Summary:
Central Basin Municipal Water District, California; Joint Criteria; Water/Sewer

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Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings lowered its long-term rating and underlying rating (SPUR) to 'A-' from 'A' on Central Basin Municipal Water District, Calif.'s outstanding revenue certificates of participation (COPs). At the same time, S&P Global affirmed its 'AA/A-1+' rating on the district's series 2008B adjustable rate refunding COPs (2007 project), with a bank facility extending to June 29, 2018. The outlook, where applicable, is negative.

The lowered rating reflects our view of the district's projected year-end results for fiscal 2017 and updated financial forecast for fiscal 2018, both of which indicate the district will continue to achieve debt service coverage (DSC) well below its rate covenant as well as the median for wholesale utilities at this rating level over the two-year outlook period.

Since our last review, we recognize that management has taken several critical steps to address noted deficiencies in the district's internal controls, including: hiring an independent consultant to do an assessment of the district's procurement policies, grant tracking practices, and cost center accounting methodologies. Management has also filled a key staffing vacancy, with the hiring of a new finance director in May 2017. The district also recently changed its governance structure, increasing the board of directors to eight individuals, following legislation enacted by the California Legislature in 2016, which required the addition of three directors appointed from and elected by the district's governmental and retail purchasing communities to bolster the size of the board from the original five directors.

We initially revised our outlook to negative on the bonds on April 4, 2014. Subsequently, we placed the district on CreditWatch with negative implications on March 21, 2017. The CreditWatch placement was based on our opinion that there was not sufficient information of satisfactory quality to maintain our rating on the securities, as the district had not produced fiscal 2016 financial statements well over 180 days after the end of the prior fiscal year. Unexpected turnover at the senior management level added to our concern about the future financial performance of the district.
We also noted that the unpublished fiscal 2016 audit that was shared with S&P Global Ratings at the time of the review included a finding from the district's independent auditor dated Dec. 27, 2016, which indicated there is a significant deficiency related to the district's internal controls in its financial accounting (identified as Finding 2016-001), wherein it was found that the district was not properly reconciling and recalculating grants revenues, accounts receivable, and unearned revenues. At this time, however, we understand management has addressed the prior period inaccuracies discussed in the finding and has also implemented new grant reimbursement practices which should ensure proper reconciliation going forward.

The COPs are secured by net system revenue of the district after payment of operations and maintenance costs. The COP provisions are what we consider adequate, with a rate covenant that requires the district to maintain and collect rates and charges for the water service that will be at least sufficient to yield net revenue for each fiscal year equal to 1.15x annual installment payments. Likewise, the additional COPs test requires that net revenue cover total existing and proposed debt service by at least 1.15x.

The 227-square-mile district is located in central Los Angeles County. It serves a total population of more than 2 million people and about 40% of the potable water needs within 24 cities, and provides wholesale water, replenishment water, and recycled water to 27 retail suppliers. While the customers are part of the large and diverse Los Angeles County service area economy, about half the cities served by the district demonstrate weak income levels and employment trends compared to the state and national averages. These retail suppliers are both public and private agencies, such as cities, mutual water companies, private companies, and investor-owned utilities. All but one agency purchases potable water from the district, while one agency purchases untreated water exclusively for replenishment purposes.

The district's primary function is to supply treated imported water imported (potable and replenishment) to retail agencies to supplement local groundwater, with the agencies paying for the water at cost, plus additional district surcharges and ready-to-serve charges. The district also purchases recycled water from the Los Angeles County Sanitation Districts and delivers recycled water to 14 retail water suppliers and one governmental agency outside the district. Imported water remains Central Basin's primary source of revenue, totaling $40.3 million for fiscal 2016, while recycled water sales amounted to $3.6 million for the same period.

In August 2016, the board of directors approved the first increase in water surcharge rates, recycled water rates, and meter service fees in five years. As such, water surcharges, recycled sales and meter service fees were raised by 16.5% effective Jan. 1, 2017. On July 1, 2017, these same rates and fees will be raised again by 8%. Despite these rate adjustments, we believe that potentially significant declines in potable and recycled water sales may continue to pressure the district's revenue base. We understand management is studying the feasibility of a new fixed charge to be implemented in fiscal 2019, which we believe could stabilize the district's financial metrics and as a potentially favorable credit development.

