FITCH AFFIRMS KENTUCKY MUNI ENERGY AGENCY PROJECT OBLIGATIONS AT 'A'; OUTLOOK STABLE

Fitch Ratings-New York-01 November 2019: Fitch Ratings has affirmed the 'A' Issuer Default Rating (IDR) of the Kentucky Municipal Energy Agency (KYMEA or the Agency) and the 'A' rating on the all-requirements project obligations (ARP Obligations) of KYMEA.

The Rating Outlook is Stable.

ANALYTICAL CONCLUSION

The IDR and rating on the Kentucky Municipal Energy Agency's (KYMEA) all-requirements project obligations (ARP obligations) primarily reflect the credit quality of the largest member, the Electric and Water Plant Board of Frankfort, KY (FPB) and FPB's ability to support ARP obligations. The rating reliance on FPB further reflects KYMEA's limited operating history.

FPB is an enterprise fund of the City of Frankfort, KY, providing electric, water and telecommunications services throughout the city and to portions of the county and surrounding areas. FPB's strong credit quality is supported by stable financial performance at its electric and water systems, which serve approximately 40,000 customers throughout its service area, and overall improving system leverage. Margins at FPB's telecomm business have been robust, but the business' competitive nature introduces meaningful risk to the overall revenue base. The service area is considered strong with limited customer growth offset by average unemployment and income levels (Franklin County).

Additional rating considerations include the strong revenue framework afforded by the long-term, take-and-pay power sales contracts (PSCs) KYMEA signed with its ARP members, and the rate-setting requirements pursuant to those contracts that provide a de-facto unlimited step-up from FPB and the other seven ARP members.

Until KYMEA has established a multi-year operating and financial performance history sufficient to support an independent assessment, the IDR and ARP ratings will continue to reflect the credit quality
of its largest members.

CREDIT PROFILE

KYMEA is a joint action agency created in 2015 to assist its members in serving their current and future power and energy requirements. Eight of KYMEA's 11 members elected to create a separate project - the ARP Project - pursuant to which KYMEA will supply and the members will purchase all power and energy needed to meet their respective retail requirements. The agreement became effective on May 1, 2019.

The eight members are bound by long-term take-and-pay PSCs that collectively obligate the systems, on an absolute and unconditional basis, to provide revenue sufficient to allow KYMEA to meet its ARP obligations. KYMEA is required to 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 eight ARP members are geographically dispersed throughout the Commonwealth of Kentucky and vary in size. The largest ARP member, FPB, serves the City of Frankfort, KY and surrounding areas, and has experienced stable, albeit modest, economic growth in recent years. The remaining

ARP members all serve relatively small cities. Aside from Frankfort and broader Franklin County, the areas are predominately rural with regional economies dependent upon light manufacturing, regional health facilities and agriculture. Collectively, the ARP members serve approximately 43,500 electric customers and a total population of 92,000.

Operations are limited as KYMEA has contracted to purchase all of its member's power needs pursuant to three multi-year purchase power agreements (PPA) with three entities: Big Rivers Electric Corporation (BBB-/Stable), Paducah Power System (BBB/Positive) and Illinois Power Marketing Co. (IPMC: not rated). ARP obligations are initially limited to payments required under the PPAs and other amounts necessary to secure member power requirements. Other power delivery services, including scheduling, are provided by a third party power marketing service.

KEY RATING DRIVERS

Revenue Defensibility: 'a'; Strong Purchaser Credit Quality Drives Rev Defensibility

The strong revenue defensibility assessment primarily reflects KYMEA's reliance on FPB, which is expected to account for about 50% of the ARP project's total revenues, and broadly supports the agency's credit quality. The assessment is further supported by the very strong revenue framework provided by the long-term, take-and-pay power supply contracts KYMEA has signed with FPB and the ARP members. The contract obligations are unconditional, payable as an operating expense of the member systems.

