FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Anaheim, CA's Water Revs at 'AA+'; Outlook Revised to Negative

Tue 23 Mar, 2021 - 3:15 PM ET

Fitch Ratings - Austin - 23 Mar 2021: Fitch Ratings has affirmed the 'AA+' rating on the following water revenue bonds issued on behalf of the city of Anaheim, CA (the city):

--$32 million Anaheim Public Financing Authority, CA revenue bonds series 2010-A and 2010-B (Build America bonds);

--$90.2 million California Municipal Finance Authority, CA revenue bonds series 2015-A;

--$71.9 million Anaheim Housing and Public Improvements Authority revenue bonds series 2016-A, series 2020-A and series 2020-B.

Additionally, Fitch has assessed the city's water system (the system) Standalone Credit Profile (SCP) at 'aa+'. The SCP represents the credit profile of the system on a stand-alone basis irrespective of its relationship with and the credit quality of the city of Anaheim (Issuer Default Rating [IDR] A+/Negative).

The Rating Outlook is revised to Negative from Stable.

ANALYTICAL CONCLUSION

The 'AA+' bond rating and 'aa+' SCP reflect the system's moderate leverage, measured as net adjusted debt to adjusted funds available for debt service (FADS), within the framework of very strong revenue defensibility and a very strong operating risk profile, both assessed at 'aa'. Pursuant to Fitch's criteria, the Negative Outlook is driven by the downgrade to 'A+'/Outlook Negative on the city's IDR, which now caps the water bond rating and Outlook. Fitch considers the system to be a related entity to the city for rating purposes given the city's reporting of the system as an enterprise fund and the city council's authority to establish rates.

CREDIT PROFILE

The system provides retail water service to the city as well as a small portion of the unincorporated area outside the city. The system currently serves a population of approximately 355,000 and has sufficient supply through build-out. Residential users regularly account for about 60% of annual revenues.

The city's water system derives its supply from two sources: local wells that pump from the local groundwater basin managed by Orange County Water District (OCWD; IDR AAA/Stable), and purchases of imported water (both treated and untreated) from Metropolitan Water District of Southern California (MWD; IDR AA+/Stable).

The OCWD establishes a Basin Production Percentage (BPP) each year, which determines how much water can be pumped by each agency, including the city. So long as the city does not pump more than the BPP allocation, it pays the established Replenishment Assessment (RA) per acre foot of water. For 2021, the RA set by OCWD is $487 per acre foot, compared with MWD's treated water cost of $1,104 per acre foot.

Coronavirus Considerations

The recent outbreak of coronavirus has not had a material effect on the system's operational or financial performance. Management reports an increase in delinquencies, yet the increase is attributed more to the power system, which is managed and operated by Anaheim Public Utilities (APU) along with the water system. There are reportedly no material delinquencies on commercial water accounts. The pandemic has acutely affected the local economy, which is dominated by tourism, entertainment and convention activity. In consideration of the customer base that is likely facing economic difficulties the system expects rate increases for the next several years will be lower than otherwise permitted under the automatic pass-through structure, which is expected to soften cash flow generation. These expectations are incorporated in Fitch's current rating.

KEY RATING DRIVERS

Revenue Defensibility 'aa'

Very Strong Revenue Defensibility, Rates Affordable for Vast Majority

The city council retains independent rate-setting authority, but the rate structure includes automatic pass-through adjusters that do not require additional annual approval by city council. The unique rate structure is considered a credit strength. However, rate adjustments for the next several years are expected to be somewhat lower than previously expected in light of the economic impact of the pandemic and what would be permitted under the automatic pass-through structure. Fitch deems the monthly bill to be affordable for a vast majority of the population. The service area is generally considered favorable, although employment metrics have weakened during the pandemic.

Operating Risks 'aa'

Very Low Operating Cost Burden, Moderate Investment Needs

The system's operating cost burden, measured as cost per million gallons (mg) of water produced, is considered very low. Capital investment needs are considered moderate. Projects are focused on the construction of treatment facilities to address polyfluoroalkyl substance (PFAS) contamination that has been identified within groundwater wells.

Financial Profile 'aa'

Very Strong Financial Profile

Leverage measured 7.5x in fiscal 2020, which is generally in line with historical performance. The Negative Outlook is driven by the dependent rating action taken on the city's IDR and revision of the Outlook to Negative. Through fiscal 2024 leverage is expected to typically remain around 7.5x, but could drop to around 6.0x by fiscal 2025 as full cost savings on purchased water are realized. The liquidity profile is considered neutral to the assessment.

