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Summary:

Livermore Valley Water Financing Authority, California Alameda County Flood Control and Water Conservation District, Zone 7; Water/Sewer

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Credit Profile

US\$27.465 mil wtr rev bnds (Alameda County Flood Control & Water Conservation District Zone 7) ser 2023 A due 06/30/2053		
<i>Long Term Rating</i>	AAA/Stable	New
Livermore Valley Water Financing Authority, California		
Alameda County Flood Control & Water Conservation District Zone 7, California		
Livermore Vy Wtr Fin Auth (Alameda Cnty Flood Ctl & Wtr Conserv Dist, Zone 7)		
<i>Long Term Rating</i>	AAA/Stable	Upgraded

Credit Highlights

- S&P Global Ratings raised its long-term rating to 'AAA' from 'AA+' on the Livermore Valley Water Financing Authority, Calif.'s revenue bonds outstanding, issued on behalf of the Alameda County Flood Control and Water Conservation District, Zone 7.
- At the same time, S&P Global Ratings assigned its 'AAA' rating to the authority's 2023 series A water revenue bonds, issued on behalf of Zone 7.
- The outlook is stable.
- The upgrade reflects our view of the agency's exceptionally strong water supply position, low leverage, and healthy financial position, which we expect will remain in line with the current rating, even when assuming adverse drought conditions and future population growth in its service area.

Security

The 2023 series A water revenue bonds are secured by net revenues of the agency's water enterprise operations and water enterprise capital expansion funds, and will finance a per- and polyfluoroalkyl substances (PFAS) treatment facility at Zone 7's Chain-of-Lakes well site and other water capital improvements.

We view bond provisions as credit neutral, including the agency's proposed amendments to bond provisions, which include updates to its rate covenant definition and additional bonds test. The agency covenants to maintain net water revenues at least 1.2x annual debt service, and an additional bonds test requiring at least 1.2x historical and pro forma coverage of maximum annual debt service (MADS) on new and existing debt. However, we note that bond provisions are subject to certain springing amendments that are in turn subject to the majority of bondholders' consent. While the agency will not maintain a debt service reserve fund for the bonds, we do not view this as a credit limitation, given the agency's robust reserve levels, including a rate stabilization fund that by policy requires the maintenance of two years

of debt service payments. As of June 30, 2022, Zone 7 had approximately \$60 million in debt outstanding.

Zone 7's general creditworthiness reflects our implied, unlimited step-up methodology under our Wholesale Utilities criteria, wherein we would expect Dublin San Ramon Services District (DSRSD), Pleasanton, and Livermore to be able to support Cal Water's share of debt without a material impact on their respective creditworthiness, given Zone 7 can adjust rates to cover costs of service at any time. However, we note that there is no explicit language within retail contracts requiring any one participant to step up in a payment disruption or default scenario.

Credit overview

Through its retail purveyors, Zone 7 provides wholesale water to an affluent population of approximately 260,000, and covers an area of around 425 square miles, roughly 35 miles east of San Francisco and 20 miles east of Oakland.

The agency sells wholesale water to four separate retail water purveyors, whose percent of annual revenues have remained relatively unchanged over the past decade, including the cities of Pleasanton (30% of Zone 7's 2021 water sales), the Dublin San Ramon Services District (DSRSD; 30%), California Water Service Co. (Cal Water; 22%), and the city of Livermore (18%). The remaining water sales are to direct customers, temporary treated water sales, and untreated water sales. All of the agency's members maintain generally strong financial and operating factors that are supportive of the current rating on Zone 7's bonds. In the unlikely event of a payment disruption from these members, including Cal Water, factors that help insulate Zone 7 from any material financial impact include its full rate-setting authority, extremely strong operational and financial performance on a stand-alone basis, and its municipal retail water purveyors' automatic rate pass-through.

In our view, Zone 7's credit quality is underpinned by its ability to store a significant amount of water in wet years for usage in dry years, given that the agency derives approximately 80% of its water supply from the State Water Project (SWP), which we consider to be an extremely volatile source of supply. Notably, the agency had an average of about six years of annual water demand from fiscal year-end 2020 to 2022, and notably had more than seven years of stored water at year-end 2021, when the SWP allocation was only 5%. The agency maintains storage capacity via agreements with local partner agencies, including Semitropic Water Storage District and Cawelo Water District, and maintains its own local groundwater supply, which will be bolstered when the Chain-of-Lakes conveyance project is completed in 2032.

