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Ratings

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Summary:

Monterey One Water, California; Water/Sewer

Primary Credit Analyst:
John Schulz, Des Moines (1) 303-721-4385; john.schulz@spglobal.com

Secondary Contact:
Tim Tung, San Francisco + 1 (415) 371 5041; tim.tung@spglobal.com

Table Of Contents

Summary:

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Credit Profile		
Monterey Regl Wtr Poll Ctl Agy wastewtr		
Long Term Rating	A+/Stable	Affirmed

Rationale

S&P Global Ratings affirmed its 'A+' rating on the Monterey One Water (MOW), formerly known as Monterey Regional Water Pollution Control Agency , Calif.'s outstanding wastewater revenue bonds. The outlook is stable. The rating reflects, in our opinion, the combination of very strong enterprise risk profile and strong financial risk profile. The outlook is stable.

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

- Service area participation in the broad and diverse Salinas metropolitan area economy partly offset by moderately high unemployment levels in the MOW's service area;
- Very low industry risk as a monopolistic service provider of an essential public utility;
- Affordable service rates that provide management with revenue-raising flexibility; and
- Strong operational management practices and policies that are forward looking and sustainable.

The strong financial risk profile reflects our view of the wastewater system's:

- Very strong all-in coverage metrics that we anticipate will be slightly stressed throughout the two-year outlook horizon as the State revolving loan debt service begins;
- Strong liquidity position that we believe will be maintained based on the MOW's adopted reserve policy that is partly offset by its large primarily cash funded capital improvement plan (CIP) beyond fiscal 2019;
- CIP that is large in the short term; and
- Strong financial management practices and policies.

The bonds are secured by a pledge of net revenue of the MOW's wastewater system, on parity with a state loan and a loan from the United States Bureau of Reclamation. Monterey County reimburses the MOW for debt service on the two loans, which are related to a recycled water treatment plant. As of June 30, 2017, the MOW had $15.2 million in parity debt outstanding, plus an $88 million subordinate lien state loan. The bonds have a reserve, funded at the lesser of 10% of par amount, 125% of average annual debt service, and maximum annual debt service (MADS). A rate covenant requires the MOW to generate debt service coverage of at least 1.25x.

Enterprise risk

The MOW owns and operates a regional wastewater treatment plant serving northern Monterey County. The local sewer utilities are responsible for their own collection systems. Monterey County is located along California's northern central coast, about 100 miles south of San Francisco. The coastal areas of the county are popular tourist destinations. The inland area's economy is based largely on agriculture. County household income levels are good, in our view, with median effective household buying income at 108% of the national median. However, the unemployment rate in the county is moderately high in our view, at 5.4% as of June 2018, compared with 4.2% for the state. We view the customer base as very diverse, with the top 10 customers representing around 7.6% of total operating revenue in 2017.

We view the MOW's service rates as affordable, and we believe this provides management with revenue-raising flexibility. The MOW bills retail customers directly for wastewater treatment services. Currently, a single-family residential customer is billed a flat $19.15 per month. Customers also pay fees to their local collection service provider for that service. We averaged and weighted for a typical residential sewer bill for treatment and collection served by MOW based on data from their budget that is roughly $29.8. We view the current rate as very affordable, at about 0.7% of Monterey County's MHHEBI, and we believe that it will remain affordable during the next five years based on management's forecast. In July 2017, the MOW adopted a three-year rate schedule and annual rate increases through fiscal 2020. Under the plan, rates increased 10% in 2018, 2019 and 2020. Future rate increases would require a public notice process and board approval. In addition to service charges, the authority also collects capacity fee revenue for new connections.

