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Alameda County Flood Control and Water Conservation District, Zone 7, California; Water/Sewer

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Credit Profile		
US$60.12 mil wtr rev bnds ser 2018 A due 07/01/2043		
Long Term Rating	AA+/Stable	New

Rationale

S&P Global Ratings assigned its 'AA+' long-term rating to the Livermore Valley Water Financing Authority's series 2018 water revenue bonds, issued on behalf of the Alameda County Flood Control and Water Conservation District, Zone 7. The outlook is stable.

Zone 7 predominantly sells wholesale water to four separate retail water purveyors: the cities of Pleasanton (31% of Zone 7's 2017 water sales), the Dublin San Ramon Services District (DSRSD; 28%), California Water Service Co. (Cal Water; 19%), and the city of Livermore (18%). The remaining water sales (4%) are to direct customers, temporary treated water sales, and untreated water sales.

Zone 7's general creditworthiness (senior-lien rating) reflects our assessment of the extremely strong credit quality of its three municipal customers, DSRSD and the cities of Pleasanton and Livermore. Although under our primary criteria, if a wholesale agency is made up of 10 or fewer participants, and there are no contractual provisions that require nondefaulting members or participants to increase their payments to account for such delinquency, we typically use a weak-link approach for our analysis. However, given Zone 7's full rate-setting authority and the automatic pass-through of its wholesale costs by the municipal customers, we have applied our unlimited step-up methodology, wherein we would expect DSRD, Pleasanton, and Livermore to be able to support Cal Water's share of debt without a material impact on their respective creditworthiness. Additional support for the rating comes from the agency's automatic drought surcharge, adopted by the agency and its municipal customers in 2016, which is board approved and triggered during periods of water conservation. Furthermore, we believe the rating is supported by Zone 7's very strong cash position, which we expect will be maintained over the two-year outlook period and manageable capital improvement plan (CIP), in which 78% of projects involve expansion, which we understand can be delayed or deferred in the event of an economic downturn or slowdown in growth.

The rating further reflects our view of the agency's:

- Broad, diversified, and growing service territory in the far eastern portion of the San Francisco-Oakland-Hayward metropolitan statistical area (MSA), which is characterized by extremely strong income levels and steadily expanding commercial and residential development;
- Diverse revenue stream including a dedicated property tax pledge that offsets most of its fixed costs associated with purchased water from the State Water Project (SWP); and

- Stable financial metrics, which we expect to continue over the two-year outlook.

Partly offsetting the above strengths, in our view, are:

- A moderate reliance on connection fees linked to service area development, which could affect the agency's all-in debt service coverage (DSC) in the event of an economic downturn; and
- Long-term uncertainty in capital costs and funding related to large-scale additional water supply projects.

We view the bond provisions as adequate. The 2018 bonds represent the agency's first revenue debt obligation, and will be used for water treatment plant upgrades and to refund Zone 7's obligations in connection with the Cawelo Water District certificates of participation (COPs), series 2006. The bonds are secured by net revenues of the agency's water enterprise operations and water enterprise capital expansion funds. We understand that a debt service reserve fund will not be established for the series 2018 bonds. The rate covenant requires 1.2x coverage of annual debt service and an additional bonds test requires 1.2x pro forma coverage of maximum annual debt service (MADS) on new and existing debt.

Zone 7 Water Agency

Zone 7 was formally established by a vote of residents of the Livermore-Amador Valley area in 1957, under the Alameda County Flood Control and Water Conservation District Act passed by the state legislature in 1949, and operates under an independently elected board to provide local control of integrated water resources. The agency provides wholesale treated and untreated water, flood control and groundwater management throughout eastern Alameda County.

Through its retail purveyors, the agency provides wholesale water to a population of approximately 240,000, and covers an area of around 425 square miles, roughly 35 miles east of San Francisco and 20 miles east of Oakland. Nearby federal defense and energy research laboratories employing more than 9,000 people anchor the local economy; however, these organizations have become less dominant as the region has become a light-industrial center and a residential base for commuters to jobs throughout the Bay Area. Additionally, we consider the service area's income levels extremely strong with median household effective buying income (MHHEBI), ranging between 180% and 225% for the customer communities served.

