

# RatingsDirect®

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## Summary:

# Eastern Municipal Water District, California; Water/Sewer

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## Summary:

# Eastern Municipal Water District, California; Water/Sewer

### Credit Profile

US\$214.085 mil rfdg wtr and wastewtr rev bnds (Eastern Municipal Water District) ser 2020A due 07/01/2047

*Long Term Rating*

AA+/Stable

New

## Rating Action

S&P Global Ratings assigned its 'AA+' long-term rating to Eastern Municipal Water District, Calif.'s series 2020A refunding water and wastewater revenue bonds. At the same time, we affirmed our 'AA+' long-term rating on the district's existing senior-lien and subordinate-lien water and wastewater revenue bonds. We also affirmed our 'AA-' long-term rating and underlying rating (SPUR) on Western Riverside Water and Wastewater Financing Authority, Calif.'s series 2005A and series 2009 bonds.

Finally, S&P Global Ratings affirmed its:

- 'A-1+' short-term rating on the district's series 2015A bonds;
- 'A-1' short-term rating on the district's series 2017A and B, and series 2018A; and
- 'AA+' long-term component of our dual rating on the district's variable-rate demand bonds.

The outlook, where applicable, is stable.

The district is issuing the series 2020A bonds to refund all or portions of its existing series 2015A, 2017A, 2017B, and 2018A bonds. The district is considering de-risking a portion of its variable rate portfolio with fixed-rate debt. In addition, the district may terminate its LIBOR interest rate swap in connection with the 2020 issuance if market conditions warrant. We view the bond provisions as credit neutral. The series 2020A bonds are secured by a subordinate lien on the net revenues of the district. Key bond provisions include a rate covenant and an additional bonds test, both of which are set at 1.10x aggregate annual debt service. While management has chosen not to establish a debt service reserve fund for the series 2020A bonds, the system's financial profile, including extremely strong liquidity, precludes any credit risk.

The rating on the district's subordinate-lien bonds reflects our view of the district's 2020 financing plan, which will result in all of the district's outstanding debt being on the subordinate lien (or working lien). The remaining senior lien bonds mature in fiscal 2021, and the district has no plans to issue any additional debt on the senior-lien. Therefore, we have equalized the rating on the subordinate-lien bonds with that on the senior-lien bonds as we believe that the subordinate-lien debtholders are no longer materially disadvantaged.

The rating on the authority's bonds is based on application of our criteria, "Issue Credit Ratings Linked To U.S. Public

Finance Obligors' Creditworthiness," published Jan. 22, 2018, on RatingsDirect. In particular, the rating on the authority's bonds is two notches below the district's issuer credit rating based on the district's pledge to use legally available funds to make up for any deficiencies in the authority's debt service payments.

### **Credit overview**

The rating reflects our opinion of the district's general creditworthiness and a combination of its very strong enterprise risk profile and extremely strong financial risk profile. The strength of the system's financial metrics provides a strong cushion, in our view, to mitigate short-term disruptions from the COVID-19 related recession.

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. We believe the district's revenues may decline somewhat for fiscal 2020 or beyond, though ultimately our expectation is that management will continue to manage the system and maintain strong coverage levels. The system, as of fiscal 2019, also has over 500 days cash on hand, which we believe provides sufficient cushion for short-term disruptions. In addition, in the most recent fiscal year, write offs were only 0.1% of the total revenue. Even if that were to increase tenfold as a result of the economic downturn and moratorium on shutoff remedies, this would amount to only 1% or an approximately \$2.5 million increase in receivables, which would not have a meaningful influence on liquidity. Additionally, management has instituted its contingency plans to ensure minimal disruptions in service provided. While we continue to monitor events related to COVID-19, we do not anticipate it affecting the system's ability to maintain budgetary balance or debt service payments.

