FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Anaheim Public Utilities, CA's Electric Sys Rev Bonds at 'AA'-; Outlook Stable

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Fitch Ratings - Austin - 07 Dec 2021: Fitch Ratings has affirmed the following bonds issued on behalf of Anaheim Public Utilities (APU) at 'AA-':

--$445.7 million qualified obligation revenue and revenue refunding bonds, series 2017A, 2017B, 2020A, 2020B and 2020C issued by the Anaheim Housing and Public Improvements Authority (AHPIA);

--$105.2 million qualified obligation revenue refunding bonds, series 2014A and 2015B, issued by the California Municipal Finance Authority, CA (CMFA);

--$90.7 million qualified obligation revenue refunding bonds series 2012A, issued by the Anaheim Public Financing Authority, CA (APFA).

The electric system stand-alone credit profile (SCP) is assessed at 'aa-'. The SCP represents the credit profile of the electric system on a stand-alone basis irrespective of its relationship with and the credit quality of the city of Anaheim (Issuer Default Rating: A+/Negative).

The Rating Outlook is Stable.

ANALYTICAL CONCLUSION

The 'AA-' rating and 'aa-' SCP reflect Anaheim's continued very strong financial profile, even with tighter performance prompted by pandemic-related economic shutdowns and impact on Anaheim's tourism driven economy. The continued stability of the rating reflects the utility's very strong financial profile going into the pandemic, including prior debt reduction efforts, robust reserves in a rate stabilization account and automatic rate components that enable timely cost recovery.

Financial performance is expected to stabilize in fiscal 2022, with the reopening of the local economy and reopening of Disneyland in May 2021. Anaheim's operating cost burden has increased, similar to other southern California utilities, reflecting increased spending on cleaner generation resources and declining per capital electric sales, and is factored into the rating.

CREDIT PROFILE

Anaheim electric is a vertically integrated retail electric utility that has the exclusive right to provide service to a customer base of approximately 121,000 within the city limits. APU owns and purchases sufficient capacity and generation to meet the electrical demand of its customers and sells excess into the California Independent System Operator (CAISO) market, as available.

California legislation requires APU to implement changes to its predominately coal and natural-gas fueled power supply in favor of renewable generation to meet a 60% renewable portfolio supply by 2030 and 100% clean energy goal by 2045. APU is on schedule to meet the state requirements, but similar to other southern California municipally owned utilities, the utility will need replacement energy and/or capacity after 2027.

Located in Orange County, approximately 30 miles south of Los Angeles, the City of Anaheim (IDR A+/Negative) is the most populous city in Orange County. The city's economy is tourism-based, which experienced pandemic-related revenue declines and operating pressures.

Fitch considers the electric system a related entity of the City of Anaheim for rating purposes, given the city's oversight of the electric utility, including the authority to establish the rates and budget of the electric system.

The rating on the electric bonds is not constrained by the credit quality of the city. However, as a related entity, the rating on the electric bonds could become constrained in the event of a decline in the city's rating quality.

KEY RATING DRIVERS

Revenue Defensibility: 'aa'

Very Strong Rate Flexibility; Favorable Service Area but Tourism Related

Anaheim's revenue defensibility is supported by revenues received primarily from retail electric sales and a service area with favorable demand characteristics, including positive customer growth and demographics slightly better than the national average. Rate affordability is very strong and automatic rate adjusters capture purchased power and environmental costs.

The revenue defensibility assessment also considers asymmetric rating factor considerations related to APU's customer base, which is more heavily weighted toward commercial and industrial customer classes, and can exhibit greater variability with economic cycles, as seen during the pandemic. Residential sales account for only 27% of revenues. The customer base concentration does not currently constrain the 'aa' assessment; however, the assessment is borderline.

Operating Risk: 'bbb'

Weaker Operating Risk Assessment

Anaheim's operating cost burden increased to 15 cents per kWh in fiscals 2020 and 2021, up from between 12 and 13 cents in fiscal 2016-2018. Fitch has revised its operating risk assessment to 'bbb' from 'a' to reflect the higher operating cost burden. While the increases in fiscals 2020 and 2021 were higher as a result of lower sales during those years, operating cost burden is expected to remain over 15 cents moving forward.