Asymmetric Additive Risk Considerations

No asymmetric additive risk considerations affected this rating determination.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/rating outlook stabilization:

--A revision of the Outlook to Stable on the city's IDR would be expected to stabilize the system's Outlook.

--Sustained actual and projected leverage closer to 5.0x in Fitch's base and stress case, assuming stability in the revenue defensibility and operating risk profiles.

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

--Deterioration in the city's IDR would lead to negative rating action in light of the current rating constraint that is applicable to the system as it is related to the city.

--Actual and projected leverage that exceeds 8.0x in Fitch's base and stress case, assuming stability in the revenue defensibility and operating risk profiles.

--A sustained weakening in the service area characteristics could eventually weaken the revenue defensibility assessment and rating if not offset with lower leverage expectations.

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].

SECURITY

The authority's bonds and outstanding system obligations are secured by purchase payments made by the city in accordance with the installment purchase agreement. Payments from the city to the authority are absolute and unconditional. Payments are required to be made from a senior lien of net revenues of the system.

Revenue Defensibility

Revenue defensibility is considered very strong, reflected by the 'aa' assessment. All revenues are derived from a monopolistic business line and the system's service area displays favorable economic underpinnings. Customer concentration is not a concern, as the top 10 customers regularly account for around 12% of annual operating revenue. The customer base is growing modestly with a five-year compound annual growth rate of 0.4%. Income levels are about 15% higher than the national median, while the unemployment rate is generally about 20% lower than the national rate. The unemployment rate is trending higher in recent months and Fitch expects income levels will also show weakening in 2020 as a result of the pandemic. Fitch will continue to monitor the economic recovery and whether sustained weaker indicators could lower the service area subfactor assessment.

The city's public utilities board (the board) and city council retain rate-setting autonomy with no additional oversight. The system has four rate components: a fixed customer charge based on meter size; a base commodity charge per hundred cubic feet (hcf) of use; a water commodity adjustment (WCA) charged per hcf to recover the actual cost of purchased water from MWD and OCWD, along with electricity charges for pumping; and a water system reliability adjustment (WSRA) charged per hcf for capital cost recovery.

The WCA and WSRA adjust automatically based on increased purchased water costs and by a maximum of 7.5 cents per hcf, respectively. Given the automatic adjusters within the rate structure city council approval is not needed on an annual basis and adjustments are only subject to the provisions of Proposition 218.

The monthly residential bill in fiscal 2020, based on Fitch's standard usage metric of 7,500 gallons, was about $44, which Fitch deems affordable for the vast majority of the population (around 85%). In light of the pandemic, rate adjustments for the next one to two years are expected to be lower than would otherwise be permitted under the automatic pass-through structure. Permitted rate adjustments could be as high as 10%, but expectations are that actual increases will be between 5% and 7% through fiscal 2023, which is reflected by the approximately 6% increase implemented in fiscal 2021. These expectations are incorporated in the current projected financial results.

Operating Risks

The operating risk profile is considered very strong and assessed at 'aa', reflecting a very low operating cost burden and moderate investment needs. From fiscal 2016 to 2019 the operating cost burden remained below $3,800 per mg, but increased to around $4,600 per mg in fiscal 2020 primarily because of higher purchased water costs. This increase was expected and the cost burden could increase further for several years because of higher purchased water costs (discussed below). However, Fitch would not expect a weakening of the cost burden subfactor assessment unless there was a sustained shift to over $6,500 per mg beyond fiscal 2025.

The system's life cycle ratio is low and has been stable between 30% and 33% since fiscal 2015, supported by healthy levels of investment. Capex as a percentage of annual depreciation costs averaged 193% for the five fiscal years ending in 2020. Planned levels of capex in upcoming years should continue to outpace annual depreciation expense and keep the life cycle ratio low. Fitch expects stability in the operating risk assessment for the longterm given current metrics that fall well under the thresholds for 'aa' subfactor assessments.

The fiscal 2021-2025 capital improvement program (CIP) totals about $215 million and increased from the last CIP spanning fiscal 2020-2024 that totaled $139 million as a result of higher spending on PFAS treatment facilities and water main replacements. The state of California established maximum levels for PFAS and there are numerous wells within the OCWD-managed basin that exceed the notification level. As such, around 40% of planned capex in the current CIP is dedicated to construction of PFAS treatment facilities.

