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HIGH PROFILE NEW ISSUE

Metropolitan Water District of Southern California

SALE DETAILS	
Special Variable Rate Water Revenue Refunding Bonds, 2010 Series A	Rating: Aa1/VMIG 1
Security	Water Enterprise Net Revenues
Bond Amount	$132.8 million
Closing Date	June, 24, 2010
Use of Proceeds	Refund 2004 C bonds

KEY FACTS (FY 2009)	
Service Area Population	19 million
Gross Operating Revenues ($ m.)	$1,136
Unrestricted Net Assets ($m)	$436
Operating Ratio	74.1%
Debt Service Coverage	1.45x
Debt Service Safety Margin	8.7%
Debt Ratio	47.80%
Net Working Capital, % of O&M	109.1%

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Rating Rationale

Moody's Investor's Service has assigned an Aa1/VMIG 1 rating to the Metropolitan Water District of Southern California's Special Variable Rate Water Revenue Refunding Bonds, 2010 Series A. These obligations are "special" in the sense that the District has pledged to purchase tendered bonds from its own liquid resources rather than from a third-party liquidity facility. The bonds are otherwise fundamentally the same as the District's prior water revenue bond issues, with annual debt service secured by the District's senior lien pledge of net revenues from its water enterprise. At this time, we have also affirmed our Aa1 rating on the District's outstanding senior lien debt, as well as the VMIG 1 ratings on the District's 2009 A-1 and A-2 series of Water Revenue "Index Mode" bonds, which are both also supported by the District's own liquidity. The District's long-term rating primarily reflects the critical importance of the District's water supplies to its exceedingly large Southern California service territory; the District Board's demonstrated willingness and ability to raise water rates as needed to maintain the enterprise's strong financial profile, even during difficult economic times; and District management's above average financial, operational, and capital planning ability. With the past year's easing of the Northern California drought, the District's near-term water supply picture has improved, significantly lessening the near-term pressure that another year of partial reliance on stored water supplies would have posed. Management anticipates adding to its storage supplies this year, though we note that long-term water supply challenges remain. The District's primary near-term challenge may prove to be the cost-effective replacement of $990 million of expiring liquidity facilities over the next nine months. The District is exploring a range of options for managing these expirations, including to a degree, additional self-liquidity supported variable rate debt. The rating assigned to the current offering significantly reflects our assumption that the District will carefully exercise those options, preserving a self-liquidity profile sufficient to maintain a VMIG 1 rating on the current offering.

USE OF PROCEEDS: Refund the District's 2004 Series C variable debt, for which the liquidity facility is expiring on June 30.

CURRENT OFFERING STRUCTURE: Variable rate bonds, initially in weekly mode, on parity with prior issues governed by the District's 1991 Master Resolution. Unlike most prior issues, the current issue does not have a debt service reserve fund. Most of the District's prior issues have benefited from debt service reserve funds sized at 50% of the standard three-prong test.

LEGAL SECURITY: Principal and interest are secured by the District's pledge of and first lien on its water enterprise net operating revenues. The District is also irrevocably committed to purchase tendered bonds from its own resources to the extent that remarketing proceeds are insufficient for that purpose.

INTEREST RATE DERIVATIVES: The District has a large, $1.4 billion swap portfolio, consisting of 17 transactions distributed among four counterparties whose ratings range from A2 to Aa1. While these primarily floating-to-fixed rate transactions expose the District to various additional financial risks, Moody's believes these risks remain manageable. As of May 31, 2010, the District's total swap portfolio had an aggregate, negative termination value of about $131 million, and the District had posted $9.3 million of collateral with one of its counterparties, Morgan Stanley Capital Services Inc.

