FitchRatings

Public Finance
Water & Sewer
United States

Zone 7 Water Agency, California

Rating

Long-Term IDR	AA+

Outlook

Long-Term IDR	Positive

New Issue

$27, 465, 000 Water Revenue Bonds, Series 2023A

Sale Date

The bonds are expected to sell via competitive sale the week of October 23, 2023.

Outstanding Debt

Livermore Valley Water Financing Authority (CA) Water Revenue Bonds	AA+

Applicable Criteria

U.S. Water and Sewer Rating Criteria (March 2023)

Public Sector, Revenue-Supported Entities Rating Criteria (April 2023)

Related Research

Fitch Rates Zone 7 Water Agency, CA's Water Revs 'AA+'; Outlook Positive

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The 'AA+' bond rating and Issuer Default Rating (IDR) reflect Zone 7 Water Agency's (the agency) exceptionally low leverage, measured as net adjusted debt to adjusted funds available for debt service (FADS), within the framework of very strong revenue defensibility and low operating risk profile. The rating is based on a consolidated fund analysis that incorporates the operations and finances of both the agency's flood control operations and water system operations. Fitch Ratings uses a consolidated analysis since the agency would be expected to access all available resources to meet its financial obligations; as such, Fitch holistically assesses the business profile of the agency.

The Positive Outlook reflects Fitch's expectation that additional debt (beyond the current sale) will be issued over the five- to seven-year period but that leverage will likely remain exceptionally low, supporting an upgrade. The agency's leverage has been below zero in each of the last five fiscal years (2018-2022; FYE June 30) as a result of cash balances exceeding adjusted debt, and the agency is positioned well to absorb a potential increase in leverage with some large capital projects contemplated in the intermediate- to long-term. Two larger capital projects in which the agency would likely share costs with other regional partners (the Sites Reservoir and the Los Vaqueros reservoir expansion, discussed below) should have more definitive cost estimates over the next one to two years and provide greater assurance that leverage expectations for the agency remain near the current projections, which would not be expected to exceed 4.0x on a sustained basis.

The agency's very strong revenue defensibility, reflected in the 'aa' assessment, is largely driven by very strong purchaser credit quality (PCQ). The operating risk assessment of 'a' results from a low operating cost burden that averaged about $7,800 over the last five fiscal years and a low life cycle ratio of just 23% as of fiscal 2022.

Security

The bonds are secured by a first lien on the agency's net water revenues, including connection fees but excluding property tax revenues.

Key Rating Drivers

Revenue Defensibility - 'aa'

Very Strong Revenue Source Characteristics and PCQ

The agency maintains independent rate-setting authority and wholesale rates are not subject to the requirements of Proposition 218 (rates for the few direct retail customers are subject to Proposition 218). Nearly all water sales revenue (about 95%) is derived from sales to four wholesale customers: the cities of Livermore and Pleasanton, Dublin San Ramon Services District (DSRSD) and California Water Service Company. Pursuant to Fitch's criteria, the contracts in place with the four purchasers create an implied step-up. Should any of the wholesale customers become past due in their payment, the agency could eventually choose to discontinue water delivery. While all costs associated with a past due amount may not be recouped, the ability to discontinue service would be expected to fully recoup all costs from the remaining customers going forward. Although three of the contracts or agreements expire in 2024 (and another in 2026), renewal risk is viewed as remote given the lack of alternate water supply. Fitch considers the credit quality of Livermore's and Pleasanton's water fund operations and DSRSD to determine the PCQ, which is considered very strong.

Operating Risk - 'a'

Low Operating Cost Burden, Moderate Investment Needs

In fiscal 2022, the system's operating cost burden was considered low at $8,569 per million gallons (mg), consistent with the operating risk assessment. The life cycle ratio was very low at 23% in fiscal 2022. Capex to depreciation has been robust, improving to a five-year average of 495% in fiscal 2022. Planned capital spending for the next five years should generally outpace historical depreciation, supporting a continued very low life cycle ratio.

Inclusive of estimated actual spending in fiscal 2023 and approved spending for fiscal years 2024-2027, capex over this period totals around $183 million. Spending is focused on construction of a second per- and polyfluoroalkyl (PFAS) treatment facility (which the current sale will finance), improvements to the transmission and conveyance system, and standard rehab and repair work. The agency is also participating in planning related to the Sites Reservoir construction project and expansion of the Los Vaqueros reservoir. Each of these large regional projects was invited to apply for a Water Infrastructure Finance and Innovation Act (WIFIA) loan. The agency estimates its allocable share of costs for the Sites Reservoir project at $211 million and its allocable share at $53 million for the Los Vaqueros expansion project. Both of these projects and potential impact to leverage have been considered in the Positive Outlook.

