

# RatingsDirect®

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## Summary:

# Southern California Metropolitan Water District; General Obligation

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## Summary:

# Southern California Metropolitan Water District; General Obligation

### Credit Profile

US\$18.6 mil wtrwks GO rfdg bnds ser 2020 due 03/01/2037

*Long Term Rating* AAA/Stable New

Southern California Metro Wtr Dist GO

*Long Term Rating* AAA/Stable Affirmed

## Rating Action

S&P Global Ratings assigned its 'AAA' long-term rating to Southern California Metropolitan Water District's (MWD) \$18.6 million series 2020A waterworks general obligation (GO) refunding bonds, and affirmed its 'AAA' long-term rating on the district's GO bonds outstanding. The outlook is stable.

The district will use the series 2020A GO bond proceeds to achieve debt service savings. At the end of fiscal 2020, the district had \$37.3 million (inclusive of the bonds refunded by the series 2020A proceeds) GO debt outstanding issued under an authorization dating back to 1966. No additional GO bonds, other than refunding bonds, may be issued under the authorization. In addition to MWD's existing GO debt, MWD has \$3.8 billion of separately secured water revenue debt.

Unlimited ad valorem taxes levied on taxable property (except certain personal property, which is taxable at limited rates) within the district secure the GO bonds. The GO bonds are not secured by any pledge of, or lien upon, water revenues.

Taxes are collected by the respective counties and provided to the district, and do not go directly to the trustee. However, the tax receipts, net of GO bond debt service, may only be used for the district's State Water Project (SWP) contract payment obligations. Nevertheless, because the board has determined that the tax revenue is essential to the fiscal integrity of the district, and as GO debt service has declined while assessed value (AV) has grown, the district's SWP contract obligations are now primarily paid from property tax receipts, thus reducing the portion of SWP costs paid from water revenues.

For more information on MWD's water system operations, please see our article published June 1, 2020, on RatingsDirect.

### Credit overview

MWD has one of the strongest property tax bases among entities with GO debt that we rate in the U.S., owing to the vast extent of its tax and service area in one of the country's largest and most diverse economic regions. Nevertheless, we believe 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 this will affect water demand as well as the overall tax base, and could lead to deteriorating financial performance. While the district is subject to recessionary losses, we recognize that market values fell by only 4% during the Great Recession. This indicates that tax collections should remain relatively resilient over the upcoming two-year outlook, assuming the pandemic does not extend meaningfully beyond current expectations.

We also view management's proactive strategic planning and strong cash reserves (totaling \$582 million as of June 30, 2020) as supportive of credit quality. The district has historically held a strong liquidity position in part to serve as a natural hedge against its variable-rate debt exposure but also to serve as a financial backstop in the event of a 20% reduction in water sales, due to hydrology or other factors.

Our current forecast assumes U.S. GDP will contract 5.0%, slightly better than our April forecast, followed by a modest rebound of 5.2% growth in 2021--a full percentage point weaker than our previous estimate of 6.2%. For more information, see "The U.S. Faces A Longer And Slower Climb From The Bottom", published June 25, 2020, on RatingsDirect.

The rating further reflect our opinion of the district's:

- Strength and diversity of its vast service area, encompassing most of Southern California's population centers, including Los Angeles, Riverside, and San Diego;
- Extremely high ratio of property tax receipts to annual debt service (approximately 10x in fiscals 2019 and 2020);
- Best in class financial management practices and policies, which includes conservative financial forecasting, and well-delineated financial policies.

The stable outlook reflects our view that the district's property tax receipts will continue to significantly exceed annual debt service. The credit profile will continue to benefit from the strength and diversity of a vast and deep economic base and MWD's well-embedded role in providing critical wholesale supply within its service area. Our issue rating also reflects 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 SWP and the Colorado River) remain susceptible to environmental scrutiny and risks related to climate change, rising temperatures, and shifting precipitation patterns. 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 be faced many other critical water supply decisions, which could require massive capital investments, such as whether to proceed with its \$3.4 billion Regional Recycled Water Project, which while costly, we would consider favorable from an environmental stewardship perspective.

