S&P Global
Ratings

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# Vernon, California; Retail Electric

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Many issues are enhanced by bond insurance.

## Credit Highlights

- S&P Global Ratings raised its long-term rating and underlying rating (SPUR) to 'A-' from 'BBB+' on Vernon, Calif.'s previously issued electric system revenue bonds issued on behalf of Vernon Public Utilities (VPU; formerly Vernon Light and Power).
- The outlook is stable.
- The rating action reflects our view of the electric system's improved risk management practices, including, for example, natural gas hedging, which we believe will enhance future cash flow stability and predictability, and protect the utility against unexpected events, especially important given the nontraditional, almost all-industrial customer base it serves.

### Security

A first lien on net revenue secures the revenue bonds. Bond provisions are adequate, in our view. The bond rate covenant requires that adjusted net revenue equal at least 1.1x annual debt service. The additional bonds test requires that adjusted net revenue before transfers equal at least 1x adjusted maximum annual debt service and that adjusted net revenue equal at least 1.25x adjusted maximum annual debt service. The flow of funds is closed. The indenture does not consider the electric fund's payment-in-lieu-of-taxes to the city's general fund an operating expense, and is subordinate to debt service, although we consider it an operating expense under our calculation of net revenue and fixed charge coverage (FCC). Total system debt outstanding as of fiscal year-end June 30, 2023, was $391 million.

## Credit overview

The rating reflects our view of VPU's diverse and ample resource portfolio and improved risk management practices, partly offset by the risks inherent to serving a customer base whose revenue and energy sales are sourced almost entirely from commercial and industrial customers. The rating also reflects our view of VPU's robust liquidity yet somewhat thin FCC metrics.

The rating further reflects our view of the electric system's:

- Ample liquidity and reserves, with fiscal 2023 unrestricted cash of $117.5 million, or 281 days of operations;
- Favorable market position as a result of rates that, despite escalation, are increasingly advantageous versus those of local investor-owned utilities and public power utilities, along with a willingness to raise base rates, the utility's fuel cost adjustment billing factor, which reduces exposure to escalated market prices for power or gas, and its renewable energy cost pass-through charge, which serves to recover the cost of more costly renewable energy; and
- Solid and diverse resource portfolio with a growing renewable energy component, and enhanced risk management practices, particularly with regard to natural gas hedging.

Partly offsetting factors include our view of the electric system's:

- Operating risks inherent in serving an almost 100% industrial and commercial customer base, with the leading 10 customers representing a concentrated 49% of retail revenue;
- Ongoing pressure to keep rates low to attract and retain large industrial customers, which are rate-sensitive; and
- Only adequate coverage metrics, including S&P Global Ratings-calculated FCC that averaged 1.12x over fiscal years 2021 to 2023, including 1.2x in fiscal 2023, although we note that FCC could improve significantly to near 5x as debt service requirements decline significantly to $9.2 million from $64.7 million in fiscal 2029.

## Environmental, social, and governance

Natural gas accounted for the bulk (37%) of 2023 energy and, although less polluting than coal, has carbon attributes and could present Vernon with long-term environmental exposure. Although Vernon continues to add renewable energy to its portfolio, we view the challenging regulatory environment in which it operates and the related costs and uncertainty it introduces as risks. While VPU has made considerable progress in meeting increasingly stringent state mandates with regard to renewable energy requirements, we expect additional onerous regulatory requirements given the state's history along these lines. Senate Bill 100, signed into law in September 2018, increased the eligible renewable energy resources requirement to 60% of retail sales of electricity by 2030 and established that eligible renewable energy resources and zero-carbon resources would supply 100% of resources for retail load by 2045. VPU anticipates complying through a combination of landfill gas, solar, wind, storage, and the purchase of renewable energy credits, and estimates achieving 41% renewable in 2023 (forecast at 44% by 2024 and 52% by 2027). It plans to materially reduce dependence on natural gas in 2030 and eliminate natural gas from its portfolio by 2035. We believe meeting these targets could stress the electric system's average cost of power supply, but the availability of pass-through mechanisms directly tied to these initiatives should contribute to sound alignment among revenue, expenses, and debt service.

To date, no wildfires have been attributed to the electric system infrastructure and thus we have seen no manifestations of this exposure. S&P Global Ratings believes that given the electric system's principally urban service territory, its location amid urban cities, and its relatively small footprint at 5.2 square miles, the potential for its power lines to spark catastrophic wildfires (such as those that have plagued other utilities in the state) is low. VPU also reports that it owns no transmission or distribution lines near a wildland interface area.