Strengths

- The six-county service territory is exceptionally large, highly diverse, and its long-term economic prospects are sound, notwithstanding the current severe recession
- The District's water supplies are critical to its service territory and will remain so for the foreseeable future, if not substantially longer
- Significantly reduced but still substantial water supplies in storage after several years of drought; stored supplies largely mitigate fluctuations in annual deliveries to the District
- Independent rate setting authority and demonstrated willingness to exercise that authority even in a difficult economic environment
- Sophisticated financial, debt, and treasury management
- Healthy liquidity and adequate financial reserves typical of the rating level; generally strong operating ratios
- Well-developed, successful long-term capital planning and delivery

Challenges

- The District has only two primary sources of long-term water supply, the State Water Project (SWP) and the Colorado River
- The SWP is currently subject to significant delivery constraints relative to its capacity, due largely to environmental/regulatory issues
- Additional water supplies are very expensive relative to existing supplies; continued population growth and inevitable drought cycles will likely require the acquisition of additional supplies or continued efficiency improvements

- Achieving member agency consensus on capital project priorities and the rate increases necessary to fund them
- Very large, five-year capital improvement plan expected to be funded in large part with additional borrowing
- The Sacramento-San Joaquin River Delta, through which the SWP supplies are transported, has notable seismic risks
- Highly variable and generally increasing operating costs, particularly for power supplies
- Substantial variable rate debt outstanding, and $990 billion in liquidity facilities expiring in the next nine months

Outlook

Moody's outlook on the District's long-term ratings is stable. While the District's near-term operating results will be below average for the rating level, the District appears to have taken the necessary steps to return it to more solid footing in the next few years, particularly with the implementation this past year of substantial rate increases. The decline in stored water supplies, which provide a key element of flexibility, and therefore credit quality, appears to have abated and may well be reversed in the coming year.

What Could Change the Rating – Up

With the District's already high rating and likelihood of continued water supply challenges in California, the prospects for upward movement are limited. Substantial improvement in the District's water storage reserves, improvement in the District's financial reserves to above average levels for the rating level, and successful management of near-term variable rate debt challenges, could put upward pressure on the rating.

What Could Change the Rating – Down

The rating would be pressured downward if the projected near-term improvement in financial operating performance is not achieved, or if additional legal/regulatory constraints were imposed on the SWP such that the District could not replenish its water storage reserves on a reasonably timely basis.

TABLE 1

Metropolitan Water District of Southern California Summary Statistics ($000s)

	2005	2006	2007	2008	2009
Operating revenues	911,102	971,010	1,069,312	1,096,519	1,136,476
Other non-operating revenues	47,236	32,510	55,254	65,906	29,989
Total	958,338	1,003,520	1,124,566	1,162,425	1,166,465
Operating Expenditures	599,653	736,575	703,801	755,223	842,153
Net Revenues	358,685	266,945	420,765	407,202	324,312
Key Ratios:					
Operating ratio (%)	65.8	75.9	65.8	68.9	74.1
Net-take down (%)	37.4	26.6	37.4	35.0	27.8
Debt service coverage (Sr. lien) (x)	2.28	1.52	2.10	1.86	1.45
Debt service safety margin (Sr. lien) (%)	21.0	9.1	19.6	16.2	8.7
Debt ratio (%)	50.7	47.3	49.9	48.3	47.8
Net working capital (% of O&M)	114.6	84.2	165.9	111.8	109.1
Unrestricted Net Assets (% of O&M)	96.9	69.9	77.0	70.1	51.8

District Provides Critical Water Supplies to Exceptionally Large Southern California Service Territory

The District provides supplemental water supplies to its 26 member agencies located, for the most part, along the urbanized southern California coast, roughly from Los Angeles to San Diego. This 5,200 square mile service area includes all or parts of six counties (Ventura, Los Angeles, San Bernardino, Orange, Riverside, and San Diego) and a population of about 19 million, or about half of the state's total population. The District's operations, therefore, are not just a fundamental municipal enterprise but of statewide economic and political significance.

