Revenue
New Issue

# Metropolitan Water District of Southern California

## Ratings

**New Issue**

| | |
|---|---|
| Special Variable-Rate Water Revenue Refunding Bonds, Series 2010A | AAA/F1+ |

**Outstanding Debt**

| | |
|---|---|
| Water Revenue and Refunding Bonds, (SIFMA Index Notes Series 2009A-1 and 2009A-2) | F1+ |
| Water Revenue Bonds | AAA |
| Water Revenue Refunding Bonds | AAA |
| General Obligation Bonds | AAA |

## Rating Outlook

Stable

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## New Issue Details

**Sale Information:** $128,000,000 Special Variable-Rate Water Revenue Refunding Bonds, Series 2010A, via negotiation on June 23.
**Purpose:** Proceeds will be used to refund outstanding variable-rate demand bonds.
**Final Maturity:** 2029.

## Related Research

**Applicable Criteria**
- *Revenue-Supported Rating Criteria, Dec. 29, 2009*
- *Water and Sewer Revenue Bond Rating Guidelines, Aug. 6, 2008*
- *Criteria for Assigning Short-Term Ratings Based on Internal Liquidity, Dec. 29, 2009*
- *Counterparty Criteria for Structured Finance Transactions, Oct. 22, 2009*

## Rating Rationale

- The 'AAA/F1+' rating on the series 2010A self-liquidity bonds, issued in the weekly mode, reflects the liquidity provided by Metropolitan Water District of Southern California's (MWD) cash and investments.
- The 'F1+' rating on the 2009 series A-1 and A-2 bonds reflects MWD's long-term credit quality and implied market access to successfully remarket the bonds.
- MWD provides an essential service as the region's wholesale water supplier to a diverse regional service area with a population of more than 19 million in Southern California.
- Legal and environmental challenges and operating constraints at the State Water Project (SWP) have reduced MWD's water supply in the past two years. However, sizable rate actions have preserved financial performance, albeit with some deterioration.
- MWD will have raised its rates 75% on a cumulative basis over the six years ending in 2012. Although rates have not kept pace with actual cost increases in the past two years, prompting the use of reserves and the need for decreased capital spending from pay-as-you-go, full cost recovery is expected to occur in fiscal 2011.
- While currently healthy, MWD's financial position has declined, with further weakening projected in fiscal 2010. Recovery is projected in fiscal 2011 following approved rate increases and expenditure reductions.
- MWD's GO rating of 'AAA' is based on its ability to levy unlimited ad valorem taxes on its $1.84 trillion tax base, the restriction on property tax revenues to be used only for payment of debt service on the GO bonds and capital projects related to SWP.

## Key Rating Drivers:

- Continued ability to balance water supply and sales to members as the economy recovers.
- Recovery of financial performance to board-adopted minimum targets, as currently projected.
- Careful management and attention to increasingly complex debt portfolio.

## Credit Summary

The Rating Outlook revision to Stable from Negative on the revenue bonds reflects stabilization of financial performance with recovery of debt service coverage levels projected in fiscal 2011 and resumption of sustainable capital spending supported from revenues. Financial recovery is supported by sizable rate actions adopted in the past two years, a decision to further cut expenditures in fiscal 2011 rather than the additional use of reserves, and MWD's action to reduce regional water use in fiscal 2010 to lower the high cost of replacement water sources in light of reductions in its own supply.

### Rating History — Revenue Bonds

| Rating | Action | Outlook/ Watch | Date |
|---|---|---|---|
| AAA | Affirmed | Stable | 6/14/10 |
| AAA | Revised[a] | Negative | 4/30/10 |
| AA+ | Affirmed | Negative | 11/19/09 |
| AA+ | Affirmed | Negative | 7/22/09 |
| AA+ | Affirmed | Negative | 5/7/09 |
| AA+ | Affirmed | Negative | 1/6/09 |
| AA+ | Affirmed | Stable | 7/1/08 |
| AA+ | Upgraded | Stable | 2/11/04 |
| AA | Affirmed | Positive | 12/5/03 |
| AA | Assigned | Stable | 8/9/01 |

[a]Due to rating recalibration.

