S&P Global Ratings

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Summary:
Mill Valley, California; Water/Sewer

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Credit Profile		
US$4.68 mil swr sys rfdg rev bnds ser 2021 dtd 08/19/2021 due 07/01/2042		
Long Term Rating	AA+/Stable	New
Mill Vy WS		
Long Term Rating	AA+/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its long-term rating of 'AA+' to the City of Mill Valley, Calif.'s 2021 sewer system refunding revenue bonds. At the same time, we affirmed our 'AA+' rating on the Mill Valley Facilities Financing Corp., Calif.'s 2012 certificates of participation (COPs), issued on behalf of Mill Valley. The outlook is stable.

The series 2021 revenue bonds will refund the city's 2012 COPs. We view the bond provisions as credit neutral, with a rate covenant of net revenue at least 1.25x. The additional bonds test requires that historical net revenue provide at least 1.25x coverage of maximum annual debt service (MADS) on parity debt.

Credit overview

With Mill Valley's participation in the San Francisco Bay Area, the service area benefits from a stable and affluent economic profile. Diverse employment opportunities bolster incomes and poverty rates, providing ample rate flexibility for the city. Recent efforts to stabilize financial performance have led to a rate structure transition, whereby the city implemented a fixed base rate in January 2021. Moving from a purely volumetric rate structure, the city targets a 40% fixed and 60% volumetric structure by 2023. We view this transition favorably, as it provides a pass-through mechanism for operational costs, most of which are charged to Mill Valley from its sewage treatment wholesaler. As seen in recent years, S&P Global Ratings-calculated all-in debt service coverage (DSC) has remained strong, with coverage in fiscal 2020 at 2.1x. All-in DSC is S&P Global Ratings' adjusted DSC metric that includes all use of utility operating revenue, regardless of lien or accounting treatment, and incorporates recognition of fixed charges, which are debt-like in nature. We view the high coverage as a credit strength and expect coverage will remain consistent, given no additional debt plans. In addition, we believe management's risk is slightly mitigated by low operational risk garnered from its collection-only system and treatment contract with the Sewerage Agency of Southern Marin (SASM). In 2018, the city had a reduction in liquidity reserves, which brought the unrestricted cash position to 139 days' cash. The drawdown was due to delayed capital expenditures, which illustrates some additional credit risk associated with the small utility size, despite economic prosperity in the service area. Mill Valley's capital improvement plan (CIP) over the next five years will be fully cash funded but is manageable. We expect unrestricted cash to be sustained at levels consistent with fiscal 2020, at approximately $5 million.

The stable outlook reflects our anticipation that the city's adjusted rate structure will provide sufficient revenue to fund pay-as-you go capital expenditures and maintain robust coverage, while continuing to benefit from a broad and diverse economic profile that provides stability to the rating.

Environmental, social, and governance

We consider Mill Valley's sewer system as more exposed to environmental risks compared with that of peers in other states, given California drought, growing wildfires, and periodic earthquakes. However, the city has proactive policies to address infrastructure damage and emergency response to these natural disasters. In addition, the city has had no financial or infrastructure impacts from prior wildfires in the state. Mill Valley has not experienced any sanitary overflows or regulatory infractions, which we view as favorable. We view the city's social risk as in line with than that of peers due to the high incomes in the area and affordable rates, which we do not expect will change in the long term. Finally, we view the utility's governance factors as credit supportive, as they include pre-approved rate-setting practices, strong financial planning and policies, and operational efficiencies provided by the contract with SASM. The city participates in routine cybersecurity training and has adequate policies and practices including cyber insurance.

Stable Outlook

Downside scenario

If coverage were to be sustained at a level inconsistent with that of similarly rated peers, despite planned rate increases, we could lower the rating. In addition, if SASM or the city experienced emergency capital needs that required significant debt, and rates were not increased commensurately, we could lower the rating.

Upside scenario

Given the comparatively small size of the service area, we do not anticipate raising the rating in the two-year outlook period.

Credit Opinion

Mill Valley is located in Marin County, about 11 miles north of San Francisco, and serves 5,609 sewer customers as of fiscal 2020. Residents have access to diverse employment opportunities throughout the San Francisco Bay Area, evidenced by higher-than-national-average incomes at 225% median household effective buying income (EBI) compared with the U.S. Given that the city is largely built out, we view the sewer customer base as stable, and management expects future growth to be minimal. The primarily residential customer base is extremely diverse, with the top 10 customers representing 5% of operating revenue in fiscal 2020. The Marin County unemployment rate is low and was 4.3% as of May 2021.

With strong economic metrics in the area, we consider the current residential rates affordable, with monthly bills at 1.5% of median household EBI. We expect they will be sustained at this level, given approved rate plans. Management restructured rates in early 2021 to be 20% fixed rather than purely volumetric, as seen in previous years. The city plans to increase fixed rates to 30% in 2022 and 40% in 2023. Assuming an average of 6,000 gallon residential usage per month, after 2023 the total bill will be slightly lower than current rates but result in more predictable revenue. We view the structure change favorably, as it will allow the city to pass through operational costs from SASM to customers. Mill Valley performs cost of service studies every five years, with the latest rates approved in March 2020 until 2026. We view the pre-approved rates as supportive of the manageable capital program and steady annual debt service.

The city sends sewer flows to the SASM wastewater treatment plant under a joint powers authority agreement with no expiration date. It is one of six members of SASM, and is required to cover about 50% of SASM's operating costs through semiannual payments. We understand from management that SASM currently has sufficient treatment capacity for average and peak demands of the system for the next 25 years. SASM recently completed significant capital improvements on the treatment facility in 2019, focused on upgrading aging infrastructure and enhancing treatment capabilities. Mill Valley has minimal capital needs over the next five years, with a total of $14 million.

Under a financing agreement between the city and SASM, the city has agreed to pay 49.5% of debt service on SASM's series 2016 revenue bonds. Accounting for this, S&P Global Ratings' all-in DSC imputes a proportional share of SASM's operating revenue as a fixed cost. Coverage was 2.1x, 2.2x, and 2.5x in fiscal years 2020, 2019, and 2018, respectively. Historically, total DSC has varied, due to the higher annual debt service and operational costs associated with SASM's capital program. Although the city has mitigated SASM's operational cost risk with rate increases and rate restructuring, we view this volatility as a credit limitation. Given pre-approved rate adjustments until 2026, we expect coverage to be sustained at about 2x.

At the end of fiscal 2020, the sewer system had about $5.3 million in unrestricted cash and investments, equating to 381 days' cash on hand, which we view as supportive of the rating. Though nominally small in comparison with that of peers, the collection-only system has less operational risk, in our view. We do not anticipate any significant change in the liquidity position given the level of expected CIP expenditures, at about $2 million-$3 million a year, which can be funded by excess rate revenue. Considering 10-year financial forecasting, a formal liquidity policy of maintaining 15% operating expenses in cash on hand, and a CIP of five years, we view Mill Valley's financial management as supportive of the rating.

Related Research

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