

FITCH RATES METRO WATER DIST OF SOUTHERN CA SUB LIEN REVS 'AA+' & SIFMA INDEX BONDS 'AA+/F1+'

Fitch Ratings-Austin-12 June 2017: Fitch Ratings has assigned the following ratings to bonds issued by the Metropolitan Water District of Southern California (Metropolitan, or the district):

- Approximately \$188 million subordinate lien water revenue refunding bonds, 2017 series B 'AA+';
- Approximately \$80 million subordinate lien water revenue bonds, 2017 series C (SIFMA Index) 'AA+/F1+';
- Approximately \$95.6 million subordinate lien water revenue refunding bonds, 2017 series D (SIFMA Index) 'AA+/F1+';
- Approximately \$96.5 million subordinate lien water revenue refunding bonds, 2017 series E (SIFMA Index) 'AA+/F1+'.

The series 2017C, D & E bonds will be issued in the SIFMA Index mode. The series 2017B bonds will be fixed rate. Bond proceeds of the 2017 series B, D and E bonds will be used to refund outstanding obligations of Metropolitan as part of an overall refunding strategy to provide savings in connection with the previously issued 2017 series A fixed-rate bonds. The 2017 series C bonds will fund capital expenditures of the district. All four series of bonds are expected to price in negotiated sale during the week of June 19, 2017.

In addition, Fitch affirms the following ratings (prerefunding amounts):

- \$3.5 billion outstanding senior lien and subordinate lien water revenue bonds and term bonds at 'AA+';
- \$431.2 million SIFMA index mode bonds, series 2009A-2, 2011A1-A4 and 2012B1-B2 at 'AA+/'F1+';
- \$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 series 2016 B-1 and B-2 bonds and 2017 authorization series A at 'AA+';
- \$74.9 million general obligation (GO) bonds at 'AA+';
- Issuer Default Rating (IDR) at 'AA+'.

The Rating Outlook is Stable.

SECURITY

The subordinate water revenue refunding bonds are payable from a subordinate lien on net water revenues of Metropolitan. Metropolitan's senior lien water revenue bonds are payable from a senior lien on net water revenues of Metropolitan. 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 18.8 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 amounts.

REVENUE VARIABILITY: Financial performance exhibits cyclical 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-agency 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-agency demand declines.

HIGH-COST WATER SUPPLY: Water is primarily provided from two independent supply sources, the State Water Project (SWP) and the Colorado River. 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 high treated water cost at \$979 per acre foot. Metropolitan still has rate flexibility, although some sensitivity and limitations exist given the varied reliance on Metropolitan by its member agencies and ongoing lawsuit with San Diego County Water Authority (SDCWA).

SELF-LIQUIDITY SUPPORTED DEBT: The 'F1+' rating on Metropolitan's self-liquidity bonds reflects the liquidity provided by \$380 million in unrestricted cash and operating and maintenance reserve as of March 31, 2017, and available liquidity provided by \$180 million in dedicated revolving credit facilities. Together these balances cover the maximum daily exposure to unremarketed puts by over 1.25x.

RATING SENSITIVITIES

WEAK FINANCIAL MARGINS: The long-term 'AA+' rating and Stable Outlook anticipate a degree of cyclical in Metropolitan's coverage and reserve levels. Stronger margins and reserves are needed to offset the periodic risk of lower revenues in years such as fiscal 2016. However, multiple years of lower coverage and/or reserve levels could place downward pressure on the rating.

GENERAL OBLIGATION CAPPED AT IDR: The GO debt rating for Metropolitan 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 member agencies (54% of water revenues in fiscal 2016) are SDCWA (senior lien revenue bonds 'AA+'), Los Angeles Department of Water and Power (water revenue bonds 'AA') and Municipal Water District of Orange County (revenue bonds 'AAA').

