S&P Global Ratings

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Summary:

Anaheim, California; Water/Sewer

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Summary:

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Credit Profile		
US$34.895 mil rev bnds (Anaheim) (Wtr Sys Proj) ser 2016A due 10/01/2046		
Long Term Rating	AA+/Stable	New
Anaheim Pub Fincg Auth, California		
Anaheim, California		
Anaheim Pub Fincg Auth (Anaheim) wtr		
Long Term Rating	AA+/Stable	Downgraded
Anaheim Pub Fincg Auth (Anaheim) wtr		
Unenhanced Rating	AA+(SPUR)/Stable	Downgraded

Many issues are enhanced by bond insurance.

Rationale

S&P Global Rating Services lowered its long-term and underlying ratings to 'AA+' from 'AAA' on the outstanding Anaheim Public Financing Authority's (APFA) and the California Municipal Finance Authority's water revenue bonds, issued on behalf of the city of Anaheim's water system. We also assigned our 'AA+' long-term rating on the APFA's series 2016 water revenue bonds. The outlook is stable.

The rating action reflects the application of our revised criteria, 'Rating Methodology and Assumptions for U.S. Municipal Waterworks and Sanitary Sewer Utility Revenue Bonds,' published Jan. 19, 2016, and the combination of an extremely strong enterprise risk profile and a very strong financial risk profile.

The enterprise risk profile reflects our view of the water enterprise's:

- Service area participation in the broad and diverse Los Angeles-Long Beach-Anaheim metropolitan area economy;
- Very low industry risk as a monopolistic service provider of an essential public utility;
- Moderate service rates in the context of the service area's strong income levels; and
- Comprehensive operational management practices and policies.

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

- Consistent historical all-in debt service coverage metrics that we anticipate will be sustained going forward;
- Formula-based rate structure, which includes automatic adjustors for commodity charges and debt service, provides a clear trajectory of the future rate increases required to meet revenue requirements;
- Manageable capital improvement program (CIP) that utilizes a mix of additional leverage and pay-as-you-go funding sources; and
- Robust financial management practices and policies.

Proceeds of the series 2016-A bonds will fund capital improvements to the water system. We view legal provisions as standard and neutral to the credit. The bonds are secured by project revenues, which consist primarily of purchase

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payments to be made by the city under an installment purchase agreement, between the authority and the city. These payments are payable from the city's water system net revenue on parity with $130.4 million of outstanding obligations, as of August 1, 2016.

The rate covenant requires net revenues equal to at least 1.1x the amount of annual debt service, and an additional bonds test of 1.1x maximum annual debt service. The bonds will sold without a debt service reserve fund.

Enterprise risk

Anaheim (population: 358,000) covers 50 square miles and is located in the northern portion of Orange County, about 28 miles southeast of downtown Los Angeles and about 90 miles north of San Diego. The city is mostly built out, which effectively limits growth rates; however, with infill growth, the utility expects the local population to rise to about 400,000 by 2030. The economic base is well diversified, in our opinion, with a mix of services, entertainment, manufacturing, and trade. Freeways in and through the city provide convenient access for commuters and tourists. Median household effective buying income (EBI) is what we consider to be strong, at 111% of the national average. In June 2016, the city's unemployment rate was 5.6%, which was lower than state's rate of 5.7% but higher than the national rate of 5.1%.

The water system serves virtually the entire area within the limits of the city and a small area that lies outside of the incorporated city boundary. The water system's customer base is residential, stable, and, our opinion, very diverse. In fiscal 2016 the water system served about 63,775 accounts. Customer growth as been less than 0.5% per year over the past three years. In fiscal 2015, the water system delivered approximately 19.5 billion gallons of water, with 59% used for residential purposes, 40% for commercial and industrial purposes, and 1% for other purposes. The ten largest commercial and industrial customers accounted for approximately 10% of total water consumption and 9% of total water revenue in fiscal 2015.

We view the utility's market position as strong based on the utility's moderate retail service rates, but weakened somewhat by the county's poverty rate. Based on typical water usage within the service area of 1,600 cubic feet of water per month, management reports the typical residential water bill is $45.70. We consider the monthly bill to be affordable at 1.1% of Anaheim's MHHEBI. The county's poverty rate as reported by the U.S. Department of Agriculture is 12.9%, which we view as somewhat elevated and a weakening factor.

The city's main source of water supply is groundwater from the Orange County Groundwater Basin (75% of fiscal 2015 supplies) and the remainder comprised of imported water. Historically, local groundwater has been the least costly and most reliable source of supply for the city. According to the city's 2015 urban water management plan, the city is expected to continue to rely on the groundwater basin for approximately 70 percent of its supply. The groundwater basin is managed by Orange County Water District (OCWD). OCWD annually sets a basin production percentage (BPP) to protect the basin from overpumping, and we understand that the BPP has ranged from 62% to 72% 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 BPuP. 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. The city purchases supplemental imported water from the Metropolitan Water District of Southern California (MWD) at a cost that is significantly higher than the cost of producing groundwater up to the BPP.

