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Ratings

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Summary:

El Toro Water District Financing Authority, California; Water/Sewer

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Credit Profile		
US$42.68 mil wtr & wastewtr rev bnds ser 2022A due 06/01/2052		
Long Term Rating	AA/Stable	New

Rating Action

S&P Global Ratings assigned its 'AA' long-term rating to El Toro Water District Financing Authority, Calif.'s $42.7 million series 2022 water and wastewater revenue bonds. The outlook is stable.

The bonds are being issued to refund the authority's 2010, 2013, and 2018 state revolving fund agreements and fund capital improvements to the systems. Post issuance, the district will have approximately $50 million of obligations outstanding. The bonds are secured by the district's net revenue, including a 1% ad valorem property tax. We view the bond provisions as credit neutral, including a rate covenant and additional bonds test of 1.1x annual debt service.

Credit overview

The district benefits from an affluent, primarily residential customer base, with affordable service rates and access to the Los Angeles-Long Beach-Anaheim, metropolitan statistical area economy. In our view, the system's reliance on imported water from the Municipal Water District of Orange County (MWDOC), a participant to the Metropolitan Water District (MWD) of Southern California, exposes the district to wholesale water supply cost increases. We view the district's large, recycled water program as a mitigating factor, but this accounts for just 18% of the total water supplied to El Toro's service area. We have also adjusted positively for the district's rate-setting practices and regional partnerships, which provide credit support. A large portion of the monthly charges are fixed to cover all operational expenses, including capital replacement. Combined with affordable rates in the area, we anticipate this flexibility will provide stability to El Toro's finances and absorb rising costs. Regional partnerships with Irvine Ranch Water District and Moulton Niguel Water District (MNWD) provide water supply reliability and diversification opportunities.

In our opinion, the credit drivers are:

- Competitive and affordable customer rates given the stable and wealthy customer base;
- All-in debt service coverage (DSC) which has ranged from 1.1x-1.4x in the past three fiscal years and which we expect will remain at approximately 1.3x in the long term based on management projections;
- Unrestricted liquidity of about $19.9 million as of June 30, 2021, equating to 312 days of operating expenses, which we expect will remain strong given 75% of capital improvements will be funded through debt proceeds; and
- Comprehensive and proactive management practices and policies, represented by adequate water supply and wastewater treatment capacity to meet demand as well as long-term financial plans.

The stable outlook reflects our view that management will continue to increase rates to fund its moderate capital plan and maintain financial metrics supportive of the current rating. The outlook also reflects our opinion of the strong service area economy and management policies that we believe anchor the credit stability.

Environmental, social, and governance

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. The district has reduced some of its exposure to imported water through development of recycled water. In addition, the utility's wholesale suppliers such as MWDOC and MNWD actively maintain water-diversification projects, which we anticipate will lessen the long-term environmental effects on El Toro. We do not believe social risk is elevated compared with that of peers, given the wealth levels in the service area. Anticipated rate increases will not significantly pressure the rate affordability. Finally, we view the district's governance factors, including its long-term planning and credit-supportive rate-setting practices, as in line with those of other similarly rated utilities.

Stable Outlook

Downside scenario

We could lower the rating if all-in coverage declines below levels seen in management's forecast, due to unforeseen capital expenditures or a significant drawdown in cash.

Upside scenario

We do not anticipate raising the rating in the two-year outlook horizon, but in the long term we could raise the rating if financial metrics exceed projections, despite rising water supply costs.

Credit Opinion

Enterprise profile: Extremely strong

The district provides water and sewer services to 48,000 residents in the City of Laguna Woods and portions of Aliso Viejo, Laguna Hills, Lake Forest, and Mission Viejo. 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 income (MHHEBI) of 137% of the national median. While the leading 10 customers, primarily homeowner associations, account for approximately 40% of the water and sewer sales, we don't consider this as highly concentrated given they ultimately represent a large, diverse base of residential customers.

The district's combined water and wastewater rates are affordable given affluent income metrics and low county poverty rate, and we believe the district has future rate-setting flexibility. The district's water rate structure has a large, fixed component, set to cover all operating and maintenance expenses. The tiered commodity rate accounts for variable wholesale water supply costs. Ultimately, we believe that the district's rate-setting autonomy enables it to set rates to cover its costs. We consider the combined bill to be affordable at about 1.6% of MHHEBI.

The district's potable water supply is reliant on imported water supply, 63% of which is already treated, while the remaining is treated at the local Baker Water Treatment Plant. Approximately 80% of the district's water is obtained from MWD through MWDOC or MNWD. The district's remaining supply totaling approximately 20% of the district's water, is recycled water from El Toro's water recycling plant. The district is considering diversification of the future water supply through either recycled water expansion or water desalination projects. The district has sufficient wastewater treatment capacity to meet continued demand and is in compliance with all environmental regulations.

Financial profile: Strong

We view the district's all-in DSC as moderately strong, and we expect coverage will be maintained at historical levels given management's practice of annual 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 1.2x. Based on management projections, we anticipate that all-in coverage will remain at approximately 1.3x over 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. At fiscal year-end 2021 (unaudited), El Toro held unrestricted cash and investments of $19.9 million, or 312 days of operating expenses. This is consistent with historical years, where the district has sustained over 200 days operating cash on hand. Management does not expect to materially draw down on cash. We understand that the district has a robust liquidity policy including maintaining a minimum of $8.5 million cash reserve.

The district's capital improvement plan is moderate, in our view, at about $34.2 million during the next five years. Its pro forma debt-to-capitalization ratio is manageable, in our view, at about 50%.

Related Research

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