Moody's Investors Service

New Issue: Moody's assigns Aaa to Metropolitan Water District of Southern California GO Bonds

Global Credit Research - 21 Nov 2014

Approximately $132 million in debt affected, including the current issue

METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA
Water Enterprise
CA

Moody's Rating

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<td>Waterworks General Obligation Refunding Bonds, 2014 Series A</td>
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Sale Amount $50,000,000
Expected Sale Date 12/03/14
Rating Description General Obligation

Moody's Outlook STA

Opinion

NEW YORK, November 21, 2014 --Moody's Investors Service has assigned an Aaa rating to the Metropolitan Water District of Southern California's (MWD) Waterworks General Obligation Refunding Bonds, 2014 Series A. We have also affirmed the Aaa rating on the district's currently outstanding general obligation bonds. The outlook on the bonds is stable.

Rating Rationale

The rating incorporates MWD's massive economic service area that includes approximately 18.4 million people across Southern California and an assessed valuation of more than $2.3 trillion. The assessed valuation is based on a particularly diverse and dynamic economy that has emerged from the economic recession to record four consecutive years of growth. The rating also reflects MWD's status as an essential water provider upon whom its customers are growing increasingly reliant during the drought. MWD also has a sound fiscal position including solid debt service coverage that is expected to improve in fiscal 2015. The district's very large water revenue bond debt profile continues to be well managed.

The California drought continues and is applying increasing pressure to water costs and availability. However, the combination of MWD's available water storage and secure water deliveries from the Colorado River will allow it to continue to meet budgeted demand without any mandatory water cuts through calendar year 2014. We expect sufficient supply of water through fiscal 2015 with even modest reductions in usage.

The bonds are secured by the district's unlimited property tax pledge on all taxable properties within its boundaries.

Strengths

- Exceptionally large and diverse assessed valuation that has resumed steady growth
- Still healthy level of stored water sufficient to provide approximately 1.35 years of demand
- Strong current and projected coverage
- The District provides critical water supplies to an exceptionally large and diverse service territory
Most recent fiscal year revenues slightly ahead of budget

Challenges
- Highly pressured California water supply environment
- Substantial variable rate debt exposure

DETAILED CREDIT DISCUSSION

MASSIVE ASSESSED VALUATION THAT HAS RECORDED FOUR CONSECUTIVE YEARS OF GROWTH

The district's assessed valuation has grown steadily in each of the last four years and is $2.3 trillion for 2015. This immense size places the district's tax base among the largest of any local government issuer. The district serves approximately 18.4 million people across six Southern California counties: Los Angeles, Orange, San Diego, Riverside, San Bernardino and Ventura. The collective annual median family income for the area is healthy at 111% of the national median. The district underwent two years of modest contraction at the height of the downturn but has since recovered as the Southern California economies have strengthened along with falling unemployment, growing home values and increased consumer spending.

Los Angeles County accounts for 48% of the assessed valuation with Orange and San Diego counties representing 20% and 17% respectively. Growing industry strength in technology, home building, logistics and shipping and tourism, will likely provide for continued improvement in incomes and employment in the region. We expect that assessed valuation will continue to grow moderately and do not anticipate any changes to the district's economy that would apply pressure to the rating by that factor alone.

SOLID POSITION TO MEET WATER DEMANDS VIA HEALTHY THOUGH DIMINISHED STORED WATER AND COLORADO RIVER SUPPLY

Management will likely decide in early 2015 what level, if any of water conservation will be enacted for calendar year 2015. This decision will be informed primarily by the SWP's water allocation forecast and precipitation to date. Historically the district has enacted some level of mandatory water reduction as it has approached approximately 1 million acre feet of stored water. Though this is not a firm policy that will dictate future action, it is likely that conservation requirements will become more stringent as the district reaches this mark. Water storage appears sufficient to enable the district to effectively absorb at least one more year of drought conditions before having to make more severe reductions in consumption.

The drought has had a moderate but growing impact thus far on MWD's total stored water supply. On January 1, 2013, the district had 3.3 million acre feet of water in storage, which amounted to 62% of total water storage capacity. As of January 1, 2014, stored water had fallen to 2.9 million acre feet, 49.7% of capacity. The district may draw upon approximately 1.0 to 1.3 million acre feet of water to compensate for the low allocation from the SWP in 2014. Stored water supply is expected to be approximately 1.7 to 2.0 million acre feet on January 1, 2015 assuming no material change in precipitation. This would allow MWD to meet budgeted demand for a little more than a year from storage alone.

The district's stored water supply is a key component to the ratings and outlook. Material diminishment of the stored water while the drought continues could apply pressure to the rating. However, the combination of the district's current level of storage plus access to the Colorado River through both its own entitlement and the QSA with Imperial Irrigation give the district a very strong additional water supply to meet demand.

