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Fitch: Water Conservation Regulations Not Likely to Affect California Utilities.

Fitch Ratings-San Francisco-05 June 2018: Legislation establishing state-wide water conservation standards is not likely to affect ratings for California water utilities, according to Fitch Ratings. That said, rate affordability could become an issue over time.

The regulations, signed into law last week by Governor Brown with implementation beginning in 2022, establish goals for indoor per person water usage, require utilities to set annual water budgets, and institute incentives for recycled water. They follow California's recent five-year drought during which the Governor declared a state of emergency and imposed a state-wide mandatory 25 percent cutback on water use and individual cutbacks for urban utilities of up to 36 percent.

In response to the drought and state mandated conservation efforts, many utilities have already adapted to new normal levels of water demand and raised rates or adjusted rate structures. As such, the legislation codifies changes already underway which, along with increasing capital investments, have pushed some utilities' rates close to or above Fitch's affordability threshold.

Water utilities have largely incorporated increased long-term water conservation and lower demand levels into their planning efforts and rate plans. Although the planning efforts are positive, rate affordability remains a long-term concern.

With an average rating of 'AA', Fitch-rated California water and sewer agencies maintain strong credit profiles overall. While increasing business pressures are likely, Fitch believes that most utilities have sufficient capacity to manage changes in water demand levels and maintain credit quality. Like other water and sewer utilities across the country, California utilities benefit from sound fundamentals rooted in their essential services, monopolistic business nature and generally local rate-setting authority that help to insulate these utilities through changing business and economic cycles.

Longer term, however, credit quality could come under pressure for individual utilities where there is an unwillingness to raise rates to accommodate potentially lower demand levels and support current and projected financial metrics. However, Fitch expects these instances to be rare given the historical willingness of California utilities to preserve their financial results despite operating challenges.

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