The operating risk assessment also reflects APU's power supply portfolio that will become predominantly natural gas-fired and renewable after 2027, as required by the state. The declining cost of renewables and final amortization of debt related to certain thermal assets, should temper the upward trend of power costs.

Financial Profile: 'aa'

Tighter Financial Margins in 2020 Improved in 2021

The financial profile remains very strong, although operating margins declined to a low point in fiscal 2020 as a result of the pandemic. Stronger than budgeted wholesale sales and lower operating costs resulted in improved financial margins in fiscal 2021 (unaudited) and the recovery of retail electric sales in fiscal 2022 has accompanied the reopening of Disneyland in May 2021.

Leverage ended fiscal 2020 at 7.2x and improved to approximately 6.0x in fiscal 2021 (unaudited). Fitch calculated coverage of full obligations (COFO) is estimated at 1.3x and days cash on hand (DCOH) at 257 days in fiscal 2021. Leverage is expected to remain between 6x and 7x in Fitch's base and stress cases, with improvement depending on the pace of retail sales recovery following the pandemic. Based on assumed 3% growth in recovered retail sales over the next two years, leverage should approach 6x.

Asymmetric Additional Risk Considerations

California's strict application of inverse condemnation poses an asymmetric additional risk consideration to credit quality. However, the likelihood of a massive wildfire event is considered remote in APU's service area. The asymmetric risk does not constrain the rating.

RATING SENSITIVITIES

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

--Positive rating action is unlikely given the role of tourism in Anaheim's economy, but leverage that declines and is consistently at or below 5x in Fitch's base and stress cases could result in upward rating movement over time.

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

--Prolonged economic disruption that diminishes the service area's strong demand characteristics;

--Leverage expected to reach or exceed 7.0x in consecutive future fiscal years in Fitch's base and stress cases;

--Extraordinary wildfire liability that results in long-term dilution of APU's financial profile;

--Material deterioration in the city's IDR could lead to negative rating action.

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

APU's bonds are qualified obligations issued by conduit issuers that include the Anaheim Housing and Public Improvements Authority (series 2016A&B, 2017A&B and 2020A, B & C), the Anaheim Public Financing Authority (series 2011 and 2012), and the California Municipal Finance Authority (series 2014 and 2015A). All of the qualified obligations are secured by purchase payments made by APU, an enterprise fund of the city of Anaheim, in accordance with each of the installment purchase agreements between the city and the conduit issuer.

Payments from the city are absolute and unconditional and are made from net revenues of the city's electric utility system after the payment of operating and maintenance expenses and off-system debt.

REVENUE DEFENSIBILITY

Nearly all of Anaheim's operating revenues originate from retail sales and other business lines that exhibit monopolistic characteristics. Anaheim also generates revenue from participation in wholesale markets, as the utility is long power during the majority of the year. Revenues from wholesale sales, which are viewed as competitive in nature, have accounted for between 3% and 8% of total operating revenues over the last five years. However, forecast wholesale revenues are consistently budgeted at less than 5% of total revenues.

Service Area Characteristics

Service area demand characteristics are favorable. Anaheim's customer growth has been positive at 0.9% annually over the last five years, although electric sales have been negative over the same period. In addition to the sales declines prompted by the pandemic and related economic closures, the electric usage trend incorporates the industry-wide trend of declining per capital consumption. Service area demographics for the City of Anaheim are favorable and include median household income at 114% of the national level and unemployment that is typically below the national average.

Rate Flexibility

Anaheim has very strong rate flexibility. Electric base rates are set by Anaheim's city council and are not subject to approval by any federal or state agency. Anaheim's average retail rate per kilowatt hour was below the state average at 94% according to 2020 data published by the U.S. Energy Information Agency (EIA).

APU's affordability ratio (a measure of annual energy costs against the city's median household income) is 1.4%, indicating very strong rate affordability. Rates include a 4% surcharge on all bills dedicated to the undergrounding of overhead lines within the city.

APU's rate structure includes annual adjustment mechanisms that recover power supply costs (the power cost adjustment; PCA) and environmental and regulatory costs (environmental mitigation adjustment; EMA), the two primary areas of cost uncertainty in the California power markets. The cumulative annual adjustments are periodically rolled into base rates, as occurred last in fiscal 2016. The financial forecast does not include any base rate increases but anticipates continued use of periodic adjustments in the PCA and EMA.

