FITCH RATES METRO WATER DIST OF SOUTHERN CA SUB LIEN REVS 'AA+'; OUTLOOK STABLE

Fitch Ratings-Austin-25 May 2018: Fitch Ratings has assigned a 'AA+' to the following bonds issued by the Metropolitan Water District of Southern California (Metropolitan):

--Approximately $100.0 million subordinate lien water revenue refunding bonds, 2018 series A;
--Approximately $65.6 million subordinate lien water revenue bonds, 2018 series B.

Bond proceeds will be used to refund a portion of outstanding senior lien bonds for interest savings, finance certain capital expenditures and pay costs of issuance. The bonds are expected to price via competitive bid on June 5, 2018.

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

--$3.2 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 bonds and 2017 authorization series A at 'AA+';
--$271.3 million subordinate lien water revenue bonds (SIFMA index mode), series 2017C-E at 'AA+'/'F1+';
--$60.6 million general obligation (GO) bonds at 'AA+;
--Issuer Default Rating (IDR) at 'AA+'.

The Rating Outlook is Stable.

SECURITY

The subordinate water revenue bonds are payable from a subordinate lien on net water revenues of Metropolitan. Its senior lien water revenue bonds are payable from a senior lien on net water revenues of Metropolitan. The district'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 18.9 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 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 during periods of strong water sales. 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.

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 $1,015 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 assuming construction of the $16.7 billion California WaterFix for which Metropolitan has committed to fund 64.6% of the project. Although the scale of this obligation would put long-term pressure on leverage metrics, scheduled debt amortization and improving cash flow from operations should create additional debt capacity.

SELF-LIQUIDITY SUPPORTED DEBT: The 'F1+' rating on Metropolitan's self-liquidity bonds reflects the liquidity provided by $401 million in unrestricted cash and operating and maintenance reserves as of April 1, 2018 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 OPERATING PERFORMANCE: The 'AA+' rating and Stable Outlook anticipate a degree of cyclicality 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 fiscals 2016 and 2017 during the recent drought. However, a sustained period of weaker operating performance and/or reserve levels could pressure the rating.

WATERFIX PRESSURES: Given the scale of the WaterFix and the cost to Metropolitan, the district's rating would be expected to be downgraded if, among other things, project costs escalate beyond current expectations or outpace anticipated rate and revenue increases, eroding financial margins well below historical norms.

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 (46% of water revenues in fiscal 2017) are San Diego County Water Authority (senior lien revenue bonds 'AA+'), Los Angeles Department of Water and Power (water revenue bonds 'AA') and Municipal Water District of Orange County.

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 transactions declined from levels of over 2 million acre-feet (maf) prior to 2008 to low points of 1.66 maf in fiscal 2011 and 1.64 maf in fiscal 2016 followed by 1.54 maf in fiscal 2017. These low points have occurred a few years into a drought period when member agency conservation efforts reduced retail water sales, which in turn led member agencies to cut purchases from Metropolitan. 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 it 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 purchased by its member agencies will likely decline, placing additional competitive pressures on the cost of Metropolitan's supply. With drought conditions abated, Metropolitan expects water transactions to improve incrementally in fiscal 2018 and thereafter but is not forecasting a return to historical highs. Metropolitan continues to expect that it will supply around 1.65-1.80 maf annually to member agencies for the foreseeable future.

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 the water sales component of Metropolitan's water transactions. 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 revenue bond debt service coverage (DSC) of 2.0x in order to provide revenues to fund a portion of annual capital needs and to build reserves.

STORED WATER SUPPORTED 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. Metropolitan currently has 6.04 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 calendars 2016 and 2017, storage increased to 3.0 maf as of Jan. 1, 2018.

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 revenue bond DSC exceeded 2.4x. 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 the district 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 FISCALS 2016 and 2017; IMPROVEMENT EXPECTED

Water sales in fiscals 2016 and 2017 were around 10% less than budgeted amounts, 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 in fiscal 2016 even with the power cost savings from pumping a lower allocation from the project. As a result, Fitch calculated revenue bond DSC excluding transfers in from reserves was 1.7x in fiscal 2017 and below 1.0x in fiscal 2016 based on audited revenues and expenditures; FCC in these years were similarly lower excluding transfers in. However, expenditures in these years included spending on one-time conservation programs (particularly in 2016) that were funded from reserves. Including the offset from reserves from these one-time expenditures, revenue bond DSC was 1.7x and 1.9x in fiscals 2016 and 2017, respectively.