Although western Riverside County continues to demonstrate a continued modest growth, in our view, growth within the service area remains highly cyclical. We recognize that management has historically adjusted its connection fees in part to provide a buffer during low development years. Even so, we believe that dramatic growth in connections followed by depressed development makes predicting new developments and infrastructure capital planning difficult, which could be a credit risk over the medium-term planning horizon. However, in the event that connection fees or other growth-related revenues decline from management's current projections, we expect management would adjust rates to ensure all-in coverage remains at levels we consider extremely strong in the near future. We also believe that the district's future financial performance is further stabilized by its diverse revenue stream--including property taxes and standby charges--that insulates revenues from conservation and other factors impacting demand.

The stable outlook reflects our opinion of the district's strong service area characteristics coupled with its operational and financial flexibility, thereby producing financial metrics consistent with the current rating level. During the two-year outlook period, we anticipate that the district will continue implementing additional rate increases while adjusting plans annually to take into consideration actual service area growth and service demands. In addition, we anticipate the extremely strong financial profile could withstand a short-term decline in revenue from challenges, particularly uncertainty related to COVID-19, and the ensuing recession.

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

- Service area participation in the broad and diverse Riverside-San Bernardino-Ontario metropolitan area economy;
- Very low industry risk as a monopolistic service provider of an essential public utility;

- Track record of annually reviewing and adjusting service rates to produce consistent financial performance; and
- Good operational management practices and policies.

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

- Extremely strong historical all-in coverage metrics of more than 1.8x during the past three fiscal years, which we believe will be sustainable going forward;
- Very strong liquidity position based on unrestricted cash and investments equivalent to 528 days of operating expenses at the end of fiscal year 2019;
- Moderate leverage level based on about \$1 billion of existing debt in combination with a capital plan that is anticipated to be funded primarily on a pay-as-you-go basis; and
- Strong financial management practices and policies.

### **Environmental, social, and governance (ESG) factors**

Overall, we believe that management has mitigated most of the district's ESG-related risk by adopting, adhering to, and adjusting its operating and financial policies and procedures. We view the district's environmental, social, and governance factors as not being significantly different from those of its peers. The district has detected perfluorooctanoic acid and perfluorooctane sulfaonic acid (collectively known as PFAS) in a couple of groundwater wells at levels that exceed new health advisory levels, which we do not anticipate will have a meaningful influence on the district's water supply, given that management estimates less than 2% of total water supply will be affected. The district has a strong management team which mitigates governance risks when compared to peers -- Management provides a framework for making a number of investments across its facilities and distribution network to reduce the system's environmental risks. The district is also invested heavily in local supplies, including recycled water (comprising 36% of the district's total water supply), which mitigates elevated drought related risks in the region. The district's allocation budget-based rate structure ensures cost recovery by passing through imported water costs into more expensive tiers as usage changes, and insulates water sales reduction during droughts. We understand the district will continue recommending updates to its future rate plans to meet revenue sufficiency in the near future, and we do not anticipate this will significantly increase affordability pressures or social risks, given the monthly combined bill is about 2.4% of local income levels.

## **Stable Outlook**

### **Downside scenario**

We could take a negative rating action if the district materially spends down its cash reserves or if the district's financial performance significantly and unfavorably deviates from its forecast. In addition, any unexpected economic or financial shock from the dampening effects of the COVID-19 pandemic and the ensuing recession, which could potentially significantly disrupt the system's operations, or any unanticipated and extraordinarily large change in the CIP that could alter related financial metrics, could present downward pressure on the rating or outlook at any time.

## **Upside scenario**

Due to the COVID-19 pandemic and ensuing recession we do not anticipate raising the rating during the outlook horizon. We could take a positive rating action in the long term, if the district's financial metrics increases to a level that we would consider exceptionally strong and sustainable, such that it overrides risks related to the district's enterprise risk profile.

## **Credit Opinion**

### **Enterprise risk**

The district is located in the western third of Riverside County and encompasses 555 square miles. The service area population is about 839,000 with retail water service provided within the cities of Moreno Valley, Menifee, Murrieta, and Temecula, and certain unincorporated areas within the county; wholesale water service is provided within the cities of Hemet, San Jacinto, and Perris, as well as to Lake Hemet Municipal Water District, Nuevo Mutual Water Co., Western Municipal Water District, and the California Department of Water Resources. We consider income indicators in the service area to be mixed but generally good to strong, with the median household effective buying income ranging from a low of 67% of the national median in Hemet to a high of 141% in Temecula.

