S&P Global
Ratings

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Summary:

Eastern Municipal Water District, California; Water/Sewer

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Table Of Contents

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Credit Profile		
Eastern Mun Wtr Dist WTRSWR		
Long Term Rating	AA+/Positive	Outlook Revised
Eastern Mun Wtr Dist WTRSWR		
Long Term Rating	AA+/A-1/Positive	Outlook Revised

Credit Highlights

- S&P Global Ratings revised the outlook to positive from stable on Eastern Municipal Water District, Calif.'s outstanding water and wastewater revenue bonds, where applicable.
- At the same time, S&P Global Ratings affirmed its 'AA+' long-term rating on the district's outstanding water and wastewater revenue bonds and its 'AA+/A-1' rating on the district's series 2018A variable-rate demand bonds.
- Given the district's exceptional financial metrics and strong management practices, the positive outlook reflects a one-in-three likelihood that we could raise the district's ratings during the outlook period, assuming no major changes to its water supply portfolio or costs of operations. We will monitor how it adjusts revenue and spending should potential recessionary conditions emerge in the near-term.

Security

We view the bond provisions as credit neutral. Key bond provisions include a rate covenant and an additional bonds test, both of which are set at 1.15x aggregate annual debt service.

The 'A-1' short-term component of the rating on the series 2018A bonds reflects the short-term rating on Bank of America, N.A. (A-1), which is providing an enhancement for the bonds in the form of a standby bond purchase agreement (SBPA) effective through Sept. 26, 2025.

Credit overview

In our view, the district benefits from its position as an essential water, wastewater treatment, and recycled water provider to a population of more than 880,000; an affordable rate structure supported by a diverse customer base with good wealth and income indicators; well-defined management practices that contribute to stable operations; significant cash on hand; and strong pro-forma debt service coverage levels that we view as supportive of the rating. The rating is further supported by management's proven track record in developing recycled water projects and local groundwater resources intended to improve the long-term reliability of its water supply.

Key risks center on the district's ability to manage customer growth and its ability to meet construction milestones for planned capital projects, given current inflationary pressures and negative economic headwinds. While unexpected, a significant increase in the district's imported water costs (from the Metropolitan Water District of Southern California or MWD) would also negatively pressure the rating. We believe management's conservative budgeting, success securing capital grants and other sources of external funding help temper these risks. We also consider the size and scope of the upcoming capital improvement program to be generally manageable in the context of the district's historical spending levels.

The rating further reflects our view of the district's:

- Diversified revenue base from water and wastewater service charges, property taxes, recycled water sales, and connection fees;
- Comprehensive water supply portfolio with approximately half of its retail water demand supplied using local sources--including treated wastewater to reuse for beneficial purpose--with the balance served by MWD;
- Competitive rates relative to those of its regional peers;
- Extremely strong all-in coverage metrics and significant cash reserves, which we anticipate will be sustained during the outlook period as management assumes 6.5% annual rate increases in fiscals 2024 and 2025, which we consider manageable; and
- Favorable debt ratios relative to similarly rated peers, coupled with a moderately sized capital improvement program, totaling $550 million through 2028, that will be funded primarily on a pay-as-you-go basis and cash on hand.

Environmental, social, and governance

Given its location in California, we view the district as facing slightly above average environmental risk due to the region's inherent water supply scarcity from natural cycles of drought, wildfire, and seismic exposure. Both MWD and the district have completed water service reliability assessments, which indicate they have supply capabilities sufficient to meet expected demands from 2025 through 2045 under both a single dry-year and a period of drought lasting five consecutive water years. However, given widespread concern about the Colorado River basin's long-term water supply, the U.S. Department of Interior could use its federal authority to unilaterally reduce water use, which could adversely influence MWD's overall costs and the credit quality of its contractors. We expect greater clarity on this issue within the next year.

Importantly, we consider the district's ability to beneficially use almost 100% of the recycled water that it produces to be credit supportive, as this supply helps insulate it from drought and shifting precipitation patterns. The district maintains a regional recycled water system that provides tertiary-treated recycled water to customers for agricultural, landscape irrigation, environmental, and industrial use. The district has further maximized its local supplies by constructing desalters (desalination facilities) or blending water to be able to use groundwater that is high in salinity and requires desalination for potable use. The district currently has adequate wastewater treatment capacity that is sufficient to meet both its average and peak day demand.

With respect to seismic, wildfire, and cyber risks, management has robust emergency planning to address these event risks in a timely manner. The district has strong management and financial policies, which mitigates its governance risks when compared to its peers. Further, the district's allocation budget-based rate structure ensures cost recovery by passing through imported water costs into more expensive tiers as usage changes and insulates it from reduced water sales during droughts.

Outlook

The outlook, where applicable, is positive, reflecting our view of management's prudent approach to mitigating the short- and long-term credit risks associated with climate variability and water shortages as well as its exceptionally strong financial profile.