### Rating History — GO Bonds

| Rating | Action | Outlook/ Watch | Date |
|---|---|---|---|
| AAA | Affirmed | Stable | 6/14/10 |
| AAA | Affirmed | Stable | 11/19/09 |
| AAA | Affirmed | Stable | 1/6/09 |
| AAA | Affirmed | Stable | 7/1/08 |
| AAA | Assigned | Stable | 8/26/02 |

### Rating History — SIFMA Notes

| Rating | Action | Outlook/ Watch | Date |
|---|---|---|---|
| F1+ | Affirmed | Stable | 6/14/10 |
| F1+ | Affirmed | Stable | 12/17/09 |
| F1+ | Affirmed | Stable | 5/27/09 |
| F1+ | Assigned | Stable | 5/07/09 |

MWD provides between 40%–60% of Southern California's water, depending on water conditions, and is responsible for the development and acquisition of long-term water supplies for the region. The service territory is vast, covering six counties, and supports a population of 19 million people. MWD consists of 26 member public agencies, including 14 cities, 11 municipal water districts, and one county water authority. Member agencies purchase water from MWD to supplement local supplies and then resell it on a wholesale or retail basis to more than 300 cities and numerous unincorporated communities in the district's service area. MWD's supply is derived from two principal sources: Northern California's San Francisco Bay/Sacramento-San Joaquin River Delta water via the SWP, which provided approximately 75% of its water supply in 2007, and the Colorado River via the Colorado River Aqueduct, which provided the remaining 25%. Since 2007, the SWP supply source dropped considerably, supplying just over 30% of MWD's water sales in 2008 and 2009. The remaining water supply was provided by the use of stored water, water transfers, exchanges, and water banking agreements (19%).

In response to this supply reduction, MWD approved a water allocation plan in 2008 that dictated exactly how water would be allocated among members in the event of an extreme water shortage. In July 2009, a regional water shortage was declared, and MWD implemented the allocation plan at a level that required a 10% water use reduction. To recover lost revenues from lower sales and fund expected higher water purchase costs (from regional water transfers), MWD implemented a sizable 20% rate increase effective September 2009. This followed a 14% increase effective January 2009. The result was a preservation of financial performance in fiscal 2010, albeit with some weakening in debt service coverage to levels that are below MWD's own formal targets. While water supply for the upcoming water year (calendar 2010 and fiscal 2011) should be slightly improved due to better hydrological conditions, the water year is only considered a "dry water year" instead of a "critically dry water year." As a result, MWD has kept its water supply allocation plan (with the 10% mandatory reduction) in place through June 2011. MWD continues to implement substantial rate increases that will become effective January 2011 (7.5%) and January 2012 (7.5%). These actions are expected to improve MWD's financial performance in fiscal 2011 to levels more in line with its own targets and Fitch's expectations at the 'AAA' rating level.

## Security/Structure

The water revenue bonds are secured by net operating revenues and other available funds of the district. The definition of revenues does not include transfers from the rate stabilization fund or subsidies from the federal government related to the Build America Bonds.

The GO bonds are secured by an unlimited ad valorem tax on all property within the district. GO bonds are not supported by water revenues.

The variable-rate self-liquidity series 2010A bonds are expected to be issued as variable-rate demand bonds in the weekly mode. The bonds are considered self-liquidity and rely on MWD's cash reserves in the event of a failed remarketing; no external liquidity facility is in place. Payment of scheduled principal and interest on the bonds is secured by net revenues on parity with MWD's outstanding water revenue bonds. However, payment of the purchase price of a tender (either optional or mandatory) is secured solely by a subordinate pledge of net revenues. The failure to pay purchase price does not constitute an event of default under MWD's master resolution governing its water revenues bonds, nor does it trigger an acceleration of the variable-rate demand bonds.

The SIFMA index notes 2009A-1 and 2009A-2 bonds are outstanding in the index mode. Bondholders have the opportunity to tender the bonds at the end of the 12-month tender period. MWD may optionally call the bonds at any time after the initial call protection period of six months. Payment of scheduled principal and interest on the notes is secured by a net operating revenue pledge on parity with MWD's outstanding water revenue bonds. However, payment of the purchase price of a tender (either optional or mandatory) is secured solely by a subordinate pledge of net revenues. The failure to pay purchase price does not constitute an event of default under MWD's master resolution.

