S&P Global
Ratings

RatingsDirect®

San Diego County Water Authority, California; CP; Note; Water/Sewer

Primary Credit Analyst:
Jenny Poree, San Francisco (1) 415-371-5044; jenny.poree@spglobal.com

Secondary Contact:
Malcolm N D'Silva, Centennial + 1 (303) 721 4526; malcolm.dsilva@spglobal.com

Table Of Contents

San Diego County Water Authority, California; CP; Note; Water/Sewer

Credit Profile		
US$149.0 mil wtr rev rfdg bnds ser 2021A&B due 05/01/2031		
Long Term Rating	AAA/Stable	New
US$263.0 mil wtr rev rfdg bnds ser 2020 due 05/01/2034		
Long Term Rating	AAA/Stable	New

Rating Action

S&P Global Ratings assigned its 'AAA' long-term rating to the San Diego County Water Authority, Calif.'s (the authority) anticipated $263 million series 2020 Bonds and $149.3 million series 2021 A&B senior-lien water revenue refunding bonds. At the same time, S&P Global Ratings affirmed its:

- 'AAA' rating on the authority's existing senior-lien revenue bonds;
- 'AAA' rating on the authority's exiting certificates of participation (COPs);
- 'AA+' rating on the authority's existing subordinate-lien bonds;and
- 'A-1+' short-term rating on the authority's existing commercial paper (CP) debt.

The outlook, where applicable, is stable.

The authority is issuing fixed-rate refunding bonds to generate upfront cash flow and net present value savings. The series 2020A&B (taxable advance refunding) will refund outstanding series 2013A bonds. The series 2021A&B (tax-exempt forward delivery) bonds will refund outstanding series 2011A&B bonds. The bonds will be self-designated green bonds.

Credit overview

The authority has been successful establishing water supply control and diversification. Management has also demonstrated an ability to navigate volatile hydrological cycles through adopting rate increases as needed and building prudent financial reserves and storage to mitigate variability. The primary risk to the authority is the reduced consumption stemming from conservation, weather, economic contraction and the development of local supply by their member agencies. The reduced consumption introduces a financial challenge given that contractual water costs are increasing. We believe management is taking important steps to mitigate this changing cost profile, including increasing the fixed charge component of the rate structure to capture contract costs and infrastructure contributions. Establishing the appropriate balance of fixed charges and maintaining ample cash is important given the nature of the authority as a primary and supplemental supplier. Maintaining historically strong coverage and liquidity levels will be a delicate balance of imposing rate increases while not burdening affordability. Astute long-term planning will be crucial to these efforts.

S&P Global Economics acknowledges a high degree of uncertainty related to the effects of COVID-19, including the rate of spread and peak of the outbreak. Nevertheless, we believe measures to contain COVID-19 have pushed the region and nation into economic recession. Although we believe the authority's sales will be affected by reduced economic activity in the region depending on the length of the recession, in our view, this risk is somewhat mitigated by its healthy liquidity position and prudent management team.

Environmental, social, and governance factors

Given its location in Southern California, we believe the authority faces elevated environmental risk due to the region's inherent water supply scarcity and seismic exposure. In particular, its imported water supply (both the State Water Project and the Colorado River) remain susceptible to environmental scrutiny and risks related to climate change, rising temperatures, and shifting precipitation patterns. The authority has been effective in obtaining alternative higher reliability supply sources and management has a comprehensive resource plan, which has assisted in their ability to navigate different hydrological conditions. In addition to environmental risk, rising water costs contribute to elevated social risk as members have become increasingly sensitive to rising water costs, which has resulted in some member discord and potential detachment. Management continues to work with the members to address affordability concerns, including utilizing the rate stabilization fund to mitigate large rate increases. The management team is tenured and experienced and maintains above-average infrastructure maintenance policies which contributes to a strong governance position.

Two-Year Stable Outlook

Downside scenario

We could lower the ratings or revise the outlook to negative if water sales decline materially from current levels--due to economic conditions or the development of significantly lower cost water supply alternatives or the loss of a major member--without being mitigated by reduced water purchases, rate increases, or an increased fixed-charge rate structure. In addition, the rating could be pressured if the authority depletes the rate stabilization fund beyond the minimum target level established by the board or fails to implement rate increases to maintain its coverage policies. The rating could also be pressured if the authority takes on a meaningful amount of additional leverage.

Upside scenario

We could raise the subordinate-lien rating if the senior lien is closed and the outstanding amount is defeased or reduced to a de minimus level.

Enterprise Profile

The authority is a supplemental water provider for 24 member agencies throughout San Diego County. The level of dependence varies from 100% dependence to no utilization of authority supplies during above normal rainfall cycles. Since 1990, the water authority has provided an average of 85% percent of the water supply within its service area, ranging from a low of 75 percent and a high of 95%. Per capita water use has declined 46% over that same period, the result of conservation, local supply development, economic conditions, member use restrictions, and supply allocations. Year to date, consumption is 14% lower, primarily as a result of wetter than average local weather conditions in fiscal year 2020 as well as economic contraction. Management expects consumption to increase incrementally during the forecast period, which we believe may be an aggressive assumption. New demand forecasting will be released in September 2020. Overall, authority management has committed itself and its member agencies to managing through different hydrological conditions and has made the necessary rate increases to maintain consistent financial performance to support operational requirements. We view this as a credit positive, as discussed in the financial profile section. That said, continued declines in consumption will necessitate higher rate increases and we believe affordability is already a credit vulnerability.