Higher Mix of Revenues from Commercial and Industrial Customer Classes than Residential

While residential customers make up the largest class, residential energy sales account for less than 30% of retail revenues, with a greater make-up of revenues coming from the commercial and industrial customer classes. The dominance of commercial and industrial revenues represents an asymmetric rating factor consideration that is incorporated into Fitch's revenue defensibility assessment. These elements currently weaken, but do not constrain the overall revenue defensibility assessment from 'aa'.

OPERATING RISK

Anaheim's operating cost burden increased to 15 cents per kWh in fiscal 2020 and 15.1 cents in fiscal 2021 (unaudited). Fitch's operating cost burden calculation, measured as total operating costs in relation to total kilowatt hour sales, has increased 4.7% annually on average over the last five years. Fitch-calculated operating cost burden includes Anaheim's required transfer to the general fund at 4% of gross revenues, which is capped by the city charter.

Operating Cost Flexibility

Operating cost flexibility is a neutral credit factor. APU's resource mix consists primarily of jointly owned resources and purchased renewable energy. Combined generation capacity of 732 MW is more than sufficient to serve APU's system peak demand of 530 MW in 2020, although the capacity includes 200 MW of peaking capacity (including the Canyon power project owned by the Southern California Public Power Authority [SCPPA]) that is only used to generate during short peak load time periods each summer. APU is also a participant in the Magnolia Power Project, a 118 MW combined cycle natural gas plant owned and operated by SCPPA.

APU has exited a number of its long-term resources over the last decade, beginning with the sale of its 68 MW share of the San Onofre Nuclear Generating Station (SONGS) in 2006, the termination of its 50 MW share of San Juan Generating Station #4 (coal) in 2017 and the retirement of Anaheim's only local resource, the Kraemer 48 MW natural gas plant in 2019. The energy from these resources has been replaced by APU's growing renewable contract portfolio.

APU's power supply is still predominately coal-based and coal accounted for 36% of energy supplies, including wholesale sales, in fiscal 2020. The remainder of the energy supply was natural gas (23%), renewable (25%), large hydro (1%) and market purchases (14%).

Replacement of Intermountain Power Project (IPP)

APU has an entitlement to 13.2% (237.1MW) of the coal-fired Intermountain Power Project (IPP) Generating Station Units 1 and 2, located in Utah. The project allocation is governed by a power sales contract with the Intermountain Power Agency (IPA) that expires in 2027. IPP is APU's only coal-fired resource. IPP provided 46% of APU's energy supply in calendar 2020.

A subset of the IPP participants plan to repower the project as a gas and hydrogen-fired resource by June 2025 to comply with California legislation. APU elected not to participate in the repowering project and plans to secure additional contracts for renewable resources to replace IPP once the original power sales contract terminates in 2027. APU will have a share of the repowered plant output for a short time, assuming the repowered plant enters commercial operation prior to 2027.

Environmental Considerations

APU is positioned to meet California's renewable portfolio standard (RPS) and clean energy targets, although additional resources will need to be secured as the targets increase over time. In calendar 2020, APU received 32.3% of its energy from eligible renewable resources, according to the power content label filed with the California Energy Commission. The 100% Clean Energy Act was enacted in 2018 as the latest iteration of California's RPS. It requires California utilities to reach 100% clean energy by 2045, in addition to the interim requirement of 60% by 2030. The requirements are in line with the overall regulatory trajectory of utilities in California.

Capital Planning and Management

Anaheim's age of plant is calculated by Fitch at 13 years, indicating moderate lifecycle investment needs. Capex to depreciation ratios have been healthy, averaging 144% over the last five years. The utility's capital improvement plan has an estimated total of $415.5 million over the next five years (2022-2026). The largest component, system undergrounding, accounts for $99 million of the total and is funded by the 4% surcharge on the bill that was first implemented in 1990. APU estimates that 57% of the total capex is expected to be funded from debt.

