FitchRatings

RATING ACTION COMMENTARY

Fitch Rates LADWP, CA's Power Rev Bonds 'AA-'; Outlook Stable

Thu 10 Mar, 2022 - 2:50 PM ET

Fitch Ratings - Austin - 10 Mar 2022: Fitch Ratings has assigned a 'AA-' rating to the following bonds issued by the Los Angeles Department of Water and Power, CA (LADWP):

--Approximately $360 million power system revenue bonds, series 2022B.

The Rating Outlook is Stable.

Bond proceeds will be used to fund capital improvements and pay the costs of issuance. Bonds are expected to price on March 30, 2022 in a negotiated sale.

Analytical Conclusion

The 'AA-' rating reflects LADWP's very strong financial profile in the context of a large and diverse retail customer base, increased operating costs and a large capital plan. The rating analysis does not incorporate full potential costs related to the city's recently adopted target of 100% carbon free energy by 2035 since the utility's roadmap to reach the target and the full costs are not yet determined. LADWP expects to develop a strategic long-term resource plan in 2022 that will identify specific steps and investments to meet the 2035 target while balancing cost, reliability and feasibility considerations.

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 senior management 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. In early 2022, the former LADWP general manager plead guilty to bribery charges and the former chief cyber risk officer plead guilty to making false statements to federal investigators.

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 in the recently released plea agreements, the LADWP Board of Commissioners 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 affirmation 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.

SECURITY

Power system revenues.

KEY RATING DRIVERS

Revenue Defensibility: 'aa'

Strong Service Area; Resilient Rate Structure

LADWP's approximately $4.3 billion of revenue exhibits very strong revenue characteristics and is provided almost entirely from the sale of retail electric service to a defined customer base within the city of Los Angeles. Rate flexibility is very strong, with the department's local control over rate setting subject only to approval by the city council. Rates are below the state average and exhibit high affordability when annual energy costs are compared to median income levels.

The assessment and rating further incorporate the flexibility of the rate structure, which protects revenues through automatic adjustment features, and management's intent to adopt a multiyear base rate package in fiscal 2023 (which begins July 1, 2022).

Operating Risk: 'bbb'

Midrange Operating Costs; Large CIP

Operating cost burden, as measured by total operating costs divided by total kilowatt hour (kWh) sales, has increased 3.9% per year over the past four years, compared to the national trend that has remained flat over the same period. LADWP's operating cost burden of 16.3 cents/kWh in fiscal 2021 is considered midrange and could continue to increase given its pursuit of clean energy goals.

LADWP has made significant progress in the evolution of its power supply over the past decade, which should position the utility towards its 2035 carbon free energy target and the city's overall goal of reaching net zero emissions by 2050. The department's calendar 2020 power supply was 56% carbon free and 37% eligible renewable. The strategic plan will build upon the work in the LA100 plan, a five-year study conducted in collaboration with the U.S. Department of Energy. The pace and scope of conversion outlined in the upcoming strategic plan will determine the ultimate impact on costs, rates and credit quality.

The five-year CIP is substantial at $10.9 billion, compared with $5.4 billion spent on capital needs over the previous five years. However, actual capex spending is likely to be lower than projected, based on historical trends.

Financial Profile: 'aa'

Very Strong Financial Profile; Elevated Leverage for the Rating

LADWP's financial profile remains very strong. Fitch-calculated coverage of full obligations (COFO) is typically in the 1.5x-1.6x range and the liquidity cushion is robust, with over 200 days cash on hand (DCOH) since fiscal 2019.

Leverage, measured by net debt to funds available for debt service, is elevated for the rating, but has declined to 6.7x in fiscal 2021 from 8.7x in fiscal 2017, even with substantial capex and debt issuance during that time period. Fitch expects leverage should remain at or around 7.0x over the next five years. Financial outcomes beyond fiscal 2022 depend in large part on revenue decisions made during the next rate case.

Asymmetric Additional Risk Considerations

California's strict application of inverse condemnation poses an asymmetric additional risk consideration to credit quality. However, Fitch considers the likelihood of a massive wildfire event remote in LADWP's service area, and DWP continues to take steps to reduce wildfire risk. The asymmetric risk does not currently constrain the rating.

RATING SENSITIVITIES

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

--Operating cost burden declines consistently below 15 cents/kWh;

--Rapid and sustained decline in leverage comfortably below 6.0x in Fitch's base and stress cases, which could occur through higher funding of capex from ongoing revenues or a dedicated component in rates to reduce debt burden.

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

--Leverage at or above 7.5x in consecutive future fiscal years in Fitch's base and stress case scenarios with no demonstrated trend of decline;

--Political action to forego expected revenues or failure to implement the next four-year rate case, which reduces robust cash reserves and reverses the expected incremental decline in leverage;

--Prolonged slowdown in economic activity in the service area resulting in weaker revenue defensibility, evidenced by less favorable demographic characteristics and a declining customer base;

--Extraordinary wildfire liability that results in long-term dilution of LADWP's financial profile.

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.

CREDIT PROFILE

LADWP's power system is a vertically integrated retail electric utility that has the exclusive right to provide service to a large and diverse service area in the city of Los Angeles with over 1.5 million customers. LADWP owns sufficient generation, transmission and distribution assets to meet customer load demands and operates as its own balancing authority, distinct from the California Independent System Operator (CAISO).

Fitch considers the power system to be a related entity of the city of Los Angeles (IDR AA/Stable) for rating purposes, given the city's oversight of the department, including the authority to establish the rates and budget of the power system. The rating on the power system bonds is not constrained by the credit quality of the city of Los Angeles. However, as a result of being a related entity, the rating on the power system bonds could become constrained in the event of a material decline in the credit quality of the city.

DATE OF RELEVANT COMMITTEE

04 January 2022

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) [Electric] 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 rating[s] 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) [Electric]				
Los Angeles Department of Water & Power (CA) /Electric System Revenues/1 LT	LT	AA- Rating Outlook Stable	Affirmed	AA- Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

U.S. Public Power Rating Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

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

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

ADDITIONAL DISCLOSURES

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

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

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