FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Zone 7 Water Agency, CA's Water Revs at 'AA+'; Outlook Stable

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Fitch Ratings - Austin - 17 Jun 2022: Fitch Ratings has affirmed the 'AA+' rating on the following obligations issued by the Livermore Valley Water Financing Authority (the authority) on behalf of Alameda County Flood Control and Water Conservation District Zone 7 Water Agency (the agency):

--$59.9 million water revenue bonds series 2018A.

Additionally, Fitch has affirmed the agency's Issuer Default Rating (IDR) at 'AA+'.

The Rating Outlook is Stable.

ANALYTICAL CONCLUSION

The 'AA+' bond rating and IDR reflect the agency's very 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 'AA+' rating is based upon a consolidated fund analysis that incorporates the operations and finances of both the agency's flood control operations and water system operations. A consolidated analysis is used as Fitch would expect all available resources to be accessed by the agency in the event of a bankruptcy, and, as such, Fitch assesses the business profile of the agency holistically.

The agency's leverage has been below zero in each of the last five fiscal years (2017-2021) as a result of cash balances exceeding adjusted debt. Yet, the rating reflects Fitch's expectation that leverage will increase within the five-year horizon in light of significant capital projects and likely debt-financing to a level that is consistent with the current rating.

The agency is considered to have very strong revenue defensibility, reflected in the 'aa' assessment, 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 $7,700 over the last five fiscal years and a low life cycle ratio of just 23% as of fiscal 2021.

To date, drought conditions have not negatively affected the rating. The agency is highly dependent on the California State Water Project (SWP) for supplies, which results in purchased water costs that include a significant fixed component reflective of associated long-term obligations. Fitch does not consider the significant dependence on SWP as an asymmetric operating risk factor within the supply portfolio as the agency maintains significant stored water that would provide for multiple years of service provision. Additionally, the agency continues to invest heavily in expanding the local supply.

CREDIT 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 the flood control services comprise for the balance of annual revenue.

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. Fitch considers the credit quality of Livermore's and Pleasanton's water fund operations and DSRSD to determine the PCQ.

As mentioned above, the agency is highly dependent on the 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 May 2022, the agency had about 202,000 acre feet (af) of stored water, which equates to nearly five years of demand based on 2021 volume.

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 build out (55,300 af estimated total demand) but continues to pursue water resiliency projects in light of the variability of SWP imports.

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 Prop. 218. Three of the largest wholesale customers, which account for nearly 80% of wholesale revenue, are considered to be of very strong credit quality and drive the PCQ assessment.

Operating Risks 'a'

Low Cost Burden, Subject to Significant Fixed Costs

The agency's operating cost burden is considered low despite a cost structure that contains significant fixed long-term obligations related to the SWP. Healthy levels of capex that well exceed annual depreciation costs, which are expected to continue, are reflected in the low life cycle ratio that measured 23% as of fiscal 2021. Significant capital projects related to improving local water supply remain on the horizon and could necessitate eventual debt-financing, but specific cost and timing estimates are uncertain.

Financial Profile 'aa'

Very Low Leverage, Additional Financing Possible

Leverage is historically very low but is likely to increase as the agency refines capital plans and associated funding sources, which is expected within the five-year horizon. Given the potential capital needs over the longer-term, the 'aa' assessment is based on expectations that leverage increases to over 4.0x for a period of time. The liquidity profile is neutral to the assessment.

Asymmetric Additive Risk Considerations

No asymmetric additive risk considerations affected this rating determination.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Ability to maintain leverage below 4.0x in the context of more definitive cost and timing of significant capital projects.

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.

Best/Worst Case Rating Scenario

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

SECURITY

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

Revenue Defensibility

The agency's revenue defensibility assessment of 'aa' is supported by the nature of the contracts in place with the wholesale customers, an independent rate-setting authority and very strong PCQ. Revenue derived from the wholesale customers accounts for about 95% of the agency's total annual water system revenue. Contracts expire in 2024 for Pleasanton and DSRSD, and in 2026 for Livermore. However, Fitch expects contracts will be renewed in upcoming years given the lack of meaningful alternate supplies in the region and because management has had no indication that the contracts will not be renewed.

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. 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.

