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Ratings

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Summary:

Norco Financing Authority, California Norco; Water/Sewer

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Credit Profile		
US$36.465 mil enterprise rev rfdg bnds (Norco) ser 2019A due 10/01/2049		
Long Term Rating	AA-/Stable	New
Norco Fincg Auth, California		
Norco, California		
Norco Fincg Auth (Norco) enterprise rev (AGM)		
Unenhanced Rating	AA-(SPUR)/Stable	Upgraded
Many issues are enhanced by bond insurance.		

Rationale

S&P Global Ratings raised its underlying rating (SPUR) to 'AA-' from 'A' on Norco Financing Authority, Calif.'s outstanding enterprise revenue refunding bonds, issued for the City of Norco. At the same time, S&P Global Ratings assigned its 'AA-' rating to the authority's series 2019A enterprise revenue refunding bonds, issued for the city. The ratings reflect a very strong enterprise profile and financial risk profile. The outlook is stable.

The raised rating reflects a rise in all-in coverage and unrestricted cash during the past five fiscal years, driven by water and wastewater rate increases. The rise in cash was intentional to use funds for future capital projects. In addition, the raised rating reflects management's long-term financial, capital, and rate planning, which in our opinion is comparable with that of peers at this rating level.

The estimated par amount of the series 2019A enterprise revenue refunding bonds is about $36.5 million, approximately $11.6 million of which is new money. The proceeds will refund the series 2009 obligations in full and finance the acquisition and construction of certain improvements to the water and wastewater system. As of 2019, the water and sewer system had about $31.2 million outstanding series 2009 revenue refunding bond obligations.

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

- Service area participation in the broad and diverse Riverside-San-Bernardino-Ontario, Calif.'s metropolitan area economy;
- Affordable water and sewer rates given the city's very strong income indicators;
- Very low industry risk as a monopolistic service provider of an essential public utility; and
- Good operational management assessment, represented by sufficient water supply to meet long-term demand from the city's local water supply, Chino Basin Desalter (CDA), Western Municipal Water District (WMWD), and rights to adequate sewage treatment capacity in Western Riverside County Regional Wastewater Authority's (WRCRWA) jointly owned wastewater treatment plant.

The financial risk profile reflects our view of the combined system's:

- Strengthening all-in coverage metrics to above 1.6x in fiscal 2018 from about 1.4x in fiscal 2014, that we believe is sustainable given the lack of future debt plans and anticipation of having another formal rate study performed in 2020;
- Very strong liquidity position, represented by about $19.1 million of unrestricted cash and investments, equivalent to about 528 days of operating expenses for fiscal 2018 that management plans to draw down to fund capital projects;
- Moderate debt-to-capitalization ratio at about 40% and sizable capital plan at about $46.8 million during the next five years; and
- Good financial management assessment, represented by formalized practices and policies that guide long-term financial and capital planning.

We view the bond provisions as credit neutral. The bonds are payable from installment payments that are secured by the net revenue of the enterprise, which consists of the water system and the sewer system. The rate covenant and additional bonds test is set at 1.25x annual debt service. The series 2019A bonds will not have a debt service reserve. In our opinion, this is credit neutral given the very strong liquidity position.

Enterprise risk

Norco is located in Riverside County, approximately 51 miles east of Los Angeles and 125 miles north of San Diego. The city encompasses about 15 square miles and has an estimated population of 27,453 as of 2018. Given that the service area is primarily built out, we do not anticipate significant additional growth going forward. City residents have access to employment throughout Los Angeles, Orange, and Riverside counties. We view the service area's income levels as very strong based on city's median household effective buying income (MHHEBI), which was 155% of the national median for 2018. The city's unemployment rate has been historically below the state and national rates. As of September 2019, Norco's unemployment rate was 2.9%, below the state rate of 3.5% and the national rate of 3.3%.

The customer base for the combined system is stable, primarily residential, and very diverse. Residential customers make up about 90% of water and wastewater system accounts. In 2019, the city served 7,418 water customers and 6,922 sewer connections. We consider the customer base to be diverse given that the leading 10 customers for the water system pay about 11.4% of water sales revenue and the leading 10 customers for the sewer system pay about 21.6% of sewer sales revenue. The leading customer for both water and sewer is the California Rehabilitation Center. Management indicated that there is no expectation the rehabilitation center will close, given continued growth and investment in the center.

Despite significant recent system rate increases, rates are affordable in the context of the service area's very strong income indicators and the average county poverty rate. In 2016, the city adopted water rate increases of about 71% (2017), 10% (2018), 10% (2019), 9% (2020), and 1% (2021) for the fixed component. In addition, the city adopted sewer rate increases of 6% (2019 and 2020) and 5% (2021). The 2020 water rate structure includes a fixed monthly charge of $47.10 (for a 3/4" meter) and a usage-based charge of $2.66 per hundred cubic feet of usage. The current monthly residential sewer rate is $51.00. Based on our benchmark of 800 cubic feet, the combined bill equates to about 1.77% of MHHEBI, which we consider affordable. It is our understanding that the city plans to undergo another formal rate study in 2020 to determine the size of and need for future rate increases. The county poverty rate as reported by the U.S. Department of Agriculture is 12.9%, which is about average across the nation and not a material source of resistance to revenue raising.