Social risks are neutral given rates that are competitive versus the statewide average and neighboring peers (both municipal and investor-owned) on a weighted average (by customer class) basis, but a nontraditional customer base particularly sensitive to rates offsets this, so we believe financial planning and maintaining strong margins are relatively more challenging. We believe supply chain issues are manageable for Vernon, and the utility has proactively focused on maintaining a healthy inventory of transformers to meet growth needs. The COVID-19-pandemic-induced recession, along with measures in place to promote health and safety, did not meaningfully affect energy sales.

We are monitoring the strength and stability of electric utilities' revenue streams for evidence of delinquent payments or other revenue erosion. Inflation as measured by the Consumer Price Index has topped 3% in recent months, and S&P Global Economics forecasts elevated interest rates persisting through the first half of 2024 with moderate softening through the remainder of the year. (See "U.S. Economic Forecast Update: A Sturdy Job Market Keeps Growth Going," published Feb. 21, 2024, on RatingsDirect.) In addition, Bureau of Labor Statistics data show that electricity price inflation continues to outpace the overall Consumer Price Index. The amalgam of material increases in delinquent consumer, credit card, and auto loans, along with October's resumption of student loan payments and drawdowns of household savings garnered during the pandemic, will likely compound the financial pressures facing electricity consumers, although this will have a more muted effect on Vernon given the minimal residential customer base. Following stronger-than-expected U.S. economic growth through the fourth quarter of 2023, S&P Global Economics revised its 2024 real GDP growth forecast to 2.4% from its November 2023 projection of 1.5%. S&P Global Economics believes that recent business and consumer activity are not sustainable and projects slowing economic activity with growth of 1.5% in 2025.

We view management and governance as improved in light of the adoption of an energy risk management policy, among other developments. The utility's improvement risk management practices, particularly with regard to natural gas hedging, discussed later, support this view. More generally, we view VPU's management, policies, and planning as comprehensive and prudent, and senior-level staff as generally strong and proactive. Management and its consultants regularly update its strategic plan and produce a long-term financial forecast and capital plan. The city has improved its financial management policies and procedures over the past several years, adopting new guidelines on long-term planning, debt management, and interfund transfers, among other areas. Projections are generally reasonable. Vernon is also finalizing a revised financial risk policy that sets minimal guidelines with regard to various reserve designations. Vernon also has a multilayered approach to cyber security, including the use of firewalls, 24/7 network monitoring, end-user cyber education, email phishing campaigns, and breach detection devices, and aligns itself with national standards and frameworks. Vernon also maintains a cyber security insurance policy.

## Outlook

The stable outlook reflects our expectation that, over the next two years, the electric system will maintain ample liquidity, at least adequate coverage, and successfully execute risk management practices to offset the operating risks inherent to the system's almost entirely commercial and industrial customer base. While we note that FCC could increase significantly in fiscal 2029 as debt service requirements decline significantly, that is beyond our two-year outlook horizon.

### Downside scenario

Over the next two years, we could lower the rating if FCC or liquidity weaken as a result of weak expense management without a credible plan to promptly restore them, other factors equal. We could also lower the rating in case of a material increase in leverage or degradation in operational factors, including the utility's competitive position or its ability to manage its natural gas exposure and environmental mandates.

### Upside scenario

We could raise the rating in the unlikely event that, over the next two years, the electric utility materially improves both FCC metrics and liquidity, along with continuing to manage risks related to its gas supply, customer base, and renewable portfolio mandates.

## Credit Opinion

VPU's electric system serves Vernon's 5.2-square-mile territory, centrally and conveniently located approximately four miles southeast of downtown Los Angeles and adjacent to key rail lines connecting to major local ports and inland destinations. The city provides electric service through VPU, while the five-member city council exercises oversight and rate-setting authority. Management reports that the city council has supported the electric system's needs over the recent years, and that decisions are typically unanimous. But we note that the pool of qualified candidates to serve on the city council is small by virtue of the city's very small population base of around 330 residents, introducing some risk.

