FitchRatings

Fitch Affirms Central Iowa Power Cooperative's IDR at 'A'; Outlook Stable

Fitch Ratings - Austin - 17 January 2020:

Fitch Ratings has affirmed Central Iowa Power Cooperative's (CIPCO) Issuer Default Rating (IDR) at 'A'.

The Rating Outlook is Stable.

ANALYTICAL CONCLUSION

The affirmation reflects CIPCO's strong revenue defensibility and Fitch's expectation that CIPCO's leverage ratio will remain below 8.0x as the cooperative implements an expanded capital improvement plan aimed at a transitioning power supply and escalating transmission investments. Fitch expects CIPCO will continue to provide a low cost and diversified power supply following the planned closure of its nuclear facility, Duane Arnold Energy Center (DAEC), in late 2020. The 'A' rating also considers the aggregate credit quality of CIPCO's members, which generally exhibit strong economic metrics and midrange financial performance.

CREDIT PROFILE

CIPCO is Iowa's largest cooperative energy provider, supplying power to a membership of 12 rural electric cooperatives and one association of municipal utilities. The members, in turn, provide power through a service territory that spans 300 miles diagonally across central and southern Iowa and encompasses 58 of Iowa's 99 counties. The members serve over 125,000 retail customers and a population of approximately 300,000 residents.

A 13-member board of directors governs CIPCO and is comprised of one appointed board member from each of the member systems. CIPCO's board members also provide active oversight by approving CIPCO's 20-year financial forecast and its annual operating and capital budgets, which consist mainly of generation and transmission construction workplans.

KEY RATING DRIVERS

Revenue Defensibility:: 'a'

LONG-TERM POWER CONTRACTS; STRONG MEMBER CREDIT QUALITY

CIPCO's revenue defensibility assessment reflects the very strong revenue source characteristics of its long-term take-and-pay, all-requirements contracts with 12 rural electric distribution cooperatives (RECs) and South Iowa Municipal Electric Cooperative Association (SIMECA). Aggregate member credit quality is assessed at midrange reflecting member service territory economic metrics that are in line with, or outperform national levels. Members also exhibited adequate financial performance characterized by high leverage and mixed liquidity metrics.

Although CIPCO members maintain autonomous rate-setting ability, member retail rates generally remain higher than neighboring utilities due to the rural nature of the service territory. Some customer concentration exists among certain CIPCO members.

Operating Risk:: 'a'

LOW COST POWER; TRANISITIONING POWER SUPPLY

CIPCO operating risk assessment of strong is based on the utility's history of providing a consistently low cost and diversified power supply to its members. However, CIPCO's nuclear facility, DAEC, which accounts for approximately a quarter of CIPCO's owned capacity, will terminate operations in late 2020 ahead of its scheduled operating license expiration in 2034. Since the announcement of DAEC's closure in July 2018, CIPCO signed a 100 MW solar purchase contract and a previously signed 100 MW wind purchase contract became operational in December 2018. CIPCO plans to add approximately 55 MW of natural gas-fired capacity, which together with wind the wind and solar generation, will help to replace the nuclear power supply.

Planned capex during the five years ending in 2023 are substantial at $306.8 million and will focus on the planned natural gas-fired facility and transmission investments.

Financial Profile:: 'a'

STRONG FINANCIAL PROFILE

CIPCO's financial profile assessment of strong is based on the utility's continued trend of stable financial performance and Fitch's expectation that CIPCO will maintain strong financial metrics following its substantial planned generation and transmission investments. The cooperative's leverage ratio is expected to rise to 6.7x in Fitch's base case within the next five years as CIPCO plans to primarily debt fund its capital investments.

A sizable portion of CIPCO's unrestricted assets are held in riskier asset classes, which creates uncertainty in regards to investment returns and market volatility. CIPCO's strong liquidity position is somewhat tempered by this increased risk.

Asymmetric Additional Risk Considerations

No asymmetric additional risk considerations affected this rating determination.

RATING SENSITIVITIES

SUSTAINED FINANCIAL METRICS: Failure to maintain a leverage ratio below 8.0x following Central Iowa Power Cooperative's substantial planned generation and transmission investments would likely lead to negative rating pressure.

FINANCIAL MARKET VOLATILITY: A sustained weakness in financial markets and a resulting sizable decrease in the value of CIPCO's unrestricted assets, which drives the cooperative's leverage ratio higher, could lead to downward rating pressure.

SECURITY

CIPCO's IDR reflects Fitch's assessment of the cooperative's relative vulnerability to default on its financial obligations.

Revenue Defensibility

CIPCO's revenue source characteristics are assessed at very strong based on the cooperative's take-and-pay all-requirements contracts with 12 RECs and SIMECA. The RECs and SIMECA have long-term contracts extending through 2045 and 2053, respectively.