Based on our operational management assessment, we view the combined system to be a '2' on a six-point scale, with '1' being the strongest. A score of good represents sufficient long-term water supply and wastewater treatment capacity to meet demand even if some long-term challenges may exist. Water supply comes from local wells, CDA, WMWD, and the city of Corona. Supply from the city's four owned active wells accounted for about 13.3% of total water supply in 2019, with maximum daily production capacity of 4.8 million gallons per day (mgd). The city also receives treated groundwater from CDA, which constituted about 17.5% of water supply in 2019. The city's long-term agreement with CDA has a take-or-pay of 1,000 acre-feet annually, and the current cost of this water supply is about $1,000 per acre-foot per year. In addition, the city receives treated groundwater from WMWD, which accounted for about 69.1% of total water supply in 2019. The agreement with WMWD does not have a take-or-pay, but the city targets to use no less than 4,400 acre-feet at $887 per acre-foot. Furthermore, the city purchases about 0.10% of water supply from the city of Corona.

Hydrology drives the fluctuations in water supply from year to year. In 2019, total water supply was down due to a wet hydrological year, and management expects 2020 demand will be higher given a dry hydrological year and improvements to the water treatment plant that will allow the city to produce more water from its own wells. The city's long-term water supply reliability plan is to expand the city's owned treatment plant to 4.32 mgd from 2.88 mgd to increase local water supply to 20% from 13%. In addition, the city would like to enter into a long-term agreement with Riverside to create redundancy within the system. Furthermore, the city maintains interties with Jurupa Community Services District and the city of Corona to ensure water source in case of major emergency or system failure.

The city has sufficient wastewater treatment capacity to meet continued demand at the WRCRWA's treatment plant. The city is a member of WRCRWA with a joint powers agreement through 2042. The city has rights to about 2.7 mgd of the tertiary treatment plant's capacity of 14 mgd. The 2.7 mgd share is sufficient given the city's average daily flows of 1.8 mgd and peak day flow of 2.5 mgd. The city pays a fixed 9.14% of annual debt service on the WRCRWA loan. The city is not aware of any future debt plans associated with WRCRWA's treatment plant capacity.

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 '1' to '6' scale, with '1' being the best.

Financial risk

The combined system's all-in coverage has risen to a figure we consider extremely strong in fiscal 2018, driven by significant water rate increases in 2017 and 2018. Based on our analysis of management's projections, we expect all-in coverage to exceed 1.6x, a figure we consider extremely strong, given the lack of future debt plans, and approved and expected future rate increases. All-in coverage is our internally adjusted debt service coverage metric that we believe best tracks the use of every dollar of utility operating revenue, regardless of lien position, accounting treatment, or ultimate purpose. It also incorporates recognition of fixed charges or costs, which we define as certain long-term recurring items that are debt-like in nature, even if legally treated as an operating expense. For the city, our calculation of fixed costs includes fixed costs and lease payments associated with CDA, WMWD, and WRCRWA. All-in coverage in fiscal 2016 was adequate at about 1.2x driven by a one-time repayment to the internal revenue service fund and mandatory conservation. All-in coverage rose in fiscal 2017 to above 1.6x, given one-time reimbursements from WRCRWA for overpayment in prior years and a 71% fixed water rate increase. Furthermore, despite extremely strong coverage in fiscal 2018 driven by a 10% water rate increase, expenses were higher because of increased water purchased costs due to the local water treatment plant that was offline and one well that was down during 2018.

The combined system's liquidity position is a credit strength and has risen intentionally to fund future capital needs. However, given uncertainty around the size of future rate increases, the exact drawdown is uncertain. Unrestricted cash has risen during the past three fiscal years to about $19 million, equivalent to 528 days of operating expenses, in fiscal 2018 from about $11.5 million, or 358 days of operating expenses, in fiscal 2016. Based on management's capital plan, approximately 70% will be funded from development impact fee revenue, unrestricted cash, and rate revenue. Management plans to draw down unrestricted cash to fund capital needs but does not plan to draw down cash below $5.8 million.

The combined system's debt-to-capitalization ratio is moderate at about 40%, and management has identified about $43 million of capital needs for fiscal 2020-2024, of which 30% will be funded from bond proceeds with the remainder funded from, development impact fee revenue, rate revenue, and unrestricted cash. Priority projects for the water system consist of renewal and replacements of water lines, construction and replacement of water storage reservoirs, well rehabilitation, improvements to the supervisory control and data system (SCADA), and upgrades to the city's water treatment plant. Wastewater projects consist of renewal and replacement projects, improvements to sewer lift stations, SCADA improvements, and manhole rehabilitation. Furthermore, the city does not have future debt plans during the next five years.

Based on our financial management assessment, we score the combined system as a '2' on a six-point scale in which '1' is the strongest. In our view, financial practices and policies exist and are transparent. It is our understanding that management presents budget-to-actual results to the council on a quarterly basis and maintains conservative revenue and expense assumptions. Management has a formalized investment and debt management policy, in addition to an informal liquidity target for to maintain three months of operating expenses. Furthermore, management reviews and updates its long-range financial and capital plan annually and complies with general accepted accounting principles.

Outlook

The stable outlook reflects our view of the combined system's primarily residential and very diverse customer base that has good access to employment opportunities in Los Angeles and Orange counties. During the two-year outlook horizon, we anticipate that management will work with an outside consultant to complete another rate study that will form the basis for future rate adjustments and that management will implement rate adjustments that will produce at least strong all-in coverage going forward.

Upside scenario

We could take a positive rating action if all-in coverage is sustained at an extremely strong level, the city reduces its debt, and unrestricted cash is sustained at an extremely strong level during the life of the water and wastewater system's capital plan.

Downside scenario

We could lower the rating if all-in coverage weakens below our projections on a consistent basis or if surplus revenue is insufficient to fund the combined system's capital plan, leading to a material drawdown in the system's cash position below projected levels.