

# Metropolitan Water District of Southern California

## Revenue Bonds New Issue Report

### Ratings

#### New Issues

|   |         |
|---|---------|
| Water Revenue Refunding Bonds, Series 2012-B1 | AA+/F1+ |
| Water Revenue Refunding Bonds, Series 2012-B2 | AA+/F1+ |

#### Outstanding Debt

|   |         |
|---|---------|
| Water Revenue and Refunding Bonds                   | AA+     |
| Special Variable-Rate Water Revenue Refunding Bonds | AA+/F1+ |
| Water Revenue and Refunding Bonds                   | AA+/F1+ |
| Waterworks General Obligation Bonds                 | AAA     |

### Rating Outlook

Stable

### Related Research

[2012 Water and Sewer Medians, Dec. 8, 2011](#)

[2012 Outlook: Water and Sewer Sector, Dec. 8, 2011](#)

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### New Issue Details

**Sale Information:** \$98,585,000 Water Revenue Refunding Bonds, Series 2012-B1 and Series 2012-B2, priced on April 24 on a negotiated basis with an initial three-year tender.

**Security:** Secured by a pledge of net revenues. However, the purchase price of a tender is an unsecured obligation of Metropolitan, secured solely by subordinate pledge on net revenues.

**Purpose:** Metropolitan Water District of Southern California (Metropolitan) issued \$98.585 million bonds in the Securities Industry and Financial Markets Association (SIFMA) average index rate mode to refund \$100 million in outstanding variable-rate demand bonds with expiring liquidity facilities.

**Final Maturity:** July 1, 2027.

### Key Rating Drivers

**Wholesale Supplier:** Metropolitan is the supplemental wholesale water supplier to 19 million people in Southern California. Water is provided from two major supply sources that have experienced some variability. Revenues are provided from 26 member agencies that exhibit strong credit quality.

**Adequate Financial Profile:** Financial metrics are low for the rating but typical for a wholesale agency, with additional financial strength provided by the members and timely rate recovery. Financial performance in fiscal 2012 has shown improvement thus far, and the district expects coverage to comply with the board-adopted financial policies.

**Adapting to Lower Sales:** Water sales declined 29% over fiscal years 2009–2011, having a direct impact on district revenues. Sales may remain at this lower level given ongoing conservation in the region and development of alternative local supplies. Metropolitan is taking steps to adjust its rate structure to compensate for lower sales.

**Rate Flexibility:** Metropolitan's revenue flexibility is evident in the 75% cumulative rate increases over the recent six-year period, although rate sensitivity is likely heightened given the magnitude of recent rate actions. The board recently approved additional rate increases of 5% per year effective January 2013 and 2014.

**Limited Expenditure Flexibility:** Expenditure flexibility is limited given Metropolitan's relatively high fixed costs associated with its water supply and debt costs. Fitch recognizes the budget cushion created by the district through the inclusion of pay-as-you-go capital appropriations and reserves designated to absorb weather-related demand fluctuations, which were used in fiscal 2011.

**Complex Debt Portfolio:** Metropolitan's debt portfolio continues to require careful management and attention given its complexity. Approximately \$1.66 billion involves either daily, weekly, or annual remarketing risk, and Metropolitan has a \$1.4 billion swap portfolio.

**GO Rating:** Metropolitan's general obligation (GO) rating of 'AAA' and Stable Rating Outlook are based on its ability to levy unlimited ad valorem taxes on its sizable \$2 trillion tax base, with the property tax revenues restricted to be used only for debt service on the GO bonds and capital costs related to the state water project (SWP).

**Rating History:  
Revenue Bonds**

| Rating | Action               | Outlook/<br>Watch | Date     |
|--------|----------------------|-------------------|----------|
| AA+    | Affirmed             | Stable            | 4/17/12  |
| AA+    | Affirmed             | Stable            | 02/16/12 |
| AA+    | Affirmed             | Stable            | 08/19/11 |
| AA+    | Downgraded           | Stable            | 05/17/11 |
| AAA    | Affirmed             | Stable            | 12/10/10 |
| AAA    | Revised <sup>a</sup> | Negative          | 4/30/10  |
| AA+    | Affirmed             | Negative          | 11/19/09 |
| AA+    | Affirmed             | Negative          | 1/6/09   |
| AA+    | Affirmed             | Stable            | 7/1/08   |
| AA+    | Upgraded             | Stable            | 2/11/04  |
| AA     | Affirmed             | Positive          | 12/5/03  |
| AA     | Assigned             | Stable            | 8/9/01   |

<sup>a</sup>Rating recalibration.

