S&P Global Ratings

RatingsDirect®

Summary:

Southern California Metropolitan Water District; General Obligation; Water/Sewer

Primary Credit Analyst:
Chloe S Weil, San Francisco + 1 (415) 371 5026; chloe.weil@spglobal.com

Secondary Contact:
Jenny Poree, San Francisco + 1 (415) 371 5044; jenny.poree@spglobal.com

Table Of Contents

Rating Action

Stable Outlook

Credit Opinion

Related Research

Summary:

Southern California Metropolitan Water District; General Obligation; Water/Sewer

Credit Profile		
US$190.485 mil wtr rev bnds ser 2021A due 07/01/2051		
Long Term Rating	AAA/Stable	New
Southern California Metro Wtr Dist wtr		
Long Term Rating	AAA/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AAA' long-term rating to the Southern California Metropolitan Water District's (MWD, or the district) $190.5 million series 2021A senior-lien water revenue bonds. At the same time, S&P Global Ratings affirmed its various ratings on the district's existing revenue bonds, including its:

- 'AAA' long-term rating and underlying rating (SPUR) on MWD's senior-lien revenue bonds;
- 'AA+' long-term rating on MWD's subordinate-lien revenue bonds;
- 'AAA/A-1+' rating on MWD's special variable-rate water revenue bonds (variable-rate bonds with bank liquidity facilities), 2018 series A-1 and A-2;
- 'AAA/A-1' rating on MWD's special variable-rate water revenue refunding bonds, 2016 series B-1 and B-2, and its series A water revenue bonds (2017 authorization), and its series B-3 water revenue bonds (2000 authorization); and
- 'A-1+' rating on MWD's subordinate water revenue refunding bonds, series 2017 C, 2017 D, and 2017 E (SIFMA Index Mode).

The outlook, where applicable, is stable.

Bond proceeds will be used to fund $255 million of capital projects that require funding through 2022. Prior to the issuance of the bonds, the district had approximately $2.4 billion aggregate principal amount of senior-lien bonds and $1.4 billion of subordinate-lien debt outstanding. MWD currently has $824.9 million of outstanding variable-rate debt, of which $386.2 million is unhedged, which complies with its debt, investment, and cash management policies.

We consider the bond provisions to be credit neutral. According to the senior-lien master bond resolution, the district must demonstrate that net operating revenue for the past fiscal year or 12 of the past 24 months to issue additional senior-lien revenue bonds, or projected net operating revenue for the first year after financed water improvements have been completed must be at least 1.2x future maximum annual debt service (MADS) on previously issued and proposed bonds. The district may adjust revenue for enacted changes in water rates and charges as well as projected revenue from additions to the water system. The rate covenant is 1.0x for both the senior and subordinate liens, which, while permissive, is not considered a credit risk given management's proven track record of all-in coverage that is well above this minimum. There will not be a debt service reserve fund for the series 2021A bonds.

Credit overview

Although Southern California has suffered under the weight of the pandemic and the restrictions implemented to protect the health and safety of the community from the spread of COVID-19, we believe MWD has taken prudent measures to mitigate financial risk from the pandemic. In September 2020, management placed a moratorium on nonemergency unbudgeted spending, and approved cost containment measures to reduce $11.7 million of expenditures in fiscal years 2021 and 2022. The district's financial performance has historically been resilient through varied economic cycles. Projected financial results, even under S&P Global Ratings' stress scenarios, indicate that both coverage and liquidity will remain at healthy levels.

Most recently, based on audited financial data, we calculate all-in coverage (across both liens) of 1.39x and 1.43x in fiscal years 2020 and 2019, respectively on $290.4 million and $310.6 million of debt service, respectively. Our calculation is slightly lower, but still strong, at 1.24x and 1.29x in fiscal years 2020 and 2019 when we include MWD's state water contract capital costs (which are largely paid from property taxes) as a fixed cost. The total unrestricted reserve position (which consists of the water rate stabilization fund and the revenue remainder fund) at the end of fiscal 2020 was $434.3 million, or over six months of cash on hand. MWD has historically held a strong liquidity position in part to serve as a natural hedge against its variable-rate debt exposure as well as a financial backstop in the event of a 20% reduction in water sales, due to hydrology or other factors. Although water sales can be volatile, and typically decline in wet weather years, which we consider a credit risk, they are partly offset by a corresponding decline in water and power supply costs, which we consider a stabilizing credit factor.

The district maintains an internal funding target of approximately 55% to 60% of capital expenditures from current revenues, which we also consider a credit strength. MWD board policy is to maintain 2.0x annual senior-lien debt service coverage by net operating revenue, which we view as strong, and 1.2x fixed-charge coverage (across both the senior and subordinate liens), which we view as good, especially for a wholesaler.

