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Summary:

Merced Irrigation District, California; Water/Sewer

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Merced Irrigation District, California; Water/Sewer

Credit Profile		
US$35.24 mil wtr and hydroelectric sys rfdg rev bnds ser 2014A		
Long Term Rating	A/Stable	New
US$5.8 mil wtr and hydroelectric sys rfdg rev bnds ser 2014B		
Long Term Rating	A/Stable	New
Merced Irr Dist Capital Appreciation rev COP (Water And Hydroelectric Sys Proj) ser 2008B		
Long Term Rating	A/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services assigned its 'A' long-term rating to Merced Irrigation District, Calif.'s series 2014A and 2014B water and hydroelectric system revenue bonds. At the same time, Standard & Poor's affirmed its 'A' long-term rating on the district's 2008A and 2008B certificates of participation (COP), issued for the systems. The outlook is stable.

The rating reflects our view of the district's:

- Adoption of a large rate increase in 2014 to offset the effects of reduced water supply due to the statewide drought,
- Strong unrestricted cash and investments position, and
- Continued progress toward the federal relicensing of the district's hydroelectric facilities.

These strengths are partially offset by our view of the district's:

- Exposure to the statewide drought, which has led to decreased water supply to sell to customers and lower output from the hydroelectric facilities;
- Scheduled increase of debt service in fiscal 2015 and 2016; and
- Regulatory uncertainty associated with the long-term relicensing of its hydroelectric facilities.

The bonds are being issued to refund the district's outstanding series 2008A and 2008B COPs for debt service savings.

The bonds are backed by a pledge of net water system revenues and net hydroelectric system revenues. The COPs also have a reserve that will be funded at maximum annual debt service (MADS). A rate covenant requires the district to generate debt service coverage of at least 1.25x. After the refunding, the 2014 bonds will be the only parity bonds outstanding. The district's series 2005 electric system bonds and COPs have a subordinate lien on net hydroelectric revenues if needed to cover debt service although management does not anticipate needing these revenues for this purpose. We understand the district plans to enter into a $25 million unsecured loan agreement with Wells Fargo Bank for capital and operating liquidity. Though this is not on parity with the 2014 bonds, in our view the loan could be refinanced with parity debt in the future.

The district covers 165,000 acres in the central San Joaquin Valley, centered around the city of Merced. The local economy is concentrated in the agriculture sector. The median household effective buying income in Merced County is 88% of the national median, which we consider adequate.

The water system primarily serves agriculture customers, and has about 2,200 accounts. Water supply is derived from senior water rights on the Merced River, with runoff stored in two district-owned reservoirs. About 48% of the planted acreage represents permanent crops. We view the customer base as relatively diverse, with the top 10 customers representing about 17% of water sales. The district's dams include power generation facilities, which represent the district's hydroelectric system. In addition to its water and hydroelectric operations, the district is a retail power provider. The revenues from the retail electric services are not included in the pledge.

The district has pre-1914 water rights and appropriative water rights for the Merced River – it's primary source of supply. The district also has 220 groundwater wells to supplement surface water supply. Merced River water is stored behind the district's New Exchequer and McSwain dams. Although the district has senior water rights on the river, its annual supply available for distribution is affected by hydrology. The state is currently in a three-year drought, which has led to lower inflows into the district's reservoirs and lower water sales, which the district projects will continue for the near term. Annual inflows to the district's two reservoirs have declined from 1.9 million acre-feet in 2011 to 464,000 acre-feet in 2013. In turn, surface water sold to customers has declined from 263,000 acre-feet in 2011 to a projected 104,500 acre-feet in 2014. The district can supplement some, though not all, of the reduced surface water supply with groundwater sales.

The hydroelectric system generates revenues from the sale of the power output from the district's two dams. For 50 years up until June 30, 2014, all power was provided to Pacific Gas and Electric (PG&E) under a power purchase contract. In return, PG&E covered all operating expenses and paid debt service related to the hydroelectric project's original financing. As of July 1, 2014, the district is now the sole owner of the electricity produced by the system, which it can sell on the open market or sell to its retail electric system. It currently sells the power and system capacity to PG&E and Shell Energy under a three-year agreement. The system's original operating license from the Federal Energy Regulatory Commission (FERC) expired on Feb. 28, 2014, with automatic annual renewals until a new license is granted. The district has been undertaking the relicensing process since well before this date. Relicensing has entailed considerable costs, with $20.4 million spent to-date and an overall anticipated cost of $25.0 million.

