Our Region's Trusted Water Leader
San Diego County Water Authority

April 1, 2021

VIA EMAIL AND U.S. MAIL

Mr. Adam Wilson, Moderator
San Diego County LAFCO
(adwilson858@yahoo.com)

Re: Fallbrook/Rainbow Reorganization Applications

Dear Mr. Wilson:

For the upcoming Ad Hoc Committee meeting on April 5, 2021, we felt it important to inform LAFCO, the Committee, and Dr. Hanemann of the following important recent events, all of which pertain to the pending reorganization applications of Fallbrook and Rainbow. We ask that you distribute this letter to LAFCO and its staff, and all Committee members.

A. State Water Project Shortages and MWD Statement

The State of California recently reduced MWD's 2021 allocation of State Water Project deliveries to *5%* due to dry conditions. In responding to this news, MWD issued a news release with a statement from its General Manager Kightlinger, which stated that though MWD has enough stored water to cover it for needs this year, MWD's future water reliability is uncertain without major investments. Mr. Kightlinger said:

> "We need reinvestments in our water infrastructure to ensure the reliability of our imported supplies and new investments in local supply development."

A copy of this news release is attached.

The Water Authority already has done exactly as Mr. Kightlinger suggested, investing billions of dollars in QSA and desalinated water supplies for the entire San Diego region. Those investments, which directly benefit Fallbrook, Rainbow, and all Water Authority member agencies, provide water reliability that is far more secure than the State Water Project on which MWD heavily relies, and which will be the sole source of water supply available to Fallbrook and Rainbow if they move to Eastern.

In fact, the Water Authority is often cited as a best practices example in statewide discussions of the Governor's goal and state policy mandate of moving to a "water portfolio" standard. The Water Authority's conservation investments in Imperial County have secured a right to QSA water that represents the region's cheapest and most reliable water. Those QSA rights are superior to MWD's Priority 4 rights to Colorado River water. As to our desalination facility in North County, this water is entirely immune to drought impacts. Similarly, our member agencies' local source and potable water reclamation innovations (such as the City of San Diego's Pure Water Program) are on the cutting edge of international standards for sound and sustainable water stewardship.

In short, the Water Authority has already made investments that MWD is only now contemplating, the cost of which are estimated in the many billions of dollars for MWD but are not included in its near or long-term projected water rates.

B. Fallbrook/Rainbow Detachments Are Cited By Standard and Poors As Financial Risk To Water Authority

The Water Authority recently went to market to sell bonds, and it received a financial rating report from Standard and Poors which LAFCO must consider in its review of the pending applications. Though Standard and Poors continued to rate the Water Authority as AAA, it also gave the Water Authority a negative outlook. Attached is the S&P Report of March 17, 2021, and on page 2 is the negative outlook rating.

Standard & Poor's states in its Report that potential detachment is a key driver of financial concern. It states on page 2, "Uncertainty resulting from two member agencies' applications to detach from the authority is an additional credit stressor." It also states on page 6:

> "While we do not believe any of the aforementioned issues will have a financial effect in the near-term, we do believe ongoing litigation has associated costs and introduces potential longer term political risk -- *especially if an approved detachment sets a precedent if members can easily detach from the authority*. This would be further exacerbated *if the two members 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 above emphases are added because it is critical that LAFCO, the public, and other member agencies of the Water Authority fully understand the implications of the Fallbrook/Rainbow sought reorganizations. If LAFCO were to allow those agencies to leave the Water Authority without having to bear their share of the financial obligations incurred to provide a base load water supply, then not only would the ratepayers in the rest of San Diego County have to foot the bill for such detachments, but the Water Authority's credit could be adversely affected, raising borrowing costs for the rest of the County as well. This would be a compounding financial blow to all our member agencies.

The questions raised in the Standard and Poors analysis are directly attributable to the speculation and uncertainty created by the detachment filings and the comments regularly made associated with them, in which the proponents ask to be relieved of their share of their obligations for the very water reliability investments cited above. Such a precedent would not only damage the Water Authority, but any other similarly situated public agencies contemplating capital investments necessary to meet conservation, environmental, or local water resource development.

