S&P Global Ratings

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Summary:

Otay Water District Financing Authority, California
Otay Water District; Water/Sewer

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Credit Profile		
US$35.3 mil wtr rev bnds (Otay Wtr Dist) ser 2018A due 09/01/2043		
Long Term Rating	AA/Stable	New
Otay Wtr Dist wtr		
Long Term Rating	AA/Stable	Affirmed
Otay Wtr Dist Fincg Auth, California		
Otay Wtr Dist, California		
Otay Wtr Dist Fincg Auth (Otay Wtr Dist) wtr		
Long Term Rating	AA/Stable	Affirmed

Rationale

S&P Global Ratings assigned its 'AA' long-term rating to Otay Water District Financing Authority, Calif.'s series 2018A water revenue bonds, issued for Otay Water District. At the same time, we affirmed our 'AA' long-term rating and underlying rating (SPUR) on the district's existing certificates of participation (COPs) and revenue bonds. The ratings reflect, in our opinion, the combination of a very strong enterprise risk profile and a very strong financial risk profile. The outlook on all ratings is stable.

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

- Service area participation in the broad and diverse San Diego metropolitan area economy;
- Very low industry risk with a monopolistic provision of potable and recycled water within its service area;
- Demonstrated ability and willingness to increase rates, although service rates exhibit moderately low affordability in the context of the service area's strong income levels and above-average county poverty rates; and
- Good operational management policies and practices.

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

- Good historical all-in coverage metrics that we believe will continue, based on the district's five-year forecast and revenue requirements;
- Strong liquidity position that we believe is sustainable and aligned with the district's robust reserve policy;
- Moderate leverage with no plans for additional borrowing to fund the approximately $82 million, six-year capital improvement program (CIP); and

- Strong financial management policies and practices.

The series 2018A bonds are being issued for construction and capital improvements of the district's water system facilities and to refinance the district's outstanding series 1996 COPs. As of September 2018, the district had approximately $47 million in existing water revenue bonds, about $2.8 million in existing general obligation bonds, and $6.9 million in outstanding series 1996 COPs.

We view the bond provisions as credit neutral. The bonds are secured by the net revenues of the district's water system and property taxes collected for operations. Key bond provisions include a rate covenant set at 1.25x annual debt service and an additional bonds test requiring at least 1.25x coverage of existing and proposed parity debt. While we understand that the district does not plan to provide a debt service reserve for the series 2018A bonds, the system's financial profile, including strong liquidity, precludes any credit concern.

Enterprise risk

Otay Water District encompasses roughly 125 square miles in southern San Diego County immediately east of the San Diego metropolitan area. The district estimates the service area population to be about 223,000, the majority of whom reside within the city of Chula Vista. The district is about 72% built out and management anticipates continued residential development in the service area. Based on the San Diego Association of Governments' 2050 Regional Growth Forecast, the district estimates that the service area population will grow at a moderate rate to about 308,000 by 2035. Access to the broad and diverse San Diego metropolitan area economy provides district residents with numerous employment opportunities, as reflected in the area's strong income indicators, and recent below-average county unemployment rates. The median household effective buying incomes (MHHEBIs) for Chula Vista and San Diego County are 121% and 122% of the national median, respectively. The county's unemployment rate was 4% (not seasonally adjusted) for calendar 2017, and most recently stood at 3.5% for July 2018, which is in line with the state's and nation's rate during this period.

The district serves a stable, primarily residential, and very diverse customer base. During the past five fiscal years, system connections have remained relatively flat and totaled 50,625 in fiscal 2018. We consider the customer base to be primarily residential based on residential customers accounting for about 90% of system connections and about 50% of water consumption. The district's customer base is also very diverse, in our opinion, as the 10 leading customers pay about 12% of water sales revenues and the leading customer, the city of Chula Vista, pays about 4.6% of water sales revenues.

We view the district's market position to be strong in the context of the service area's strong income levels and slightly above-average county poverty rates, although service rates exhibit moderately low affordability in our opinion. The district reports that a typical residential customer uses about 1,300 cubic feet of water per month, which generates a monthly water bill of $84.25 currently. After annualizing this amount, it represents about 1.7% of the service area's MHHEBI, which we view as exhibiting moderately low affordability. The county poverty rate as reported by the U.S. Department of Agriculture is 14.7%, which we understand makes the water system rates less affordable for a portion of the district's customer base. In our view, the need for consistent rate increases has historically been driven by the continually rising wholesale water costs. Except for fiscal 2018, the district raised rates annually during the past decade and twice during fiscal 2016. We understand that the district completed a cost of service rate study in 2017 and approved a five-year rate plan. The current rate authorization provides management the ability to raise rates by up to 10% each year, with additional flexibility to pass through higher wholesale water costs to the customer base without limitation. We understand that the district also updates a six-year rate model annually and that the board reviews and adjusts rates on an annual basis. Effective January 2019, the district's forecast includes rate increases of 3.2% annually in each of the next four years. Management reports that there have not been any material payment delinquencies.

