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Fitch: California Tunnel Project to Further Increase Water Rates.

Fitch Ratings-New York-16 August 2017: The proposed twin-tunnels project in California would likely drive a further increase in monthly water rates which could test utilities' rate flexibilities, says Fitch Ratings.

The fate of the California Water Fix (the Fix), a plan to convey water through two tunnels under the Sacramento San-Joaquin Delta (Delta) to improve water reliability and the health of the Delta ecosystem, is nearing resolution as agencies that would benefit from, and pay for such water, take a position on the outcome. The estimated \$16.3 billion in project costs would be borne by the utilities' rate payers, including State Water Project (SWP) and Central Valley Project (CVP) members. The Metropolitan Water District of Southern California (MWD), a SWP wholesaler to 26 member agencies serving about 19 million residents, expects to bear about one-quarter of the total cost. MWD estimates the monthly household bill within its service territory would increase by about \$2-\$3.

The MWD estimate is based on a cost split for the Fix of 55% SWP and 45% CVP. However, this assumes that all other SWP and CVP contractors sign on to the Fix. The cost to MWD and its ratepayers could be higher if some contractors decline to participate.

The timing and ultimate cost of the Fix, formerly known as the Bay Delta Conservation Project, are important to California's water and sewer utilities as this cost ultimately will be passed on to end users. Many California utilities implemented substantial rate increases or alternative rate structures in recent years to mitigate significant declines in financial margins in fiscal years 2015 and 2016 due to conservation-related demand declines resulting from the state's five-year drought. The cost related to the Fix would be an added charge.

Ratepayers have thus far shown a willingness and ability to absorb higher rates and most California utilities have ratepayer bases able to bear the estimated increase to fund the Fix. However, some agencies have water bills that already exceed Fitch's affordability threshold (combined water and sewer utility bill equal to, or higher than, 2% of median household income) and could become more pressured.

The Fix is intended to increase the reliability of water supplies through the Delta via the SWP while protecting native fish populations. Much of California's water supply is dependent on levees constructed half a century ago. The plan proposes the construction of two 45-mile long tunnels and three intakes on the Sacramento River and may produce an average annual yield of 4.9 million acre feet.

Contact:

Shannon Groff
Director, U.S. Public Finance
+1 415 732-5628

Fitch Ratings, Inc.
650 California Street, Suite 2250
San Francisco, CA

Robert Rowan
Senior Analyst, Fitch Wire
+1 212 908-9159

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email:
elizabeth.fogerty@fitchratings.com.

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