**Rating History: GO  
Bonds**

| Rating | Action   | Outlook/<br>Watch | Date     |
|--------|----------|-------------------|----------|
| AAA    | Affirmed | Stable            | 4/17/12  |
| AAA    | Affirmed | Stable            | 9/22/10  |
| AAA    | Affirmed | Stable            | 11/19/09 |
| AAA    | Affirmed | Stable            | 1/6/09   |
| AAA    | Affirmed | Stable            | 7/1/08   |
| AAA    | Assigned | Stable            | 8/26/02  |

**Related Criteria**

[Revenue-Supported Rating Criteria, Jun. 20, 2011](#)

[U.S. Water and Sewer Revenue Bond Rating Criteria, Aug. 10, 2011](#)

[Tax-Supported Rating Criteria, Aug. 15, 2011](#)

[U.S. Local Government Tax-Supported Rating Criteria, Aug. 15, 2011](#)

[Criteria for Assigning Short-Term Ratings Based on Internal Liquidity, June 20, 2011](#)

[Rating U.S. Municipal Short-Term Debt, Dec. 8, 2011](#)

**Credit Profile**

Metropolitan is the supplemental supplier of water in a large and diverse six-county area in Southern California to 26 member agencies, many of which have some limited form of local water supply. The previous five years have brought significant developments to the water supply mix in Metropolitan's service area and the demand profile from members for its water. Drought conditions and regulatory changes to pumping on the SWP have prompted Metropolitan and its members to work together to develop new local supplies that will reduce the regional demand in Southern California for imported water sold by Metropolitan. The significant increase in Metropolitan's water rates to its members over the past six years has made local investments cost effective that had previously not been considered viable alternatives.

Metropolitan's members are not required to buy minimum amounts of water from Metropolitan but instead use the imported water supply to supplement existing and new local sources. In addition, Metropolitan's rate structure is heavily weighted toward volumetric pricing, so fluctuations in demand have a direct impact on revenues. Metropolitan's role in the region is crucial in that it supplies 40%–60% of Southern California's water supply in six counties with a population of 19 million. As the high cost provider, Metropolitan absorbs much of the regional demand variability due to conservation and efficiency investments as well as economic pressures. Although a regional economic recovery may increase demand, Metropolitan's members are required to meet a legislative requirement to reduce per capital usage by 20% in 2020, so investments in recycling and conservation may continue to place longer term downward pressure on Metropolitan's water sales and revenue base.

**Security**

**Go Bonds:** The GO bonds are secured by an unlimited ad valorem tax on all property within the district. Metropolitan's GO rating of 'AAA' and Stable Rating Outlook are based on its ability to levy unlimited ad valorem taxes on its sizable \$2 trillion tax base, with the property tax revenues restricted to be used only for debt service on the GO bonds and capital costs related to the SWP.

**Water Revenue Bonds:** The bonds are secured by net water revenues of the district. The definition of revenues does not include transfers from the rate stabilization fund or subsidies from the federal government related to the Build America bonds.

**Variable-Rate Self-Liquidity:** The 'AA+/F1+' rating on the series 2010A self-liquidity bonds, outstanding in the weekly mode, reflects the liquidity provided by Metropolitan's cash and investments. The 2010A bonds are outstanding as variable-rate demand bonds in the weekly mode. Payment of scheduled principal and interest on the bonds is secured by a net operating revenue pledge on parity with Metropolitan's outstanding water revenue bonds. Payment of the purchase price of a tender (either optional or mandatory) is an unsecured obligation, secured solely by a subordinate pledge of net revenues.

**SIFMA Index Mode Bonds:** The 'AA+/F1+' rating on the SIFMA bonds reflects the market access implied by the Metropolitan's long-term credit quality; the purchase price of the bonds at the end of each annual interest rate period is only secured by a pledge of remarketing proceeds.

The 2009A-1, 2009A-2, 2011A-1, 2011A-2, 2011A-3, and 2011A-4 bonds are outstanding in the index mode. Bondholders have the opportunity to tender the bonds at the end of the tender period. Payment of scheduled principal and interest on the notes is secured by a net operating

revenue pledge that is on parity with Metropolitan's outstanding water revenue bonds. Payment of the purchase price of a tender (either optional or mandatory) is an unsecured obligation, secured solely by a subordinate pledge of net revenues.

**No Cross Default:** A failure by Metropolitan to provide sufficient proceeds to pay the purchase price of the SIFMA notes or the self-liquidity 2010A bonds at the tender date would constitute an event of default under the respective paying agent agreements but would not constitute an event of default under Metropolitan's master resolution governing its water revenue bonds.

## Recent Developments

### Financial Performance Stabilizing After Fiscal 2011

Metropolitan's financial position is healthy despite a trend of declining financial margins between 2006 and 2011. Financial performance reached an exceptionally low level in fiscal 2011, primarily resulting from only 1.63 million acre feet (maf) of water sales compared with the budgeted amount of 1.93 maf. Debt service coverage on a cash basis was 1.35x on revenue bonds and 0.94x coverage on all payment obligations. Metropolitan used \$61 million from its rate stabilization fund, which improved coverage levels to 1.60x and 1.12x, shown in the table on page 8.

Metropolitan's financial performance has improved thus far in fiscal 2012, even though water sales continue to be low, currently estimated around 1.67 maf. A 7.5% rate increase, effective midyear 2012, and expenditure reductions in areas such as conservation spending, water delivery costs, and power expenses have increased net revenues in fiscal 2012. Water sales include 225,000 af of replenishment water sales to members once Metropolitan removed its allocation restrictions in late fiscal 2011. Management estimates that debt service coverage of revenue bonds at the end of fiscal 2012 will be 1.70x, with fixed-charge coverage of 1.22x, which appears reasonable given the known water sales forecast.