The agency maintained coverage of 8.35x, 20x, and 14.3x in fiscal years 2022, 2021, and 2020, respectively, net connection fees. In addition to its available water supply, we attribute the agency's stable financial metrics to several factors, including its fixed-charge rate structure, which will have increased from 35% of total charges in 2017 to 45% by 2023, and regular review and implementation of rate adjustments. The agency's drought surcharge can be implemented during various stages of mandated conservation, adding additional financial stability. Furthermore, each of the agency's retail water purveyors have implemented rate structures that allow for an automatic pass-through of rate adjustments from Zone 7, including its drought surcharge.

We believe the rating is also supported by Zone 7's improved and robust cash position, including nearly two-years' worth of operating expenses as of fiscal 2022, which we expect to be maintained over at least the two-year outlook period, given management's lack of current plans to spend reserves down. The agency maintains formal reserve policies, including an operational reserve policy, that target the maintenance of 90 days of budgeted total operating

expenses, among others, which we believe supports financial continuity. According to projections provided by management, we expect financial metrics to remain consistent over at least the next four years (through 2027), with coverage not expected to be lower than 4x. In addition to assumptions that include an average hydrological year, projections include debt service for a potential 2026 debt issuance of about \$33 million and an adopted 5.5% annual rate increase through calendar year 2026. Given management's available water supplies in a low SWP allocation year, we view management's assumptions for an average hydrological year as reasonable. The agency's current capital improvement plan (CIP) is totaled at \$214 million, which will be funded by the series 2023 A bonds, a potential fiscal 2026 issuance, and net revenues.

We believe credit risks center around the implementation of the agency's long-term capital plans, which includes its Chain-of-Lakes transmission and conveyance project, currently estimated at \$162 million, and potentially the Sites Reservoir Project and Los Vaqueros Reservoir Expansion. Each project would support water resiliency through additional supply and storage, along with supporting the service area's continued growth, which is expected to reach full build-out in 2040. Although these projects are sizable and could require additional debt, given the agency's low debt position and the economic strength of its service area, we expect that the agency's rate base will be able to absorb a measurable amount of additional debt without substantial credit pressure.

The rating further reflects our view of the agency's:

- Broad, diversified, and growing service territory in the far eastern portion of the San Francisco-Oakland-Hayward metropolitan statistical area (MSA);
- Extremely strong service area income levels, with median household effective buying income (MHHEBI) ranging from about 190% and 230% of the national average for the customer communities served;
- Diverse revenue stream, including a dedicated property-tax pledge that offsets most of its fixed costs associated with purchased water from the SWP; and
- Rate affordability when considering market position at the retail level, with a monthly water bill that is not more than 1% of local incomes for any of the agency's customers.

Environmental, social, and governance

We view environmental risks as a negative credit consideration, given the agency is exposed to chronic and persistent drought, emerging contaminants, wildfire, and seismic events. However, despite environmental risk exposure, we view agency management as a key credit strength, and we believe that the agency's asset management--including asset redundancy, long-term planning, and substantial water storage--reduces the likelihood that these vulnerabilities could influence the rating during the two-year outlook period. Additionally, in March 2020 Zone 7 completed its federally mandated risk and resiliency assessment, which considers natural disaster vulnerabilities, including wildfires and earthquakes. The agency also maintains cyber insurance and robust cyber policies and practices. We view governance risks as credit neutral. We also view social risks as credit neutral, given the affordability of water rates in the context of local incomes.

Outlook

The stable outlook reflects our view of the agency's diverse water supply when considering its surface and groundwater storage, strong financial position in terms of all-in coverage and liquidity, fixed-rate schedule, and drought surcharge schedule, which we believe will allow it to recover costs and stabilize revenues in the event of future drought conditions. The outlook also reflects our assessment that the three strongest retail customers' water fund credit quality will remain consistent with current projections.

Downside scenario

A negative rating action would be predicated on material weakening of the agency's or its retail water purveyor's coverage and liquidity, such as due to a material downturn in the service area economy, the need for higher-cost supplemental water on a consistent basis, or a paradigm shift in the financing of capital projects, such as a drawdown in cash reserves or the issuance of substantial debt that is not offset by operational adjustments, such as revised rates.

Rating above the sovereign

The agency's water revenue bonds are eligible to be rated above the sovereign because we believe the agency can maintain better credit characteristics than those of 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 water system, to have moderate sensitivity to country risk because local service charges, derived through an autonomous rate-setting process, represent virtually all of its revenue. This, coupled with operating expense flexibility, independent treasury management, and no history of government intervention, limits the agency's exposure to federal revenue.

Related Research

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

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