

RatingsDirect®

Summary:

Escondido Joint Powers Financing Authority, California Escondido; Water/Sewer

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Credit Profile

US\$30.215 mil taxable wtr sys rev rfdg bnds (Escondido) ser 2019B dtd 11/20/2019 due 09/01/2041		
<i>Long Term Rating</i>	AA-/Stable	New
US\$19.63 mil wtr sys rev rfdg bnds (Escondido) ser 2019A dtd 0//20/11/2 due 09/01/2041		
<i>Long Term Rating</i>	AA-/Stable	New
Escondido Wtr		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed

Rationale

S&P Global Ratings assigned its 'AA-' long-term rating to Escondido Joint Powers Financing Authority, Calif.'s series 2019A and 2019B (taxable) water system revenue refunding bonds, issued on behalf of the City of Escondido. At the same time, S&P Global Ratings affirmed its 'AA-' long-term rating and underlying rating (SPUR) on the water system's outstanding obligations. The outlook is stable.

The series 2019A bonds will have an estimated par amount of about \$19.6 million and are being issued to refund the city's series 2007 certificates of participation. The series 2019B (taxable) bonds will have an estimated par amount of \$30.2 million and are being issued to refund the city's series 2012 obligations. The water system currently supports about \$69 million of outstanding obligations, including a series 2002 loan, 2007 certificates of participation, a 2011 loan, 2012 revenue bonds, and 2019 infrastructure and economic development debt obligations.

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

- Service area participation in the broad and diverse San Diego-Carlsbad metropolitan statistical area economy, with a primarily residential and agricultural customer base and good income indicators;
- Higher-than-average water rates when compared with the national average but competitive with those of neighboring communities;
- Very low industry risk as a monopolistic service provider of an essential public utility; and
- Good operational management assessment, represented by sufficient current water supply to meet long-term demand and management's efforts diversity its water supply.

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

- Good all-in coverage metrics, which have averaged at about 1.4x during the past three fiscal years and which we

expect to improve, given the savings on the current refunding bonds and planned rate increases;

- Very strong liquidity position, with about \$28 million, equivalent to 186 days of operating expenses, for fiscal 2018, and our expectation that liquidity will stay at least very strong despite planned annual pay-go spending;
- Moderate debt-to-capitalization ratio at about 50.1% as of June 30, 2018, that we expect to stay manageable given the planned refunding obligations and potential \$10 million bond issuance in 2022; and
- Good financial management assessment, represented by long-term capital and financial planning, in addition to formalized policies and practices.

In our view, the water system's reliance on water supplied by San Diego Water Authority (SDCWA; AAA/Stable) exposes the city to wholesale water supply cost increases, which are outside of management's direct control.

The bonds are special limited obligations of the authority payable solely from installment payments that are payable from net revenue of the city's water system. In our opinion, legal provisions are credit neutral. Provisions consist of a rate covenant and additional bonds test set at 1.20x annual debt service. A fully funded debt service reserve is provided for the 2007 certificates, although the 2012 and 2019 bonds do not have a debt service reserve fund. We do not consider the lack of reserve fund for these two series a material credit weakness given the water system's consistently strong unrestricted cash position.

Enterprise risk

Escondido, with a population of about 154,000, is in northern San Diego County, about 30 miles north of the city of San Diego. The city has diversified from its origins as an agricultural center for the surrounding citrus and avocado farms. Today, more than 175 industrial firms are located in the city. Leading employers in the city are Palomar Medical Center (3,045 employees), Escondido Union School District (1,900), and the city itself (1,101). The service area is primarily built out, and total population in the city grew about 3% between 2014 and 2018. Income indicators for the city are good, in our view, with median household effective buying income (EBI) at 95% of the national average in 2018. In August 2019, the unemployment rate of Escondido City was 3.2%, lower than the state average of 4.2% and the national average of 3.8%.