Financial Profile - 'aaa'

Exceptionally Low Leverage Despite Additional Potential Debt Financing

Leverage is historically exceptionally low, registering (1.5x) in fiscal 2022, which is in line with performance since fiscal 2018. The liquidity profile is neutral to the assessment with coverage of full obligations of 1.7x and current days cash on hand of over 1,000. Fitch-calculated all-in debt service coverage has been significantly stronger (which excludes the fixed services expense related to purchased water) and measured 4.7x in fiscal 2022.

In the base case scenario, the leverage ratio is expected to increase to 0.5x over the next five years. In the stress case, the leverage ratio is projected to increase to 0.9x through fiscal 2027. Fitch also considered an alternate stress scenario with an additional $150 million of planned capital spending and debt financing in fiscal 2027 (while making no other adjustments to revenue growth assumptions). In this scenario, leverage remained below 4.0x, supporting the Positive Outlook. Liquidity is expected to remain neutral to the assessment over the five-year horizon.

The Fitch Analytical Stress Test (FAST) considers the potential trend of key ratios in a base case and stress case over a five-year period. The stress case is designed to impose capital costs 10% above expected base case levels and evaluate potential variability in projected key ratios. The FAST reflects Fitch's view of a reasonable scenario, which is generally informed by publicly available and/or management provided information with respect to capital expenditures, user charges and rate of revenue and expenditure growth.

Sensitivities

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

- Sustained projected leverage of around 6.0x in Fitch's base and stress cases as a result of capital needs not adequately supported by FADS.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

- Ability to maintain leverage below 4.0x, should the agency decide to participate definitively with either the Sites or Los Vaqueros reservoir projects once all final cost sharing agreements are in place.

Profile

The agency was established to provide wholesale treated and untreated water (irrigation) to wholesale purchasers (and a handful of direct retail customers) and to provide flood control and groundwater management functions in the eastern portion of Alameda County, encompassing a service area of nearly 430 square miles. Water-system operations are the primary revenue source for the agency, accounting for around 85% to 90% of annual revenue. Revenue related to flood control services comprises the balance of annual revenue.

The agency is highly dependent on the State Water Project (SWP) for supplies, but deliveries can vary widely depending on weather conditions. Typically, SWP water will account for at least 80% of the agency's annual supply (inclusive of SWP carryover supplies). Local surface water, stored groundwater, and banked groundwater in Kern County account for the balance of the supply portfolio. As of July 2023, the agency had about 210,000 acre feet (af) of stored water, which equates to around five years of demand based on recent demand patterns. Moreover, an additional 128,000 af (over three years of usage) for emergency use is stored in the local groundwater basin.

The agency owns two water treatment plants (WTP), the Del Valle WTP with a 36 million gallons per day (mgd) treatment capacity and the Patterson Pass WTP. The Patterson Pass WTP's initial capacity was 12 mgd but was recently expanded to 24 mgd. The overall site master plan at Patterson Pass WTP can accommodate a 36 mgd plant footprint, but there are no plans to expand to the 36 mgd at this time. The agency estimates it has enough water supply within its current portfolio to meet full buildout (55,300 af estimated total demand) but continues to pursue water resiliency projects in light of the variability of SWP imports.

Revenue Defensibility

Revenue Source Characteristics

The revenue derived from the agency's four wholesale customers accounts for about 95% of total annual water system revenue. Contracts expire in 2024 for Pleasanton and DSRSD and in 2026 for Livermore. Management does not anticipate issues with renewal of the contracts and reports good working relationships with each purchaser. Moreover, there is no meaningful alternate supply in the region to which the purchasers could look to replace the agency's supply.

During the terms of the contracts, the wholesale customers are required to purchase all water required for use within their service territory from the agency, excluding any groundwater pumped under each customer's groundwater pumping quota. As noted, pursuant to criteria, Fitch considers there to be an implied step-up and that the agency has the ability to fully reallocate costs in the event of non-payment by a purchaser.

Rate Flexibility

The agency's board of directors maintains independent rate-setting autonomy, supporting very strong rate flexibility. Both wholesale and direct customer rates must be approved by the agency's board of directors but do not require additional approval. While rates for the direct customers are subject to Prop. 218 requirements, wholesale rates are not.

Purchaser Credit Quality

The purchaser credit index (PCI) score is below '1.5' and is based on three of the wholesale customers: DSRSD and the water enterprise operations of the cities of Livermore and Pleasanton. The PCI score indicates very strong purchaser credit quality. The purchasers generally display very favorable demographics and sound demand characteristics in addition to solid rate flexibility.

Asymmetric Factor Considerations

Fitch believes the wholesale customers would have limited to no options as far as replacing the agency as a water supplier in a cost-effective manner. As such, there are no asymmetric rating factor considerations affecting the revenue defensibility assessment.

