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Fitch Ratings' View of Wildfire Credit Risk for LADWP Posed by Getty Fire.

Fitch Ratings-New York-11 November 2019: Fitch Ratings has not taken rating action on the Los Angeles Department of Water and Power (LADWP) or any publicly owned utility (POU) in California, to date, related to wildfire risk and the potential liability resulting from California's strict interpretation of inverse condemnation. However, wildfires have become more prevalent in California and present an ongoing business risk to POUs. POUs in California have inherent characteristics and strategies in place that mitigate wildfire risk and its impact on credit quality. These include largely urban service areas with quick fire service response times, vegetation management and wildfire prevention programs, robust cash reserves and the legal ability to recover costs associated with wildfire related liabilities from ratepayers. The new wildfire liability fund created by California Assembly Bill 1054 in July 2019 is exclusive to investor-owned utilities and not considered one of the strategies in place for POUs. Given these factors, coupled with the low likelihood of a massive liability event, Fitch considers the occurrence of a catastrophic event sizable enough to prompt a rating action as a remote event risk that is therefore not factored into the ratings. If a massive liability event occurs, ratings could be affected.

Getty Fire

The Getty fire that began on Oct. 28 in Los Angeles burned approximately 745 acres and was fully contained as Nov. 5, 2019, according to the Los Angeles Fire Department (LAFD). The LAFD reports there were no fatalities, although five fire-fighters sustained injuries considered to be 'non-life threatening'; ten homes were destroyed and 15 were damaged. According to the LAFD, its preliminary investigation determined the cause of the fire was an accidental start from a tree branch that broke off and landed on nearby power lines during high wind conditions, causing sparking and arcing of the power lines and igniting nearby brush.

The power lines are owned and operated by LADWP. LADWP reports they had recently completed vegetation management trimming and inspection in this area in July 2019. There is no alleged failure to act or failure of equipment. However, due to California's application of inverse condemnation that can impose liability against utilities regardless of fault, LADWP may face financial liabilities as a result of the Getty fire.

What Circumstances Would Prompt Fitch to Take Rating Action

LADWP has an Issuer Default Rating (IDR) of 'AA'/Stable. As Fitch indicated in its rating action commentary on LADWP published earlier this year on April 12 and Aug. 26, a rating action could occur if LADWP is found liable for a specific wildfire event of such a magnitude that it exceeds insurance and liquidity resources and outstrips LADWP's ability to recover the costs through rates and maintain rate flexibility. The potential development related to wildfire risk that could change Fitch's rating is the magnitude of the liability, not whether or not a wildfire occurs. It remains to be determined whether LADWP will face a liability for the Getty fire and, if so, the size of the liability.

Fitch expects that the initial recourse for LADWP will be to seek coverage under its wildfire liability insurance policy ($177.5 million), with additional coverage available to LADWP through its general excess liability coverage policy ($160.0 million) and self-insurance reserve ($192.5 million). In addition to insurance, LADWP has sizable cash reserves that could be used to meet any potential liability, although these reserves protect against multiple business risks and their use may be more of an interim step, depending again on the magnitude of the liability. LADWP's unrestricted cash for the power system at the end of fiscal 2018 was approximately $1.3 billion, including the debt reduction fund and rate stabilization fund.

If a potential liability exceeds LADWP's insurance policies and cash reserves, Fitch assumes LADWP could borrow to pay part or all of the liability, with repayment expected over the long term. If a wildfire results in a liability that is massive enough to alter LADWP's financial profile, the deterioration would appear in Fitch's net leverage ratio that measures long-term, fixed obligations, net of cash reserves, in relation to annual cash flow.

LADWP's net leverage ratio is currently expected to decline and the 'AA'/Stable IDR is based on that expectation. LADWP's net adjusted debt to adjusted FADS ratio was 7.8x in fiscal 2018. Fitch's Analytical Stress Test (FAST) model, a forward five-year look, indicates that net leverage should trend down slightly, closer to 7x by year three of the forecast period, while liquidity and coverage levels remain robust. Although Fitch assumes that LADWP would spread payment of any wildfire-related liability over the long term and recover those costs through its power rates, a new, large fixed obligation that alters our expectation of lower leverage could be enough to trigger downward rating action.

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