Fitch Affs Choctaw Generation LP, LLLP's $295MM Lessor Notes; Outlook Revised to Negative Series 2

October 06, 2016 04:40 PM Eastern Daylight Time

SAN FRANCISCO--(BUSINESS WIRE)--Fitch Ratings has affirmed Choctaw Generation Limited Partnership, LLLP's (CGLP) combined $295.2 million of pari passu lessor notes as follows:

--$235.9 million ($221.1 million outstanding) Series 1 lessor notes due December 2031 at 'B'/Stable Outlook;

--$59 million ($74.1 million outstanding) Series 2 lessor notes due December 2040 at 'B-'; Outlook revised to Negative from Stable

KEY RATING DRIVERS

The ratings reflect the project's susceptibility to underperformance and dependence on an improved operational profile following recently completed facility modifications. Series 1 lacks a debt service reserve to support potential shortfalls in operating cash, which may occur under Fitch rating case conditions. Substantial credit risk is present for the Series 2 notes if deferred payments extend the notes' maturity beyond the purchase power agreement (PPA) term and into the merchant period. The Negative Outlook on Series 2 is based on higher than expected deferment of payments to date and the potential for increased default risk if the project is unable to achieve base case performance.

Revenue Contract with Strong Counterparty - Series 1 Revenue Risk: Midrange

CGLP has a PPA with federally owned Tennessee Valley Authority (TVA; 'AAA'/Stable Outlook) for the project's full capacity and energy output through mid-2032. The Series 1 notes mature four months prior to PPA expiration.

Potential for Significant Merchant Exposure - Series 2 Revenue Risk: Weaker

Under a variety of sensitivity scenarios, a significant portion of Series 2 debt would remain unpaid prior to PPA expiration. There is a high level of uncertainty regarding CGLP's ability to operate economically in a fully merchant environment.

Operations Yet to Achieve Expected Performance - Operation Risk: Weaker

The owner-lessor, a subsidiary of Southern Company (Southern), funded substantial modifications to improve plant performance. The operator, also a Southern subsidiary, is considered strong but the facility has not yet achieved expected operating performance following completion of modifications.

Adequate Mine-mouth Coal Supply - Supply Risk: Weaker

CGLP's mine-mouth location and a reputable fuel supplier reduce supply risk. However, early termination or expiration of the supply agreement in 2032 with potentially less favorable pricing could lead to inadequate fuel cost recovery.

Debt Structure Lacks Typical Support Features - Debt Structure: Weaker

Both series lack a dedicated debt service reserve, relying instead on draws from other project accounts to fund Series 1 payment shortfalls. The ability to defer Series 2 target interest and principal payments introduces the risk of a high outstanding balance to be repaid after the PPA expires.

Projected Financial Profile

Under Fitch's rating case operational assumptions, Series 1 will be close to 1.0x for most years from 2021 through maturity in 2031. In the absence of a debt service reserve, the project will need to access funds from subordinate accounts if available, or will require an equity injection to avoid payment default. This profile suggests that material default risk is present and repayment is highly sensitive to moderate underperformance. The structural subordination on Series 2 notes yields weaker credit metrics. Payment deferrals under rating case conditions cause the outstanding balance to balloon from $59 million to $125 million in 2031. Beyond 2031, there is a high degree of uncertainty regarding project economics under fully merchant conditions.

Peer Comparison

Pennsylvania Economic Development Financing Authority (Colver; 'BB'/Stable Outlook) and CGLP face performance challenges typical of coal facilities, although Colver has a longer history of established operating performance with a strong cash balance to support debt service under various stress scenarios through its remaining debt term. CGLP's lower ratings are a result of the project experiencing variability in plant performance, high sensitivity to underperformance, and lack of liquidity reserves.

RATING SENSITIVITIES

Positive: Stable operations with coverages exceeding base case projections could result in a positive rating action.

Negative: Operating performance below rating-case projections will erode limited financial cushion and lead to negative rating action.

