 April 2017: Fitch Ratings has assigned an 'A' rating to the Kentucky Municipal Energy Agency's (KyMEA or the Agency) all-requirements project obligations (ARP Obligations).

The Rating Outlook is Stable.

SECURITY

The ARP Obligations are payable from revenues derived from KyMEA's joint interlocal agreement and individual power supply contracts (PSCs) with eight municipally owned electric systems (ARP Members). Pursuant to the PSCs, KyMEA will begin providing all-requirements power supply to ARP Members on May 1, 2019.

KEY RATING DRIVERS

RATING DRIVEN BY LARGEST MEMBER: KyMEA is a newly created joint action agency. The rating on KyMEA's ARP Obligations primarily reflects the credit quality of its largest ARP Member, the Electric & Water Plant Board of Frankfort, KY (FPB) and its ability to support the ARP Obligations. PSC rate-setting requirements provide a de facto unlimited step-up broadening the support from FPB and other ARP Members.

STABLE MEMBER RISK PROFILE: FPB's credit quality is supported by strong and stable performance at its electric and water systems, which serve approximately 40,000 customers throughout Frankfort, KY and surrounding counties. FPB's meaningful telecommunications division introduces heightened revenue variability and risk to the multi-utility system, but consolidated leverage (5.7x adjusted debt to funds available for debt service [FADS]) and liquidity (139 days cash) are sufficient to offset the additional risk at the current rating.

STABLE MEMBER SERVICE AREA: As the capital of Kentucky and the seat of Franklin County, the Frankfort-area economy is dominated by state and local government, providing a base for stable, albeit modest growth. Although employment metrics throughout Franklin County have improved in recent years, median household income remains well below the national average which could limit demand growth and rate flexibility.

LIMITED, FLEXIBLE OBLIGATIONS: KyMEA's ARP Obligations are initially limited to payments required under three multi-year purchased power contracts and other amounts necessary to secure member power requirements. Each of KyMEA's power contracts provides meaningful flexibility to adjust capacity obligations and extend tenor. No debt is currently planned.

POWER SUPPLY COUNTERPARTY RISK: Initial purchase power contracts will include two counterparties (Big Rivers Electric Cooperative [BREC; rated 'BB'/Outlook Stable] and Illinois Power Marketing Company [IPMC; NR]) that exhibit below investment grade characteristics exposing KyMEA and its ARP Members to meaningful counterparty risk. The risk is partially mitigated by letter of credit support and the three-year tenor of the IPMC contract.

RATING SENSITIVITIES

CHANGE IN MEMBER CREDIT QUALITY: The rating of the Kentucky Municipal Energy Agency (KyMEA) is currently driven by the credit quality of its largest member, the Electric & Water Plant Board of Frankfort, KY (FPB). Changes in the credit quality of the FPB will have a corresponding effect on the rating of KyMEA.

CREDIT PROFILE

NEW JOINT ACTION AGENCY

KyMEA was formed in 2015 for the purpose of assisting its 11 member municipal electric systems in serving their current and future power and energy requirements. Eight of the 11 KyMEA members have elected to create a separate project - the ARP Project - pursuant to which KyMEA will supply and the eight members have agreed to purchase, all power and energy needed to meet their respective retail requirements beginning May 1, 2019.

All eight ARP Members have been wholesale customers of Kentucky Utilities Company (KU), a subsidiary of PPL Corporation, for over four decades. The ARP Members expect to realize the benefits of economies of scale working together through KyMEA, while benefitting from customer focused decision making.

The ARP Members have executed PSCs that collectively obligate the systems, on an absolute and unconditional basis, to provide revenue sufficient to allow KyMEA to meet its ARP Obligations. Rate setting provisions included in the PSCs obligate the ARP Members to set and maintain retail electric rates at levels sufficient to meet their obligations to KyMEA. KyMEA is required to continuously set and maintain rates that are sufficient to meet its revenue requirements, providing a de facto unlimited step-up in the event of member default.

The PSCs have an initial term that runs through May 31, 2024, with an evergreen provision that allows for termination thereafter upon five years notice making the earliest termination date May 31, 2029. Notwithstanding the termination provision, members would remain responsible for their share of contracted or acquired resource obligations after termination.

FRANKFORT DOMINATES MEMBERSHIP
FPB's role as the largest participant in KyMEA is highly supportive of the Agency's credit quality. FPB is an enterprise fund of the City of Frankfort, which provides electric, water and telecommunications services throughout the city, as well as portions of Franklin, Shelby and Woodford Counties. Each utility segment within FPB is budgeted and accounted for separately, but no legal separations exist. FPB is expected to account for approximately 54% of ARP revenue.

The city of Frankfort and its regional economy are dominated by the state and local government, which accounts for nearly half of the jobs in Franklin County. A range of small manufacturers also support the regional economy which has expanded steadily, albeit modestly in recent years providing reasonable underpinning for utility demand. Unemployment throughout the county has declined along with national and state trends from 9% in 2009 to 4.4% in 2015; however, household income throughout the county, and Kentucky in general, remains well below the national average challenging revenue and demand growth.