While District's supplies are not its service territory's only water supply source (hence their characterization above as "supplemental"), they are nevertheless critical. District supplies account for between 40% to 60% of its service territory's total annual water use. While a substantial portion of this use is fundamentally discretionary, water service remains a relatively small portion of household budgets and only modestly price elastic, even with recent years' price increases. Individual member agencies' average, annual reliance on District supplies ranges from about 30% to 100%, though some members' annual demands are quite variable around their averages. Individual members' annual demand variance is primarily driven by local rainfall within each member agency's own watershed and service area. Some of these, such as the City of Los Angeles and San Diego County Water Authority, the District's two largest members/customers, are themselves very large. Rainfall in their watersheds is, however, generally quite limited and their own water sources are subject to many of the same constraints as the District's.

A few of the District's member agencies are pursuing alternate sources of new water supplies—principally desalination projects and transfers from agricultural users—but these efforts are integrated

into the District's own long-term water resource planning. In some cases, they are even financed in part with District subsidies. Given the tight water supply environment of the growing southern California area, successful development of such alternate, non-District supplies does not pose a threat to the District's fundamental water supply relationship with its member agencies. Even with these alternate sources fully developed, the member agencies will remain dependent on District supplies. This dependence would be both a practical matter, in terms of the volume of water they require, and by virtue of economic logic, given the District's continuing price advantage over alternate sources.

Near-Term Financial Performance Weak for the Rating Level; Large, Implemented Rate Increases Should Fully Remedy this Recent Trend

The District's financial performance in fiscal 2009 was below average for the rating level, as anticipated, but still adequate given the likelihood of significant near-term improvement from adopted rate increases. The current fiscal year just ending (FY 2010) shows some overall financial improvement but still relatively weak financial ratios compared to Moody's medians for the rating level and comparably large water enterprises nationally. (see Tables 2 and 3) After years of two, three, and six percent rate increases, the District implemented a 14% increase January 2009 and another 20% increase nine months later. Another 7.5% in each January 2011 and 2012 were also just approved in April 2010. Lower projected power costs in FY 2010 primarily account for some improvement in the FY 2010 projection since this past fall, since projected water sales remain relatively depressed. With only moderate storage supplies and still constrained deliveries from the SWP, the District's projected water sales volume will likely remain low compared to historical levels for at least the next several years, if not longer.

TABLE 2

Water Enterprise Medians

SELECTED FINANCIAL DATAPOINTS	AA1 RATED WATER ENTERPRISES	MET WATER OF SO. CAL	LARGE* WATER ENTERPRISES
	MOST RECENT AVAILABLE	JUNE 30, 2009	MOST RECENT AVAILABLE
Financial Data : Key Financial Ratios			
Operating ratio (%)	64.0	74.1	64.2
Net Take-Down (%)	38.6	27.8	37.3
Debt Service Safety Margin (%)	20.1	8.7	16.1
Debt Ratio (%)	25.1	47.8	50.3
Total Annual Senior Lien Debt Service Coverage (x)	1.76	1.45	1.91
Maximum Annual Debt Service Coverage (x)	1.34	1.07	1.40
Net Working Capital (%of O&M)	126.2	109.1	80.3
Unrestricted Reserves (% of O&M)	52.6	51.8	53.6

* Water enterprises with greater than $100 million of operating revenues. Median rating is Aa2.

Source: Moody's Financial Ratio Analysis, June 10, 2010.

