FitchRatings

Fitch Rates Metro Water District of Southern CA Water Revs 'AA+'; Outlook Stable

Fitch Ratings - Austin - 16 January 2020:

Fitch Ratings has assigned a 'AA+' rating to the following bonds issued by the Metropolitan Water District of Southern California (Metropolitan, or the district):

--Approximately $214.0 million water revenue bonds, 2020 series A;

--Approximately $154.9 million subordinate water revenue refunding bonds, 2020 series A.

Bond proceeds will be used to fund a portion of the district's capital program, refund a portion of the district's outstanding bonds for interest savings, retire $100 million in senior lien notes, and pay costs of issuance. The water revenue bonds, 2020 series A (senior lien bonds) are expected to price via negotiation the week of January 27 and the subordinate water revenue refunding bonds, 2020 series A are expected to price via negotiation the week of February 10.

In addition, Fitch has affirmed the following ratings (pre-refunding):

--$2.5 billion outstanding senior lien and subordinate lien water revenue bonds and term bonds at 'AA+';

--$314.8 million special variable rate (self-liquidity) water revenue refunding bonds, series 2013D, 2014D, 2015A-1 and 2015A-2 at 'AA+'/'F1+';

--Bank bond ratings associated with water revenue bonds, series 2016 B-1 and B-2, 2017 authorization series A and 2018A-1 and 2018A-2 at 'AA+';

--$271.3 million subordinate lien water revenue bonds (SIFMA index mode), series 2017C-E at 'AA+'/'F1+';

--$31.3 million general obligation (GO) bonds at 'AA+;

--Issuer Default Rating at 'AA+'.

The Rating Outlook is Stable.

SECURITY

The senior lien bonds are payable from a senior lien on net water revenues of Metropolitan. Subordinate lien bonds are payable from net water revenues of Metropolitan subordinate in payment to the senior lien bonds. Metropolitan's GO bonds are payable from an unlimited ad valorem tax levy on all taxable property within the district.

KEY RATING DRIVERS

WHOLESALE SUPPLEMENTAL WATER SUPPLIER: Metropolitan is the supplemental wholesale water supplier to around 19 million people in Southern California. Revenues are provided from 26 member agencies that rely on water purchased from Metropolitan to supply their retail customers, although there are no minimum annual purchase or payment requirements.

REVENUE VARIABILITY: Financial performance exhibits cyclicality as a result of Metropolitan's role as the supplemental supplier and its highly volumetric rate structure. Financial margins depend on the volume of water sales achieved in any given year, which fluctuate considerably. The variability may grow more pronounced over time as customers invest in alternative water supplies in order to reduce their purchases from Metropolitan.

ROBUST RESERVES: Metropolitan's credit profile is supported by the accumulation of robust cash reserves and stored water reserves. Stored water reserves provide water supplies to meet higher member demand during a moderate drought or the initial years of a prolonged drought, and cash reserves help buffer the financial impact after those initial years when member demand declines or during years of wet weather.

HIGH COST WATER SUPPLY: Water is primarily provided from two independent supply sources, the State Water Project (SWP) and the Colorado River, and supply fluctuations occur on both supplies. The capital and operating costs associated with the import of these water supplies across the state result in a relatively high treated water costs at $1,078 per acre foot. Metropolitan still has rate flexibility, although some sensitivity and limitations exist given the varied reliance on Metropolitan by its members.

ESCALATING DEBT PROFILE: Debt levels are moderate but could climb rapidly over the next 10-15 years depending on the ultimate costs and Metropolitan's share of a SWP Bay-Delta water conveyance project that would replace the previously envisioned California WaterFix. State officials are currently evaluating a smaller, but still expensive project.

SELF-LIQUIDITY SUPPORTED DEBT: The 'F1+' rating on Metropolitan's self-liquidity bonds reflects the district's long-term credit quality and 'AA+' rating, as well as liquidity provided by $514 million in unrestricted cash and operating and maintenance reserve as of Nov. 30, 2019, and available liquidity provided by $200 million in a dedicated revolving credit facility. Together these balances cover the maximum daily exposure to unremarketed puts by over 1.25x.

RATING SENSITIVITIES

WEAK OPERATING PERFORMANCE: The 'AA+' rating and Stable Outlook anticipate a degree of cyclicality in Metropolitan's coverage and reserve levels. Strong reserves are needed to offset the periodic risk of lower revenues. Therefore, multiple years of lower coverage and/or the erosion of reserve levels could pressure the rating.

BAY-DELTA PROJECT PRESSURES: Given the potential scale of a SWP Bay-Delta conveyance project and the cost to Metropolitan, the district's rating could come under pressure if, among other things, ultimate project costs lead to erosion of financial margins from historical norms.

