Moody’s
INVESTORS SERVICE

Rating Update: Moody's downgrades Central Basin Municipal Water District's (CA) Refunding Revenue Bonds to A1

Global Credit Research - 15 Oct 2015

$48.4M debt affected

CENTRAL BASIN MUNICIPAL WATER DISTRICT, CA
Water Enterprise
CA

NEW YORK, October 15, 2015 --Moody’s Investors Service has downgraded to A1 from Aa3 the rating on Central Basin Municipal Water District's (CA) outstanding revenue refunding bonds totaling approximately $48.4 million. The downgrade specifically affects the district's outstanding Refunding Revenue Certificates of Participation, Series 2010A; and Adjustable Rate Refunding Certificates of Participation (2007 Project), Series 2008B (LOC). The COPs are ultimately secured by a senior lien on net revenues of the district, on parity with the district's swap payments.

SUMMARY RATING RATIONALE

The downgrade to A1 is primarily driven by debt service coverage levels that will likely be lower than previously anticipated, given declining operating revenues largely due to conservation efforts associated with prolonged drought conditions. We anticipate stable debt service coverage moving forward, however, given resolved litigation and contracted water sales through fiscal 2017. We expect that the system will have stable liquidity and unrestricted reserve levels in the near term at current metric levels. The A1 rating also reflects the district's large, southeastern Los Angeles County service area and average socioeconomic indicators of area residents. The district has a relatively large amount of debt outstanding, including variable rate debt and derivative instruments, which we feel will be manageable given the revenue streams available to make debt service payments.

OUTLOOK

Outlooks are not usually assigned to this amount of outstanding debt.

WHAT COULD MAKE THE RATING GO UP

-Sustained trend of strong debt service coverage ratios
-Sustained trend of increasing net working capital and unrestricted net assets

WHAT COULD MAKE THE RATING GO DOWN

-Lower than expected debt service coverage ratios
-Significant amount of increased and complex debt issuances
-Trend of decreasing unrestricted net assets

STRENGTHS

-Large service area
-Declining litigation expenses

CHALLENGES

-Relatively high debt ratio
-Declining net working capital as % of operations and maintenance
RELATIVELY NARROW DEBT SERVICE COVERAGE RATIO AS CALCULATED BY MOODY'S

RECENT DEVELOPMENTS

The district has a new General Manager who joined the district in November 2014 and will remain in the current role, by contract, through April 2017. The district also has a new Finance Director who joined in April 2015.

DETAILED RATING RATIONALE

SERVICE AREA AND SYSTEM CHARACTERISTICS: LARGE SERVICE AREA IN SOUTHEASTERN LOS ANGELES COUNTY

The district provides supplementary water to a large, built-out service area that should continue to increase in population. The district covers approximately 227 square miles of southeast Los Angeles County and has an estimated population of more than 2.0 million people. The service area is largely built out, but its population continues to grow. The district supplies approximately 40% of the water used within its boundaries with the remainder drawn from the adjudicated groundwater basin managed by the Department of Water Resources.

The district's water supply is almost entirely derived from the Metropolitan Water District (MWD), the predominant source of water for Southern California. The district's primary service is to provide MWD water to 27 imported water and 19 recycled water customers, which in turns provide water to residents and businesses within their respective areas. Reliance on MWD exposes the district to challenging statewide and regional water supply issues and the relatively high prices of imported water supplies. However, the district passes 100% of the cost of MWD water to retail agencies, plus a $90 per acre foot (AF) surcharge ($70 per AF for administration and $20 per AF for infrastructure) and a readiness-to-serve charge on a volumetric basis.

The district also wholesales untreated MWD water to the Water Replenishment District (WRD), which uses the water to replenish the groundwater basin. WRD did not buy water from the district as contracted in fiscal 2012 and fiscal 2013, which resulted in extremely low coverage levels. Litigation has been resolved, which requires WRD to purchase water from the district through fiscal 2017, after which WRD water purchases from the district could be intermittent.

