FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades Zone 7 Water Agency, CA's Water Revs to 'AA+'; Outlook Stable

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Fitch Ratings - Austin - 17 Jul 2020: Fitch Ratings has upgraded to 'AA+' from 'AA' the 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):

--$62.7 million water revenue bonds series 2018A.

Additionally, Fitch has assigned an Issuer Default Rating (IDR) of 'AA+'.

The Rating Outlook is Stable

ANALYTICAL CONCLUSION

The upgrade on the bond rating to 'AA+' from 'AA' is supported by improved coverage of full obligations (COFO) excluding connection fees that in recent years began to come in over 1.0x. This has been supported in part by a wholesale water rate package that is gradually beginning to recoup more costs from a fixed component. Additionally, the agency's liquidity position continued to improve, increasing by over 50% from fiscal 2015 to fiscal 2019, when it recorded about 1,200 current days cash on hand. A very strong cash position provides the agency with a solid flexibility to withstand potential headwinds in connection-fee revenue generation in light of the current economic slowdown. The robust liquidity also supports the upgrade in conjunction with the strong COFO excluding connection fees.

The 'AA+' IDR 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 to assess the business profile of the agency holistically. The 'AA+' IDR and bond rating reflect the agency's very low net leverage, measured as net adjusted debt to funds available for debt service (FADS), within the framework of very strong revenue defensibility and low operating risks. Yet, the rating reflects Fitch's expectation that net leverage will increase beyond the five-year horizon in light of significant capital projects to a level that is more reflective of the current rating.

The agency is considered to have very strong revenue defensibility, reflected in the 'aa' assessment. The operating risks assessment of 'a' results from a low operating cost burden that averaged about $7,340 over the last five fiscal years (2015-2019) and a low, generally stable, life cycle ratio of just 28% as of fiscal 2019. Net leverage is below 1.0x and has even been negative within the last five years as a result of cash balances exceeding outstanding debt. The agency has no definitive debt issuance plans, but recognizes some of the larger projects in the capital improvement program (CIP) could entail debt-financing. Fitch considered a potential debt issuance in its five-year forward look and expects some level of debt could be absorbed at the current 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.

Coronavirus Considerations

The recent outbreak of coronavirus and related government-mandated containment measures worldwide creates an uncertain global environment for the water and sewer sector. While the agency's most recently available performance data does not indicate impairment, material changes in revenue and cost profile are occurring across the sector. The agency's board of directors delayed implementation of a previously approved 6.7% rate increase for calendar 2021 by one year in light of potential financial impacts on the customer base. The one year deferral is not expected to have an adverse effect on the agency's operations as cost savings realized in fiscal 2020 (FYE June 30) are expected to make up for the revenue differential. Fitch's ratings are forward-looking in nature. Fitch will monitor developments in the sector as a result of the virus outbreak as it relates to severity and duration and incorporate revised expectations for future performance and assessment of key risks as appropriate.

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 account 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 agency's purchaser credit quality (PCQ).

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. At the end of calendar year 2019 the agency had over 258,000 acre feet (af) of stored water, which equates to over six years' worth of demand based on 2019 demand. Moreover, an additional 128,000 af for emergency use is stored in the local groundwater basin.

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 have 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 by the low life cycle ratio that remained below 30% over the last five fiscal years (2015-2019). 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 Net Leverage, Additional Financing Possible

Net leverage is historically very low below 1.0x, but considered modestly higher in consideration of the long-term obligations associated with the agency's purchased water. COFO excluding connection fees that has now exceeded 1.0x in recent years supports the upgrade.

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:

-Greater clarity around the timing and cost of significant capital projects to assess the implications to the agency's leverage profile to determine whether net leverage will remain below 4.0x over the long-term, should debt issuances become necessary.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- A weakening in the revenue defensibility assessment concurrent with an increase in net leverage to around 6.0x, which Fitch considers unlikely.

- A material deterioration in the agency's liquidity position to a point that it no longer provides sufficient flexibility in light of variable connection fee revenue.

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 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 given management has no indication that contacts would 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 and groundwater pumped under each customers' groundwater pumping quota. Over the last five fiscal years (2015-2019) purchases from the agency have only increased and become a more meaningful supply source for each of the wholesale customers. Should any of the wholesale customers become past due in their payment the agency could eventually choose to discontinue water delivery. While any costs associated with a past due amount may not be recouped, the ability to discontinue service would be expected to fully recoup costs going forward.