Operating Risk: 'a'; Power Purchased Through Short and Medium Term Agreements

The operating risk profile is assessed at strong reflecting a diverse and flexible power supply with three separate counterparties, and the anticipated cost of such supply. The relatively short tenor of the initial power contracts coupled with the inherent counterparty risk in the credit quality of the providers somewhat limits the assessment. However, the credit quality of the providers has improved somewhat over the past several years as two of the three are now rated investment grade (rated in the BBB category) by Fitch.

Financial Profile: 'a'; Financial Profile based on FPB

Financial profile is a lesser consideration in the rating and based largely on FPB's profile given KYMEA's limited operating history and financial results recorded to date.

Asymmetric Additional Risk Considerations

There are no additional asymmetric risks affecting the rating.

RATING SENSITIVITIES

Change in Member Credit Quality: The rating on KYMEA remains 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 could have a corresponding effect on the rating of KYMEA.

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 began providing all-requirements power supply to ARP Members on May 1, 2019.

Revenue Defensibility

All of the ARP members executed PSCs collectively obligating them to provide revenue sufficient to allow KYMEA to meet all ARP obligations, including those related to power procurement, administration and potential prospective debt issuance. 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. KYMEA currently has no long-term debt outstanding.

The PSCs obligate the ARP members to set and maintain retail electric rates at levels sufficient to meet all of KYMEA's expenses. The agency is required to set rates sufficient to meet its revenue requirements, providing a de-facto unlimited step-up in the event of member default.

Rate flexibility is very strong. Neither KYMEA's rates nor the rates of the ARP members are subject to the jurisdiction of any regulatory authority. Further, the agency's wholesale rates are established by the ARP project committee and ARP members are required under the PSC to maintain retail rates sufficient to meet obligations to the agency. The board expects to review the wholesale rate at least every year as part of the annual budgeting/planning process. Payments to KYMEA by the ARP members will be made as operating expenses of the respective utility systems and paid prior to any direct system debt service.

Purchaser credit quality is strong and based on Fitch's assessment of the FPB's credit quality.

FPB is an enterprise fund of the City of Frankfort, which provides electric, water and telecommunications services throughout the city, and to portions of Franklin, Shelby and Woodford Counties. Governance is provided by a separate five-member board appointed by the mayor and approved by the city commissioners. The telecommunications division introduces heightened revenue variability and risk to the multi-utility system, but Fitch believes consolidated leverage (4.4x net adjusted debt to funds available for debt service [FADS]) and liquidity (152 days cash) are sufficient to offset the revenue risk at the telecomm business.

FPB provides electric, water and telecommunications services to a range of retail customers, many of which receive all three services. Each utility segment within FPB is budgeted and accounted for separately but no legal separations exist. The electric system customer base is predominately residential but roughly (54%) of energy sales are to industrial customers including the commonwealth and local government. FPB's cable telecommunications division accounts for a sizable 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 system product offerings of cable, broadband and telephone are subject to competitive pressures absent in the electric and water divisions, reducing revenue defensibility.

Frankfort is the capital of Kentucky, and is located north of the I-64 corridor between the larger cities of Louisville and Lexington. As the capital 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. The city's population and regional economy continues to expand as evidenced by steady employment growth and a declining unemployment rate. However, customer growth has been modest and electric demand has trended lower over the past five years. The city's population grew by about 1.3% since the 2010 census to approximately 27,679 in 2018, trailing growth throughout the commonwealth and Franklin County.

The regional economy is dominated by commonwealth and local government, accounting for nearly half of the jobs in Franklin County. A range of small manufacturers support economic activity. Unemployment throughout the county declined along with national and state trends to 3.9% in 2018 from 9.0% in 2009. Median household income throughout Franklin County was

$53,539 in 2017, 15% more than the average in the commonwealth and about 93% of the national average.