The ratings further reflect our view of the following credit factors:

- The district serves an important role as the primary wholesale water provider to an extremely robust and diverse service territory in Southern California. The district's service territory is very large, offering it several advantages, including the ability to spread its costs over a large customer base. In addition, a very minor rate increase can generate millions in water revenue.
- MWD's comprehensive resource planning and risk management practices, which have been a cornerstone of the credit rating, result in credit stability despite past periods of drought, litigation, and water supply uncertainties.
- Strong member agency contracting provisions limit delinquent payments. Member agencies are billed monthly, and a late charge of 1% of the delinquent payment is assessed for a payment that is delinquent for no more than five business days. A late charge of 2% of the amount of the delinquent payment is charged for a payment that is delinquent for more than five business days for each month or portion of a month that the payment remains delinquent.
- Because the customer base is sufficiently large and diverse, in our view, MWD has no dependence on any of its principal member agencies for its operating revenues. Nevertheless, we recognize the strong credit quality of its key members, particularly the San Diego County Water Authority (SDCWA) and Los Angeles Department of Water and

Power (LADWP).

- MWD has demonstrated willingness and ability to raise rates, with board-approved 3.0% and 4.0% rate increases effective Jan. 1, 2021, and Jan. 1, 2022, which, in our view, will support sound financial metrics over the outlook period. Rates and charges are projected to increase an average of 5.0% in calendar years 2023 and 2024, and 4.0% for calendar year 2025, subject to adoption by the board.
- The district's cash position is likely to remain a key credit strength. Based on the 10-year forecast, management anticipates that unrestricted reserves will gradually rise to more than $700 million by 2030. The district targets maintaining unrestricted reserves equal to the portion of the fixed costs estimated to be recovered by water revenues over a two-year period.
- Current projections assume the issuance of $330 million of additional water revenue bonds (net of the series 2021A bonds) through fiscal year 2025 to finance capital projects, which we consider manageable. However, current forecasts exclude potential expenditures related to a proposed $3.4 billion recycled water project (in partnership with Los Angeles County Sanitation). Costs to modernize Bay Delta conveyance--we believe MWD's share could exceed $5 billion, although the district's proportionate share has not been specified--have also not been incorporated into the current capital improvement plan.
- The district's financial management is extremely strong, and its conservative financial forecasting and well-delineated policies to address any contingent liabilities provide additional support for the ratings.

The stable outlook reflects our view that Southern California's continued dependence on MWD for water will likely remain strong, and that MWD's ability to supply needed water is critical to the health of the Southern California economy, creating a large political incentive to meet future water demand. Our ratings also reflect our view that the district's general creditworthiness is above that of the U.S. sovereign. This reflects our view that the district would not default in a stress scenario likely to accompany a sovereign default given autonomy from sovereign intervention.

Environmental, social, and governance factors

Given its location in Southern California, we believe MWD faces elevated environmental risk due to the region's inherent water supply scarcity and seismic exposure. In particular, its imported water supply--both the state water project and the Colorado River--remains susceptible to environmental scrutiny and risks related to climate change, rising temperatures, and shifting precipitation patterns. Notably, the district currently maintains record dry-year storage balances (3.2 million acre-feet, or over two years of demand, as of Dec. 31, 2020) which we consider a stabilizing credit factor over the near term. We expect MWD will continue to play a key role regarding Delta water conveyance and resource management in the Colorado River basin over the next decade. Over the near term, management will face many other critical water supply decisions, which could require massive capital investments, such as whether to proceed with its Regional Recycled Water Project, which, while costly, would be favorable from an environmental stewardship perspective, in our view.

Metropolitan's general manager will be stepping down in mid-2021, after an accomplished 15-year tenure at the helm of the organization. Given the complexities of the organization, having a leader with commensurate skill and experience in the water industry will be important to ongoing credit quality.

The district is sensitive to affordability concerns, given that retail water rates in its service area may not be affordable for all customers served (particularly those living in census tracts below 80% of median household income, which we estimate accounts for about 50% of the population). MWD oversees targeted programs for increasing water conservation in disadvantaged communities, such as by providing incentives for multifamily housing and grant funding support for the local agencies. We believe COVID-19 presents added social risk, as MWD's member agencies could seek further rate deferrals or reductions as the pandemic spreads and the effects of the recent recession deepen. The pandemic, to date, has not resulted in material member delinquencies. Finally, while not currently a credit risk, in our view, persistent negative public sentiment or rising political pressure--especially should decision-makers' willingness and ability to raise rates in a rising cost of service environment--would adversely affect our view of its governance practices.

Stable Outlook

Downside scenario

The current stable outlook reflects our belief that the district has significant financial capability to weather the immediate revenue effects from the pandemic. While unexpected, we could lower the ratings or revise the outlook to negative, or both, if water decline on a protracted basis from current levels--due to the development of significantly lower cost water supply alternatives or the loss of a major member--although we believe neither is likely to occur over the two-year outlook period.

