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U.S. Public Power and Electric Cooperative Sector

“Where we were; where we are; and where we are going”

American Public Power Association GAFA Webinar

April 24, 2020
Where we were – December 2019

Outlooks for the Public Power sector were Stable

More importantly, the sector had been enjoyed the most favorable operating environment experienced in decades, characterized by:

- Record affordability of electric service
- Operating and capital costs near record lows
- Manageable environmental regulations
- Subdued rates of capital investing
- Declining leverage and improving credit quality
Where we are – April 2020

- Outlooks for the Public Power sector remain Stable
- Operating environment is facing unprecedented near-term challenges, including:
  - Diminished affordability as a result of economic shocks and “shelter-in-place” restrictions
  - Dramatic declines in energy demand
  - Unsettled capital markets
  - Heightened liquidity requirements
- Outlooks for Airport, Higher Education, Not-for-Profit Hospital and State and Local-Tax Supported sectors are Negative.
Where we are going....

- Outlooks for the Public Power sector will hinge on the ultimate severity of the economic contraction and the duration of government restrictions.
- Operating environment will be dictated by trends and developments related to:
  - Recovery of employment and household income
  - Recovery of electric demand and energy sales
  - Fuel prices and interest rates
  - Capital requirements
  - November elections
• **Where we were**
  - Positive rating actions have dominated the rating landscape in recent years
  - Rating actions driven by positive operating environment and improved financial profiles
  - New criteria released on April 3, 2019
    - 42 Ratings Placed Under Criteria Observation
    - 19 Positive rating actions
    - 9 Negative rating actions
• Where we are

• More recently, positive rating actions continued to outpace negative ratings actions, but affirmations or “no action” remained the norm:

• Rating activity for the year ended April 3, 2020 included:
  • 183 actions to affirm or take “no action” (69%)
  • 57 positive rating actions (21%)
  • 11 negative rating actions (4%)
  • 15 new rating actions (6%)

• Period represents a full year of activity under the new criteria and the review of the entire portfolio.
**Where we are**

- The Fitch’s Economics Team continues to update the agency’s Global Economic Outlook (GEO) bi-weekly.
- The GEO includes a Global Forecast Summary for GDP Growth, as well as inflation, interest rates, exchange rates and oil prices.
- The GEO provides a basis for analytical assumptions used in Fitch’s rating activities.
- The “Late April 2020” edition was released on April 21, 2020.
• **Where we are**

  • Latest GEO revision lowered expectations for 2020 GDP and the rate of economic recovery.
  
  • Anticipates national lockdowns of eight to nine weeks for most major advanced economies versus previous estimates of five weeks.
  
  • Each additional month of lockdown reduces GDP by around 2pp.
  
  • Expectations adapted for regional and local circumstances.
• Where we are

Fitch’s Credit Policy Group has developed Baseline and Downside Cases related to the Coronavirus to inform scenario analysis.
• Where we are
  • Recovery is a key aspect of Fitch’s scenario analysis

**Green trajectory:** Key performance metrics see a sharper uptick immediately after the peak impact of lockdowns.

**Blue trajectory:** Key performance metrics see slower recovery, given high developed market unemployment, wealth deterioration and supply chain disruptions.

**Red trajectory:** Key performance metrics see the possibility of distress or at best a greatly delayed recovery, particularly for those most exposed to effects of movement restrictions, payment holidays, cash flow timing mismatches, and volatile financial markets.
• Where we are

- Fitch’s Public Power Team is in the midst of reviewing its portfolio of rated issuers, using the stress scenario outlined in its rating criteria, as well as additional sensitized baseline stress scenarios.
Fitch Ratings Outlook for U.S. Public Power and Electric Cooperatives – Ratings Review

• Where we are
  
  • Fitch’s baseline stress scenario incorporates a more severe decline in electric demand in 2020 followed by a timely recovery in 2021 and 2022.
Where we are

- Fitch’s portfolio review will also include consideration of its key rating factors
- Particular consideration will be given to assessments of service area characteristics, rate flexibility, customer concentration, liquidity and leverage.
- Concerns focus on systems that:
  - Rely heavily on travel and tourism;
  - Exhibit customer concentration;
  - Suffer from low affordability;
  - Maintain weaker liquidity;
  - Serve very weak economies, limiting rate flexibility;
  - May be subject to increased transfers;
  - Report leverage that is on the cusp of a lower rating category.

