S&P Global
Ratings

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Summary:

Southern California Metropolitan Water District, California; Water/Sewer

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Credit Profile		
Southern California Metro Wtr Dist wtr subord		
Long Term Rating	AA+/Stable	Rating Assigned
Short Term Rating	NR	Affirmed

Rating Action

S&P Global Ratings assigned its 'AA+' long-term rating to the Metropolitan Water District of Southern California's (MWD, or the district):

- $80 million of 2017 series C subordinate water revenue bonds (index interest rate period),
- $95.6 million of 2017 series D subordinate water revenue refunding bonds (index interest rate period), and
- $95.6 million of series E subordinate water revenue bonds (index interest rate period).

Because the expected tenor of the 2017 series C, D, and E index tender bonds exceeds 13 months, in accordance with our criteria, we are assigning a long-term rating to each of these series of bonds. The outlook is stable.

The 'AA+' long-term rating reflects our view of MWD's general creditworthiness. We maintain a one-notch difference between the senior and subordinate bonds based primarily on the active utilization of both. We rate the senior issues 'AAA'.

The subordinate series 2017C, D, and E bonds are Securities Industry and Financial Markets Association (SIFMA) index tender bonds. The subordinate series 2017C, D, and E bonds are being remarketed at a spread above the SIFMA Index in connection with an unscheduled mandatory tender. The series 2017C, D, and E bonds are expected to be sold with a call protection date of November 2023 and scheduled purchase date six months later in May 2024, and a nominal final maturity ranging between July 1, 2033 and July 1, 2047. The bonds will be on parity with $1.09 billion of subordinate lien obligations.

A failed remarketing of the series 2017C, D, and E index tender bonds would most likely occur due to something exogenous in the financial markets, unrelated to the credit quality of the district. We understand that if MWD can't cover any mandatory tenders with the proceeds of the remarketing of the index tender bonds, MWD would refund the bonds before the scheduled mandatory tender date, requiring future market access, or by temporarily drawing on available reserves. MWD may also use available capacity (currently $200 million) under its Royal Bank of Canada revolving credit agreement for this purpose.

MWD's net operating revenue secures the series 2017 C, D and E index tender bonds; repayment is subordinate to the debt service on MWD's $2.58 billion aggregate principal amount of senior bonds. Any draws on MWD's revolving credit agreement as well as certain potential swap repayments, are also senior to the subordinate-lien bonds.

We view the master subordinate resolution bond provisions to be somewhat permissive. There is a 1.0x rate covenant and 1.0x additional bonds test for the subordinate-lien bonds. The resolution adjusts the "assumed" debt service for certain "covered obligations" in the rate covenant, such as any principal and interest payments under a revolving credit facility (as long as the facility is outstanding) and any mandatory tender payments of any index tender bonds (or potential variable-rate demand obligations [VRDOs]) to be issued on this lien. At the same time, failure to remarket the bonds on the scheduled mandatory tender date is now considered an event of default. The resolution also revises the assumed interest rate on variable-rate obligations for purposes of the subordinate-lien rate covenant to be equal to the average of the SIFMA municipal swap index for the 12-week period immediately preceding the calculation date.

Credit overview

The district serves an important role as the primary wholesale water provider to an extremely robust and diverse service territory in Southern California. Our ratings are supported by MWD's ability to draw water supplies from the Colorado River, the State Water Project (SWP), stored water, and supplemental water transfers to keep supplies and regional demands in balance, even under adverse water supply conditions. In particular, we consider MWD's comprehensive resource planning and its well-defined risk management practices and financial policies to be the cornerstone to its credit quality. Although the Feather River watershed (one of the district's primary sources of supply) is on track for its second driest year on record, we do not expect current year hydrology to adversely influence the district's ability to meet its members' needs.

The pandemic has also not had a meaningful effect on the district's water sales to date. However, the district's water revenue have declined to levels that are well below historical averages, as per capita consumption has dropped and the member agencies, primarily the Los Angeles Department of Water and Power, 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 (the district is projecting stronger sales of about 1.55 MAF in fiscal 2021); thus, the ability to maintain steady financial metrics despite variability in water sales is a key credit strength.

The district maintains an internal funding target of approximately 55% to 60% of capital expenditures from current revenues, which we also consider credit supportive. MWD board policy is to maintain 2.0x annual senior-lien debt service coverage by net operating revenue, which we view to be credit supportive, 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'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. 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 revenue.
- Strong member agency contracting provisions that 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.

- Stable financial metrics despite declines in water sales over the last five years. 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.
- Sound projected financial metrics supported by the district's robust resource planning and forward-looking rate setting. Based on current projections, we expect the district to achieve over 1.6x all-in coverage in fiscal 2021. 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.
- 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 20 years, primarily related to the Bay Delta.

MWD has historically held a strong liquidity position in part to serve as a natural hedge against its variable-rate debt exposure. MWD's 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 more than six months of cash on hand. We understand the district expects to increase its cash reserves to about $500 million by fiscal year end, and we view strong reserves (and the maintenance of the dedicated credit facilities) as necessary if the district can't refund or remarket (or is unsuccessful in doing so) the $446.2 million of senior (and subordinate) index tender bonds.

The stable outlook reflects our view that MWD will continue to take steps to reduce market access risk well in advance of the next scheduled purchase date for the subordinate series 2017 C, D, and E index tender bonds.

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 SWP 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 and emergency storage balances (3.9 million acre-feet, or over two years of demand, as of Jan. 1, 2021) 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.

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. 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 and water in storage to manage through various hydrological cycles. 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.

Related Research

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