MWD's comprehensive resource planning and risk management practices have been a cornerstone of the credit rating,

resulting in credit stability despite past periods of drought, litigation, and water supply uncertainties. Metropolitan's general manager will be stepping down at the end of this year, 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 is comprised of about 50% of the population.) MWD oversees targeted programs for increasing water conservation in disadvantaged communities, such as by providing incentives for multi-family housing and grant funding support for the local agencies.

We believe COVID-19 presents added social risk, as MWD's member agencies could seek rate deferrals or reductions as the pandemic spreads and the recession deepens. 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 that are being exacerbated by the response to COVID-19. However, we could take a negative rating action if the economic recession causes measurable financial variances that are worse than those that we have already incorporated into our rating. These factors include a sustained unemployment rate above 10%, significant increases in county poverty rates for the region, economic growth that is consistently below national trends (using county-level GDP compared with national trends), and income levels across the MSA. We would incorporate these assessments into our analysis once we are more certain on how these benchmarks would normalize after the acute effects from COVID-19 are through.

## **Credit Opinion**

MWD has one of the largest sub-state property tax bases in the nation, encompassing \$3.1 trillion in market value. The district's tax base has doubled since 2005. We consider the district's income profile to be good-to-strong, with a median household effective buying income (EBI) of about 114% of the national level, and a per capita EBI of 98% of the national average. We have calculated these figures using the weighted average by population of the district's overlapping counties. Nevertheless, the pandemic has resulted in a significant rise in unemployment across Southern California. For example, the most recent unemployment data, as of May 2020, indicates unemployment in Los Angeles County has risen to over 20.8%.

The district's service territory is extremely large, offering it several advantages, including the ability to spread its costs over a large customer base. Although taxpayer concentration data is not available for the district as a whole, we believe the tax base is extremely diverse, and assume the leading taxpayer is likely responsible for less than 2.0% of

the overall GO revenue base. For example, Los Angeles County (which makes up 49% of the tax base) has a top 10 concentration of 1.7% and Orange County (the next largest in the district, proportionally) has a concentration of 2.6%, both of which we consider very low.

By design, the district's historical tax receipts have historically exceeded GO debt service, with the remainder (exceeding \$133 million in 2020) available to offset its SWP contract obligations. With regard to water transaction revenues, given the size of the population served, a very minor rate increase can generate millions in additional revenue.

Property tax receipts rose to \$147.1 million in fiscal 2020 (unaudited) from \$129.7 million in fiscal 2018. Over this period, GO debt service declined to \$13.2 million in fiscal 2020 from \$18.0 million in fiscal 2018. MWD has not adjusted the percentage tax rate (0.0035%) since 2013, and management has not indicated that they do not have any plans to lower the percentage over the outlook period.

The district's cash position is a key credit strength. The total unrestricted reserve position (which consists of the water rate stabilization fund and the revenue remainder fund) at the end of fiscal 2019 was \$575 million, equivalent to 240 days' of operating expenses. Metropolitan expects to hold unrestricted reserves of about \$582 million at the end of fiscal 2020. Based on the 10-year forecast, management anticipates that unrestricted reserves will gradually rise to more than \$700 million by 2030.

The overall net debt burden, which consists of tax-secured direct and overlapping debt, is low, in our view, relative to market value at 2.6% and moderate at \$4,229 per resident. The district's now 52-year-old GO authorization is fully exercised and management indicates that the district is unlikely to request GO authorization from voters again, because the district is able to finance its capital needs via revenue-secured debt and because securing such authorization would require a sizable two-thirds majority voter approval. Amortization of GO and revenue debt is slow, in our view, with 45% of principal retired in the next 10 years.

## **Related Research**

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

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