

RatingsDirect®

Summary:

Crescenta Valley Water District, California; Water/Sewer

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Summary:

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Credit Profile

US\$10.395 mil rev COPs ser 2020 dtd 09/10/2020 due 09/01/2050

Long Term Rating

AA-/Stable

New

Rating Action

S&P Global Ratings assigned its 'AA-' long-term rating to Crescenta Valley Water District, Calif.'s anticipated \$10.4 million series 2020 revenue certificates of participation (COPs). The outlook is stable.

The 2020 bonds are being issued to finance approximately \$5 million in construction of certain water capital improvement projects, and to refinance an outstanding 2017 Pacific Western Bank installment payment agreement for debt service savings. We view the bond provisions as credit neutral. The bonds are payable from installment payments that are secured by the district's net revenues of the water system. Key provisions include a rate covenant and additional bond test, both of which is set at 1.25x maximum annual debt service. We understand that the district does not intend to provide a debt service reserve fund for the 2020 bonds, and we do not view this as a material credit risk given the water system's strong liquidity position. The district also operates a wastewater system, but revenues from the wastewater system are not pledged to pay installment payments on the COPs.

Credit overview

The ratings reflect our opinion of the district water system's general creditworthiness and a combination of its very strong enterprise and financial risk profiles. The district has a predominantly residential customer base, with affordable service rates and adequate operational capacity to meet demand. Partly offsetting these credit strengths, in our view, is the system's reliance on imported water supplied by the Metropolitan Water District (MWD) of Southern California, which exposes the district to wholesale water supply increases, although, we recognize the district is working to improve its water supply reliability through local sources in the near future.

S&P Global Ratings acknowledges a high degree of uncertainty related to the effects of COVID-19, including the rate of spread and peak of the outbreak. We believe measures to contain COVID-19 have pushed the economy into recession. Although we consider the water system's financial flexibility could likely be affected by reduced economic activity in the region depending on the length of the recession, in our view, this risk is somewhat mitigated by the system's strong liquidity position, which we believe provides sufficient cushion for short-term disruptions. While we continue to monitor events related to COVID-19, we do not currently anticipate it affecting the system's ability to maintain budgetary balance and make debt service payments. For more information, see "All U.S. Public Finance Sector Outlooks Are Now Negative," published April 1, 2020, on RatingsDirect, and "The U.S. Faces a Longer and Slower Climb from the Bottom," published June 25, 2020.

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

- Substantially built-out bedroom community and service area with access to the broad and diverse Los Angeles-Long Beach-Anaheim, Calif. metropolitan statistical area economy;
- Primarily residential underlying customer base with competitive and affordable service rates, given very strong income levels;
- Very low industry risk as a monopolistic service provider of an essential public utility; and
- Good operational management practices and policies, represented by sufficient water supply to meet future demand, in addition to a focus on long-term water supply reliability.

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

- Improved all-in debt service coverage (DSC) metrics in recent fiscal years from less than 1x coverage (in fiscal years 2015 and 2017), with projections of a strong DSC at more than 2x in the next five years;
- Strong unrestricted liquidity position of about \$10.5 million, or 404 days of operating expenses, for fiscal 2020 (estimated), which we expect to stay strong in the near future despite planned cash-funded portions of the district's capital plan;
- Moderately leveraged system, with a pro forma debt-to-capitalization ratio of about 31% when including the new money portion of the 2020 bonds; and
- Good financial management assessment (FMA), represented by long-term capital planning and formalized reserve policies.

The stable outlook reflects our view that management will continue to adjust rates to fund its capital plan, while maintaining at least strong all-in coverage and liquidity metrics. In addition, our outlook reflects our anticipation that the district will move towards improving its water supply reliability to offset the risk of rising imported water costs. In addition, we believe the district's financial profile could withstand a short-term decline in revenue from changing economic conditions, particularly uncertainty related to COVID-19, and the recession.

