Summary:

Eastern Municipal Water District, California; Water/Sewer

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

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

Table Of Contents

Rationale

Outlook
Summary:
Eastern Municipal Water District, California; Water/Sewer

Credit Profile

<table>
<thead>
<tr>
<th>Description</th>
<th>Long Term Rating</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>US$53.485 mil rfdg wtr and wastewtr rev bnds ser 2018B due 07/01/2048</td>
<td>AA+/Stable</td>
<td>New</td>
</tr>
<tr>
<td>US$47.7 mil rfdg wtr and wastewtr rev bnds ser 2018C due 07/01/2048</td>
<td>AA+/Stable</td>
<td>New</td>
</tr>
<tr>
<td>Eastern Mun Wtr Dist WTRSWR</td>
<td>AA+/Stable</td>
<td>Affirmed</td>
</tr>
<tr>
<td>Western Riverside Wtr &amp; Wstwtr Fincg Auth WTRSWR</td>
<td>AA-/Stable</td>
<td>Upgraded</td>
</tr>
</tbody>
</table>

Rationale

S&P Global Ratings raised its long-term rating and underlying rating (SPUR) to ‘AA-’ from ‘A+’ on Western Riverside Water and Wastewater Financing Authority, Calif.’s series 2005A and series 2009 bonds. At the same time, we assigned our ‘AA+’ long-term rating to Eastern Municipal Water District, Calif.’s $53 million series 2018B and $48 million series 2018C refunding water and wastewater revenue bonds. We also affirmed our ‘AA+’ long-term rating on the district's senior-lien and subordinate-lien water and wastewater revenue bonds, and the 'AA+' long-term component of our dual rating on the district's variable-rate demand bonds. The 'AA+' rating reflects, in our opinion, the combination of a very strong enterprise risk profile and an extremely strong financial risk profile. The outlook, where applicable, is stable.

We raised the rating on the authority's bonds based on application of our revised criteria, "Issue Credit Ratings Linked To U.S. Public Finance Obligors' Creditworthiness," published Jan. 22, 2018, on RatingsDirect. In particular, the rating on the authority's bonds is two notches below the district's issuer credit rating based on the district's pledge to use legally available funds to make up for any deficiencies in the authority's debt service payments. This rating change affects $32.5 million of the authority's existing bonds.

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

- Service area participation in the broad and diverse Riverside-San Bernardino-Ontario metropolitan area economy;
- Very low industry risk as a monopolistic service provider of an essential public utility;
- Track record of annually reviewing and adjusting service rates to produce consistent financial performance; and
- Good operational management practices and policies.

The financial risk profile reflects our view of the district's:
• Extremely strong historical all-in coverage metrics of more than 1.8x during the past three fiscal years, which we believe will be sustainable going forward;

• Very strong liquidity position based on unrestricted cash and investments of $310 million, equivalent to 577 days of operating expenses, at the end of fiscal year 2017;

• Moderate leverage level based on about $1 billion of existing debt in combination with a capital plan that is anticipated to be funded primarily on a pay-as-you-go basis; and

• Strong financial management practices and policies.

Although western Riverside County continues to demonstrate a strong economic rebound from the recession, in our view, growth within the service area remains highly cyclical. We recognize that management has historically adjusted its connection fees in part to provide a buffer during low development years. Even so, we believe that dramatic growth in connections followed by depressed development makes predicting new developments and infrastructure capital planning difficult, which could be a credit risk over the medium-term planning horizon. However, in the event that connection fees or other growth-related revenues decline from management’s current projections, we expect management would adjust rates to ensure all-in coverage remains at levels we consider extremely strong through 2023. We also believe that the district’s future financial performance is further stabilized by its diverse revenue stream—including property taxes and standby charges, and drought-based rates—that insulates revenues from conservation and other factors impacting demand.

The district is issuing the series 2018B and 2018C bonds to refund existing bank-placed bonds to achieve a lower overall cost of funds.

We view the bond provisions as credit neutral. The series 2018B and series 2018C bonds are secured by a subordinate lien on the net revenues of the district. Key bond provisions include a rate covenant and an additional bonds test, both of which are set at 1.10x aggregate annual debt service. The district does not intend to provide a debt service reserve for the series 2018B or series 2018C bonds.

