S&P Global Ratings

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Summary:

Moulton-Niguel Water District, California; Water/Sewer

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Credit Profile		
US$52.57 mil 2021 certs of part due 09/01/2051		
Long Term Rating	AAA/Stable	New
Moulton-Niguel Wtr Dist WS		
Long Term Rating	AAA/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AAA' long-term rating to Moulton-Niguel Water District (MNWD), Calif.'s anticipated $52.6 million series 2021 certificates of participation (COPs). At the same time, S&P Global Ratings affirmed its 'AAA' rating on the district's outstanding bonds or COPs. The outlook is stable.

The COPs are being issued to finance the acquisition and construction of certain wastewater and water system capital improvements. Post-issuance, the district will have approximately $168 million of outstanding obligations.

The bonds are secured by the district's net revenue including property taxes. We view the bond provisions as credit neutral. Specifically, the district has covenanted to maintain a rate stabilization fund with a minimum balance of at least 50% of maximum annual debt service (MADS), unless pledged revenue exceeds 1.25x MADS for two consecutive fiscal years, in which case the rate stabilization fund can be less than 50% MADS. However, should debt service coverage (DSC) fall below 1.25x, the district has covenanted to restore the rate stabilization balance to its minimum requirement. In addition, the district has a rate covenant of 1x DSC if the rate stabilization fund contains at least 50% of MADS, although this rate covenant increases to 1.25x DSC if the rate stabilization fund contains less than 50% of MADS. Finally, the district has covenanted to maintain an additional bonds test of 1.1x of MADS and has a board-adopted coverage policy target of 1.75x. The series 2021 COPs will not have a debt service reserve. In our opinion, the lack of a debt service reserve is credit neutral given the district's strong cash position.

Credit overview

The district has a predominantly residential customer base, with affordable service rates and adequate operational capacity to meet demand. The district has not experienced a substantial decline in revenues to date related to the pandemic. It is entering the current drought on a strong fiscal footing based on the maintenance of strong liquidity and financial forecast, which we view as reasonable and achievable during the next five years. Partially offsetting these credit strengths, in our view, is the system's reliance on imported water supplied by the Metropolitan Water District (MWD) of Southern California, which exposes the district to wholesale water supply increases, although, we recognize the district is working to develop local sources to reduce dependence on imported water over time. The district is in the middle of a large capital cycle to meet future water supply reliability planning, and we view the district as having strong financial flexibility to absorb these future costs.

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

- Service area in southern Orange County in the strong Los Angeles-Long Beach-Anaheim, Calif. metropolitan statistical area economy;
- Affluent, primarily residential underlying customer base with incomes that we consider very strong;
- Competitive and affordable customer rates, given the very strong wealth levels; and
- Good operational management practices and policies, represented by sufficient water supply and wastewater treatment capacity to meet demand, in addition to a focus on long-term water supply reliability.

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

- Strong all-in coverage metrics at more than 1.7x during the past three fiscal years and projected years based on proposed rate adjustments and strong long-range financial planning;
- Strong unrestricted liquidity position of about $123 million, or 541 days of operating expenses, for fiscal 2021 (unaudited), which we expect will stay strong despite planned cash-funded portions of the district's capital plan;
- Low leveraged system, with a pro forma debt-to-capitalization ratio of about 31% when including the 2021 COPs; and
- Strong financial management practices and policies represented by long-term capital and financial planning in addition to formalized policies.

The system has a predominantly locally derived revenue base. Local service charges, derived through an autonomous rate-setting process, represent virtually all the system's revenue. This, coupled with operating expense flexibility, limits exposure to federal revenue.

The stable outlook reflects our view that management will continue to increase rates to fund its large capital plan along with additional leverage, while maintaining at least strong all-in coverage metrics. In addition, our outlook reflects our opinion of the strength of management policies and our expectation that the district will move toward diversifying its water supply to improve resiliency and offset the risk of rising imported water costs. The outlook also reflects our opinion of the strong service area economy that we believe anchors the credit stability.

Environmental, social, and governance (ESG) factors

California utilities are exposed to elevated environmental physical risks related to climate change, including wildfires, drought, and sea-level rise. The district has comprehensive long-range plans, drought risk assessments and water-shortage contingencies to mitigate growing environmental risks. MNWD is currently working on enhancing its local water supply and increasing resiliency as part of its strategic priorities. The district currently obtains all its potable water from MWD. As a result, the district has a large capital improvement plan (CIP) to address its objective of reducing exposure to imported water and mitigating drought-related risks through development of local sources, including recycled water expansion. Officials have been making several investments across its facilities and distribution network to reduce the district's overall environmental risks. We understand the district will continue recommending updates to its future rate plans to meet revenue sufficiency and we do not believe this will significantly increase affordability pressures or social risks, given the very strong local incomes. Finally, we view the district's governance factors, including its long-term planning, and credit-supportive rate-setting practices in line with those of other rated utilities. The district recently produced a 2020 long-range water reliability plan update that provides a long-term strategy and management framework for enhancing overall water supply reliability.

