MOODY'S
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RATINGS

Big Rivers Electric Corporation

County of Ohio, Kentucky PCRBs	Ba2
Outlook	Stable

Source: Moody's Investors Service

ANALYST CONTACTS

Kevin G. Rose 212-553-0389
VP-Senior Analyst
kevin.rose@moodys.com

A.J. Sabatelle 212-553-4136
Associate Managing Director
angelo.sabatelle@moodys.com

Chee Mee Hu 212-553-3665
MD-Project Finance
cheemee.hu@moodys.com

Big Rivers Electric Corporation

Credit Opinion

Rating Drivers

» Good progress on implementing load mitigation plans following termination of contracts with two aluminum smelters

» Rate setting subject to jurisdiction of the Kentucky Public Service Commission (KPSC) and credit supportive rate case outcomes in 2013 and 2014

» Revenues from electricity sold to rural and other non-smelter customers under long-term wholesale power contracts with three member owners through 2043

» Ownership of generally competitive, albeit excess, coal-fired generation plants; pursuing environmental compliance plan approved by regulators; environmental cost surcharge in place

Corporate Profile

Big Rivers Electric Corporation (BREC or Big Rivers) is an electric generation and transmission cooperative headquartered in Henderson, Kentucky and owned by its three member system distribution cooperatives -- Jackson Purchase Energy Corporation; Kenergy Corp; and Meade County Rural Electric Cooperative Corporation. These member system cooperatives provide retail electric power and energy to approximately 114,000 residential, commercial, and industrial customers in 22 Western Kentucky counties.

SUMMARY RATING RATIONALE

The Ba2 rating considers the credit challenges BREC is facing while it implements load mitigation plans following significant load loss since two aluminum smelters being served by BREC's largest member owner, Kenergy Corp., terminated their respective power purchase contracts, in the first instance effective August 20, 2013 and the second effective January 31, 2014. The rating further reflects significant rate increases approved by the KPSC during 2013 and 2014 and other mitigation steps to compensate for the load loss and to maintain viable financial performance. The Ba2 rating further recognizes the cost plus nature of the cooperative model which generally allows for cost recovery from its members, albeit tempered in this case to some degree because BREC's rates are regulated by the KPSC, which is atypical for the G&T coop sector. Still, Big Rivers' credit profile also reflects the financial benefits of rate case decisions in 2013 and 2014, as well as several steps it took in 2008 and 2009 to unwind a lease and other transactions wherein its prior deficit net worth turned substantially positive, cash receipts were used to repay debt, and residual cash was set aside in restricted accounts. Following the 2014 rate case decision, cash in the restricted accounts is being used, in part, to mitigate cost pressures from significant smelter load loss.

DETAILED RATING CONSIDERATIONS

CONTRACT TERMINATIONS OF TWO LARGE ALUMINUM SMELTERS CREATE NEED FOR LOAD MITIGATION PLANS; SMELTERS CONTINUE TO OPERATE

BREC's contracts with its largest customer, Century Aluminum of Kentucky (a subsidiary of Century Aluminum Company, which owns the Hawesville smelter and the Sebree smelter) historically made up roughly two-thirds of BREC's annual energy sales and accounted for just under 60% of its system demand and in excess of 60% of annual revenues. Revenues which BREC had been receiving from base energy charges paid by the smelters ended on August 20, 2013 in the case of the Hawesville smelter and January 31, 2014 in the case of the Sebree smelter.

While initial expectations contemplated the prospect that both smelters could cease operations upon termination of their respective power contracts, subsequent developments are allowing the smelters to continue operating, while purchasing power on the wholesale market. When compared to the alternative scenario of having both smelters permanently shut down, we view this outcome as being acceptable particularly since BREC and Kenergy are being reimbursed for any incremental costs to their members of the smelters' continued operation.

Effective June 3, 2013, Century acquired substantially all the assets of the Sebree aluminum smelter from Rio Tinto Alcan. This deal followed Century's definitive agreement with BREC and Kenergy that, upon receiving various regulatory approvals, is allowing Century to continue operating its Hawesville smelter by purchasing electricity on the open market. Under the agreement, Kenergy arranges for the energy purchases at wholesale market prices and Century pays the market price and additional amounts to cover any incremental costs incurred by BREC and Kenergy to accommodate Century's desire to purchase energy on the market for the Hawesville smelter. Century used this framework as a model for a similar arrangement for the Sebree smelter, which became effective when its termination period expired on January 31, 2014.

