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Ratings

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Wabash Valley Power Association, Indiana; Rural Electric Coop

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Rationale

S&P Global Ratings affirmed its 'A-' issuer credit rating (ICR) Wabash Valley Power Association (Wabash). The outlook is stable.

The ICR reflects our view of Wabash's credit strengths:

- Long-term, all-requirements contracts with its 23 member cooperatives through 2050, well beyond the maturity on outstanding debt (2045);
- A diverse customer base primarily covering northern Indiana, with residential end-use customers accounting for a relatively high 60% of annual sales revenues; and
- A power supply portfolio that is diverse by unit and by fuel-source, including flexible load-following purchased power agreements (PPAs) that enable Wabash to closely match its power purchases to its load.

Offsetting the above strengths is a debt load that is somewhat high, given that a significant share of Wabash's power is contracted.

Wabash is a generation and transmission (G&T) cooperative based in Indianapolis, Ind. Wabash serves a membership base of 23 distribution cooperatives. Members are located mainly in the northern half of Indiana, with four members in Missouri and Illinois. We consider the customer base to be diverse, with nearly 60% of operating revenues are derived from members' energy sales to residential customers. The largest member, Citizens Electric Corp. (Missouri) accounted for about 13.8% of fiscal 2015 sales revenue.

Wabash serves its 1,686 MW (megawatt) peak load (2015) through a combination of purchased and owned generation resources. Overall, we believe the cooperative's operational profile benefits from fuel and shaft diversity, in addition to the flexibility to match owned resource output and load-following power purchases to loads. Its contracts, spread among several suppliers, include a mixture of cost-based long-term resources, load-following contracts, and shorter-term blocks. Owned resources include coal-fired, natural gas-fired, and some renewable (landfill gas) energy, with a total owned generation portfolio projected to reach 1,136 MW as of 2017, up slightly from 1,104 MW in 2015.

Wabash management made several changes to its power supply portfolio in 2016. Overall, we view the recent developments as credit neutral to credit positive. In May 2016, Wabash purchased a 5.06% share of the Prairie State Energy Campus, at a favorable price, adding 83 MW of generating capacity. The purchase also included a share of the energy campus's coal mine. Management estimates that coal reserves at the facility will be sufficient to meet plant fuel needs through at least 2030.

In addition the acquisition of a share of Prairie State, Wabash's integrated gasification combined cycle (IGCC) plant closed in the spring of 2016. Management expects that the IGCC plant closure will reduce ongoing operating and maintenance costs, as the plant was inefficient and unprofitable. We believe this action reduces business risk.

In our opinion, Wabash's financial performance remains adequate. Debt service coverage (DSC) ratios averaged 1.4x from fiscal 2012 through 2015. Fixed charge coverage (FCC), which imputes capacity payments for purchased power as a debt-like obligation, is about 20 basis points below FCC each year, and averaged 1.2x from 2012-2015. Moving forward, management's forecast indicates that annual debt service obligations will rise through 2020. However, the forecast also indicates that FCC will improve modestly due to the combination of strengthening margins and reduced capacity charges. Wabash forecasts modest rate increases, and declining power costs, as high-cost purchased power agreement lapse. Overall, we expect coverage metrics will remain adequate over the next few years.

In recent years, surplus margins have enabled the cooperative to increase equity above 20%, in line with management's goals. Wabash's board recently raised its equity ratio target to 30%, with 2023 as the timeframe to meet the higher goal. Management's current financial forecast calls for $446 million in additional debt from 2016 through 2021, however about 37% of that figure is not certain, but linked to a potential debt-financing of a new generating unit in the next two to four years. Overall, we expect rising margins and reduced capacity costs will enable management to continue working to increase equity while maintaining an adequate financial profile overall.

Wabash's liquidity position benefits from a $200 million committed line of credit, which was extended in June 2016 through fiscal 2021, and increased from a prior figure of $160 million. Total liquidity has been adequate-to-strong in recent years, and we expect will remain so moving forward, strengthening modestly in the near-term due to the increased amount available to the cooperative under its committed line of credit.

Although Wabash may at any time, it has primarily made annual rate changes as part of its budget process. This is usually in the form of a true-up, with one year's cost deferral, if any, fully recouped in the subsequent year's budget and rate-setting process. Wabash's board has also demonstrated that it would adjust rates on an interim basis in the event that costs exceeded forecast.

