

RatingsDirect®

Summary:

Eastern Municipal Water District, California; Water/Sewer

Primary Credit Analyst:

Malcolm N D'Silva, Centennial + 1 (303) 721 4526; malcolm.dsilva@spglobal.com

Secondary Contact:

Jenny Poree, San Francisco + 1 (415) 371 5044; jenny.poree@spglobal.com

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Summary:

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Credit Profile

US\$53.28 mil rfdg wtr & wastewtr rev bnds ser 2021A due 07/01/2030		
<i>Long Term Rating</i>	AA+/Stable	New
US\$48.155 mil rfdg wtr & wastewtr rev bnds ser 2021B due 07/01/2046		
<i>Long Term Rating</i>	AA+/Stable	New
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

Rating Action

S&P Global Ratings assigned its 'AA+' long-term rating to Eastern Municipal Water District, Calif.'s series 2021A and 2021B 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 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 2021A and B bonds to refund all of its existing series 2018B and 2018C bonds, which are currently in variable rate mode with the 2018B bonds synthetically fixed through a swap agreement. For the series 2021A, depending on market conditions, management has indicated that it is considering either refinancing all or a portion of the 2018B floating rate notes with fixed rate debt and simultaneously terminating all or a portion of the associated LIBOR interest rate swap or alternatively enter into an unhedged floating rate note agreement payable based on SIFMA. For the series 2021B, the district plans to leave the series 2018C in floating rate note mode payable based on SIFMA.

We view the bond provisions as credit neutral. The 2021 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 1.15x aggregate annual debt service. While management has chosen not to establish a debt service reserve fund for the 2021

bonds, the system's financial profile, which includes unrestricted liquidity that has been no less than \$275 million since 2018, lessens any credit risk in our view.

The rating on the district's subordinate-lien bonds reflects our view of the district's financing plan, which resulted in all of the district's outstanding debt being on the subordinate lien (or working lien). The senior lien bonds have matured on July 1, 2020, 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 Western Riverside Water and Wastewater Financing Authority's series 2005A and series 2009 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. Like many utilities in Southern California, the district has been balancing its water supply portfolio with diversification from local sources (49% of total supplies) to navigate growth pressures and supply risks from volatile hydrological conditions in the state. In our view, the district will likely remain dependent on imported supplies provided by Metropolitan Water District of Southern California (MWD) water (pursuant to a long-term water supply contract). We view the district's enterprise profile may likely be challenged by the rising contractual water costs in the future as MWD plans to fund a significant portion of the California WaterFix (the proposed delta conveyance project).

In recent years, the service area growth 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. Although Riverside County continues to demonstrate a continued modest growth, in our view, historical growth within the service area has been cyclical. We recognize that management has historically adjusted its connection fees in part to provide a buffer during low development years. 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 strong in the near future. Moreover, near-term forecasted financial and affordability metrics benchmark well to those of its peers at the 'AA+' rating level.

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 adjust its rate plans annually to take into consideration actual service area growth and service demands, while maintaining its very strong liquidity.

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 district has adequate capacity for both systems to meet demand over the medium-term horizon, and it follows a comprehensive drought management plan to mitigate water supply risks in the near future.

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

- Very 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 based on management's financial forecast;
- Very strong liquidity position based on unrestricted cash and investments equivalent to about 593 days of operating expenses at the end of fiscal year 2020, which we believe is sustainable in the near term, despite the planned utilization of cash to fund capital needs;
- Moderate leverage level based on approximately \$1 billion of existing debt generating slightly less than 40% debt-to-capitalization 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 under our Financial Management Assessment (FMA) methodology. We view positively the district's financial policies and robust, long-range capital and financial planning, which ultimately support a stable financial profile. The district has a comprehensive long-term capital improvement plan (CIP) for continued investment in renewal and replacement, facility improvements and required growth projects.

