

RATING ACTION COMMENTARY

Fitch Affirms Yorba Linda Water District CA's Water Revs at 'AA'; Outlook to Positive

Thu 03 Sep, 2020 - 5:37 PM ET

Fitch Ratings - Austin - 03 Sep 2020: Fitch Ratings has affirmed its 'AA' rating on the following bonds issued by the Yorba Linda Water District (YLWD or the district):

--\$6.6 million revenue refunding bonds, series 2012A;

--\$27.6 million Yorba Linda Water District Financing Authority, CA revenue bonds, series 2017A (issued on behalf of the district).

In addition, Fitch has assigned an 'AA' issuer default rating (IDR) to the district.

The Rating Outlook is revised to Positive from Stable.

ANALYTICAL CONCLUSION

The current ratings reflect the district's very strong net leverage ratio, or net adjusted debt-to-adjusted funds available for debt service (FADS), in the context of very favorable revenue defensibility and operating risk profile. Net leverage has been relatively stable the past five years and finished fiscal 2019 at a very low 3.0x. Based on management's forecast and capital improvement plan (CIP), net leverage will likely temporarily increase due to a

\$5.8 million LOC drawdown projected in fiscal 2021, but then should quickly rebound to historical levels.

The Positive Outlook reflects the continuing resolution of historical rate controversy. Progress has been made from a rate-setting standpoint, as demonstrated by recent rate increases, which were in part reflective of management's community outreach and education. The continued ability to enact necessary rate increases should further support the district's financial profile and potentially a higher rating.

CREDIT PROFILE

The district is an upper-income suburban community located in northeastern Orange County, approximately 35 miles southeast of downtown Los Angeles. The service area predominantly covers the city of Yorba Linda (the city), in addition to portions of Anaheim, Brea, and Placentia, and unincorporated county areas. About 93% of the district's 25,200 customers are residential.

The district typically gets about 75% of its supply from relatively affordable local groundwater. The remaining 25% is surface water provided by the Municipal Water District of Orange County (MWDOC) via water delivered from the Metropolitan Water District of Southern California (MWD, 'AA+' / Stable Outlook). However, earlier this year, the State Water Resources Control Board (SWRCB) lowered the allowable levels of perfluoroalkyl substances (PFAS) in the state's public drinking water, which has led to groundwater well closures throughout southern California. The YLWD's groundwater supply is directly affected by this mandate which, in the near term, will effectively require it to purchase more surface water at a higher cost until a new treatment plant is built in 2021. Current estimates show approximately 64% of fiscal 2021 supply coming from surface water. Favorably, management reports that MWD's supply is sufficient to service its affected retail customers with no impact until the new plant is complete. After 2021, the YLWD anticipates returning to around 75% of supply coming from groundwater.

Coronavirus Considerations

The outbreak of coronavirus and related government containment measures worldwide creates an uncertain global environment for the water and sewer sector. While the district's performance through most recently available data has not indicated impairment, changes in revenue and cost profiles are occurring across the sector. Fitch's ratings are forward-looking in nature. Fitch will continue to monitor developments in the sector as a

result of the virus outbreak and incorporate any revised expectations for future performance and assessment of key risks as appropriate

KEY RATING DRIVERS

Revenue Defensibility 'aa'

Very Strong Service Area, Affordable Rates.

The system's service area exhibits very favorable demand characteristics, including strong income and unemployment metrics, while customer growth is midrange. Rates are affordable for a significant majority of the population.

Operating Risks 'aa'

Operating Cost Burden and Life-Cycle Ratios both Very Favorable.

The operating cost burden is measurably lower than Fitch's 'aa' threshold. The system's life-cycle ratio is very favorable and capex to depreciation is midrange.

Financial Profile 'aa'

Net Leverage Very Strong and Should Remain So.

Net leverage is very favorable and, after a minor short-term increase from the LOC draw, should improve further over the next five years as no additional debt is expected at this time.

ASYMMETRIC ADDITIVE RISK CONSIDERATIONS

Although easing, management and government risks related to the district's history of rate controversy continue to weigh on the current rating.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to a positive rating action/upgrade:

--Continued ability to pass rate increases sufficient to cover the increasing cost of operations and capital investment;

--Sustained net leverage of less than 6.0x.

Factors that could, individually or collectively, lead to a negative rating action/downgrade:

--Inability to pass rate increases sufficient to cover the increasing cost of operations and capital investment;

--Sustained net leverage of more than 8.0x.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [\[https://www.fitchratings.com/site/re/10111579\]](https://www.fitchratings.com/site/re/10111579).

SECURITY

The revenue bonds are parity obligations secured by net water revenues of the district after payment of operations and maintenance expenses.

REVENUE DEFENSIBILITY

The district's revenue defensibility is very strong. Revenues are derived from 100% monopolistic sources (retail water sales) and, assuming Fitch's standard 7,500 and 6,000 gallons per month of water and sewer usage, respectively, monthly bills are affordable for a significant 90% of the city's customers. Actual usage is typically higher than Fitch's standard assumption, but even considering this, affordability is still very strong due in part to the service area's higher income metrics. Approved rate adjustments in fiscal 2021 meant to address the higher cost of service tied to the PFAS mandate (i.e., higher water-purchase costs) should not significantly affect affordability.