## Self-Liquidity Variable-Rate Demand Bonds

The series 2010A bonds will be issued as variable-rate demand bonds in the weekly mode. While MWD has a large $1.6 billion portfolio of variable-rate demand bonds outstanding, this is the first series issued as self-liquidity bonds. The bonds will rely solely on MWD's reserves to provide liquidity in the event of a failed remarketing; no other liquidity facility is in place. Payment of the bonds is secured by a first lien on net revenues of the district and is on par with outstanding revenue bonds. However, the payment of the purchase price of any tender is secured only by a subordinate pledge of net revenues. Payment of a tender purchase price is not explicitly secured by a pledge of cash and investments. Furthermore, the failure to pay the purchase price of a tender is not a cross default under the master resolution governing MWD's outstanding revenue bonds.

Fitch believes that MWD's sizable cash and investment portfolio, typically around $1 billion including unrestricted and restricted assets, provides sufficient internal liquidity to meet unremarketed tenders. Approximately $545 million is invested in highly liquid assets such as treasury bonds or federal agencies. Fitch specifically views MWD's rate stabilization funds as the primary source of liquidity to support the bonds. The rate stabilization funds are replenished from net revenues and remain above a board approved minimum level. However, MWD is legally permitted to invest and hold its own securities, without limit, so that, if needed, it could use any of its reserves to purchase the bonds in the event of a failed remarketing.

MWD intends to secure a revolving credit agreement to provide support to its own liquidity and enable issuance of additional self-liquidity bonds. The agreement is expected to stand behind MWD in payment on the bonds and would be a dedicated facility, to be used for no other purpose, but it would not directly pay bondholders. The agreement is anticipated to be sized at $400 million to support a like amount of variable-rate demand bonds. Fitch does not view MWD's cash and investments as having the ability to support additional issuance of variable-rate self liquidity bonds without the agreement.

## Governance

Management continues to be led by experienced executive officers and staff that use comprehensive forecasting to predict and plan for various operational and financial scenarios. Management and the board's responses to the recent legal and operational challenges related to the SWP have been swift and meaningful in terms of securing additional supplies and reducing demand.

MWD's board of directors consists of 37 members. Each member agency has a minimum of one board member plus an additional representative for every full 5% of total AV in the district's service area. Voting is based on AV, with one vote for every $10 million of AV within each member agency's service area. A simple majority determines most board actions. To date, the board appears to act with relative unanimity with regard to cost recovery and the financial protection of bondholders.

## System

The district's water supply is derived from Northern California's bay/delta (765,000 af in calendar 2009) through a long-term contract with DWR (the SWP) and its apportionment of Colorado River (550,000 af in 2009). The remaining approximately 30% of the supply was provided by a variety of storage supplies, exchange, and transfer programs. MWD and its members are working together on the development of new local water supplies.

### State Water Project

The SWP is owned by the state and operated by the DWR. The project transports Feather River water released from Oroville Dam and unregulated flows diverted directly from the bay/delta via a 444-mile aqueduct (the California Aqueduct) to MWD's service territory. MWD is the largest of the 29 agencies with an SWP water contract with DWR in terms of service area population and water entitlement (at about 46%). MWD's contract with DWR entitles the district to slightly more than 1.9 million af per year, although actual average delivery from the project to its contracted agencies has been lower than the contracted entitlement and has historically been driven by water conditions in the northern Sierra Mountains.

Typically, DWR announces initial allocation levels in December for the following calendar year. The allocations may be increased over the next few months, as DWR has better information about the snowfall and snowpack in the Sierra Mountains. The table below shows initial allocations and final allocations for the past six years and the initial allocation announced for the 2010 calendar year.

