S&P Global
Ratings

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Summary:

Marin Municipal Water District Financing Authority, California Marin Municipal Water District; Water/Sewer

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Credit Profile		
US$36.225 mil rfdg rev bnds (Marin Mun Wtr Dist) ser 2016 due 07/01/2040		
Long Term Rating	AA+/Stable	New
Marin Mun Wtr Dist Fincg Auth, California		
Marin Mun Wtr Dist, California		
Marin Mun Wtr Dist Fincg Auth (Marin Mun Wtr Dist) sub lien wtr rev bnds		
Long Term Rating	AA+/Stable	Upgraded
Marin Mun Wtr Dist Fincg Auth (Marin Mun Wtr Dist) WTRSWR		
Long Term Rating	AA+/Stable	Affirmed

Rationale

S&P Global Ratings raised its long-term rating to 'AA+' from 'AA' on the Marin Municipal Water District Financing Authority, Calif.'s subordinate lien 2012 series A water revenue bonds, issued for the Marin Municipal Water District. At the same time, S&P Global Ratings assigned its 'AA+' long-term rating on the authority's series 2016 water revenue refunding bonds, issued for the district. The outlook on all ratings is stable.

Our assessment of the district's general creditworthiness (ICR) reflects our view of the district's extremely strong enterprise risk profile and very strong financial risk profile, as well as the application of our criteria, "Rating Methodology and Assumptions for U.S. Municipal Waterworks and Sanitary Sewer Utility Revenue Bonds," published Jan. 19, 2016, on RatingsDirect.

The series 2016 bonds are being issued to advance refund and restructure the series 2010 bonds for near-term debt service savings. With the full defeasance of the 2010 bonds, which were on a senior lien, there will be only one lien securing the 2012, 2016, and subsequent parity issues. As such, we will no longer notch our long-term rating on the district's subordinate lien bonds to 'AA' from 'AA+'.

The enterprise risk profile reflects our view of the district's:

- Service area participation in the broad and diverse San Francisco Bay Area metropolitan statistical area (MSA) with strong income indicators;
- Pre-approved, two-year rate restructuring plan with an additional multiyear rate authorization planned for late 2016, which together mitigate the effect of decreased water sales and establish a funding plan for the upcoming capital improvement plan (CIP);
- Adequate water supply comprised of 75% local runoff (stored in the district's own reservoirs) and 25% imported

surface water from the Sonoma County Water Agency (SCWA); and
- Strong operational management practices and policies.

The financial risk profile reflects our view of the district's:

- Thin debt service coverage (DSC) in fiscals 2015 and 2016, as calculated by S&P Global Ratings, although financial performance is expected to improve thereafter upon implementation of proposed rate structure modifications;
- Good liquidity position with over half a year of operating cash that, according to the department's forecast, will be maintained and aligned with the department's robust reserve policy;
- Sizable CIP that utilizes a mix of additional leverage and pay-as-you-go funding sources; and
- Strong financial management practices and policies.

As of June 30, 2016, the district had $84.4 million of series 2012 bonds outstanding. The bonds are backed by installment payments made by the district pursuant to an installment sale agreement. A rate covenant and additional bonds test requires the district to generate coverage of at least 1.25x annual debt service; the rate covenant may also include transfers from a Rate Stabilization Fund. This covenant is permissive, in our view, as there is no limitation on the amount of the transfer. A debt service reserve fund will not be funded for the bonds.

Enterprise Risk

The district provides water to residents of southern and central Marin County. The district serves 10 incorporated cities and towns, including San Rafael, Mill Valley, Fairfax, San Anselmo, Ross, Larkspur, Corte Madera, Tiburon, Belvedere, and Sausalito, as well as a large unincorporated area of the county. The service area is largely residential and built out. The district serves a population of approximately 187,500 through about 61,675 service connections. We view the service area's income levels as very strong based on the median household effective buying income in Marin, which were about 164% of the national median for 2015. The county's unemployment rate was most recently 3.3% as of September 2016, significantly below the state's rate of 5.3% and national rate of 4.8%.

Precipitation levels within the district can vary greatly. The district relies on reservoir storage of rainfall runoff captured on the north slope of Mt. Tamalpais for about 75% of its water supply, which is supplemented by water purchases from the Sonoma County Water Agency (SCWA) for the remaining 25% of water consumed each year. The district's rainfall runoff is stored in seven reservoirs, which have a combined capacity of 79,566 acre-feet. SCWA water originates from rainfall that flows into Lake Sonoma and Lake Mendocino, and is released into the Russian River. To ensure the availability of water purchases from SCWA for the next 40 years, the district finalized contract revisions for water purchases from SCWA, effective July 1, 2015, and renewal of the intertie agreement with North Marin Water District (NMWD) for transmission of water purchases from SCWA. The take-or-pay minimum from SCWA is for 5,300 acre-feet per year. We view the district's large storage capacity (and ability to supplement supplies with purchases from SCWA) as important for operational flexibility during dry years.