The PCQ assessment of '1' is based upon three of the wholesale customers: DSRSD and the water enterprise operations at the cities of Livermore and Pleasanton. Fitch views the credit quality of all three as very strong. Fitch also 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 Risks

The agency's operating risk assessment is 'a', supported by a historically low operating cost burden and moderate capital investment needs. The operating cost burden measured about $7,500 per million gallons as of fiscal 2021, which is in line with historical performance. As an importer that relies heavily on SWP water, purchased water costs are a significant share of operating expenses. However, over the last five fiscal years the costs have been generally stable averaging about 45% of total operating expenses annually (including depreciation).

Healthy levels of capital investment are reflected in the life cycle ratio of just 23% as of fiscal 2021. Estimated fiscal 2022 spending and planned capex in fiscals 2023-2026 continue to reflect strong levels of investment suggesting the life cycle ratio will remain well below the 45% threshold and will also continue supporting the 'a' operating risk assessment for the long-term. On an annual basis, capex is largely dedicated to water operations with capex on the flood control system typically accounting for about $1 million to $2 million, while total annual capex has ranged between around $10 million and nearly $48 million over the last five fiscal years.

Spending over fiscals 2022 through 2026 totals about $335 million and includes projects related to supply expansion projects, system-wide improvements, and standard rehabilitation and renewal. Approximately 50% of planned spending is related to expansion projects that are expected to be funded with connection fee revenue. Management has indicated that if connection fee revenue tapers off expansion projects would similarly be delayed until revenue rebounded to expected levels. Aside from an expected $25 million state revolving fund (SRF) loan, the remainder of the CIP is funded on a pay-go basis.

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 the planning process and developing a cost share agreement related to the expansion of the neighboring Los Vaqueros reservoir to 275,000 af from 160,000 af. Early cost estimates are up to $900 million and illustrate the scope of supply expansion projects underway in the region. Importantly, the agency would be sharing costs among other participants and would not incur all related project costs, yet debt-financing for the project is possible.

Other water supply expansion projects in the latter years of the current CIP could also include debt-financing, but the timing and size of any potential issuances remains uncertain. The agency expects to complete a comprehensive CIP update by the end of calendar 2023, which should provide greater clarity around cost estimates and potential debt needs for supply expansion projects.

Financial Profile

The agency's financial profile is assessed as 'aa', reflecting expectations that leverage will increase. Leverage was negative in each of the last five fiscal years (2017-2021) 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 (2.38)x. The agency's liquidity profile is solid and neutral to the assessment. Current days cash on hand was nearly 1,200 in fiscal 2021, which is in line with historical performance. Coverage of full obligations (COFO) measured 2.1x in fiscal 2021. 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 6.1x.

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, which includes estimated fiscal 2022 results, informed Fitch's base case. Total revenues increase by an average of 4.5% annually while total operating expenses increase by an average of 3.6% annually from fiscal 2022 to 2026. Fitch included the expected $25 million SRF loan in the scenario. While not part of the agency's formal CIP, Fitch also included a $200 million issuance in fiscal 2025 when spending potentially ramps up for larger capital projects.

Under these assumptions, leverage remains negative in both the base case and stress case until fiscal 2025 in light of the debt issuance Fitch included in the analysis. In the base case leverage increases to 3.8x in fiscal 2025 and further to 4.1x in fiscal 2026. In the stress case leverage increases to 4.1x and 4.7x in the same years, respectively. The liquidity profile is expected to remain neutral to the assessment with solid days cash annually and COFO that measures at least 1.9x each year through fiscal 2026. The 'aa' financial profile assessment is reflective of expectations that debt-financing for large capital projects in upcoming years will push leverage over 4.0x.

Sources of Information

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This 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. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Alameda County Flood and Water Conservation District Zone 7 Water Agency (CA)	LT IDR	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Stable
Alameda County Flood and Water Conservation District Zone 7 Water Agency (CA) /Water & Sewer Revenues/1 LT	LT	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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PARTICIPATION STATUS

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APPLICABLE CRITERIA

U.S. Water and Sewer Rating Criteria (pub. 18 Mar 2021) (including rating assumption sensitivity)

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 01 Sep 2021) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Livermore Valley Water Financing Authority (CA)	EU Endorsed, UK Endorsed

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Parliament and of the Council of 16 September 2009 and The Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019 respectively.

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