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Ratings

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Summary:

Big Rivers Electric Corp., Kentucky; Rural Electric Coop

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Credit Profile		
Big Rivers Electric Corp. ICR		
Long Term Rating	BB/Stable	Upgraded
Ohio Cnty, Kentucky		
Big Rivers Electric Corp., Kentucky		
Ohio Cnty (Big Rivers Electric Corp.) RURELCCOO		
Long Term Rating	BB/Stable	Upgraded

Rationale

S&P Global Ratings raised its issuer credit rating on Big Rivers Electric Corp., Ky. (BREC) to 'BB' from 'BB-'. At the same time, S&P Global Ratings raised its rating on Ohio County, Ky.'s $83.3 million pollution control refunding revenue bonds, series 2010A (Big Rivers Electric Corp. Project), issued for BREC, to 'BB' from 'BB-'. The outlook is stable.

The upgrade reflects our view of the following developments:

- The cooperative has added more contracts with nonmembers for the sale of surplus portions of generation capacity output following the loss of two aluminum smelters that represented its members' two principal industrial customers. We believe these contracts add more predictability to the revenue stream and mitigate the utility's and its lenders' vulnerability to default. Debt service coverage (DSC) levels were essentially stable in 2015 and 2016 at nearly 1.2x. Nevertheless, a mismatch remains between the duration of the utility's debt and the shorter tenor of the contracts. For the most part, the nonmember contracts will expire five-to-eight years before the maturity of nearly $200 million of the utility's amortizing and nonamortizing debt outstanding. This figure compares with $814 million of long-term debt that the utility reported as of Dec. 31, 2016.
- Following the customer departures, the Kentucky Public Service Commission (KPSC) approved rate adjustments in 2013 and 2014 that allocate a greater share of fixed costs to BREC's members' remaining native load customers. We believe that these rate actions temper, but do not eliminate, the utility's dependence on nonmember sales for margins and fixed cost recovery.

The ratings also reflect our opinion of the following exposures:

- BREC's contracts for the sale of surplus energy to nonmembers do not cover a meaningful portion of the utility's long generation position, leaving it exposed to competitive market forces.
- BREC is a price-taker that is exposed to market prices when it sells its power plants' output to nonmembers through competitive markets transactions. Also, the negotiated prices in nonmembers contracts reflect market conditions. We view the inability to set prices for competitive market sales as limiting some of the financial forecast's predictive value.

- The utility's aging generation fleet is largely coal-based, faces emissions remediation issues, and competes in the markets in which the Midcontinent Independent System Operator Inc. operates where there are many newer, gas-fired assets that are often more efficient.
- The company forecasts continuing meaningful dependence on nonmember revenues for about a third of its revenues through 2020, which we view as limiting the utility's power to steer its financial performance. BREC projects that its member energy sales will remain close to current levels during those years, which we view as an exposure given the significant size of principal repayments the utility is deferring to later years through its use of non-amortizing debt and inclining principal amortization for its amortizing debt.
- Members' residential revenues, which we consider to generally represent the most stable and predictable revenue stream, accounted for only one-third of members' 2017 revenues. Large commercial and industrial revenues accounted for half of their revenues.
- Although DSC reached 1.19x in 2016, we view DSC levels as only adequate relative to the business risks the utility faces. In 2015 accrual DSC dropped to 1.15x from 1.53x in 2014 and 1.35x in 2013, due to the weak wholesale market prices BREC received for its surplus power sales.
- Because more than one-third of BREC's debt does not amortize before maturity, it skews DSC metrics upward relative to those of other cooperative utilities with amortizing debt.
- BREC's average revenue per megawatt-hour from nonmember sales remained anemic in 2016 at about $32. Annual principal repayments will spike to $72 million in 2020 and $67 million in 2021, which will require cash flows sufficient to retire these maturities or market access to refund the maturities. However, BREC was able to secure financing in 2017 to retire a $26 million bridge facility borrowing to fund emissions remediation projects. We view the refinancing as a favorable development.
- The member distribution cooperatives' 2016 residential customers' retail rates were between 44% and 59% higher than they were in 2011, which we view as potentially limiting financial flexibility. Overall, rates are competitive with state averages, but we believe the sharp increases that were needed to temper the loss of the smelter roads might erode the regulator's and customers' appetite for further increases.
- We believe BREC's few, vintage, coal-fired generation assets present operational exposures that can affect financial performance.

