Fitch Rates Metropolitan Water District of Southern California GO Bonds 'AAA'; Outlook Stable

Fitch Ratings-San Francisco-19 November 2014: Fitch Ratings assigns an 'AAA' rating to the Metropolitan Water District of Southern California, CA's (Metropolitan) obligations as follows:

--$50.5 million waterworks general obligation (GO) refunding bonds, 2014 series A.

Bond proceeds will refund a portion of waterworks GO refunding bonds, 2005 series A (outstanding principal $60.1 million). Bonds are expected to price via competitive sale on or around Dec. 2, 2014.

Fitch also affirms the following outstanding Metropolitan ratings:

--$4.2 billion outstanding water revenue bonds and term bonds at 'AA+';
--$167.1 million special variable rate water revenue refunding bonds, series 2013D and 2014D (self-liquidity) at 'AA+/'F1+';
--$132.3 million waterworks GO bonds at AAA'.

The Rating Outlook on all bonds is Stable.

SECURITY

GO BONDS: The GO bonds are payable from an unlimited ad valorem tax on all property within the district.

WATER REVENUE BONDS: Revenue bonds are payable from net water revenues of the district. The series 2013D and 2014D (self-liquidity) bonds do not have a liquidity facility to support the weekly tender but instead rely on Metropolitan's own liquidity. Payment of a tender purchase for these bonds, the 2013E flexible index mode, the 2009A-2, 2011A1-A4, and 2012B1-B2 SIFMA index mode bonds, or the series 2012E, 2014C, and 2014G term mode bonds is secured by remarketing proceeds and a subordinate pledge of Metropolitan's net revenues. Payment of principal at the final maturity or on prior redemption is secured by a senior pledge of net revenues, on parity with all other revenue bonds.

NO CROSS-DEFAULT OR ACCELERATION: A failure by Metropolitan to provide sufficient proceeds to pay the purchase price of the flexible index mode, SIFMA index mode, term mode bonds or the self-liquidity bonds at the tender date would not constitute an event of default on Metropolitan's revenue or GO bonds nor prompt an acceleration of debt.

KEY RATING DRIVERS

GO BONDS: Metropolitan's GO rating of 'AAA' is based on its ability to levy unlimited ad valorem taxes on its $2.3 trillion tax base, with the property tax revenues restricted to be used only for debt service on the remaining GO bonds and capital costs related to the SWP.

WATER REVENUE BONDS: The 'AA+' rating on the water revenue bonds is based on the wholesale district's solid fixed-charge coverage, strong cash reserves, rate flexibility, and significant investment
Long-term analysis: The 'F1+' rating assigned to the flexible index mode bonds and SIFMA index mode bonds corresponds to the long-term rating on Metropolitan's revenue bonds.

Self-liquidity variable-rate debt: The 'F1+' rating on the self-liquidity bonds reflects the liquidity provided by Metropolitan's $1.1 billion in unrestricted cash as of Sept. 30, 2014 and internal liquidity provided by a $96 million revolving credit facility, together covering the authority's maximum daily exposure to un-remarketed puts by over 1.25x.

Wholesale supplier: Metropolitan is the supplemental wholesale water supplier to 18.4 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.

Water supply fluctuations: Water is provided from two independent supply sources. Supply fluctuations occur on the in-state water supply, the State Water Project (SWP). The Colorado River supplies, banking arrangements, and Metropolitan's substantial storage facilities help balance this risk. Consequently, Metropolitan has sufficient supplies to meet customer demands despite statewide drought concerns.

Flexible financial profile: Financial performance exhibits cyclicality linked to hydrological and weather conditions in the state given Metropolitan's role as the supplemental supplier and its highly volumetric rate structure. Financial margins in the past two years have been stronger given higher water sales.

Rate flexibility: Metropolitan's revenue flexibility is evident in the 75% cumulative rate increases between 2008 and 2013, although rate sensitivity is likely heightened given the magnitude of recent rate actions. Higher rates improve the economics of a variety of local water supply investment options for Metropolitan's members that will ultimately reduce sales.

Rating sensitivities

Pressure from statewide drought: Pressure on financial margins could occur in fiscal 2016 if water sales fall below assumed levels, which is only expected to occur in a multi-year water rationing scenario. Metropolitan will be considering allocation scenarios over the next few months before possibly taking an action that would go into effect in 2015.

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 members (55% of water revenues in 2014) include the San Diego County Water Authority (senior lien revenue bonds rated 'AA+' by Fitch), Orange County Water District (revenue bonds rated 'AAA'), and Los Angeles Department of Water and Power (water bonds rated 'AA').

Significant developments to water supply sources and the demand profile from members have occurred since the beginning of California's last drought in 2007-2009. Greater variability and uncertainty exists on Metropolitan's in-state water supply, the SWP. Demand level from members has declined from pre-recession levels although it continues to exhibit a high degree of annual variability. Finally, Metropolitan's significant rate increases have prompted regional investment in new local supplies that will further reduce demand for water sold by Metropolitan.
Metropolitan's members 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 it supplies 40%-60% of Southern California's water supply. Fitch expects Metropolitan to remain a key water supplier although over the long term there may be further pressure on demand.

Metropolitan absorbs much of the regional demand variability as the 'high-cost' resource, due to conservation and efficiency investments as well as weather conditions. The swing in annual demand can exceed 200,000 acre-feet (AF). With Metropolitan's primarily volumetric rate structure (89% in 2013), the district must operate with a strong financial cushion to absorb the revenue implications of demand variations.

