FitchRatings

FITCH DOWNGRADES METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA REVS TO 'AA+'; OUTLOOK STABLE

Fitch Ratings-San Francisco-17 May 2011: Fitch Ratings assigns the following ratings to the Metropolitan Water District of Southern California, CA's (Metropolitan) revenue bonds:

--$170 million water revenue refunding bonds, series 2011B 'AA+';
--$230 million water revenue refunding bonds, series 2011A-1, 2011A-2, 2011A-3, 2011A-4 'AA+/F1+'.

Bond proceeds from the series 2011A and 2011B bonds will refund outstanding obligations of Metropolitan and pay costs of issuance. The series 2011A bonds are expected to price via negotiated sale the week of May 23, 2011. The 2011B bonds are expected to price during the week of June 6, 2011. The bonds do not have a debt service reserve fund.

In addition, Fitch assigns the following new rating:

--$208 million series 2009A-1 and 2009A-2 bonds (SIFMA Index Notes) 'AA+'. The 'F1+' rating on the bonds is affirmed for a rating of 'AA+/F1+' on the bonds.

Fitch also downgrades the following long-term ratings and affirms the short-term rating listed below:

--$4.4 billion in outstanding water revenue and water revenue refunding bonds downgraded to 'AA+';
--$128 million special variable rate water revenue refunding bonds, series 2010A (variable rate self liquidity) affirmed at 'F1+'.

The Rating Outlook on all bonds is Stable.

SECURITY:

Water Revenue Bonds: The bonds are secured by net water revenues 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.

Variable Rate Self Liquidity Bonds: The 2010A bonds are outstanding as variable rate demand bonds in the weekly mode. Payment of scheduled principal and interest on the bonds is secured by a net operating revenue pledge on parity with Metropolitan's outstanding water revenue bonds. Payment of the purchase price of a tender (either optional or mandatory) is secured solely by a subordinate pledge of net revenues.

SIFMA Index Notes: The 2009A-1 and 2009A-2 bonds are outstanding in the index mode. The series 2011A-1, A-2, A-3, and A-4 bonds are being issued in this mode. Bondholders have the opportunity to tender the bonds at the end of the tender period, which is expected to be 12 months. Payment of scheduled principal and interest on the notes is secured by a net operating revenue pledge that is on parity with Metropolitan's outstanding water revenue bonds. Payment of the purchase price of a tender (either optional or mandatory) is secured solely by a subordinate pledge of net revenues. However, a failure by Metropolitan to provide sufficient proceeds to pay the purchase price of the series 2010A bonds or the 2009A-1, 2009A-2, 2011A-1, 2011A-2, 2011A-3, and 2011A-4 notes at the tender date would constitute an event of default under the respective paying agent agreements for those series but would not constitute an event of default under Metropolitan's master resolution governing its water revenue bonds.

RATING RATIONALE:

--The downgrade reflects a weakened financial profile and demand volatility. Following multiple years of water supply variability and fluctuations in regional demand, Metropolitan's financial performance has declined for the past five years to a low point in fiscal 2011 with all-in debt service coverage around 1.0 times (x). Fitch expects Metropolitan's financial performance to recover from this low point but expects that the likely range of financial performance will remain more reflective of a 'AA+' category credit, given the regional water supply and demand pressures.

--Metropolitan is a wholesale provider of balance of supply water in a large and diverse six-county area in southern California to 26 member agencies, many of whom have some limited form of local water supply and, given the significant cost increases in Metropolitan's supply, are investing in alternative supplies where economical.

--Metropolitan has a relatively reliable and diverse water supply from two major sources, notwithstanding the hydrological and regulatory issues that have been present at both sources in the past decade. Metropolitan has substantial storage facilities in the service territory, rate stabilization fund reserves, and other programs to mitigate supply variability.

--Metropolitan's revenue flexibility has been substantial, as demonstrated by the Board's action to raise rates 75% cumulatively over a six-year period. However, the scale and pace of recent rate escalation and the continued economic downturn in the region could dampen future rate flexibility.

--Expenditure flexibility is limited given Metropolitan's relatively fixed costs associated with its water supply and debt costs. Flexibility in the budget results from Metropolitan's practice of budgeting a healthy level of pay-as-you-go capital from annual revenues that can be curtailed, if needed, and its reserves designated to absorb weather related demand fluctuations.

--The 'AA+/F1+' rating on the series 2011A and 2009A index notes reflects the market access implied by the Metropolitan's long-term credit quality; the purchase price of the bonds at the end of each tender period is only secured by a pledge of remarketing proceeds.

--The 'AA+/F1+' rating on the series 2010A self-liquidity bonds, outstanding in the weekly mode, reflects the liquidity provided by Metropolitan's cash and investments.