FINANCIAL PROFILE

Fitch-calculated coverage of full obligations (COFO) has ranged between 1.15x and 1.47x over the last five years, and ended fiscal 2021 (unaudited) at 1.33x. Fitch-calculated COFO includes revenues collected each year through APU's rate stabilization adjustments (RSAs) although these receipts may be placed in a deferred account for future recognition as revenues or amounts recognized from the deferred account in any given year. For example, in fiscal 2020, APU collected $22.7 million in the RSA but only recognized $17.3 million in that year as revenues (as shown in the audited financial statements).

Fitch's COFO calculation includes the full $22.7 million in cash received but excludes the deferred revenue recognition. APU plans to recognize RSA balances over the next five years, which may result in slightly lower Fitch COFO but continues to represent healthy financial performance. The RSA fund balance was $106.5 million at the end of fiscal 2021, which is well above the target balance amount of $50 million.

Cash on hand at the end of fiscal 2021 was $161.4 million or 191 days of operations. Unrestricted cash balances include the rate stabilization accounts and unrestricted funds held at SCPPA. Liquidity is further bolstered by APU's $86 million revolving credit agreement (RCA) with Wells Fargo.

APU's leverage has ranged between 6x and 7.2x over the past five years. Total debt outstanding has remained relatively steady, but fluctuations in cash flow has resulted in some fluctuation in the leverage calculation.

Fitch Analytical Stress Test (FAST) - Base Case and Stress Case

Fitch's FAST base and stress cases are based on APU's unaudited year-end results in 2021 and proforma for fiscals 2022-2025. COFO and liquidity are both expected to remain in the range of historical levels. Leverage is also indicated to continue to trend between 6x and 7x in both the base and stress cases, although closer to 7x in the stress case. Fitch's stress case includes a demand stress in the initial two years of the projected period, with a recovery occurring in the next three years.

Fitch's stress case comes on top of a period during which APU experienced successive declines in retail sales (5% in 2020 and 6.7% in 2021) and therefore, less weight was placed on the stress case in this review. Both cases are supportive of the current rating.

Base and stress case assumptions include no base rate increases but periodic changes to the power cost adjustment and environmental cost adjustment components of rates, capital spending based on the five-year $415.5 million CIP, and modest load recovery of approximately 3% in fiscal 2022 and 1% in fiscal 2023. Assumptions anticipate lower operating expenditures going forward related to lower joint-action agency debt payments.

The model also assumes APU's planned recognition of rate stabilization revenues in the next five years in amounts that will draw the rate stabilization account balance down from just over $100 million at the end of fiscal 2021 to $75 million by the end of fiscal 2025. The RSA account is expected to remain above the target policy threshold of $50 million.

Debt Profile

Anaheim's debt profile is neutral to the rating. APU's direct outstanding debt is structured as fixed-rate, amortizing debt. In addition to direct debt, Fitch's leverage ratio includes amounts APU is obligated to pay, as an operating expense, related to just over $500 million in off balance sheet debt at SCPPA and IPA. The largest amounts are for the Canyon Power project ($300 million) and the Magnolia Power Project ($100 million).

ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS

Wildfires have become more prevalent in California in recent years and pose potential credit risk. This year is an active wildfire season given the ongoing drought. California's application of inverse condemnation could result in potential financial liability to APU if its lines or operations are determined to cause or contribute to a damaging wildfire, even if the utility is not found to be negligent.

The rating is not currently constrained as a result of the low likelihood of a wildfire event catastrophic enough to result in a massive liability event. Although 14.6% of APU's service area is located in areas that present elevated or extreme wildfire risk, as defined by the California Public Utility Commission Fire Threat Map, less than 2% of its transmission or distribution lines are located in the higher risk areas. The lines that are located in the zones with elevated risk (the eastern side of the city) are almost entirely underground, reducing the risk of wildfire ignition.

Wildfire risk-mitigation measures in Anaheim include the use of underground lines in areas of extreme fire risk, vegetation management, construction standards, wildfire cameras, routine inspections and the authority to de-energize high risk lines during fire-threat conditions.

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

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
Anaheim Public Utilities Department (CA) [Electric]				
Anaheim Public Utilities Department (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

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Anaheim Housing and Public Improvements Authority (CA)	EU Endorsed, UK Endorsed

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Utilities and Power US Public Finance North America United States