With only modest improvement in expected water transactions, financial margins in fiscal 2018 are expected to be very similar to fiscal 2017 results. With recently adopted 3% annual adjustments in water rates for calendar years 2019 and 2020 coupled with expectations of incremental water transaction increases to 1.75 maf, revenue bond coverage and FCC are forecasted to improve to more normalized levels by fiscal 2020.

CASH BALANCES ROBUST DESPITE UTILIZATION OF TARGET RESERVES DURING DROUGHT

The healthy water transactions 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, a portion of cash reserves that exceeded Metropolitan's financial reserve policy target reserve level was used in conjunction with other cash balances to fund $450 million of conservation programs during the drought. Despite the drawdown, Metropolitan has continued to exceed its minimum reserve level and total balance sheet unrestricted cash and investments has remained robust, equaling 288 and 327 DCOH for fiscals 2016 and 2017, respectively. Metropolitan's historically strong cash reserves have provided a high degree of financial flexibility that has helped mitigate variable water transactions.

In addition to cash balances, Metropolitan also has two liquidity facilities totaling $400 million which can be drawn for any purpose. Metropolitan currently has drawn $198.3 million on these facilities which are expected to be taken out in June through a variable rate debt issuance. Metropolitan may draw up to $86 million in the near term to fund initial participation costs related to the WaterFix.

ESCALATING LEVERAGING EXPECTED FROM WATERFIX PROJECT

In July 2017, the California Department of Water Resources (DWR), which owns and manages the SWP, approved the WaterFix, a plan that has been championed by the governor to improve the reliability of Sacramento-San Joaquin River Delta (the delta) water supply. The WaterFix calls for $16.7 billion (2017 $s) in capital spending to construct three new intakes on the Sacramento River and two 45-foot diameter, 40 mile-long tunnels south under the delta to existing SWP and Central Valley Project pumping facilities. The project has been subject to strong opposition from potential participants, who cite high costs, as well as many environmental groups, local governments and others who have challenged the project through the legal process.

As a result of these setbacks, the state had indicated a willingness to consider downsizing or phasing the project as funding is secured. Metropolitan's board had originally voted in 2017 that it would be willing to support 26% (around $4.3 billion) of the original project costs. However, to prevent potential permitting delays associated with a staged approach and to better meet the co-equal goals of supply reliability and environmental improvement of the delta, Metropolitan's board voted in April 2018 to increase its support for the original project to around 65% ($10.8 billion). Metropolitan estimates that the resulting cost to individual households for construction and operation of the WaterFix will equal just under $5 per month.

While there are still hurdles to overcome before the project can become a reality, Metropolitan's vote added a significant boost in moving the WaterFix forward. Since Metropolitan's vote, DWR has entered into an agreement with a newly-created joint action agency (of which the district is a member) to complete design and manage construction of the WaterFix, and initial financing for the project is contemplated within the next several months.

Metropolitan's financial obligation related to the WaterFix is expected to be from paying its proportionate share of DWR financing costs as a SWP contractor and through a combination of other forms of financial support. These are expected to include gap funding for continued work on the project over the coming months, support for obligations issued by a financing joint action agency, and the acquisition of transfers of SWP water supplies related to the project and acquisition of the unsubscribed portion (roughly 33%) of the project.

If the project moves forward as envisioned, the overall impact of Metropolitan's financial commitment will significantly increase the district's debt burden over the long-term and lead to ongoing incrementally higher rate increases than previously contemplated. This will add further pressure to the district's cost competitiveness. Maintenance of the rating will depend of tight management of project costs and Metropolitan's ability to sustain operating cash flow sufficient to maintain reasonable leverage.

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. 26 Feb 2018)
https://www.fitchratings.com/site/re/10020113

U.S. Public Finance Short-Term Debt Rating Criteria (pub. 01 Nov 2017)
https://www.fitchratings.com/site/re/905637
U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018)
https://www.fitchratings.com/site/re/10024656
U.S. Water and Sewer Rating Criteria (pub. 30 Nov 2017)
https://www.fitchratings.com/site/re/10010508