As a means of diversifying its resources and revenues, the district also purchases recycled water from the County Sanitation Districts of Los Angeles County for sale to 19 retail water suppliers inside and one governmental agency outside the boundaries of the district. Sales of recycled water are a growing portion of the district's demand, and one which the district believes is important to expand. The number of recycled water accounts has increased steadily. Demand for recycled water was 5,857 AF in fiscal 2014 and should to increase to 8,211 AF by fiscal 2020. Recycled water rates will increase by approximately 3% per year from fiscal 2015 through fiscal 2020, resulting in recycled water revenue of $4.1 million in fiscal 2015 to $4.8 million in fiscal 2020. The average recycled water rate will increase from $510 per AF in fiscal 2014 to $599 per AF in fiscal 2019.

Revenues from recycled water sales should help to offset the district's declining sales of imported water due to conservation efforts related to prolonged drought conditions.

Additionally, the district imposes a $10 per parcel standby charge on the county tax roll each year, which produces nearly $3.3 million in annual property-based revenues, and will be the source of debt service payments for the district's outstanding COPs.

CURRENT DROUGHT SHOULD HAVE MINIMAL FINANCIAL IMPACT IN THE NEAR TERM

Prolonged drought conditions should not have a material impact on the district, but could result in slightly lower net revenues in the near term. Because of the $90 per AF surcharge and the readiness-to-serve charge on a volumetric basis, declining imported water sales will result in a greater decline in revenues than the cost of imported water, which should be offset by reduced administrative costs or increased recycled water sales to ensure stable net revenues.

DEBT SERVICE COVERAGE AND LIQUIDITY: LOWER, BUT STABLE DEBT SERVICE COVERAGE AND UNRESTRICTED NET ASSETS EXPECTED

The district's fairly diverse revenue sources should help to enhance the financial stability of the district. Revenue sources include grants and other revenues, property assessment on the county tax role, imported water sales, and recycled water sales. The district projects that these revenue streams will provide net revenues sufficient for debt service coverage of 1.25x in fiscal 2015, 1.27x in fiscal 2016, and similar levels in fiscal 2017. While these coverage levels are adequate, they are lower than previously estimated based on the impact of the drought on the
district's operations. We anticipate that debt service coverage will remain stable moving forward given the resolution of recent litigations and the expectation that legal fees will be limited moving forward.

The district had a significant increase in water sales in fiscal 2015 from fiscal 2014. Increased water sales in fiscal 2015 were largely the result of 18,515 AF of water purchased by WRD, part of WDS's desire to have all contracted 60,000 AF delivered as soon as possible. Purchases from WRD will increase to 19,635 AF in fiscal 2016, before falling to approximately 15,000 feet in fiscal 2017 and fiscal 2018. After fiscal 2018, it is likely that WRD will purchase only limited water from the district on an intermittent basis.

Imported water sales will likely decline to 26,000 in fiscal 2016 from 30,345 in fiscal 2015 because of drought and conservation efforts. Imported water sales could diminish slightly more depending on drought and conservation conditions in fiscal 2017, but should remain relatively stable from the fiscal 2016 level. We anticipate that recycled water sales mentioned above should offset these imported revenue reductions.

Liquidity

The district's cash and unrestricted net assets should be stable in fiscal 2015 and fiscal 2016. Reserves for the district were $13.4 million in fiscal 2014, but increased to an estimated $17.4 million in fiscal 2015. We anticipate that reserve levels will be close to $15.6 million in fiscal 2016. The slight decline in reserve levels in fiscal 2016 was from $2.7 million in capital expenditures and $1.7 million for recycled water connections. The district's day's cash on hand was an average 117 days in fiscal 2014 and should be relatively stable in fiscal 2015 and fiscal 2016.

