

RATING ACTION COMMENTARY

Fitch Upgrades Eastern Municipal Water District, CA's Rev Bonds to 'AAA'; Outlook Revised to Stable

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Fitch Ratings - San Francisco - 24 Nov 2021: Fitch Ratings has assigned a 'AAA' rating to the following obligations issued by the Eastern Municipal Water District Financing Authority (the authority) on behalf of the Eastern Municipal Water District, CA (EMWD or the district):

--\$23.1 million refunding revenue bonds, series 2021 (Eastern Municipal Water District Improvement Districts General Obligation Refunding Bonds).

The bonds are expected to sell via negotiation on or around Dec. 7. Proceeds will be used to refund the Western Riverside Water and Wastewater Financing Authority revenue bonds (Eastern Municipal Water District improvement district general obligation bond financing), series 2005A and 2009.

In addition, Fitch has upgraded the following obligations issued by the district or the authority on behalf of the district to 'AAA' from 'AA+':

--\$812.9 million water and wastewater revenue bonds;

--\$29.1 million Western Riverside Water and Wastewater Financing Authority revenue bonds (Eastern Municipal Water District improvement district general obligation bond financing), series 2005A and 2009 (pre-refunding);

--Issuer Default Rating (IDR) of the EMWD.

The Rating Outlook has been revised to Stable from Positive.

RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕			PRIOR ↕
Eastern Municipal Water District (Riverside County) (CA)	LT IDR	AAA Rating Outlook Stable		AA+ Rating Outlook Positive
	Upgrade			
Eastern Municipal Water District (Riverside County) (CA) /Water & Sewer Revenues (2nd Lien)/1 LT	LT	AAA Rating Outlook Stable	Upgrade	AA+ Rating Outlook Positive
Eastern Municipal Water District (Riverside County) (CA) /Water & Sewer Revenues (3rd Lien)/1 LT	LT	AAA Rating Outlook Stable	Upgrade	AA+ Rating Outlook Positive

[VIEW ADDITIONAL RATING DETAILS](#)

ANALYTICAL CONCLUSION

The upgrade of the bond ratings and IDR to 'AAA' from 'AA+' along with the revision in Outlook to Stable from Positive, reflect the district's continued low leverage, measured as net adjusted debt to adjusted funds available for debt service, within the framework of very strong revenue defensibility and low operating risk. Leverage has declined each of the last four years and stood at 3.6x in fiscal 2021. Fitch expects a modest uptick the next two years

but leverage is expected remain below 5.0x and in line with a 'AAA' rating as indicated in Fitch's base and stress scenarios.

The district maintains rate setting autonomy and a high degree of rate affordability. The system has manageable capital needs largely based upon growth-related expansion, which has been driven by an affordability advantage over nearby coastal regions and the availability of undeveloped land within commuting distance of major Southern California employment centers.

CREDIT PROFILE

As the sixth-largest water district in the state, EMWD provides essential retail water, recycled water, and sewer services to a large and diverse suburban service area in western Riverside County (the county). The service area covers 550 square miles and population of about 850,000, including all or portions of the cities of Temecula, Murrieta, Moreno Valley, Hemet, San Jacinto and Perris, as well as unincorporated areas within the county. The formerly agricultural region suburbanized rapidly in recent decades and is close to Orange, Los Angeles and San Diego Counties.

The district's water supply is about evenly split between local sources and water imported from Metropolitan Water District of Southern California (IDR AA+/Stable). Local water includes recycled water (35% of supply), potable groundwater (11%) and desalinated groundwater (5%). EMWD has invested heavily in local supplies and has long recycled most of its wastewater flows. This provides a highly reliable source of irrigation water that is not subject to interruptions due to weather variability and shifting environmental regulations that constrain imports. The district has also invested in groundwater production, including desalination of brackish groundwater.

Coronavirus Considerations

District revenues and delinquencies have not experienced any material effects from the pandemic.

KEY RATING DRIVERS

Revenue Defensibility 'aa'

High Rate Flexibility; Favorable Service Area Characteristics

The district's board has the legal ability to set rates, which are affordable for the vast majority of the population and expected to remain so for the foreseeable future. All revenues are derived from its monopolistic business lines. Growth within the service area is higher than average, while income levels are about even with the U.S. average.

Operating Risks 'aa'

Very Low Cost Burden and Manageable Capital Needs

The district's operating cost burden is very low despite its reliance upon imported water. Capital needs are manageable with a moderate life cycle ratio supported by annual spending at least equal to depreciation. No additional debt is expected to fund the five-year capital improvement plan (CIP).

Financial Profile 'aaa'

Leverage to Remain Low

The district's low leverage is expected to increase in fiscal 2022 given a budgeted modest decline in operating revenues coupled with an increase in spending and implementation of voluntary annual \$15 million supplemental pension contributions. It will then gradually decline given no additional planned debt and assumed moderate rate increases. The liquidity cushion and coverage of full obligations (COFO) are sound and are considered neutral to the assessment.

Asymmetric Additive Risk Considerations

No asymmetric additional risk considerations affected this rating determination.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Not applicable given the 'AAA' rating.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--A sustained increase in leverage approximating 5.0x or higher provided stable revenue defensibility and operating risk assessments;

--A sustained increase in the operating cost burden approximating \$6,500 per million gallon (mg) or higher could pressure the operating risk assessment, which in turn would tighten the leverage threshold to around 4.0x for the current rating level.