The district's primary water source is derived from the State Water Project (SWP), which can allocate as much as two million acre feet of water per year to the district. This allocation is well above the 1.75 million acre feet the district uses as an expected sales volume for budgeting purposes. However, actual allocations from the water project are typically much lower and as a result of the drought, the state's current water allocations for 2014 is just 5%.

Though the Colorado River is also in drought, the State of California's 4.4 million acre feet of entitlement is senior to the other lower basin states and would not be in jeopardy even in the most likely allocation scenarios that could take effect in 2016. MWD is entitled to 550,000 acre feet of California's share of Colorado River water. The district receives an additional 112,000 acre feet of Colorado River via the QSA agreement. Snowpack runoff on the Colorado River is projected to be 103% of normal this year.

Despite the current level of water sufficiency, negative credit pressure will mount as the severity and duration of
the California drought deepens. Negative pressure would most likely take the form of increased operating costs and weaker operating margins if the district is exposed to buying significant amounts of water on the open market. In such a scenario, we would also expect weakened liquidity, which is currently a credit strength and is an important part of the district's credit profile given its debt profile and substantial short-term obligations.

DISTRICT IS ESSENTIAL WATER SUPPLIER FOR 26 AGENCIES ACROSS AN EXCEPTIONALLY LARGE PORTION OF SOUTHERN CALIFORNIA

The District provides supplemental water supplies to its 26 member agencies located mostly along the urbanized southern California coast. These agencies service approximately half of the state's population and therefore the scope of the district's operations provide not only an essential municipal service but they also have statewide political and economic significance.

While the District's water supplies are not its service territory's only supply source (hence the District's characterization as a "supplemental" water supplier), its supplies are nevertheless critical for its customers. District supplies account for 40% to 60% of its service territory's total annual water use. Its individual member agencies' average annual reliance on District supplies ranges from about 30% to 100%, with some members' demands quite variable around their annual averages. This annual variance is driven by local rainfall within each member agency's own service area and the watersheds from which they draw supplies. Member agencies do not have an annual contractual obligation to purchase any water from the District, but their high reliance on District supplies over the long-run generally obviates the need for such commitments.

SOLID DEBT SERVICE COVERAGE ON PACE TO IMPROVE IN 2015; LONGER TERM COVERAGE WILL BE MORE MODEST BUT STILL SATISFACTORY

While the drought is a long term credit negative, in the short term it has benefitted MWD by making member agency's even more reliant on MWD supply. This reliance has driven up water demand well above the district's long-standing budgeted amount of 1.75 million acre feet per year.

The district completed fiscal 2013 with its highest level of total debt service coverage in five years at 2.37 times on the strength of a 5% rate increase and higher than budgeted water sales. The district's final fiscal 2014 results reflect total water sales above 2 million acre feet, and water sales revenues over $1.48 billion, its highest level ever and consistent with earlier projections. Total debt service coverage by net revenues was 2.5 times debt service resulting in part from a 9% drop in operating expenses.

Though we do not anticipate that the district will maintain this level of coverage on a consistent basis going forward, we do expect that coverage will approximate 2 times, a level that was regularly maintained prior to the economic downturn. The district's practice of budgeting for 1.75 million acre-feet of water sales has proven to be fairly conservative in recent years. However, increased conservation in response to the drought's impact on water availability could result in actual water sales much closer to or below budget. We anticipate that the district will continue to generate solid coverage in part due to adopted rate increases of 1.5% in fiscal years 2014-15 and 2015-16 and projected rate increases of 3% to 5%, thereafter.

VERY LARGE BUT WELL MANAGED DEBT PROFILE

The district's outstanding general obligation bonds are all fixed rate debt amounting to $132 million outstanding. The remaining portion of the district's $4.2 billion in debt is secured by a pledge of water revenues. Approximately 21% of MWD’s total debt outstanding is in variable rate. Approximately half of the district's existing variable rate obligations are swapped to fixed, giving the District a correspondingly large interest rate swap portfolio. With the District's sound cash flow and reserves, managing fluctuating interest costs remains easily within its means. To date, the District has not experienced any significant difficulty in either finding replacement providers or in extending existing facilities. MWD intends to continue to gradually eliminate its hedged variable rate obligations as market opportunities become available.

WHAT COULD CHANGE THE RATING UP

N/A

WHAT COULD CHANGE RATING DOWN

-Downward credit pressure will increase in concert with the severity, duration and impact of the drought on the district's access to cost effective water.
- Consistently weak financial performance relative to the District's peers, whether from reduced sales/supplies or unwillingness to raise rates on a timely basis.

- Significant and sustained deterioration of the assessed valuation

KEY STATISTICS

Fiscal 2013 debt service coverage: 2.38 times
Fiscal 2014 debt service coverage: 2.52 times
Variable rate as a % of total debt: 21%
Debt ratio: 44.2%
Assessed valuation: $2.3 trillion

The principal methodology used in this rating was US Local Government General Obligation Debt published in January 2014. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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