CREDIT POSITIVE REGULATORY DECISIONS BY KPSC

On October 29, 2013 the KPSC approved a wholesale power rate increase of $54.2 million (retroactive to August 20, 2013), and, on April 25, 2014 approved a wholesale power rate increase of $36.2 million (retroactive to February 1, 2014). Even though the approved rate increase in the October 2013 decision is about 20% less than the full amount included in the revised filing and the approved rate increase in the April 2014 decision is just over half of the full amount included in the revised filing, the rate increases are credit positive for BREC because the incremental amounts are supporting financial performance, ensuring a degree of cushion for compliance with financial covenants, (minimum required margins for interest (MFI) ratio of 1.1 times in its debt documents), and allowing for BREC to further advance strategies to mitigate the significant electric load loss owing to the termination of contracts with the two aluminum smelters. It is not uncommon for a state public service commission to disallow certain requested amounts in rate case proceedings and in some instances, disallowed amounts are even more substantial compared to BREC's two latest decisions. Notwithstanding the fact that BREC is left with substantial excess capacity due to large customer contract termination notices, the KPSC made supportive comments in the rate orders about prudent steps taken by BREC and the commission clearly states its intent to ensure rates are sufficient to maintain BREC's financial integrity. For example, the revenue requirements approved in the April 25, 2014 rate decision are specifically targeting achievement of a 1.3 times interest earned ratio (TIER) which is akin to the MFI ratio and comfortably above the 1.1 times minimum required in the debt documents, which we view as credit positive.

The substantial majority of the rate increases requested in the cases were seeking replacement revenues to offset loss of the Hawesville and Sebree smelter loads, respectively, and, in both instances, to also cover anticipated lower margins from off-system sales and other operating cost pressures.

Among the more significant items contributing to the lower than requested rate increase approved in the October 2013 decision were the deferral of costs related to depreciation of a generation plant that will be in excess of BREC's needs at least in the near term, as well as several other reductions to costs of service that will reduce BREC's operating margins, and to some extent, its cash flow. The most significant item contributing to the lower than requested rate increase approved in the April 2014 decision was the deferral of costs related to depreciation of the Wilson Generation Plant that is in excess of BREC's system needs at this time. There were several other reductions relating to various costs of service items, offset in part by the KPSC's support for additional revenue amounts to support BREC's TIER at 1.3 times. Collectively the April 2014 decision reduces BREC's operating margins, and to some extent, its cash flow. Importantly and a key rating consideration are the KPSC's approval of plans to accelerate use of the economic reserve, rural economic reserve and transmission revenue economic reserve accounts in the amount of roughly $97 million as of June 30, 2014 to offset the rate increase approved April 25, 2014. The accelerated use of the reserve accounts is effectively neutralizing the non-smelter customer rate impact from the April 25, 2014 rate order for large industrial/business (non-smelter) customers and for rural (residential) customers. Under this approach, the additional rate shock for BREC's non-smelter customers is now expected to be delayed into October 2015 for large industrial/business (non-smelter) customers and at least mid-2016 for rural (residential) customers, during which time BREC will continue to implement other load concentration mitigation strategies.

We also note that the KPSC included in its April 25, 2014 order a requirement for BREC to hire an independent consultant to conduct a management audit, with a particular focus on BREC's load mitigation strategies. The outcome of this audit, which is anticipated to be available before the end of 2015, will be one of the data points Moody's considers regarding the future directional trend of the BREC rating.

In addition to the recent rate increases approved by the KPSC, we view the existence of certain fuel and purchased power cost adjustment mechanisms and the existence of an environmental cost surcharge in rates as favorable to BREC's credit profile since they can temper risk of cost recovery shortfalls if there is a mismatch relative to existing rate levels.

OTHER LOAD MITIGATION STRATEGIES

Other load mitigation strategies, some of which are already being implemented, include entering into long-term bilateral sales arrangements, temporarily idling generation and reducing staff. BREC is selling power forward from the Wilson plant under four separate transactions that will allow BREC to continue operating the Wilson plant through May 31, 2016. More recently, BREC entered into three nine-year contracts to sell capacity and energy to three Nebraska entities. Effective July 21, 2015, the KPSC approved, the long-term power sales contracts which collectively will facilitate BREC transmitting 67 MWs to the Nebraska entities, with power beginning to flow in 2018 and reaching full output in 2022. Also, the cooperative is responding to other requests for proposals to sell power from the Wilson plant to other energy providers and awaits further developments related to those responses. The Coleman plant was idled in May 2014 and will be maintained to permit restart should market conditions become economically feasible. By idling the Coleman plant, BREC achieved overall cost savings of $26 million. Longer term opportunities may also arise for sales of electricity, depending on economic development activity in its service territory. Should a transaction, either an outright sale or a unit specific long-term power arrangement for all capacity involving both Wilson and Coleman occur, BREC's total owned/available capacity would reduce to 584 MW from 1,444 MW. BREC also has rights to about 197 MW of coal-fired capacity from Henderson Municipal Power and Light Station Two and about 178 MW of contracted hydro capacity from Southeastern Power Administration.