Best/Worst Case Rating Scenario

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

SECURITY

The revenue bonds issued by the district are payable from net revenues on a second lien basis. In addition, the subordinate lien bonds issued by the authority are payable from installment payments from the district to the authority from net revenues on a second lien basis. All outstanding senior lien bonds matured on July 1, 2020, though the lien remains open.

The GO bonds are payable from net system revenues after payment of all revenue bonds (senior and subordinate lien) as well as from available reserves and ad valorem property taxes. The bonds are rated to the water and sewer revenue pledge.

There are no cross-default provisions or acceleration in the event of default within the legal framework of the obligations.

Revenue Defensibility

The district's revenue defensibility is assessed at 'aa'. All revenues are derived from monopolistic businesses of providing essential water and sewer services. In fiscal 2021, the district's largest single revenue source were customer charges at approximately 68%, made up of water sales (39%), sewer sales (27%) and recycled and irrigation water sales (2.4%). Connection fees and property taxes provided about 16% and 12%, respectively, of total revenues.

The district's board of directors has independent rate-setting authority and customer charges are affordable for the vast majority of the population, providing a high degree of rate flexibility. Rates increased 3.7% in fiscal 2021 (effective Jan. 1, 2021) on a combined basis for water and sewer. Projected annual increases for water include volumetric and fixed-rate increases of 1.8% to 4.0% through fiscal 2026 as well as pass-through adjustments for purchased water cost increases of 4% to 5%. Projected annual increases for sewer are 1.8% to 4.0% through fiscal 2026. However, these rates are subject to board approval and the district plans a new cost of service study in 2022 to inform these expected rate increases. This level of annual rate increase is not expected to pressure overall rate flexibility.

Riverside County's affordable housing stock and proximity to employment centers in San Bernardino, San Diego, and Los Angeles counties have driven recent growth. Customer account growth over the past five years has been above average with a five-year CAGR of 1.8%. Wealth levels approximate the U.S. average while unemployment is slightly above the average. The service area will likely continue to grow as it is only about 40% developed. Concentration risk is limited with the top 10 water and sewer customers providing about 5% of operating revenues.

Operating Risks

The district's operating risk is assessed at 'aa'. The operating cost burden has remained under \$5,300 per mg over the last five years despite fluctuations in water production, but is on a slight upward trend. Imported water purchases are the district's largest expense, representing about 20% of operating expenditures. The district plans to make annual \$19 million supplemental pension contributions beginning in fiscal 2022 with a goal of reaching 100% funded within six years. Fitch expects the operating cost burden to increase but remain under the 'aa' threshold of \$6,500 per mg for at least the near term.

The district's life cycle ratio of 38% suggests moderate investment needs. Although the metric has increased modestly over the last few years, the district has been investing in assets with annual capital expenditures equal to at least depreciation. The five-year CIP totals \$534.5 million and is focused on maintenance and growth-related expansion. As such, some projects will not go forward without growth. The district has received grant funding for 50% (about \$45 million) of its Perris North Basin Groundwater Project and plans to fund the remaining CIP projects with connection fees and paygo. It has no plans for additional borrowing over the five-year horizon.

Financial Profile

The district's leverage position is low and expected to decline modestly over the five-year horizon with no additional debt expected. Leverage declined over the last five years with an increase in cash levels and operating margins and amortizing debt, dropping to 3.6x in fiscal 2021. The liquidity profile supports the 'aaa' assessment, with days cash on hand of 632 and COFO (which includes fixed services expenses related to the MWD purchases) at 3.1x at fiscal 2021, or 2.0x excluding connection fees. Fitch-calculated debt service coverage was 4.5x for fiscal 2021.

Fitch Analytical Stress Test (FAST)

The FAST considers the potential trend of key ratios in a base case and a stress case. The stress case is designed to impose capital costs 10% above expected base case levels and evaluate potential variability in projected key ratios. Management's financial projections informed Fitch's base case and reflects expected rate increases through fiscal 2026, annual discretionary payments of about \$15 million towards a trust for its pension liabilities, as well as water purchase cost increases. The district's CIP is also incorporated into the forward look.

Using these assumptions, leverage increases in fiscal 2022 to 4.3x in the base and stress cases before gradually declining by fiscal 2026 to approximately 3.3x and 3.6x in the base and stress cases, respectively. The planned supplementary contributions to the pension trust do not reduce leverage in the near term as they will appear as an asset on the district's balance sheet until such time as the district transfers the trust to the pension administrator to reduce the net pension liability. Leverage is expected to remain below 5.0x and the inclusion of these contributions in the metric would likely reduce leverage even further.

Asymmetric Additive Risk Considerations

No asymmetric additive risk considerations affected this rating determination.

Sources of Information

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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APPLICABLE CRITERIA

[U.S. Water and Sewer Rating Criteria \(pub. 18 Mar 2021\) \(including rating assumption sensitivity\)](#)

[Public Sector, Revenue-Supported Entities Rating Criteria \(pub. 01 Sep 2021\) \(including rating assumption sensitivity\)](#)

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