The city has adjusted its service rates annually during the past decade and this trend is forecast by management to continue during the next five years. There are four components of the water enterprise's residential rate structure, including a fixed "monthly customer charge" which does not fluctuate with customer demand. This fixed charge was most recently increased to $9.90 per customer to offset reduced revenues and demand associated with drought and mandatory water conservation measures, effective February 1, 2016. Rates also include (i) a "base commodity charge" which covers the cost of utility operations and maintenance, (ii) a "water commodity adjustment charge" for the costs of imported water purchased from MWD, groundwater pumping and replenishment charges paid to OCWD, and power costs associated with the distribution system, and (iii) a system "reliability adjustment charge" associated with capital expenditures and debt service. Each of these charges are calculated based on 100 hcf of water usage. The latter two charges are calculated by formula, and changes to the amount of the water commodity adjustment and water system reliability adjustment may be made at any time, without further city council action. We view the utility's ability to quickly pass through water supply costs (including MWD and OCWD charges) to be important to be a key credit strength.

Based on our operational management assessment, we score the utility a '2' on a six-point scale on which '1' is the strongest. The city's 19 active groundwater wells provide a maximum capacity of 79 million gallons per day (mgd), which, together with its imported water connections, provide a total combined capacity of 188 mgd of water. Management reports that the combined supply capacity is well above the average 56 mgd demand level, and even above peak demand of 80 mgd over the past five years.

The utility's operational contingency plans include an adopted drought management plan that is incorporated into its urban water management plan. We understand that the utility uses both SCADA and hydraulic models for tracking the maintenance and condition of the system's assets. The city last hired an outside rate consultant to provide a water rate study in 2008; however, we understand management expects to an updated 5-year rate study to be completed later this fall. Although the utility's current practice is to approve rates on an annual basis rather than through pre-approved multiyear rate schedules, we still view this practice as strong given the ability to pass through rising water supply and fixed capital costs.

Consistent with "Methodology: Industry Risk," published Nov. 19, 2013, we consider industry risk for the utility to be very low, the most favorable assessment possible on a '1' to '6' scale, with '1' being the best.

Financial risk

The water enterprise's historical financial performance has been stable and we anticipate that it will remain steady going forward, despite a one-time decline in coverage in fiscal 2015 resulting from a $4.1 million transfer to the electric fund. Based on audited financial statements and estimates for the most recent unaudited period, we calculate that all-in coverage during the past four fiscal years ranged from a low of 1.2x (1.5x excluding the one-time transfer) for fiscal 2015 to a high of 1.7x for fiscal 2016, which we consider adequate at this rating level. Our calculations of all-in coverage take into consideration all of the enterprise's direct debt that is paid from net revenues as well as imputed debt service from OCWD and MWD. Direct DSC (excluding imputed OCWD and MWD debt service) after transfers was 1.5x in fiscal 2015, down from 2.3x in fiscal 2014, but is expected to return to 2.1x in fiscal 2016 (unaudited.)

According to management's projections, direct DSC (after transfers) will be roughly in line with historical levels, and is expected to exceed 2.0x through fiscal 2021.

The utility's unrestricted cash balances have been strong over the past three years; we forecast cash balances to improve steadily from current levels through fiscal 2021. The unrestricted cash and investment balance stood at $20.3 million or 159 days' cash in hand, at the end of fiscal 2016 (unaudited), down modestly from $22.4 million, or 163 days' cash, in fiscal 2014. Cash on hand is supplemented by a $14 million revolving credit agreement (which expires in fiscal 2021) which is equal to another 110 days' of operating expenses, which bolsters the utility's total liquidity position of 268 days' of operations in fiscal 2016. Management's pro forma assumes unrestricted cash to rise to $46.6 million, or 243 days' cash in hand, not including the line of credit, over the forecast period. The utility's formal policy is to maintain a minimum of 120 days' cash on hand, a level it has comfortably exceeded in recent years.

We believe the utility's five-year CIP is manageable and the amount of additional leverage contemplated does not materially affect the utility's financial profile. We understand that capital improvement projects during the next five fiscal years are primarily comprised of renewal and replacement projects and system improvements to increase storage and treatment capacity. The CIP through fiscal 2021 totals $138 million, and will be funded through the series 2016A bonds ($40 million), funds available from the 2015 bonds ($28.4 million), surplus revenues ($40.3 million) and an additional bond issuance in fiscal 2020 ($30 million). We calculate the debt-to-capitalization ratio for fiscal 2015 at about 45%, which we consider moderate.

Based on our financial management assessment, we rate the utility a '2' on a six-point scale on which '1' is the strongest. We believe that the utility's practices are supportive of high credit quality. Revenue and expenses assumptions are reasonable, and interim financial reporting is provided to the city council on a monthly basis. The long-term planning process is rigorous, and the detailed multiyear forecast is updated quarterly. However, we note that management's current five-year financial forecast is not publicly available and it is not presented in the disclosure for this bond offering (although we did request and receive the pro forma in advance of this review). The utility has an adopted reserve policy that we believe supports adequate liquidity levels and articulates the rationale for maintaining its various reserves. Furthermore, financial planning and operational information are somewhat easily obtained, as the utility's budget, financial statements, and other important operational and financial information is generally available on its website.

Outlook

The stable outlook reflects our view of Anaheim's very strong service area characteristics, ample and relatively low-cost groundwater supply, coupled with good operational and rate-making flexibility.

Upside scenario

We may contemplate raising the ratings if financial metrics improve such that the financial risk profile is commensurate with peers at a higher rating level.

Downside scenario

While unexpected (given management's five-year projections, which we view to be achievable), we could take a negative rating action if the city significantly draws down unrestricted liquidity over the two year outlook period. Similarly, an erosion in median household effective buying income or county GDP (or an increase in county poverty rates) would also likely result in a negative rating action.