Until the treatment facilities are complete, which is expected by 2025, the system will increase purchases from MWD which will drive purchased water costs higher. The city is working with a third-party engineering firm to assess the most efficient approach to construction (e.g., one centralized treatment plant or multiple, small local treatment facilities) and the city council is expected to approve a final approach in April 2021. Once the facilities are operational the system will be able to utilize its local supply via OCWD more heavily.

Nearly 40% of spending is also planned for water main replacement, although the timing and pace of spending could be scaled back, if needed. The balance of work is standard rehab work and less costly system improvements. Including previously issued bonds and a planned sale in fiscal 2023 about 30% of the CIP is expected to be debt financed. The system has entered into an agreement with OCWD providing that the city will pay for the construction of the PFAS facilities and then be reimbursed by OCWD. As such, this is the largest funding source within the CIP (nearly 40%). The balance of the CIP is expected to be funded on a pay-go basis.

Financial Profile

The financial profile is considered very strong and supported by the 'aa' assessment. Leverage peaked at 9.7x in fiscal 2017, but measured 7.5x in fiscal 2020, which is more representative of historical performance. The liquidity cushion is strong at approximately 400 days, as of fiscal 2020, benefitting from APU's $100 million revolving credit agreement, of which about $20 million is available to the system. Coverage of full obligations (COFO) has remained over 1.0x over the last five fiscal years. Overall, the liquidity profile is considered neutral to the assessment. Fitch-calculated all-in debt service coverage is stronger (as this is based on annual debt service requirements and does not include the fixed services expense related to purchased water) and measured 1.9x in fiscal 2020.

Fitch Analytical Stress Test (FAST)

The five-year forward look provided by FAST considers the potential trend of key ratios in a base case and a stress case. The stress case is designed to impose capital costs 10% above expected base case levels and evaluate potential variability in projected key ratios. Management's financial forecast for fiscals 2021-2025 informed Fitch's base case. Projections include a 3.3% decrease in demand in fiscal 2021, that then rebounds in 2022 and the out years. Average rate adjustments are between 5% and 7% through fiscal 2023 and a lower 3% adjustments in fiscal 2024 and 2025. Operating expenses generally increase an average of around 6% annually through fiscal 2024, mostly driven by higher MWD purchased water costs. Operating expenses could then decrease nearly 7% in fiscal 2025 when the system can begin utilizing more its local supply via OCWD. The system's CIP and debt plans are also incorporated in to the projections.

Under these assumptions in Fitch's base case leverage peaks at around 7.3x in fiscal 2023 and decreases to 5.6x by fiscal 2025. In the stress case leverage peaks at a modestly higher 7.7x in fiscal 2023 and is down to 6.0x by fiscal 2025. COFO is expected to remain at 1.2x or higher in both cases and continue to remain neutral to the assessment.

Asymmetric Additive Risk Considerations

No asymmetric additive risk considerations affected this rating determination.

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

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means 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. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Audra Dickinson
Director
Primary Rating Analyst
+1 512 813 5701
Fitch Ratings, Inc.
2600 Via Fortuna, Suite 330 Austin, TX 78746

Shannon Groff
Director
Secondary Rating Analyst
+1 415 732 5628

Douglas Scott
Managing Director
Committee Chairperson
+1 512 215 3725

MEDIA CONTACTS

Sandro Scenga
New York
+1 212 908 0278
sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

APPLICABLE CRITERIA

Public Sector, Revenue-Supported Entities Rating Criteria - Effective from February 23, 2021 to September 1, 2021 (pub. 23 Feb 2021) (including rating assumption sensitivity)

U.S. Water and Sewer Rating Criteria (pub. 18 Mar 2021) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Anaheim Housing and Public Improvements Authority (CA)	EU Endorsed, UK Endorsed

DISCLAIMER

HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR WHICH THE LEAD ANALYST IS BASED IN AN ESMA- OR FCA-REGISTERED FITCH RATINGS COMPANY (OR BRANCH OF SUCH A COMPANY) CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH RATINGS WEBSITE.

READ LESS

COPYRIGHT

NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see https://www.fitchratings.com/site/regulatory), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

READ LESS

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch’s international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch’s approach to endorsement in the EU and the UK can be found on Fitch’s Regulatory Affairs page on Fitch’s website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

US Public Finance Infrastructure and Project Finance North America United States