S&P Global Ratings

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Summary:

Mesa Water District, California; Water/Sewer

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Credit Profile		
US$29.8 mil 2017 rev certs of part ser 2017 due 03/15/2027		
Long Term Rating	AAA/Stable	New
Mesa Wtr Dist rfdg certs of part		
Long Term Rating	AAA/Stable	Affirmed
Mesa Wtr Dist 2010 subord ln rev certs of part		
Long Term Rating	AAA/Stable	Affirmed

Rationale

S&P Global Ratings assigned its 'AAA' long-term rating to Mesa Water District, Calif.'s series 2017 certificates of participation (COPs). At the same time, we affirmed our 'AAA' rating on the district's senior and parity obligations. The rating reflects, in our opinion, the combination of a very strong enterprise risk profile and an extremely strong financial risk profile. The outlook is stable.

The 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
- Strong operational management practices and policies.

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 2016 equivalent to more than 700 days of operating expenses, although cash is expected to decline to about 365 days following a one-time cash draw of $13 million;
- Manageable capital improvement program (CIP) that utilizes a mix of leverage from proceeds from the series 2017 COPs with the remainder pay-as-you-go funding sources; and
- Strong financial management practices and policies.

The combination of a very strong enterprise risk profile and an extremely strong financial risk profile tracks to an indicative rating of 'AA+' under our utility revenue bond criteria; however, we have elected to notch the rating up one level to the 'AAA' level due to the district's exceptionally strong financial metrics, low leverage, and our expectation that all outstanding debt will be paid off in the next 10 years. 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 revenues.

The series 2017 COPs are being issued to refund the district's series 2010 COPs for debt service savings and fund $13 million of capital projects, including the acquisition of land and construction of two wells. We view the certificate provisions as credit neutral.

The COPs are payable from installment payments that are secured by a subordinate lien on net revenues of the district's water system. We understand that the senior lien is closed, and the district's remaining $1.8 million of senior certificates (series 2009 COPs) are scheduled to mature on March 15, 2018. As such, the senior and subordinate liens are rated on parity. Subordinate covenants include a 1.15x annual debt service rate covenant and a 1.15x annual debt service additional bonds test. For the purpose of the additional bonds test, the district may include an adjustment for additional revenues from any increases in service charges that are deemed economically feasible and reasonably considered necessary. There is no reserve fund for the series 2017 COPs. We do not view this as a material credit weakness in the context of the district's historically extremely strong liquidity position.

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. The 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 24,448 connections in fiscal 2016. 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 124% of the national median for 2016. The unemployment rate in Costa Mesa for March 2017 was 3.7%, which was lower than that of the state (5.1%) and nation (4.6%).

The district's 10 largest customers accounted for approximately 14.0% of water sales revenues in fiscal 2016, which we consider diverse. The largest customer, Mesa Verde Partners (a golf course), was responsible for 3.3% 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 0.45% over the next five years.

We view the district's market position as moderate based on the district's current retail service rates, but weakened somewhat by the county's poverty rate. In 2013, the board approved a five-year rate plan effective through Jan. 1, 2018, and we understand management expects to adopt an additional five-year package of rate increases in late 2017 or 2018, following the completion of a cost of service study this year. 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 $63.08, which we consider moderately high at 1.3% of Costa Mesa's MHHEBI. The county's poverty rate was last reported by the U.S. Department of Agriculture at 12.9%, which we view as somewhat elevated and a weakening factor.

Based on our operational management assessment, we score the district a '1' on a six-point scale on which '1' is the strongest. Management regularly communicates its strategic goals internally and to outside parties, such as engaging in public outreach regarding water conservation to meet state mandates during the recent drought. We understand that during this period the board implemented enhanced funding for water saving rebate programs and funded additional enforcement activities.

Water supply is derived almost exclusively from local sources, and more expensive imported water is utilized as a supplementary source. The district's water supply sources include groundwater (91% of total supply), non-potable recycled water for irrigation purposes (8%) purchased from the Orange County Water District (OCWD), and imported water (1%) purchased from the Municipal Water District of Orange County (MWDOC), the local member agency of the Metropolitan Water District of Southern California (MWD) as part of OCWD's Coastal Pumping Transfer Program (CPTP), an incentive program which assists in maintaining protective groundwater elevations in the aquifer along the coastal area. By participating in the CPTP, the district receives a reduction in its basin equity assessment (BEA) from OCWD, which provides financial assistance to inland producers to pump over the basin production percentage (BPP).

