

# RatingsDirect®

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## Summary:

# Escondido, California; Water/Sewer

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## Summary:

# Escondido, California; Water/Sewer

### Credit Profile

Escondido wtr rev bnds ser 1996 dtd 08/15/1996 due 11/01/1996-2009

*Unenhanced Rating* AA-(SPUR)/Stable Upgraded

#### Escondido Wtr

*Unenhanced Rating* AA-(SPUR)/Stable Upgraded

#### Escondido wtr certs of part ser 2007

*Unenhanced Rating* AA-(SPUR)/Stable Upgraded

#### Escondido Jt Pwrs Fin Auth, California

Escondido, California

Escondido Jt Pwrs Fin Auth (Escondido) wtr rev bnds (Escondido)

*Long Term Rating* AA-/Stable Upgraded

Many issues are enhanced by bond insurance.

## Rationale

Standard & Poor's Ratings Services raised its long-term rating to 'AA-' from 'A+' on the Escondido Joint Powers Financing Authority, Calif.'s existing series 2012 revenue bonds (water system financing), issued on behalf of the city of Escondido. At the same time, Standard & Poor's raised its rating to 'AA-' from 'A+' on the city's series 2007 water system certificates of participation (COPs). The outlook is stable.

The raised rating is based on the city's consistently strong historical financial performance, which we believe will be sustainable at least for the next two years.

Further supporting the rating is our view of the city's:

- Stable, primarily residential, and very diverse customer base that participates in the broad and diverse San Diego metropolitan area economy;
- Good income levels;
- Recent track record of significant water system annual rate increases to support operations and fund capital projects; and
- Strong and improved water system financial metrics, including debt service coverage (DSC) of at least 2.0x during the past three years, including most recently 2.9x DSC in fiscal 2015 (unaudited).

Partly offsetting these credit strengths, in our view, are the water system's heavy reliance on water supplied by San Diego County Water Authority (SDCWA) (AA+/Stable), which exposes the city to wholesale water supply increases, as well as uncertainty due to the statewide drought and the impact of the mandatory state-wide conservation on near-term system finances.

The series 2012 bonds are limited obligations of the authority payable solely from installation payments made by the city from net revenues of the water system. The certificates are limited obligations of the city and are secured by net revenues of the water system. Both the bonds and certificates are on parity with two state loans. Legal provisions are adequate and consist of a 1.2x rate covenant and a projected 1.2x maximum annual debt service additional bonds test. A fully funded debt service reserve is provided for the 2007 certificates although the 2012 bonds do not have a debt service reserve fund. However, management has a policy of maintaining a designated debt service reserve equal to at least six months of annual debt service.

Escondido, with a population of about 150,000, is in northern San Diego County, about 30 miles north of the city of San Diego. Originally an agricultural center, the city has grown and diversified while the larger San Diego region has expanded. The total population in the city grew about 8% between 2009 and 2014. Income indicators for the city are good, in our view. Median household effective buying income (EBI) was 95% of the national average in 2014. As of April 2015, the unemployment rate in the city was 4.8%, lower than the state and national rates of 6.1% and 5.1%, respectively.

The water system serves about 80% of the city's geographic area and some unincorporated areas of San Diego County. The customer base is stable, primarily residential, and very diverse. The number of connections has been nearly unchanged during the past five years, at about 26,542 as of June 30, 2014. We consider the customer base to be primarily residential because residential customers account for about 89% of connections. We also consider the customer base to be very diverse because the leading 10 customers contributed 6.6% of system billings in fiscal 2014.

The city has an ample water supply, which management believes can accommodate demand for the foreseeable future. The water system, however, is reliant on expensive imported water purchases from SDCWA, the local member agency of the Metropolitan Water District of Southern California for the majority of its water supply, especially in periods of drought. The availability of lower-cost local water is highly dependent on weather, and declined as a percentage of total potable supplies from a wet-year high of 45% in fiscal 2011 to a low of 5% in fiscal 2014. In fiscal 2015, Escondido purchased about 94% of its water supply from SDCWA. Under normal hydrological conditions, the city expects the percentage of local supplies to comprise 20% to 25% of its water supply. The city, though, is looking to reduce the cost of its supplies by expanding its sales of non-potable recycled water from its wastewater treatment plant. Although these water sales are booked as wastewater revenues rather than water revenues, they allow the water system to purchase less imported water.

As a result of Governor Brown's April 2015 executive order, the city is required to meet a 20% mandatory conservation target for June 2015 through February 2016, relative to a benchmark period in 2013. We understand that the city is currently well ahead of its conservation target. Although management has budgeted for lower water sales this year, weaker financial performance in the near term could result from reduced water sales during the mandatory water conservation period.

