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Ratings

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Summary:

Escondido, California; Water/Sewer

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Credit Profile		
US$22.06 mil wastewtr rev rfdg bnds ser 2021A due 09/01/2041		
Long Term Rating	AA-/Stable	New
Escondido WTRSWR		
Long Term Rating	AA-/Stable	Affirmed
Escondido WTRSWR		
Long Term Rating	AA-/Stable	Affirmed
Escondido Jt Pwrs Fin Auth, California		
Escondido, California		
Escondido Jt Pwrs Fin Auth (Escondido) wastewtr rev bnds		
Long Term Rating	AA-/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AA-' rating to Escondido, Calif.'s $22 million series 2021 wastewater revenue refunding bonds. At the same time, S&P Global Ratings affirmed its 'AA-' rating on Escondido's wastewater revenue bonds outstanding. The outlook is stable.

Management intends to use the series 2021 bond proceeds to currently refund the system's series 2012 wastewater revenue bonds outstanding.

A net enterprise system revenue pledge secures the series 2021 bonds, which are on parity with about $9 million of series 2015 revenue bonds outstanding. The system also has about $13.4 million in State of California Water Resources Control Board (SWRCB) loans outstanding after this transaction.

The rate covenant calls for net revenue to cover 1.15x annual debt service coverage (DSC) on senior debt. An additional bonds test for first-lien debt calls for historical net revenue to cover 1.15x annual debt service. No debt service reserve fund or account has been established in connection with the issuance of the 2021 bonds. We consider the city's bond provisions credit neutral.

Credit overview

The rating reflects our opinion that despite planned increases in capital expenditures within the next decade, financial performance will remain sound, given a history of timely rate increases, when needed, and robust operating margins in recent years. The capital improvements in question involve systems repairs and expansions of the system's recycled water system, totaling about $53.8 million over the next five years. Additionally, there is a sizable Potable Water Reuse Program estimated to cost $250 million over 15 years, inclusive of the $53.8 million expansion, that has been conceptually approved by the city council. If costs exceed expectations, long-term financial performance could be pressured. However, over 90% of the customer base resides in Escondido, where above-average income indicators represent rate-raising flexibility while allowing for moderately affordable bills.

Credit strengths of Escondido include its:

- Customer base throughout the broad and diverse San Diego-Carlsbad metropolitan area, with most customers residing in Escondido, which exhibits above-average income indicators at 106% of the national average. The system also treats wastewater from a community within San Diego under a sewage disposal agreement. Under the agreement, San Diego reimburses Escondido for its pro rata share of operating expenses associated with treating the wastewater;
- Robust all-in coverage during the past three years averaging above 2.3x, albeit declining to levels we still consider high at about 1.7x because of increasing insurance and union expenses, based on our forward-looking analysis of financial forecasts;
- High unrestricted liquidity compared with that of other peers at the current rating level, averaging at around $40 million for the past three fiscal years. We recognize the days' cash figure is sufficient for any near-term disruptions, with over 500 days' operating expenses; and
- Strong financial management policies, including annually updated budgets and financial forecasts, as well as robust disclosures on their capital improvement needs.

Somewhat offsetting these credit strengths are Escondido's:

- Sewer rate of about $72, which is moderately affordable for most of the customer base, representing about 1.5% of median household effective buying income (EBI), which limits rate-raising flexibility. Management has historically raised rates by about 5.5% per annum, and are currently performing a rate study to determine the rate structure for the next five years;
- Customer concentration on the recycled water portion of the system, with about 78% of recycled water revenues coming from San Diego Gas & Electric's Sempra power plant. We note, however, that the top 10 customers are otherwise diverse for the wastewater system;
- Moderately high debt and liabilities burden with the addition of the debt that will be coming online to facilitate the capital improvement program. An additional stressor to our assessment is the low pension funded ratio of 69.54% as of fiscal year-end 2020; and
- Sizable capital plan driven by an expansion of the system's recycled water system.

The stable outlook reflects our expectation that management will continue to monitor rates and charges and adjust them when necessary to maintain the current financial position, despite potential future debt service increases. The stable outlook also reflects the local service area economy, highlighted by strong wealth and income levels.

Environmental, social, and governance (ESG) factors

We view environmental risk as elevated compared with similarly rated peers that are wastewater and recycled water utilities. As a utility in California, Escondido is exposed to increased climate risk on account of drought, wildfire, and seismic events that may lead to voluntary or mandatory orders to decrease water usage. The wastewater system has a capacity of 18 million gallons per day (mgd), with 12.7 mgd owned by the city and 5.3 mgd owned by the City of San Diego in order to serve the Rancho Bernardo Community. Escondido projects that average daily demand to the system will be consistent at about 12.9 mgd through 2026. We note that the city is building out its recycled water system to provide increased capacity to dispose of treated effluent. Effluent is discharged into the Pacific Ocean under a partnership with San Elijo Joint Power Agency. We view the infiltration and inflow to the system low at about 5%, and Escondido is not under a consent decree.

For social factors, health and safety precautions that officials enacted in response to the COVID-19 pandemic did not significantly affect the system's demand because of the residential nature of the customers. S&P Global Economics forecasts that U.S. GDP declined by 3.4% in 2020 and estimates a rebound of 5.7% in 2021. (See "Economic Outlook U.S. Q4 2021: The Rocket Is Leveling Off," published Sept. 23, 2021, on RatingsDirect.) S&P Global Ratings believes that uncertainty remains high, albeit moderating, surrounding the evolution of the coronavirus pandemic and its economic effects. Other social risk factors are also in line with peers. In our opinion, rates are still affordable in terms of median household EBI and the county poverty rate, limiting social risk. Should affordability relative to service area income levels and poverty be pressured, social risk would increase.

Furthermore, governance risk factors are in line with peers. Management reviews financial and operational risks throughout the year and has informal and formalized policies to maintain financial stability.

Stable Outlook

Upside scenario

We do not expect to raise the rating during our two-year outlook because the system remains in a very capital-intensive period. However, we could raise the rating based on Escondido maintaining an extremely strong financial profile as it reaches substantial completion of its treatment plant.

Downside scenario

Barring significant or unexpected financial deterioration, we are unlikely to lower the rating or revise the outlook to negative.

Related Research

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