SUBORDINATE LIEN BONDS RATED ON PAR WITH SENIOR LIEN

Fitch views the legal provisions of the subordinate lien indenture as similar to those offered by Metropolitan to existing bondholders. The inclusion of a subordinate net revenue pledge to the payment of tender purchase price on the district's SIFMA index bonds is a stronger credit feature while other changes result in weaker covenants. The distinction in subordinate lien covenants does not warrant a rating distinction given the small amount of subordinate lien debt outstanding in relation to Metropolitan's full debt profile and the overall credit strength of Metropolitan, as indicated by the IDR.

The most significant item in the subordinate lien indenture is the change to the definition of debt service used in the rate covenant and additional bonds test calculations. Variable-rate obligations issued under the subordinate lien indenture can pledge net revenues towards repayment of tender purchase but do not have to be included at the full par amount at each tender purchase date. Therefore, the series 2017C, D & E SIFMA Index bonds include a subordinate net revenue pledge on the tender purchase price of those bonds. Failure to pay the purchase price would trigger a default under Metropolitan's subordinate lien indenture. Other differences in the subordinate lien indenture include a change to the rate covenant to allow the inclusion of unrestricted reserves in the calculation and a change to the additional bonds test to 1.0x average annual debt service in comparison to the 1.2x maximum annual debt service that is required by the senior indenture.

DECLINING WATER SALES

Significant variation in member-agency water sales has occurred over the past 10 years but the overall trend has been downward. Member-agency sales declined from levels of over 2 million acre-feet (maf) prior to 2008 to low points of 1.63 maf in fiscal 2011 and 1.62 maf in fiscal 2016. Both of these low points occurred a few years into a drought period when member-agency conservation efforts reduced retail water sales and member agencies ceased purchasing water from Metropolitan. In most cases, Metropolitan's water supply is the most expensive source in a member-agency's overall water supply portfolio. Metropolitan expects water sales to decline even further to 1.56 maf in 2017 and 1.5 maf in 2018. Rate increases averaging 4% per year have been adopted in 2017 and 2018 although these rate increases were adopted in April 2016 when water sales in these years were expected to be 1.7 maf.

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 sales, 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 there will likely be further declines in the volume of water purchased by its member agencies, placing additional competitive pressures on the cost of Metropolitan's supply. Metropolitan continues to project that it will supply 1.75-1.80 maf annually to member agencies over the next 20 years.

Metropolitan absorbs most of the regional demand variability from naturally occurring hydrological conditions that impact the member agencies' local supplies. As drought lowers available local supplies and households have greater outdoor watering demands, member agencies increase their purchases from Metropolitan. Conversely, as one of the highest-cost resources in the region, Metropolitan bears a disproportionate impact of reduced demand, such as from the state-mandated conservation levels; member-agencies reduce purchases from Metropolitan before reducing production from their own local supplies.

REVENUE VARIABILITY

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 sales. As a result, Metropolitan's financial margins can vary from year to year. Budgets have traditionally been designed to achieve a fixed charge coverage (FCC) of at least 1.2x and debt service coverage of 2.0x in order to provide revenues to fund a portion of annual capital needs and to build reserves.

STORED WATER SUPPORTS SALES DURING INITIAL YEARS OF DROUGHT

Metropolitan made substantial investment in its physical storage facilities and inter-agency water storage agreements in the past 20 years. Storage capacity is nearly four times what it was in 1994.

Metropolitan currently has 5.83 maf in storage capacity. Strong hydrological conditions allowed Metropolitan to build its stored water reserves in 2011-2013. Storage reached a high point of 3.38 maf on Jan. 1, 2013 before declining to 1.55 maf as of Jan. 1, 2016. With lower member sales and an increased water allocation from SWP in calendar 2016, storage increased to 1.9 maf on Jan. 1, 2017.

Metropolitan's substantial stored water position allowed it to meet the increased water demand of members during the initial years of the recent drought. Financial performance in fiscals 2014 and 2015 exceeded budget expectations and Fitch calculated all-in debt service coverage exceeded 2.2x. FCC in those years was over 1.8x, in excess of Metropolitan's internal target.

