

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 SUPPLY 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.

Contact:

Primary Analyst
Dennis Pidherny
Managing Director
+1-212-908-0738
Fitch Ratings, Inc.
33 Whitehall Street
New York, NY 10004

Secondary Analyst
Jeremy Williams
Analyst
+1-646-582-4870

Committee Chairperson
Doug Scott
Managing Director
+1-512-215-3725

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: elizabeth.fogerty@fitchratings.com.

Additional information is available on www.fitchratings.com

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>

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](https://www.fitchratings.com/understandingcreditratings). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE,

AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. DIRECTORS AND SHAREHOLDERS RELEVANT INTERESTS ARE AVAILABLE AT [HTTPS://WWW.FITCHRATINGS.COM/SITE/REGULATORY](https://www.fitchratings.com/site/regulatory). FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

Copyright © 2017 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001