GENERAL OBLIGATION CAPPED AT IDR: Metropolitan's GO debt rating is sensitive to changes in the Issuer Default Rating.

CREDIT PROFILE

Metropolitan is a wholesale water supplier in southern California to 26 member agencies, many of whom have some form of local water supply. The largest three members (43% of water revenues in fiscal 2019) include the San Diego County Water Authority (senior lien revenue bonds rated AA+/Stable), Metropolitan Water District of Orange County, and Los Angeles Department of Water and Power (water revenue bonds rated AA/Stable).

DECLINING WATER SALES

Significant developments to water supply sources and the demand profile from members have occurred over the past decade. Greater variability and uncertainty also exists on Metropolitan's in-state water supply, the SWP. Demand level from members has declined from 20-year historical averages of over 2.0 million acre-feet (maf) to low points in the 1.4-1.6 maf range over the last few years. Management has responded by lowering its sales forecast about 10% per year from previous projections and now expects transactions to remain in this range through fiscal 2024.

In most cases, Metropolitan's water supply is the most expensive source in a member agency's overall water supply portfolio. As a result, Metropolitan absorbs most of the regional demand variability from naturally occurring hydrological conditions that impact the member agencies' local supplies and demand.

Metropolitan's member agencies are not required to buy minimum amounts of water from Metropolitan but instead use the imported water supply to supplement their other sources. However, Metropolitan's role in the region is crucial in that, even with its reduced water transactions, it still supplies 40%-60% of Southern California's water supply. Fitch expects Metropolitan to remain a key water supplier although over the long term the volume of water transactions by its member agencies will likely decline, placing additional competitive pressures on the cost of Metropolitan's supply.

VARIABLE REVENUE AND FINANCIAL RESULTS

With Metropolitan's primarily volumetric rate structure, rates are set to achieve a strong financial cushion in order to absorb the revenue implications of a potential drop in water transactions. As a result, Metropolitan's financial margins can vary from year to year. Metropolitan's budgets have traditionally been designed to achieve revenue bond debt service coverage (DSC) of 2.0x and a fixed charge coverage (FCC) of at least 1.2x in order to provide revenues to fund a portion of annual capital needs and to build reserves. FCC includes the amount of SWP costs that are a capitalized expense as if they were paid as debt service making FCC function similar to Fitch's calculation of total DSC.

Over the last few years, Metropolitan's financial results have been weaker than historical norms as water transactions were affected in fiscal years 2016 and 2017 by state-mandated conservation requirements for members in light of severe drought conditions. Since then wet weather generally has prevailed leading to reduced demand in fiscals 2018 and 2019 as well. Despite the challenging operating environment, Metropolitan exceeded its FCC target for fiscal years 2016-2019 (ending fiscal 2019 at just over 1.4x) but revenue bond coverage was lower than Metropolitan's internal goal and approximated the FCC level.

For fiscal 2020, Metropolitan anticipates FCC above 1.2x (currently projected at slightly under 1.4x) but expects revenue bond coverage will be only marginally higher at around 1.5x. Fitch's calculation of forecasted revenue bond DSC for fiscal 2020 is 1.9x, but total DSC (which includes SWP capitalized costs and GO debt service) is below 1.3x. Assuming a return to more normal hydrological conditions, albeit with lower than historical demand, as well as projected 3%-5% annual adjustments in water rates for fiscals 2021-2024, Metropolitan anticipates both revenue bond coverage and FCC will gradually improve to at or around 1.8x by fiscal 2024.

The healthy water sales in the initial years of the recent drought ending in 2017 bolstered unrestricted cash and investments as shown on the balance sheet to over $1 billion at the end of fiscal 2015 (days cash on hand

[DCOH] of 385). From fiscal years 2016-2018, a portion of cash reserves that exceeded Metropolitan's financial reserve policy was used in conjunction with other cash balances to fund $450 million of conservation programs as well as for repaying short-term revolving credit facilities. For fiscal 2019, reserves improved somewhat to over $715 million and Metropolitan was able to end the year with 301 DCOH.

Despite the reduction in reserves since fiscal 2015, Metropolitan has continued to exceed its minimum target reserve levels and total balance sheet unrestricted cash and investments has remained solid. Metropolitan's historically strong cash reserves have provided a high degree of financial flexibility that has helped mitigate variable water sales. In addition to cash balances, Metropolitan also a liquidity facility for $200 million which can be drawn for any purpose; Metropolitan currently has $100 million in draws outstanding against this facility, which were used for capital purchases and will be refinanced with a portion of the 2020A senior lien bonds.