Since 2010, new connections have slowly been increasing; but they remain well below the peak levels of new developments seen in the early 2000s. As the population within the service area continues to grow, the characteristics of the service area are also continually changing. We understand that tract homes, commercial centers, and new industrial warehouses are replacing areas of agriculture and vacant land. Management indicates the district's total population is projected to grow by over 500,000 people during the next 25 years, an approximately 60% increase from the current population.

The district has adjusted its service rates annually during the past decade, and management forecasts this trend to continue during the next five years. Furthermore, the use of budget-based rates has insulated the district's financial performance from decreasing water volumes during the past several years. Management adjusts the water budgets to achieve changes in customer behavior by sending stronger pricing signals when additional conservation is required. Customers who elect to use water beyond their budgets pay the highest prices for water that is over their budgeted use. Management indicates that the average consumption for a typical single family home has declined from 1,800 cubic feet of water a month to approximately 1,500 cubic feet a month from conservation with minimal impact to the district's net margins. We calculate an average monthly-equivalent combined bill of approximately \$106 (in fiscal 2020), or about 2.4% of MHHEBI when annualized, which we consider moderately affordable.

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, even if some challenges exist. Approximately 51% of the district's total water supply comes from local sources, including approximately 10% from potable groundwater, approximately 6% from groundwater that must undergo desalination treatment to be used as potable water and approximately 36% from recycled water. The remaining 49% of the district's water supply is imported from the Metropolitan Water District of Southern California (MWD). In our view, management is focused on securing a diversified long-term water supply that is appropriate in both quantity and quality to serve the existing and

likely future customer base. The district currently has adequate sewer treatment capacity that is sufficient to meet its average and peak day demand. The district has detected PFAS in a couple of groundwater wells at levels that exceed new health advisory levels. We recognize the regulatory landscape is becoming more stringent with respect to various contaminants, while we do not anticipate it will have a meaningful influence on the district's water supply, given that management estimates less than 2% of district's water supply will be affected. The United States Air Force, the designated responsible party, has entered into agreements with the district to fund water supply replacement and well treatment.

### **Financial risk**

As calculated by S&P Global Ratings, the district achieved extremely strong all-in coverage (across both liens, and including off-balance-sheet obligations) of over 1.9x in the past three fiscal years. The district's strong financial performance is somewhat reliant on development activity, as demonstrated by the all-in coverage metrics excluding one-time developer fees of 1.2x in recent years. Management's financial forecast, which we view as reasonable, indicates consistent financial metrics similar to historical levels through fiscal year 2024.

We calculate an "all-in" coverage metric that considers imputed debt service that is implicitly passed on to the district from its wholesale water suppliers. Based on the contractual relationship with MWD, the district does not have any take-or-pay minimum water sales payments. Instead, we assume that approximately 30% of the district's imported water costs go to pay a portion of MWD's direct debt service and fixed costs related to the State Water Project, therefore we also imputed 30% of the district's imported water costs in lieu of an explicit fixed cost to arrive at our all-in coverage metric. We expect all-in coverage (including off-balance sheet obligations to MWD) to exceed 1.8x through 2024. Management's projections, however, incorporate increasing connection fee revenue as a result of projected growth in the customer base. We performed a number of stress scenarios, including management's base case and more extreme scenarios that includes a significant decline in connection fees for 2020 and 2021. For example, growth-related connection fees have more than doubled since the Great Recession, and under our stress case scenario (including a 50% haircut to connection fees for 2020 and 2021), we calculate all-in DSC will continue to remain above 1.4x, levels we consider strong. If new connections do not meet the district's projections, we believe coverage could be pressured.

The district has also historically held an extremely strong liquidity position in part to serve as a natural hedge against its variable-rate debt exposure. Based on the district's audited financial statements and information provided by management, the district held approximately \$300 million of unrestricted cash and investments, equivalent to 528 days of operating expenses, at the end of fiscal year 2019. We understand the district does not plan to materially spend down cash reserves, and we view strong reserves as necessary to manage any contingent liabilities related to its variable-rate bonds.

