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Fitch: California Water Credits May Struggle with New Rules.

Fitch Ratings-New York-08 May 2015: The California State Water Resources Control Board's new water conservation mandate will reduce revenues available to pay bondholders at many agencies and could create an unintended disincentive to invest in necessary local water supply and storage projects, Fitch Ratings says.

The rules adopted this week dictate cuts in customer usage regardless of local supply conditions. The impact will be greatest in Southern California communities that have borrowed billions of dollars to invest in water supply reliability and now must meet some of the highest reductions. The cutback levels and short compliance timeframe set by the board suggest many utilities will likely fail to meet the targets.

The state water board rules require all retail California water utilities to reduce usage from 2013 levels by 8% to 36% between June 2015 and February 2016. Utilities are acting quickly to curtail their retail usage through water conservation ordinances, mandatory use reductions to retail customers and price signals. However, it may be very difficult for utilities required to meet the higher percentage reductions to garner significant water consumption behavior changes in this short time frame. California's Proposition 218 limits the speed at which new rates can be implemented, including rates that incentivize consumers to conserve. Initial compliance will be measured beginning in June 2015, and the state water board has indicated its willingness to work with utilities that are exhibiting a good faith effort to meet the requirements.

We expect the financial impact will occur primarily in fiscal 2016 and to vary across the 49 Fitch-rated retail California water utilities. Utilities that have decoupled revenues from water sales through a number of mechanisms will likely sustain their credit quality during this emergency compliance order. Tools that protect revenues from declines in consumption include drought rates, fixed drought surcharges, higher fixed charges in the overall rate structure, rate stabilization reserves and imported water expenditures that decline with lower usage. However, the speed of the cuts will force some to spend down their reserves or divert capital funds, possibly reducing credit quality in the short run. Fitch believes most utilities will adjust rates appropriately, avoiding widespread credit rating downgrades.

The state water board's decision to impose conservation from the top down ignores various local supply conditions and brings local control regarding water supply planning into question. Fitch's rating criteria assesses the quality of a utility's long-term supply planning and acquisition of supplies, storage and backup arrangements to manage through cyclical hydrological conditions, including severe drought years. To the extent the emergency rules begin to shape long-term water supply planning and investments in the state, the impact could unintentionally delay long-term water supply investments. The board has indicated that the temporary rules are designed to preserve water supply into next year during these extraordinary emergency conditions and should not impair investment decisions during normal times.

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