FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Zone 7 Water Agency, CA's Water Revs at 'AA+'; Outlook Positive

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Fitch Ratings - Austin - 01 Oct 2024: Fitch Ratings has affirmed the 'AA+' rating on the following obligations issued by the Livermore Valley Water Financing Authority on behalf of Alameda County Flood Control and Water Conservation District Zone 7 Water Agency (the agency):

--$56.8 million water revenue bonds series 2018A;

--$28.4 million water revenue bonds series 2023A.

Additionally, Fitch has affirmed the district's Issuer Default Rating (IDR) at 'AA+'.

The Rating Outlook remains Positive.

RATING ACTIONS

ENTITY / DEBT	RATING		PRIOR
Alameda County Flood and Water Conservation District Zone 7 Water Agency (CA)	LT IDR Affirmed	AA+ Rating Outlook Positive	AA+ Rating Outlook Positive

Alameda County Flood and Water Conservation District Zone 7 Water Agency (CA) /Water Revenues/1 LT	LT	AA+ Rating Outlook Positive	AA+ Rating Outlook Positive
	Affirmed		

VIEW ADDITIONAL RATING DETAILS

The 'AA+' bond rating and IDR reflect the agency's exceptionally low leverage, measured as net adjusted debt to adjusted funds available for debt service (FADS), within the framework of very strong revenue defensibility and strong operating risk profiles. The rating is based on a consolidated fund analysis that incorporates the operations and finances of both the agency's flood control operations and water system operations (the system). Fitch Ratings uses a consolidated analysis since the agency would be expected to access all available resources to meet its financial obligations. As such, Fitch holistically assesses the business profile of the agency.

The Positive Outlook reflects Fitch's expectation that additional debt will be issued over the five-year period, but that leverage will likely remain exceptionally low and below 2.5x in Fitch's Analytical Stress Test (FAST) analysis. The agency's leverage has been below zero in each of the last five fiscal years (2019-2023; FYE June 30) as a result of cash balances exceeding adjusted debt, and the agency is positioned well to absorb a potential increase in leverage with some large capital projects contemplated in the intermediate- to long-term.

It was recently announced that one of the large regional projects in which the agency was potentially going to participate, the Los Vaqueros Reservoir (LVR) expansion project will not proceed. The agency had considered participation in the project as a means to diversify and add resiliency to its current supply portfolio, which remains sufficient for current long-term demand. Cancellation of the LVR project should not impact the agency's current operations. Consequently, Fitch removed possible participation in this project from its analysis.

The agency is still considering participating in another large regional project, the Sites Reservoir project. Over the next year, cost, timing, and participation by regional partners should become clearer. This clarity should help ensure that leverage expectations for the agency remain near current projections and do not exceed 4.0x on a sustained basis.

The agency's very strong revenue defensibility, reflected in the 'aa' assessment, is largely driven by very strong purchaser credit quality (PCQ). The operating risk assessment of 'a' is due to a low operating cost burden that averaged about $7,740 over the last five fiscal years and a very low life cycle ratio of just 24% as of fiscal 2023.

SECURITY

The bonds are secured by a first lien on the agency's net water revenues, including connection fees but excluding property tax revenues.

KEY RATING DRIVERS

Revenue Defensibility - 'aa'

Very Strong Revenue Source Characteristics and Purchaser Credit Quality (PCQ)

The agency maintains independent rate-setting authority and wholesale rates are not subject to Proposition 218 requirements. Rates for the few direct retail customers are subject to Proposition 218. Nearly all water sales revenue (about 95%) is derived from sales to four wholesale customers: the cities of Livermore and Pleasanton, Dublin San Ramon Services District (DSRSD) and California Water Service Company. Pursuant to Fitch's criteria, the contracts in place with the four purchasers create an implied step-up. Should any of the wholesale customers become past due in their payment, the agency could eventually choose to discontinue water delivery.

While the agency may not recover all costs associated with a past due amount, discontinuing service should allow for full cost recovery from the remaining customers going forward. Although three of the contracts or agreements expire in 2024, contract renewal discussions are well underway. If formal renewal has not been completed by the expiration dates, the contracts automatically move into a two-year renewal phase. Renewal risk is viewed as remote given the lack of an alternate water supply. Fitch considers the credit quality of Livermore's and Pleasanton's water fund operations and DSRSD to determine the PCQ, which is considered very strong.

Operating Risk - 'a'

Low Operating Cost Burden, Moderate Investment Needs

In fiscal 2023, the system's operating cost burden was considered low at $8,476 per million gallons (mg), consistent with the operating risk assessment. The life cycle ratio was very low at 24% in fiscal 2023. Capex to depreciation has been robust, improving to a five-year average of 500% in fiscal 2023. Planned capital spending for the next five years should generally outpace historical depreciation, supporting a continued very low life cycle ratio.

Including estimated actual spending in fiscal 2024, budgeted spending in fiscal years 2025 and 2026, along with planned spending the following two years, capex totals approximately $195 million. Spending is focused on construction of the second and third per- and polyfluoroalkyl (PFAS) treatment facilities, improvements to the transmission and conveyance system, and standard rehab and repair work. The agency is also participating in planning related to the Sites Reservoir construction project. This large regional project was invited to apply for a Water Infrastructure Finance and Innovation Act (WIFIA) loan. An application has been submitted and is currently under review by the U.S. Environmental Protection Agency (EPA).

