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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. (BREC), Ky. 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 factors:

- The cooperative utility has entered into five contracts with nonmember public power utilities for the sale of the output from surplus portions of its generation capacity. Excess generation capacity followed the loss of two aluminum smelters that represented its members' two principal industrial customers.
- We believe the nonmember contracts, together with the idling of the utility's uneconomical Coleman power plant, and the cessation of the utility's obligation to purchase output from a Henderson Municipal Power And Light power plant, should better align BREC's 1,200 megawatts (MW) of generation resources with load through 2026. These developments should also add more predictability to the revenue stream and mitigate the utility's and its lenders' vulnerability to default.
- Although the nonmember contract purchasers will not reach their peak requirements until 2022, Big Rivers projects that adding the portfolio of about 340 MW of nonmember contracts will reduce its exposure to market revenues from 37% in 2017 to 9% in 2022. The utility also projects that its gross margins will increase as it migrates from market sales to contracted sales.
- The utility reports that the association representing its members' industrial electric customers has agreed to support the utility's plans to apply to the Kentucky Public Service Commission in late 2020 for the recovery of investments in retired generation assets.
- The utility projects debt balances will remain relatively stable through 2022 as it pursues about $250 million of capital investments.
- In 2017 and 2018, BREC reduced market access risk by retiring with cash, $80 million of debt maturing in 2019-2021. It plans to use cash to retire about 40% of a $245 million 2023 bullet maturity and refinance the balance

of that bullet. The utility is exploring options for its $83 million 2031 bullet maturity.

The ratings also reflect our opinion of these exposures:

- The tenor of the contracts with nonmembers provides only near-term revenue stream security and predictability, which constrains the ratings. The contracts expire in 2026 and 2029 and if they are not renewed or replaced, their expiration will expose about one-third of the utility's generation capacity to competitive markets. Therefore, we continue to consider long-term financial performance as vulnerable because 240 MW of the contracted capacity will roll off in 2026 and another 100 MW in 2029.
- BREC is a price-taker when it sells its power plants' output in competitive markets. The utility's 2017 energy production was almost exclusively from aging coal units that face emissions remediation issues. Self-production accounted for about two-thirds of BREC's 2017 energy sales.
- Members' residential revenues accounted for only one-third of members' 2017 revenues. Large commercial and industrial revenues accounted for half of their revenues. We consider residential revenues as generally representing the most stable and predictable revenue stream,
- Because 40% of BREC's debt does not amortize before maturity, the deferred principal amortization skews debt service coverage (DSC) metrics upward relative to those of other cooperative utilities with amortizing debt. Accrual DSC levels were essentially stable in 2015 and 2016 at nearly 1.2x. Accrual DSC declined to 1.0x in 2017, but cash from operations coverage was nearly 1.6x. That year's diverging cash and accrual coverage reflects, in part, timing differences relating to the recording of interest expense.
- BREC's average revenue per megawatt-hour from nonmember sales were anemic at $32 in 2016, $34 in 2017, and an estimated $30 in 2018.
- In 2017, the member distribution cooperatives' residential customers' retail rates were 12%-16% higher than the state average. Moreover, each of the members' residential rates in 2017 were at least 69% higher than in 2011, because the utility allocated costs from the lost smelter loads to its remaining customers. The sharp increases, the rate disparity relative to state average, and the low income levels might limit financial flexibility.
- We believe BREC's few vintage, coal-fired generation assets present operational exposures that can affect financial performance.

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 117,000 retail customers. The members serve in 22 counties. The state's median household income levels are nearly 20% below that of the nation, which could limit ratemaking flexibility. The utility reported $804 million of debt as of Dec. 31, 2017. In April, BREC reduced its debt balances by retiring a $65 million 2021 bullet maturity. BREC's 63% debt-to-capitalization ratio is favorable for a generation-owning, cooperative utility.

The Kentucky Public Service Commission must approve the utility's rate adjustment requests and those of 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 industrial loads and 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. Contracts with new loads should contribute to stable financial performance for a number of years, but the specter of volatility remains because substantial debt will remain after the contracts expire.

The utility's generation portfolio provides little fuel diversity. It includes the idled 443-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. The cooperative also has an allocation of 178 MWs of Southeastern Power Administration hydroelectric power. Coal represents the dominant energy source and we believe that BREC's concentration in coal resources exposes the utility to the potential financial and operational effects of regulations governing power plant emissions and coal combustion residuals.

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 security interest on the county's bonds is on par with that on BREC's senior secured debt.

Outlook

The stable outlook reflects improved prospects for stable financial performance through the term of the contracts to sell surplus power to nonmember public power utilities. We view the contracts as reducing the revenue stream's exposure to competitive market forces during the life of the contracts.

Upside scenario

We do not expect to raise the ratings within our two-year outlook horizon without prospects for a more secure long-term revenue stream that aligns predictable revenues with debt maturities. We view several additional exposures as constraining the ratings. These include recent years' sharp rate increases relative to low income levels, an almost exclusively coal-fired generation portfolio and its potential exposure to more stringent emissions regulations, DSC levels that are only adequate relative to these exposures, and the presence of nonamortizing debt, which we believe distorts DSC coverage levels relative to utilities with greater percentages of amortizing debt.

Downside scenario

We could lower the ratings if the utility cannot sustain sound financial performance because of poor prospects for renewing or replacing nonmember contracts, weak market conditions, or poor plant performance. Similarly, if the financial profiles of BREC's members 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.

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