Los Angeles Department of Water & Power, California

Key Rating Drivers

Revenue Defensibility: 'aa'; Very Strong Revenue Defensibility: LADWP’s very strong revenue base is provided almost entirely from the sale of retail electric service to a captive customer base within the city of Los Angeles. Service area characteristics are midrange and support future revenue collections, as evidenced by solid customer growth of just less than 1% annually, and wealth and unemployment levels in line with national levels. Rate flexibility is very strong, with local control over rate setting, rates below the state average and very high affordability.

Operating Risk: 'a'; Low but Increasing Operating Cost Burden: LADWP made significant progress in the evolution of its power supply portfolio required by California legislation. The utility’s operating cost burden is low, but grew steadily, with increasing costs but declining kWh sales. The operating cost burden averaged 14.7 cents per kWh over the past three years, including higher operating expenses in fiscal 2019 (unaudited), which is close to Fitch’s ‘midrange’ threshold.

Operating cost flexibility is neutral, but may become increasingly limited over time as state and local constraints restrict future investments to renewables and clean energy options.

Financial Profile: 'aa'; Strong Financial Profile; Elevated but Declining Leverage: LADWP’s financial profile is strong. Leverage declined consistently since fiscal 2015 with the adoption of the 2016 rate package and a robust funding of capital spending from revenues. Fitch's
Fitch Ratings Outlook for U.S. Public Power and Electric Cooperatives – Rating Activity

• Where we are
  • Recent rating actions limited
    • Fitch Places Reedy Creek Improvement District's Utilities Rev Bonds on Rating Watch Negative
    • Fitch Rates LADWP, CA's Power Rev Bonds 'AA-'; Downgrades IDR to 'AA-' from 'AA'; Outlook Stable
    • Fitch Rates Sacramento Municipal Utility Dist, CA Electric Rev Bonds 'AA'; Outlook Stable
    • Fitch Rates Chelan County PUD, WA's $165MM Consolidated Sys Rev Bonds at 'AA+'; Outlook Stable
    • Fitch Affirms Lubbock Power & Light, TX's Power System Rev Bonds at 'A+'; Outlook Stable
    • Fitch Rates Philadelphia PA's Gas Works Revs 'BBB+'; Outlook Positive
    • Fitch Affirms 'AA' Ratings for Six Prepaid Energy Transactions; Revises Outlook to Negative
    • Fitch Assigns 'BBB+' IDR to Peninsula Clean Energy, CA; Outlook Stable
• Where we are going

  • Outlook for the Public Power issuers remains overwhelmingly stable
    • Stable Outlook: 88%
    • Positive Outlook/Watch: 4%
    • Negative Outlook/Watch: 8%
  • The Outlook for the sector and individual issuers will continue to depend on:
    • Expectations for the severity and length of the economic contraction and government restrictions.
    • The prospects for, and pace of, economic recovery on a national, regional and local basis.
    • The ability and willingness of issuers to exercise rate-setting authority to preserve financial performance
    • The extent of strains on issuer liquidity and leverage ratios
Affordability Susceptible to Economic Shocks

• While affordability exceeded pre-recession levels in recent years (2.2% of median household income [MHI] in 2019), economic shocks related to the coronavirus are expected to dampen metrics related to MHI and wages, and reverse the favorable trend.

• Current estimates related to MHI, electric prices, and usage should keep the ratio below the most recent peak of 2.8% in 2010.

• Expectations of a severe contraction in GDP of (5.6%) in 2020 should be followed by a reasonable recovery in 2021 of 4.3%.

Electric Costs Will Drive Affordability

- EIA’s latest estimate is that retail electric sales will fall by approximately 3% in 2020 as a result of the economic slowdown. Commercial and industrial demand will decline an estimated 4.7% and 4.2%, respectively due to the closure of many businesses and cut backs in production.

- Total residential electric consumption has declined steadily over the past decade, as efficient devices and production processes have replaced less efficient uses and equipment.