The agency estimates its allocable share of costs for the Sites Reservoir project at $211 million; however, cost estimates continue to be refined. The Positive Outlook factors the project's potential impact to leverage. However, increased costs to or participation by the agency not offset with increased FADS could potentially lead to an Outlook revision.

Financial Profile - 'aaa'

Exceptionally Low Leverage Despite Additional Debt

Leverage is historically exceptionally low, registering less than 0.0x annually since fiscal 2019 as available cash exceeded debt. As of fiscal 2023 leverage measured (1.8x). The liquidity profile is neutral to the assessment with coverage of full obligations of 1.7x and current days cash on hand of over 1,000. Fitch-calculated all-in debt service coverage has been significantly stronger (which excludes the fixed services expense related to purchased water) and measured 6.2x in fiscal 2023.

The Fitch Analytical Stress Test (FAST) considers the potential trend of key ratios in a base case and stress case over a five-year period. The stress case is designed to impose capital costs 10% above expected base case levels and evaluate potential variability in projected key ratios. The FAST reflects Fitch's view of a reasonable scenario, which is generally informed by publicly available and/or management provided information with respect to capital expenditures, user charges and rate of revenue and expenditure growth.

In the base case scenario, the leverage ratio is on a generally upward trend annually since capex over the next five years ramps up relative to average spending seen the last five years, reaching 1.9x by fiscal 2028. In the stress case, which is considered the rating case, the leverage ratio is projected to increase to 2.3x through fiscal 2028. Given the potential for large capital projects on the horizon (but excluding LVR), Fitch also considered an alternate stress scenario with an additional $75 million of planned capital spending and debt financing in fiscal 2028 (while making no other adjustments to revenue growth assumptions). In this scenario, leverage remained at or below 4.0x, supporting the Positive Outlook. Liquidity is expected to remain neutral to the assessment over the five-year horizon.

Asymmetric Additional Risk Considerations

No asymmetric additive risk considerations affected this rating determination.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--Sustained leverage exceeding 4.0x in Fitch's rating case as a result of capital needs not adequately supported by FADS could lead to an Outlook revision;

--While not expected, projected leverage in Fitch's rating case sustained at around 6.0x would likely pressure the rating;

--While considered unlikely, failure to execute renewed contracts with the four largest purchasers that results in lower revenues and margins, or material changes in operations, could pressure the rating.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Ability to maintain leverage below 4.0x in Fitch's rating case, should the agency decide to participate definitively in the Sites reservoir project.

PROFILE

The agency was established to provide wholesale treated and untreated water (irrigation) to wholesale purchasers (and a handful of direct retail customers) and to provide flood control and groundwater management functions in the eastern portion of Alameda County, encompassing a service area of nearly 430 square miles. Water-system operations are the primary revenue source for the agency, accounting for around 85% to 90% of annual revenue. Revenue related to flood control services comprises the balance of annual revenue.

The agency is highly dependent on the State Water Project (SWP) for supplies, but deliveries can vary widely depending on weather conditions. Typically, SWP water will account for at least 80% of the agency's annual supply (inclusive of SWP carryover supplies). Local surface water, stored groundwater, and banked groundwater in Kern County account for the balance of the supply portfolio. As of July 2024, the agency had about 237,000 acre feet (af) of stored water, which equates to over five years of demand based on recent demand patterns. Moreover, an additional 128,000 af (over three years of usage) for emergency use is stored in the local groundwater basin.

The agency owns two water treatment plants (WTP), the Del Valle WTP with a 40 million gallons per day (mgd) treatment capacity and the Patterson Pass WTP. The Patterson Pass WTP's initial capacity was 12 mgd but was expanded to 24 mgd. The overall site master plan at Patterson Pass WTP can accommodate a 36 mgd plant footprint, but there are no plans to expand to the 36 mgd at this time. The agency estimates it has enough water supply within its current portfolio to meet full buildout (55,300 af estimated total demand) but continues to pursue water resiliency projects in light of the variability of SWP imports.

Updated U.S. EPA Regulations

The EPA's enhanced focus on lead and copper lines and PFAS contaminants has led to the introduction of the Lead and Copper Rule Revisions (LCRR) and the proposed Lead and Copper Rule Improvements, along with specific testing requirements for PFAS chemicals. The system has been addressing PFAS contaminants for several years and the agency's first PFAS treatment facility treating to the necessary levels came online in 2023.

A second facility is expected to be complete by the end of 2024 and a third treatment facility is already in the planning phase and expected to be complete in fiscal 2028, within the EPA's stipulated timeline. Compliance with the EPA's Lead and Copper Rule is not an issue since, as a wholesale provider, lead service lines are not within the agency's oversight.

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

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

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APPLICABLE CRITERIA

U.S. Public Sector, Revenue-Supported Entities Rating Criteria (pub. 12 Jan 2024) (including rating assumption sensitivity)

U.S. Water and Sewer Rating Criteria (pub. 29 Feb 2024) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Livermore Valley Water Financing Authority (CA)	EU Endorsed, UK Endorsed

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