FitchRatings

RATING ACTION COMMENTARY

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

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Fitch Ratings-San Francisco-21 March 2018: Fitch Ratings has assigned a 'AA' rating to the following Alameda County Flood Control and Water Conservation District Zone 7 Water Agency, CA (Zone 7) bonds:

--$66.2 million water revenue bonds 2018 series A to be issued by the Livermore Valley Water Financing Authority.

The bonds are scheduled to be sold via negotiation on March 28, 2018. Proceeds will refund approximately $16 million of obligations to the Cawelo Water District and provide about $57 million of funding for Zone 7's ongoing capital improvement plan, including upgrades to allow ozone treatment of water of surface water supplies.

The Rating Outlook is Stable.

SECURITY

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

KEY RATING DRIVERS

ANALYTICAL CONCLUSION: The 'AA' rating reflects the agency's strong but variable financial performance and low direct debt burden, balanced against high fixed cost burden and significant connection fee revenue variability.

SOLID REVENUE DEFENSIBILITY: Zone 7 provides wholesale water services to a growing, affluent suburban service area in the San Francisco Bay Area. The agency's elected board retains the authority to adjust rates as necessary without outside regulatory approval. Local water retailers buy water under take-and-pay contracts with a significant fixed charge. The district's recently revised rate structure is expected to deliver relatively stable water revenues, which together with very stable property tax revenues pay a significant amount of fixed costs. However, the agency is highly dependent on economically cyclical connection fee revenues.

MEANINGFUL OPERATING RISKS: Zone 7's primary operating risks are dependence on highly variable imported water supplies, a cost structure with significant fixed obligations, and expected future capital pressures. The agency is dependent on the California State Water Project (SWP) for supplies with deliveries varying widely depending on weather conditions. Direct debt is very low, but the agency has substantial long-term obligations for capital costs related to the SWP. The agency continues to explore major supply reliability initiatives to meet the needs of its growing service area, which could require significant debt issuance in the years ahead.

VARIABLE FINANCIAL PERFORMANCE: Financial performance is expected to vary across the business cycle due to the agency's dependence on development-related connection fees. Performance is expected to be very strong during expansions but to fall to more moderate levels in economic contractions. The agency forecasts debt service coverage (DSC) above 8x over the next five years, but Fitch-calculated coverage would fall below 1x without connection fees. Zone 7 retains solid financial reserves to withstand periods of weakness with 706 days cash on hand at the end of fiscal 2017.

RATING SENSITIVITIES

FINANCES, LEVERAGE DRIVE RATING: The rating could come under downward pressure if the Zone 7 Water Agency fails to sustain rates at a level that provides both strong debt service coverage (above 1.5x) and liquidity (significantly greater than 365 days cash). The rating could also come under downward pressure if the agency's debt issuance plans increase significantly.

CREDIT PROFILE

Zone 7 Water Agency is the primary source of water to the Livermore Valley in the eastern San Francisco Bay Area. The agency's four primary customers are the city of Pleasanton, the city of Livermore, the California Water Service Co., and the Dublin San Ramon Services District.

SOLID REVENUE DEFENSIBILITY

The service area economy is strong with median household income at 235% of national level in the city of Pleasanton and 202% in Livermore. Poverty and unemployment rates are very low. Population growth outpaces the state and the nation.

The service area is largely residential and diverse in terms of ultimate payers, though revenues are somewhat concentrated in its four primary wholesale customers. The agency also sells water directly to a small group of large water users in the area, including the federal government's Lawrence Livermore Lab, local park districts, the state of California and a large vineyard. None of the direct customers is large enough to materially impact the agency's financial performance.

The agency's elected board has the authority to adjust rates without outside regulatory approval and is not subject to the constraints of California's proposition 218. It has adjusted rates as necessary to restore financial performance after periods of weakness. The board imposed significant drought surcharges in fiscal 2017 to recover lost water revenues during the record-breaking 2012 to 2017 drought. It also revamped its water rate structure to include a significant fixed charge equal to 35% of its water enterprise fund's revenue requirement, which is unusual for wholesalers with take and pay contracts. Wholesale contracts expire in the mid-2020s, but Fitch expects contract extensions through the final maturity of the bonds as customers lack meaningful alternatives to the agency's supplies in a relatively dry region with very limited unallocated supplies.