Stable Outlook

Downside scenario

We do not anticipate lowering the rating over the two-year outlook horizon as long as management continues to produce financial metrics that are consistent with, or exceed, projections while successfully funding its CIP. However, we could lower the rating if all-in coverage declines below management's forecast due to unforeseen leverage or a significant drawdown in cash beyond what management has planned.

Credit Opinion

Enterprise risk

The district provides water and sewer services to over 170,000 residents in the cities of Laguna Niguel and Aliso Viejo, as well as portions of Laguna Hills, Mission Viejo, San Juan Capistrano, and Dana Point. Situated in southern Orange County, the district is built out and primarily residential, with little fluctuation in the number of its residents. We view the service area's income levels as very strong based on the median household effective buying incomes (MHHEBIs) for these cities, which range from 139% (San Juan Capistrano) to 168% (Mission Viejo) of the national median.

The district's customer base is stable, primarily residential, and very diverse, in our view. MNWD serves slightly over 55,000 water and wastewater service connections, which have risen by less than 1% annually. We consider the customer base to be very diverse based on the leading 10 water customers contributing about 4% of water sales revenue and the leading 10 sewer customers contributing about 6% of sewer sales revenue. Furthermore, the leading 10 recycled-water customers contribute about 45% of recycled water sales revenue. We do not view the recycled-water concentration as a risk given that recycled revenue is about 10% of total operating revenue.

The district's combined water and wastewater rates are affordable given very strong income metrics and low county poverty rate, and we believe the district has future rate-setting flexibility. The district's water rate structure is based on a "water budget" methodology under which service rates are based on the cost of service, but also considers efficient water usage for different purposes, such as indoor usage and outdoor usage. Ultimately, we believe that the district's rate-setting autonomy enables it to set rates to cover its costs. A typical residential customer uses about 13 hundred cubic feet of water usage per month. We consider the combined bill to be affordable at about 1.1% of MHHEBI.

The district's potable water supply is reliant on imported water supply, and we understand that MNWD is focusing on water diversification and long-term water supply reliability. Approximately 80% of the district's water is obtained from MWD through the Municipal Water District of Orange County (MWDOC). The district's remaining supply totaling approximately 20% of the district's water, is recycled water from South Orange County Wastewater Authority (SOCWA) and the self-operated Plant 3A. Furthermore, the district is also one of five participants in the Baker Water

Treatment Plant, which provides additional local water system reliability. MNWD is evaluating several future water supply initiatives consisting of groundwater exchange with Orange County Water District, recycled water expansion, direct potable water reuse, ocean water desalination, and urban run-off stormwater diversions. The district has sufficient wastewater treatment capacity to meet continued demand and is in compliance with all environmental regulations.

Financial risk

We view the district's all-in coverage as strong, and we expect all-in coverage will stay strong given planned rate adjustments to meet rising cost-of-service. Despite the district's future debt plans, we expect all-in coverage will stay strong given strong financial management and a history of timely rate increases. All-in coverage is our internally adjusted DSC metric that we believe best tracks the use of every dollar of utility operating revenue, regardless of lien position, accounting treatment, or ultimate purpose. It also incorporates recognition of fixed charges or costs, which we define as certain long-term recurring items that are debtlike in nature, even if legally treated as an operating expense. For the district, we include fixed costs associated with water supply from MWDOC, which ultimately comes from MWD. During the past three fiscal years, all-in coverage averaged about 2x. In addition, the district's revenue stream is supported by stable property tax revenues, which can be used for operations. For fiscal 2021, the district received $31 million in property tax revenues, and this source of revenue averaged approximately 30% over the past five fiscal years. Based on our analysis of management-provided projections, we expect all-in coverage will stay strong during the next five years. Projections incorporate planned rate increases, future debt plans, and rising costs associated with wholesalers.

The district has historically maintained a strong liquidity position, and we anticipate it will likely continue to do so despite a planned drawdown for a portion of its capital plan. At fiscal year-end 2021 (unaudited), MNWD held unrestricted cash and investments of about $123 million, or 541 days of operating expenses. The district plans to cash-fund about 42% of its total capital plan. We understand that the district has a robust liquidity policy including maintaining a cash equivalent to at least three months of operating expenses.

The district's CIP is large, at about $611 million during the next 10 years. Its pro forma debt-to-capitalization ratio is manageable, in our view, at about 32%; this includes the proposed $75 million bond issuance in 2025. We expect the leverage position will rise given future debt plans but it will likely be manageable given that the district is also exploring grant funding for capital projects that could potentially lower its debt financing needs.

Related Research

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