Downside scenario

Should the district experience a sustained material negative shift in economic momentum or erosion in its market position assessment, resulting in a significant deterioration in its financial profile, we could revise the outlook to stable.

Upside scenario

We could raise the ratings if near-term financial performance remains credit supportive, and we believe the district's water resources will continue to be adequate despite Colorado River regulatory exposure.

Credit Opinion

The district encompasses 555 square miles and is located in the western third of Riverside County, providing retail water and wastewater service within the cities of Moreno Valley, Menifee, Murrieta, and Temecula, as well as certain unincorporated areas within the county. The district also provides wholesale water service within the cities of Hemet, San Jacinto, and Perris, as well as to Lake Hemet Municipal Water District, Nuevo Mutual Water Co., Rancho California Water District, Western Municipal Water District, and the California Department of Water Resources. We consider income indicators in the service area to be mixed but generally good to strong, with the median household effective buying income (MHHEBI) ranging from a low of 67% of the national median in Hemet to a high of 141% in Temecula.

Although the service area's growth has moderated, the district population continues to climb, driven by cycles of economic expansion and conversion of agricultural land to urban development. Since 2010, new connections have slowly been increasing but remain well below the peak levels of new development seen in the early 2000s. Current forecasts indicate the district's population will grow by about 300,000 people by 2045, an approximately 30% increase from the current population; accordingly, we expect EMWD will continue to invest in local supply and regional partnerships (such as the San Jacinto Enhanced Recharge and Recovery Program) as well as with MWD to ensure it has adequate water supply to serve a growing population over time.

The district has adjusted its service rates annually during the past decade, and management forecasts this trend to continue during the next five years. Furthermore, the use of budget-based rates has insulated the district's financial performance from decreasing water volumes during the past several years. Management adjusts the water budgets to achieve changes in customer behavior by sending stronger pricing signals when additional conservation is required. Customers who elect to use water beyond their budgets pay the highest prices for water that is over their budgeted use. Based on the district's current rate plans, we expect the average monthly-equivalent combined bill of approximately $114 (in fiscal 2023) to rise to about $130 in fiscal 2025, or about 2.5% of MHHEBI when annualized, which we generally consider affordable.

The district does not anticipate a reduction in supply reliability due to water quality constraints from local contaminants. The district previously detected PFAS in several groundwater wells at levels that exceed health advisory levels, but the wells have been placed back in service after wellhead treatment services were completed. While we recognize the regulatory landscape is becoming more stringent with respect to various contaminants, we do not anticipate it will have a meaningful influence on the district's water supply. Management reports that although certain portions of its supply may require treatment or blending, the quantity of available water is not expected to be diminished from projected levels due to quality.

As calculated by S&P Global Ratings, the district achieved very strong all-in debt service coverage (including off-balance-sheet obligations) of 2.9x in fiscal 2022 and 2.7x in fiscal 2021. We consider the district's financial performance strong, although it is somewhat reliant on development activity, as demonstrated by the all-in coverage metrics excluding one-time developer fees of about 2.0x in both years. We calculate an "all-in" coverage metric that considers imputed debt service that is implicitly passed on to the district from its wholesale water suppliers. Based on the contractual relationship with MWD, the district does not have any take-or-pay minimum water sales payments. Instead, we calculate that approximately 30% of the district's imported water costs go to pay a portion of MWD's direct debt service and fixed costs related to the State Water Project, therefore we also impute 30% of the district's imported water costs in lieu of an explicit fixed cost to arrive at our all-in coverage metric.

The district has also historically held an exceptionally strong liquidity position, supported by a well-defined reserve policy. Based on the district's audited financial statements, the district held approximately $455 million of unrestricted cash and investments, equivalent to 733 days of operating expenses, at the end of fiscal 2022. While a portion of the district's cash reserves may be used to fund capital projects, we expect cash balances to remain at levels we consider credit supportive.

We view the district's leverage level as moderate, and we believe its five-year capital improvement plan is manageable. The five-year plan totals $550 million, which will be funded on a pay-as-you-go basis. We consider the district's debt-to-capitalization ratio moderate at less than 40% as of June 30, 2022.As of that date, the district's total outstanding revenue bonds and state revolving fund loans totaled $915 million, of which 84% were issued at a fixed interest rate while 16% were issued in a variable interest rate mode. The district participates in the California Public Employees' Retirement System and has been making its necessary annual employer contributions. We view the pension and other post-employment benefit costs as credit neutral to the district's debt and liabilities profile.

Related Research

Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022

Ratings Detail (As Of March 28, 2023)		
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Ratings Detail (As Of March 28, 2023) (cont.)		
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Long Term Rating	AA+/Positive	Outlook Revised
Eastern Mun Wtr Dist Fincg Auth, California		
Eastern Mun Wtr Dist, California		
Eastern Mun Wtr Dist Fincg Auth (Eastern Mun Wtr Dist) rfdg wtr and wastewtr rev bnds		
Long Term Rating	AA+/Positive	Outlook Revised

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