C. <u>Other Member Agencies May Seek Detachment If LAFCO Were To Approve The Fallbrook/Rainbow Applications</u>

The "slippery slope" risk articulated by Standard and Poors in their above Report was recently highlighted by Enrico Ferro, Vice President of the Valley Center Water District ("Valley Center"). His statements were made at a March 16, 2021, Farm Bureau Water Committee meeting attended by Water Authority staff members. In that meeting Mr. Ferro of Valley Center (which agency is adjacent to Rainbow) made clear that if the pending detachments were approved it would be a clear encouragement for other agencies to also leave. He said, "I applaud Fallbrook and Rainbow for doing this. I say to myself why aren't more agencies doing this?" He also stated that he believes other agencies are going to seek detachment.

The simple fact is, as stated by both Standard and Poors and Valley Center Board Officer Ferro, that if agencies are simply allowed to walk away from their San Diego County water reliability obligations, exiting into Riverside County with a "free pass" from LAFCO, it will naturally encourage other agencies to do the same. This would not be prudent governance and would harm the rest of San Diego County water ratepayers.

In closing, we look forward to the meeting on April 5 where we can discuss these important matters with the rest of our Committee members. Thank you.

Sincerely,

Sandra L. Kerl

Sandra L. Kerl
General Manager

Enclosures

cc via e-mail:

Jeffrey Kightlinger, General Manager, MWD
Jack Bebee, General Manager, Fallbrook PUD
Paula C. P. de Sousa, Counsel, Fallbrook PUD
Nick Kanetis, Deputy General Manager, Eastern MWD
Tom Kennedy, General Manager, Rainbow MWD
Alfred Smith, Counsel, Rainbow MWD
Water Authority Board of Directors
Kristina Lawson, Counsel, Water Authority
Mark J Hattam, General Counsel, Water Authority

The Metropolitan Water District of Southern California

NEWS RELEASE

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March 23, 2021

METROPOLITAN STATEMENT ON REDUCTION OF STATE WATER PROJECT ALLOCATION TO 5 PERCENT

Jeffrey Kightlinger, general manager of the Metropolitan Water District of Southern California, issues the following statement regarding the reduction of Metropolitan's State Water Project allocation from 10 percent to 5 percent due to ongoing dry conditions:

"The state's deteriorating water supply conditions reinforce the need to maintain the lower water use we have seen among Southern Californians since the last drought. This water conservation ethic, combined with Metropolitan's investments in storage and a more flexible system, has allowed us to build a record high level of reserves that will help us manage through this critically dry year.

"California's existing water system, however, isn't prepared for the extremes brought by future climate change that may arrive sooner than later. We need reinvestments in our water infrastructure to ensure the reliability of our imported supplies and new investments in local supply development."

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The Metropolitan Water District of Southern California is a state-established cooperative that, along with its 26 cities and retail suppliers, provide water for 19 million people in six counties. The district imports water from the Colorado River and Northern California to supplement local supplies, and helps its members to develop increased water conservation, recycling, storage and other resource-management programs.

S&P Global
Ratings

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

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

Credit Profile		
US$196.27 mil wtr rev rfdg bnds ser 2021C due 05/01/2038		
Long Term Rating	AAA/Negative	New
US$145.965 mil wtr rev rfdg bnds ser 2021S-1 due 05/01/2028		
Long Term Rating	AA+/Negative	New
US$101.055 mil wtr rev rfdg bnds (green bnds) ser 2021B due 05/01/2038		
Long Term Rating	AAA/Negative	New
San Diego Cnty Wtr Auth Wtr		
Long Term Rating	AAA/Negative	Outlook Revised

Rating Action

S&P Global Ratings revised its outlook to negative from stable on San Diego County Water Authority, Calif.'s (the authority) existing debt. At the same time, S&P Global Ratings assigned its 'AAA' long-term rating to the authority's anticipated $101 million series 2021B and $196 million series 2021C senior lien water revenue refunding bonds, and assigned its 'AA+' long-term rating to the authority's anticipated $146 million series 2021S-1 subordinate lien water revenue refunding bonds. Finally, 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 negative outlook reflects our view of the heightened business risks associated with potential projected declines in water sales volumes as new upcoming local potable reuse projects come online, further challenged by the authority's rising contractual costs and near-term forecasted financial metrics that we consider weak relative to those of its peers at the 'AAA' rating level. Like many utilities in Southern California, we anticipate the authority will continue to experience hydrological volatility and ongoing behavioral changes in customer water use that has been a source of declining water demand since the past decade. Affordability is already a credit vulnerability for the authority as its existing rates are elevated relative to those of its regional and national peers. We expect the authority to continue to rely on withdrawals from the rate stabilization fund through 2023, given its rising cost of service and a desire to moderate rate increases for members. Uncertainty resulting from two member agencies' applications to detach from the authority is an additional credit stressor.