Since 2013, the district has experienced significant negative budget variances with regard to both replenishment water (to the Water Reclamation District of Southern California, or WRD) and potable water sales. Replenishment sales to WRD totaled $11.5 million in fiscal 2016 and are expected increase to $19.5 million in fiscal 2017 (projected), up from zero sales in fiscals 2013 and 2014, and $6.3 million in fiscal 2012. The variation in recent years is partly related to
litigation with regard to the replenishment fee rates and groundwater storage issues, and led to $1.6 million in legal costs for the district in fiscal 2013. The litigation and disputes with WRD were resolved in late 2013, and a February 2014 agreement between the parties provides for WRD to purchase a total of 120,000 acre-feet of replenishment water from the district over the next 10 years. However, management indicates that WRD intends to reduce its purchases from Central Basin over the next few years. We understand management has begun budgeting for reduced sales to WRD. Compounding the expected reduction in replenishment sales to WRD, potable water sales are projected to be 40% below budget in fiscal 2017 ($17.2 million) and are anticipated to rebound only slightly to $18.4 million in fiscal 2018, and could remain well below fiscal 2015 sales (of $27.5 million) thereafter.

Because the reduction in water sales over the past few years have not been matched with a commensurate decline in operating costs, DSC has been insufficient since 2013. DSC improved marginally to 0.96x in fiscal 2014 from 0.2x in fiscal 2013, but remained at 1.1x in both fiscals 2015 (or 1.5x when including non-reoccurring grant revenues, which we typically exclude from our debt service calculations) and 1.0x in 2016 as calculated by S&P Global Ratings. At the same time, fiscal 2017 DSC is forecast to decline to 0.8x. This continuation of thin coverage is a credit risk, especially as the district's letter of credit reimbursement agreement expires in 2018, which could result in higher bank fees thereafter.

The district's thin financial margins, in our view, poses significant uncertainty regarding the integrity of its financial projections, and raises the risk that the district's water rates may not be fully capturing the true cost of service, despite the approved rate increases effective Jan. 1, 2017 and July 1, 2017—especially in the event that the district may not be generating sufficient margins to adequately reinvest capital into the system, which could also result in deferred maintenance. In our view, however, the district's liquidity position has been good despite the thin DSC over the last few years, in part due to its established reserve policies, which set minimum working capital thresholds. Cash reserves as of June 30, 2016 totaled $14.7 million or 125 days' cash, an improvement from $14.1 million or 103 days' cash at fiscal year-end 2015.

The district reports $45.7 million of major capital projects between fiscal 2017 through fiscal 2021, which are primarily focused on expansions of the recycled water system. Although we consider the capital plan to be relatively large, about half of which ($26.7 million) will be funded with grants, and the remainder may be funded with a state revolving fund loan ($12.9 million) and contribution from the city of Monterey Park ($3.7 million) and only a modest contribution from the district's reserves ($2.1 million).

The long-term component of the series 2008B rating is based jointly (assuming low correlation) on the ratings on the obligor, which is the district, and the letter of credit provider, U.S. Bank N.A. The short-term component of the rating is based solely on the rating on U.S. Bank.

The district has a floating- to fixed-rate swap relating to its series 2008B variable-rate COPs. The swap is LIBOR-based, whereby the district pays the counterparty a fixed interest rate and receives a variable rate based on the LIBOR index. The swap had a negative fair market value to the district of $2.8 million as of June 30, 2016. Mitigating termination risk is, in our view, the rating strength of the counterparty, Citibank N.A. New York (A+/A-1). The swap terms associated with the district's 2008B COPs, the proceeds of which refunded the district's 2007B COPs, include the district's paying a fixed rate of 3.323%. The district will receive 55.7% of LIBOR plus a 0.23% spread. The agreement
terminates in 2037, while the final maturity of the 2008 COPs is in 2040.

**Outlook**

The outlook reflects our view that during the next two years, both the district's replenishment water and potable water sales may remain thin or decline, which will likely result in a continuation of inadequate DSC.

**Upside scenario**

We could revise the outlook to stable or take a positive rating action if the district's financial performance improves (and is sustainable, in our view) resulting in materially higher DSC in excess of the 1.15x rate covenant.

**Downside scenario**

If the district's financial profile continues to deteriorate as a result of unanticipated declines in revenue, and if the board does not approve management's (yet to be formalized but planned) corrective rate actions, we could further lower the rating.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.