Based on our operational management assessment, we view the district to be a '2' on a six-point scale, with '1' being the strongest. This indicates, in our view, that operational and organizational goals are generally well aligned, even if some challenges exist. The district relies on expensive imported water purchases for the majority of its water supply, although it plans to diversify its potable water supply in the near future. For potable water, the district currently purchases virtually all of its supply from San Diego County Water Authority (SDCWA), the local member agency of the Metropolitan Water District (MWD) of Southern California. SDCWA supplied about 27,000 acre-feet of water to the district in fiscal 2017, which represented roughly 6.4% of total SDCWA water supplies. The variable cost of this water supply increased by an average annual rate of approximately 6% during the past five years to an estimated $1,600 per acre-foot for 2019. Management anticipates that this wholesale rate will continue to rise by roughly 6% annually through fiscal 2023. These variable costs are in addition to monthly fixed charges that the district pays to access SDCWA'ss water supply. More recently, potable water purchases have increased by about 6% and 10% in fiscal years 2017 and 2018 from a low point in fiscal 2016, due in part to an abatement in water use restrictions.

In addition to potable water, the district produces and purchases reclaimed water for distribution to customers for landscape irrigation and other nonpotable purposes. Reclaimed water accounts for about 12% of the district's water supply, and the sale of reclaimed water benefits the district by offsetting the need to purchase expensive potable water for this purpose. A portion of the reclaimed water supply is purchased from the city of San Diego on a take-or-pay basis. Looking at alternative water supply in the region, we understand that there may be a potential desalination project in Mexico; however, currently management reports that the district is not part of this project. Management has reasonable expertise and experience to manage the utility system, and we believe that its rate-setting practices have been strong with a pre-approved rate plan.

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

Financial risk

The water system's all-in coverage metrics have been good during the past three fiscal years, and we anticipate that the district's financial performance will be maintained going forward. Based on the district's financial statements, we calculate that during the past three fiscal years, the water system's debt service coverage (DSC) improved to about 3.2x for fiscal 2018 (unaudited) from about 1.7x for fiscal 2016. The improved performance during this period was driven primarily by implemented rate adjustments in 2016 and 2017 that widened operating income margins despite lower water demand in fiscal 2016. Because the district relies on SDCWA and MWD for its imported water supply, we calculate an all-in coverage metric that accounts for the imputed debt service related to these agencies and is implicitly passed on to the district through wholesale water rates. After using the district's proportionate share of SDCWA and MWD water sales revenues to impute the district's share of its wholesalers' debt service, we calculate that all-in coverage ranged from about 1.2x for fiscal 2016 to about 1.7x for fiscal 2018 (unaudited). Based on management's forecast, which incorporates the projected rate increases, we anticipate that the district's financial performance will be good with the maintenance of an average all-in DSC of about 1.5x in the next five fiscal years. We view management's forecast to be reasonable given the recent updated rate authorization and no additional debt plans.

The water system's liquidity position has historically been strong, and we anticipate that it will remain strong going forward despite a recent draw down in cash reserves to prepay part of its existing unfunded pension liability. During the past three fiscal years, the district has reported no less than $45 million of unrestricted cash and investments at fiscal year-end for the water system, equivalent to about 200 days of operating expenses. In addition, management reports that the district held board designated reserves that could be used for operations as needed. The combined unrestricted and board designated cash and investments totaled $72 million, or about 343 days of operating expenses at the end of fiscal 2017, which we consider strong. Management's reports that cash reserves were deployed to prepay about $30 million of its existing pension obligation which will reduce combined reserves to $52 million or 217 days of operating expenses at the end of fiscal 2019. We anticipate that liquidity will continue to remain strong despite this drawdown in cash and after considering future CIP needs.

The six-year CIP for the water system is manageable, in our view, with no negative implication to financial metrics, and includes $82 million of projects for the water system. The CIP is broadly categorized as expansion projects ($6 million), betterment projects ($8.8 million), replacement projects ($66.7 million), and new supply projects ($47,000). We understand that management does not anticipate any additional borrowing to fund the CIP; officials stated that in addition to the $28 million in new money funding from this bond issuance, about $6 million of developer fees are included as a source along with $48 million of surplus revenues and reserves. We view the system as having a relatively moderate leverage position based on a 25% debt-to-capitalization ratio. In addition, the district participates in the California Public Employees' Retirement System and has been making its necessary annual employer contributions. With the recent prepayment to reduce the unfunded pension actuarial liability, the district projects its funding level to improve to about 88%, which we view as favorable. We understand the pension prepayment will also reduce its annual pension payment contributions by about 50% over the next few years, and we view the lower annual pension contribution as benefiting the district's total operating cost structure in the near future.

Based on our financial management assessment, we view the district to be a '1' on a six-point scale, with '1' being the strongest. We believe that the district's practices are strong, comprehensive, and support high credit quality. Revenue and expenses assumptions are reasonable, and interim financial reporting is provided to the district through monthly reports to the district board. The long-term planning process is rigorous, and the detailed six-year plan is regularly updated. The district has an adopted reserve policy that supports the maintenance of a strong liquidity position. Financial planning and operational information is relatively easily obtained, because the district's budget and financial statements are readily available on its website. However, financial transparency is somewhat limited given that the district does not publish a full set of basic financial statements that segregate the water system's financial data from other unrelated activities.

Outlook

The stable outlook reflects our view of the district's strong service area economy and recent improved financial performance. During the two-year outlook period, we anticipate that the district's implementation of its new multiyear rate schedule as approved by the district board will support the district's very strong financial risk profile.

Upside scenario

We could take a positive rating action if the district is able to materially widen margins and provide stronger levels of all-in coverage on a basis that we believe to be sustainable.

Downside scenario

Although unlikely, we could take a negative rating action if the district experiences substantial increases in its water supply costs, or its capital plans changes significantly over time, resulting in pressured all-in coverage metrics or a substantially weaker liquidity position.