In our opinion, the water system is largely residential and very diverse. The city provides water service to approximately 24,085 residential customers; 2,765 commercial, industrial, and other customers; and 191 agricultural customers as of June 30, 2019. During the past four years, customer growth has ranged from 0.1% to 0.79% annually. 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 8.2% of operating revenue in fiscal 2018. The leading customers consist primarily of agricultural businesses. The leading customer, EC&BJ Malone, an agricultural user, represented about 1.38% of operating revenue in 2019.

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. In addition, each customer pays a fixed readiness to serve fee, an Metropolitan Water District of Southern California (MWD) pass-through cost, and an infrastructure access charge that is a fixed charge paid to SDCWA. The city has an automatic pass-through mechanism for any rate increases from its wholesale provider, SDCWA. SDCWA has planned rate increases during the next five years between 2.4% and 6.9%

annually. Currently, a typical single-family residential customer pays about \$100 per month for 10,000 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 2.5% of median household EBI after annualizing this water bill. In 2017, the city council adopted a rate increase schedule effective March 1 of each year from 2017 to 2021. The next two preapproved rate increases for 2020 and 2021 are about 5.5% each. Management plans to have another rate study performed in 2021 and expects annual rate increases of about 5% annually during the next five years.

Based on our operational management assessment, we score the water system a '2' on a six-point scale on which '1' is the strongest. 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 MWD for the majority of its water supply, especially in periods of drought. Water purchased from SDCWA is untreated and treated at the city's treatment plant. During the past five years, management has shifted its agricultural customers from imported water to lower-cost recycled water produced at the city's Hale Avenue Resource Recovery Treatment Plant, which began deliveries in 2007. In 2018, the city purchased about 70% of its water supply from SDCWA, down from about 94% in 2015. The remaining water supply comes from recycled water and other local water sources stored at Lake Wohlford (2,761 acre-feet [AF]) and Lake Dixon (2,455 AF).

It is our understanding that management wants to continue to decrease its imported water purchases and expand its local water supply. One important component of the city's local water infrastructure, Lake Wohlford Dam, has been declared seismically unsound. Specifically, the upper portion of the dam could fail during a severe earthquake near the dam. In cooperation with the California regulators, the city has lowered the level of the lake so that only the seismically sound portion of the dam holds water. Maximum capacity at Lake Wohlford is 6,500 AF, and current actual capacity is presently limited to 2,800 AF. The city has been operating at the lower level the past 12 years, and the supply is sufficient to meet demand. In order to increase resiliency, the city is determining the cost-to-benefit analysis of building a new dam below Lake Wohlford or performing upgrades to the current dam. 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 75 million gallons per day (mgd). Of this amount, 60 mgd is owned by the city and 15 mgd is owned by the Vista Irrigation District (VID). The combined average flow in fiscal 2018 was 32 mgd, and the peak demand during the summer months was approximately 55 mgd.

Consistent with "Methodology: Industry Risk," published Nov. 19, 2013, on RatingsDirect, we consider industry risk for the system very low, the most favorable assessment possible on a six-point scale on which '1' is the best.

Financial risk

All-in coverage during the past three fiscal years has averaged about 1.4x, which we consider good, and we expect coverage will stay good given a history of timely rate increases and planned rate increases. Our all-in coverage metric recognizes a fixed cost associated with water purchases from SDCWA and MWD. From fiscal 2017 to fiscal 2018, operating revenue rose by about 13% and operating expenses by about 19%. This rise in revenue was associated with a 5.5% rate increase and higher water demand in 2018. Lower water purchases in 2016 and 2017 were driven by conservation measures. From fiscal 2017 to 2018, the rise in operating expenses was driven by a spike in chemical costs over the years and an increase in purchased water expense.