Credit Opinion

MWD is the main water wholesaler to 26 member agencies in a service area of approximately 19 million people in Los Angeles, Orange, Riverside, San Bernardino, San Diego, and Ventura counties in Southern California. The district provides 40% to 60% of the water within its 5,200-square-mile service area, depending on water conditions. The leading 10 customers represented about 83% of water transaction revenue and water volume in fiscal 2020, with the SDCWA the largest customer by transactions at 22.9% of water volume resulting in the highest percentage of transaction revenue at 15.8%. Although no customer is required to purchase water from MWD, all members must pay a readiness-to-serve charge calculated from historical purchase levels.

Over the last five years, the district's water revenues have declined to levels that are well below historical averages, as per capita consumption has dropped and the member agencies, primarily the LADWP, have relied on alternative supplies when available. For example, the district's water transactions declined from 2.1 million acre feet (MAF) in fiscal 2014 to 1.4 million MAF in fiscal 2020.

For forecasting purposes, the district assumes that water transactions will rebound to 1.6 MAF in fiscal 2021 and gradually rise to 1.74 MAF in fiscal 2026 and then remain stable thereafter. The forecast assumes Colorado River Aqueduct diversions of about 0.8 MAF to 0.9 MAF annually and State Water Project allocations of 50% annually. Although we believe these assumptions are reasonable as long-term averages, we expect that year-to-year actuals will vary significantly based on annual hydrologic conditions and demand. In particular, demand from LADWP varies significantly depending on water availability from the southern Sierras, which feeds the Los Angeles Aqueduct.

The district has indicated that the shelter-in-place order has shifted some water use from the commercial, industrial, and institutional customer classes to residential, and that, in addition to increased indoor water use, outdoor use may increase as residents turn their attention to gardening during the stay-at-home time. Nevertheless, our forward-looking analysis incorporates a 10% cut to fiscal 2021 water transactions to reflect S&P Global Economics' economic outlook. We performed a number of stress tests to evaluate future coverage. Based on current projections, we expect the district to achieve about 1.4x all-in coverage in fiscal 2021. Although a 10% decline in water sales would likely be offset by some drop in water supply and power costs, in the absence of any extraordinary expenditures, we assume coverage will remain above the 1.2x, even under a protracted recession scenario.

While we consider the district's anticipated capital spending through 2025 to be manageable and unlikely to affect our opinion of the district's leverage or financial flexibility, we recognize the potential for significant additional debt over the next twenty years, primarily related to the Bay Delta. MWD's board approved the funding of up to 64.6% of approximately $10.8 billion (in 2017 dollars) of the overall capital cost of the project then known as California WaterFix; this sizable funding commitment was intended to support a two-tunnel project. However, under the governor's direction, the proposed project has been revised to a single tunnel project now referred to as the Delta Conveyance Project (DCP). On Dec. 8, 2020, MWD's board voted unanimously to fund its share of the environmental planning and preconstruction costs of the DCP, which is estimated at 47.2% of project costs, $160.8 million, over the next four years. We expect further clarity regarding MWD's share of overall DCP capital funding as the environmental review is completed.

Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

Ratings Detail (As Of January 8, 2021)		
Southern California Metro Wtr Dist wtr		
Long Term Rating	AAA/A-1/Stable	Affirmed
Southern California Metro Wtr Dist wtr		
Long Term Rating	AAA/Stable	Affirmed
Southern California Metro Wtr Dist wtr		
Long Term Rating	AAA/Stable	Affirmed
Southern California Metro Wtr Dist wtr		
Long Term Rating	AAA/Stable	Affirmed
Southern California Metro Wtr Dist wtr		
Long Term Rating	AAA/A-1/Stable	Affirmed
Southern California Metro Wtr Dist wtr		
Long Term Rating	AAA/A-1/Stable	Affirmed
Southern California Metro Wtr Dist wtr		
Long Term Rating	AAA/A-1/Stable	Affirmed
Southern California Metro Wtr Dist wtr		
Long Term Rating	AAA/A-1+/Stable	Affirmed

Ratings Detail (As Of January 8, 2021) (cont.)		
Southern California Metro Wtr Dist wtr		
Long Term Rating	AAA/A-1+/Stable	Affirmed
Southern California Metro Wtr Dist wtr		
Long Term Rating	AAA/Stable	Affirmed
Southern California Metro Wtr Dist wtr subord		
Short Term Rating	A-1+	Affirmed
Southern California Metro Wtr Dist wtr subord		
Long Term Rating	AA+/Stable	Affirmed
Southern California Metro Wtr Dist wtr (FGIC) (SEC MKT)		
Unenhanced Rating	AAA(SPUR)/Stable	Affirmed
Southern California Metro Wtr Dist GO		
Long Term Rating	AAA/Stable	Affirmed

Many issues are enhanced by bond insurance.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.