Vernon, known as the "industry-only" city, has an electric system customer base consisting primarily of 1,759 industrial customers (in addition to 74 residential accounts) and reports a workday population of more than 40,000. Approximately 66% of the system's customers are commercial and 26% are industrial, and industrial load accounted for 64% of total energy sales and 58% of revenue in fiscal 2023. The fiscal 2023 system load factor was 67%, in line with historical levels and moderately high, reflecting the industrial nature of the customer base with many major customers operate 24 hours per day. The leading 10 customers account for a concentrated 49% of retail revenue, and the leading customer (a chemical processor) almost 13% on its own, although many of the leading customers (including cold storage, bottling, plastics, and food processing firms) are less sensitive to economic conditions. In general, we view industrial and commercial customers as having less stable and predictable demand patterns than those of utilities with more diversified customer bases that include a significant residential component, and we factor this key risk into the rating. However, certain aspects partly offset industrial and leading customer concentration, including a track record of annual energy sales' having not declined by more than 6% in any given year since at least

1997. In addition, the leading 10 customers have been operating in Vernon an average of 39 years and have made considerable local investments. Management reports that its third-largest customer, Farmer John (6.3% of retail revenue), decided to cease operations in Vernon after 77 years as a result of economic and financial considerations. However, management reports that several new, high-load customers are in line to replace Farmer John and bolster overall demand, including various data centers (150 megawatts, or MW, of load growth over the next five to 10 years versus current peak demand of 190 MW). Management expects the load loss related to Farmer John, specifically, to be fully recovered by the end of calendar 2024; mostly as a result of Farmer John's exit, energy sales declined 5.5% in fiscal 2023.

Vernon's main baseload power resource is its owned, natural-gas-fired 139 MW Malburg Generating Station (MGS), which accounted for about half of its power supply on an energy basis in fiscal years 2019 to 2023 but just 37% in fiscal 2023 as lower market prices displaced MGS generation. Vernon constructed MGS and put the plant into operation in 2005, but then sold MGS to Bicent (California) Power LLC in 2008 to generate liquidity for greater system stability and economic development needs, to reduce plant operating risk, and to repay various auction rate bonds outstanding. Simultaneous with the sale of MGS, Vernon entered into a 15-year power purchase tolling agreement (PPTA) for 100% of the output from MGS that included capacity and energy payments from Vernon, with an option for Bicent to extend the PPTA to 2028. The management team, which differs greatly from that which decided to sell MGS in 2008, decided to repurchase the plant in 2021 for $198 million (with bond proceeds) given a view that owning MGS offers significant benefits to the city and electric system, including the ability to meet resource adequacy and capacity requirements beyond 2028, retention of control of the MGS site (including repowering and adding interconnections), operational flexibility and ability to reconfigure the plant with peaking generation, and flexibility to import and integrate renewable energy. Vernon has reassumed plant operating risk, which we view as manageable given Vernon's strong familiarity with the plant and because existing plant staff were retained to run MGS. Vernon was required to supply natural gas for MGS under the PPTA and had continued to do so under an ownership model.

Prior to adopting an energy risk management policy in November 2022, the utility was unhedged on its fuel procurement for MGS, and we viewed this as a risk and credit limitation given recent more volatile and high gas prices. However, Vernon's adopted energy risk management policy is robust and proactive, in our view, and more credit supportive. Generally, the policy is aimed at limiting spot market exposure; prompt month and nearby fiscal years are to be more fully hedged versus outer years to reduce short-term risk and improve budget certainty. More specifically, among other parameters, the policy requires hedging no less than 60% of natural gas requirements at least one year in advance and 20% two years out (and as much as 100% in both cases). Other objectives of the policy include providing stable rates, reducing market and counterparty exposure, preserving business flexibility, and delivering the lowest-cost power supply that also meets environmental compliance mandates. The policy included the formation of an Energy Risk Management Committee that ensures compliance with the policy and approves such aspects as internal control processes and risk tolerance parameters.

Debt service resulting from the 2021 bonds issued to acquire MGS as well as MGS operating costs substitute for capacity payments as part of the now-terminated PPTA. According to S&P Global Ratings' FCC methodology, we treat fixed-capacity payments as debt service rather than as operating costs. A relatively small amount of fixed capacity payments remains and is related to Hoover hydropower and renewable purchase power agreements.

VPU's portfolio of generating assets exhibits excellent shaft and good fuel diversity. Other than MGS, baseload resources consist of nuclear generation from the Palo Verde generating station (8%), solar generation from three separate projects (15%), landfill gas generation from Puente Hills (3%), hydroelectric generation from Hoover Dam (2%), and short-term contracts and spot purchases (34%). Resource adequacy is sufficient, and the utility's latest Integrated Resource Plan indicates a significant increase in solar and wind energy combined with storage as it aims to reduce reliance on MGS in 2030 and to completely eliminate MGS by 2035.