We view the district's service rates as affordable in the context of the service area's income levels. Effective Jan. 1, 2016, the board approved a two-year rate plan, which is intended to bolster revenue stability through a rate increase and a rate structure modification (total 22% increase; which also shifted rates from a predominantly volumetric structure to a higher percentage of fixed charges) and a Consumer Price Index (CPI) adjustment of up to 4% in fiscal 2017. The revised water rate structure includes fixed monthly charges based on the customer's water meter size and four usage-based rate tiers per 100 cubic feet of water. The rate modification would include an increase in the bi-monthly fixed service charge and the addition of a fixed "Watershed Management Fee". We consider the district's current rates to be affordable at about 1.1% of median household effective buying income (EBI) after annualizing the water bill. The average monthly bill in 2016 is $61.22, assuming an average demand of 810 cubic feet of water. The district also charges connection-fee revenues for new connections.

Based on our operational management assessment, we view the district to be a '2' on a six-point scale, with '1' being the strongest. We view the operational management of the system as good. Organizational effectiveness, management expertise and drought management are good; management communicates the utility's long-term needs and strategic goals to internal and external key officials. Rate-setting practices are strong based on management's pre-approved rate increases and completed cost of service analysis. We understand that a local citizen filed a class action lawsuit against the district on May 26, 2015, which asserts that the district's tiered water rate increases between fiscals 2010 and 2015 represented a financial penalty intended to force conservation and was not a fee for service per Article XIIID of the California Constitution (Proposition 218). The district asserts that its rate structure, as challenged by the petitioner, complied in all respects with Proposition 218. While the district has sufficient reserves to cover the potential financial impact, we believe an adverse legal action could pressure the district's future rates and charges.

Consistent with "Methodology: Industry Risk," published Nov. 19, 2013, we consider industry risk for the district to be very low, the most favorable assessment possible on a six-point scale, with '1' being the best.

Financial Risk

Direct debt service coverage (DSC) for the district's senior and subordinate debt has declined over the past two years to levels that are below average at the current rating level as a result of reduced water sales due to the district's drought management measures and conservation. Direct DSC has historically exceeded 2.0x. However, between fiscals 2014 and 2015, operating revenues declined by 12.5% on a year-over-year basis, as a result of reduced demand without a commensurate decline in operating expenses. As a result, the district realized direct DSC (excluding rate stabilization fund transfers) of 1.01x, which we consider very low in fiscal 2015. Based on mid-year rate increases, direct DSC improved modestly to 1.18x in fiscal 2016 (unaudited.) We also impute an "all-in" coverage calculation, which takes into consideration all of the district's direct debt that is paid from net revenues as well as imputed debt service for water purchases from SCWA. All-in coverage has also been thin during the past two fiscal years, in our view, at 1.01x and 1.17x (unaudited) in fiscals 2015 and 2016.

Based on management's forecast which anticipates an 8.5% rebound in demand in fiscal 2017 and 7% annual rate increases, we anticipate that the district's financial performance will return to levels more in line with historical metrics starting in fiscal 2017. In our view, continued reliance on rate stabilization funds to meet the rate covenant would put downward pressure on the rating.

The district's liquidity position has declined over the past two years but remains at levels we consider good, most recently equivalent to 247 days' of operations. Based on the district's well defined reserve policy and assumed rate increases, we expect the district's unrestricted reserves will be maintained at more than 150 days' of operations over the forecast period. The reserve policy includes targeted minimum levels for its operating fund reserve (90 days), capital and equipment fund reserve ($10 million), and rate stabilization fund (one year of debt service).

The district's five year CIP for fiscals 2017 through 2021 is sizable, and totals $153.0 million, of which $80.0 million will be financed with new debt, $36.0 million on a pay-go-basis through net revenues, $22.5 million through designated fire flow funds, and the remaining $13.5 million with other funds. The capital projects include replacement and upgrade of transmission and distribution system facilities, pump stations, storage tanks, and improvements to the district's water treatment facilities.

Based on our FMA, we view the district to be a '2' on a six-point scale with '1' being the strongest. We view financial management of the system as strong, meaning policies are embedded and are likely sustainable. Interim financial results are produced and shared throughout the year. Also, independently audited financial statements are produced annually.

Outlook

The stable outlook reflects our view that, over the next two years, the district will continue to reap the benefits of mature, primarily residential economic base, and that its revised rate structure will result in an improvement in the district's financial metrics.

Upside scenario

We believe several factors constrain upward potential for the rating in the outlook's two-year timeframe, including the funding of the CIP, the need to pre-approve additional rate increases per the cost of service analysis, and finally we believe the Prop. 218 lawsuit provides an additional layer of uncertainty.

Downside scenario

We could lower the rating if rising costs and debt compromise ratemaking flexibility and financial metrics or cash balances decline during the next two years.