The city council has complete rate setting autonomy, and has a history of regular rate increases. Water customers pay a monthly fixed rate and a tiered volume rate. Currently, a typical single-family residential customer pays \$75.95 per month for 8,000 gallons of water, which we view as moderately high, but not atypical for the San Diego region. We consider rates to be affordable at about 2.2% of median household EBI after annualizing this water bill. The city

recently had a series of rate increases--12% increases in 2012 and 2013 and 5.5% increases in 2015 and 2016--designed to provide additional revenues to fund system capital improvements and partly offset the rising cost of imported water from SDCWA. According to management, the city expects to increase rates in 2017 through 2020 by 5.5%, though these increases have not yet been adopted by city council. We understand that water service may be discontinued on delinquent accounts and that there have not been any significant delinquencies.

All water, both imported and local, is delivered to the Escondido-Vista Water Treatment Plant in an untreated condition. The treatment plant has a designed capacity of 90 million gallons per day (mgd). Of this amount, 72 mgd of capacity is owned by the city and 18 mgd of capacity is owned by the Vista Irrigation District (VID). The combined average flow in fiscal 2014 was 34 mgd, and the peak demand during the summer months was approximately 42 mgd. Current treatment plant improvements include an on-site chlorine generation and electrical upgrade project, with no additional debt financing for the facility required during the next five years.

The city's five-year (2016-2020) capital improvement plan (CIP) for the water system totals about \$39.8 million, net of projects to be funded through existing capital reserves. The replacement of the Wohlford Lake dam is the most significant CIP project, in our view. The maximum allowed storage capacity in the lake, which is used to store untreated local water before delivery to the city's treatment facility, has been reduced to 2,800 acre feet (AF) from 6,500 AF, after the Federal Energy Regulatory Commission and the state determined that the existing dam is seismically unsound. The city will conclude the design phase for the replacement dam in September 2015, and expects to break ground on the project thereafter. The city anticipates the full capacity of the lake to be restored when the project is completed by early 2018. The city has applied for a \$25 million state revolving fund loan for the dam project, and the remaining balance of the CIP is expected to be funded on a pay-as-you-go basis. This additional borrowing is manageable, in our view, as the water system's leverage is moderate, based on a debt-to-capitalization ratio of 46%, as of June 30, 2014.

The water system's financial performance has improved, and we anticipate it will remain strong during the five-year forecast period. Historical DSC rose to a very strong 2.9x in fiscal 2015 (unaudited) from 1.9x in fiscal 2011. However, the city projects DSC will decline to about 1.75x in fiscal 2017 while management phases in future rate increases. However, DSC is expected to rise to over 2x thereafter. Fixed charge coverage (inclusive of water system debt service and the city's fixed infrastructure payments to SDCWA) was 1.75x in fiscal 2015, and is forecasted to remain greater than 1.3x during the five-year forecast period. The forecast assumes drought conditions for fiscal 2016 and a return to normal hydrological conditions for each fiscal year thereafter; so to the extent that the drought persists, DSC may be weaker than projections for those fiscal years.

We believe future rate increases will be necessary to maintain the city's strong financial metrics given the potential for reduced local water supplies and reduced sales due to conservation. The city's reserve policy is adequate, in our view, and includes the funding of an operating fund reserve (25% of average annual historical operating costs during the past five years), an imported water reserve (10% of average imported water costs) and a debt service account (six months of water system debt payments, including parity state loan obligations.) Unrestricted cash and investments totaled \$17.1 million as of June 30, 2014, which represented a strong 138 days' cash on hand. Based on our review of the city's financial forecast, we anticipate that the water system will be able to maintain a strong liquidity position going forward.

The city also maintains a sizable water system capital reserve fund, with a balance of \$54.8 million as of June 30, 2015. This fund is comprised of \$27.2 million of unspent bond proceeds, as well as grants, surplus rate revenue fees, and connection fees. Surplus revenues in the operating fund are typically transferred to this account when capital projects are budgeted or funds appropriated. Management indicates that \$8.1 million of unrestricted cash was transferred in fiscal 2015, and plans to transfer about \$4.0 million annually to this account during the five-year forecast period to fund additional capital projects.

We understand that the city and VID have entered into a settlement agreement with the Indian Water Authority, and have agreed to remove and replace a portion of the Escondido Canal that is located within the San Pasqual Reservation with an underground pipeline. The cost of this project is currently unknown, but the city estimates the total project to be about \$24 million, to be split between the city and VID. Additionally, each are expected to pay the Indian Water Authority \$3.85 million. We expect that the city will raise rates to pass these settlement costs directly to its customers once a final amount is determined, which in our view, would have a neutral effect on system finances.

## Outlook

The stable outlook reflects our anticipation that the city's financial performance will remain strong over our two-year outlook period, as continued rate increases will help counter near-term exposure to revenue shortfalls from uncontrollable factors, such as wholesale water purchase costs and mandated conservation. If cash levels or DSC were to fall substantially during the next two years, we could lower the rating. It is unlikely that we could raise the rating in advance of the completion of the CIP and before the city finalizes its payments to the Indian Water Authority in relation to the San Pasqual Reservation settlement agreement.

## Related Criteria And Research

### Related Criteria

- USPF Criteria: Water And Sewer Ratings, June 25, 2007
- USPF Criteria: Key Water And Sewer Utility Credit Ratio Ranges, Sept. 15, 2008
- USPF Criteria: Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

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