Outlook

The stable outlook reflects our expectation that coverage ratios will remain adequate as Wabash implements its strategy of increasing equity to 30%.

Upside scenario

We could raise the rating if we observe a track record of audited results that produce stronger financial metrics, including FCC and liquidity metrics.

Downside scenario

We do not expect to lower the rating, given our view of Wabash's stable power supply portfolio, reduced business risk, and expected maintenance of adequate financial metrics. However, if the cooperative's financial metrics fall materially short of projected levels, we could lower the rating.

Business Description

Wabash Valley Power Association is a G&T cooperative headquartered in Indianapolis, providing wholesale power to its 23 distribution system members, whose service territories are spread across Indiana, Illinois, and Missouri. Three members have exited since 2012, following a 10-year notice period. The 10-year notice period provided Wabash with sufficient time to adjust its purchased-power portfolio, and allowed Wabash time to plan for the loss of load of exiting members. As such, we note that financial metrics have not suffered as the members exited, and we do not believe the exits of the three members have had a material impact on Wabash's credit quality. Wabash also was able to collect a termination fee that covers the member's proportionate share of fixed costs in the interim.

The remaining 23 members are under contract through 2050, with new contracts implemented in 2007. The new contracts take effect in April 2028 and include a new three-year exit clause feature and financial termination provisions. Although termination will require just three years' notice under the new contracts, the financial penalties for early termination increased. The current contracts require 10-year's notice for exit, effective until the new contracts begin in 2028. Wabash's diverse portfolio of power purchase contracts includes a substantial amount of load-following capacity in addition to short- and medium-term contracts. The nature of the load following contracts enables Wabash to adjust energy purchases to match demand, while the rolling off of PPAs over time further reduced the impact of load losses associated with departing members.

Diverse but rural membership

Wabash's 23 member cooperatives serve a diverse yet highly rural territory spanning across much of northern Indiana, in addition to 30 counties in Illinois, and three counties in Missouri. With approximately 311,000 end-use customers as of fiscal year-end 2015, the membership serves a highly rural service territory, with fewer than nine customers per line mile system-wide. However, several metropolitan areas are within, or in close proximity, to members' service territories. These include the Indiana cities of Indianapolis, Fort Wayne, Gary, and Terre Haute; St. Louis, Mo., and the Illinois cities of Chicago, Peoria, Bloomington, and Decatur.

About 74% of Wabash's total sales revenue is derived from its Indiana members, with 13% and 14%, respectively, coming from Illinois and Missouri. The largest member cooperative by revenue, Citizens, accounted for 13.8% of fiscal 2015 operating revenues, and the 10 leading members combine for about 72% of the total. Members' financial profiles are good, overall, with median DSC of 2.9x and average equity ratio of 61%, reflective of the low debt loads that are typical for distribution utilities.

Customer concentration, in our view, is moderate and not a credit concern. Although the top three end-use retail customers comprise about 10% of sales revenue, these customers are served as pass-through loads and comprise a low (less than 2%) share of Wabash's total net available revenues. ACES, a power marketer, handles hourly purchasing for the pass-through customers. Wabash's arrangement to serve these pass-through customers transfers price risk from the cooperative to the customers, and mitigates our concern over moderate revenue stream concentration.

Stable operations

Wabash owns a moderate and growing amount of generation assets, totaling 1,105 MW, including 44 MW of baseload landfill gas capacity. However, the cooperative meets a large portion of its peak load obligation (1,686 MW in 2015)

through a combination of power supply contracts and market power purchases. Purchased power represented an estimated 53% of Wabash's total capacity for 2016, and an estimated 73% of total energy. The cooperative's PPAs include cost-based and market contracts with a diverse list of suppliers, and with staggered terms. Given its reliance on purchased power, Wabash has developed a portfolio approach to its power supply and applied a comprehensive risk management policy, which includes using multiple suppliers, a mixture of contract shapes, demand side management, and price hedges. Additionally, Wabash contracts with ACES Power Marketing for energy risk management services. Overall, Wabash's risk management policies are conservative, in our opinion.