The water system generates most of its revenue through annual standby charges and volume-based water sales. The standby charge has been unchanged for many years at $24 per acre. The district had an election to raise the rate to $34 in April 2014, but the landowners voted the increase down (this type of charge requires a majority vote of landowners by state law). The volume-based charge was raised to $23.25 per acre foot in fiscal 2013, rising from $18.25 per acre foot -- the rate since 2007. In April 2014, the district approved a large rate increase to a maximum of $100.67 per acre-foot in response to drought conditions, lower water supply, and thus lower projected water sales. Due to subsequent revenue generation from water transfers, the district lowered the rate to $75 on June 3, 2014, though the board can raise rates back to $100.67 without going through a new public notice process. In its projections, the district is assuming it can lower rates to $58 in fiscal 2016 and to $47 in fiscal 2017 and maintain stable financial performance due to anticipated improved hydrologic conditions, though the board has discretion over these rate changes.

Historically the district has generated strong debt service coverage, though debt service is scheduled to increase substantially in fiscal 2015 and 2016. Despite anticipated lower water sales by volume in fiscal 2015, the inclusion of hydroelectric revenues and the district's large water rate increase should help support the increase in debt service, in our view. Operating revenues in fiscal 2014 (12-month period ending March 31, 2014) totaled $15.9 million and consisted of $12.0 million in water sales and $3.9 million in water transfers. Operating expenses excluding depreciation were $18.2 million. The system also benefits from local property tax revenues, which totaled $2.8 million in 2014. Total net revenues, which also includes interest income and other non-operating income, totaled $2.1 million in fiscal 2014, providing debt service coverage of 3.22x on debt service of $638,000, as calculated by Standard & Poor's. Coverage has been above 1.7x in each of the past four years, although fiscal 2013 represents a 15-month period as the district shifted from a fiscal year ending on March 31 from Dec. 31.

After this refunding, annual debt service is estimated to increase to $2.9 million by fiscal 2016, then step down starting in 2022. Fiscal 2015 represents the first year the district will have access to hydroelectric net revenues, which are pledged to the bonds after the expiration of the 50-year contract with PG&E on June 30, 2014. Despite lower hydroelectric power generation due to the drought, the district still anticipates positive net revenues from the system in fiscal 2015. The large rate increase adopted earlier this year are also anticipated by the district to offset lower water sales. Under the projections, the district anticipates coverage of above 2x through fiscal 2019. We view the projections as reasonable, though they rely on assumed improvement in precipitation during the period, which is inherently uncertain. The projections also assume a step down in rates from $75 per acre foot currently to $47 by fiscal 2017. In our view, the risk of lower-than-anticipated precipitation is partially offset by the district's flexibility to raise rates up to the approved maximum of $100.67.

The water system's liquidity position has declined during the past three years, though it has remained strong. Unrestricted cash and investments totaled $14.5 million as of March 31, 2014, representing about 292 days of operating expenses on hand. This is down from $18.5 million in Dec. 31, 2011. According to management, the hydroelectric system does not currently have unrestricted cash due to the nature of its 50-year agreement with PG&E that just ended. We understand the district is entering into a loan agreement with Wells Fargo for $25 million, which will provide additional liquidity to the district's operating units, including the hydroelectric system.

During the next five years, the district has plans for about $23.6 million in capital projects for the water and hydroelectric systems. However, it is also developing a water resources management plan, which could lead to changes in its planned water capital projects. In addition, the final FERC relicensing could lead to other hydroelectric projects. According to management, the district will use funds on hand, net revenues, proceeds from the $25 million loan agreement, and potentially additional debt to cover capital projects.

Outlook

The stable outlook reflects our view that the district's approved maximum per-volume water rate provides it some revenue raising flexibility should future available water supplies be volatile. If lower water sales revenue or lower hydroelectric revenues lead to substantially lower-than-projected debt service coverage or if the district were to draw down liquidity to a much weaker level during the next two years, we could lower the rating. As debt service increases during the next two years, if coverage and liquidity remain strong, we could raise the rating.

Related Criteria And Research

Related Criteria

- USPF Criteria: Key Water And Sewer Utility Credit Ratio Ranges, Sept. 15, 2008
- USPF Criteria: Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011

Related Research

U.S. State And Local Government Credit Conditions Forecast, July 8, 2014

Ratings Detail (As Of July 24, 2014)		
Merced Irr Dist Current Interest rfdg rev COP (Water And Hydroelectric Sys Proj) ser 2008A due 09/01/2020		
Long Term Rating	A/Stable	Affirmed

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