MOODY'S
INVESTORS SERVICE

Rating Action: Moody's Upgrades Los Angeles Department of Water and Power (CA) - Power System Revenue Bonds; Outlook Stable

Global Credit Research - 29 Apr 2016

New York, April 29, 2016 -- Issue: Power System Revenue Bonds 2016 Series A; Rating: Aa2; Rating Type: Underlying LT; Sale Amount: $275,000,000; Expected Sale Date: 05/04/2016; Rating Description: Revenue: Government Enterprise;

Issue: Power System Revenue Bonds 2016 Series B; Rating: Aa2; Rating Type: Underlying LT; Sale Amount: $226,000,000; Expected Sale Date: 05/04/2016; Rating Description: Revenue: Government Enterprise;

Summary Rating Rationale

Moody's Investors Service has assigned an Aa2 rating to the Los Angeles Department of Water and Power (CA) Power System (LADWP) Revenue Bonds Series A and Series B. The Series A bonds have an expected par value of $275 million while the Series B bonds have an expected par value of $226 million. Concurrent with the rating assigned, we have upgraded to Aa2 from Aa3 the rating on LADWP's $8.2 billion of outstanding parity revenue bonds. The outlook is stable.

The rating upgrade to Aa2 from Aa3 recognizes the strong supportiveness of the Los Angeles Mayor and City Council reflected in its approval of an annual increase in the base rate for the next five years. Moreover, the upgrade recognizes changes to LADWP's electric rate structure that will provide additional cost recovery stability to maintain financial strength while LADWP's management transforms the electric utility's power resource mix. In addition, as reflected in the electric utility's forecasts, adherence to sound board policy financial metric targets and the addition of new sources of financial liquidity have provided further fundamental improvements in credit position.

The Aa2 rating, which is at same rating level as the city's separately secured water utility revenue bonds, includes our consideration of LADWP's strong flexibility as an unregulated monopoly providing essential electricity service to customers in Los Angeles, California (City of Los Angeles rated Aa2). The rating considers as a strength the benefits of size (LADWP is the largest municipal electric utility); its record meeting board adopted financial performance metrics; the utility's diverse and competitive power supply; and its ownership, control and reliable operation of a transmission network that represents about 25% of the state's transmission grid. Importantly, such control gives LADWP the ability to manage both carbon reduction and meet its renewable energy portfolio requirements more effectively than if it was part of the state's restructured market. LADWP has no dominant customers and has very competitive retail rates relative to the state average and more specifically, relative to Southern California Edison Company (SCE: A2 stable).

LADWP's transition out of its dependence on coal-fired generation, the associated execution risk of its transformative power resource plan and the expected increased debt leverage are risks we considered in today's rating action. But LADWP's record of strong management of its power supply and its measured approach at implementing changes to meet state regulatory requirements are a positive offset.

Our rating acknowledges that while LADWP has had a more complicated process for setting electric rates than typically found for a municipal utility, the recent rate process has yielded several important changes to strengthen LADWP's flexibility in meeting challenges ahead. Besides the continued ability to pass through about 50% of costs that can be automatically passed through to customers without governing board action, a decoupling mechanism, an elimination of certain caps and a new power access and tier rate structure provide positive changes including encouraging energy efficiency; access of solar distributive opportunities and revenue certainty.

LADWP remains in compliance with the numerous state statutes and executive orders dealing with carbon reduction and renewable energy standards. As such, LADWP is reasonably well positioned for compliance with expected new federal EPA Carbon rules. In 2016, LADWP will be supplying its retail load with 25% of energy from renewable sources.

In this vein, we believe LADWP's recent acquisition of a portion of the Mead Phoenix and Mead Adelanto

transmission lines will assist it in further integration of renewables regionally into its power supply mix. The transmission line acquisition through the Southern California Public Power Authority (SCPPA) is also expected to better link LADWP with the Palo Verde energy hub, providing more opportunities for lower cost energy.

That said, a new executive order by Governor Brown which requires electric utilities to achieve by 2030 50% of its retail demand with renewable energy and a reduction in greenhouse gas emissions by 40% from 1990 levels represent significant new challenges for the sector.