Based on our analysis of management-provided projections, which assume annual rate increases of about 5% through 2024 and a decrease in purchased water expense by about 2% on average per year, we expect all-in coverage to remain good and potentially rise above 1.6x, which we consider extremely strong, by 2022. If recycled water sales increase to the extent that current water system customers purchase recycled water rather than potable water, water system operation and maintenance costs (in particular the costs of purchasing imported water) and water system revenue would be reduced. However, management expects recycled water sales and water system revenue will increase as a result of increased connections and water system rates and charges. If rate increases are not adopted and purchased water does not decline as projected, we would expect coverage metrics to average about 1.3x, or a good level, during the next six years.

The water system's liquidity position has historically been very strong, though it has varied in recent years due to a lag in the timing of reimbursements. In fiscal 2018, unrestricted cash and investments totaled about \$28 million, equivalent to 186 days of operating expenses. This is up from about \$4 million, equivalent to 46 days of operating expenses, in fiscal 2017. The lower cash in fiscal 2017 was due to capital projects being paid for from unrestricted cash and reimbursements that were delayed. The capital projects had multiple funding sources that needed to be reconciled. In 2018, the city received those reimbursements, leading to the spike in unrestricted cash. Based on our cash projections, which assume the city issues about \$10 million of new-money debt in 2022 and cash-funds the remaining capital, we would expect unrestricted liquidity to stay very strong in the future. However, this expectation depends on continued annual rate increases and the city's funding a portion of its capital needs with bond proceeds.

In our opinion, the water system's five-year capital plan is manageable at about \$19.3 million, although future costs associated with building a new dam or improving Lake Wohlford could be significant. The total five-year capital plan is net of VID's portion of the canal project. The current capital plan includes the installation of advanced metering infrastructure, water pipeline replacements, and the San Pasqual Undergrounding Project on the Escondido Canal. The current \$19.3 million, five-year capital plan excludes the costs associated with the Lake Wohlford Dam upgrades and will be funded from unrestricted cash, rate revenue, grants, and potentially \$10 million of bond proceeds. The replacement of the Wohlford Lake dam is the most significant capital improvement plan project, in our view. The estimated cost to replace Lake Wohlford Dam could be between \$35 million and \$50 million, not including potentially up to \$10 million of wetland mitigation costs. The city is now determining the cost-to-benefit analysis of developing a new dam or upgrading the current Lake Wohlford through a phased upgrade approach. Furthermore, the water system's debt-to-capitalization ratio is about 50%, which we consider moderate; however, given the refunding bonds and the \$10 million of potential new-money debt, we do not expect this metric to materially deviate during the next five years.

Based on our financial management assessment, we score the water system as a '2' on a six-point scale on which '1' is the strongest. In our view, financial practices and policies exist and are transparent. It is our understanding that management presents budget-to-actual results to the board on a quarterly basis and maintains conservative revenue and expense assumptions. Management has a formalized investment and debt management policy, in addition to an informal liquidity target for the water system to maintain six months of operating expenses. Furthermore, management reviews and updates its long-range financial and capital plan annually and complies with general accepted accounting principles.

Outlook

The stable outlook reflects our expectation that management will undergo another rate study and implement future rates to continue to support debt and capital needs. In addition, the stable outlook incorporates our analysis of financial projections, which include at least good all-in coverage and a very strong liquidity position.

Upside scenario

We could raise the ratings if all-in coverage and unrestricted cash are sustained at a very strong level. An upgrade would be contingent on the water system's maintenance of its strong financial metrics during its long-range capital plan, including during future projects related to Wohlford Lake.

Downside scenario

We could lower the ratings if the city's financial metrics are pressured by continued increases in purchased water costs that are not offset by a decrease in purchased water through the use of recycled water or rate increases, leading to overall weaker financial metrics.

Ratings Detail (As Of November 1, 2019)		
Escondido WTRSWR		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
Escondido wtr certs of part ser 2007		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
Escondido Jt Pwrs Fin Auth, California		
Escondido, California		
Escondido Jt Pwrs Fin Auth (Escondido) wtr rev bnds (Escondido)		
<i>Long Term Rating</i>	AA-/Stable	Affirmed

Many issues are enhanced by bond insurance.

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