Environmental, social, and governance (ESG) factors

Overall, we believe that management has mitigated most of the system's ESG-related risk by adopting, adhering to, and adjusting its operating and financial policies and procedures. The district is currently working on enhancing its local water supply reliability as part of its strategic priorities. The district currently obtains almost 50% of its potable water from MWD. The district also has a capital improvement plan (CIP) to address aging infrastructure needs, and meet long-term infrastructure reliability. Officials plan to make a number of investments across its facilities and distribution network to reduce the system's environmental risks. We understand the system will continue recommending updates to its future rate plans to meet revenue sufficiency in the near future, and we do not believe this will significantly increase affordability pressures or social risks, given the very strong local incomes. We will also continue to monitor any possible pressures on the service area economy due to higher public health and safety risks related to COVID-19, which we view as social risk factors. Finally, we view the system's governance factors, including its long-term planning, and credit-supportive rate-setting practices in line with other similarly rated utilities.

Stable Outlook

Downside scenario

We could lower the rating if all-in coverage significantly declines below management's forecast due to unanticipated and extraordinarily large change in its CIP or higher-than-expected operating costs that could alter related financial metrics, including significant spend down of unrestricted reserves. Moreover, we could lower the rating, if economic and financial metrics are no longer consistent with the rating level, as a result of the dampening effects of the COVID-19 pandemic and recession on local economic activity.

Upside scenario

Due to the COVID-19 pandemic and the recession we do not anticipate raising the rating during the two-year outlook horizon. We could take a positive rating action in the long term, if the district is able to materially widen margins for the system and sustains a track record of stronger levels of all-in coverage on a basis that we believe is commensurate with financial metrics at a higher rating level.

Credit Opinion

Enterprise risk

The district (estimated population of approximately 33,000) is located in the Crescenta Valley area of Los Angeles County in the foothills of the San Gabriel Mountains, approximately 15 miles northeast of downtown Los Angeles. The district includes the unincorporated communities of La Crescenta, Montrose, Verdugo City, and portions of the cities of Glendale and La Canada Flintridge. This stable, bedroom community has access to the deep and diverse Los Angeles metropolitan economy and is characterized by very strong income levels. Income levels are very strong in our view, with median household effective buying income (MHHEBI) for La Crescenta and Montrose at 153% of the national level. The unemployment rate for the county was 19.5% in June 2020 in line with the nationwide trends, and we anticipate pressures on near-term unemployment rates in the region, due to continued containment measures from the pandemic. The district's customer base is stable, primarily residential, and very diverse. The district serves about 8,041 water accounts, and the customer base is primarily built out and more than 90% residential. We consider the customer base to be very diverse based on the leading 10 water customers contributing about roughly 7% of total operating revenue.

We view the system's market position as strong given the affordable service rates in the context of the service area's very strong income metrics, and we believe the district has future rate-setting flexibility. The district bills its customers bi-monthly for water services. The water rates consist of a fixed base rate and a volumetric component per hundred cubic feet of water usage. The average bi-monthly bill for 17,000 gallons of water use for a typical residential customer is \$152.13. We calculate the average monthly-equivalent water bill is about 1.1% of MHHEBI when annualized, which we consider affordable. The pass-through provisions of wholesale costs ensures cost recovery by passing through imported water costs. The district has raised water rates with regularity in recent years and despite these increases, the wealth in the area makes these rates reasonable, in our view. In response to the COVID-19 pandemic, the district is reducing its operating budget and the board elected to defer the fiscal 2021 rate increase. The district anticipates its

next cost-of-service rate study in 2021, and currently projects raising rates by approximately 5% to 6% annually, consistent with prior practice.

We consider the system's operational management to be good under our operational management assessment methodology, which indicates a favorable alignment of operations and organizational goals, although some challenges may exist. The district's potable water supply is reliant on imported water supply, and the district is focusing on long-term water supply reliability. The district is evaluating several cost-effective, alternative water supply options including storm water recharge, conjunctive use, and indirect potable reuse (to optimize groundwater storage and production). Approximately 50% of the district's potable water is obtained from the more expensive MWD imported water through the Foothills Municipal Water District (FMWD). The district's remaining supply is from an adjudicated groundwater basin. The basin has a slightly higher concentration of nitrates, and the district groundwater is generally blended with imported surface water to lower the nitrate levels below the maximum contaminant level. The district currently has adequate water supply to meet demand and, given the built-out nature of the service area, this is likely to remain the case.

