FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Los Angeles, CA's Water Rev Bonds 'AA'; Outlook Negative

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Fitch Ratings - Austin - 16 Feb 2022: Fitch Ratings has assigned a 'AA' rating to the following water system revenue debt issued by the Los Angeles Department of Water and Power, CA (LADWP or the department):

--Approximately $300 million water system revenue bonds series 2022A (SIFMA index rate);

--Approximately $416 million water system revenue bonds series 2022B (fixed rate).

The bonds are scheduled to sell via negotiation the week of Feb. 28, 2022. The bond proceeds will be used to pay costs of capital improvements to LADWP's water system (the system); refund certain maturities of the system's outstanding series 2012A, 2012B, 2012C, and series 2016A bonds, and portions of outstanding state loans; and pay certain costs of issuance.

Additionally, Fitch has affirmed the 'AA' rating on the following bonds issued by LADWP:

--$5.3 billion water system revenue bonds (prior to refunding);

--$182.3 million in bank bonds corresponding to the variable rate series 2001B-1, B-2, B-3 and B-4 bonds;

--$200 million in bank bonds corresponding to the variable rate series 2019 A-1 and A-2 bonds;

--$200 million in bank bonds corresponding to the variable rate series 2021 A-1 and A-2 bonds.

Fitch has also assessed the system's Standalone Credit Profile (SCP) at 'aa'. The SCP represents the credit profile of the system on a stand-alone basis irrespective of its relationship with, and the credit quality of, the city of Los Angeles (Issuer Default Rating [IDR] AA/Stable).

The Rating Outlook is Negative.

ANALYTICAL CONCLUSION

The 'AA' bond and bank bond ratings and 'aa' SCP reflect LADWP's very strong revenue defensibility, supported by a large and diverse retail customer base in the service territory of the city of Los Angeles (the city) and a rate structure that can decouple demand from revenue generation. Stability in the 'aa' revenue defensibility assessment is largely dependent on continued implementation of the automatic pass-through adjustments and recovery of targeted base rate revenue as allowed under the system's dynamic rate structure. The system's very low operating risk is similarly assessed at 'aa' based on a very low, albeit increasing, operating cost burden, stable life cycle ratio and healthy levels of capex.

The system's historically elevated leverage ratio, measured as net adjusted debt to adjusted funds available for debt service (FADS), pressures the rating, but has recently shown improvement. As of fiscal 2020, the leverage ratio was 8.4x and further improved to 8.3x in fiscal 2021, which is the lowest ratio in the past five fiscal years. Between fiscal 2016 and fiscal 2019, leverage typically measured closer to 10.0x. The Negative Outlook is based on Fitch's expectation that leverage could remain between 8.0x and 9.0x over the intermediate term, which may be more consistent with a 'AA-' rating.

The current sale will fund capital projects in the current capital improvement program (CIP) along with refunding existing outstanding bonds and loans. The index mode bonds will not be supported by any liquidity and or credit facility.

Heightened Concern over Management and Governance Practices

Fitch has heightened concerns regarding management and governance practices at LADWP in light of recently publicized events. In December 2021 the Department of Justice announced plea agreements with two former members of LADWP's executive team and one attorney hired by the Los Angeles City Attorney's office to represent LADWP's legal interests. The attorney charged with bribery also appears to have had serious conflicts of interest in regards to his representation of LADWP. LADWP's former general manager plead guilty to bribery charges in January 2022 and a second former executive (chief cyber risk officer) plead guilty to making false statements to federal investigators in early February 2022.

Also, in early February 2022, a former senior official at the city attorney's office who was involved in LADWP's billing system litigation agreed to plead guilty to a federal charge of aiding and abetting extortion. Sentencing for all is pending.

The federal investigation is ongoing, and Fitch does not have any visibility into the scope and extent of the investigation and whether or not additional criminal charges will occur.