The series 2018B and series 2018C bonds will be issued initially in index mode with the series 2018B bonds bearing interest based on the LIBOR index and the series 2018C bonds bearing interest based on the SIFMA index. Both series of bonds are expected to be subject to an initial mandatory tender in September 2021. The district’s failure to purchase the bonds on the mandatory tender date does not trigger an event of default, but rather the bonds will bear interest at a penalty rate until they are remarketed, redeemed, or converted to another mode.

Enterprise risk

The district is located in the western third of Riverside County and encompasses 555 square miles. The service area population is about 845,000 with retail water service provided within the cities of Moreno Valley, Menifee, Murrieta, and Temecula, and certain unincorporated areas within the county; wholesale water service is provided within the cities of Hemet, San Jacinto, and Perris, as well as to Lake Hemet Municipal Water District, Nuevo Mutual Water Co., 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 ranging from a low of 67% of the national median in Hemet to a high of 141% in Temecula for 2017.
Since 2010, new connections have slowly been increasing; but they remain well below the peak levels of new developments seen in the early 2000s. As the population within the service area continues to grow, the characteristics of the service area are also continually changing. We understand that tract homes, commercial centers, and new industrial warehouses are replacing areas of agriculture and vacant land. Management indicates the district's total population is projected to grow by over 500,000 people during the next 25 years, a 67% increase from the current population.

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. Management indicates that the average consumption for a typical single family home has declined from 1,800 cubic feet of water a month to about 1,470 cubic feet a month with minimal impact to the district's net margins.

Based on our operational management assessment, we score the district a '2' on a six-point scale on which '1' is the strongest. Approximately 51% of the district's total water supply comes from local sources, including approximately 10% from potable groundwater, approximately 6% from groundwater that must undergo desalination treatment to be used as potable water and approximately 36% from recycled water. The remaining 49% of the district's water supply is imported from the Metropolitan Water District of Southern California (MWD). In our view, management is focused on securing a diversified long-term water supply that is appropriate in both quantity and quality to serve the existing and likely future customer base. The district currently has adequate sewer treatment capacity that is sufficient to meet its average and peak day demand.

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

**Financial risk**
As calculated by S&P Global Ratings, the district achieved extremely strong all-in coverage (across both liens, and including off-balance-sheet obligations) of 1.8x, 2.2x, and 1.9x for fiscal years 2015 through 2017, sequentially. Management's financial forecast indicates consistent financial metrics within this range through fiscal year 2023. Strong financial performance is somewhat reliant on development activity, as demonstrated by the all-in coverage metrics excluding one-time developer fees of 1.3x, 1.4x, and 1.3x for these same periods.

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 assume 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 imputed 30% of the district's imported water costs in lieu of an explicit fixed cost to arrive at our all-in coverage metric. We expect all-in coverage (including off-balance sheet obligations to MWD) to exceed 1.9x through 2023. Management's projections, however, incorporate increasing connection fee revenue as a result of projected growth in the customer base. If new connections do not meet the district's projections, we believe coverage
could be lower.

The district has also historically held an extremely strong liquidity position in part to serve as a natural hedge against its variable-rate debt exposure. Based on the district’s audited financial statements and information provided by management, the district held about $310 million of unrestricted cash and investments, equivalent to 577 days of operating expenses, at the end of fiscal year 2017. To calculate this balance, we have excluded bond proceeds, debt service reserve funds, customer deposits, and refundable advances from developers. We understand the district does not plan to materially spend down cash reserves, and we view strong reserves as necessary to manage any contingent liabilities related to its variable-rate bonds.

We view the district’s leverage level as moderate, and we believe the district’s five-year capital improvement plan (CIP) is manageable. The five-year CIP totals $397 million, of which 63% will be funded on a pay-as-you-go basis and the remainder with previously issued debt and additional state loans. The largest project in the CIP continues to be the $99 million expansion of the Temecula Valley Regional Wastewater Reclamation Facility. The project’s objectives are to increase the facility’s capacity from 18.0 million gallons per day (mgd) to 23.0 mgd. We consider the district’s debt-to-capitalization ratio moderate, at about 40%.

