Fitch Affirms Ohio Valley Electric Corp's IDR at 'BBB-'; Outlook Stable

January 21, 2015 12:41 PM Eastern Standard Time

NEW YORK--(BUSINESS WIRE)--Fitch Ratings has affirmed the long-term Issuer Default Rating (IDR) of Ohio Valley Electric Corporation (OVEC) at 'BBB-'. The Rating Outlook is Stable. A complete list of rating actions is provided at the end of this release.

The ratings reflect the legal enforceability of the inter-company power agreement (ICPA) between OVEC and its sponsors. OVEC is a sponsor-owned generation company that sells electricity to its sponsors or the sponsor-appointed off-taker under a long-term ICPA. Sponsors, a consortium of regulated utilities, power cooperatives, and captive generation affiliates of utility holding companies, are severally responsible to compensate OVEC for its operating and capital costs including debt service under the ICPA expiring in 2040.

KEY RATING DRIVERS

ICPA Enforceability is Key: OVEC's credit profile is derived from the creditworthiness and the legal enforceability of the ICPA between OVEC and its sponsors. ICPA was last amended in August 2011 and expires in June 2040. The expected operating life of these plants, based on the independent engineers' assessment report, will run through 2014.

Off-takers' Ability to Recover Costs: Fitch has assumed continued ability of sponsors/off-takers to recover OVEC related costs even during the currently depressed wholesale market conditions. Currently about 60% of sponsors/off-takers can recover OVEC related costs either through a regulatory construct or through sponsors' membership charter provisions. Fitch is unaware of any discussions to renegotiate the ICPA by the remaining off-takers that may not currently have any regulatory mechanism to recover high demand charges resulting from low demand and high costs, rendering the contract out-of-the-money. Any attempt by a sponsor/off-taker to terminate the contract will be negative for OVEC's IDR.

Sponsor Credit Profile Critical: Sponsors are responsible to reimburse for all of OVEC's expenditures, including debt service and capital improvements, regardless of total electricity generated and supplied by OVEC. Over 90% of the sponsors/off-takers currently have an investment grade credit rating and Fitch relies on the ICPA feature that allows the transfer of ownership in OVEC only to an investment grade entity. Credit quality of the sponsors is the basis for Fitch to assign the 'BBB-' IDR to OVEC.

Back-dated Debt Maturities: OVEC's debt structure is heavily weighted with long-term maturities. Of $1.53 billion in outstanding debt as of Sept. 30, 2014, about $200 million or 13% will mature by 2019 - the company plans to refinance these debt maturities; and about 65% of the current outstanding debt will mature between 2025 and 2040, resulting in a large back-ended demand charge for debt service. Current plans for additional debt financing later in this decade will further exacerbate the back-ended demand charge rate.

Debt Financed Capex: OVEC plans to borrow funds to complete environmental compliance-related additions at its power generation facilities in 2018 and 2019. The management estimates that the projects will cost between $300 million and $325 million. Fitch believes that the company will have access to capital markets to borrow funds to complete the installations/modifications required under the environmental regulations. However, Fitch has concerns as to the current rate of debt amortization. New borrowings will further exacerbate these concerns of an exceptionally high demand charge in a low-electricity price environment. Fitch expects OVEC to, over time, incorporate higher amortization of long-dated debt maturities in its demand charge to avoid a large increase in the demand charge towards the end of the ICPA.

Cost Controls Critical: Fitch believes that a continued cost reduction program at OVEC to lower unit cost of generation in a stagnant-to-falling wholesale electricity price environment is critical for OVEC to be competitive for its sponsors. Fitch has assumed that the management will be able to achieve the forecasted decrease of about $40 million in annual non-fuel operating costs over the rating horizon and is reflected in Fitch's rating model.

Challenging Power Pricing Environment: Power prices have been adversely affected by low natural gas prices and stagnant electricity demand. Fitch expects a modest recovery in the electricity-pricing environment led by strengthening capacity prices. However, a majority of off-takers still enjoy regulatory protection for the recovery of their respective power-related expenses, supporting OVEC's credit profile.

Stringent New Environmental Regulations: Current and expected regulations from the Environmental Protection Agency will continue to increase pressure to retrofit coal-fired power plants with additional environmental control equipment, increasing OVEC's unit cost of generation, in Fitch's opinion. Increase in compliance costs and lower capacity utilization may render the ICPA significantly out-of-money for the off-takers and is a rating concern.

Sufficient Liquidity: Liquidity at the end of Sept. 30, 2014 included $180 million available under a $200 million revolving credit facility (RCF) maturing on Nov. 18, 2019. OVEC primarily uses its revolver to support letters of credit (LOCs) as well as for general corporate purposes. Semi-monthly settlement of accounts receivable reduces OVEC's working capital needs. Fitch has assumed that average borrowing under the RCFs will remain below the forecasted average of about $150 million.

Fitch affirms the following ratings:

-- Long-term IDR at 'BBB-'

-- Senior unsecured debt at 'BBB-';

-- Senior secured debt at 'BBB'.

The Rating Outlook is Stable and reflects recoverability of the demand charge through ICPA, dispatch of OVEC-owned power plants under Fitch's natural gas forward price curve, and available liquidity helping the company to meet its obligations over the next 18 to 24 months.

RATING SENSITIVITIES:

Positive: Rating update is unlikely given that the credit profile is constrained by the sponsors' credit ratings.

Negative: Future developments that may, individually or collectively, lead to negative rating action include:

--Any adverse amendments to ICPA;

--Severe decline in creditworthiness of sponsors;

--Compliance with existing and new environmental rules that materially limit OVEC's ability to achieve a high capacity factor and render the ICPA very expensive for the sponsors/off-takers to be able to recover these costs either through regulatory mechanisms or in wholesale power markets.

Additional information is available on www.fitchratings.com.

Applicable Criteria and Related Research:

--'Corporate Rating Methodology', dated Aug. 28, 2014.

Applicable Criteria and Related Research:

Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=749393

Additional Disclosure

Solicitation Status

http://www.fitchratings.com/gws/en/disclosure/solicitation?pr_id=974575

FOLLOWING THIS LINK: HTTP://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS. IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEBSITE 'WWW.FITCHRATINGS.COM'. PUBLISHED RATINGS, CRITERIA AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE 'CODE OF CONDUCT' SECTION OF THIS SITE. FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

Contacts

Fitch Ratings
Primary Analyst
Roshan Bains
Director
+1-212-908-0211
Fitch Ratings, Inc.
33 Whitehall Street
New York, NY 10004
or
Secondary Analyst
Glen Grabelsky
Managing Director
+1-212-908-0577
or
Committee Chairperson
Shalini Mahajan
Senior Director
+1-212-908-0351

or
Media Relations
Alyssa Castelli, +1 212-908-0540
alyssa.castelli@fitchratings.com
Elizabeth Fogerty, +1 212-908-0526
elizabeth.fogerty@fitchratings.com