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Fitch: California Public Power Utilities Face Carbon Neutral Target in 2045.

Fitch Ratings-Austin-13 September 2018: California has ratcheted up its statewide environmental goals with the passage of the California 100% Clean Energy Act. The legislation, signed by the Governor earlier this week, is the latest step in the state's ambitious transformation of its energy supply through the implementation of additional constraints on utility power supplies.

Fitch Ratings expects the credit quality of Fitch-rated public power utilities in California to remain strong over the medium term, although compliance with the legislation will require careful resource planning and heighten the importance of meaningful industry developments in areas that extend beyond individual publicly owned utility (POU) control. Advances in generation and storage technologies, the pace of electrification in the transportation sector, and potential regional market expansion and design changes will be crucial to the state's success in reaching its targets.

California's 100% Clean Energy Act requires utilities to achieve 60% of their energy supply from renewable sources by 2030, which is an increase from the 50% renewable by 2030 mandate set by legislation passed as recently as 2015. Significantly, the legislation also requires 100% of a retail utility's energy supply to be provided by renewable or carbon-free energy by 2045, the same goal as the state of Hawaii, which previously held the most ambitious renewable standard.

POUs must make long-term resource decisions while factoring in the requirements of the new legislation, the limitations of existing storage technologies and carbon-free generation resources, and near-term system needs. Decisions regarding the development of additional natural gas-fired resources must now be evaluated under the legislatively imposed deadline of 2045, which shortens the timeframe over which to recover the investment.

MOUNTING REGULATIONS ADD TO LONG-TERM INVESTMENT UNCERTAINTY

The 100% Clean Energy Act was proposed during the 2017 legislative session so the industry was prepared for it or a similar bill to be enacted. The act's requirements are in line with the trajectory established by previous mandates. However, this legislation further heightens investment uncertainty for natural gas-fired generation. The rapid decline in energy that can occur from both wind and solar requires a corresponding generation resource that can ramp-up energy production in minutes to provide grid stability and service reliability. One such option is natural-gas generation given its flexibility and fast start capabilities. Several utilities have delayed or changed planned or expected investment in natural gas resources given the uncertainty regarding the state's unfolding environmental mandates.

Los Angeles Department of Water and Power (LADWP; power revenue bonds rated 'AA'/Stable Outlook) placed its multi-decade local generation investment plan on hold in 2017. Since 2011, LADWP has been investing capital to reconstruct three of its local gas-fired generation facilities. In order to comply with state regulations, the plants must be rebuilt to cease using ocean water for once-through power plant cooling purposes by 2029 with a total estimated cost of over \$2.0 billion.

The three power plants account for 70% of the 4,736MW net generating plant capacity owned by LADWP. LADWP's pause in the long-term investment is intended to provide time to analyze the need for the continued investment in local gas-fired generation in light of other alternatives, including the increased availability of renewables in the state and the greenhouse gas emissions of various alternatives.

Glendale Water and Power (electric revenue bonds rated 'A+' /Stable Outlook) has also been planning the replacement of its older gas-fired generation unit, the Grayson Power Plant. The city's integrated resource plan identified the rebuild of the Grayson power plant on the existing site with approximately 200 MW of new, efficient natural gas-fired capacity as the city's best option at an estimated cost of just under \$500 million. However, earlier in 2018, Glendale decided to place the repowering decision on hold while it solicited alternative proposals. Similar to LADWP's reasoning, Glendale wanted to explore renewable and non-carbon emitting alternatives.

In both cities, the alternative exploration process was initiated by community requests and City Council direction ahead of the passage of the 100% Clean Energy Act but both actions reflect the climate of uncertainty in which utilities are attempting to make long-term investment decisions. While it appears that natural gas-fired generation will need to continue to play a significant role in the state's power supply until other technology developments occur, the 2045 deadline now puts a hard limit on the potential useful life of this investment, with the ongoing risk that subsequent state legislation moves the target date forward in the future.

THE FATE OF THE INTERMOUNTAIN POWER PROJECT REPOWERING

Certain POU's in California are involved in a multi-year process to implement a repowering of the Intermountain Power Project (IPP), a 1,800 MW coal-fired generation plant located in Utah with a 490 million 500 kV direct current transmission line into California. California utilities are contracted to purchase the output of the IPP coal plant through 2027. IPP represents one of the last sources of coal-fired generation for California's POU's following the recent divestiture of the San Juan power project in New Mexico and the Navajo Generating Station in Arizona. The repowering was designed to allow the California participants to comply with state legislation enacted in 2006 that limits the use of coal-fired resources in the future by repowering the resource as a combined cycle natural gas-fired plant. Project participants have worked through a multi-year process towards this goal. The repowered IPP may still provide valuable capacity and reliability benefits prior to 2045 and the IPP transmission line into California provides valuable import capability for out-of-state renewable energy.

STRONG CREDIT QUALITY BUT WITH COMPLIANCE COST RISKS

California's POU's have managed the challenge of mandated energy targets thus far and have exhibited strong credit quality due largely to the timeliness of cost recovery and the preservation of margins. Fitch expects this success to continue over the medium term. It is noteworthy, however, that the rate impact to consumers during the initial years of regulatory compliance was materially dampened by the corresponding decline in the cost of renewable energy and natural gas commodity prices during the same period of time. Future compliance costs may not experience the same buffer.

Future compliance costs could also be significantly higher than recently observed. While the 100% Clean Energy Act is just one in a succession of mandates levied on the state's POU's that began over a decade ago, the legislation further constrains future resource options. The confluence of the 2045 deadline and reliance on still emerging technologies raises the concern that utilities will be hampered by sizable cost increases while simultaneously challenged to maintain the high reliability levels that ratepayers have come to expect. Over the longer term, the preservation of credit quality

will continue to depend upon the timely recovery of those costs and maintenance of strong financial margins during any potential operational challenges.

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