AUTONOMOUS RATE-SETTING ABILITY

Fitch assesses CIPCO's rate flexibility as very strong, reflecting the cooperative's autonomous rate-setting ability. The board approves rates annually, but management can adjust the rates throughout the year in order to ensure recovery of costs and that the cooperative's financial obligations are met. Rates can be adjusted based on a demand charge, which covers fixed and operating costs, or the energy charge, which is primarily related to fuel costs.

Fitch assesses CIPCO's Purchaser Credit Quality (PCQ) as midrange based on the aggregate credit quality of its members and a calculated purchaser credit index of 2.5x. The members exhibit stable financial metrics and generally above-average service territory metrics. Member service territories range from heavily rural to somewhat metropolitan.

Fitch evaluated the credit quality of CIPCO's three largest members, which represent nearly half of the cooperative's revenues. Overall, these members exhibited strong to midrange credit quality, characterized by median household income levels that remain in line with the national level and unemployment that remains well below the national level.

The customer base is relatively diverse, save for a handful of larger retail users that include a crude oil pumping station, three natural gas compression stations, and two ethanol producers. Residential revenues accounted for at least half of each of the top three member revenues, but four of CIPCO's top 10 load customers are served by one CIPCO member exposing it to customer concentration. Sales to these large customers are tracked separately by CIPCO as contract sales. The contract sales present some volatility risk with respect to CIPCO's power supply requirements; however, each customer is served pursuant to staggered multiyear contracts that include clauses to collect fluctuating energy costs on a monthly basis, and, in some cases, provide for minimum volumetric thresholds.

Each of CIPCO's members maintains autonomous rate-setting ability. However, the retail rates of CIPCO member cooperatives vary widely with some member rates well above the state average, which is partially attributable to the rural nature of member service territories. Retail rates at the top three utilities ranged from 11% to 25% above the state average retail rate and affordability, as measured by total residential electric cost of service divided by median household income, ranged from 2.1% to 3.2%.

CIPCO wholesale rates are expected to remain at or below the 2018 wholesale rate through the five-year forecast. Rate changes will depend on CIPCO's ability to access low-cost power through their generation portfolio or purchased power contracts, and any rate increases will likely be driven by the proposed layering in of additional natural gas-fired generation and recovery for the amortization costs related to the DAEC facility.

The financial profiles of the three largest members span from midrange to strong, characterized by midrange to high leverage levels and adequate cash flow and liquidity. Fitch believes the member financial profiles, in conjunction with each member utility's ability to absorb rate increases, support the midrange PCQ assessment.

Operating Risk

Fitch assesses CIPCO's operating cost burden as strong reflecting the utility's consistently low operating cost burden, which has averaged approximately 5.7 cents/KWh during the past five years. CIPCO has historically benefited from a relatively low-cost power supply derived from primarily coal and nuclear generation.

Fitch assesses CIPCO's operating cost flexibility as neutral reflecting CIPCO's diversified power supply, which offers a balance between fuel types, in addition to a mix of both owned resources and long-term PPAs. CIPCO's 2019 owned resource portfolio included nuclear (25%), coal (41%), natural gas/diesel (16%), in addition to member-owned generation (18%). Long-term PPAs, which accounted for approximately 37% of CIPCO's installed capacity, provides additional resource diversity including wind, solar, landfill, and hydro resources. Fitch expects CIPCO's resource portfolio to remain diversified despite the planned closure of CIPCO's nuclear facility, DAEC, in late 2020.

CIPCO underwent a full review of their integrated resource plan following the announcement of the DAEC closure to ensure the cooperative provided an adequate and diversified power supply, minimized rate impacts to members, and ensured sufficient cash flows to service DAEC debt maturing through 2034. CIPCO received approval from both its board and the RUS to establish a regulatory asset for the DAEC early closure, which will allow the utility to amortize the unrecovered costs through 2028 and minimize the near term rate impact for its members.

CIPCO's energy supply strategy for the next five years focuses on further diversifying its energy resources by layering in long-term wind and solar contracts and adding gas-fired generation capacity. Management will purchase 100% of the energy and capacity output from the 100 MW Wapello Solar facility, which is expected to be completed in December 2020. Additionally, CIPCO is currently replacing the steam generation units at its Summit Lake Generating Station (Summit Lake) with natural gas-fired reciprocating engines (55 MW) and the facility is expected to become operational in 2021.