### Metropolitan Water District — Water Sales

| Year | Historical |            | Projected June 2010 | Projected May 2011 | Projected April 2012 |           |
|------|------------|------------|---------------------|--------------------|----------------------|-----------|
|      | Acre Feet  | Change (%) |                     |                    | Acre Feet            | Acre Feet |
| 2005 | 2,214,399  |            | —                   | —                  | —                    | —         |
| 2006 | 2,152,818  | (2.8)      | —                   | —                  | —                    | —         |
| 2007 | 2,247,214  | 4.4        | —                   | —                  | —                    | —         |
| 2008 | 2,305,364  | 2.6        | —                   | —                  | —                    | —         |
| 2009 | 2,166,936  | (6.0)      | —                   | —                  | —                    | —         |
| 2010 | 1,857,564  | (14.3)     | —                   | —                  | —                    | —         |
| 2011 | 1,632,277  | (12.1)     | —                   | —                  | —                    | —         |
| 2012 | —          | —          | 2,000,000           | 1,850,000          | 1,670,000            | 2.3       |
| 2013 | —          | —          | 2,030,000           | 1,800,000          | 1,700,000            | 1.8       |
| 2014 | —          | —          | 2,100,000           | 2,000,000          | 1,700,000            | 0.0       |
| 2015 | —          | —          | 2,110,000           | 2,000,000          | 1,750,000            | 2.9       |
| 2016 | —          | —          | —                   | —                  | 1,750,000            | 0.0       |

Source: Metropolitan Water District.

### Assumptions Anticipate Continued Lower Sales

Waters sales have declined considerably in the past few years — first, as a result of drought conditions, the allocation plan, and concentrated investments in conservation and efficiency and, more recently, as a result of the abundant rainfall in 2010 and 2011, coupled with depressed economic conditions. Fitch's rating downgrade in 2011 reflected, in part, the challenge of the lower sales environment and the likely continuation of slimmer financial margins for bondholders in line with those experienced in the past few years.

Given the lower sales conditions, Metropolitan has adapted its future water sales assumptions for financial planning and rate-setting purposes. The lower forecast shown in the April 2012 forecast includes water sales Metropolitan began using in 2012 to prepare for the possibility water sales will remain at this lower level.

### Higher Rate Increases Required; Board Adopts Lowest Alternative

As a result of the lower assumed sales, Metropolitan considered higher rate increases to members during the March/April 2012 rate-setting process. The board considered three proposals submitted by staff for the next biennium that ranged from a low proposal of 5% in each year to the high proposal of 7.5% in fiscal 2013 and 5% in 2014. Staff indicated that the lowest of its proposals, 5% in each year, would have a higher chance of necessitating greater than 3% rate increases in future years but would maintain reserve levels at the minimum threshold and preserve Metropolitan's financial flexibility. The board adopted the 5% per-year rate increase proposal, though there was some dissent, with only 75% of the board voting in favor of the rate proposal.

This was the lowest of the three rate options proposed by staff, reflecting rate sensitivity among the member agencies given the sizable rate increases to date. The San Diego County Water Authority (SDCWA) proposed a fourth alternative, with rate increases equal to 3% in each of the next two years, which was rejected by the board. The rate structure is the subject of ongoing litigation filed by SDCWA in 2010. The litigation relates to the rate methodology used to allocate costs between rate categories. Although it is not surprising to have customer equity issues arise regarding rate-setting, given the magnitude of costs at such a large wholesale agency with so many members, Fitch views the increasing tension between the two as a potential credit concern.

The lower revenues provided by the 5% rate increases that will become effective Jan. 1, 2013 and Jan. 1, 2014 will be mitigated in the budget through lower spending on storage programs, staffing, and equipment replacement. Debt service coverage is projected to remain around 1.63x in fiscal 2013 and 1.15x fixed-charge coverage. The 'AA+' rating assumes that Metropolitan will generally operate, at a minimum, at or above this level. Given the cyclical nature of demand, certain years will likely generate stronger metrics.

### Governance

Metropolitan's board of directors consists of 37 members. Each member agency has a minimum of one board member plus an additional representative for every full 5% of total assessed valuation (AV) in the district's service area. Voting is based on AV, with one vote for every \$10 million of AV within each member agency's service area. A simple majority determines most board actions. The board, overall, appears to have demonstrated relative unity during the recent statewide drought during 2007–2009; it implemented difficult reductions or temporary eliminations to each type of water sale. However, the most recent rate action,

approved in April 2012, carried only 75% of board approval. Increasing tension between SDCWA and other Metropolitan members related to the rate structure and ongoing litigation could become a governance concern.

As the regulatory body that sets rates, the board has increased rates substantially, totaling 75% on a cumulative basis over six years through January 2012. Although rates have not kept pace with actual cost increases, these significant rate actions were implemented during an economic recession and demonstrate a strong degree of financial flexibility. However, given the scale and scope of recent cost escalation and enacted rate increases, future appetite for rate increases in the region is viewed as strained.