**SWP Allocation**

(%)

| Year | Initial Allocation | Final Allocation |
|---|---|---|
| 2004 | 35 | 65 |
| 2005 | 40 | 90 |
| 2006 | 55 | 100 |
| 2007 | 60 | 60 |
| 2008 | 25 | 35 |
| 2009 | 15 | 40 |
| 2010 | 5 | 45 Currently |

Prior to 2008, it was typical for SWP contractors to plan on receiving at least 60% allocations, which represents a delivery of 1.15 million af to MWD. Deliveries in 2006 actually reached 100% of each SWP contractor's allocation for the first time since 1999 as a result of strong precipitation levels. In 2008, the lower allocation was the result of critically dry conditions, but also was reduced due to the interim court-ordered restrictions on pumping. MWD supplemented the reduced deliveries through various water transfers and groundwater banking and exchange programs as well as sales from its storage supplies located in southern California. DWR's announcement in October 2008 that the initial allocation in 2009 would only be 15% is a significant reduction even from the 2008 levels. With the snowfall received, the final allocation reached 40%. Initial allocations for calendar year 2010 were at 5%, but based on hydrology to date have been increased to 45%.

### Colorado River

California's total apportionment of the Colorado River water supply is 4.4 million af per year plus one-half of any combined surplus available to Arizona, California, and Nevada. MWD has a fourth-priority right to the Colorado River water, totaling 550,000 af per year, which is the fourth and last-ranked priority right under California's 4.4 million-af-per-year firm allocation. The district also holds a fifth-priority right to 662,000 af per year in excess of the state's allotment. However, receipt of the fifth-priority right depends on water conditions, and the Colorado River system has experienced a drought for the past nine years. The Colorado River source is viewed as having little risk of near-term interruption although persistent drought conditions have reduced the excess available to all users.

### Storage, Transfers, and Exchange Agreement Resources

MWD used a variety of storage sources, transfer agreements, banked storage, and exchange agreements to supplement water supply from its two traditional sources. The largest components included additional transfers from the Colorado River, central valley water banking programs, and land fallowing and the use of stored water from Diamond Valley Lake. The success of this effort allowed MWD to essentially absorb a 30% reduction to its primary water supply in 2008 and 2009 before it had to mandate a reduction in sales to members in 2010. The availability of these additional sources reflects work done by management in previous years to supplement and put in place contingency agreements, build storage resources, and negotiate new exchange agreements. To help rebuild these assets, MWD has kept its water supply reductions in place through July 2011 even though hydrology is improving slightly.

### Storage Capacity

MWD has storage capacity of approximately 5.6 million af, including reservoirs, conjunctive use, and other groundwater storage programs both in its service territory and in other areas. Approximately 670,000 af of local stored water is designated by the board as emergency storage and reserved for use in the event of a seismic event. The remaining storage provides MWD with the ability to withstand typical weather variability; the stored reserves are used during drought years and replenished during wet weather years. Over the past two years, MWD has used water it had in storage to replace water deliveries that were not received due to the lower allocation received from the SWP and persistent drought conditions on the Colorado River. As a result, as of January 2010, MWD has 1.64 million af in storage, down from 2.37 million af in January 2008. Remaining reserves are around 1.0 million af in excess of the emergency storage.

## Rates

MWD’s board formulates the revenue structure and sets rates and charges without oversight from local, state, or federal agencies. Member agencies submit 10-year purchase orders that provide a schedule of their expected needs. The majority of the amount requested in the purchase orders is served at a lower Tier 1 rate, while a small portion and any sales above what members committed to in their purchase orders are served at the higher Tier 2 rate.

Full service Tier 1 rates ($701 per af for treated water) increased from $508 in 2008. Full service Tier 2 rates ($811 per af of treated water) increased from $606 in 2008. These rates include the implementation of a $69 per af Delta supply surcharge implemented Sept. 1, 2009 to provide MWD with additional revenues to cover the increased water costs anticipated in 2009 and 2010. With the implantation of the 7.5% rate increases approved for Jan. 1, 2011 and Jan. 1, 2012, full-service treated and untreated water prices will climb to $794 and $920, respectively by 2012.

## Financial Position

Debt service coverage in fiscal 2009 (June 30 year-end) was a good 1.79x. This is in line with debt service coverage in the past few years but below MWD’s historical norms of debt service coverage levels that exceeded MWD’s board-approved target of 2.0x. MWD projects that debt service coverage could decline to 1.52x in fiscal 2010 but then recovers to 1.9x in fiscal 2011 and goes above 2.0x in fiscal 2012. More importantly, fixed-charge coverage is projected to decline to below 1.1x in fiscal 2010 before recovering to levels above the board policy of 1.2x in fiscal 2011. Fixed-charge coverage includes amounts paid to California Department of Water Resources (DWR) for capital costs associated with the SWP. Fitch believes fixed-charge coverage more accurately reflects true cash flow debt service coverage, since the capital costs paid to DWR come from annual revenues, albeit on a subordinate basis.