The authority is issuing 2021S-1 medium term notes to refund extendable commercial paper and 2016S-1 bonds to reduce market exposure and increase cash flow savings. The 2021 B&C bonds will refinance outstanding series 2019 bonds. The bonds include a make whole call. They will be self-designated green bonds.

We base our 'AAA' rating on the authority's revenue base, which is primarily locally derived. This, coupled with operating expense flexibility, limits exposure to federal revenue.

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. Forecasted coverage is narrow relative to peers at the 'AAA' level and if rate increases are not sufficient to offset consumption declines, the rating could be lowered. We believe this will require a higher degree of fixed charges to meet fixed reliability objectives. In our view, 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 volatile hydrological conditions and the continued increases in local supply which will reduce the demand for the authority's supply. 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 contraction. While the approval and early administration of a number of vaccines is a positive development, it is merely the first step toward a return to social and economic normality; equally critical is the widespread availability of effective immunization, which could come by mid-2021. We use this assumption in assessing the economic and credit implications associated with the pandemic. As the situation evolves, we will update our assumptions and estimates accordingly.

The negative outlook reflects our view that there is a one-in-three chance that the authority's financial profile could realize diminished financial capacity that would no longer be consistent with a 'AAA' rating. A return to stable outlook would be incumbent on greater clarity regarding the authority's upcoming long-range financial plans and its ability to plausibly demonstrate that it can maintain healthy operating margins even with potentially reduced water sales.

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, sea level rise, wildfire 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. The water authority also faces climate risks associated with sea level rise and weather conditions that result in algae blooms, which would affect the desalination facility operations. However, management notes that recent upgrade at the desalination facility have potentially mitigated the risk of operational shutdowns in the future. Management has a climate change action plan in place that is frequently updated and partners with Scripps Institution of Oceanography in climate change analysis and mitigation efforts.

With respect to seismic, wildfire, and cyber risks, management has robust emergency planning, including cyber policies and cyber insurance. The Integrated Contingency Plan (ICP), which is the emergency planning document, complies with the National Incident Management System and is compliant with state and federal regulations. The plan was updated in September 2020 as required by the America's Water Infrastructure Act. To prepare for a major emergency, the Water Authority regularly activates its Emergency Operations Center for planned event control, coordinates with member agencies on emergency preparedness issues, and participates in County of San Diego Operational Area exercises.

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, lawsuits 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. We understand management supports SB 222 which creates a framework for ratepayer support. Despite above-average ESG exposure, the management team is tenured and experienced with strong water supply leaders and maintains robust infrastructure maintenance and operational policies which contributes to a strong governance position.

Negative Outlook

Downside scenario

We could lower the ratings if consumption declines pressure water sales revenue by more than currently forecast--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 further depletes the rate stabilization fund beyond the minimum target level established by the board or fails to implement rate increases to maintain financial metrics commensurate with a 'AAA' rating. The rating could also be pressured if the authority takes on a meaningful amount of additional leverage.

Return to stable scenario

We could return the ratings to stable if the authority produces a credible financial plan that demonstrates stable financial results based on a stronger alignment of its cost structure with fixed revenue that we believe is commensurate with peers at a 'AAA' level.

Credit Opinion

Enterprise Profile

The authority is a primary and 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 flat relative to 2019, reflecting local weather conditions as well as ongoing pandemic related economic effects. Management expects consumption to increase incrementally during the forecast period, which we believe may be an aggressive assumption. New demand forecasting including a long-range financial plan will be released in September 2021. 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. As major projects come on-line, such as the two regional recycled water projects, demand for water authority supply may decline but the authority will still be required to supply water when projects are offline. Reliability planning will become an even greater strategic focus for the authority. 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. We believe integrating a higher percentage of fixed charges to meet fixed obligations is critical to maintaining the rating.