The PCQ assessment of '1' is based upon three of the wholesale customers: DSRSD and the cities of Livermore and Pleasanton, all of which are deemed to be of very strong purchaser credit quality. Fitch believes the wholesale customers would have limited to no options as far as replacing the agency as a water supplier in a costeffective manner. As such, there are no asymmetric rating factor considerations affecting the revenue defensibility assessment.

OPERATING RISKS

The agency's operating risks assessment is 'a', supported by a historically low operating cost burden and moderate capital investment needs. The operating cost burden has averaged $7,340 per million gallons delivered over the last five fiscal years (2015-2019). As an importer that relies heavily on SWP water, purchased water costs are a significant share of operating expenses. Yet, Fitch notes that over the last five fiscal years the costs have been generally stable at around 40% to 45% of total operating expenses annually (including depreciation), despite increasing demand over this same period. While the operating cost burden dropped below $6,500 in fiscal 2019, the operating cost burden subfactor assessment at 'a' is based on historical results and the expectation that purchased water costs will increase incrementally with any increase in demand that will generally result in an increasing cost burden over time. A sustained cost burden below $6,500 could result the operating risks assessment improving to 'aa', but Fitch would not expect this change to affect the rating as net leverage is already very low.

Healthy levels of capital investment are reflected in the life cycle ratio of just 28% as of fiscal 2019. Estimated fiscal 2020 results and planned capex in fiscals 2021-2024 continue to reflect strong levels of investment suggesting the life cycle ratio will remain well below the 45% threshold for a 'aa' capital planning and management subfactor 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 $7 million and nearly $35 million over the last five fiscal years. The current CIP (2020-2024) for the water system operations totals nearly $400 million and includes projects related to supply expansion projects, system-wide improvements, and standard rehabilitation and renewal. About 60% 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.

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 six to ten year 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. 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.

FINANCIAL PROFILE

The agency's financial profile is assessed as 'aa', despite very low net leverage of less than 1.0x over the last five fiscal years, in light of significant capital needs over the longer-term which are expected to increase leverage. Historically the agency depended more heavily on connection fee revenue as illustrated by COFO excluding connection fees that was well below sum sufficient in fiscals 2015 and 2016, but has improved to stronger levels, at about 1.4x in fiscal 2019, as calculated by Fitch. The agency retains significant cash reserves that could withstand decreases in connection fee revenue that could materialize in light of the current recessionary period. As of fiscal 2019 the agency had around 1,200 current days cash on hand. COFO inclusive of connection fee revenue is much stronger, coming in over 2.0x over the last five fiscal years (2015-2019), and most recently at 3.4x.

Fitch Analytical Stress Test (FAST)

The five-year forward look provided by FAST considers the potential trend of key ratios in a base case and a stress case. 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 2020 results based on YTD results through around mid-June, informed Fitch's base case. In light of historical reliance on connection fees, Fitch assumed connection fee revenue that is at 50% of the five-year average collected in 2015 through 2019. Fitch also considered capex that was scaled back somewhat to reflect lower connection fee revenue. Expansion projects were not eliminated entirely in Fitch's base case as Fitch would expect some capital projects would continue through to completion despite a slowdown in connection fees. Lastly, Fitch also included a debt issuance in its five-year forward look in light of possible debt financing, although not currently included in the agency's formal CIP. In both the base case and rating case cash is expected to remain very strong and continue providing good flexibility. Net leverage would be expected to remain low and continue supporting the rating, but could be on an upward trajectory by the end of the five-year horizon, although only modestly over 5.0x. The current rating is reflective of Fitch's expectation that the agency could absorb a notable increase in its direct debt burden should debt-financing become necessary over the five-year horizon. Yet, greater clarity regarding the timing and cost of longer-term capital projects would likely be needed before additional positive rating action could occur.

ASYMMETRIC ADDITIVE RISK CONSIDERATIONS

No asymmetric additive risk considerations affected this rating determination.

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

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING

ENTITY/DEBT	RATING		
Alameda County Flood and Water Conservation District Zone 7 Water Agency (CA)	LT IDR	AA+ Rating Outlook Stable	New Rating
• Alameda County Flood and Water Conservation District Zone 7 Water	LT	AA+ Rating Outlook Stable	Upgrade

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

U.S. Water and Sewer Rating Criteria (pub. 03 Apr 2020) (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

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