Operating Risk

Fitch expects KYMEA's operating cost burden to be low over the near term reflecting the anticipated cost of power supply pursuant to the PPAs. The PSCs provide for a combination of fixed and cost-based charges, which are based almost entirely on the costs associated with the supply of baseload power from coal facilities through the PPA's, which are expected to be cost competitive.

KYMEA's operating cost flexibility is expected to be neutral. Each of KYMEA's three PPAs provides some flexibility to adjust capacity obligations and extend tenor. The three contracts include: a 10-year arrangement with BREC providing 100 MW of firm base load capacity from the cooperative's portfolio of owned resources; a three-year contract with IPMC for 100 MW of capacity from the 500 MW Joppa Power Station, which consists of three coal-fired generating units; and an initial nomination of 90 MW of peaking capacity from Paducah Power System (PPS), which is also a 10-year agreement.

While most of the agency's capacity is mainly coal-fired, natural gas peaking capacity and the expected addition of new solar power in 2022 helps diversify the resource base and provides the basis for the neutral operating cost flexibility assessment.

Counterparty risk is still a concern although supplier credit quality has recently improved with the upgrade of BREC's rating to 'BBB-' and the revision of PPS' outlook to positive over the past few years. In addition, the risk is partially mitigated by letter of credit support and the three-year tenor of the IPMC contract. The agency's overall operating risk profile remains supportive of the rating.

Life-cycle investment needs are limited as KYMEA does not own any generating assets. KYMEA recently entered into a 20-year PPA to purchase 62.5% of the capacity/energy from Ashwood Solar I, LLC beginning in 2022. The solar contract will replace a portion of the capacity currently provided by IPMC and set to expire in 2022. Approximately 60 MW of additional capacity is expected to be needed. An integrated resource plan is currently underway to identify additional long-term resources.

Financial Profile

KYMEA's financial profile assessment largely reflects the profile of FPB. The agency has only limited financial operations to date as it only recently began supplying power to ARP members. All of KYMEA's power procurement expenses will be recovered from the ARP members on a monthly basis, with liquidity initially provided by a line of credit but supplemented by staggered payment dates and cash reserves from operations as they accumulate.

Fiscal 2019 results (ended June 30) reflect the agency's administrative costs associated with initial start-up expenses and approximately two months of revenues and expenses related to power delivery. Operating revenues totaled nearly $15.5 million, which generated operating income of about $2.5 million for the year. KYMEA repaid all outstanding draws on the initial line of credit in 2019. A one-year extension to the credit line expires in March of 2020 and is not expected to be renewed.

FPB's consolidated financial profile has improved in recent years driven by steady profitability at the telecommunications division, and rate increases at the electric and water divisions. Debt service coverage exceeded 2.2x in fiscal 2019, and coverage of full obligations has steadily improved from 1.12x in 2012 to a healthy 1.37x in 2019.

Adjusted leverage remains relatively low at 4.4x FADS, even after factoring FPB's purchased power obligations. FPB's outstanding debt totaled $37.8 million at fiscal year-end 2019. All of the outstanding debt is fixed rate and debt service requirements are relatively stable at $5.0 million-$5.6 million per year through 2021 before declining thereafter. Liquidity measured in terms of cash on hand has steadily improved since 2012 from 66 days to 152 days at year-end 2019 ($36.5 million).

KYMEA has no debt outstanding and has no plans to issue any debt over the intermediate term. The integrated resource plan currently being undertaken is not likely to lead to KYMEA building future generation capacity. However, the results of the process are not expected until sometime in 2020 and management remains open to all potential scenarios.

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ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3 - ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity.

For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

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Additional information is available on www.fitchratings.com

Applicable Criteria
Public Sector, Revenue-Supported Entities Rating Criteria (pub. 28 May 2019)
https://www.fitchratings.com/site/re/10064680
U.S. Public Power Rating Criteria (pub. 03 Apr 2019)
https://www.fitchratings.com/site/re/10066654