The authority has a higher degree of litigation and member discord than is standard in the sector, in our opinion. This includes ongoing rate litigation with Metropolitan Water District, some of which has been settled in the authority's favor and some of which is ongoing. In addition, the authority is currently resolving a $6.1 million lawsuit with Vallecitos Water District regarding overcharges. Lastly, 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 with a draft report anticipated in Spring 2021. The authority has hired a consultant to advise on the proceedings and 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 any of the aforementioned issues will have a financial effect in the near-term, we do believe ongoing litigation has associated costs and introduces potential longer term political risk--especially if an approved detachment sets a precedent if members can easily detach from the authority. This would be further exacerbated if the two members 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. Member support for the long-term strategic plan is important to the credit quality in our opinion.

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%). The initial State Water Project allocation for 2021 is 10% due to below normal precipitation and snowfall in the Northern Sierra. As of March 9, 2021, precipitation is 49% of normal at the Northern Sierra Precipitation 8-Station Index and snow water equivalent is 58% of normal in the Northern Sierra. The Upper Colorado River snowpack is 82% of normal as of March 8 and five-year projections indicate an increased probability of shortage. 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 remains a significant imported water supply source for the water authority, which we consider credit neutral.

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. 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. 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, which we view favorably.

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 affected by the COVID-19 related shelter-in-place requirements, which have led to business closures and elevated unemployment. 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 and liquidity 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. In addition, there are no issues with member delinquencies and the authority has the ability to attach delinquencies to the property tax lien of a ratepayer which increases likelihood of collections.

Debt service coverage for all senior and subordinate obligations had consistently exceeded 1.4x, which we view as healthy for a wholesaler, including payments associated with the desalination plant which are technically below the line but we include for coverage purposes. For the forecasted 2021 through 2023, fixed charge coverage, excluding the rate stabilization fund is just over 1.3x, which is narrow in our view. Given the effects of the pandemic, weather, and economic contraction, water sales declined considerably in 2019 from $595 million to $582 million and again further in 2020 to $568 million. Water sales are expected to slightly rebound in 2021 to $597 million due to normal weather and as well as potential improvement in coronavirus-related business closures and other factors. Expenditures are increasing in forecast periods as well, resulting in fixed charge coverage declining, without the RSF included. 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. If water sales continue to decline, with rate increases not keeping up with consumption declines, the current rating could be pressured. 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. Water consumption trends will continue to pressure rates with increases of just under 5% in 2021.

Management reports that despite the planned use of the rate stabilization fund, the fund will remain above the internal target through the forecast period, with $81 million in 2023. Management changed the policy in January of 2021 to reflect a 15% drop in water sales. Maintaining the rate stabilization at the current level and continuing to implement reasonable rate increases is critical to maintaining the 'AAA' rating.

The liquidity position has been sufficient to cushion volatility and provide with manageable rate increases. The water authority has over $265 million in cash and codified reserves in 2020, which is a decline from prior levels that were over $300 million. 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. 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. By 2023, liquidity is expected to drop to just under $230 million, which we still view as reasonable but is approaching levels that could pressure the rating. Liquidity is a critical to the authority's financial health, given variable hydrology conditions and the development of significant additional local supply.

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. However, there is discussion of a major capital investment for a regional conveyance system. We believe a project of that magnitude could have a material impact on the authority's leverage ratios which could pressure the rating given how highly leveraged the water authority currently is. The present CIP totals approximately $1.3 billion. The authority expects to spend approximately $387.2 million over the next five years on capital improvement projects, though a new long-range forecast plan that is "in progress" and expected to be finalized in September of 2021, one year later than was projected last year.

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 March 17, 2021)		
San Diego Cnty Wtr Auth sr lien wtr rev rfdg bnds		
Long Term Rating	AAA/Negative	Outlook Revised
San Diego Cnty Wtr Auth wtr COP (AGM)		
Unenhanced Rating	AAA(SPUR)/Negative	Outlook Revised
San Diego Cnty Wtr Auth wtr (MBIA) (MBIA of Illinois)		
Unenhanced Rating	AAA(SPUR)/Negative	Outlook Revised
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)/Negative	Outlook Revised
San Diego Cnty Wtr Auth CP		
Short Term Rating	A-1+	Affirmed
San Diego Cnty Wtr Auth WTRSWR		
Long Term Rating	AA+/Negative	Outlook Revised

Many issues are enhanced by bond insurance.