Management has demonstrated an ability and willingness to raise rates, as evident in its more than 10 electric system base rate increases since 2012, including 5% for fiscal 2024. The city also has a monthly energy cost adjustment billing factor, which passes through the difference in fuel and energy expenses between actual and estimated amounts included within rates, and a monthly renewable energy cost adjustment factor, a pass-through charge designed to capture the cost of acquiring more costly renewable energy. However, we believe overall that rate-setting practices are only adequate given that FCC has averaged only about 1.1x the past five years. (Such marginal FCC is an elevated credit risk given Vernon's heavily industrial base.) Informing this assertion is our view of pressure to keep rates industrial rates low, limiting rate flexibility.

Vernon's rates are competitive at about 3% below the statewide average on a weighted average basis in 2022 (as of the most recent information available). Management has shown a willingness to routinely raise base rates, and the electric system's various power cost adjustment factors promote financial stability. Rates are even more competitive with those of investor-owned utilities nearby such as Pacific Gas and Electric Co. and Southern California Edison. In our view, this enhances the stability of the utility's customer base, but the city's industrial customers are sensitive to rates, limiting rate flexibility. Other advantages that the city offers include proximity to downtown Los Angeles, a high degree of transportation access (freeways and rail), low taxes, and a full-service police department. There are no base rate increases forecast through 2029.

We view the electric system's coverage metrics as thin, as evident in FCC averaging a modest 1.12x in fiscal years 2021 to 2023 but improving to 1.2x in fiscal 2023. According to the forecast, which we view as reasonable, we calculate FCC remaining in the 1.1x-1.2x range through fiscal 2025 and improving to 1.2x-1.3x during fiscal years 2026 to 2028 before accelerating to a very high 4.6x in fiscal 2029, when debt service requirements plummet to $9.2 million from $64.7 million. The electric system projects to recognize $18 million from its $41 million rate stabilization fund balance in fiscal 2024 (the first use of such funds since 2020) to limit rate increases; FCC without the inclusion of these funds in fiscal 2024 is slightly less than 1x.

We consider liquidity and reserves extremely strong, with fiscal 2023 unrestricted cash at $117.5 million, or 281 days of operations. Unrestricted cash is forecast at $91 million to $140 million, or no less than 228 days of operations, in fiscal years 2024 to 2028. We understand that the city anticipates sustaining these reserves to serve as a hedge against the power supply portfolio and other operating risks through at least fiscal 2028.

Debt to capitalization in fiscal 2023 was a moderate 65%, with $391 million in direct debt. The forecast assumes that no additional debt will be necessary to fund capital needs, which we view as manageable at $81 million.

### Vernon Public Utilities key credit metrics

| | --Fiscal year ended June 30-- | | |
|---|---|---|---|
| | **2023** | **2022** | **2021** |
| **Operational metrics** | | | |
| Electric customer accounts | 1,833 | 1,927 | 1,905 |
| % of electric retail revenue from residential customers | 0 | 0 | 0 |
| Top 10 electric customers' revenues as % of total electric operating revenue | 49 | 44 | 47 |
| Service area median household effective buying income as % of U.S. | 78 | 78 | 80 |
| Weighted average retail electric rate as % of state | 97 | 97 | 96 |
| **Financial metrics** | | | |
| Gross revenue ($000s) | 236,810 | 209,548 | 184,609 |
| Total operating expenses less depreciation and amortization ($000s) | 152,910 | 146,999 | 136,762 |
| Debt service ($000s) | 69,707 | 51,850 | 44,728 |
| Debt service coverage (x) | 1.2 | 1.2 | 1.1 |
| Fixed-charge coverage (x) | 1.2 | 1.1 | 1.0 |
| Total available liquidity ($000s)* | 117,512 | 130,132 | 123,485 |
| Days' liquidity | 281 | 323 | 330 |
| Total on-balance-sheet debt ($000s) | 390,478 | 447,587 | 271,901 |
| Debt to capitalization (%) | 65 | 73 | 68 |

*Includes available committed credit line balances, where applicable. Debt service coverage--Revenues minus expenses divided by debt service. Fixed-charge coverage--Sum of revenue minus expenses minus total net transfers out plus capacity payments (or their proxy), divided by the sum of debt service plus capacity payments (or their proxy). N.A.--Not available.

## Related Research

Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022