Although BREC’s rates are experiencing upward pressure owing to the loss of smelter loads, we note the economics of power produced from BREC's generation sources have been enabling it to still maintain a reasonable competitive advantage in the Southeast and even more so when compared to other regions around the country. The capacity factors and efficient operations of the assets resulted in 2014 net member wholesale revenue per MWh for rural members and large industrial members of $61.59 and $47.62, respectively, compared to $51.17 and $40.94, respectively, for 2013 (including the beneficial effects of the member rate stability mechanism). Excluding the benefits of the member rate stability mechanism, the 2014 member wholesale revenue per MWh for rural members and large industrial members would have been $81.79 and $63.56, respectively, compared to $57.74 and $47.00, respectively, for 2013.

WHOLESALE POWER CONTRACTS SUPPORT BIG RIVERS' CREDIT PROFILE

The revenues derived under Big Rivers' long-term wholesale contracts with its members for sales to non-smelter customers will continue as the contracts are in effect through December 31, 2043. The underlying favorable economics of power produced by BREC's generation assets can help temper some of the member disenchantment that undoubtedly stems from significant rate increases approved in 2013 and 2014. Notwithstanding a relatively competitive starting point in 2013 and other price mitigating strategies, it remains possible that the specter of member unrest could surface if further substantial rate increases become necessary due to environmental compliance or other operating cost pressures. That said, the currently overall sound member profile helps provide a degree of assurance of the revenue stream from members, which is integral to servicing Big Rivers' debt.

BASE RATE INCREASES AND OTHER LOAD MITIGATION STRATEGIES TO SUPPORT FINANCIAL VIABILITY

Big Rivers financial performance is being supported by the outcomes in its last two rate cases and other mitigation strategies. BREC's financial performance in fiscal year December 31, 2014 exceeded management's expectations owing to successful cost controls and better than anticipated margins from off system sales, with net margins of $32.7 million, which were more than $25 million above budget. For the first quarter ended March 31, 2015, BREC's net margins were $14.5 million, reflecting a 65% decline from the first quarter of 2014 when financial performance far surpassed the cooperative's budget reflecting the weather effects of the 2014 polar vortex, benefits of off-system sales during the period and forward sales of power from the Wilson Plant. Financial performance for the first quarter of 2015 also reflect the effects of the contract termination of the Sebree smelter in January 2014, and reduced margins from sales to non-members compared to the prior period.

On a three-year average basis over the fiscal years 2012-2014, Big Rivers' funds from operations (FFO) coverage of interest and FFO to debt ratios, as well as its debt service coverage (DSC) ratio fall into the "Ba", "B" and "B" rating categories, respectively, for the ratios covered under the Rating Methodology for U.S. Electric G&T Cooperatives. For example, Big Rivers' three year average FFO coverage of interest, FFO to Debt, and DSC for 2012-2014 were 1.39 times, 2.0%, and 1.0 times, respectively. Although the three year average scores for these three metrics are at weak levels under the rating methodology, the recent weak levels for the FFO to interest and FFO to debt metrics are directly tied to the accounting effects of noncash member rate mitigation revenue. Importantly, the 2013 and 2014 rate case decisions have firmly established the necessary revenue requirements and rate levels to maintain the financial viability of Big Rivers and restore these metrics to stronger levels once all the economic reserve, rural economic reserve and transmission revenue economic reserve accounts are utilized. The weak average DSC ratio for the same period primarily reflects some pressure in FY 2013 as a large principal payment was made. We expect that the DSC ratio will also improve going forward. For the same 2012-2014 period, TIER averaged 1.5 times (in the "Aa" category range) primarily reflecting supportive regulatory decisions and strong net margins, especially in FY 2014, and equity to total capitalization averaged 32.8% (in the "A" category range) as the metric is benefitting from debt reduction and full retention of net margins. The equity ratio continues to benefit from the lease unwind transactions that were completed in 2009. Prior to that Big Rivers had negative equity. Even as Big Rivers' FFO coverage of interest and debt and DSC ratios are expected to improve, the Ba2 rating still factors in the substantial overcapacity at BREC, the remaining execution risk as BREC implements its mitigation strategy, and the industry concentration risk that remains given the region's reliance on the aluminum smelter industry.

