FitchRatings

RATING ACTION COMMENTARY

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

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Related Fitch Ratings Content:
Anaheim Public Utilities Department, California

Fitch Ratings - Austin - 28 Feb 2022: Fitch Ratings has assigned a 'AA-' rating to the following qualified obligation bonds issued by the Anaheim Housing and Public Improvements Authority, CA (AHPIA) on behalf of Anaheim Public Utilities (APU):

--Approximately $43 million revenue bonds, series 2022A;

--Approximately $65 million revenue bonds, series 2022B;

--Approximately $342 million revenue refunding bonds, series 2022C (taxable);

--Approximately $46 million revenue refunding bonds, series 2022D.

In addition, Fitch has affirmed the 'AA-' rating on the following parity outstanding bonds (amounts prior to planned refunding):

--$457.8 million qualified obligation revenue and revenue refunding bonds, series 2017A, 2017B, 2020A, 2020B and 2020C issued by AHPIA;

--$123.8 million qualified obligation revenue refunding bonds, series 2014A and 2015B, issued by the California Municipal Finance Authority, CA;

--$63.0 million qualified obligation revenue refunding bonds series 2012A, issued by the Anaheim Public Financing Authority, CA.

The electric system's standalone credit profile (SCP) is assessed at 'aa-'. The SCP represents the credit profile of the electric system on a standalone basis irrespective of its relationship with and the credit quality of the city of Anaheim (Issuer Default Rating [IDR] A+/Stable).

The Rating Outlook is Stable.

ANALYTICAL CONCLUSION

The 'AA-' rating and 'aa-' SCP reflect Anaheim's continued very strong financial profile, even with tighter financial performance in the past two years 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 in recent years, 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 121,500 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 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, including the interim targets, but the utility will need replacement energy and capacity after 2027.

Located in Orange County, approximately 30 miles south of Los Angeles, Anaheim 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 system bonds is not constrained by the credit quality of the city of Anaheim. However, as a result of being a related entity, the rating on the electric system bonds could become constrained in the event of a material decline in the credit quality of the city.

KEY RATING DRIVERS

Revenue Defensibility: 'aa'

Very Strong Rate Flexibility; Favorable Service Area but Tourism Concentrated

Revenue Defensibility

Anaheim's revenue defensibility is supported by revenues received primarily from retail electric sales in 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 approximately 30% of revenues. The customer base concentration does not currently constrain the 'aa' assessment; however, the assessment is borderline.

Operating Risk: 'bbb'

Midrange Operating Risk Assessment

Operating Risk

Anaheim's operating cost burden increased to 15 cents per kWh in fiscal 2020, up from between 12 and 13 cents in fiscal years 2016-2018. Although lower costs in fiscal 2021 brought the operating cost burden down, operating cost burden is expected to trend near or above 15 cents moving forward as additional capacity and energy resources are secured.

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 pace of power costs.

Financial Profile: 'aa'

Tighter Financial Margins in 2020 Improved in 2021

Financial Profile

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 and the continued recovery of retail electric sales in fiscal 2022 accompanied the reopening of Disneyland in May 2021.

Fitch calculated coverage of full obligations (COFO) were 1.4x and days cash on hand at 249 days in fiscal 2021. Leverage ended fiscal 2020 at 7.2x and improved to 6.1x in fiscal 2021. Leverage is expected to remain between 6.0x and 7.0x in Fitch's base and stress cases, with improvement depending on the pace of retail sales recovery following the pandemic.

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 in the near-term, but leverage that declines and is consistently at or below 5.0x 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.

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, the Anaheim Public Financing Authority, and the California Municipal Finance Authority. 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.

Installment 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 0.7% annually over the last five years, although electric sales have been negative over the same period, declining by 3.3% on average per year. 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, but has trended higher since the pandemic began in 2020.

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.

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.

Revenue Defensibility Assymetric

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 approximately 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 risk assessment is considered midrange, primarily reflecting the increases in the operating cost burden in recent years. Operating cost burden increased to 15 cents per kWh in fiscal 2020 but declined to 14.2 cents in fiscal 2021 with lower operating expenditures. Even with the most recent decline, Fitch's operating cost burden calculation, measured as total operating costs in relation to total kilowatt hour sales, has increased 4.0% 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 732MW is more than sufficient to serve APU's system peak demand of 559MW in 2021, although the capacity includes a sizable amount of peaking capacity (including the 200MW Canyon power project owned by the Southern California Public Power Authority [SCPPA]) that is primarily used to generate during short peak load time periods each summer.