### Water Supply

The district's water supply is derived from Northern California's bay/delta through a long-term contract with the California Department of Water Resources (DWR) for water from the SWP and the Colorado River. In recent years, the SWP supply has exhibited a greater amount of variability than the Colorado River supply. As shown in the table at right, the expected amount (on a calendar-year basis) in 2012 is 67% of the amount received in 2011.

#### Metropolitan Water District Supplies

| (acre feet)                       | 2011             | 2012 <sup>a</sup> |
|-----------------------------------|------------------|-------------------|
| Colorado River Aqueduct Sources   | 870,000          | 905,000           |
| State Water Project Sources       | 1,720,000        | 1,146,000         |
| <b>Total</b>                      | <b>2,590,000</b> | <b>2,051,000</b>  |
| Member Agency Demand <sup>b</sup> | 1,645,000        | 1,657,000         |
| Demands and Obligations           | 273,000          | 0                 |
| Net to Storage                    | 672,000          | 394,000           |

<sup>a</sup>Projected <sup>b</sup>Calendar-year demand.

### State Water Project

The SWP is owned by the state and operated by DWR. The project transports Feather River water released from Oroville Dam and unregulated flows diverted directly from the bay/delta via a 444-mile aqueduct (the California Aqueduct) to Metropolitan's service territory. Metropolitan is the largest of the 29 agencies with an SWP water contract with DWR in terms of service area population and water entitlement (at about 46%). Metropolitan's contract with DWR entitles the district to slightly more than 1.9 maf per year, although the actual average delivery from the project to its contracted agencies has been lower than the contracted entitlement in most recent years and is driven by water conditions in the northern Sierra Mountains. Typically, DWR announces initial allocation levels in December for the following calendar year. The allocations may be increased over the next few months, as DWR has better information on the snowfall and snowpack in the Sierra Mountains. The table below shows initial allocations and final allocations for the past nine years.

Prior to 2008, it was typical for SWP contractors to plan on receiving at least 60% allocations, which represents a delivery of 1.15 maf to Metropolitan. Deliveries in 2006 actually reached 100% of each SWP contractor's allocation for the first time since 1999 as a result of strong precipitation levels. In 2008, the lower allocation was the result of critically dry conditions but also was reduced

#### SWP Allocation

| Year | Initial Allocation (%) | Final Allocation (%) |
|------|------------------------|----------------------|
| 2004 | 35                     | 65                   |
| 2005 | 40                     | 90                   |
| 2006 | 55                     | 100                  |
| 2007 | 60                     | 60                   |
| 2008 | 25                     | 35                   |
| 2009 | 15                     | 40                   |
| 2010 | 5                      | 50                   |
| 2011 | 25                     | 80                   |
| 2012 | 60                     | Current 60           |

due to the interim court-ordered restrictions on pumping. Metropolitan supplemented the reduced deliveries through various water transfers and groundwater banking and exchange programs, as well as sales from its storage supplies located in Southern California. DWR's announcements of initial allocations in 2009 and 2010 of 15% and 5%, respectively, signaled lower certainty regarding water availability that resulted, in part, from pumping restrictions at the project. The initial allocation for 2011 was only 25%. However, above-average precipitation resulted in accumulated snowpack in the Sierra Nevada Mountains to 179% of normal conditions and a revision of the final allocation to 80%. Even in such strong water years, contractors did not receive 100% allocations, reflecting ongoing operational constraints.

The initial allocation in 2012 was 60% based on strong storage levels. However, in February 2012, DWR reduced the allocation to 50% because water conditions at that point in the year had been low. While it is highly unusual for the initial allocation to be reduced during the year, it has happened in the past. Given strong precipitation levels across the state primarily in March 2012, the allocation was increased again to 60% in April 2012.

### **Environmental Constraints**

The SWP is home to several listed species of endangered fish either under the federal Endangered Species Act (ESA) or the California ESA. As a result, protection of each species is covered under separate biological opinions, leading to isolated and distinct protocols for the project for each species. There are multiple ongoing lawsuits related to the various biological opinions that affect operation of the SWP.

DWR estimates there are significant impacts on its ability to deliver water from the SWP as a result of the biological opinions. The ongoing litigation results in continuous uncertainty in the available water supply from the SWP. Fitch views the litigation risk as a moderate credit risk that will likely result in cost escalation in SWP water over time. Resolution of most of the litigation appears unlikely in the short term.

### **State Water Project Improvements**

Operational constraints will likely continue until a long-term solution to the variety of environmental, seismic, and land use issues in the bay/delta is identified and implemented. A number of interested parties, including state and federal agencies, as well as environmental organizations and water users, have developed the bay-delta conservation plan (BDCP), which is designed to address the multiple demands of the delta, including the needs of the ecosystem as well as water use. A working draft of the plan was completed in 2010, and a full report and environmental impact report (EIR) are anticipated in 2012.