In response to the criminal schemes exposed, the LADWP Board of Commissioners (the board) called for a series of actions and reforms in a special board session in December 2021. The reforms target legal representation conflicts of interest, including petitioning the city to permit LADWP to hire its own independent counsel, hiring of an Inspector General at LADWP, reviewing ratepayer funds spent on billing system issues, establishing a formal process for internal reporting of employee concerns to the board, and reform of LADWP's procurement practices.

The rating further reflects actions being taken by the board to understand and prevent repetition of the crimes committed by former employees. Fitch expects LADWP will face increased workflow burden on staff as the federal investigation and related LADWP reviews and reforms proceed. However, fundamental factors supporting credit quality are not expected to be disrupted, including the upcoming rate package for which LADWP expects to have a schedule for proposing the next rate package to the board prior to June 30, 2022.

CREDIT PROFILE

The city is the commercial and cultural center of a very large, diverse economy. LADWP provides retail water service to about 692,000 customers, serving an estimated population of four million. The service area mostly overlaps with the city limits, covering about 470 square miles. LADWP's water supply is derived from four sources: 1) deliveries via the city's Los Angeles Aqueduct, 2) local groundwater, 3) recycled water and 4) imported water purchased from Metropolitan Water District of Southern California (MWD; water revenue bonds rated AA+/Stable), which typically provides the remaining water supply not available from the first three sources.

Fitch considers the system to be a related entity to the city for rating purposes given the city's oversight of the system, including the authority to establish rates and the city's reporting of the department as an enterprise fund of the city. The credit quality of the city does not currently constrain the bond rating. However, as a result of being a related entity, the rating could become constrained by a material decline in the general credit quality of the city.

KEY RATING DRIVERS

Revenue Defensibility 'aa'

Diverse and Favorable Service Area, Unique Rate Structure

The system's very strong revenue defensibility is supported by a service area with a strong and diverse economy. A rate structure implemented in fiscal 2016 includes automatic pass-through adjustments and a mechanism that largely decouples demand from revenue generation, resulting in stable performance. The final year of the prior rate package was fiscal 2020. The department expects to propose the timing of its next rate package to the board by June 30, 2022.

Operating Risks 'aa'

Very Low Operating Risk Profile, Solid Operations Work to Expand Local Supply

The system's operating risk assessment reflects a very low operating cost burden and sustained capital investment that averaged about 360% of annual depreciation costs for the five fiscal years ending in 2021. Capital projects are focused on infrastructure rehab and renewal (R&R) and expanding the recycled water program to reduce dependence on purchased water supplied by MWD.

Financial Profile 'aa'

Sustained Elevated Leverage, Stable Financial Performance

LADWP's financial profile remains very strong, but the Negative Outlook reflects Fitch's expectation that leverage could remain between 8.0x and 9.0x over the intermediate term, which is considered elevated for the rating. The liquidity profile is considered neutral to the assessment.

Asymmetric Additive Risk Considerations

No asymmetric additive risk considerations affected this rating determination.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to a positive rating action/upgrade/rating stabilization:

--Actual and projected leverage approximating 8.0x on a sustained basis in Fitch's base and stress case, assuming stability in the revenue defensibility and operating risk assessment, could stabilize the Outlook.

Factors that could, individually or collectively, lead to a negative rating action/downgrade:

--Sustained actual and projected leverage that approaches 9.0x in Fitch's base and stress case, assuming stability in the revenue defensibility and operating risk assessments;

--A sustained increase in the operating cost burden to over $6,500 per million gallons (mg) of water produced would likely weaken the operating risk assessment and likely adjust leverage expectations;

--Sustained delays in increasing base charges and/or implementing pass-through adjustments could lead to weaker rate flexibility and revenue defensibility assessments.

Best/Worst Case Rating Scenario

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

SECURITY

The bonds are special obligations of LADWP payable solely from water system revenues.