DEBT AND LEGAL COVENANTS: RELATIVELY HIGH BUT MANAGEABLE DEBT BURDEN

The district has a relatively high, but manageable, debt burden that could increase somewhat, given that the district is currently preparing its 5-year capital improvement plan. The amount of future debt to be issued has yet to be determined, but the district has no immediate plans to issue additional debt over the next five years. The district's debt ratio has remained relatively high, but stable, at 49.2% in fiscal 2014 and should remain at this level in the near term. The debt is also fairly quickly retired. Additional debt could potentially put stress on the rating.

Debt Structure

The district has $13.2 million of the Adjustable Rate Refunding Certificates of Participation (2007 Project), Series 2008B (LOC) outstanding as of the 2014 audit supported by a letter of credit from U.S. Bank, N.A. (Aa1 Stable) that will expire on September 1, 2016. Available cash reserves, which have remained generally stable and totaled $13.5 million as of June 30, 2014, partially offset risks associated with potential events that might require accelerated amortization of the $13.2 million in COPs or payment of a negative termination value.

Debt-Related Derivatives

The district has an outstanding swap corresponding to the Certificates of Participation (2007 Project), Series 2008B (LOC). Under the swap, for which Citibank, N.A. (A1 Stable) is the counterparty, the district receives a LIBOR-based payment and pays a fixed rate of 3.323% monthly. The district's swap payments are on parity with all the district's outstanding COPs, while termination payments are subordinate. As of August 2014, the Series 2008B swap was valued at negative $2.1 million. The counterparty does not have the right to terminate the swap; the district may do so, although it requires the permission of the counterparty to terminate in part rather than in whole. The rating trigger for termination is Baa1 by two of the three rating agencies.

Legal Covenants

The rate covenant pledge is a relatively narrow 1.15 times parity debt service. The additional bonds test is also a more narrow 1.15 times coverage on maximum annual parity debt service. The Series 2010A bonds benefit from a cash funded debt service reserve fund at the lesser of the standard 3-tiered test. The Series 2008B bonds do not have a debt service reserve fund.

Pensions and OPEB

The district contributes to the California Public Employees' Retirement System (CalPERS), a cost-sharing multiple-employer public employee retirement system. The district's annual pension costs are reasonable given the district's overall expenditures. The district made its full annual pension contribution $343,388 (0.8% of fiscal 2014 operating revenues) in fiscal 2014.
The district has a very low unfunded OPEB liability of $65,166 as of March 13, 2015. The district made its full annual OPEB cost of $209,541 (0.5% of fiscal 2014 operating revenues) in fiscal 2014.

MANAGEMENT AND GOVERNANCE

The district has a new General Manager who joined the district in November 2014 and will remain in the current role, by contract, through April 2017. The district also has a new Finance Director who joined in April 2015.

As one of the largest member agencies of MWD, the five Central Basin directors appoint two representatives to the 37-member MWD Board of Directors.

The system is also up-to-date with all regulatory compliance and the remaining life of its capital assets is consistent with the national average.

KEY STATISTICS

- Asset Condition (Remaining Useful Life): 22 years
- System Size (O&M in 000s): $41,977
- Service Area Wealth (MFI): 97.8%
- Annual Debt Service Coverage: 1.04x
- Days Cash on Hand: 117 days
- Debt to Operating Revenues: 1.18x
- Rate Management: A
- Regulatory Compliance and Capital Planning: A
- Rate Covenant: 1.15x
- Debt Service Reserve Requirement: A

OBLIGOR PROFILE

Central Basin is a public agency established in 1952 by a vote of the people to help mitigate the over-pumping of underground water resources in southeast Los Angeles County. District founders realized that they would have to curtail the use of relatively inexpensive yet diminishing local groundwater by providing the region with imported water. In 1954, Central Basin became a member agency of MWD, an agency that was formed to bring imported water to the greater Los Angeles region.

LEGAL SECURITY

The COPs are ultimately secured by a senior lien on net revenues of the district, on parity with the district’s swap payments.

USE OF PROCEEDS

N/A

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was US Municipal Utility Revenue Debt published in December 2014. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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