One of the components of the BDCP is the development of environmental assessments associated with the dual conveyance option, which would construct a secondary pipeline to convey water to Southern California that does not move through the bay/delta. One option under discussion is an underground pipeline. Metropolitan approved agreements with other state and federal water contractors to fund the costs of the environmental assessments needed to advance the study of a pipeline alternative. These initial documents are anticipated in 2012.

### **Colorado River**

California's total apportionment of the Colorado River water supply is 4.4 maf per year plus one-half of any combined surplus available to Arizona, California, and Nevada. Metropolitan has a fourth-priority right to the Colorado River water, totaling 550,000 af per year, which is the

fourth and last-ranked priority right under California's 4.4-maf-per-year firm allocation. The district also holds a fifth-priority right to 662,000 af per year in excess of the state's allotment. However, receipt of the fifth-priority right depends on water conditions, and the Colorado River system had experienced a drought until 2010. The Colorado River source is viewed as having little risk of interruption related to Metropolitan's priority rights.

In addition to Metropolitan's basic apportionment, Met has another approximately 300,000 af of reliable yield from various Colorado River supply programs. In calendar 2011, the additional programs provided 320,000 af. The largest program is the exchange agreement with SDCWA for water purchased by SDCWA from the Imperial Irrigation District (IID) in connection with a transfer agreement and canal lining savings. Since there is no transportation link between SDCWA and IID, SDCWA has the conserved water delivered to Metropolitan with its own Colorado supply and pays Metropolitan a conveyance rate for the delivery of that water. The transfer and canal lining water accounted for 158,000 af in 2011. The other significant program is a land following arrangement with the Palo Verde Irrigation District that provided 116,000 af to Metropolitan in 2011.

### Storage Capacity

Metropolitan has storage capacity of approximately 5.8 maf, including reservoirs, conjunctive use, and other groundwater storage programs, both in its service territory and in other areas. Approximately 674,000 af of local stored water is designated by the board as emergency storage and is reserved for use in the event of a seismic event. The remaining storage provides Metropolitan with the ability to withstand typical weather variability; the stored reserves are used during drought years and replenished during wet weather years. During the drought years, from 2007–2009, Metropolitan used water in storage to replace water deliveries that were not received due to the lower allocation received from the SWP and persistent drought conditions on the Colorado River. As a result, as of January 2010, Metropolitan had 1.64 maf in storage, down from 2.13 maf in January 2008. However, record snowfall affected both of Metropolitan's main water supply systems, and as a result, excess water replenished most storage resources. As of Jan. 1, 2012, the district's storage had rebounded to 3.0 maf, placing its water supply in a much healthier position than the past few years.

### Rates

Metropolitan is largely a voluntary wholesale supplier in the region. It does not have minimum amounts that members are required to buy. However, member agencies can enter into 10-year purchase order agreements that provide a pricing incentive by allowing them to buy a higher amount of water at Tier 1 rates. The purchase orders establish a minimum amount that the member agency will buy from Metropolitan over the 10-year period, which is equal to 60% of its highest demand during the 1990–2002 period. From the 10-year period (2002–2012), 24 of Metropolitan's member agency had executed purchase agreements. All but one met the minimum. Metropolitan and its members are currently in discussions about extending or renegotiating the purchase orders after the existing agreements expire in December 2012. Fitch views the contracts as helpful in providing some planning parameters from Metropolitan's sales but members still retain a high degree of flexibility to reduce their purchases. Metropolitan absorbs much of the regional risk associated with declining water sales.

Metropolitan's board formulates the revenue structure and sets rates and charges without oversight from local, state, or federal agencies. Member agencies submit 10-year purchase orders that provide a schedule of their expected needs. The majority of the amount requested

in the purchase orders is served at a lower Tier 1 rate, while a small portion and any sales above what members committed to in their purchase orders are served at the higher Tier 2 rate.

Full-service Tier 1 rates (\$794 per af of treated water) have increased from \$478 in 2007. Full-service Tier 2 rates (\$920 per af of treated water) have increased from \$574 in 2007. These rates include the \$58-per-af Delta supply surcharge designed to recover additional supply costs resulting from pumping restrictions and environmental protection costs related to the Delta, which was put into effect in fiscal years 2011 and 2012. With the 5% rate increases approved by the board in April 2012, Tier 1 rates will increase to \$847 per af on Jan. 1, 2013 and \$890 on Jan. 1, 2014.

## Financial Summary

(\$000 Audited Fiscal Years Ended June 30)

