S&P Global Ratings

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## Summary:

# California Department of Water Resources; CP; Water/Sewer

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**Summary:**

# California Department of Water Resources; CP; Water/Sewer

| Credit Profile | | |
|---|---|---|
| US$264.0 mil central vy proj wtr sys rev bnds ser BF due 12/01/2035 | | |
| *Long Term Rating* | AAA/Stable | New |
| California Dept of Wtr Resources (Cent Vy Proj) wtr | | |
| *Long Term Rating* | AAA/Stable | Affirmed |
| California Dept of Wtr Resources (Cent Vy Proj) wtr | | |
| *Long Term Rating* | AAA/Stable | Affirmed |
| California Dept of Wtr Resources (Cent Vy Proj) wtr | | |
| *Long Term Rating* | AAA/Stable | Affirmed |

## Credit Highlights

- S&P Global Ratings assigned its 'AAA' long-term rating to the California Department of Water Resources' (DWR) anticipated $264 million series BF water system revenue bonds.
- S&P Global Ratings also affirmed its 'AAA' long-term rating and underlying rating (SPUR) on DWR's existing Central Valley Project (CVP) water system revenue debt and Northern California Power Agency's Lodi Energy Center revenue bonds.
- S&P Global Ratings also affirmed its 'A-1+' short-term rating on DWR's water revenue commercial paper (CP) notes.
- The outlook, where applicable, is stable.

### Security

We consider the bond provisions to be credit supportive. The water system revenue bonds are secured by the portion of revenue received by DWR from State Water Project (SWP) contractors attributable to water system projects financed by revenue bonds. DWR has covenanted to charge amounts under the contracts sufficient to repay all water system project costs and to produce net revenue at least equal to 1.25x annual debt service on the bonds. The bonds are further secured by a reserve account, with a funding requirement of 50% of maximum annual debt service (MADS). Revenue received by DWR net of operations and maintenance costs, debt service, and funding of reserves is held by DWR and credited back to the contractors approximately one year after receipt. Under the CVP Act, payment of debt service has priority over operating expenses.

The long-term rating on Northern California Power Agency's Lodi Energy Center revenue bonds, series 2010 series B reflects our view of the unconditional, take-or-pay obligation of DWR to make payments sufficient to cover all debt service on the bonds. The short-term rating on DWR's series 1 CP notes is based on our view of the long-term credit quality of the department (AAA/Stable) and the additional liquidity provided by a revolving line of credit agreement provided by Bank of America N.A. with a principal commitment of $600 million. The short-term ratings on series 2, 3, and 4 is also based on the long-term credit quality of the department as well as a revolving line of credit agreement provided by J.P. Morgan Bank, N.A. with a total principal commitment (across the three series) of $800 million. The Bank of America revolving line of credit extends through July 19, 2024 unless extended or terminated, while the J.P. Morgan agreement extends through Feb. 9, 2024. We consider the lines of credit strong, with limited immediate termination events, including an issuer default if the rating is lowered to less than 'BBB-'.

Bond proceeds will be issued to refund the outstanding variable-rate series AT bonds and to take out approximately $128.5 million in CP.

The department typically maintains around $750 million of unrestricted cash on hand, which is over a year's worth (although it ended fiscal 2021 with over $1 billion due to the timing of the Federal Emergency Management Agency [FEMA] reimbursements), and $3.1 billion of senior lien obligations outstanding. The department also has a $1.4 billion CP program payable on a subordinate basis, of which approximately $234.5 million (including the notes to be refunded with bond proceeds) are currently outstanding.

### Credit overview

The department's strong contracting provisions require the water contractors to make payments to the department to cover SWP expenses, regardless of the amount of water delivered, which provides revenue certainty despite large swings in available water supply on a year-to-year basis. Nevertheless, we consider the relatively short tenor of the existing contracts to be a credit risk.

The Dec. 31, 2035 contract expiration date requires the department to amortize all debt, including planned new issuance, over the next 13 years, which we believe could adversely influence contractor water supply costs over the near to mid-term, depending on the timing and magnitude of upcoming capital spending. We understand that 24 of the 29 contractors have agreed to extend their water supply contracts through 2085, which would allow the department to issue future debt with a final maturity beyond 2035. Management indicates that it expects to complete the contract extensions over the next two years; failure to do so would put negative pressure on the rating.

