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Fitch: California Water Restrictions May Sink Utility Revenue.

Fitch Ratings-New York-08 April 2015: The governor's executive order to reduce California's water usage will lead to lower revenues for the state's utilities and could pressure a few ratings, Fitch Ratings says. The order is the latest sign that the current drought and minimal 2014 snowpack have reached a severity that will test drought preparedness and water supply planning statewide. However, widespread downgrades are unlikely, as many California utilities can mitigate this risk by decoupling revenues from sales.

California Governor Jerry Brown signed an executive order last week that aims to cut the state's overall water usage by 25% from 2013 levels over the coming nine months. Fitch expects water sales to decline by 10% to 15% in fiscal 2015, based on reporting from rated issuers. We expect it to fall further in fiscal 2016 due to the governor's order. Drought and the mandated conservation requirements will have a negative impact on the revenues of many utilities, though the impact will vary widely.

The impact of the governor's order on budgets will vary and depend mostly on the way the regulatory framework is implemented. The California Department of Water Resources (which has the mandate) has not generally taken a one-size fits all approach to conservation enforcement. Top-down conservation orders that ignore local supply conditions could force water utilities with stronger supplies to conserve more than they actually need to, reducing the value of investments in supply reliability, storage, water recycling and groundwater management. Fitch believes the state is likely to take a more balanced approach. However, rulemaking is ongoing, and use restrictions could have negative impact on credit quality if they fail to consider local supply conditions as well as local use levels.

The impact on credit quality will depend heavily on utilities' rate-setting decisions. As utilities generally have the ability to offset revenue losses with rate adjustments and their expenses are generally fixed, California water rates will rise. Some utilities have structural rate design features that smooth revenue declines when water sales drop. The city of Santa Cruz, for instance, has implemented aggressive drought rate structures designed to raise prices and stabilize revenues as sales volumes fall. Others such as the Eastern Municipal Water District in Riverside County have significant fixed meter charges and water budget-based rate structures in which tier sizes can be adjusted to reflect drought stresses and supply availability. Even in the absence of self-stabilizing rate structures, Fitch believes most utilities will raise rates as needed to maintain solid financial performance. Where policymakers hesitate to make necessary adjustments, rating changes could occur.

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