STRONG ECONOMY UNDERPINS GO RATING

Fitch's 'AAA' rating on Metropolitan's GO bonds is based on its ability to levy unlimited ad valorem taxes on its stable $2.3 trillion tax base. Overall, the counties in Metropolitan's service territory showed an increase of 2.9%-4.7% in taxable AV in fiscal 2014. Property tax revenues may only be used for debt service on the GO bonds and a portion of capital projects related to SWP.

The revenues needed to support the outstanding $132.3 million (as of Nov. 1, 2014) in GO bonds require a minimal property tax levy. Metropolitan establishes its tax rate each year based on AV received from the counties in August. The tax rate has been established at 0.0035% for fiscal 2013-2014 and fiscal 2014-15.

Issuance of additional GO debt is not expected and would require Metropolitan to hold a referendum; no GO bonds have been submitted for voter approval since the 1966 authorization. Outstanding bonds have a final maturity date of 2037. The district plans to fund its capital improvement plan (CIP) through a combination of revenue bonds and ongoing revenues.

HIGHER WATER SALES IN 2013 and 2014; STRONG FINANCIAL MARGINS

Dry conditions in the past two years (prompting a drought declaration by the Governor in January 2014) led to strong water sales for Metropolitan, given lower availability of the members' local supplies. Water sales were 1.86 million acre-feet (MAF) in fiscal 2013 and 2.04 MAF in fiscal 2014, versus a projected 1.97 MAF. These results exceed the 1.7 MAF budget target that Metropolitan adopted in 2011 for fiscals 2013 and 2014 after water sales declined to just over 1.6 MAF in 2011 and 2012. Wetter conditions in those years resulted in lower purchases from members.

Financial performance in fiscal 2014 exceeded budget expectations and debt service coverage equaled 2.5x, up slightly from 2013. The additional revenue has led to improved reserves (about $1 billion unrestricted cash as of fiscal-year end 2014) that exceed maximum reserve targets established by the board. In April the board authorized the transfer of excess reserves of $100 million into the replacement and refurbishment fund, $100 million into the OPEB trust, and any remaining excess amounts to a water management fund ($232 million was deposited to cover costs associated with replenishing storage, purchasing transfers, and funding drought response programs and another $20 million for conservation related programs). While excess reserves can be remitted to members, this has not occurred since 2009.

Fitch views the decision of utilizing a portion of reserves for capital purposes positively given the need for additional system investment and the potential for subsequent years to be leaner in the event of lower water sales.

STRONG FIXED-CHARGE COVERAGE
Fixed-charge coverage increased to 2.1x in fiscal 2014 from 1.8x the prior year, in excess of Metropolitan's internal target for rate-setting of 1.2x. Fitch uses fixed-charge coverage 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. The fixed-charge calculation 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 not considered an 'operating expense' of the system.

POSITIONED TO MAINTAIN CREDIT QUALITY DURING CA DROUGHT

The SWP has provided just less than half of Metropolitan's water supply in recent years with the Colorado River supply providing the remainder. The SWP allocation for the 2014 water year was 5%, reflecting some of the driest conditions on record in the state. Metropolitan's supplies from the Colorado River and its substantial stored water position at present will allow it to meet the water demand of members through calendar 2014 without triggering any mandatory cutbacks.

MWD has 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 5.93 MAF in storage capacity. Stored water was used in the last drought of 2007-2009 but stronger hydrological conditions recently allowed Metropolitan to add to its stored water in 2011-2013. Storage reached a high point of 3.37 MAF on Jan. 1, 2013 before falling to 2.97 MAF as of Jan. 1, 2014. Metropolitan expects to draw between 1 MAF and 1.3 MAF in 2014 due to the reduced allocation from the SWP. As such, the year-end storage is expected to total between 1.7 MAF and 2.0 MAF.

Conservative rate-setting based on 1.75 MAF water sales should continue to preserve healthy financial operations even though Metropolitan may sell less water in fiscal 2015 if drought conditions continue beyond this year.

CASH RESERVES MITIGATE RISK

Metropolitan's reserves provide a strong degree of financial flexibility. As of June 30, 2014, there was $1 billion in unrestricted cash including the operating and maintenance fund, or 389 days of operating cash. This had grown to nearly $1.1 billion by Sept. 30, 2014. However, reserves are used to mitigate other risks, such as providing self-liquidity for $167 million in variable-rate bonds.

The unrestricted cash amount above excludes $148 million that is set aside for disputed amounts paid by the San Diego County Water Authority, which are the subject of ongoing litigation. The litigation relates to the rate methodology used to allocate costs between members. Although customer equity issues regarding rate-setting at such a large wholesale agency with so many members are consistent with the district's history, Fitch views the tension between the two entities as a potential credit concern.

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In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria and Revenue-Supported Rating Criteria, this action was additionally informed by information from Creditscope.

Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria' (Aug. 14, 2012);
--'U.S. Local Government Tax-Supported Rating Criteria' (Aug. 14, 2012);
--'Revenue-Supported Rating Criteria' (June 16, 2014);
--'U.S. Water and Sewer Revenue Bond Rating Criteria' (July 31, 2013);
--'Rating U.S. Public Finance Short-Term Debt' (Dec. 9, 2013).

Applicable Criteria and Related Research:
U.S. Water and Sewer Revenue Bond Rating Criteria
Rating U.S. Public Finance Short-Term Debt
Tax-Supported Rating Criteria
U.S. Local Government Tax-Supported Rating Criteria
Revenue-Supported Rating Criteria

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