Public Power
Credit Analysis

Lodi, Calif.

Lodi Electric Utility

Ratings

Security Class	Current Rating	Previous Rating	Date Changed
$78.6 Million Electric System COPs	BBB+	A–	10/28/02

COP – Certificate of participation.

Rating Watch... None
Rating Outlook....................................... Negative

Analysts

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Profile

LEU serves and provides retail electric service to a customer base of approximately 27,500 customers in and around the city of Lodi, which is located in the San Joaquin Valley of California, 35 miles south of Sacramento. Revenues by customer class are composed of residential (33%) commercial (43%) and industrial (24%) revenues.

Key Credit Strengths

- Diverse customer base and stable service territory.
- Management and city council focus on improving electric system's financial profile.

Key Credit Concerns

- Current net short power position.
- Below-average financial measures.
- Continued exposure to natural gas market.

Rating Rationale

On Jan. 24, 2006, Fitch Ratings revised the Rating Outlook for the Lodi Electric Utility (LEU) to Negative, reflecting Fitch's increasing concern regarding the system's credit profile. The utility's net short position has become increasingly costly, as the price of natural gas and wholesale energy increased over the past year. Over the next 12–18 months, Fitch will monitor LEU's progress in implementing its strategic plan to procure a more stable power supply and the city councils' willingness to set and maintain rates to fully recover costs and improve the utility's finances.

Fitch recognizes that the city and the electric system have already taken many positive steps over the past few months. These steps include the city council passage of a 17% rate increase, the creation of a risk oversight committee and a risk management policy, the authorization from the city council to procure power beyond the city's current fiscal year, and the recent hiring of a new general manager. If the utility and the city are able to implement the current financial and power supply plan, a revision of the Rating Outlook to Stable is attainable.

The electric's system's rating is supported by the ability to set its own electric rates and recent willingness to raise rates. In addition, the system has a diverse customer base with modest industrial loads and competitive industrial rates. Also, the lack of retail competition in California alleviates the potential threat of load loss from competition for the near future.

Credit concerns include the substantial net short power supply position that still exists and a financial profile projected to remain below average over the next few years.

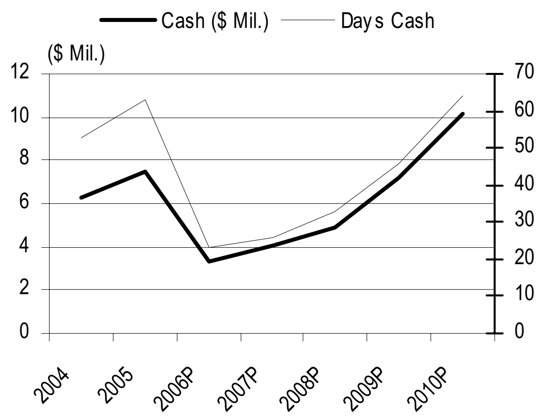
Financial Summary

In the fiscal year ended June 30, 2005, the electric system achieved debt-service coverage of 1.1 times (x) and currently has an approximately $7 million in operating and rate-stabilization reserves (equal to more than a month of operating expenses). Fitch notes that Lodi's reserves are expected to decrease to $3.3 million by the end of fiscal-year 2006 despite the recent rate increase. These measures do not compare favorably with most public power systems. Fitch views the system's liquidity as a concern, especially given its exposure to the volatile natural gas and short-term wholesale market and the lack of an automatic fuel-adjustment mechanism in its rate structure.

Management expects its rates and future decreases in natural gas and electricity prices should improve the system's margins and cash balances over next 3–5 years (see Cash Reserves table on page 2). Fitch reviewed LEU's assumptions regarding future commodity prices and believes they are reasonable, although volatility in the energy

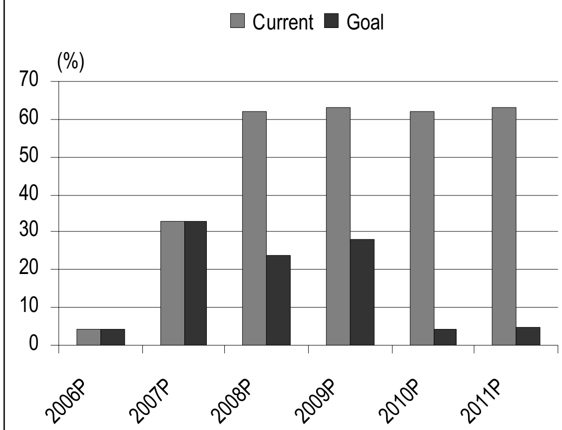
March 30, 2006

Cash Reserves



P – Pro forma. Source: Company reports.

Uncommitted Resources



P – Pro forma. Source: Company reports.

markets is becoming increasing difficult to predict. LEU's primary risk is that if commodity prices are higher than expected they will pressure the utility's financial margins.

In addition to its $76.5 million of direct electric system debt through certificates of participations (COPs), LEU is also obligated under take-or-pay contracts for approximately $100 million of the Northern California Power Agency (NCPA) debt and an additional $1 million of debt related to the Transmission Agency of Northern California.