|  | 2007             | 2008             | 2009             | 2010             | 2011             |
|--|------------------|------------------|------------------|------------------|------------------|
| <b>Balance Sheet</b>                                 |                  |                  |                  |                  |                  |
| Unrestricted Cash and Investments                    | 181,007          | 404,528          | 415,880          | 449,773          | 395,256          |
| Accounts Receivable                                  | 18,461           | 175,219          | 186,248          | 186,175          | 191,935          |
| Other Current Unrestricted Assets                    | 1,299,661        | 614,584          | 373,448          | 391,705          | 493,433          |
| Current Liabilities Payable from Unrestricted Assets | (532,679)        | (521,869)        | (549,074)        | (470,140)        | (569,545)        |
| <b>Net Working Capital</b>                           | <b>966,450</b>   | <b>672,462</b>   | <b>426,502</b>   | <b>557,513</b>   | <b>511,079</b>   |
| Net Fixed Assets                                     | 7,461,443        | 7,844,462        | 8,209,719        | 8,464,182        | 8,573,541        |
| Net Long-Term Debt Outstanding                       | 4,616,368        | 4,425,444        | 4,729,000        | 4,769,672        | 4,892,617        |
| <b>Operating Statement</b>                           |                  |                  |                  |                  |                  |
| Operating Revenues                                   | 1,069,312        | 1,096,519        | 1,136,476        | 1,165,582        | 1,177,846        |
| Non-Operating Revenues                               | 65,373           | 68,900           | 42,422           | 30,287           | 23,975           |
| BABs/RZED Bonds Subsidy <sup>a</sup>                 | —                | —                | —                | 6,600            | 3,600            |
| <b>Gross Revenues</b>                                | <b>1,134,685</b> | <b>1,165,419</b> | <b>1,178,898</b> | <b>1,202,469</b> | <b>1,201,821</b> |
| Operating Expenses (Excluding Depreciation)          | (703,801)        | (755,223)        | (842,153)        | (829,294)        | (759,692)        |
| Depreciation   | (214,395)        | (228,963)        | (226,059)        | (246,431)        | (286,365)        |
| <b>Operating Income</b>                              | <b>216,489</b>   | <b>181,233</b>   | <b>110,686</b>   | <b>126,744</b>   | <b>155,764</b>   |
| Net Revenues Available for Debt Service <sup>b</sup> | 430,884          | 410,196          | 336,745          | 373,175          | 442,129          |
| Senior Lien Debt Service Requirements                | 200,000          | 219,000          | 223,000          | 244,000          | 277,000          |
| Total Debt Service Requirements                      | 261,000          | 310,000          | 310,000          | 360,000          | 396,000          |
| <b>Financial Statistics</b>                          |                  |                  |                  |                  |                  |
| Senior Lien Debt Service Coverage (x)                | 2.15             | 1.87             | 1.51             | 1.53             | 1.60             |
| Total Debt Service Coverage (x)                      | 1.65             | 1.32             | 1.09             | 1.04             | 1.12             |
| Days Cash on Hand                                    | 94               | 196              | 180              | 198              | 190              |
| Days Working Capital                                 | 501              | 325              | 185              | 245              | 246              |
| Debt to Net Plant (%)                                | 62               | 56               | 58               | 56               | 57               |
| Outstanding Long-Term Debt per Capita (\$)           | —                | —                | —                | 251              | 258              |
| Free Cash to Depreciation (%) <sup>c</sup>           | 79               | 44               | 12               | 5                | 16               |

<sup>a</sup>Build America Bonds (BABs)/Recovery Zone Economic Development (RZED) Bonds subsidy per the American Recovery and Reinvestment Act (ARRA) of 2009. <sup>b</sup>Equals gross revenues, including Federal Direct Subsidy Payments, less operating expenses. <sup>c</sup>Equals net revenues available for debt service less operating transfers out, less total debt service, divided by depreciation. Note: Numbers may not add due to rounding.

## Financial Position

Metropolitan's rate structure is heavily weighted toward volumetric charges. In fiscal 2011, volumetric charges accounted for approximately 87% of operating revenues. Fixed charges only accounted for 13%, although Metropolitan received another \$88 million from property

taxes as well, but these revenues are restricted for payment of GO bond debt service and certain capital costs associated with the SWP. The higher reliance on volumetric revenues is valuable in the conservation message the district sends to members but introduces greater variability to the revenue base.

The district's reserve policies designate pay-as-you-go moneys for capital projects and target minimum and maximum balances of reserves held in the water rate stabilization and revenue remainder funds based on probabilities for wet periods. The minimum amount is kept in the revenue remainder fund, and funds above the minimum but below the maximum amount are kept in the rate stabilization fund. Moneys in excess of the maximum reserve may be used for any lawful purpose, including remittance to member agencies. Transfers in from the rate stabilization fund were used in fiscal 2011 and planned in fiscal 2012 to balance the impact of the loss of revenues from lower water sales.

### Financial Summary: Projections

| (\$000, Fiscal Years Ending June 30)                       | 2012             | 2013             | 2014             | 2015             | 2016             |
|--|------------------|------------------|------------------|------------------|------------------|
| <b>Operating Statement</b>                                 |                  |                  |                  |                  |                  |
| Operating Revenues   | 1,234,000        | 1,358,000        | 1,423,000        | 1,526,000        | 1,580,000        |
| Non-Operating Revenues                                     | 88,000           | 56,000           | 53,000           | 55,000           | 60,000           |
| <b>Gross Revenues</b>                                      | <b>1,322,000</b> | <b>1,414,000</b> | <b>1,476,000</b> | <b>1,581,000</b> | <b>1,640,000</b> |
| Operating Expenses (Excluding Depreciation)                | 826,000          | 917,000          | 903,000          | 969,000          | 992,000          |
| <b>Net Revenues Available for Debt Service<sup>a</sup></b> | <b>496,000</b>   | <b>497,000</b>   | <b>573,000</b>   | <b>612,000</b>   | <b>648,000</b>   |
| Senior Lien Debt Service Requirements                      | 291,000          | 305,000          | 308,000          | 316,000          | 325,000          |
| Total Debt Service Requirements                            | 404,000          | 432,000          | 431,000          | 461,000          | 483,000          |
| <b>Financial Statistics</b>                                |                  |                  |                  |                  |                  |
| Senior Lien Debt Service Coverage (x)                      | 1.70             | 1.63             | 1.86             | 1.94             | 1.99             |
| Total Debt Service Coverage (x)                            | 1.23             | 1.15             | 1.33             | 1.33             | 1.34             |