The agency's primary water source is the SWP, constituting 80% of its supply. Imported water supply for the agency consists of SWP Table A and Article 21, SWP carryover, SWP turnback pool/Yuba Accord, dry year transfers, banked water, and other transfers. The agency has contracted with the California Department of Water Resources (DWR) for 80,619 acre-feet annually from the SWP, averaging 50,000 acre-feet per year. However, each year DWR sets an allocation percentage based on water supply availability, and this percentage is applied to each SWP contract to determine the amount of water that will be made available to each contractor. During the past decade, the SWP allocation has ranged from 5% to 100%, given the variability in hydrology over this period. Based on a Nov. 29, 2017 announcement by DWR, the agency's SWP contractors' Table A allocations for 2018 is 20% or approximately 14,280 acre-feet. The allocation for 2018 is subject to revision by DWR.

Supplementing imported water is the agency's ground water and surface water storage. Zone 7 maintains two water treatment plants, with a combined treatment capacity of 55 million gallons per day (mgd); 10 groundwater wells with a peak capacity of 42 mgd; and a groundwater demineralization plant. Zone 7 has 642 thousand acre feet (TAF) of storage between Lake Del Valle, the main groundwater basin, and Kern County water banks. The agency also has the ability to artificially recharge its groundwater basin through local arroyos.

In October 2016, the agency revised its rate structure to implement a 35% fixed-charge component and a 65% volume-based rate which was adopted for calendar years 2017 and 2018. We expect the revised wholesale rate structure should provide greater stability in Zone 7's financial performance. Furthermore, each of the agency's customers have implemented rate structures that allow for an automatic pass-through of increases from Zone 7. In response to the recent prolonged drought, the agency also implemented a temporary drought surcharge of $0.57 per hundred cubic feet (CCF) of water for calendar years 2016 and 2017. To mitigate future impacts on revenues as a result of water shortages, the agency adopted a water shortage contingency plan and water shortage surcharges. The surcharges are implemented during various stages of mandated conservation and sunset after six months, unless extended by the agency board.

We believe the agency's financial position is strong based on our calculation of all-in DSC and the agency's unrestricted cash position. We note that our calculation of all-in DSC includes all proprietary funds of the agency, including pledged operations and capital expansion funds, but also including the unpledged SWP fund. Although unpledged and supported by dedicated property taxes, we believe the state water facilities fund is key to the operation of the agency and therefore include net revenues of the fund for our calculation of all-in coverage to determine the agency's general creditworthiness. All-in coverage is our internally adjusted DSC metric that we believe best tracks the use of every dollar of utility operating revenues, regardless of lien position, accounting treatment, or ultimate purpose. It also incorporates recognition of fixed charges or costs, which we define as certain long-term recurring items that are debt-like, even if legally treated as an operating expense. In cases where an unconditional take-or-pay minimum, capacity payment, or demand charge does not exist or is not explicit, these criteria will impute what we consider a logical and reasonable equivalent for calculating all-in coverage. The methodology uses the utility's relative contribution to its wholesaler provider's total revenues as the basis for the fixed-cost imputation.

In fiscal 2017, net operating revenues (including pledged revenues and state water facilities fund revenues) totaled $34.2 million compared to $25.1 million in 2016 and $5.8 million in 2015. The increase in revenues reflects increasing wholesale charges, the agency's restructuring of rates (including implementation of fixed costs recovery) and the drought surcharge in effect for fiscal years 2016 and 2017. As calculated by S&P Global Ratings, the agency's all-in coverage (including imputed SWP debt) was 1.4x, 2.2x, and 2.6x in fiscal years 2015, 2016 and 2017, respectively, which we consider an improvement to very strong levels. However, we note that the agency's very strong coverage is supported by the receipt of nonrecurring connection fee revenues, which, when excluded, bring coverage down to 1.1x in fiscal 2017. Projections provided by management, which include conservative estimates of future connection fee receipts, indicate net revenues will cover debt obligations by at least 2.3x through 2022. Also supporting the agency's very strong financial profile is its very strong liquidity position. Unrestricted cash in the pledged operating funds improved to over $122 million, or 593 days' cash, in 2017 from $84.5 million (443 days' cash) in 2015.

The agency's upcoming CIP is sizable. Zone 7 has identified projects with total estimated costs of approximately $430 million through fiscal year 2023 and $924 million through fiscal year 2028. Approximately 78% of the projects are predicated on future growth and can be deferred if demand does not materialize. Capital projects are presented in future dollars with an assumed inflation rate of 4% annually. Other than the portion of the capital project funded with proceeds from the 2018 bonds, management plans to continue to fund the agency's CIP on a pay-as-you-go basis; we do not expect unrestricted cash to be drawn down materially over the upcoming five-year planning period given that the majority of the CIP is expansion related and expected to be funded by the future receipt of connection fees. Moreover, without the issuance of additional bonds, the agency will maintain a low leverage position. However, a paradigm shift in funding capital projects, particularly the issuance of debt or a drawdown in cash reserves, in our opinion, would significantly alter the financial position of the agency as well as its customers.