Although the majority of revenues are derived from water sales, the district also receives moneys from ad valorem tax collections (8%), which can only be used for debt service on GO bonds and SWP capital costs. While the district pays for most of its SWP costs with water sales revenues, the contract requires that if the district cannot raise funds through other means, it may instead levy a property tax. That levy would be exempt from tax limitations imposed by Proposition 13.

The district's reserve policies designate pay-as-you-go moneys for capital projects and target minimum and maximum balances of reserves held in the water rate stabilization and revenue remainder funds based on probabilities for wet periods. The minimum amount is kept in the revenue remainder fund, and funds above the minimum but below the maximum amount are kept in the rate stabilization fund. Moneys in excess of the maximum reserve may be used for any lawful purpose, including remittance to member agencies. In fiscal 2009, the minimum reserve level was $216 million and the maximum was $535 million. The combined balance of the water rate stabilization and revenue remainder funds was $322 million. Planned rate stabilization fund transfers to support operations are projected to bring rate stabilization fund balances down to $276 million at the end of fiscal 2010. Unrestricted reserves are slightly higher at approximately $400 million.

**Financial Summary — Cash Basis**

($ Mil., Fiscal Years Ending June 30)

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|---|---|
| Water Sales | 819 | 827 | 892 | 968 | 988 | 1,011 | 1,201 | 1,338 | 1,439 | 1,570 |
| Other System Revenues | 171 | 191 | 197 | 208 | 195 | 198 | 221 | 249 | 270 | 285 |
| **Total System Revenues** | **990** | **1,018** | **1,089** | **1,176** | **1,183** | **1,209** | **1,422** | **1,587** | **1,709** | **1,855** |
| Operating and Maintenance Expenditures | 365 | 416 | 392 | 470 | 532 | 564 | 566 | 622 | 687 | 746 |
| SWC Costs | 229 | 277 | 256 | 321 | 251 | 274 | 314 | 337 | 351 | 366 |
| **Total Operating Expenditures** | **594** | **693** | **648** | **791** | **783** | **838** | **880** | **959** | **1,038** | **1,112** |
| Adjusted Net Revenues | 396 | 325 | 441 | 385 | 400 | 371 | 542 | 628 | 671 | 743 |
| Parity Debt Service | 157 | 176 | 200 | 219 | 223 | 242 | 286 | 313 | 329 | 346 |
| Parity Debt Service Coverage (x) | 2.5 | 1.8 | 2.2 | 1.8 | 1.8 | 1.5 | 1.9 | 2.0 | 2.0 | 2.1 |
| Funds Available from Operations | 238 | 148 | 240 | 165 | 176 | 128 | 255 | 314 | 341 | 396 |
| Capital and Other Expenditures | (216) | (242) | (194) | (191) | (133) | (171) | (228) | (268) | (291) | (304) |
| Tax Receipts | 98 | 98 | 101 | 101 | 105 | 92 | 82 | 82 | 83 | 82 |
| General Obligation Debt Service | (49) | (49) | (49) | (49) | (49) | (48) | (39) | (39) | (41) | (41) |
| SWC Capital Costs Paid from Taxes | (49) | (49) | (52) | (52) | (56) | (44) | (43) | (43) | (42) | (41) |
| **Net Funds Available from Current Year** | **22** | **(94)** | **46** | **(26)** | **43** | **(43)** | **27** | **46** | **50** | **92** |
| Fixed-Charge Coverage (x)[a] | 1.57 | 1.27 | 1.69 | 1.24 | 1.29 | 1.03 | 1.30 | 1.39 | 1.37 | 1.43 |

[a]Includes the MWD's debt service obligations and the capital component of state water contract (SWC) costs from net operating revenues. Note: Numbers may not add due to rounding.
Source: Metropolitan Water District of Southern California.