The Feather River watershed, which feeds into Lake Oroville (the primary reservoir of the SWP), has seen significantly less precipitation than normal over the last three fiscal years. During water years 2022 and 2021, the state allocation was just 5%, down from 20% in 2020. In aggregate, SWP deliveries over the past decade are down significantly from those of the early 2000s.

Because a significant portion of DWR's costs are fixed, the reduction in water sold year-to-year can result in huge swings in wholesale costs to its contractors. For example, DWR's cost to the Metropolitan Water District of Southern California (MWD) ranged from $423 per acre-foot in calendar 2019 to $1,617 per acre-foot in calendar 2021, as calculated by S&P Global (the contractors are not billed on a unit rate basis by DWR). Because of MWD's comprehensive resource planning and well-defined risk management practices, the variability in the costs per acre-foot has not adversely affected MWD's financial position. Nevertheless, if contractors do not have adequate financial risk management practices (e.g., a rate structure that allows for a pass-through of DWR's costs or an ability to manage their own supplies conjunctively or otherwise hedge against fluctuations in SWP deliveries) we believe there is an increased likelihood that protracted drought conditions would adversely affect their operating margins, which would ultimately weigh on DWR's credit quality.

We also consider the department's aging infrastructure to be a constraining credit factor. For example, FEMA disputed various costs submitted by the department for costs DWR incurred to address severe erosion at its Lake Oroville flood control spillways in early 2017. We believe these determinations by FEMA highlight the importance of preventative maintenance, particularly related to aging infrastructure and event risk associated with extreme weather in the future. DWR currently expects FEMA to reimburse it for about 50% of the $1.2 billion of incurred costs; this figure has been revised down from the 75% presented to S&P Global previously (this is because FEMA has determined that $361 million of the total will not be eligible for the FEMA cost share). Moreover, we understand that the SWP contractors will be responsible for a share of the $1 billion in safety upgrades to the 55-year-old dam at San Luis Reservoir, which is shared between the Central Valley Project and SWP, and that are scheduled for completion in 2028.

### Environmental, social, and governance

We believe that the department is exposed to credit risk related to drought, climate change, and related shifts in hydrology. DWR's identified capital needs total $3.0 billion and are largely intended for facilities reconstruction and improvements. This figure excludes the San Luis dam project as well as the proposed, re-conceptualized Delta Conveyance project currently being studied by the department, the cost of which, per a report released by the state of California in August 2020, could exceed $16 billion. We note, though, that no decision has been made on how to finance this project, including whether to finance with water system revenue bonds or otherwise. While significant hurdles remain before the Delta Conveyance project becomes reality, SWP contractors may become increasingly sensitive to rising water costs and affordability risks, depending on if and how the project is ultimately financed. We believe that DWR also faces significant social risk because of the highly politicized and evolving nature of the Delta Conveyance project and DWR's exposure to various state laws, which could result in significant financial liabilities, including inverse condemnation.

We understand that the Route Fire, which is currently burning near Castaic and is only 27% contained, has not affected water quality at nearby Castaic Lake or Pyramid Lake, both of which are assets of the SWP.

The department has adequate governance, in our view, characterized by its autonomous rate setting practices and strong contracting provisions. However, given the size and scope of the SWP, we consider its asset management practices to not be commensurate with those of its peers at the 'AAA' rating level. Financial performance is typically released on a delayed basis (primarily due to delays in receiving information related to pensions and other post-employment benefits, which is provided by the State Controller's office), which we consider a credit weakness. For example, the audit for the fiscal year ending June 30, 2021 was not released until August 11, 2022.

## Outlook

### Downside scenario

If evidence points to deferred maintenance on the SWP or to lack of timely repairs to mitigate against weather and climate-related risks, or if DWR's liquidity were to decline substantially, we could lower the rating. Any impediments or resistance to the department's covering all its expenses through its billing process (such as a delay to the contract extension process) could also negatively affect the rating. If credit quality of the principal water contractors, particularly MWD, were to deteriorate, it could also pressure the rating downward.

