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How Will California Water Utilities Fare Amid the Long Drought and New Conservation Mandates?

In light of the fourth consecutive year of drought conditions in California, concerns about the reliability of the state's water supply have spiked, as have worries about the effects of Governor Jerry Brown's recent statewide water conservation mandate. Standard & Poor's Ratings Services seeks to explain the effects of the persistent drought on California water utilities' financial performance and credit quality.

Frequently Asked Questions

What is the credit impact of the drought on California water utilities?

The financial and credit impact of the drought and required conservation levels vary across water utilities. Rate-setting flexibility, sources of supply, supply costs, and management's actions — either proactive or reactive — all factor into the degree of credit impact, and thus we are analyzing the impact of the drought case by case. Many of the California water utilities we rate entered this drought period with good to strong debt service coverage and solid liquidity positions, which can somewhat mitigate the impact of lower water sales volumes for a time. Also, many water utilities plan in advance for droughts from both an operational perspective and a financial perspective. We are closely monitoring how our rated water utilities respond to Governor Brown's executive order, including how they plan to adjust rates given the required conservation. Complicating the matter is the ruling by the 4th District Court of Appeal on April 20, 2015, in the case of *Capistrano Taxpayers Association, Inc. v. City of San Juan Capistrano*(1) that struck down certain tiered-rate structures, which are a common tool to encourage water conservation. If the regulatory framework the state adopts on May 5 or 6 differs significantly from the current proposal (which we describe below), then we will again comment on the potential for credit impacts.

Can you explain the executive order Governor Brown issued this month in response to the drought?

On April 1, 2015, California Governor Brown issued an executive order(2) mandating statewide water conservation. This is the first time in California's history that water use restrictions have been mandated, and it represents a departure from prior requests for voluntary statewide water conservation. The governor issued the order following three consecutive years of drought and against a backdrop of historically low water supply: Snowpack in the Sierra Nevada Mountains — a critical source of water for the state during the spring and summer periods — was a mere 5% of the historical average(3) for April 1. The National Drought Mitigation Center estimates that about 67% of the state is experiencing either extreme or exceptional levels of drought(4), and virtually the entire state is experiencing some level of drought.

The objective of the order is to reduce statewide urban potable water usage by 25% through Feb. 28, 2016, but the order does not affect other water use categories, such as water used for agricultural production. If achieved, the State Water Resources Control Board (SWRCB) estimates that this level

of water conservation would total about 1.5 million acre-feet(5), or roughly the volume of water currently held in Lake Oroville(6), one of the state's largest reservoirs with a capacity of 3.5 million acre-feet.

How does the executive order affect California water utilities?

For urban water suppliers, the impact of the executive order varies primarily depending on 1) the service area's per capita water usage and 2) and the level of water conservation already achieved during the past year. Although the executive order targets a 25% statewide reduction in water usage as compared to 2013, state officials do not expect to achieve the water savings through a uniform reduction in water usage across the state. Instead, the revised regulatory framework(7) — which SWRCB published on April 18 and is subject to board adoption on May 5 or 6(8) —contemplates nine conservation tiers ranging from 4% to 36% reductions, stepping up in 4% increments(9).

Each urban water supplier's conservation standard is based on the service area's residential per capita water use during July through September 2014, three summer months when water demand for outdoor irrigation is typically high. The conservation standard is lower for service areas with lower residential per capita usage and higher for service areas with higher residential per capita usage. Notably, the conservation standard is measured relative to water usage during a benchmark period from June 2013 through February 2014. Some urban water suppliers have already achieved the required conservation level or are nearly at the required level, and we don't expect the modest additional conservation to significantly affect those suppliers' operations or finances relative to their prior-year performance.

For example, of the 413 urban water suppliers subject to the executive order, San Francisco Public Utilities Commission (SFPUC) had the ninth-highest total water production during the benchmark period (20.4 billion gallons), but the service area had the second-lowest residential per capita water use during July to September 2014, at 45.4 billion gallons. Based on this residential per capita use, the assigned conservation standard is 8%; however, because SFPUC already achieved 8% water conservation in 2014 relative to the benchmark period, no additional conservation would be required to comply with the executive order. In contrast, Coachella Valley Water District (CVWD) had the seventh-highest total water production during the benchmark period (28.3 billion gallons), and the service area had the seventh-highest residential per capita water use during July to September 2014, at 475.1 billion gallons. Based on this residential per capita use, the assigned conservation standard is 36%. Given that CVWD achieved only 4% water conservation in 2014 relative to the benchmark period, significant additional conservation of 32% for 2015 is required to comply with the executive order.