STORED WATER SUPPORTS SALES DURING INITIAL YEARS OF DROUGHT

Metropolitan made substantial investment in its physical storage facilities and inter-agency water storage agreements over the past few decades. Storage capacity is around five times what it was in the early 1990s allowing Metropolitan to build stored water reserves during periods of wet hydrological conditions and/or low member transactions. Metropolitan currently has 6.1 maf in storage capacity and had a record total water in storage of 3.8 maf as of Jan. 1, 2020, nearly two years of average historical demand.

Metropolitan's substantial stored water position allowed it to meet the increased water demand of members during the initial years of the latest drought that ended in 2017, and Metropolitan's robust water storage amounts position it well to meet member demands during the next drought cycle.

ESCALATING LEVERAGE POTENTIAL FROM BAY-DELTA CONVEYANCE PROJECT

In July 2017, the California Department of Water Resources (DWR), which owns and manages the SWP, approved the WaterFix, a plan that had been championed by former governor Brown to improve the reliability of Sacramento-San Joaquin River Delta (the delta) water supply. The WaterFix called for $16.7 billion (2017 $s) in capital spending to construct three new intakes on the Sacramento River at 9,000 cubic-feet per second (cfs) capacity and two 45-foot diameter, 40 mile-long tunnels south under the delta to existing SWP and Central Valley Project pumping facilities. Construction was expected to commence in 2021 and be complete by 2035. The project had been subject to strong opposition from potential participants, who cited high costs, as well as many environmental groups, local governments and others who had challenged the project through the legal process.

Metropolitan's board had voted in July 2018 to support up to $10.8 billion (around 65% of project costs). However, in February 2019 governor Newsom expressed in his State of the State speech that he did not support the two-tunnel WaterFix but did support a single tunnel project. Consequently, in May 2019 DWR withdrew the approval of the WaterFix and rescinded the notice of determination required under the environmental process, among other actions, and has been evaluating a proposed change in scope of the project since.

Metropolitan has reviewed two single-tunnel potential options that would provide a 3,000 cfs diversion as well as a 6,000 cfs diversion staged implementation option that was previously considered by DWR. Metropolitan's preliminary cost estimates of these particular options in 2017$s are $9.2 billion and $11.1 billion, respectively. Until DWR identifies the actual scope of the project and addresses key issues, it is unclear as to whether or to what extent any revised Bay-Delta conveyance project will be implemented.

Metropolitan's financial forecast currently includes around $115 million in costs related to a Bay-Delta conveyance project, although Fitch expects Metropolitan would revise its forecast as the scope of any revised project becomes known and Metropolitan determines its potential level of participation. Assuming a project ultimately moves forward and Metropolitan participates relative to its existing SWP contract percentage or even at a higher level, the overall impact of Metropolitan's financial commitment has the potential to significantly increase the district's debt burden over the long-term and lead to ongoing incrementally higher rate increases than currently projected. This would add further pressure to the district's cost competitiveness. Consequently, maintenance of the rating, would be expected to depend on tight management of project costs and Metropolitan's ability to sustain operating cash flow sufficient to maintain reasonable leverage.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of Environmental, Social and Governance (ESG) credit relevance is a score of 3. This signals that ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
Metropolitan Water District of Southern California (CA)	LT IDR AA+ ○ Affirmed		AA+ ○
Metropolitan Water District of Southern California (CA) /General Obligation - Unlimited Tax/1 LT	LT AA+ ○ Affirmed		AA+ ○
Metropolitan Water District of Southern California (CA) /Water Revenues (2nd Lien)/1 LT	LT AA+ ○ Affirmed		AA+ ○
Metropolitan Water District of Southern California (CA) /Water Revenues - SIFMA and Flexible Index Mode/1 LT	LT AA+ ○ Affirmed		AA+ ○
Metropolitan Water District of Southern California (CA) /Water Revenues/1 LT	LT AA+ ○ Affirmed		AA+ ○
Metropolitan Water District of Southern California (CA) /Self-Liquidity/1 ST	ST F1+ Affirmed		F1+
Metropolitan Water District of Southern California (CA) /Water Revenues - SIFMA and Flexible Index Mode/1 ST	ST F1+ Affirmed		F1+

Additional information is available on www.fitchratings.com

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Applicable Criteria

U.S. Water and Sewer Rating Criteria (pub. 29 Nov 2018)
Fitch Internal Liquidity Worksheet (pub. 15 Feb 2019)
Public Sector, Revenue-Supported Entities Rating Criteria (pub. 07 Nov 2019)
U.S. Public Finance Tax-Supported Rating Criteria (pub. 10 Jan 2020)

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