## Debt Structure

Debt levels are manageable for the size of the utility and balance long-term financing and pay-as-you-go spending to address capital needs. However, the debt portfolio is complex and involves a high degree of oversight by management. The complexity and need for staff time results from the management of a $1.4 billion swap portfolio with the associated counterparty risk, $1.6 billion in variable-rate demand obligations secured, in part, by liquidity agreements, the use of SIFMA index notes, and now the issuance of self-liquidity variable-rate demand bonds that could prompt a demand in any week for the full par amount to be paid from MWD's cash reserves, in the event of a failed remarketing.

Total long-term revenue bonds outstanding equal approximately $4.6 billion. MWD's $1.75 billion five-year CIP, for fiscal years 2010–2014, will require an estimated $960 million in additional revenue bonds. When combined with the relatively slow amortization of MWD's existing debt, the result is an increasing fixed-cost burden associated with debt service.

MWD's debt structure includes substantial variable-rate debt outstanding of approximately $2 billion, or 42% of its outstanding debt. However, $1.16 billion of this amount has been hedged with floating-to-fixed interest rate swaps. MWD monitors its swap portfolio monthly with reports to the board's finance committee. The current portfolio, which also includes $250 million of basis swaps, has a termination value of $131 million. The board has authorized an additional $500 million in swaps, although management anticipates increasing its portion of unhedged variable-rate debt rather than entering into additional interest rate swaps. The board has also authorized management to enter into cancellation options, which MWD may decide to do, that would sell a given swap counterparty the right to cancel the swap at a future point in time.

The variable-rate debt includes the use of 17 liquidity agreements to provide external liquidity support to the outstanding variable-rate demand bonds. This presents MWD with rollover risk, which is heightened by the $858 million par amount of the agreements expiring in the next year. MWD expects to renew the liquidity agreements, issue fixed-rate take-out bonds, or use additional self-liquidity variable-rate demand bonds if a revolving credit agreement is in place.

## Service Territory

MWD's massive service area encompasses about 5,200 square miles, including the urban and economic core of Southern California. The area includes approximately 85% of the six-county area population consisting of Los Angeles, Orange, Riverside, San Bernardino, San Diego, and Ventura counties. The six-county area is the most densely populated and heavily industrialized portion of Southern California, with 57% of the state's population.

The current district population of more than 19 million is expected to increase substantially over the next two decades. Projections for the six-county area indicate a population of 27 million in 2030. The 2008 gross domestic product of the six-county area, estimated at $1 trillion, was larger than that of all but 14 countries in the world. Major economic and employment sectors include manufacturing, business and professional services, transportation and trade, and entertainment.

Economic trends in the six-county region have been similar to the national recession, although California has been greatly affected by the collapse of housing prices and loan defaults and foreclosures. Median home prices in the counties have fallen between 33% and 46%, bringing prices back down to levels last seen in 2003. As a result, the AV in five of the six counties posted year-to-year declines, ranging from 12.3% for Riverside County to 1.3% for Orange County. Los Angeles County AV remained essentially flat. Los Angeles (47.6%), Orange (20.1%), and San Diego (18.0%) counties accounted for 85.7% of MWD's tax base. Overall, MWD's service territory showed a 1.9% decline in AV for fiscal 2010. Southern California has been hard hit by the recession with unemployment levels in five of the six counties over 10%.

## General Obligation Bonds

Fitch's 'AAA' rating on MWD's GO bonds is based on its ability to levy unlimited ad valorem taxes on its $1.84 trillion tax base. TAV within MWD's service area decreased 1.9% from fiscal 2009 to fiscal 2010, reflecting impacts from falling home prices. Property tax revenues may only be used for debt service on GOs and a portion of capital projects related to SWP. As these expenditures decrease over time, MWD must decrease its tax collections. The revenues needed to support the outstanding $255.1 million in GO bonds require a minimal property tax levy. Although certain regions of MWD's six-county service territory have experienced slower growth and some declines in AV due to the housing market collapse, MWD's property tax revenues should not be affected. MWD establishes its tax rate each year based on AVs received from the counties in August. The tax rate for fiscal 2010 (0.0043% of AV) remains the same as in fiscal 2009. Total direct and overlapping debt levels remain moderate at 2.9% of adjusted AV. Issuance of additional GO debt would be possible if MWD were to hold a referendum, but no GO bonds have been submitted for voter approval since the 1966 authorization. The district expects to fund its CIP through a combination of revenue bonds and ongoing revenues.