Based on our Financial Management Assessment methodology, we view the district to be a ‘1’ on a scale of 1-6, with ‘1’ being the strongest. The management team in our view maintains most of the best practices deemed critical to supporting credit quality and these are well embedded in the system’s daily operations and practices. Formal policies support many of these activities, adding to the likelihood that these practices will be continued into the future and transcend changes in the operating environment or personnel. This includes perpetual budget monitoring and regular reporting, a well-defined cost of service study that supports the district’s financial forecast, a comprehensive debt policy, and an adopted reserve policy that we believe supports strong liquidity levels and articulates the rationale for maintaining its various reserves.

About 65% of the district’s revenue-backed bonds are fixed rate, 28% is unhedged variable rate, and 7% is variable-rate debt hedged with two floating-to-fixed-rate swaps. As of June 30, 2017, the mark-to-market value of the two swaps (which hedge $82.1 million in variable-rate debt) was negative $9.9 million. Regularly scheduled swap payments for both swaps are on parity with the subordinate-lien bonds. With the district’s very strong cash balance, we do not view its interest rate exposure to be a material credit weakness. However, should the district’s unrestricted cash reserves continue to decline, we would reassess our opinion of the district’s interest rate exposure from variable-rate debt. Given the rating level, exceptional management practices, and very robust transparency and disclosure, we view the district as having strong market access, all of which support the district’s credit quality.

**Outlook**

The stable outlook reflects our opinion of the district’s strong service area characteristics coupled with its operational and financial flexibility. During the two-year outlook period, we anticipate that the district will continue implementing additional rate increases while adjusting plans annually to take into consideration actual service area growth and service demands.
Upside scenario
We could take a positive rating action if the district's liquidity position increases to a level that we would consider exceptionally strong and sustainable, such that it overrides our concerns about risk related to the district's enterprise risk profile.

Downside scenario
Although we do not anticipate it at this time, we could take a negative rating action if the district materially spends down its cash reserves or if the district's financial performance significantly and unfavorably deviates from the district's forecast.

Ratings Detail (As Of August 31, 2018)

<table>
<thead>
<tr>
<th>Eastern Mun Wtr Dist WTRSWR</th>
<th>Long Term Rating</th>
<th>Affirmed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Mun Wtr Dist WTRSWR</td>
<td>AA+/Stable</td>
<td></td>
</tr>
<tr>
<td>Eastern Mun Wtr Dist WTRSWR</td>
<td>AA+/Stable</td>
<td></td>
</tr>
<tr>
<td>Eastern Mun Wtr Dist WTRSWR</td>
<td>AA+/A-1+/Stable</td>
<td>Affirmed</td>
</tr>
<tr>
<td>Eastern Mun Wtr Dist WTRSWR</td>
<td>AA+/Stable</td>
<td>Affirmed</td>
</tr>
<tr>
<td>Eastern Mun Wtr Dist WTRSWR</td>
<td>AA+/Stable</td>
<td>Affirmed</td>
</tr>
<tr>
<td>Eastern Mun Wtr Dist WTRSWR</td>
<td>AA+/A-1/Stable</td>
<td>Affirmed</td>
</tr>
<tr>
<td>Eastern Mun Wtr Dist WTRSWR</td>
<td>AA+/A-1/Stable</td>
<td>Affirmed</td>
</tr>
<tr>
<td>Eastern Mun Wtr Dist WTRSWR</td>
<td>AA+/Stable</td>
<td>Affirmed</td>
</tr>
<tr>
<td>Western Riverside Wtr &amp; Wstwtr Fincg Auth (Eastern Mun Wtr Dist Imp Dist GO Bnd Fincg) (ASSURED GTY)</td>
<td>Unenhanced Rating</td>
<td>Upgraded</td>
</tr>
<tr>
<td></td>
<td>AA-(SPUR)/Stable</td>
<td></td>
</tr>
</tbody>
</table>

Many issues are enhanced by bond insurance.

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.