TABLE 3

Financial Projections

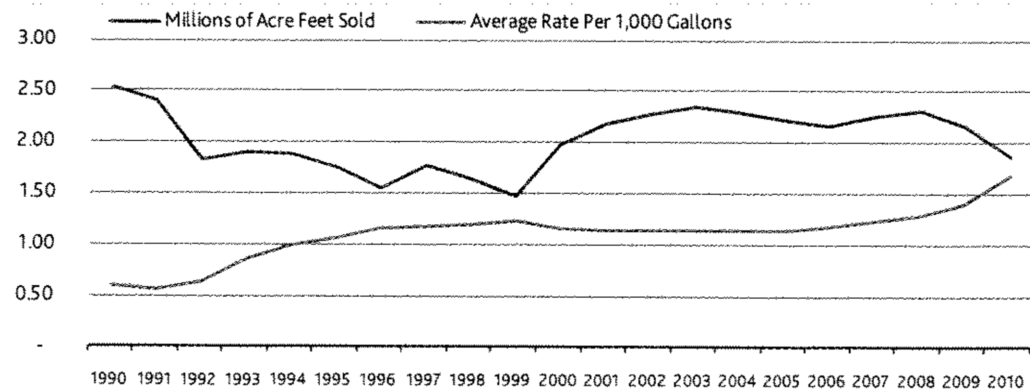
INCOME STATEMENT SUMMARY ($000):[1]	2009	2010	2011	2012	2013	2014
SOURCE OF FINANCIAL DATA	AUDIT/ CAFR	ISSUER ESTIMATE/ PROJEC-TION	ISSUER ESTIMATE/ PROJEC-TION	ISSUER ESTIMATE/ PROJEC-TION	ISSUER ESTIMATE/ PROJEC-TION	ISSUER ESTIMATE/ PROJEC-TION
Gross revenue and income	1,66,465	1,210,000	1,422,000	1,587,000	1,709,000	1,855,000
Total O&M	842,153	838,000	880,000	959,000	1,038,000	1,112,000
Net revenues	324,312	372,000	542,000	628,000	671,000	743,000
Debt Service						
Senior lien	223,000	242,000	286,000	313,000	329,000	346,000
Junior lien	1,000	1,000	1,000	1,000	1,000	1,000
Total debt service	224,000	243,000	287,000	314,000	330,000	347,000
Key Ratios						
Operating ratio (%)	74.1	73.0	64.9	63.6	63.8	62.9
Net take-down (%)	27.8	30.7	38.1	39.6	39.3	40.1
Debt service coverage (senior lien) (x)	1.45	1.54	1.90	2.01	2.04	2.15
Debt service safety margin (snr. lien) (%)	8.7	10.7	18.0	19.8	20.0	21.4
Debt ratio (%)	47.8	--	--	--	--	--

[1] Operating results for FY 2009 are on a full accrual GAAP basis. The 2010-2014 projections are on a cash basis.

Improving water deliveries from the SWP remains an uncertain prospect given the complexity and range of issues faced by the San Francisco Bay/Sacramento-San Joaquin River Delta. To offset the weakened water supply picture, the District prudently implemented substantial rate increases noted above. This demonstrated willingness and ability to sharply raise rates when water supplies are constrained has been a hallmark strength of the District.

FIGURE 1

Average Rates and Sales Volume, 1990-2010



As a result of these rate increases, the District projects nearing its target 2.0x-or-better debt service coverage next year (FY 2011); substantially ramping up its pay-go capital construction from recent years; and ending the year with the cash-basis surplus of $27 million, rather than FY 2010's projected $44 million deficit. Subsequent years of the projection reflect further pay-go capital increases and larger surpluses.

Sound Liquidity Position

The District has more than sufficient liquidity to purchase tendered bonds from its own resources in the event of a failed remarketing. As of May 31, 2010, the District had $528 million of Moody's-discounted daily liquidity in comparison to its $341 million of puttable debt supported by its own liquidity. This includes both the $133 million current offering and $208 million in outstanding long-mode put bonds (Series 2009 A-1 and A-2). Virtually the entire amount of these investments are U.S. Treasuries and Aaa-rated Agencies. Sixty-seven percent of these securities are relatively short, with maturities of three years or less.

Over the past year, however, the District's daily liquidity has varied widely, ranging from a low of $347 million in June to a high of $736 million in December (both figures are on a Moody's-discounted basis). At the low point of this cycle, the District's discounted daily liquidity relative to its outstanding, puttable debt (including the current offering) falls in the mid-range of municipal issuers with self-supported VRDBs. This variability in daily liquidity largely reflects differing investment mixes and the receipt of bond proceeds. Continued daily liquidity variability is likely, though perhaps dampened somewhat as the District adjusts to having a greater amount of self-liquidity supported bonds outstanding.

As of May 31, 2010, the District also had a sizable amount of fixed income investments, P-1 rated commercial paper, and deposits in the California Local Agency Investment Fund. These summed to $323 million and could if necessary be liquidated in less than a week. Over the past twelve months, the District's overall liquidity including such investments has been relatively stable compared its daily liquidity.