LIQUIDITY

BREC maintains ample liquidity by supplementing its existing cash on hand and internally generated cash flow with a three-year $130 million syndicated senior secured credit agreement with five banks, led by National Rural Utilities Cooperative Finance Corporation (NRUCFC), which expires in March 2018. As of March 31, 2015, BREC reported its cash and temporary investments balance at approximately $95 million and $121.4 million available under the NRUCFC credit agreement. Usage under the credit agreement is comprised entirely of outstanding letters of credit. BREC has manageable debt maturities over the next eight quarters, which are largely comprised of scheduled amortizations of long-term debt to be paid at a rate of roughly $5.5 million per quarter.

$30 million of the NRUCFC credit agreement is reserved for interim financing of KPSC approved environmental related capital expenditures. BREC has applied for long-term senior secured financing of the KPSC approved environmental related capital expenditures under the U.S. Department of Agriculture's Rural Utilities Service (RUS) loan program. Once those funds are secured, BREC would be required to repay any draws under the NRUCFC led credit agreement which were used for the environmental related expenditures at which time the total available amount of the credit agreement would be reduced to approximately $100 million.

The quality of the alternate liquidity provided by the syndicated credit agreement benefits from the multi-year tenor and the absence of any onerous financial covenants, which largely mirror the financial covenants in existing debt documents. Big Rivers is in compliance with those covenants. Additionally, the credit agreement benefits from no ongoing material adverse change (MAC) clause. The syndicated credit agreement does not have any rating triggers, just a pricing grid based on rating.

Structural Considerations

As part of the unwinding of various transactions completed in 2009, Big Rivers replaced the previously existing RUS mortgage with a new senior secured indenture. Under the current senior secured indenture RUS and all senior secured debt holders, including the $83.3 million of County of Ohio, Kentucky (the county) Pollution Control Refunding Revenue Bonds (Big Rivers Electric Corporation Project; cusip number 677288AG7), are on equal footing in terms of priority of claim and lien on assets. The current senior secured indenture provides Big Rivers with the flexibility to access public debt markets without first obtaining a case specific RUS lien accommodation, while retaining the right to request approval from the RUS for additional direct borrowings under the RUS loan program, if they choose to do so. Given persistent questions about the availability of funds under the federally subsidized RUS loan program, we consider the added flexibility of the current senior secured indenture to be credit positive.

Rating Outlook

BREC's rating outlook is stable, reflecting its good progress in implementing load mitigation strategies, the most critical ones being the credit supportive rate case outcomes at the KPSC and better than anticipated success in selling excess energy and capacity off system in the MISO and other markets at good margins. The stable outlook also incorporates our view that the smelters will continue to operate, thereby providing support for the local economy, including employment levels.

What Could Change the Rating - Up

Further significant support from the KPSC in any future regulatory filings, favorable outcomes from the findings of the internal audit and successful results through other ongoing load mitigation strategies would be credit positive and help to improve BREC's rating.

What Could Change the Rating - Down

In light of the stability that has surfaced in Big Rivers' results and near term prospects, there are limited expectations for a negative rating action. That said, we could take a negative rating action, if there was a shift to less regulatory support in future regulatory filings and a weakening of external liquidity. Also, we would view a scenario under which either or both of the smelters discontinued operations as credit negative given the potential residual negative effects such action would have on the local economy. Furthermore, if full and timely recovery of environmental compliance costs does not occur as anticipated under the KPSC approved environmental cost recovery mechanism, that would add downward rating pressure, especially if such amounts increase substantially from currently anticipated levels.

U.S. Electric Generation & Transmission Cooperatives Rating Methodology

Big Rivers' mapping under Moody's U.S. Electric Generation & Transmission Cooperative Rating Methodology is based on historical data through December 31, 2014. The grid indicated rating for Big Rivers' senior most obligations under the Methodology is currently Baa3 and relies on the aforementioned historical quantitative data and qualitative assessments. The grid indicated rating under the Methodology largely reflects B and Ba scores for the factors relating to funds from operations coverage of debt and interest, respectively, and also the B scores for the factors relating to the DSC ratio and potential for rate shock, as well as the Ba score for contractual relationships and regulatory status. These low scores are partially balanced by the stronger Aa scores for new build exposure and TIER, as well as the A score for the equity to total capitalization ratio. Notwithstanding the current Baa3 grid indicated rating for Big Rivers under the Methodology, as mentioned above, its actual senior secured rating of Ba2 reflects the unique risks relating to Big Rivers' need for further progress including further implementation of its load mitigation strategies following the smelter contract terminations.

AUTHOR
Kevin Rose