Our ratings also incorporate these mitigating factors:

- The utility projects its debt balances will remain relatively stable through 2020 as it pursues nearly $170 million of capital investments.
- BREC's 64% debt-to-capitalization ratio is favorable for a generation-owning, cooperative utility.

Henderson, Ky.-based BREC is a generation and transmission cooperative that produces and procures electricity for sale to its three distribution cooperative members--Kenergy Corp., Jackson Purchase Energy, and Meade County Rural Electric Cooperative--and their approximately 116,000 retail customers. The members serve in 22 counties. The state's median household income levels are nearly 20% below the nation's, which could limit ratemaking flexibility.

The KPSC must approve the rate adjustment requests of the utility and its member distribution cooperatives, which distinguishes these utilities from many other cooperative utilities that have autonomous ratemaking authority. Although the regulator has provided rate adjustments that support adequate financial performance, we consider the financial margins to be weak relative to the magnitude of the utility's exposure to the vicissitudes of competitive wholesale markets where the utility cannot exert price-setting authority over its customers. The commission allows the utility to use a fuel adjustment clause to capture changes in variable costs, which we view as a positive factor. We

believe this tool helps reduce financial volatility, but does not sufficiently compensate for the utility's exposure to nonmembers for about one-third of revenues.

The commission granted a 15.6% rate increase in October 2013 and a 14.1% increase in April 2014. Its latter decision provided only about half of the utility's 26.5% requested increase. Moreover, the utility depleted the reserve balances it had used as a rate stabilization fund to soften the impacts of the commission-approved rate adjustments on customers. The loss of large industrial loads whose high load factors historically absorbed a substantial portion of the utility's fixed costs, coupled with the depletion of the reserves translate into retail rates that are much higher than they were five years ago. The service territory's low income levels exacerbate the limits that such sharp increases might place on future increases.

To temper the severity of the fixed cost reallocations flowing from its customer losses, BREC is remarketing some of the generation output that previously served those customers. We believe that market sales partially transform the utility into a merchant generator that faces the risks inherent in facing volatile market demand and prices. Moreover, we believe that the mismatch between the tenor of the contracts and the maturity schedule for the utility's debt distinguishes this cooperative utility from others that tend to align debt maturities with the duration of all-requirements power sale contracts. The utility reported $814 million of long-term debt and $26 million of draws on credit lines as of Dec. 31, 2016.

The utility's generation portfolio provides little fuel diversity. It includes the 443-megawatt (MW), coal-fired Coleman power plant; the 417-MW, coal-fired Wilson plant; the 454-MW, coal-fired Green station; and 130 MWs from multiple units at the coal- and gas-fired Reid Station. Although the cooperative also has an allocation of 154 MWs of Southeastern Power Administration hydroelectric power, coal represents the dominant energy source. In 2016, BREC's coal-fired Green and Wilson plants produced 77% of the energy it sold. BREC sourced another 13% of its 2016 energy supply from its rights to the output of the coal-fired Henderson Municipal Power & Light Station 2 power plant. We believe that BREC's concentration in coal resources exposes the utility to the potential financial and operational effects of emissions regulations and coal combustion residuals regulations.

BREC's Coleman station has been idle since the loss of the smelter loads in 2014. The Reid plant's coal capacity can only operate if the utility remediates the plant's emissions.

Ohio County sold $83.3 million of bonds in 2010 for the benefit of BREC, which used bond proceeds to refund auction-rate securities. The bonds do not amortize and have a 2031 bullet maturity. We understand that the financing structure obligates the utility to unconditionally pay the county's bonds' debt service. BREC issued a note to the county that provides it with a security interest in the utility's assets under its mortgage indenture. The county's bonds' security interest is on par with BREC's senior secured debt.

Outlook

The stable outlook reflect the utility's ability to maintain adequate DSC under adverse market conditions, its access to liquidity, the rate relief that the KPSC provided in 2013 and 2014, and the addition of nonmember contracts that provide more predictability to the revenue stream.

Upside scenario

We do not expect to raise the ratings within our two-year outlook horizon without prospects for a more secure revenue stream that is better aligned with debt maturities. Furthermore, residential customers are shouldering sharply higher rates that we view as potentially limiting ratemaking flexibility. We also consider the utility's reliance of coal-fired resources to support 90% of BREC's 2016 energy sales as a significant hurdle. We view DSC levels as only adequate relative to these exposures.

Downside scenario

We could lower the ratings if the utility cannot sustain sound financial performance because of weak market conditions or poor plant performance. Similarly, if BREC's members' financial profiles erode, we could lower the ratings.

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