FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades Western Municipal Water District, CA's Bonds to 'AAA'; Outlook Stable

Fri 14 May, 2021 - 10:10 AM ET

Fitch Ratings - Austin - 14 May 2021: Fitch Ratings has upgraded to 'AAA' from 'AA+' the following Western Municipal Water District Facilities Authority (the authority), CA obligations issued on behalf of the Western Municipal Water District, CA (the district):

--$37.5 million adjustable-rate water revenue refunding bonds series 2012A (underlying long-term rating) and associated bank bonds should they ever be purchased by the letter of credit provider;

--$121.6 million water revenue bonds series 2020A.

Fitch has also upgraded the district's Issuer Default Rating (IDR) to 'AAA' from 'AA+'.

The Rating Outlook is revised to Stable from Positive.

Feedback

ANALYTICAL CONCLUSION

The upgrade on the bond rating and IDR to 'AAA' is driven by strong results in fiscal 2020 and sustained projections that point to leverage below 3.0x in the upcoming years. Fiscal 2020 leverage (measured as net adjusted debt to adjusted funds available for debt service) was 2.3x, beating previous expectations of about 3.1x. Additionally, a refunding transaction that closed earlier in fiscal 2021 (fiscal year end June 30) refunded the district's unhedged variable rate debt, which previously accounted for about one-third of total outstanding debt, which was considered elevated. All remaining variable rate debt is now hedged with a fixed rate swap.

The district's very low leverage is considered within the framework of very strong revenue defensibility and a very low operating risk profile. The 'aa' revenue defensibility assessment is supported by very strong purchaser credit quality (PCQ) and a contractual framework with its wholesale customers that provides for full cost recovery. The operating risk assessment is also 'aa' and supported by moderate investment needs and an operating cost burden metric that falls comfortably below the $6,500 per million gallons (mg) of water production and sewer flows threshold.

CREDIT PROFILE

Western Municipal Water District provides essential water and sewer services to a 527-square-mile service area in western Riverside County. It serves a population of nearly one million residents through around 24,500 direct retail water connections, 900 direct retail sewer connections, and eight wholesale water customers. On an annual basis, water services account for about 90% of the district's operating revenues, while sewer accounts for the remaining 10%. While the district is able to supply treated and untreated water to 14 wholesale customers, only eight customers currently purchase from the district. These wholesale customers regularly account for about 65% of the district's annual water revenues and sales volume, and have remained largely unchanged for the last decade. Fitch considers the district to be a wholesale provider for purposes of its analysis.

Over the last two decades the district has significantly reduced its reliance on imported water, which it purchases from the Metropolitan Water District of Southern California (MWD; IDR AA+/Stable). Purchases from MWD have declined over the past couple of decades from as much as 90% of the district's retail supply such that purchased water now accounts for about 60% of its supply with the balance provided by local sources. The district expects it will be able to reduce water purchases by an additional 10% in upcoming years as additional capital projects are completed to increase access to local sources. As the local supply is significantly more cost-effective this should result in cost savings over the long term.

Coronavirus Considerations

The outbreak of coronavirus and related government containment measures have not materially impaired the district's operational or financial performance to date and are not expected to have a material impact going forward.

KEY RATING DRIVERS

Revenue Defensibility 'aa'

Very Strong Revenue Source Characteristics and PCQ

The district maintains independent rate-setting authority and wholesale rates are not subject to the requirements of Proposition 218 (while retail rates are subject to Prop. 218). Two of the largest wholesale customers, which account for over half of wholesale revenue, are of very strong credit quality and drive the PCQ assessment.

Operating Risks 'aa'

Favorable Operating Risk Profile Expected Over Long Term

The operating risk profile is considered very strong, supported by a very low operating cost burden and moderate investment needs. Capital projects remain focused on asset repair and replacement (R&R) and expanding the local water supply, which are consistent with prior plans.

Financial Profile 'aaa'

Very Low Leverage Expected to Continue

The upgrade is driven by strong fiscal 2020 results and projections that continue to point to very low leverage in Fitch's scenario analysis. As of fiscal 2020, the leverage ratio measured 2.3x and it has not exceeded 5.0x in any of the previous five fiscal years (2016-2020). The leverage ratio is not expected to exceed 3.0x for at least the next five fiscal years. The liquidity profile is considered 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:

--Not applicable given the current rating.

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

--Leverage that exceeds 5.0x in Fitch's base and stress scenarios, assuming stability in the revenue defensibility and operating risk assessments.

--A significant weakening of the PCQ that ultimately leads to a lower revenue defensibility assessment would raise the bar of leverage expectations at the current rating level.

--A sustained increase in the operating cost burden to over $6,500 would likely weaken the operating risk assessment.

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 payable from net revenues of the district's water and sewer utilities.