Outlook

The stable outlook reflects our view of the agency's adequate water supply, strong financial position in terms of all-in coverage and liquidity, and restructured rate schedule and implemented drought surcharge schedule, which we believe will allow it to recover costs and stabilize revenues in the event of future drought conditions. The outlook also reflects our assessment that the strongest three retail customer's water fund credit quality will remain consistent with current projections.

Upside scenario

While unlikely, we could take a positive rating action if the financial metrics of the agency and the three municipal purveyors materially strengthen, particularly all-in coverage (excluding connection fees), and if we believe the stronger performance level is sustainable.

Downside scenario

Negative rating action would be predicated on material weakening of the agency's or its retail water purveyor's coverage and liquidity. Scenarios which we think would weaken the rating would include a return to significantly prolonged drought conditions, resulting in a need for higher cost supplemental water, material downturn in the service area economy, or significant additional leverage should the agency shift its capital funding.

Retail Purveyors

California Water Service Co.

For information on California Water Service Co., see our summary analysis, published Feb. 2, 2018, on RatingsDirect.

Dublin San Ramon Services District

For information on Dublin San Ramon Services District, see our summary analysis, published Dec. 5, 2017.

City of Pleasanton

The city of Pleasanton, with a population of about 77,100, is 40 miles east of San Francisco. We view the service area's income levels as very strong based on the city's MHHEBI, which was 206% of the national median for 2016. Pleasanton, on average, accounts for 32% of the agency's water sale revenues, making it the largest contributor. The city has a state revolving fund loan and private bank-placed debt outstanding in relation to its water system. It restructured rates in 2017, including the automatic pass-through component of Zone 7 rate increases. Currently, a single-family residential customer pays about $59.15 monthly, which is collected on a utility bill.

The water system's financial performance has been strong, although slightly declining in recent years, in our view. The system has a state revolving fund loan and private bank-placed debt outstanding, along with imputed Zone 7 and SWP debt. Net water revenues provided all-in coverage—including Zone 7 and SWP imputed debt--of about 1.4x for fiscal year 2017, as calculated by S&P Global Ratings. When allocating a portion of California Water Service Co.'s imputed Zone 7 and SWP debt service to stress-test the city's financial profile, all-in DSC was 1.4x in 2017. Based on management's forecast, we anticipate that all-in coverage will increase to about 1.6x by fiscal year 2019. The system's cash position is very strong, in our view, at $22.6 million, equivalent to 341 days of operating expenses, as of June 30, 2017.

Pleasanton's capital plan primarily features rehabilitation and expansion of its water distribution system. Management is planning to spend about $4 million annually on capital improvements during the next five fiscal years, and we understand that the city plans to fund these projects on a pay-as-you-go basis.

City of Livermore

The city of Livermore, with a population of about 89,100, is 45 miles east of San Francisco. We view the service area's income levels as very strong based on the city's MHHEBI, which was 180% of the national median for 2016. Livermore, on average, accounts for 19% of the agency's water sale revenues. The city has one series of water system COPs outstanding in the amount of $4.119 million, after retiring its series 2011 COPs in 2017. It recently restructured its water rates in 2017, including establishing an automatic pass-through component of Zone 7 wholesale costs. Currently, the city reports that a single-family residential customer pays about $91.79 monthly, which is collected on a utility bill. We understand that management plans to increase rates by about $2 per month on July 1 every year until 2021 to preserve the water fund's financial position and fund capital needs.

The water system's financial performance has been strong, in our view. Net water revenues provided all-in coverage—including Zone 7 and SWP imputed debt--of about 1.7x for fiscal year 2017, as calculated by S&P Global Ratings. When allocating a portion of California Water Service Co.'s imputed Zone 7 and SWP debt service to stress-test the city's financial profile, all-in DSC was 1.6x in 2017. Based on management's forecast, we anticipate that all-in coverage will decline to about 1.6x by fiscal year 2019, which we still consider very strong. The system's cash position is extremely strong, in our view, at $26.9 million, equivalent to 805 days of operating expenses, as of June 30, 2017.

Livermore's capital plan primarily features rehabilitation and expansion of its water distribution system. Management is planning to spend about $8.7 million from fiscal years 2018 through fiscal 2021, and we understand that the city plans to fund these projects on a pay-as-you-go basis.