Negative: If the projected Series 2 outstanding balance continues to increase and is not expected to repay within the PPA period, the notes could be downgraded.

TRANSACTION SUMMARY

In December 2002, SE Choctaw purchased the 440MW lignite-fired Red Hills Generation Facility from CGLP. Immediately following the acquisition, the owner leased the facility back to CGLP under a 45-year lease, expiring Dec. 20, 2047. Lessor notes were issued in accordance with the lease, but steady declines in performance prompted a restructuring of the original lessor notes. The notes were restructured to reduce interest rates, extend the debt term, and introduce a payment-in-kind (PIK) feature to Series 2. As part of the lease restructuring, the owner-lessor agreed to make approximately $60 million in equity investments for needed repairs and maintenance and to implement various modifications to improve the performance of the facility. The restructuring also included a new operator and new refined coal-purchase agreement. Along with the lease restructuring, the ownership interest in lessee CGLP was sold to two indirect wholly owned subsidiaries of PurEnergy I, LLC.

SUMMARY OF CREDIT

Upgrades completed at the end of 2015 have yet to demonstrate performance in line with expectations. The equivalent availability factor and capacity factor, at 91.5% and 75.2%, respectively, are below rating case expectations of 94% and 86%. The operator expects performance to improve, as outstanding issues were recently resolved during the spring outage, and has not changed its long-term expectation for operations.

Although operating performance has fallen short of expectations so far in 2016, the capacity factor has increased significantly from 2014, when ongoing plant modifications required relatively long plant outages. CGLP is expected to incur reduced downtime moving forward to mainly address maintenance needs. However, the project has depleted the allowable PPA outage hours and any additional downtime from 2016 to 2017 will count against the project's availability, directly impacting PPA revenues. The allowable outage hours reset in five-year cycles with the next cycle beginning in 2018. The six-month debt service coverage ratio (DSCR) based on the June 2016 payment reached 1.54x, compared with 2015's annual DSCR of 1.21x. Series 2 payments are being deferred through a mandatory PIK feature into 2017.

Uncertainty remains if the project will be able to achieve base case forecasts without additional capital expenditures or equity support. CGLP is continuing to explore further reliability improvements to enhance performance with on-going discussions involving both sponsors and noteholders. The lack of any dedicated debt service reserve fund heightens the repayment vulnerability of the Series 1 notes to shortfalls in performance. CGLP is additionally behind on the funding schedule for its Series 2 retained cash flow account for the upcoming payment in December 2017. This heightens the risk of the Series 2 notes not being repaid within the PPA maturity. Continuing funding and operational shortfalls will substantially increase the risk of eventual default on Series 2 with the potential for negative rating action if the deferred balance increases and repayment is likely to extend into the merchant period.

SECURITY

CGLP is structured as a leveraged lease transaction and the Series 1 and 2 notes are pass-through trust certificates secured by the project's rent payments. Although Series 2 is structurally subordinated in the payment waterfall, the two series of notes are pari passu.

Additional information is available on www.fitchratings.com

Applicable Criteria

Rating Criteria for Infrastructure and Project Finance (pub. 08 Jul 2016)

https://www.fitchratings.com/site/re/882594

Rating Criteria for Thermal Power Projects (pub. 28 Jun 2016)

https://www.fitchratings.com/site/re/883254

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=1012774

Solicitation Status

https://www.fitchratings.com/gws/en/disclosure/solicitation?pr_id=1012774

Endorsement Policy

https://www.fitchratings.com/jsp/creditdesk/PolicyRegulation.faces?context=2&detail=31

verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third- party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

Contacts

Fitch Ratings
Primary Analyst
Justin Wu
Associate Director
+1-415-732-5612
Fitch Ratings, Inc.
650 California Street
San Francisco, CA 94108
or
Secondary Analyst
Andrew Joynt
Director
+1-212-908-0594
or
Committee Chairperson
Gregory Remec
Senior Director
+1-312-606-2339
or
Media Relations
Sandro Scenga, +1-212-908-0278
sandro.scenga@fitchratings.com