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

Based on our operational management assessment, we view the MOW to be a '1' on a six-point scale, with '1' being the strongest. This indicates, in our view, that operational and organizational goals are generally well aligned and comprehensive, even if some challenges exist. The plant has a capacity of 29.6 million gallons per day (mgd) and is currently treating an average of 18.4 mgd. The MOW treats wastewater for about 61,000 customers in: Pacific Grove, Monterey, Del Rey Oaks, Salinas, Seaside and Sand City, the former Fort Ord Military Reservation, the Marina Coast Water District, the Castroville Community Services Water District, the Moss Landing County Sanitation District, the Boronda County Sanitation District, and certain other unincorporated areas within Monterey County. The local sewer utilities are responsible for their own collection systems. The MOW also owns and operates a recycled water treatment plant, which treats wastewater to a tertiary level and provides irrigation for food crops. Under an operating agreement, Monterey County sells the recycled water and reimburses the MOW for all operating costs and debt service associated with the tertiary treatment plant. We understand that the MOW's strategic plan is regularly updated, and that it discusses strategies for staff succession. The MOW's rate-setting practice has historically been to adopt rate adjustments on an annual basis, although we understand that it has recently shifted to adopting multiyear rate schedules.

Financial risk

Financial performance dipped in fiscal 2017, due in part to a cost of living increase, raising health and pension benefit costs, and initial costs associated with the Pure Water Monterey advanced water purification project. Operating revenue totaled $28.3 million in fiscal 2017, increasing 5.6% from 2016.

Operating expenses were up 17.5% in fiscal 2017, totaling $23.1 million. Net revenue, including net operating income, $52,000 in interest income, $1.0 million in capacity charges or other revenue, totaled $6.4 million, providing debt service coverage of 1.25x as calculated by S&P Global Ratings. This is down from 1.94x in 2016 and 1.75x in 2015. Based on the MOW's 2018 unaudited financials , projected net revenue is projected to be good-to-strong, with increased operating revenue from the rate increase being partly offset by decreased expenses and decreased debt service. Based on projections provided by management, we anticipate that all-in coverage remained good to strong, at around 1.25x as the state revolving fund (SRF) debt service begins in 2019; however we anticipate coverage will increase as preapproved annual rates increases take place through fiscal 2020.

The MOW's liquidity position is strong, in our view. Unrestricted cash and investments as of June 30, 2017 totaled $6.4 million, representing about 101 days of operating expenses on hand. The unrestricted cash has remained consistent nominally; however, as expenses have grown the days' cash has decreased slightly. We anticipate this trend to continue as MOW cash funds projects beyond Pure Water Monterey project.

The MOW's five-year capital plan includes $91.7 million in projects. According to management, the MOW plans to pay for these projects with wastewater revenues and capital reserves beyond the recharge project that will be funded by a SRF loan. There are no additional debt plans beyond 2019. MOW is moving forward with the development of a groundwater replenishment project in which highly treated wastewater would be injected into the local groundwater basin. The project's purpose is to help recharge the basin and provide additional local water supply. The MOW expects the cost of the project to be reimbursed by customers receiving the water. The MOW has a defined-benefit pension plan with California Public Employees' Retirement System (CalPERS). The net pension liability is funded at 74% and the ARC is currently funded at 189%. We understand that the MOW has made its required contributions to CalPERS. With this debt issuance, the debt to capitalization is 65.9%, which we consider moderate when including fiscal 2019 SRF loans. With no debt plans in the next five years, we believe this will continue to be a credit strength.

Based on our financial management assessment, we view MOWs to be a '1' on a six-point scale, where '1' is the strongest. We believe that the MOW's practices are strong and generally comprehensive in nature. The MOW's strengths include: interim financial reporting that is provided to the MOW's finance committee, reasonable revenue and expense assumptions with financial performance that is not dependent on one-time revenue, and an adopted reserve policy that provides a rationale for the MOW to maintain strong liquidity going forward. We understand that MOW reviews an adopted a 10-year CIP annually. In addition, MOW has a robust and formal a debt management plan. Financial planning and operational data are easily obtained, as the budget, financial statements, and projections are readily available on the MOW's website.

Outlook

The stable outlook reflects our anticipation that the MOW will set rates going forward to maintain stable financial performance and provide funding for the capital plan.

Upside scenario

We could take a positive rating action if the MOW's unrestricted liquidity is maintained at a more robust nominal amount that is more commensurate with its higher-rated peers and the completion of their tertiary treatment project to get a better understanding of the operating expenses with these additional treatment processes and full debt load as the SRF loan debt service begins.

Downside scenario

We could take a negative rating action if the MOW shifts its capital funding strategy to significantly more leverage, thereby leading to more narrow coverage metrics going forward, or if cash reserves are materially spent down.

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.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.