S&P Global
Ratings

RatingsDirect®

Mesa Water District, California; Water/Sewer

Primary Credit Analyst:
Chloe S Weil, San Francisco (1) 415-371-5026; chloe.weil@spglobal.com

Secondary Contact:
Melody W Vinje, Centennial + 1 (303) 721 4163; melody.vinje@spglobal.com

Table Of Contents

Mesa Water District, California; Water/Sewer

Credit Profile		
US$55.0 mil rev certs of part ser 2020 due 06/30/2050		
Long Term Rating	AAA/Stable	New
Mesa Wtr Dist		
Long Term Rating	AAA/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AAA' long-term rating to Mesa Water District, Calif.'s series 2020 certificates of participation (COPs). At the same time, we affirmed our 'AAA' rating on the district's parity obligations. The outlook is stable.

The $70 million of COP proceeds will be used to finance the construction of two new groundwater production wells, the development and construction of the Mesa Water Reliability Facility education center, and other system improvements. The COPs will be on parity with the district's $25.8 million of COPs outstanding as of June 30, 2019.

We view the COP provisions as credit neutral. The COPs are payable from installment payments that are secured by net revenues of the district's water system and are on parity with its outstanding series 2017 COPs. COP covenants include a 1.25x annual debt service rate covenant and a 1.15x annual debt service additional bonds test. There is no reserve fund for the series 2020 COPs. We do not view this as a material credit weakness in the context of the district's historically extremely strong liquidity position.

Credit overview

The rating reflects our opinion of district's general creditworthiness and the combination of a very strong enterprise risk and extremely strong financial risk profile, including this proposed series 2020 COP issuance. S&P Global Economics acknowledges a high degree of uncertainty related to the effects of COVID-19, including the rate of spread and peak of the outbreak. We believe measures to contain COVID-19 have pushed the economy into recession. Although we believe the district's volumetric sales could be affected by reduced economic activity in the region depending on the length of the economic recession, this risk is mitigated by the district's extremely strong liquidity position, its primarily residential customer base, and strong, forward-looking management practices.

As a result of the pandemic, recession, and associated moratorium on shutoffs, we understand that the district has adjusted its fiscal 2020 forecast to reflect a 7.8% decline in revenue, which is partially offset by a 6.4% decline in expenses. We also believe the utility system's revenues may decline somewhat for fiscal 2021 or beyond, though ultimately our expectation is that management will continue to manage the system and maintain strong coverage levels. The strength of the system's liquidity metrics provides a strong cushion, in our view, to mitigate short-term disruptions from the COVID-19 related recession. Additionally, management has instituted contingency plans to ensure minimal disruptions in service provided.

For more information, see our articles "COVID-19's Potential Effects In U.S. Public Finance Vary By Sector" (published

March 5, 2020, on RatingsDirect), "All U.S. Public Finance Sector Outlooks Are Now Negative" (published April 1, 2020), and "An Already Historic U.S. Downturn Now Looks Even Worse" (published April 16, 2020).

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

- Service area participation in the broad and diverse Los Angeles-Long Beach-Anaheim metropolitan area economy;
- Moderate service rates in the context of the service area's strong income levels;
- Very low industry risk as a monopolistic service provider of an essential public utility; and
- Comprehensive operational management practices, characterized by an ample water supply, well-defined drought management programs, and forward-looking rate setting practices.

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

- Extremely strong all-in coverage metrics (of over 2.0x) that we anticipate will be sustained going forward;
- Extremely strong liquidity position, with cash on hand at the end of fiscal 2019 equivalent to over 400 days' of operating expenses, while liquidity has declined over the past two years, we expect it to rebound to 600 days' by 2023;
- Manageable capital improvement program (CIP) that utilizes a mix of leverage from proceeds from the series 2020 COPs with the remainder coming from pay-as-you-go funding sources; and
- Strong financial management practices and policies.

The stable outlook reflects our opinion of the district's strong service area characteristics coupled with its good operational and financial flexibility. During the two-year outlook period, we anticipate that the district will continue implementing additional rate to capture water supply costs and reflect demand. The district has a predominantly locally derived revenue base. Local service charges, derived through an autonomous rate-setting process, represent virtually all of the district's revenues. This, coupled with operating expense flexibility, limits exposure to federal revenue.

Environmental, social, and governance factors

In our view, the district's governance factors, including the adoption of multi-year rate plans, ongoing engagement in public outreach regarding water conservation and other strategic initiatives, are credit supportive and in line with those of other rated water and sewer utilities. Nevertheless, we believe COVID-19 could result in rate deferrals or reductions as the pandemic spreads and the recession deepens, which presents increased social risk.

The district is not reliant on imported surface water. However, its groundwater is pumped from the Orange County groundwater basin, which is managed by Orange County Water District (OCWD). While per- and polyfluoroalkyl substances (PFAS) have not been detected in any district wells, the district anticipates that the replenishment assessment and additional replenishment assessment it pays to OCWD will increase (after fiscal 2021) as OCWD undertakes projects to treat water in wells within the Orange County groundwater basin. Nevertheless, we do not believe that the projected cost increases will materially affect the district's water supply or market position. Accordingly, we believe the agency's environmental factors do not present elevated risk and are line with other rated water and sewer utilities.

Stable Outlook

Downside scenario

Although we do not anticipate it at this time, we could take a negative rating action if the district's future rate plans are delayed, management materially spends down its cash reserves, and financial performance significantly and unfavorably deviates from the district's forecast.