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. However, given its location in California, we view the district as facing slightly above average environmental risk due to the region's inherent water supply scarcity from natural cycles of drought, wildfire, and seismic exposure. In particular, its imported water supply (from the State Water Project) remain susceptible to environmental scrutiny and risks related to climate change, rising temperatures, and shifting precipitation patterns. The district has a comprehensive resource plan, which has assisted in its ability to navigate different hydrological conditions. The district is also invested heavily in local supplies, including recycled water (comprising 37% of the district's total water supply), which mitigates elevated drought related risks in our view. In addition, 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 1% of total water supply will be affected. With respect to seismic, wildfire, and cyber risks, management has robust emergency planning to address these event risks in a timely manner.

The district has strong management and financial policies 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'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 update its future rate plans, 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. Although there have not been any limitations on water demand in the service area or noted COVID-19 outbreaks at this time, we believe there are public health and safety risks due to the pandemic.

Stable Outlook

Upside scenario

Any potential for an upgrade in the next two years would be based on an significant economic improvements leading to growing incomes that outpaces rising contractual water costs, combined with the system's maintenance of strong all-in coverage (without growth-related connection fees--which yield a degree of cyclicity in coverage) at levels exceeding current metrics. We could take a positive rating action in the long term, if the district's financial metrics improve to a level that we would consider sustainable as it approaches build-out, such that it overrides our view of risks related to the district's rising water costs on sustained rate affordability within its service area.

Downside scenario

We could take a negative rating action if the district materially spends down its cash reserves such as from financial performance that significantly and unfavorably deviates from its forecast or if there is a material erosion in its affordability metrics as a result of economic factors. In addition, any unexpected economic or financial shock, which could potentially significantly disrupt the system's operations, or any unanticipated large change in the CIP that could alter related financial metrics, could present downward pressure on the rating at any time.

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 850,000 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 (MHHEBI) 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 anticipates total population 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. We calculate an average monthly-equivalent combined bill of approximately \$106 (in fiscal 2021), 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. 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 1% 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. Management noted that one of the wells have been placed back in service after wellhead treatment services were completed. During this process, the district worked closely with the Department of Defense and was ultimately reimbursed approximately \$11 million for the overall cost.

Financial risk

As calculated by S&P Global Ratings, the district achieved very strong all-in coverage (across both liens, and including off-balance-sheet obligations) of over 1.8x 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 about 1.2x in recent years. Management's financial forecast, which we view as reasonable, indicates consistent financial metrics similar to historical levels through fiscal 2025.

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 calculate 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 impute 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 2025. Management's projections incorporate increasing growth-related connection fee revenue as a result of projected growth in the customer base. We performed some stress scenarios, including management's base case and more extreme scenarios that includes a significant decline in connection fees for the forecasted period. 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), we calculate all-in DSC will average 1.4x, levels we consider good-to-strong. If new connections do not meet the district's projections, we believe coverage could likely be pressured.

The district has also historically held a very 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, the district held approximately \$355 million of unrestricted cash and investments, equivalent to 593 days of operating expenses, at the end of fiscal 2020. 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 CIP is manageable. The five-year CIP totals \$546 million, of which about 80% 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 slightly less than 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.

Currently, about 78% of the district's revenue-backed bonds are fixed rate, 15% is unhedged variable rate, and 7% is variable-rate debt hedged with one floating-to-fixed-rate swaps. As of April 20, 2021, the mark-to-market value of the swap (which hedge \$52.7 million in variable-rate debt) was approximately negative \$10 million. Regularly scheduled swap payments for both swaps are on parity with the subordinate-lien bonds. With the district's very 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 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 2021 debt issuance)--which could further reduce the unhedged variable rate debt to 12%--as credit positive. Given the rating level, strong financial management practices, and robust transparency and disclosure, we view the district as having strong market access, all of which support the district's credit quality.

Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

Ratings Detail (As Of April 27, 2021)		
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+/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

Ratings Detail (As Of April 27, 2021) (cont.)

Eastern Mun Wtr Dist WTRSWR

Long Term Rating

AA+/A-1/Stable

Affirmed

Eastern Mun Wtr Dist Fincg Auth, California

Eastern Mun Wtr Dist, California

Eastern Mun Wtr Dist Fincg Auth (Eastern Mun Wtr Dist) rfdg wtr and wastewtr rev bnds

Long Term Rating

AA+/Stable

Affirmed

Many issues are enhanced by bond insurance.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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