Operating Risk

Operating Cost Burden

The system's operating cost metric of $8,570 per mg in fiscal 2022 indicates a low cost burden. As an importer that relies heavily on SWP water, purchased water costs are a significant share of operating expenses, regularly accounting for 40% to 50% of operating expenses (excluding depreciation). Fluctuations in demand in recent years have contributed to the operating cost burden ranging from a low of around $6,720 per mg in fiscal 2020 to a high of about $8,850 per mg in fiscal 2018.

Capital Planning and Management

Healthy levels of capital investment are reflected in the very low life cycle ratio of just 23% as of fiscal 2022. Planned capex in upcoming years continues to reflect strong levels of investment, suggesting the life cycle ratio will remain very low and supportive of the operating risk assessment for the long term.

Total annual capex has ranged from $33 million to $48 million since fiscal 2019. On an annual basis, capex is largely dedicated to water operations with spending on the flood control system typically only accounting for $1 million to $2 million annually.

Estimated actual fiscal 2023 spending and planned capex in fiscal years 2024-2027 totals around $183 million and includes projects related to supply expansion projects, construction of a PFAS treatment facility, and systemwide improvements.

Recently completed and planned projects will address PFAS contamination and position the agency well to comply with any finalized rule the EPA may announce. The first PFAS treatment facility, the Stoneridge facility, was recently brought online and received a $16 million grant, which covered nearly all of the related costs. The current sale will finance a second PFAS treatment facility, the Chain of Lakes treatment facility. A third facility is likely to be constructed within the next three to five years, given the limits and hazard index proposed by the EPA earlier this year. Inclusive of the current sale and a potential sale of up to $33 million by 2027, debt financing accounts for about 34% of the 2023-2027 spending. The balance is largely funded on a pay-go basis, but the agency will continue to pursue grant funding as available.

The system remains dedicated to expanding its local supply in light of the variability of SWP water. Fitch expects that significant capital projects will remain on the longer-term horizon for the foreseeable future. For example, the agency remains involved in planning and developing a cost share agreement related to the expansion of the neighboring Los Vaqueros reservoir to 275,000 af from 160,000 af. Updated cost estimates are $1.38 billion, but the agency's share is currently estimated at $53 million. Another potential large scale project is the construction of the Sites Reservoir. Total costs for that project are estimated at $3.9 billion but would also be shared among participating parties. The agency's current allocable costs for the Sites Reservoir project are $211 million. These additional projects have been considered in Positive Outlook, as Fitch believes the agency has capacity for additional debt financing if/when it becomes necessary.

Asymmetric Factor Considerations

No asymmetric rating factor considerations affect the operating risk assessment.

Financial Profile and FAST Analysis

The agency's financial profile assessment has been revised to 'aaa' from 'aa' in light of continued expectations that leverage will remain below 4.0x even with upcoming large capital projects and potential increased spending and/or debt-financing. Leverage was negative in each of the last five fiscal years (2018-2022) in light of cash balances that were greater than adjusted debt. The lowest leverage over this period was realized in fiscal 2021 when it measured (2.4x). The agency's liquidity profile is neutral to the assessment. Current days cash on hand was over 1,000 in fiscal 2022, which is in line with historical performance, while coverage of full obligations (COFO) measured 1.7x. Fitch-calculated all-in debt service coverage is significantly stronger (as this is based on annual debt service requirements and does not include the fixed services expense related to purchased water) and measured 4.7x.

Fitch Analytical Stress Test (FAST)

The FAST considers the potential trend of key ratios in a base case and a stress case. The base case reflects Fitch's expectation of both historical financial results and projected performance while the stress case is designed to impose capital costs 10% above expected base case levels and evaluate potential variability in projected key ratios. The agency's financial forecast and current CIP for the water system, including estimated fiscal 2023 results, informed Fitch's base case with some revenue and expense assumptions adjusted by Fitch. Overall, total revenues are projected to increase by an average of 4% annually, while total operating expenses increase by an average of 3.6% annually from fiscal years 2023 to 2027. The FAST also includes the current bond sale and another sale for $33 million in fiscal 2027.

Under these assumptions, leverage remains negative in both the base case and stress case through fiscal 2026 and increases to 0.5x by fiscal 2027 of the base case, or 0.9x in the same year of the stress case. As noted, Fitch also considered an alternate stress scenario with an additional $150 million of planned capital spending and/or debt financing in fiscal 2027 (while making no other adjustments to revenue growth assumptions). In this scenario, leverage still remained below 4.0x. The liquidity profile is expected to remain neutral to the assessment with solid days cash annually and COFO that measures at least 1.7x annually.