Management also plans to add up to 200 MW of additional wind and solar generation by 2023, although no additional PPAs have been signed yet. Fitch views CIPCO's strategy favorably, as it further diversifies its energy supply and provides some flexibility by allowing the utility to slowly add generation capacity to accommodate the cooperative's forecasted load growth. Fitch notes that CIPCO expects regulatory capacity purchases will account for more than one-third of CIPCO's reserve requirement in 2021, leading to some market price exposure. The planned addition of the PPAs and the expectation of continued lower energy market prices mitigate longer term concerns.

SUBSTANTIAL CAPITAL INVESTMENTS

Fitch assesses CIPCO's capital planning and management as very strong reflecting the utility's average age of 12 years. Future capital expenditures will be substantial and are expected to total $306.8 million through 2023. Expenditures will primarily focus on the Summit Lake facility repowering project and planned transmission investments to improve system reliability. Planned capital investments will primarily be debt financed and capex-to-depreciation is expected to average 229% over the next five years.

Financial Profile

CIPCO continues to demonstrate strong financial performance. The utility's leverage ratio, as measured by net adjusted debt to adjusted funds available for debt service, was 4.6x in fiscal 2018. Operating cash flow remains very healthy with coverage of full obligations averaging 1.5x during the past five years. The cooperative conservatively targets and sets member rates on, the greater of a 1.20x debt service coverage (DSC) ratio or a net operating margin of 5%.

Liquidity, as measured by unrestricted funds on hand, is also robust at 230 days. However, approximately 81% of these unrestricted assets are invested in equities, real estate investment trusts and hedge funds, which creates some uncertainty in regards to the amount of, and return on, investments. Fitch views CIPCO's investment strategy as somewhat risky, given the impact unpredictable income can have on financial metrics including debt service coverage, leverage and liquidity ratios. The cooperative's margin policy that excludes investment income partially mitigates this risk.

CIPCO maintains two lines of credit totaling $145 million. The cooperative uses these lines primarily for working capital purposes but may also use them to fund capital expenditures prior to long-term financing.

CIPCO took a one-time impairment charge in 2018 of $15.1 million to reduce the undepreciated DAEC asset down to the remaining balance of the plant debt. The impairment resulted in a 2018 net margin of $1.5 million, down from $15.9 million in 2017 and equity to capitalization declined to 27% in 2018 from 30% in 2017. CIPCO management intends to maintain equity to capitalization in a range of 25% to 30% through 2023.

Fitch Analytical Stress Test (FAST) - Base and Rating Cases

Fitch used management's projections for energy sales, revenues, and expenses, in addition to CIPCO's planned capital expenditures and debt issuances, to establish a base case in Fitch's scenario analysis. Fitch expects CIPCO's total debt to increase to approximately $485 million in 2023 from approximately $398 million in

2018 to pay for the construction of the natural gas generation facility and transmission investments. The increased debt levels take into consideration CIPCO's application of its cushion of credit funds to prepay debt owed to the RUS, which was permitted following the passage of the Farm Bill in 2018. CIPCO prepaid approximately $37 million in debt in 2019 and plans to use the remaining funds in the cushion of credit to prepay an additional $6 million in debt in 2020.

Factoring the incremental debt, the cooperative's leverage ratio is expected to increase to 6.7x in fiscal 2020 and remain in the range of 6.5x to 6.7x during fiscals 2021 to 2023. Coverage of full obligations is expected to decline over the next five years as debt service costs increase, but should still remain healthy, ranging from 1.3x to 1.6x.

Fitch's rating case applies a moderate stress to management's forecasted energy sales using the FAST model demand stress outputs, which are calculated based on CIPCO's historical demand volatility. Under the rating case, Fitch expects leverage ratio would peak at 7.5x as debt levels rise and operating margins tighten. Fitch believes CIPCO has ample flexibility to respond to deteriorating financial metrics through timely rate adjustments, reducing market power purchases, or delaying planned capital investments.

Debt Profile

CIPCO's debt profile is neutral to the rating. Total debt outstanding on Dec. 31, 2018 was approximately $397.8 million, all long term, with the exception of current debt maturities. The majority of CIPCO's long-term debt has been funded through the RUS loan program at conservatively fixed interest rates. The remaining long-term debt includes CoBank notes, a small amount of notes issued by the CFC, and outstanding borrowings on CIPCO's credit facility with CoBank.

Asymmetric Additional Risk Considerations

No asymmetric additional risk considerations were applied in this rating determination.

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

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.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR

Central Iowa Power Cooperative (IA)	LT IDR A ○ Affirmed		A ○
Central Iowa Power Cooperative (IA) /Issuer Default Rating - Electric/1 LT	LT A ○ Affirmed		A ○

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Applicable Criteria

U.S. Public Power Rating Criteria (pub. 03 Apr 2019)
Public Sector, Revenue-Supported Entities Rating Criteria (pub. 07 Nov 2019)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
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