The SWRCB plans to assess a water supplier's compliance with the executive order by examining monthly reports that the suppliers will file. Enforcement actions for noncompliance may include informal enforcement, such as warning letters, or formal enforcement, such as cease and desist orders accompanied by administrative civil liabilities of up to \$10,000 per day.

Agricultural water suppliers are not subject to the executive order; however, low river flows and low allocations from the two major water projects in the state have cut into their surface water supplies.

What impact does Standard & Poor's expect the drought and the executive order to have on water utility revenues?

Although reduced volume of water sales seem likely to cause a corresponding reduction in operating revenues and net revenues, we understand that the financial performance of urban water suppliers also depends on other factors. For most retail water systems that have a volume-based component to

their rate structure, reduced volume of water sales would indeed correspond to lower revenues (barring an increase in rates). However, the relationship between the percent reduction in the volume of water sales and the percent reduction in operating revenues is not necessarily one to one. User rates for most retail water systems have a fixed component, which lower sales volume would not affect.

Many rate structures also have tiered pricing, with higher water use leading to a higher per-unit rate. In these cases, the impact of lower water sales is more complex, with the loss of revenues determined in part by the water rate tiers and the amount of usage within each tier. Even further complicating the matter is the April 20 ruling on *Capistrano Taxpayers Association, Inc. v. City of San Juan Capistrano*. In that ruling, the 4th District Court of Appeal struck down certain tiered-rate structures; specifically, those for which the water utility has not demonstrated that the tiers closely correspond to the actual cost of providing service at a given level of usage. We understand that the case has been remanded for further proceedings related to another issue in the case. Water utilities could also offset the volume lost with increased rates, as we address below.

Can California water utilities increase rates to offset any decline in water sales volume?

In general, California water utilities have the ability to adjust rates to offset lower sales volume. However, to increase rates, they must meet the public hearing and protest requirements under Proposition 218. The requirements include a public notice and a public rate hearing at least 45 days after the notice. The rate increase can be prevented if a majority of the parcel owners within the utility's service area protest at the public hearing or in writing. In our experience, it is rare for a rate increase to be outright prevented due to this provision although significant opposition from a vocal minority of the customer base may sway decision makers from the recommended course of action.

Some utilities already have the ability to increase rates in a drought because they have been through a previous Proposition 218 process. These utilities can likely increase rates up to the preapproved level through a governing board action. If a utility has not yet gained this ability, it would likely need to undertake a public notice process to comply with the procedural requirements of Proposition 218. This process could cause a lag between required conservation and the implementation of higher rates. In particular, if the ruling on *Capistrano Taxpayers Association, Inc. v. City of San Juan Capistrano* is left to stand, then the timeline to adjust rates may be significantly extended if the water utility is required to conduct a new cost-of-service study to demonstrate compliance with the ruling.

Could a reduction in water sales volume lower a utility's operating expenses?

Yes. In many cases lower water sales will lead to lower operating costs, although the impact will vary among utilities depending on their water supply sources and the marginal cost of additional supply. A water system relying exclusively on groundwater from its own wells would likely save on pumping costs if it sells less water. However, the savings may only be modest relative to a utility's operating budget because high-quality groundwater tends to be a relatively low-cost supply. If a utility directly purchases imported water on a per-unit basis, on the other hand, the lower water use will of course reduce water costs, and these savings could be substantial if imported water represents a significant portion of the utility's budget.

Although utilities could see some expense reduction, many of their costs — including fixed payments to suppliers, rents, leases, and debt service — are independent from the volume of water sold and likely wouldn't change. A decline in water sales would likewise have little short-term impact on salaries, benefits, and maintenance costs.

Footnotes

(1)<http://www.courts.ca.gov/opinions/documents/G048969.PDF>

(2)http://gov.ca.gov/docs/4.1.15_Executive_Order.pdf

(3)<http://www.water.ca.gov/news/newsreleases/2015/040115snowsurvey.pdf>

(4)<http://droughtmonitor.unl.edu/Home/StateDroughtMonitor.aspx?CA>

(5) <http://www.water.ca.gov/waterconditions/waterconditions.cfm>

(6)<http://cdec.water.ca.gov/cdecapp/resapp/resDetailOrig.action?resid=ORO>

(7)http://www.swrcb.ca.gov/waterrights/water_issues/programs/drought/docs/emergency_regulations/fact_sheet_implementing_25.pdf

(8)http://www.waterboards.ca.gov/waterrights/water_issues/programs/drought/docs/emergency_regulations/regulations_fact_sheet.pdf

(9)http://www.swrcb.ca.gov/waterrights/water_issues/programs/drought/docs/emergency_regulations/draft_usage_tiers.pdf

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