Asymmetric Additive Risk Considerations

No asymmetric additive risk considerations affected this rating determination.

ESG Considerations

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/topics/esg/products#esg-relevance-scores.

Financial Summary

(Audited Fiscal Years Ended June 30)	2018	2019	2020	2021	2022
Operating Risk					
Operating Cost Burden					
Operating Cost Burden ($/mg)	8,855	7,455	6,721	7,474	8,569
Capital Planning and Management					
Life Cycle Ratio (%)	29	28	26	23	23
Annual CapEx/Depreciation (%)	158	512	718	633	442
5-Year Average Capex/Depreciation (%)	—	257	377	448	493
Financial Profile ($000, unless otherwise indicated)					
Current Unrestricted Cash/Investments	261,369	294,016	304,466	301,022	278,418
Current Restricted Cash/Invest (Available Liquidity)	—	—	—	—	—
Current Cash Available	261,369	294,016	304,466	301,022	278,418
Noncurrent Unrestricted Cash/Investments	—	—	—	—	—
Noncurrent Restricted Cash/Invest (Available Liquidity)	—	—	—	—	—
Available Cash	261,369	294,016	304,466	301,022	278,418
Current Restricted Cash/Invest (Debt Service or Debt Service Reserve)	—	804	816	2,833	2,800
Noncurrent Restricted Cash/Invest (Debt Service or Debt Service Reserve)	—	—	—	—	—
Funds Restricted for Debt Service	—	804	816	2,833	2,800
Total Debt	71,377	70,736	68,705	66,661	64,753
Capitalized Fixed Charges	101,674	104,423	107,126	108,829	128,003
Adjusted Net Pension Liability	34,239	41,006	32,255	27,549	37,962
Available Cash	261,369	294,016	304,466	301,022	278,418
Funds Restricted for Debt Service	—	804	816	2,833	2,800
Net Adjusted Debt	-54,079	-78,655	-97,197	-100,816	-50,500
Total Operating Revs	120,450	116,913	112,146	105,713	111,035
Purchased Water/Sewer Services	41,499	42,622	43,725	44,420	52,246
Other Operating Expenses	61,525	46,418	45,732	48,340	47,921
EBITDA	17,425	27,873	22,690	12,953	10,868
Investment Income/(Loss)	2,919	6,673	6,214	2,214	-1,941
Non-Operating Revenues from Taxes	8,518	9,145	9,834	10,344	10,792
Other Cash Revenues/(Expenses)	142	177	—	—	—

Financial Summary

(Audited Fiscal Years Ended June 30)	2018	2019	2020	2021	2022
BAB Subsidy	—	—	—	—	—
Capital Contributions	—	—	—	—	—
Funds Available for Debt Service	29,004	43,868	38,738	25,511	19,718
Fixed Services Expense	14,525	14,918	15,304	15,547	18,286
Net Transfers In/(Out)	—	—	—	—	—
Pension Expense	1,194	2,005	1,299	1,318	(3,245)
Adjusted Funds Available for Debt Service	44,723	60,791	55,340	42,376	34,759
Net Adjusted Debt/Adjusted Funds Available for Debt Service (x)	-1.2	-1.3	-1.8	-2.4	-1.5
Funds Available for Debt Service	29,004	43,868	38,738	25,511	19,718
Fixed Services Expense	14,525	14,918	15,304	15,547	18,286
Net Transfers In/(Out)	—	—	—	—	—
Adjusted FADS for Coverage of Full Obligations	43,529	58,785	54,041	41,058	38,004
Total Annual Debt Service	—	2,311	4,214	4,212	4,218
Fixed Services Expense	14,525	14,918	15,304	15,547	18,286
Adjusted Debt Service (Includes Fixed Services Expense)	15,444	17,228	19,518	19,759	22,504
Coverage of Full Obligations (x)	2.82	3.41	2.77	2.08	1.69
Coverage of Full Obligations Excluding Connection Fees (x)	2.82	3.41	2.77	2.08	1.69
Current Days Cash on Hand	926	1,205	1,242	1,184	1,015
Liquidity Cushion Ratio (Days)	926	1,205	1,242	1,184	1,015
All-In Debt Service Coverage (x)	—	18.99	9.19	6.06	4.67

Note: Fitch may have reclassified certain financial statement items for analytical purposes. N.A. - Not available.
Source: Fitch Ratings, Fitch Solutions, Zone 7 Water Agency (CA)

SOLICITATION & PARTICIPATION STATUS

For information on the solicitation status of the ratings included within this report, please refer to the solicitation status shown in the relevant entity's summary page of the Fitch Ratings website.

For information on the participation status in the rating process of an issuer listed in this report, please refer to the most recent rating action commentary for the relevant issuer, available on the Fitch Ratings website.

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