

## MUNICIPAL MARKET UPDATE CALIFORNIA WATER AND RELATED UTILITIES

### OVERVIEW:

The California water utility universe is diverse both in size and scope, ranging from state agencies which provide statewide infrastructure to facilitate delivery and storage, to both regional and local entities which deliver it to intermediate or final customers. Many of these credits also operate electric utilities and issue bonds backed by both or either revenue stream. In addition, wastewater treatment facilities are sometimes funded by bonds backed solely by sewer fee revenue. Utility credits, in general, have traditionally been considered very safe by the nature of their near monopoly status, essentiality of service, and ability to raise rates. In this context, water has been considered the marginally better credit as it is more essential, is less subject to competition, and has fewer impediments to raising rates. Bonds issued by the same agency backed solely by the electric revenue stream are usually rated one to two levels lower as a result.

While the drought does present varying challenges to these agencies, ongoing they have generally maintained strong debt service coverage and liquidity. In the event lower volume of water sales impacts revenue, there can be a lag before rate increases are implemented, but we think this is manageable given the high liquidity levels. What has increased though is “headline” risk. This is somewhat offset by the very professional management culture of these agencies, given their high component of career technicians and engineers in comparison to elected officials facing the election cycle.

To give a better picture of the sector we evaluate several representative credits held in our client accounts below:

### STATE LEVEL: CALIFORNIA DEPARTMENT OF WATER RESOURCES

The Department of Water Resources (DWR) oversees and operates the State Water Project (SWP), a system of dams, storage facilities, aqueducts, pumping stations and electric generation facilities. The SWP provides service to 29 public agency water contractors representing 25% of

the state’s land area and 71% of its population. The contractors are obligated to cover the annual costs of the SWP, inclusive of debt service, for the life of the water revenue bonds regardless of the amount of water provided to them. In addition, the bonds are secured by debt service reserve account funded at 50% of maximum annual debt service and a minimum debt service covenant of 1.25x annual debt service. Liquidity is high with unrestricted cash at almost 70% of operating expenses net of depreciation. The DWR’s water revenue bonds are rated Aa1/AAA/Stable, and it also issues debt secured by electric revenue rated Aa2/AA-.

### REGIONAL LEVEL: METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

The District (MWD) is a supplemental water supplier to 26 member agencies along the southern coast with a service area including Los Angeles and San Diego and about half the state’s population. It is also the largest contractor of the DWR covering over 50% of the costs of the SWP. It provides 40% to 60% of its service area’s water. MWD’s main sources of water are from the SWP, which has been minimal in the last year, and senior rights to water from the Colorado River, which although also in drought, is not in jeopardy. The MWD has developed large storage capacity, which though drawn down over the last few years, still amounts to about a year’s worth of normal usage. The District has also been a very proactive proponent of conservation and recycling. Debt service coverage is good at 2 - 2.5x, and liquidity high, with unrestricted cash at more than 90% of operating expenses net of depreciation. MWD’s water revenue bonds are rated Aa1/AAA/Stable. The District also levies ad valorem property taxes to pay debt service on some outstanding general obligation bonds and a large part of their share of SWP costs. Although these taxes are not pledged to the revenue issues the Board of the MWD can levy increased property taxes if it thinks it necessary for the operation of the District.

## **LOCAL LEVEL (LARGE): LOS ANGELES DEPARTMENT OF WATER AND POWER**

The Department (LADWAP) provides water to a large and diverse customer base of 676,000 mostly residential (89%) users. The primary water sources are the MWD, the SWP, the Los Angeles Aqueduct, and local groundwater. LADWAP makes quarterly rate adjustments and has demonstrated a willingness to raise rates in the face of the drought (12% in 2013, 15% in 2014, and 9% projected for 2015). It has also pursued aggressive conservation, recycling and storm water recapture initiatives. It has a debt service coverage target of 1.7x, which it currently exceeds at 1.9x, and an unrestricted cash target of 150 days of operating expenses, which it exceeds at 174 days. LADWAP's water system revenue bonds are secured by a pledge of net revenues of the system with a 1x debt service coverage covenant, and a 1.25x additional bonds test. They are rated Aa2/AA/Stable. LADWAP also operates a retail and wholesale electric system and issues power system revenue bonds backed by the system's revenue which are rated Aa2/AA-/Stable.

## **LOCAL LEVEL (Small): MERCED IRRIGATION DISTRICT**

The District comprises 165,000 acres of the San Joaquin Valley, serving primarily agricultural customers, with approximately 2,200 accounts. The customer base is diverse with the top ten representing only 17% of sales.

It has senior rights to water from the Merced River, and 220 groundwater wells to supplement supply. It operates reservoirs and dams, which also include hydroelectric power facilities. The District is also a retail power provider. The District has dealt aggressively with drought conditions adopting large rate increases in the past two years: from \$18.25 per acre-foot to \$23.25 in 2013, and to a maximum of \$100.67 in 2014, subsequently lowered to \$75.00 on higher than projected revenue. It also collects annual standby charges from customers and receives a portion of local property taxes. Debt service coverage is strong at 2x with unrestricted cash on hand equivalent to 292 days of operating expenses. The District's water and hydroelectric revenue bonds are backed by a pledge of net water and hydroelectric system revenue with a rate covenant of 1.25x. They are rated A/Stable by S&P. The District also issues Retail Electric revenue bonds backed by the retail system's net income which are rated A-.

## **SUMMARY**

We view California water utilities as maintaining their strong credit characteristics and financial performance. They have professional, forward looking managements, who have shown a willingness to adjust pricing and operations in response to the drought, retaining financial and operational flexibility. We will continue to monitor the situation going forward and report on any further developments.

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