- This trend is expected to continue over the long term, but consumption could rise in 2020 as a result of changing work habits and virus-related isolation.

- Real prices have fallen 4% since the most recent peak in 2015; The trend reflects the effect of declining capital requirements and operating costs;

- EIA expects nominal residential electric prices to remain unchanged in 2020.
Key Issues – Operating Cost Burden

Lower Fuel and Energy Prices Reduce Operating Costs

- Low fuel costs and energy prices remain broadly positive supporting affordability, revenue defensibility and operating risk;
- Fitch’s base case price assumption for Henry Hub natural gas prices has fallen to $1.65/mcf from $2.50/mcf less than a year ago as markets remain vastly oversupplied.
- Demand has waned due to the coronavirus outbreak. U.S. shale production is expected to decline in response.
- EIA forecasts an average Henry Hub spot prices of $2.11/mcf in 2020 and $2.98/mcf in 2021 on lower production.
- Wholesale energy prices were generally lower in 2019 and should remain low through 2020 due to lower demand and robust levels of generating capacity throughout most of the country;
Historically Low Interest Rates Positive

- Low interest rates and robust access to the capital markets have been positive, reducing capital costs and supporting affordability.
- Replacement and refunding of debt has reduce revenue requirements; Roughly 57% of 2018-2019 electric power debt earmarked for refunding; Down from levels near 80%;
- The Fed’s unexpected March 2020 rate cut and recent declines in the 10-year U.S. Treasury yield to historic lows should reduce financing costs and revenue requirements further through 2021.
- Fitch expects policy rates to remain near zero through 2021 and a 10-year Treasury yield of 1.30% over the same period.
- Greater stability in the capital markets could provide issuers with broad access to very-low cost long-term capital.
Key Issues – Operating Cost Burden and Capital Planning

Subdued Rates of Capital Investing

- Preliminary rates of capital investment for public power issuers have declined meaningfully since 2009, and remain stubbornly low.

- The preliminary median ratio of capital investment to depreciation for 2018 is 122%; Down from 166% in 2010 and largely unchanged from 123% in 2017.

- Wholesale systems reported a median capex/depreciation ratio of less than 100% for the third year in a row (82%).

- Median for retail systems was 134% in 2018.

- Early indications are that the portfolio median ratio for capex/depreciation will remain consistent with the recent trend at about 110% in 2019.

Capex/D&A
(Indicates whether annual capital spending keeps pace with depreciation.)

(%)

Retail | Wholesale | Portfolio


0 | 50 | 100 | 150 | 200 | 250
Subdued Rates of Capital Investing

- Low growth in electric consumption, particularly for residential users, has obviated the need for significant new generation build.
- Investment throughout the broader utility sector has continued, driven in part by tax credits and other incentives, offsetting retirements of coal and natural gas capacity.
- Renewal and replacement investment remains steady for public power utilities, and investment in transmission has grown.
Leverage Metrics will Drive Future Credit Quality

• Leverage ratios across the sector have steadily declined, supported by the favorable operating environment, lower capital requirements and improving cash flow.

• Indications are that leverage ratios are expected to be modestly lower once again in 2019.

• Days cash on hand medians have similarly remained strong and stable.

• Leverage metrics are likely to weaken in 2020 driven by lower electric sales and weaker operating performance and expectations of temporary drains on liquidity.

• As capital requirements remain low, incremental long-term borrowing should have a limited effect on leverage ratios.

• Economic expansion and a recovery in electric sales should help to drive leverage metrics to levels observed in 2019, absent major new capital requirements.
Environmental Regulations are Manageable, but Pressures Remain

- The current slate of federal environmental regulations appear manageable.

- New and legacy regulations related to the disposal of coal combustions residuals, mercury and air toxins, and effluent guidelines will continue to frustrate economics for existing coal-fired generation, and preclude new construction.

- State level renewable mandates, as well as mounting pressure from consumers, local governments and investors alike are expected to affect resource planning for years to come.

- The results of the 2020 U.S. elections could lead to the consideration of more aggressive strategies related to climate change or Green New Deals.

- Material compliance costs and required investment could strain service affordability and challenge credit quality.
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