FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Anaheim, CA's Water Revs 'AA+'; Outlook Revised to Stable

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Fitch Ratings - Austin - 28 Feb 2022: Fitch Ratings has assigned a 'AA+' rating to the following water revenue bonds issued on behalf of the city of Anaheim, CA (the city):

--Approximately $42.8 million water revenue bonds series 2022-A;

--Approximately $121.3 million water revenue refunding bonds (taxable) series 2022-B;

--Approximately $31.6 million water revenue refunding bonds series 2022-C.

The bonds are scheduled to sell via negotiation on or around March 29, 2022. The series 2022-A bond proceeds will be used to finance the acquisition and construction of certain capital improvements to the city's water system (the system) and pay costs of issuance. The series 2022-B bond proceeds will be used to refund all or a portion of the system's outstanding series 2010-B bonds and pay costs of issuance. The series 2022-C bond proceeds will be used to refund all or a portion of the system's outstanding series 2015-A, and series 2020-A bonds and pay costs of issuance.

Additionally, Fitch has affirmed the 'AA+' rating on the following bonds:

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

--$90.2 million California Municipal Finance Authority, CA revenue bonds series 2015-A (prior to refunding);

--$71.9 million Anaheim Housing and Public Improvements Authority revenue bonds series 2020-A and series 2020-B (prior to refunding).

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

The Rating Outlook has been revised to Stable from Negative.

ANALYTICAL CONCLUSION

The 'AA+' bond rating and 'aa+' SCP reflect the system's low 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'. The 'aa' revenue defensibility is anchored in the system's rate-setting autonomy, and a service area that displays solid demand characteristics, despite some softening during the pandemic. The 'aa' operating risk assessment reflects the very low operating cost burden, low life cycle ratio and sustained strong levels of capex.

Fitch considers the system 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. The city's Issuer Default Rating (IDR) currently caps the water bond rating and Outlook. Therefore, pursuant to Fitch's criteria, the Outlook revision to Stable from Negative is driven by the city's (IDR A+) Outlook revision to Stable from Negative. The system's financial and operational performance (both actual and expected) also supports a Stable Outlook.

CREDIT PROFILE

The system provides retail water service to the city, and a small portion of the unincorporated area outside the city. The system currently serves a population of approximately 357,000, 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 2022, the RA set by OCWD was $507 per acre foot, compared with MWD's treated water cost of $1,143 per acre foot.

Coronavirus Considerations - Limited Impact

The pandemic and related government containment measures did not materially impair the system's operational or financial performance and are not expected to have a material impact going forward. While past due balances did increase compared to pre-pandemic levels (a little over $1 million is more than 90 days past due as of December 2021), the system expects to recoup the majority of the past due balance through the state's arrearage programs.

KEY RATING DRIVERS

Revenue Defensibility 'aa'

Revenue Defensibility Lead

Very Strong Revenue Defensibility, Rates Affordable for Vast Majority

Revenue Defensibility

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 the city council. The unique rate structure is considered a credit strength. Fitch deems the monthly bill affordable for a vast majority of the population. The service area is generally considered favorable. Employment metrics weakened during the pandemic, but are beginning to rebound.

Operating Risks 'aa'

Operating Risks Lead

Very Low Operating Cost Burden, Moderate Investment Needs

Operating Risks

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'

Financial Profile Lead

Very Strong Financial Profile

Financial Profile

Leverage measured 7.5x in fiscal 2021, which is generally in line with historical performance. The Outlook revision to Stable from Negative is driven by the dependent rating action taken on the city's IDR and Outlook revision to Stable, in addition to system leverage that supports the Stable Outlook. While leverage ticks up in fiscal 2022 with the current sale, leverage remains generally between 6.5x and 7.5x through fiscal 2026. 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/upgrade:

--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, given the current rating constraint that is applicable to the system, as it is related to the city.

--Sustained actual and projected leverage that approaches 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, as 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 0.3%, as of fiscal 2021. Income levels are about 15% higher than the national median.

Prior to the pandemic, the unemployment rate was generally about 20% lower than the national rate. The metric weakened notably in 2020 as closures in leisure and hospitality hit the city hard, but now shows improvement. As of December 2021, the 4.3% unemployment rate is still weaker than the national rate (3.7%), but significantly improved from the rate one year prior when it measured 8.8%. 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.

Based on Fitch's standard usage metric of 7,500 gallons, the monthly residential bill in fiscal 2021 was about $46, which Fitch considers affordable for the vast majority of the population (around 85%). In light of the pandemic, rate adjustments for 2021 and 2022 were lower than otherwise permitted under the automatic pass-through structure. Permitted rate adjustments in future years could be as high as 10%, but expectations for actual increases to be closer to 2% to 3%.

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 in the last two fiscal years primarily because of higher purchased water costs. It measured about $4,930 in fiscal 2021.

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 2024.

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 227% for the five fiscal years ending in 2021. Planned levels of capex in upcoming years should continue to outpace annual depreciation expense and keep the life cycle ratio low.

The fiscal 2022-2026 capital improvement program (CIP) totals about $240 million with a significant share of spending devoted to construction of PFAS treatment facilities (56%) and water main replacements (32%). The state of California established maximum levels for PFAS, and there are numerous wells within the OCWD-managed basin that exceed the response level, which resulted in the system taking 14 of its 19 wells offline.

The system increased MWD purchases to make up for the decrease in groundwater supply and expects purchased water costs to remain higher than historical norms through fiscal 2023. The treatment facilities are expected to be online by the end of calendar 2023, at which point costs of MWD purchased water should decrease significantly. As other treatment facilities have recently come online in neighboring districts there does not appear to be any completion or technology risk associated with the initiative.

While the system will be responsible for constructing the treatment facilities, nearly all of the associated costs will then be reimbursed to the system by OCWD. As such, OCWD reimbursements account for a little over half of the CIP's funding. Additionally, once the treatment facilities are online OCWD has agreed to pay for 50% of the operation and maintenance costs. The balance of CIP spending will be paid on a pay-go basis (26%) and with bond proceeds (remaining series 2020 proceeds and the current sale, 23%).

Financial Profile

The financial profile is considered very strong and supported by the 'aa' assessment. Leverage peaked at 9.6x in fiscal 2017, but measured 7.5x in fiscal 2021, which is more representative of historical performance. Additionally, absent one-time costs in fiscal 2021 related to capital costs that had to be written off when the project was terminated, leverage would have measured 6.9x in fiscal 2021. The liquidity profile is sound, albeit considered neutral to the assessment. The liquidity cushion is strong at 316 days, as of fiscal 2021, benefitting from a $100 million revolving credit agreement which it shares with the city's electric system.

Coverage of full obligations (COFO) has remained at 1.2x or higher over the last five fiscal years. 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 1.7x in fiscal 2021.

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 2022-2026 informed Fitch's base case. Over this period, operating revenue increases by an average of 3.2% annually while total expenses increase by an average of 1.3% annually. 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 8.5x in fiscal 2022 as a result of the current sale but ranges from 6.2x to 6.5x in fiscals 2024 and 2026. In the stress case leverage peaks at a modestly higher 8.7x in fiscal 2022 and ranges between 6.5x and 7.0x in fiscal years 2024 and 2026. The liquidity profile is expected to remain neutral to the assessment as COFO remains at 1.2x or higher and days cash also remains solid.

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.

RATING ACTIONS

ENTITY / DEBT	RATING	PRIOR

Anaheim (CA) [Water]

Anaheim (CA) /Water Revenues/1 LT	LT	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Negative

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

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

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 01 Sep 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

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