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

APU's power supply is still predominately coal-based and coal accounted for 39% of energy supplies, including wholesale sales, in fiscal 2021. The remainder of the energy supply was natural gas (19%), renewable (25%), large hydro (1%) and market purchases (16%).

Environmental Considerations and Clean Energy Transition

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 majority (17.6%) was provided by biomass generation with another 8% from wind energy.

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 state RPS requirement of 60% renewable energy by 2030. Utilities must also meet interim RPS targets of 44% by 2024 and 52% by 2027.

Replacement of Intermountain Power Project

APU's largest single-generation resource is its 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 includes a two-unit, 1,800MW coal-fired generating plant and an extensive transmission system. LADWP operates the project located in Delta, UT. California's environmental regulations require reductions in greenhouse gas emissions in the state and limit continued investment in coal-fired resources, such as IPP, beyond current contract terms.

In recent months, IPP has experienced challenges in securing sufficient coal deliveries and has run at lower capacity. One of the units has been shut down during the current winter period in order to preserve the existing coal supply for the summer months, when it is needed the most by the IPP participants.

The development is not a credit concern at this time, given Anaheim's sufficient capacity and energy resources during the winter, although wholesale revenues will likely be reduced. However, if coal supplies are still tight in the upcoming summer months, the lack of availability of IPP could result in cost pressure on purchased power expenses in fiscal 2023.

A subset of the IPP participants plan to repower the project as an 840MW gas and hydrogen-fired resource by July 1, 2025. 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.

Capital Planning and Management

Anaheim's age of plant is calculated by Fitch at 14 years, indicating moderate lifecycle investment needs. Capex to depreciation ratios have been healthy, averaging 148% over the last five years. The utility's capital improvement plan has an estimated total of $447.4 million over the next five years (2022-2026). APU estimates that 59% of the total capex is expected to be funded from debt.

One of the largest components of the CIP is a 50MW battery storage project. The project has an estimated cost of $75 million, but will depend on final specifications, including battery life. APU owns the land for the project and plans to begin the RFP process in the first half of 2022. The other large component in the CIP is the city's undergrounding program.

FINANCIAL PROFILE

Fitch-calculated COFO has ranged between 1.15x and 1.47x over the last five years, and ended fiscal 2021 at 1.41x. 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). In fiscal 2021, APU collected $34.5 million, based on the increase in the automatic adjusters in the rate structure, but recognized $35 million, using a small amount of the balance accumulated in prior years.

Fitch's COFO calculation includes the amount collected 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 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 $211 million or 249 days of operations. Unrestricted cash balances include the rate stabilization accounts and unrestricted funds prepaid and held at SCPPA. Liquidity is further bolstered by APU's $86 million revolving credit agreement with Wells Fargo.

Sizable Accounts Receivable Balance

APU has a large accounts receivable balance since a moratorium on service disconnections for non-payment began in March 2020 at the start of the pandemic. Accounts receivable increased to approximately $6 million as of December 2021, up from approximately $7,000 at the same time two years prior.

California established a state program, the California Arrearage Payment Program (CAPP), in the state's fiscal 2022 budget to provide funding to customers in arrears on electric bills during the period from March 4, 2020 to June 15, 2021. APU has received $4.8 million through the CAPP program that will be applied against the $6 million balance. The moratorium continues to be in place, so accounts receivable may continue to grow. If the amounts cannot be recovered, they will be written down at the end of fiscal 2022.

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

Fitch's FAST base and stress cases are based on APU's proforma for fiscals 2022-2026. COFO and liquidity are both expected to remain in the range of historical levels. Leverage is also indicated to continue to trend between 6.0x and 7.0x in both the base and stress cases, although closer to 7.0x 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 CIP, and modest load recovery of approximately 2% in fiscal 2022 and 1.2% 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 approximate the target policy threshold of $50 million by 2026.

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 ($271 million) and the Magnolia Power Project ($96 million).

ASYMMETRIC ADDITIONAL RISK CONSIDERATIONS

Wildfires have become more prevalent in California in recent years and pose potential credit risk, 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.

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

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

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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