Revenue Defensibility

LADWP's revenue defensibility is assessed at 'aa' and is considered very strong. The system derives all of its revenue through its monopolistic business line providing retail water treatment and distribution. Service area characteristics are considered favorable, with income levels that are comparable with the national level, but an unemployment rate that historically tracked about 10%-20% higher than the national rate. As of December 2021, unemployment rates were about 70% higher than the national rate in light of the ongoing economic contraction, but Fitch expects employment levels will gradually return to those seen in recent years.

The customer base is growing modestly at a 0.4% five-year CAGR, as of fiscal 2021, and presents no concentration concerns as the top-10 customers regularly account for 7% or less of annual operating revenues. Despite a modestly growing customer base in recent years, demand per capita has dropped due in part to fixed conservation measures, such as water-efficient appliances and fixtures, but also due to conservation measures adopted during the recent statewide drought, such as less and more infrequent home irrigation.

Adaptive Rate Structure, Affordability Concerns Remain

The system is able to maintain solid financial performance amid generally declining demand primarily due to its rate structure that includes automatic pass-through adjustments to recoup costs. Moreover, a base rate revenue target decouples revenue generation from demand and is expected to recover any targeted revenue shortfall in the following year or, conversely, return any overage to customers. The system's unique rate structure includes seven cost-adjustment factors, four of which can be adjusted semi-annually, while the others are adjusted annually.

The adjusters recoup costs associated with purchased water, operations and maintenance, infrastructure costs (such as projected capital spending), bad debt and legal expenses, among other items. A base rate revenue target is established as part of the annual budget process. Any shortfall in the revenue target would be expected to be recouped in the subsequent year's proposed base rate revenue target adjustment. A failure to implement the pass-through adjusters or adjust base rate revenue targets would likely preclude stabilization in the Outlook.

Based on 7,500 gallons, the monthly residential bill in fiscal 2021 was estimated at about $74, which Fitch considers affordable for about only two-thirds of the population. However, rates continue to be competitive compared with other large providers in the state, and much of the pass-through adjustments affect higher-usage customers, thereby mitigating some of the effect on economically vulnerable customers. The prior rate package ran through June 30, 2020. The next rate study and proposal was delayed as a result of the pandemic. Management hopes to present the timing of both the water and electric rate packages to the board by June 30, 2022.

Operating Risks

The system's 'aa' operating risk assessment is supported by its very low operating cost burden and healthy capital spending. The operating cost burden has generally trended upward from about $5,350 per mg in fiscal 2017 to $6,300 in fiscal 2021, but remains supportive of the assessment. Purchased water costs had averaged 19% of total operating expenses in fiscals 2017-2020, but increased to 28% in fiscal 2021 in light of planned increased MWD purchases to allow time for groundwater replenishment. The dry year also drove demand higher in fiscal 2021, contributing to higher purchased water costs.

The system's life cycle ratio is low and has been stable between 26% and 27% annually over the last five fiscal years (2017-2021), supported by healthy and consistent capex. Capex/depreciation averaged 364% over the last five fiscal years ending in 2021. The capital improvement plan (CIP) calls for sustained capital investment that will continue to significantly outpace annual depreciation costs.

LADWP's five-year CIP spanning fiscals 2022 to 2026 totals $4.96 billion. Planned spending over the last several CIPs has fluctuated between around $4.5 billion to $5.5 billion. The variability in planned spending is attributed to changes in project schedules and continued cost refinements as projects move from planning to design to construction phases. As the CIP is not dictated by regulatory actions, changes in the project scheduling are not seen as an operational risk. The CIP remains focused on infrastructure R&R, addressing water quality and expanding the local water supply. The system continues to target at least 35% pay-go financing, which is maintained in the current CIP. Other funding sources include revenue bond sales, including the current sale, state grants and potential rate reduction (securitization) bonds.

Planned projects include completion of a treatment facility to provide remediation treatment to local groundwater wells that will increase capacity for groundwater replenishment, construction of new and rehabilitation of existing reservoirs to increase storage capacity, and construction of an ultraviolet treatment facility to meet water quality regulations.