The state is adopting new water-use objectives for retail water agencies for indoor and outdoor use, system water loss, variances, and potable reuse credit. The state expects to adopt these standards by June 2022. Such objectives could further reduce demand and lead to development of additional alternative local resources. We believe the continued development of local supply could further reduce the demand for authority supply. That said, diversification of supply is beneficial to the regional water supply picture and management does not expect local supply to negatively affect the authority's financial position. We believe the current water supply management team demonstrates considerable acumen in strategic supply planning. Further, member agencies are required to pay certain charges irrespective of whether they order water from the water authority in a given year. During the recent fiscal sustainability council, the authority adopted an even higher percentage of fixed charges, which we view positively given the authority's fixed cost profile and role as a supplemental supply provider.

Two member agencies have petitioned the Local Agency Formation Commission (LAFCO) for detachment from the authority because they believe they can receive their water supply more affordably directly from Metropolitan Water District (through an arrangement with Eastern Municipal Water). Given the geographic location of the members, they reportedly believe that they do not receive sufficient benefit from remaining with the authority. LAFCO may deny the detachments, or approve the detachments with conditions. The authority's management reports that the LAFCO process will likely take up to two years and that the authority intends to seek reimbursement for associated debt and costs attributable to the two agencies. Management believes they could adjust supply requirements through resource planning. While we do not believe this will immediately effect the authority's financial position, we do believe an approved detachment could set a poor precedent if members can easily detach from the authority, especially if they are not required to pay for their portion of the associated debt and infrastructure costs that the authority has undertaken to provide reliable water sources.

The authority has been successful in their efforts to increase control over their supply and diversify the source of their supply. The majority of the authority's supply is via California's participation in the Colorado River Compact and related subsequent agreements (65%). This includes the drought contingency plan and a quantification settlement agreement (QSA) between the authority, other providers in the region, the state and the federal Bureau of Reclamation. The authority also receives about 11% of its water from the State Water Project, with the remainder coming from local sources. State Water Project allocations are below average for this water year at 15%, with the Northern Sierra Precipitation 8-Station Index at 57% of normal through May 6. Upper Colorado River snowpack is at 77% of average as of May 6, 2020, and no shortage allocation is expected. The authority has made meaningful progress on the acquisition and control of the water supply portfolio through regional agreements and construction of the Carlsbad seawater desalination project. However, Metropolitan Water District of Southern California (AAA) remains a significant imported water supply source for the water authority, which we consider credit neutral.

The drought contingency plan better defines allocations during drought and weaker stream flow conditions to the seven states and even sovereign nation of Mexico that are allocated Colorado River water. Still, as the drought contingency plan acknowledges, changes in economic and population growth as well as climate risk creates long-term uncertainty. The QSA, which was upheld after legal challenges, defines a number of regional cooperation measures that include lining canals (which reduces losses from evapotranspiration and soil permeability, allowing more water to get to the recipient). This is the more positive measure for the authority, because these canals could eventually provide as much as half of the area's raw water by 2021 and is now the authority's cheapest source of supply and will provide it with a firm source essentially through the rest of this century. The QSA also obligates the authority to pay for certain environmental mitigation in the Salton Sea, with only $13 million of a total $94 million still to be appropriated.

The authority's wholesale rates will continue to be pressured by rising purchased water costs and other pass-through obligations. Management's forecast shows the range for projected rates by 2023 to be $1,716-$2,800 (including desalinated water) with annual moderate rate increases each year. One AF is enough water to serve two-to-three single-family residential customers for a year. The authority's most expensive source of supply, which provides about 10% of its water, is the Carlsbad desalination plant. The facility achieved commercial operations in late 2015. After some initial project complications, the plant delivered 49,000 acre-feet (AF) of water to the authority within calendar year 2018, within its contractual obligation to provide a minimum of at least 48,000 AF and up to 56,000 AF in any given year. Any deliveries of less than the minimum would lead to a true-up credit benefitting the authority, relatively insulating the authority from significant operating risk (other than energy price risk). This source of supply will be more expensive than initially projected because Poseidon (the plant developer and operator) is constructing new intake and discharge facilities that it estimates will cost as much as $83 million by its 2023 completion. All costs of the intake system are a direct pass through to the authority. The authority prudently has adopted contractual fixed charges to cover a significant portion of these costs directly from pass through payments.

The authority has a formal asset management program that addresses the long-term sustainability of its infrastructure and facilities. The program includes evaluating the condition and expected useful life of each asset and developing a strategy to rehabilitate and replace these assets. Management regularly communicates its strategic goals internally and to outside parties. Rate adjustments have been timely historically, and management undertakes periodic rate studies that are cost of service based. Drought management planning is strong, and management has generally succeeded in executing strategic plans, including complex capital planning.