REVENUE DEFENSIBILITY

The revenue defensibility assessment of 'aa' is supported by the district's independent rate-setting authority and very strong PCQ. The two largest wholesale customers, Elsinore Valley Municipal Water District (Elsinore) and Rancho California Water District (Rancho California) account for more than half of wholesale revenues and have Fitch IDRs of 'AA'/Stable and 'AAA'/Stable, respectively. In fiscal 2020, Elsinore accounted for 26% of the district's wholesale revenue while Rancho California accounted for 31%. The two purchasers have historically been two of the largest wholesale customers, in addition to the city of Corona, which accounted for another 23% of wholesale revenue in fiscal 2020. The PCQ assessment is based upon the credit quality of Elsinore and Rancho California.

Other purchasers include the city of Norco (10% of fiscal 2020 wholesale revenue), Temescal Valley Water District (6%), Jurupa Community Services District (4%) and Box Springs Mutual Water Company and Eagle Valley Mutual Water District (which each represent less than 1% of wholesale revenue).

Revenue derived from wholesale customers regularly accounts for about two-thirds of the district's annual water sales revenue. Contracts with the wholesale customers run in perpetuity. Any increased costs associated with higher MWD purchased water costs are passed directly through to the customer base, both wholesale and retail customers. In the event of non-payment by a wholesale customer the district would first begin assessing a 1% interest charge on all past-due amounts. In the event of sustained non-payment by a wholesale customer the district could suspend water deliveries.

While costs related to the past due amount may not be recouped, with the eventual discontinuation of water delivery, full operating costs should then be recouped as expenses amongst the remaining purchasers. Fitch believes it is highly unlikely service would need to be discontinued due to non-payment as the district supplies a meaningful portion of most purchasers supply portfolio. Moreover, Fitch believes the wholesale customers would have limited options as far as replacing the water provided by the district in a cost-effective manner.

OPERATING RISKS

The district's operating risk assessment of 'aa' is supported by a very low operating cost burden and moderate investment needs. Operating costs are materially affected by the annual cost of purchased water and over the last five fiscal years this expense has ranged from a low of $55 million in fiscal 2016 to a high of $72 million in fiscal 2018.

In years with lower demand, less water is purchased from MWD resulting in average flows and purchased water costs that typically move in tandem. This ultimately results in an operating cost burden that has increased only marginally over the last five years and remained near $5,000 per mg in fiscals 2019 and 2020. Sustained capital investment results in a stable life cycle ratio measuring 29% to 30% since fiscal 2017.

Planned capital spending suggests capex will continue to comfortably outpace annual depreciation expenses and keep the life cycle ratio low. The district's capital improvement plan (CIP) totals $95 million and is focused on R&R work and continued efforts to expand local water supply. Current CIP projects are expected to enable the district to reduce MWD purchases by about 10% over the next several years. The district expects to enter into a $10 million line of credit (LOC) agreement within the next two years and the LOC could fund some capex. The district has no plans for debt in the current CIP, aside from the potential draws on the LOC.

FINANCIAL PROFILE

The district's sustained and projected very low leverage in relation to its very strong revenue defensibility and low operating risk profile drive the upgrade. The peak leverage ratio over the last five fiscal years was 4.6x in fiscal 2017, which decreased to 2.3x in fiscal 2020. Coverage of full obligations (COFO) and the liquidity cushion are both sound and considered neutral to the assessment. COFO is 2.2x as of fiscal 2020 and is still solid at 1.7x excluding connection fees.

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 improved from 3.2x in fiscal 2016 to 4.9x in fiscal 2020. The liquidity cushion is also strong and improved from 347 days to 537 days over the same period.

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 district's financial forecast informed Fitch's base case as the assumptions were deemed reasonable. Operating revenue generally increases by an average of 4.3% annually, driven by rate adjustments to retail and wholesale customers, while operating expenses increase by an average of 2.5% annually. The district's CIP and potential draws on the LOC totaling $7.5 million through fiscal 2025 are also included.

Under these assumptions, leverage remains between 2.0x and 2.6x through fiscal 2025 in Fitch's base case and remains between 2.1x and 2.7x in the stress scenario. COFO should remain at 1.6x or higher over the same time period and continue to remain neutral to the assessment.

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
Western Municipal Water District (CA)	LT IDR	AAA Rating Outlook Stable	Upgrade	AA+ Rating Outlook Positive
• Western Municipal Water District (CA) /Water Revenues/1 LT	LT	AAA Rating Outlook Stable	Upgrade	AA+ Rating Outlook Positive

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 23 Feb 2021) (including rating assumption sensitivity)

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

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Western Municipal Water District Facilities Authority (CA)	EU Endorsed, UK Endorsed

Feedback

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US Public Finance Infrastructure and Project Finance North America United States

Feedback

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