KEY RATING DRIVERS:

--Fitch anticipates Metropolitan will exhibit financial recovery in fiscal 2012 from the low point in fiscal 2011. Metropolitan anticipates higher replenishment water sales in fiscal 2012 that should increase revenues and has identified $164 million in cost reductions to the fiscal 2012 budget.

--In the medium term, financial performance is anticipated to improve to a balanced level with the resumption of sustainable capital spending supported from revenues. Management has no further plans to use reserves, although rate stabilization funds remain healthy and available to absorb fluctuations in water sales.

--Metropolitan's debt portfolio continues to require careful management and attention, given its complexity. Approximately $1.73 billion involves either daily, weekly or annual remarketing risk and Metropolitan has a $1.4 billion swap portfolio.

--Discussions continue regarding Metropolitan's participation in a long-term solution in the Bay-Delta, which will likely involve additional capital spending, paid for by state and federal water contractors, including Metropolitan. The improvement could put further pressure on Metropolitan's rates.

CREDIT SUMMARY:

The downgrade of Metropolitan's long-term rating reflects its lingering lower financial performance since 2006, albeit still strong, and an evolving water supply and demand environment in the service area. While financial performance may reach an exceptionally low level in fiscal 2011, Fitch expects Metropolitan to achieve the improved financial performance it has projected for fiscal 2012. Future financial performance is expected to be in line with levels experienced prior to fiscal 2011; levels that are still strong and provide significant bondholder protection, as indicated by the 'AA+' rating.

The previous five years have brought significant developments to the water supply mix in Metropolitan's service area and the demand profile. Drought conditions and regulatory changes to pumping on the State Water Project prompted Metropolitan and its members to work together to develop new local supplies that would reduce the regional demand in Southern California for imported water sold by Metropolitan. The significant increase in Metropolitan's water rates to its members helped to make local investments cost effective that had previously not been considered viable alternatives. Metropolitan's members are not required to buy minimum amounts of water from Metropolitan but instead use the imported water supply to supplement existing and new local sources. In addition, Metropolitan's rate structure is heavily weighted towards volumetric pricing, so fluctuations in demand have a direct impact on its revenues. Metropolitan's role in the region is crucial in that it supplies 40%-60% of Southern California's water supply in six counties with a population of 19 million. As the high cost provider, Metropolitan absorbs much of the regional demand variability due to conservation and efficiency investments as well as economic pressures. Although a regional economic recovery may increase demand, Metropolitan's members are required to meet a legislative requirement to reduce per capital usage by 20% in 2020, so investments in recycling and conservation may continue to place longer-term pressure on Metropolitan's revenue base.

The 2010 water year marked a significant turnaround in water conditions across the state. With a three-year drought ending, hydrological conditions were above average and Metropolitan's storage reserves have been replenished to 2.33 million acre feet (maf) as of Jan. 1, 2011, which is nearly back to pre-drought levels. The Board of Directors removed Metropolitan's allocation plan, a rationing program for its members, in place for nearly two years. However, since wet weather conditions prompted a lower need for outdoor watering, Metropolitan saw its water sales decline well below budgeted levels. Water sales declined 14.3% in fiscal 2010 and are projected to decline another 12.1% in fiscal 2011.

Declining water sales in fiscal 2011 will directly impact Metropolitan's financial performance. At the beginning of the fiscal year, Metropolitan anticipated it would end fiscal 2011 with a return to nearly 2.0x debt service coverage, healthy capital spending from revenues, and balanced operations. Instead, with only 1.63 maf of water sales, compared to the budgeted 1.93 maf planned in the budget, management projects ending the year with 1.4x revenue bond debt service coverage and approximately 1.0x coverage on all payment obligations. These coverage levels depend on the receipt of $62 million in one-time revenues by June 30, 2011, which management states is likely to occur. In addition, the use of $82.3 million from the rate stabilization fund will be required. While this level of slim financial cushion is not typical for a 'AA+' credit, Fitch anticipates water sales will recover in fiscal 2012, given the likely interest in replenishment purchases by Metropolitan's members and its intent to reduce its expenditures. Metropolitan continues to have financial flexibility provided by its robust reserves, with the rate stabilization fund still over $220 million (down from over $300 million in the past four years) and remaining rate flexibility.

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Applicable Criteria and Related Research:
--'Revenue-Supported Rating Criteria' (Oct. 8, 2009);
--'Public Power Rating Guidelines' (June 11, 2009);
--'Rating U.S. Municipal Short-Term Debt' (Dec. 23, 2010);
--'Criteria for Assigning Short-Term Ratings Based on Internal Liquidity' (Dec. 29, 2009).

For information on Build America Bonds, visit 'www.fitchratings.com/BABs'.

Applicable Criteria and Related Research:
Revenue-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=564565
U.S. Public Power Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=613065
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Criteria for Assigning Short-Term Ratings Based on Internal Liquidity
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