Groundwater is currently supplied by seven existing wells and pumping stations. We understand the district intends to use proceeds from the series 2017 COPs to construct two additional wells to increase capacity. The district's wells are located in the Orange County groundwater basin, which is managed by OCWD. OCWD annually sets a basin production percentage (BPP) to protect the basin from over pumping, and we understand that the BPP has ranged from 62% to 75% during the past five years. OCWD charges a replenishment assessment for each acre-foot of water that is pumped out of the basin up to the BPP, and charges an additional basin equity assessment (BEA) for water that is pumped in excess of the BPP. The BEA is set at a level that makes the cost of additional groundwater equal to the price of imported water, thereby providing a financial disincentive to overproduce from the basin.

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 district's financial metrics have been maintained at extremely strong levels, despite a year-over-year 11.4% decline in water sales between fiscals 2015 and 2016 attributable to mandatory conservation. Over this period, operating revenues declined by about 8.5% to $31.9 million in fiscal 2016 compared to $34.9 million in fiscal 2015, however, operating expenses declined by an almost commensurate amount, 7.8% to $21.4 million from $23.4 million. Accordingly, direct debt service coverage (DSC across both liens) declined to 3.1x from 3.5x over this period. Excluding one-time connection fees (about $1.9 million and $1.2 million in fiscals 2016 and 2015, respectively), direct DSC was also strong at 2.7x in fiscal 2016, down from 3.2x in fiscal 2015.

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 5.2% of OCWD's replenishment revenues, while for MWDOC, standby charges totaled approximately $670,000 in fiscal 2016 but are expected to decline to less than $500,000 in 2017 and thereafter.

We estimate all-in DSC of 2.5x in fiscal 2016, down from 2.7x 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 would likely pressure the rating downward.

Management's projections appear reasonable with no imported water purchases beyond those associated with the district's participation in CPTP and MWD's local resource program. Following the lifting of the state's mandatory conservation restrictions earlier this year, operating revenues are expected to rebound 8% in fiscal 2017 (followed by an additional 8% in fiscal 2018.) Thereafter, operating revenues are forecasted to increase by 2%-4% per year, which indicates that the district's projections are somewhat dependent on future rate increases, which have yet to be approved. The district's projections also assume an average of $1.2 million in future connection fee revenues per year.

The district's liquidity position is extremely strong, in our view. Unrestricted cash and investments totaled $41.7 million as of June 30, 2016, equivalent to about 700 days of operating expenses based on the district's audited financial statements. Management expects to draw $13 million from its reserves to prepay a portion of its pension obligation by the end of fiscal year 2017, which we understand will result in about $500,000-$650,000 in reduced operating expenses each year over the 5-year planning period. With the drawdown in cash, management does not expect liquidity to drop below 365 days' of operating expenses through fiscal 2022.

We believe the district's five-year CIP is manageable and the amount of additional leverage in the series 2017 COP transaction does not materially affect the district's financial profile. Capital spending through 2022 totals $25.2 million, and focuses on pipeline renewal and replacements, the construction of two new wells, and planned office building improvements. The district anticipates funding a portion of the CIP from proceeds of the series 2017 bonds, with the balance of the CIP is expected to be funded on a pay-as-you-go basis, and the district does not anticipate drawing down reserves to fund the CIP. We view the district's leverage position to be very strong based on a debt-to-capitalization ratio of about 24.7% inclusive of the series 2017 COPs. The district expects to pay off all outstanding debt by 2027.

Based on our financial management assessment, we rate the district a '2' on a six-point scale where '1' is the strongest. We believe that the district's practices are strong, comprehensive, and supportive of high credit quality. Revenue and expenses assumptions are reasonable, and interim financial reporting is regularly provided to the district's board throughout the year. The long-term planning process is rigorous, and the detailed multiyear forecast is annually updated. The district has an adopted reserve policy that we believe supports strong liquidity levels and articulates the rationale for maintaining its various reserves. Financial planning and operational information are relatively easily obtained, as the district's budget, financial statements, and other important operational and financial information are readily available on its website.

Outlook

The stable outlook reflects our opinion of the district's strong service area characteristics coupled with its operational and financial flexibility. During the two-year outlook period, we anticipate that the district will continue implementing additional rate increases while adjusting plans annually to take into consideration OCWD's replenishment assessments and the district's other water supply costs. Although we do not anticipate it at this time, we could take a negative rating action if the district materially spends down its cash reserves or financial performance significantly and unfavorably deviates from the district's forecast.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.