The district's recently revised rate structure is expected to deliver relatively stable water revenues, and very stable property tax revenues pay a significant amount of fixed costs. However, the agency is highly dependent on economically cyclical connection fee revenues. About a third of the agency's revenues came from connection fees in 2017. Over the past 20 years, new connections have averaged about 1,600 a year but varied widely with a high of 3,743 in 2005 and a low of 435 in

2011. The level of new connections fell 88% during the housing market collapse of the last economic downturn. Development is currently occurring at a strong pace with new connections averaging 1,250 over the past five years. Fitch assumes connections will continue to vary widely but also assumes that the district is likely to have significant connection fee revenues even in downturns. This risk is partially mitigated by the district's robust reserves and the legal ability to control other rates.

MEANINGFUL OPERATING RISKS

Zone 7 is dependent on the California SWP for about 80% of its supplies, exposing it to periodic supply reductions due to drought and the risk of supply interruptions due to seismic events or levee failures in the ecologically fragile Sacramento-San Joaquin River Delta. The district has an allocation of 80,619 acre feet of SWP water. SWP deliveries vary widely with hydrological conditions and have also been limited by environmental rulings in recent years. SWP supplies (excluding carryover water) have ranged in recent years from as little as 4,031 acre feet in 2014 to as much as 68,526 acre feet in 2017. Water sales have averaged about 35,000 acre feet annually over the past decade and are expected to rise significantly with continued development.

The agency stores large amounts of water during wet periods in order to withstand periods of low deliveries and has managed the vulnerabilities of its supply portfolio well. Zone 7 stores water in its local groundwater basin, offsite banking programs in Kern County, state reservoirs (carryover water), and the Del Valle Reservoir (local surface water). Its position on the state water project also gives it the capability to enter into open market water purchases during periods of stress. At the end of 2016 as the district entered the final year of the last drought, the agency had 215,400 acre feet of water in storage with about half in local storage (7.9 years of water at 2016 usage).

The expense profile is typical of a water utility with fixed obligations (SWP and debt service payments) making up a large proportion of expenditures. Direct debt will be very low at about $279 per capita after the current offering, but the agency has substantial long-term obligations for capital costs related to the SWP. The fixed components of SWP charges have equaled about $40 million, or half of operating expenses, in recent years. While the district benefits from an unlimited ad valorem property tax that funds about half of the SWP costs, it relies on highly volatile connection fees to pay SWP fixed costs related to the expansion of the South Bay Aqueduct, creating a mismatch between the revenue and cost structures. The agency continues to explore major supply reliability initiatives to meet the needs of its growing service area, which could require significant debt issuance or additions to the fixed cost burden in the years ahead. For instance, the agency has agreed to participate in both California's plan to build SWP supply tunnels under the delta and the proposed Sites Reservoir in the Sacramento Valley.

VARIABLE FINANCIAL PERFORMANCE
Financial performance is highly variable but strong on average. The agency hasn't had debt outstanding in recent years, but funds available for debt service have varied widely from just $5.4 million in a drought-impacted 2015 to a high of $24 million in 2017, when drought surcharges boosted revenue significantly. Connection fees have been strong across the recent period, somewhat offsetting the impact of drought related water conservation on total revenues. Free cash to depreciation averaged a very strong 227% over the past five years. Liquidity also remained strong across the period with days cash averaging 606 with a low of 486 days.

Financial performance is expected to remain strong after the new debt is issued. The agency's financial forecast shows debt service coverage ranging from 17.8x to 8.1x over the next five years. The agency's forecast appears reasonably conservative, but it is also subject to inherent uncertainty given the difficulty of forecasting connection fee revenues. Fitch-calculated coverage would fall below 1x without connection fees. Fitch's rating assumes periods of recessionary declines in connection fee revenues but does not assume that connection fees decline to zero. The rating would come under downward pressure if coverage fell below 1.5x on a sustained basis, which Fitch does not expect.

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Applicable Criteria

Rating Criteria for Public-Sector, Revenue-Supported Debt (pub. 26 Feb 2018)
U.S. Water and Sewer Rating Criteria (pub. 30 Nov 2017)

Additional Disclosures

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