Power Supply

Currently, LEU's power supply is a net short position and heavily reliant on natural gas generation and short-term spot market purchases (see Uncommitted Resources table). LEU does not own any generation assets but receives power as part of its membership in the joint-action agency, NCPA, and participates most notably in NCPA's geothermal and hydroelectric projects (both rated 'A' with Stable Rating Outlooks by Fitch).

Historically, from April through September, the city lacked 40%–50% of its needs, and during October through March, the system lacked 80%–90% of its needs. The electric system's net short power position resulted from the city's load growth, the 2002 termination of a power purchase contract with Calpine Corp., a long-term seasonal power exchange agreement with Seattle City Light (expiring in 2014) and a strategy that assumed LEU would benefit from a "buyer's" market in a deregulated California market that did not materialize.

Recognizing the risk of its power supply strategy as well as the utility's deteriorating financial profile, the city and the electric system have recently taken steps to address its above-average power supply risk. These steps include:

- Creating a risk oversight committee and a new risk management policy that, among many benefits, sets hedging goals, counterparty credit standards and a transparent process for risk review.
- Gaining the authorization from the city council to procure power beyond the city's current fiscal year.
- Modifying its power supply strategy to minimize cost variability.

Fitch believes that these polices (if fully implemented) should add meaningful and needed transparency, stability and oversight to the electric system. As part of its strategy to gain more control over its power supply, LEU is exploring projects that will add generation assets to its portfolio either through direct ownership or through a new NCPA project. Fitch notes that regardless of any new generation assets LEU may procure, its exposure to natural gas will remain substantial over the foreseeable future (similar to many California utilities).

Management/Governance

A five-member city council governs LEU. City council members are elected citywide for staggered four-year terms. The utility department is under the direction of the electric utility director, who is appointed by the city manager. In the past two years, management of the city and the utility have undergone significant changes with a new city manager, finance director and utility general manager.

Fitch recently met with city and utility officials and believes there is substantial support to improve the utility's financial profile and reduce its risk position. Fitch will monitor city councils' willingness to set and maintain rates to fully recover costs and improve the utility's finances.

Rates

LEU's electric rates (which do not include any automatic fuel-adjustment mechanism) are set by the city council. To meet rising energy costs, in November 2005, the city council passed a 17% rate increase increased the average rates to 14 cents/kilowatt-hour (kwh) from 11.8 cents/kwh. It is important to note that the rate increase was heavily weighted toward LEU's industrial customers. In the past, the electric system did not charge the full cost of service to its industrial customers.

After accounting for the recent rate adjustment, LEU's electric retail rates remain in line with neighboring investor-owned utility, Pacific Gas & Electric (PG&E). LEU's residential rates are slightly higher than PG&E rates, commercial rates are approximately even and industrial rates are lower. Further assisting LEU's competitiveness is that PG&E's rates are expected to increase over next year, as it continues to pass fuel cost increases to its customers.

Service Area and Customers

Fitch views the Lodi service area and customers as credit neutral. Lodi is located in California's Central Valley, approximately 90 miles east of San Francisco. The regional economy is based primarily in agricultural products, in particular, the wine grape industry. Income levels are 72% and 78% of state and U.S. levels, respectively, although unemployment and poverty levels are comparable with state and national averages. Population and energy sales growth has been moderate averaging 1.6% and 3%, respectively, over the past five years.

LEU serves the entire city, or approximately 27,500 customers. Revenues by customer class are drivers and consist of residential (33%) commercial (43%) and industrial (24%) revenues. LEU has minimal customer concentration, with the 10 largest customers representing 11% of revenue and the largest General Mills processing plant (comprising 8% of energy sales and 3.4% of revenues). Fitch also notes that the largest utility customers have been part of community for several decades.

Security Features

Revenue Pledge

Net revenues of electric system.

Rate Covenant

Electric system must set rates to equal 1.10x annual debt service. Net revenues include available funds authorized for the electric fund.

Debt-Service Reserve Fund

Lesser of 10% of COP proceeds, maximum annual debt service (MADS) or 1.25x average annual debt service.

Additional Bonds Test

Additional parity obligations are permitted if net revenues in the 12 consecutive months of the previous 18 equal 1.10x MADS for existing and proposed debt or an engineer's report certifies that adjusted net revenues for the next five years equal 1.10x MADS on existing and proposed debt.

Flow of Funds

All revenues are deposited to the electric fund and used in the following priority:

- Operation and maintenance expenses.
- Debt-service fund (amounts required to pay principal and interest).
- Reserve fund (amounts required to restore reserve fund requirement).
- Surplus fund (any lawful use of the city).

What Could Lead to a Positive Rating Action?

- Procuring a more stable power supply.
- City council's setting and maintenance of rates to fully recover costs and improve the utility's finances.

What Could Lead to a Negative Rating Action?

- Deterioration of cash and coverage beyond current projections.
- Continued volatility and higher for natural gas and wholesale energy prices.