Longer term, LADWP is working to increase local supply via recycled water as outlined in the mayor's Green New Deal. The Green New Deal aims to recycle all wastewater by 2035. Three of the four city-owned wastewater plants already provide for reuse, but the largest plant, the Hyperion Water Reclamation Plant (HWRF), would require significant investment. Outfitting the HWRF with 100% reuse would increase the local water supply by an estimated 243,000 acre-feet, equating to one-third of projected demand in 2035.

Many projects will be completed in conjunction with the city's sewer system, run out of the Bureau of Sanitation (SAN). (Fitch rates the city's sewer revenue bonds AA/Stable.) SAN was recently awarded a $224 million Water Infrastructure Finance and Innovation Act (WIFIA) loan to pay certain project costs related to increasing reuse at Hyperion. While LADWP is not responsible for repayment of the WIFIA loan, it benefits from the low-interest funding source since LADWP pays SAN an allocable share of capital costs for projects that will also benefit LADWP. The scale of these longer-term projects suggests projected annual capex will remain well over annual depreciation costs for the foreseeable future.

Financial Profile

The system's financial profile is considered very strong. The benefit of the system's unique rate structure is reflected in its stable financial profile, albeit with an elevated leverage ratio, which pressures the rating. LADWP's historical leverage over the past five fiscal years (2017-2021) has ranged from a high of 10.8x in fiscal 2017 to a low of 8.3x most recently in fiscal 2021.

LADWP's liquidity profile is considered neutral to the assessment. Fitch-calculated all-in debt service coverage is stable, between 1.6x and 1.8x over the prior five fiscal years. Coverage of full obligations (COFO), which accounts for the system's fixed-service costs related to purchased water, is also stable between 1.5x and 1.7x. The system's liquidity cushion is sound at 434 days as of fiscal 2021, which includes additional liquidity provided by a $300 million revolving credit agreement that can be drawn upon by either LADWP's water system or power system, with an option that allows the revolver to be increased to $500 million with 30 days' notice.

Fitch Analytical Stress Test (FAST)

The FAST considers the potential trend of key ratios in a base case and a stress case. The base case reflects Fitch's expectation of both historical financial results and projected performance while the stress case is designed to impose capital costs 10% above expected base case levels and evaluate potential variability in projected key ratios. As there is a cost adjustment within the system's rate structure meant to recover capital spending, which is adjusted annually, Fitch would expect any increase in required capital spending to be recovered in the subsequent year. As such, the stress case produces results largely in-line with the base case.

The system's financial plan through fiscal 2026 informs Fitch's base case as assumptions were deemed generally reasonable. The system's CIP and planned debt issuances (including potential securitization bonds in the future) are also included. Results from the base case indicate leverage peaking at 8.6x in fiscal 2023 and declining to 8.3x by fiscal 2026. In the stress case, leverage peaks at 8.7x in fiscal 2023 and declines to 8.4x by fiscal 2026. The liquidity profile is expected to remain neutral to the assessment through the five-year horizon as COFO remains at 1.7x of higher and days cash remains solid under both scenarios.

Additional Notes

For additional information see Fitch's "Los Angeles Department of Water & Power, California" dated May 29, 2020, and available on www.fitchratings.com.

Sources of Information

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

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

Los Angeles Department of Water & Power (CA) [Water] has an ESG Relevance Score of '4' for Governance Structure due to the ongoing federal investigation into criminal schemes tied to LADWP and the city attorney's office and recently announced efforts to restructure the internal controls that enabled the schemes, which has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means 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
Los Angeles Department of Water & Power (CA) [Water]				
Los Angeles Department of Water & Power (CA) /Water Revenues/1 LT	LT	AA Rating Outlook Negative	Affirmed	AA Rating Outlook Negative

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

U.S. Water and Sewer Rating Criteria (pub. 18 Mar 2021) (including rating assumption sensitivity)

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 01 Sep 2021) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Los Angeles Department of Water & Power (CA)	EU Endorsed, UK Endorsed

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