The district serves a diverse, affluent suburban residential service area in Orange County, California that exhibits very strong demand characteristics. Median household income is more than twice the national level, and unemployment rates trend lower than the national average. Customer concentration is manageable with the top-10 ratepayers providing 10% of 2019's total revenues.

OPERATING RISKS

The district's current operating risk profile is very favorable, as fiscal 2019 finished with an operating cost burden of approximately \$5,160 per million gallons (mg) of water produced, which is measurably less than Fitch's 'aa' threshold of \$6,500 per mg. Given the need to sometimes purchase more surface water based on weather variability, the operating cost burden can be volatile. Additionally, increases in operational costs are expected in fiscal 2021 due to the PFAS mandate, which will likely temporarily result in an increased cost burden. However, completion of the new groundwater treatment plant in fiscal 2022 should result in water costs again moving lower, and thus a trend of an elevated operating cost burden is not expected in the medium term.

At approximately 65% over the last five years, capex-to-depreciation is somewhat below average, but this is balanced by the system's very favorable life-cycle ratio of 37% (versus the 'aa' sub-assessment threshold of 45%). Capital spending through fiscal 2024 is

projected at about \$26.5 million, with most projects tied to repair and rehabilitation of existing infrastructure. This is somewhat higher than spending the previous five years, which should lead to improvements in the capex-to-depreciation ratio. The CIP utilizes a subordinate-lien LOC for partial funding, but the large majority will be funded by surplus cash.

Although not part of the district's capital plan, the aforementioned new groundwater treatment plant is estimated to begin in the 1Q21, and is scheduled for completion by the third quarter. Under an agreement with the YLWD, the OCWD will be funding the design and construction, and will also pay half of the operational and management costs. Total plant costs are projected to be around \$250 million, but this will be spread between the 19 retail members.

FINANCIAL PROFILE

The district's financial profile is very strong. After having averaged a healthy 2.25x since fiscal 2015, coverage of full obligations (COFO) remained robust in fiscal 2019, and net leverage continues to hover around a very low 3.0x. The district's liquidity ratio is also very strong, averaging 484 days since fiscal 2015. Overall, COFO and liquidity are neutral to the overall financial profile assessment.

Fitch Analytical Stress Test (FAST)

Fitch's FAST provides a five-year forward look at net leverage in base and stress case scenarios. Based on management's latest forecast, which Fitch deems to be reasonable, the base-case FAST shows net leverage weakening from the fiscal 2019 level of 3.0x to approximately 5.0x in fiscal 2021 before then declining to a very low 1.8x by the end of the forecast period. The increase in 2021 is driven by management's projected \$5.8 million LOC draw combined with an expected 8% increase in operational costs. Improvements in years three through five (fiscal 2022-2024) are based on sales growth and meaningful rate increases, as projected by management, leading to stronger FADS.

Fitch's rating case, which includes the same assumptions as its base case plus an additional 10% annual increase in capex, results in net leverage increasing to 5.2x in fiscal 2021 before finishing the five-year period again at very favorable level of 2.0x. Both the base and rating case demonstrate net leverage supportive of a higher rating after fiscal 2021.

ASYMMETRIC ADDITIVE RISK CONSIDERATIONS

Management's history of rate controversy continues to constrain the current rating. Successful implementation of the rate increases expected in fiscal 2021 would largely offset Fitch's concerns, and likely eliminate this asymmetric additive risk factor as a rating constraint.

SOURCES OF INFORMATION

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Yorba Linda Water District (CA): Governance Structure: 4

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of 3 - ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity.

RATING ACTIONS			
ENTITY/DEBT	RATING		PRIOR
Yorba Linda Water District (CA)	LT	AA Rating Outlook Positive	New Rating
	IDR		

ENTITY/DEBT	RATING			PRIOR
Yorba Linda Water District (CA) /Water Revenues/1 LT	LT	AA Rating Outlook Positive	Affirmed	AA Rating Outlook Stable

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FITCH RATINGS ANALYSTS

Major Parkhurst

Director

Primary Rating Analyst

+1 512 215 3724

Fitch Ratings, Inc.

111 Congress Avenue Suite 2010 Austin 78701

Audra Dickinson

Director

Secondary Rating Analyst

+1 512 813 5701

Dennis Pidherny

Managing Director

Committee Chairperson

+1 212 908 0738

MEDIA CONTACTS

Sandro Scenga

New York

+1 212 908 0278

sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

[Public Sector, Revenue-Supported Entities Rating Criteria \(pub. 27 Mar 2020\) \(including rating assumption sensitivity\)](#)

[U.S. Water and Sewer Rating Criteria \(pub. 03 Apr 2020\) \(including rating assumption sensitivity\)](#)

ADDITIONAL DISCLOSURES

[Dodd-Frank Rating Information Disclosure Form](#)

[Solicitation Status](#)

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ENDORSEMENT STATUS

Yorba Linda Water District (CA)

EU Endorsed

Yorba Linda Water District Financing Authority (CA)

EU Endorsed

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