In the past, the district was not able to pump its full adjudicated groundwater right due in part to the spread of methyl tert-butyl ether (MTBE) contamination. In 2013, the district settled the MTBE litigation with several oil companies for a total settlement of over \$22 million, which was applied to pay remediation costs and other damages incurred by the district. Based on the remediation and cleanup efforts, management believes that improved water quality in the aquifer has allowed the district to pump its full amount of adjudicated groundwater rights in recent years. Overall, the district has good operational policies including drought and contingency planning, and three emergency interconnections with neighboring utilities. Management undertakes periodic rate studies and updates its CIP annually, which in our view, sets a clear trajectory regarding future capital funding needs.

Financial risk

We view the district's projected all-in coverage as strong and we expect all-in coverage to remain strong given planned rate adjustments in the future. The district's improved all-in DSC metrics in recent fiscal years from less than 1x coverage (in fiscal years 2015 and 2017) is primarily attributed to rate adjustments and a rebound in water demand that enhanced operating revenues. All-in coverage is our internally adjusted DSC metric that we believe best tracks the use of every dollar of utility operating revenue, regardless of lien position, accounting treatment, or ultimate purpose. It also incorporates recognition of fixed charges associated with imported water supply from FMWD (which ultimately comes from MWD), which we define as certain long-term recurring items that are debt-like in nature, even if legally treated as an operating expense (our methodology differs from the indenture-based calculations). Based on the district's audited financial statements, we calculate that all-in DSC averaged about 1.7x in the past three fiscal years, with fiscal 2019 providing about 2.2x all-in coverage.

Based on management's five-year forecast, we anticipate that financial performance will remain strong, with all-in coverage exceeding 2x during the five-year forecast period through fiscal 2025. Key forecast assumptions include annual 6% growth in operating revenues supported by annual rate adjustments during fiscal years 2022-2025, and operating expense growth at an average of 5% annually for most years. In our view, even under scenarios that includes a potential reduced demand and a 5% loss in revenues through the two-year outlook period, we view all-in coverage would remain above 1.6x during the forecast, and we anticipate management to take action to preserve its finances at

levels we consider strong.

The district has maintained a strong liquidity position, and we anticipate it will likely continue to do so despite a planned drawdown for a portion of its capital plan. At fiscal year-end 2019, the district held unrestricted cash and investments of about \$10.8 million, or 404 days of operating expenses. Management estimates the system's unrestricted liquidity at \$10.5 million or 404 days at the end of fiscal 2020. Based on the system's CIP, we understand that it plans to deploy reserves to supplement its capital needs. However, based on management's forecasted cash flows, we anticipate relatively nominal draws on internal operating cash to fund future capital projects, and we anticipate management will continue to maintain sufficient liquidity to meet operations. The district's recent reserve policy calls for a rate stabilization reserve funded at 25% of total water commodity sales, an emergency reserve equal to \$1 million, and working capital equal to three months of operations and maintenance expenses excluding purchased water cost.

The district's CIP is approximately \$18 million during the next five years. Roughly 28% will debt financed through the 2020 revenue COPs, and the remaining portion of the CIP will largely be funded on a pay-as-you-go-basis from excess revenues and reserves. The CIP primarily includes water supply reliability projects, and capital replacement projects to meet aging infrastructure needs in the distribution system. The district's pro forma debt-to-capitalization ratio is moderate, at about 31%, and the district has no plans for additional debt in the near future. The district participates in the California Public Employees' Retirement System and has been making its necessary annual employer contributions. We view the district's annual pension costs as credit neutral to the debt and liabilities profile.

Also supporting the financial risk profile is a good FMA. Revenue and expense assumptions are reasonable, and an annual budget process is conducted with formal monitoring by the board. The district maintains a formalized investment and reserve policy target. The long-term planning process is good, in our view, with financial and capital improvement projections as part of this financing. Financial reports and operational information are relatively easily obtained, and financial statements adhere to generally accepted accounting principles and Governmental Accounting Standards Board standards.

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