In addition to its shaft diversity, Wabash's power supply is also fairly diverse by fuel. Coal from owned assets represented just 5% of total energy in 2015. However, with the acquisition of Prairie State, this figure will rise to about 17% by 2018. Including power purchases, coal as a percent of total energy is around 40%, but will fall to around 32% beginning in 2018 as the PPA with Hoosier Energy, under which Wabash purchases a share of the output of Hoosier's Merom plant, expires. Also with the Dec. 31, 2017 expiration of the Hoosier PPA, Wabash's capacity charges will significantly decline. As such, we note that the current financial forecast indicates that FCC will improve slightly beginning in 2018. Aside from coal, Wabash's projections indicate it will obtain about 10% of energy from natural gas resources in 2017, up from just 3% in 2015, 9% from nuclear resources, about 6% from wind and landfill gas, with the remaining share from unidentified market purchases. As such, we note that Wabash's carbon exposure is and will remain moderate, but relatively low compared to peer cooperatives in the Midwest.

In September 2015, the U.S. Environmental Protection Agency (EPA) released its final version of the Clean Power Plan (CPP). The final CPP calls for a 32% nationwide cut in carbon dioxide (CO2) emissions from existing power plants by 2030, with interim reductions covering 2022-2029. However, on Feb. 9, 2016, the U.S. Supreme Court granted a stay in implementation of this final regulation. The U.S. Court of Appeals for the District of Columbia Circuit has heard the case challenging the constitutionality of the CPP, and is expected to rule in early 2017, upon which we expect further appeal to the U.S. Supreme Court. We also note that there is the potential for the CPP and other recent environmental mandates to be significantly relaxed or even completely unwound, given stated positions of the Trump administration, which signal the potential to roll back Obama-era environmental regulations. As the many related legal and compliance issues come into focus, S&P Global Ratings will evaluate the challenges and assess the extent to which the response affects credit quality.

Regulation and rates

Wabash's regulatory situation is relatively strong. On July 1, 2004, the cooperative transitioned to Federal Energy Regulatory Commission (FERC) regulation, superseding regulation by the Indiana and Michigan state utility commissions. FERC assumed rate-setting oversight for Wabash through an order granting formula rate treatment to its members and market based rate authority for its market transactions with nonmembers. Pursuant to the arrangement with FERC, Wabash's board of directors sets rates for the utility.

Under FERC's "formulary rate procedure," the utility's board adopts annual rate adjustments, while reserving the right to adjust rates at any time. Annual or interim changes to rates do not require FERC approval. However, such approval would be required if Wabash wants to modify its system of accounts, add a new expense or cost component not presently included in the formula, or make any other change to the components of its rate formula. Rates become effective 60 days after board approval.

Although midyear rate changes are possible with Wabash's board approval, typically annual true-ups are made based on the difference between billed revenue and actual costs (revenue requirements) incurred. True-up amounts are billed/refunded to the members as a fixed monthly charge/credit during the next calendar year. True-ups do not require FERC approval.

The Wabash rate structure, as adopted, no longer includes the favorable power and fuel cost adjustment mechanisms previously authorized by its former state regulators. However, we note that management's rate-setting practices have led to manageable, in our view, annual rate adjustments between about 1% and 2% over the last five years.

As of 2015, none of Wabash's 23 members are subject to rate oversight at the retail level by state regulators. FERC regulation does not affect the regulatory status of those members.

Financial Profile

Wabash's strategic plan supports a number of financial policies that exceed the requirements of its loan covenants. Under its mortgage and loan agreement, Wabash is required to achieve a times interest earned ratio of 1.0x and a DSC ratio of 1.1x. However, Wabash's board policy targets a higher DSC ratio minimum (1.2x) as compared with the indenture requirement (1.1x). We note that the cooperative has established a track record of DSC near 1.4x, well above the board's target. FCC, which adjusts DSC by imputing the portion of purchased power related to capacity payments as debt-like obligations averaged around 1.2x over the past four audited fiscal years.

Moving forward, we expect lower capacity costs to support slightly stronger FCC starting in 2018, and we expect that coverage metrics will remain supportive of the current rating. Similarly, we note that management acted to increase its committed line of credit from $160 million to $200 million. Under the current forecast, the higher amount available under the line of credit is projected to produce available liquidity equivalent to around 170 days' operating expenses in 2016-2020, up from around 130 days' expenses over the past two audited fiscal years. To the extent that coverage metrics and liquidity improve materially, as demonstrated by audited results, we believe the cooperative's business risk profile could potentially support a higher rating over the medium- to long-term.

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