<sup>a</sup>Equals gross revenues less operating expenses. Note: Numbers may not add due to rounding.

### Debt and Capital Investment Plan

Debt levels are manageable and use both long-term financing and pay-as-you-go spending to address capital needs. Total long-term revenue bonds outstanding equal approximately \$4.6 billion. Metropolitan's \$1.45 billion five-year capital investment plan, for fiscal years 2013–2017, will require an estimated \$930 million in additional revenue bonds. When combined with the relatively slow amortization of Metropolitan's existing debt, the result is an increasing fixed-cost burden associated with debt service. Debt service on the outstanding revenue bonds accounted for 23% of total revenues in fiscal 2011, up from 19% two years ago.

Metropolitan has a complex debt portfolio that includes extensive variable-rate debt products, liquidity facilities, and swaps. Metropolitan has 67% fixed-rate debt, another 22% in synthetically fixed debt, and 11% unhedged variable-rate debt, which includes the SIFMA index notes. However, its exposure to expiring liquidity facilities has diminished significantly over the past few years, and there appears to be little risk of Metropolitan not finding replacements for its remaining facilities. Since 2008, Metropolitan has replaced a substantial amount of its outstanding traditional variable-rate debt supported by liquidity facilities with SIFMA bonds (\$538 million), self-supported variable-rate debt (\$127 million), and fixed-rate bonds (\$590 million) to reduce counterparty and liquidity facility rollover risk.

Metropolitan's \$1.4 billion swap portfolio includes four counterparties and a variety of different derivative products. Although Metropolitan has a negative mark-to-market value on the swap portfolio, Metropolitan is considering a termination of a portion of its swap portfolio. Currently, Metropolitan has \$23.6 million posted as collateral with one of its swap counterparties. The cash for the collateral posting came from Metropolitan's unrestricted reserves and is held by the counterparty.

### Service Territory

Metropolitan's massive service area encompasses about 5,200 square miles, including the urban and economic core of Southern California. The area includes approximately 85% of the six-county area population consisting of Los Angeles, Orange, Riverside, San Bernardino, San Diego, and Ventura counties. The six-county area is the most densely populated and heavily industrialized portion of Southern California, with 57% of the state's population.

The current district population of more than 19 million is expected to increase substantially over the next two decades. Projections for the six-county area indicate a population of 27 million in 2030. The 2010 gross domestic product of the six-county area, estimated at \$1 trillion, was larger than that of all but 12 countries in the world. Major economic and employment sectors include manufacturing, business and professional services, transportation and trade, and entertainment.

Economic trends in the six-county region have been similar to the nation, although California has been greatly affected by the collapse of housing prices, as well as loan defaults and foreclosures. Median home prices in the counties have fallen between 31% and 54%, pushing prices down to levels last seen in 2003.

Southern California has been hard hit by the recession, with unemployment levels in the six counties ranging from 7.8%–12.5% in December 2011.

### General Obligation Bonds

Metropolitan's massive service area encompasses about 5,200 square miles, including the urban and economic core of Southern California. The area includes approximately 85% of the six-county area population consisting of Los Angeles, Orange, Riverside, San Bernardino, San Diego, and Ventura counties. The six-county area is the most densely populated and heavily industrialized portion of Southern California, with 19 million people. Economic trends in the six-county region have been similar to the national recession, although job gains were experienced during the final months of 2011. California was greatly affected by the collapse of housing prices and loan defaults and foreclosures. Median home prices in the counties fell between 33% and 46%, bringing prices back down to levels last seen in 2003.

Fitch's 'AAA' rating on Metropolitan's GO bonds is based on its ability to levy unlimited ad valorem taxes on its stable \$2 trillion tax base. Overall, Metropolitan's service territory showed an increase of 0.9% in taxable AV in fiscal 2012 following two years of modest declines of less than 2% annually. Property tax revenues may only be used for debt service on the GO bonds and a portion of capital projects related to SWP. As these expenditures decline over time, Metropolitan decreases its tax collections. The revenues needed to support the outstanding \$195.1 million in GO bonds require a minimal property tax levy. Metropolitan establishes its tax rate each year based on AV received from the counties in August. The tax rate for fiscal 2012 was reduced to 0.0037% of AV from 0.0043% during the past three years. Issuance of additional GO debt is not expected and would require Metropolitan to hold a referendum; no

GO bonds have been submitted for voter approval since the 1966 authorization. The district will fund its capital improvement plan (CIP) through a combination of revenue bonds and ongoing revenues.