Credit Opinion

Enterprise risk

The district provides water service to a population of over 110,000 within an 18 square-mile area that includes the city of Costa Mesa, portions of the city of Newport Beach, and certain adjacent unincorporated areas of Orange County, including John Wayne Airport. South Coast Plaza, the largest mall on the West Coast, is located in Costa Mesa. Given the mall's national recognition and the service area's proximity to multiple beaches, the district typically receives many visitors throughout the year. However, the district's customer base is extremely diverse, and is not heavily concentrated in the hospitality sector, which mitigates some of the economic challenges presented by COVID-19.

The district's service area is substantially built out, and the number of connections served has been relatively stable during the past five years, rising by a modest average annual rate of just 0.4% to 24,933 connections in fiscal 2019. We consider the service area's income levels to be strong, based on Costa Mesa's (87% of connections) median household effective buying income (MHHEBI) which was 123% of the national median for 2019.

The district's 10 largest customers accounted for approximately 12.3% of water sales revenues in fiscal 2019, which we consider diverse. The largest customer, Mesa Verde Partners (a golf course), was responsible for 1.7% of total water sales. The customer base is primarily residential (81.6% of total accounts) and the number of customers is projected to grow at an average annual rate of 0.75% over the next five years.

We view the district's market position to be adequate based on the district's current retail service rates. Rates are typically pre-approved on a multi-year basis, setting a clear trajectory for the funding of capital expenditures and revenue needs. In November 2017, the board approved a five-year rate, which included annual rate increases between 5.0% and 8.2% through Jan. 1, 2022. The residential water rate structure is composed of a flat bi-monthly meter charge and a usage-based commodity charge. Based on the typical water usage within the service area of 1,425 cubic feet of water per month, management reports a monthly-equivalent water bill for a single-family residential user of $71.81, which we consider moderately high at 1.3% of Costa Mesa's MHHEBI.

We consider the system's operational management to be strong under our operational management assessment methodology, which indicates a favorable alignment of operations and organizational goals. The district has adequate water supply capacity to meet long-term demand from local sources, and is not reliant on imported water as a source of supply. The district's facilities consist of eight groundwater wells, two of which produce amber-colored groundwater; a colored-water treatment facility; two water reservoirs; and 350 miles of pipeline. Groundwater is pumped from the underlying Lower Santa Ana River Groundwater Basin. Due to increased pumping capacity in the lower aquifer resulting from the expansion of its amber water treatment facility, known as the Mesa Water Reliability Facility in 2012, together with conservation efforts, the district eliminated imported water purchases in 2014. Since then, the district has only taken water under OCWD's Coastal Pumping Transfer Program, which shifts pumping from along the coastal area to inland areas, and is reimbursed by OCWD for these expenses. The district also purchases recycled water to meet about 5% of annual demand.

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

Financial Risk

The agency's financial performance has historically been excellent and we anticipate that it will remain so going forward, given management's plan to continue building cash reserves and fund the remainder of its upcoming CIP on a pay-as-you-go basis.

Our financial assessment also considers the district's "all-in" coverage metric, which includes imputed debt service that is implicitly passed on to the district from its water suppliers. In lieu of an explicit fixed cost to arrive at our all-in coverage metric, we specifically allocate a proportionate share of OCWD's debt service based on the district's groundwater pumping and water purchased by OCWD, and consider standby charges paid to MWDOC also as a fixed charge. The district has, on average, represented about 4%-5% of OCWD's replenishment revenues, while for MWDOC, standby charges have declined to less than $500,000 in 2017 and thereafter.

We estimate all-in DSC of 2.5x in fiscal 2019, up from 2.2x for the district in 2015, and project all-in DSC exceeding 2.0x over the five-year forecast period, even when we exclude one-time development-related connection fees, although we forecast all-in DSC declining slightly in fiscal 2019 and beyond as the district begins amortizing the new money portion of the series 2017 COPs. While unexpected, failure to provide all-in DSC of at least 2.0x thereafter could pressure the rating downward.

Liquidity has historically been a key credit strength. Although cash balances have declined from previous exceptionally strong levels to below management's internal targets, to about $31.9 million as of June 30, 2019 from $44.6 million as of June 30, 2017, or to 461 days' cash on hand from 690 days. We understand management used about $13 million to pay down a portion of its unfunded accrued liability (UAL) with CalPERS by funding a Section 115 trust, which we consider a prudent undertaking. Management's reserve policy dictates a target of 600 days' on hand, which we consider favorable.

We performed a number of stress scenarios, including a 10% decline in service revenue in 2020 and a deferral of rate increases through 2022, wherein coverage would still remain well above 1.5x, which we consider credit supportive. Although we expect that a portion of the upcoming capital plan will be funded from reserves, based on management's current projections, we expect liquidity to remain at levels we consider commensurate with the rating.

Upcoming capital needs are manageable and are not expected to adversely effect our debt and liabilities assessment, given the district's low outstanding leverage prior to this transaction. The $85 million capital improvement plan (CIP) will be primarily funded with proceeds of the 2020 issuance, with about $16 million funded from reserves.

Based on our financial management assessment, we believe that the district's practices are commensurate with those of its peers at the 'AAA' rating level. Revenue and expenses assumptions are reasonable, and interim financial reporting is provided to the board through monthly reports and quarterly presentation. The financial forecast and CIP is reviewed annually as part of the budget process. The district has a formal reserve policy that is considered through the rate-setting process. Financial planning and operational information are relatively easily obtained, as the district's budget, financial statements, and rate studies are readily available on Mesa's website.

Ratings Detail (As Of May 15, 2020)	
Mesa Wtr Dist 2010 subord ln rev certs of part dtd 12/21/2010 due 03/15/2013-2025	
Long Term Rating	NR