San Diego County has a diversified economy based on tourism, international trade, military, and high-tech manufacturing. The economy has been significantly affected by the COVID-19 related shelter-in-place requirements, which have led to business closures and unemployment of 15% for April and May, which is higher than the national level. Leading employers include the government, education, military, and health care sectors, all of which, in our opinion, are relatively more stable. Tourism, trade, and retail are also economic drivers and those sectors have exhibited outsized exposure to the current economic contraction. Median household effective buying income is significantly higher than the U.S., helping to blunt the effect of the rising cost of water to the ultimate retail customers of member agencies.

Financial Profile

The authority's financial position has historically been a credit strength although we believe the coverage will be less robust during this upcoming forecast period as a result of consumption declines and rising contractual costs. We view favorably that management has, through fiscal sustainability efforts, recently increased the percentage of fixed charges associated with contract and infrastructure costs. We understand that there will be continued efforts to improve the rate structure to provide enhanced stability and cost recovery.

Debt service coverage for all senior and subordinate obligations has consistently exceeded 1.4x in each of the past five years, which we view as extremely strong for a wholesaler. For 2019, coverage dropped slightly, to just under 1.4x when netting out the rate stabilization fund. Given the effects of the pandemic, weather, and economic contraction, consumption has declined considerably in 2020. Water sales have declined 14% below the current budget and expected to remain low in 2021 due wetter than average weather conditions in fiscal year 2020 and a slight rebound of demands to a normal weather year in 2021, as well as potential effects from coronavirus-related business closures and other factors. Decreased water sales are expected to put upward pressure on rates. The 2020 consumption decline has been mitigated by an increased percentage of fixed charges, a reduction in the cost of sales related to purchasing less desalinated water as well as a $20 million rate stabilization withdrawal. Coverage without the use of the rate stabilization fund was approximately 1.3x. We expect the authority to continue to rely on withdrawals from the rate stabilization fund through 2023, given the rising cost of services and a desire to moderate rate increases for members. Under a stress scenario where there is an additional 5% decline in 2021 followed by no-growth in water sales revenue, the authority would breach sum sufficiency by 2023 without significant additional rate increases.

Management reports that despite the planned use of the rate stabilization fund, the fund will remain above the internal target through the forecast period. Maintaining the rate stabilization at the policy level and continuing to implement reasonable rate increases is critical to maintaining the 'AAA' rating.

Liquidity is also in our opinion a strength with over $300 million in cash and codified reserves. After consistently adding to the rate stabilization fund (RSF) during periods of fiscal strength, the authority utilized the RSF in 2019 and expects to leverage those funds through 2023 without breaching the target level. The RSF provides a financial cushion to withstand weather volatility that could lead to an unfavorable variance in the budget. Management also maintains an operating reserve equivalent to at least 45 days' of operating expenses (with $5 million held for emergencies), and several funds designated for specific capital items. All told, management is projecting to end fiscal 2020 with more than eight months of operating expenses. Liquidity is a critical to the authority's financial health, given variable hydrology conditions.

Revenue and expenses assumptions are reasonable, and management provides interim financial reporting. The long-term planning process is rigorous, and the detailed forecast is updated annually. The authority's reserve policy is robust and articulates a rationale for maintaining its extremely strong liquidity position. Financial planning and operational information is transparent and periodically updated.

The authority's five-year capital improvement plan is manageable, in our view. The water authority expects to spend approximately $387.2 million over the next five years on capital improvement projects, though a new long-range forecast will amend that estimate when it is completed in September. The authority reduced its two-year spending on the capital plan in response to the current economic contraction and to defer projects associated with the two members who are attempting to detach from the authority.

Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

Ratings Detail (As Of June 25, 2020)		
San Diego Cnty Wtr Auth Wtr		
Long Term Rating	AAA/Stable	Affirmed
San Diego Cnty Wtr Auth cml pap nts ser 9 due 05/10/2018		
Short Term Rating	A-1+	Affirmed
San Diego Cnty Wtr Auth sr lien wtr rev rfdg bnds		
Long Term Rating	AAA/Stable	Affirmed
San Diego Cnty Wtr Auth wtr COP (AGM)		
Unenhanced Rating	AAA(SPUR)/Stable	Affirmed
San Diego Cnty Wtr Auth wtr (MBIA) (MBIA of Illinois)		
Unenhanced Rating	AAA(SPUR)/Stable	Affirmed
San Diego Cnty Wtr Auth CP notes ser 10 due 12/31/2099		
Short Term Rating	A-1+	Affirmed
San Diego Cnty Wtr Auth Wtr (MBIA of Illinois)		
Unenhanced Rating	AAA(SPUR)/Stable	Affirmed
San Diego Cnty Wtr Auth CP		
Short Term Rating	A-1+	Affirmed
San Diego Cnty Wtr Auth WTRSWR		
Long Term Rating	AA+/Stable	Affirmed

Many issues are enhanced by bond insurance.