A longer-term challenge remains with the utility's overall power resource transition plan particularly with regards to further reduction in coal-fired generation as part of LADWP's fuel mix. LADWP's divestiture from the Navaho coal unit is now almost complete. While potential stranded cost questions remain regarding the future of the 1800 MW coal-fired Intermountain Power Plant (IPP) after the 2027 IPP contract ends, Intermountain Power Agency (IPA) is in discussions to repower the site to a natural gas fired plant or another energy production technology. There are also questions about the role of the Southern Transmission System (STS), a major transmission line from IPP to southern California that is owned by IPA, in which LADWP is the major participant through SCPPA at 59.5% of total.

We think additional debt leverage could potentially create rate pressure as LADWP continues to finance improvements to the reliability of the distribution system, the repowering of its coastal natural gas units, and the procurement of new renewable and gas fired energy resources. The LADWP capital improvement is $7.7 billion over the next five years, with 68% funded by new debt issuance.

The debt ratio in FY 2015 was 70.2 %. Importantly, and a key data point in our stable outlook, is the fact that after the five year capital improvement plan is completed, LADWP's debt ratio is expected to remain near current level as the principal is amortized and internal funds are contributed on a pay as you go basis to the plan. While higher electricity rates is a longer-term potential risk, most LADWP customers on average use about 30% less electricity than the national average due to the temperate weather as a primarily coastal service territory. Generally, electricity bills are a lower percentage of household income compared to elsewhere. Also, retail rates have a volume based rate structure which somewhat protects lower income rate payers. Even with higher rates in 2016-2017, LADWP remains competitive against neighboring utilities. On a prospective basis, forecasts incorporate higher retail rates to fund new debt.

We understand that while the City of Los Angeles (General Obligation, unlimited tax bonds rated Aa2) has been faced with related financial stress and the burdens of its past pension commitments, no additional General Transfers (above the current 8% of operating revenues) have been requested of the utility over past several years. The city's General Obligation debt rating has been stable and the LA economy has continued to strengthen with unemployment below the US average.

Rating Outlook

The stable rating outlook reflects our view that the electric utility continues to manage well the transition of its power resources to less carbon content, while maintaining its well established record of sound finances and competitive rates. New rate structure should provide additional stability and flexibility to meet reasonable cost pressures and maintain sound financial margins.

Factors that Could Lead to an Upgrade

The long-term rating is now at one of the highest rating levels for a US public power electric utility and a higher rating would require significant and consistent improvement in financial metrics, while leverage is moderated and LADWP is successful at its power supply transformation plan.

Factors that Could Lead to a Downgrade

If the LA City Council does not adopt sufficient future rate increases if necessary to ensure that LADWP has sound financial metrics

LADWP's rates become externally regulated

Costs to transition out of IPP become significant

General Fund transfer becomes a significant operating burden

Legal Security

LADWP power revenue bonds are issued pursuant to Section 609 of the City Charter and the Master Bond Resolution. The bonds are special obligations of LADWP payable only from the Power Revenue Fund. There is a sum-sufficient rate covenant and there is no debt service reserve requirement. The LADWP has maintained a Debt Reduction Trust Fund of approximately $500 million that can be used for payment of debt service. There is an additional bonds test of net income for 12 of 18 consecutive months shall amount to 1.25 times maximum annual adjusted debt service on all parity obligations. LADWP water bonds (rated Aa2) are separately-secured, payable from water fund revenues.

Use of Proceeds

2016 Series A and B will primarily be used to finance the LADWP 2016 capital improvement plan; and advance refund 2007 Series A bonds.

Obligor Profile

LADWP is the third largest California electric utility in terms of consumption, behind Pacific Gas & Electric Company (A3 stable) and SCE.

LADWP is the nation's largest municipal electric utility.

Methodology

The principal methodology used in this rating was US Public Power Electric Utilities With Generation Ownership Exposure published in March 2016. Please see the Ratings Methodologies page on www.moodys.com for a copy of this methodology.

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