We view the district's leverage level as moderate, and we believe the district's five-year capital improvement plan (CIP) is manageable. The five-year CIP totals \$398 million, of which about 64% will be funded on a pay-as-you-go basis and the remainder with previously issued debt and state loans. We consider the district's debt-to-capitalization ratio moderate, at about 40%. The district participates in the California Public Employees' Retirement System and has been making its necessary annual employer contributions. We view the pension and other post-employment benefit costs as credit neutral to the debt and liabilities profile.

Based on our Financial Management Assessment methodology, we view the district to be a '1' on a six-point scale, with '1' being the strongest. The management team in our view maintains most of the best practices deemed critical to supporting credit quality and these are well embedded in the system's daily operations and practices. Formal policies support many of these activities, adding to the likelihood that these practices will be continued into the future and transcend changes in the operating environment or personnel. This includes perpetual budget monitoring and regular reporting, a well-defined cost of service study that supports the district's financial forecast, a comprehensive debt policy, and an adopted reserve policy that we believe supports strong liquidity levels and articulates the rationale for maintaining its various reserves.

Currently, about 63% of the district's revenue-backed bonds are fixed rate, 30% is unhedged variable rate, and 7% is variable-rate debt hedged with two floating-to-fixed-rate swaps. Both floating rate notes have a mandatory tender in September 2021, ahead of LIBOR's discontinuation. As of June 30, 2019, the mark-to-market value of the two swaps (which hedge \$68.2 million in variable-rate debt) was negative \$7.9 million. Regularly scheduled swap payments for both swaps are on parity with the subordinate-lien bonds. With the district's extremely strong cash balance, we do not view its interest rate exposure to be a material credit weakness. However, should the district's unrestricted cash reserves continue to decline, we would reassess our opinion of the district's interest rate exposure from variable-rate debt. In addition, we view the district's debt optimization strategy and plans to de-risk a portion of its variable rate portfolio with fixed-rate debt (as part of this 2020 debt issuance)--which could reduce the unhedged variable rate debt to 6% -- as credit positive. Given the rating level, exceptional management practices, and very robust transparency and disclosure, we view the district as having strong market access, all of which support the district's credit quality.

Ratings Detail (As Of April 24, 2020)		
Eastern Mun Wtr Dist WTRSWR <i>Long Term Rating</i>	AA+/Stable	Affirmed
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Eastern Mun Wtr Dist WTRSWR <i>Long Term Rating</i>	AA+/Stable	Affirmed
Eastern Mun Wtr Dist WTRSWR <i>Long Term Rating</i>	AA+/A-1+/Stable	Affirmed
Eastern Mun Wtr Dist WTRSWR <i>Long Term Rating</i>	AA+/Stable	Affirmed
Eastern Mun Wtr Dist WTRSWR <i>Long Term Rating</i>	AA+/Stable	Affirmed
Eastern Mun Wtr Dist WTRSWR <i>Long Term Rating</i>	AA+/A-1/Stable	Affirmed
Eastern Mun Wtr Dist WTRSWR <i>Long Term Rating</i>	AA+/A-1/Stable	Affirmed
Eastern Mun Wtr Dist WTRSWR <i>Long Term Rating</i>	AA+/Stable	Affirmed

Ratings Detail (As Of April 24, 2020) (cont.)		
Eastern Mun Wtr Dist WTRSWR		
<i>Long Term Rating</i>	AA+/Stable	Affirmed
Eastern Mun Wtr Dist WTRSWR		
<i>Long Term Rating</i>	AA+/A-1/Stable	Affirmed
Western Riverside Wtr & Wstwtr Fincg Auth WTRSWR		
<i>Long Term Rating</i>	AA-/Stable	Affirmed
Western Riverside Wtr & Wstwtr Fincg Auth (Eastern Mun Wtr Dist Imp Dist GO Bnd Fincg) (ASSURED GTY)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
Many issues are enhanced by bond insurance.		

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