The electric system customer base is predominately residential, but roughly 54% of energy sales are to industrial customers including state and local government. Energy sales and customers at FPB have remained relatively flat since 2011 after falling during the last recession. Costs incurred under the KU contract are generally passed through to retail users, subject to board approval. Despite the trend of higher wholesale power costs, average retail rates at FPB (8.00 cents/kWh) remain below the state weighted average (8.14 cents/kWh) offering reasonable rate flexibility.

FPB's water operations are relatively stable, modest and account for only 10% of consolidated revenue. The system serves approximately 16,000 retail customers and provides wholesale water to six water districts and one municipal system. Raw water supply is drawn from the Kentucky River and treated at the FPB's water treatment plant. FPB's access to water supply has been plentiful, even during periods of drought, and treatment capacity is well in excess of average daily usage.

FPB's cable telecommunications division accounts for a meaningful 29% of consolidated revenue and exposes the consolidated utility to a higher degree of business risk and revenue volatility. Although the division is highly profitable and financially self-sustaining, the product offerings - cable, broadband and telephone - are subject to competitive pressures that are absent in its electric and water divisions, which reduces revenue defensibility.

FLEXIBLE POWER SUPPY RESOURCES

KyMEA expects to supply virtually all of its power requirements through a portfolio of purchased power agreements, and member-owned hydroelectric and diesel-fired resources, that is reasonably well diversified in terms of fuel mix, asset concentration and counterparties, and extremely flexible in terms of capacity nominations. Counterparty risk is a concern, but the Agency's overall operating risk should support the rating.

The resource portfolio will be anchored by three purchase power contracts designed to provide sufficient base load, intermediate and peaking capacity to serve member requirements. The contract counterparties and initial capacity provided will be: BREC (100 MW); Illinois Power Marketing Company (IPMC), a subsidiary of Dynegy (100 MW); and Paducah Power System (PPS; 90 MW).

Certain of the contracts include favorable extension and nomination provisions that should limit operating risk. Contract terms allow KyMEA to adjust capacity during the initial contract tenors to track load growth or lack thereof, and extend certain contracts past the initial tenor at its option. Moreover, there is no requirement for KyMEA to take delivery of energy under any of its current contracts.

KyMEA expects to deliver power and energy in 2019 at wholesale rates of $51/MWh, approximately 15% below the comparable cost of each ARP Member's existing arrangement. The Agency's competitive wholesale cost of power should enable the ARP Members to lower retail rates over the near term, improving rate flexibility and revenue defensibility.

FINANCIAL PROFILE SUPPORTED BY FRANKFORT

KyMEA has no meaningful financial operations and does not anticipate incurring any substantial obligations until it begins supplying power to the ARP Members in 2019. KyMEA's assigned rating is therefore based on the credit quality of the largest ARP Member, FPB, and the absolute and unconditional obligation of the members to provide revenue sufficient for the Agency to meet its obligations.

FPB's consolidated financial profile has broadly improved in recent years driven by steady profitability at the telecommunications division, and recent rate increases at the electric and water divisions. Coverage of full obligations has steadily improved from 1.12x in 2012 to a healthy 1.48x in 2016, with the exception of fiscal 2015 when FPB's decision not to recover higher wholesale power costs resulted in weaker performance (1.18x coverage). Debt service coverage exceeded 2.6x in fiscal 2016.

FPB's projected performance is expected to improve gradually. Although more than half of FADS is projected to come from the more volatile telecommunications operations, stable performance by the electric system and meaningful rate increases at the water system should together produce FADS sufficient to cover total debt service.

Adjusted leverage remains relatively low at 5.7x FADS, even after factoring FPB's purchased power obligations. FPB's outstanding debt totaled $48.8 million at fiscal year-end 2016. All of the outstanding debt is fixed rate and debt service requirements are relatively stable at $5.0 million-$5.6 million per annum through 2021 before declining thereafter.

Future borrowings should be limited to approximately $9 million, including debt necessary to fund the replacement of FPB's water reservoir. Despite additional borrowing, total outstanding debt should begin declining in fiscal 2020 to $37 million in 2021.

Liquidity measured in terms of cash on hand has steadily improved since 2012 from 66 days to and 129 days at year-end 2016 ($29 million). Although no formal policy exists, cash holdings would gradually improve under the projections.

Overall, FPB's financial metrics are broadly stronger than the medians for similarly rated retail systems, which is appropriate given the utility's reliance on its telecommunications operations that exhibit a lower degree of revenue defensibility.

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Applicable Criteria
Revenue-Supported Rating Criteria (pub. 16 Jun 2014)
https://www.fitchratings.com/site/re/750012
U.S. Public Power Rating Criteria (pub. 18 May 2015)
https://www.fitchratings.com/site/re/864007