Management has clearly indicated its intent, and we believe it has the ability, to quickly position its portfolio to provide full coverage of puttable debt when and if necessary. The District's treasury staff has sufficient depth and experience to achieve this objective, and the District is directly notified of any tenders seven days in advance of the put date. Staff closely monitors the District's remarketing agents and would ensure sufficient liquidity to purchase any un-remarketed bonds one day in advance of the put date. Notably, the District is well prepared to liquidate investments even if access to the District's headquarters were compromised following a natural disaster or other emergency.

Significant but Manageable Variable Rate Debt Exposure

Forty percent of the District's outstanding water revenue bonds are in variable rate obligations, with about 63% of these swapped to fixed. The District's net variable rate exposure is 15% of its total revenue bond debt. Given this level of exposure and the District's sound cash flow, rate flexibility and reserves, managing fluctuating interest costs remains easily within its means. During the 2008 credit crisis the District also demonstrated above average ability to quickly restructure debt if necessary by, for example, converting its auction rate debt to VRDBs within a month.

The more significant challenge District's variable rate portfolio presents is the expiration of its current liquidity facilities. As noted above, $990 million—or about 60% of its total third-party liquidity support—will expire over the next nine months. The District is pursuing various options for managing this transition, including renewal/replacement of some existing facilities, fixing out some of this debt, and increasing its self-liquidity supported bonds. The ultimate mix it adopts could have both long- and short-term rating implications, though we anticipate the District will choose a mix that would not significantly pressure these ratings.

Challenging Water Supply Environment Will Continue Despite Easing of Drought in Northern California

Rainfall variations and increasingly stringent regulatory constraints imposed on the District's two main water supply sources—the federal Colorado River System and the California State Water Project (SWP)—result in highly variable annual deliveries to the District. The Colorado River watershed suffered a drought much of this past decade, with deliveries from that system between 2003 and 2008 averaging a little more than half the District aqueduct's 1.25 million acre-foot (maf) capacity. In prior years, the aqueduct had generally been full, and only in the past two years has the Colorado system resumed providing about 1.0 maf annually. Supplies from the State Water Project have historically made up for Colorado River cutbacks, and vice versa. Over the last several years Northern California has also suffered drought conditions, resulting in reduced supplies from the SWP and the District's partial reliance on storage supplies to meet local demand. Local demand was also relatively high owing to locally warm, dry conditions. The District's storage supplies fell over 30% over the last two years alone, from 2.371 maf to 1.642 maf., though they remain sizable compared to projected annual sales volume (currently about 1.9 maf). Had the drought continued in Northern California, the District would likely have been somewhat pressured in the near-term, both operationally and financially, as it would be if drought conditions return before the District has an opportunity to materially replenish its storage supplies. Such replenishment now appears likely in the coming year. This past year's precipitation in Northern California was above average, and the SWP has increased its allocation to member agencies from an initial 5% to 45% of their contracted amounts. With this 45% allocation (approx. 860,000 acre-feet), some supplemental SWP supplies, and the relatively more certain deliveries anticipated from the Colorado River, the District expects to make net contributions of potentially several hundred thousand acre feet to its storage supplies over the next year. Actual SWP deliveries remains somewhat uncertain, however, owing to operational constraints imposed on the system for environmental protection. The District's projections however reflect the likely impact of these restrictions.

Principal Methodology

The principal methodology used in assigning the long-term rating was "Analytical Framework for Water and Sewer System Ratings", published in August 1999, and available on www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. The principal methodology used in assigning the short-term rating was "Variable Rate Debt Instruments Supported By An Issuer's Own Liquidity", published in November 2006, also available on www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

Last Rating Action

The last rating action with respect to the Metropolitan Water District of Southern California was on November 19, 2009, when municipal finance scale rating of Aa2 was assigned to the District's 2009 E Series of Water Revenue Refunding Bonds. That rating was subsequently recalibrated to Aa1 on April 16, 2010.

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