Fitch uses FCC as the key financial metric for Metropolitan (a proxy for total debt service coverage) and Metropolitan uses this calculation for internal rate-setting as well. FCC includes the amount of SWP costs that are a capitalized expense as if they were paid as debt service. This expense is paid to the state for SWP expenses and is a cash outflow, much as principal on debt-financed assets is paid but is not considered an operating expense of the system in its accounting treatment.

FINANCIAL MARGINS DECLINED IN FISCAL 2016; SOME IMPROVEMENT EXPECTED

Water sales in fiscal 2016 were 1.62 maf, below the 1.75 maf assumed in the budget, affected by the state's very quick implementation of mandatory conservation requirements on Metropolitan's retail utility members. In addition, SWP costs were above budget even with the power cost savings from pumping a lower allocation from the project. As a result, Fitch calculated all-in debt service coverage was below 1.0x in fiscal 2016 based on audited revenues and expenditures; FCC in fiscal 2016 was similarly low. However, expenditures in that year included spending on one-time conservation programs that were funded from reserves. Without these one-time expenditures, debt service coverage was higher at 1.6x.

Financial margins in fiscal 2017 are forecasted to rebound, given the easing of drought conditions and water rates implemented Jan. 1, 2017. However, results may still be below Metropolitan's typical strong levels as sales are expected to remain constrained. Water sales in fiscal 2017 are currently projected at 1.56 maf as compared to the 1.7 maf in the budget. Financial margins are projected to tighten again in fiscal 2018 based on the new assumption of 1.5 maf water sales (as compared to the budgeted level of 1.7 maf). Fitch assumes expenditure reductions or other measures will occur, as needed, during fiscal 2018 to bring FCC into compliance with Metropolitan's 1.2x target.

RESERVES SPENT DOWN IN 2016

The healthy water sales in the initial years of the recent drought bolstered unrestricted cash and investments as shown on the balance sheet to over \$1 billion at the end of fiscals 2014 and 2015 (days cash on hand [DCOH] of 389 and 385, respectively). In fiscal 2016, overall cash reserves were spent down to fund \$450 million of conservation programs and to purchase property and related water rights, but unrestricted cash remained robust at the end of fiscal 2016 with around \$950 million, or 288 DCOH.

Fitch views the rapid spenddown in reserves in fiscal 2016 as reasonable from a credit perspective given the starting point of Metropolitan's reserves in excess of its unrestricted reserve target level, the extreme nature of the drought and the governor's executive order that required each of Metropolitan's member agencies to significantly reduce water sales. 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 put in place two liquidity facilities in April 2016 with RBC Municipal Products, LLC and U.S. Bank for a total of \$400 million. These facilities can be drawn for any purpose. Metropolitan currently has \$262.25 million drawn on these facilities, \$250 million of which replaced a portion of the district's funds being held in an exchange agreement set-aside fund for the disputed amount related to litigation with SDCWA. Another \$50 million may be drawn prior to the end of fiscal 2017 to bolster reserves. Metropolitan also has \$180 million in dedicated revolving credit agreements to pay the purchase price of its self-liquidity bonds, if needed.

CRITERIA VARIATION

Fitch applied a variation in its 'U.S. Water and Sewer Revenue Bond Rating Criteria' in determining the district's IDR. The variation relates to the application of the 'U.S. Public Finance Tax Supported Rating Criteria' in evaluating the impact of tax revenues on the district's IDR.

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Applicable Criteria

Fitch Internal Liquidity Worksheet (pub. 13 Jun 2013)
<https://www.fitchratings.com/site/re/710906>
Rating Criteria for Public Sector Revenue-Supported Debt (pub. 05 Jun 2017)
<https://www.fitchratings.com/site/re/898969>
Rating U.S. Public Finance Short-Term Debt (pub. 08 Feb 2017)
<https://www.fitchratings.com/site/re/893974>
U.S. Public Finance Tax-Supported Rating Criteria (pub. 31 May 2017)
<https://www.fitchratings.com/site/re/898466>
U.S. Water and Sewer Revenue Bond Rating Criteria (pub. 30 Nov 2016)
<https://www.fitchratings.com/site/re/890402>

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