## Credit Opinion

DWR is responsible for the construction, planning, and operation of the SWP and delivers water to 29 public agency water contractors located principally in the San Francisco Bay Area, the Central Valley, the Central Coast, and Southern California.

The SWP is a system of dams, water storage facilities, aqueducts, pumping stations, and electric generation facilities that DWR constructed for the purposes of developing a water supply and conveyance system. The project also provides flood control, recreation, hydroelectric power, and environmental benefits.

Key credit strengths include:

- The credit strength of DWR's public agency water contractors, primarily MWD, which has been responsible for approximately 50% of water billings over the past five years;
- The essentiality of the SWP, which supplies water to 27 million Californians, and its critical role in the state economy; and
- DWR's strong cash position, which we view as important for providing liquidity during a lag in billings under a two-year "true-up" billing procedure.

Partly offsetting the above strengths, in our view, are:

- Water supply deliveries that are exposed to extremes in hydrological conditions, as California has one of the most variable climates of any state in the U.S. and often experiences wet years followed by very dry ones, although DWR's contract-based cost recovery structure partly offsets this risk;
- The relatively high cost of SWP water, which, on average, is the costliest source of water for the public water agencies served, although we recognize the lack of meaningfully cheaper water supply alternatives given constraints on local groundwater, imported Colorado River water, and the high capital costs associated with recycled water and desalination; and
- DWR's projected issuance of additional bonds for increased capacity, environmental purposes, and seismic purposes, with the potential for substantial borrowing to help finance a proposed water conveyance system through the Sacramento-San Joaquin River Delta.

For balance-sheet reporting, DWR combines its water operations, including those for non-CVP water facilities, into one operating fund. DWR has historically maintained a liquidity position we consider strong. At fiscal year-end 2021, the unrestricted cash equaled 130% of DWR's total operating expenditures less depreciation, including certain non-CVP expenditures.

We understand that DWR is adopting process improvements to bolster its long-range capital planning and improve work order efficiencies, which we view as important, as DWR's future long-term capital expenditures are sizable. Failure to implement these improvements could affect the department's credit quality, given the size of the upcoming capital improvement plan.

The department's revenue bonds are eligible to be rated above the sovereign because we believe the department can maintain better credit characteristics than the U.S. in a stress scenario. Under our criteria, "Ratings Above The Sovereign: Corporate And Government Ratings--Methodology And Assumptions" (published Nov. 19, 2013 on RatingsDirect), we consider not-for-profit utilities, such as the department, to have moderate sensitivity to country risk because local service charges, derived through an autonomous rate-setting process, represent virtually all of their revenues. This, coupled with operating expense flexibility, independent treasury management, and no history of government intervention, limits the department's exposure to federal revenues.

## Related Research

Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022

| Ratings Detail (As Of September 6, 2022) | | |
|---|---|---|
| California Dept of Wtr Resources wtr | | |
| *Long Term Rating* | AAA/Stable | Affirmed |
| California Dept of Wtr Resources wtr rev commercial pap nts ser 2,3,4 dtd 02/01/2021 due 04/01/2025 | | |
| *Short Term Rating* | A-1+ | Affirmed |
| California Dept of Wtr Resources wtr CP ser 1 | | |
| *Short Term Rating* | A-1+ | Affirmed |
| California Dept of Wtr Resources wtr CP ser 2 | | |
| *Short Term Rating* | A-1+ | Affirmed |
| California Dept of Wtr Resources wtr (AGM) | | |
| *Unenhanced Rating* | AAA(SPUR)/Stable | Affirmed |
| California Dept of Wtr Resources wtr (FGIC) (National) | | |
| *Unenhanced Rating* | AAA(SPUR)/Stable | Affirmed |
| California Dept of Wtr Resources (Cent Vy Proj) wtr | | |
| *Long Term Rating* | AAA/Stable | Affirmed |
| **Northern California Pwr Agy, California** | | |
| California Dept of Wtr Resources, California | | |
| Northern California Pwr Agy (California Department of Water Resources) | | |
| *Long Term Rating* | AAA/Stable | Affirmed |

Many issues are enhanced by bond insurance.