## Legal Provisions

### Water Revenue Bonds

The bonds are secured by net water revenues of the district. The definition of revenues does not include transfers from the rate stabilization fund or subsidies from the federal government related to the Build America Bonds.

### Rate Covenant

Metropolitan covenants to set rates and collect revenues at least sufficient to pay operations and maintenance costs, principal and interest on outstanding bonds and parity obligations, other payments required under the master resolution, and other payables.

### Additional Bonds Test

Additional parity debt may not be incurred, unless net operating revenues equal at least 1.2x maximum annual debt service (MADS), subject to the bond resolutions. Pursuant to Metropolitan's enabling legislation, total debt (including GO and revenue bonds) cannot exceed 15% of the taxable AV of all property within the district's service area, which is currently more than \$2.0 trillion. Additionally, the district's revenue bonds (\$4.6 billion) may not exceed the prior fiscal year's net assets (\$6.26 billion in fiscal 2011). The district is currently below both of these debt limits.

### Reserve Requirement

The district is required on certain series of fixed-rate bonds to maintain a debt service reserve fund equal to 50% of the least of MADS, 125% of the average ADS requirements on the bonds, or 10% of bond proceeds. However, certain recent series of bonds do not carry a reserve requirement. The reserve requirement may be satisfied by a surety policy.

### SIFMA Bonds

Metropolitan issued \$98.585 million in 2012B SIFMA index mode bonds to replace \$100 million in outstanding variable-rate demand obligations (VRDOs). The outstanding VRDOs were supported by liquidity facilities in the amount of \$50 million each provided by Bank of America and JPMorgan Chase that expire in May 2012. The risk associated with SIFMA bonds includes rollover, or refinancing, risk at the end of the mandatory tender period. This risk will replace the risk associated with VRDOs of liquidity facility rollover risk, which carries some counterparty risk that is factored into the weekly pricing of the bonds.

Fitch views the incremental risk as appropriate for Metropolitan, given its past experience with the SIFMA bonds, its practice of executing an optional tender prior to the mandatory tender date, and it staggering the mandatory tender dates of all the outstanding SIFMA bonds to reduce the impact of market disruption.

Payment of principal and interest on the index bonds is secured by a lien on net water revenues of Metropolitan's system, on parity with outstanding parity obligations. However, net

revenues are not pledged to repayment of the purchase price, either scheduled or unscheduled (scheduled: at the end of the tender period; unscheduled: at Metropolitan's option after the call protection date, six months prior to the end of the tender period, and at no premium). The purchase price is secured only by remarketing proceeds. Although Metropolitan has the option to use other resources, such as its cash reserves, to fund the purchase price in the event of a failed remarketing, it is not legally obligated to do so, nor is there any assurance that cash reserves would be sufficient. However, management has stated it intends to use its cash reserves in such an event, and its short-term investments typically exceed \$500 million.

A failure by Metropolitan to provide sufficient proceeds to pay the purchase price of the bonds at the tender date would constitute an event of default under the SIFMA bond series paying agent agreements but would not constitute an event of default under Metropolitan's master resolution, which governs its other revenue bonds. In the event Metropolitan ever failed to pay the purchase price, bondholders would retain the bonds and enter into a purchase default period, during which bondholders would receive a default rate. The purchase default period also triggers a term-out period, during which Metropolitan is required to pay one-third of the principal and interest due within 18 months, another one-third within 36 months, and the remaining amount by 54 months. These payments would be on parity with Metropolitan's revenue bonds.

### **Self-Liquidity Variable-Rate Bonds**

The 2010 series A bonds are variable-rate demand bonds in the weekly mode. While Metropolitan has a large \$1.7 billion portfolio of variable-rate demand bonds outstanding, this is the only series issued as self-liquidity bonds. The bonds rely solely on Metropolitan's reserves to provide liquidity in the event of a failed remarketing. No other liquidity facility is in place. Payment of the bonds is secured by net revenues of the district. However, the payment of the purchase price of any tender is an unsecured obligation, secured only by a subordinate pledge of net revenues. The payment of a tender purchase price is not explicitly secured by a pledge of cash and investments. Furthermore, the failure to pay the purchase price of a tender is not a cross-default under the master resolution governing Metropolitan's outstanding revenue bonds.

Metropolitan has a total investment portfolio that is typically about \$1 billion, including unrestricted and restricted assets. Approximately \$585 million of the portfolio is invested in highly liquid assets, such as Treasury bonds or federal agency obligations. Fitch specifically views Metropolitan's rate stabilization funds as the primary source of liquidity to support the bonds, which has a balance of \$258 million as of March 31, 2012. The rate stabilization fund has remained over \$220 million in the past few years despite draws from the funds for operations to provide collateral posting to swap providers and to reserve against litigation risk. Fitch does not view Metropolitan's cash and investments as having the ability to support additional issuance of variable-rate self-liquidity bonds without an additional internal liquidity facility.

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

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