

## **FITCH AFFIRMS YORBA LINDA WATER DISTRICT, CA'S WATER REVS AT 'AA'; OUTLOOK STABLE**

Fitch Ratings-San Francisco-15 August 2014: Fitch Ratings has affirmed Yorba Linda Water District, California's (the district) bonds at 'AA' as noted below:

--\$8.3 million refunding revenue bonds series 2012A;

--\$32.1 (2008 Capital Improvement Projects) revenue certificates of participation (COPs) series 2008.

The Rating Outlook is Stable.

### **SECURITY**

The water revenue bonds and COPs are parity obligations secured by net water revenues after payment of operations and maintenance expenses.

### **KEY RATING DRIVERS**

**IMPROVED, SOLID SUPPLY POSITION:** The remainder of the district's service area was annexed to the Orange County (OCWD). Upon build-out of the district's pumping facilities, the annexation will substantially increase the district's groundwater supply, thus improving the district's long-term cost structure by lowering dependence on expensive imported water.

**SOUND FINANCIAL PROFILE:** The district's financial operations are sound, with three year average debt service coverage at a solid 2.07x in fiscal 2013. Liquidity historically has been satisfactory and a one-time substantial liquidity reduction in fiscal 2013 is estimated to have been reversed in fiscal 2014 due to solid free cash flow, proceeds from a legal settlement, and the issuance of short-term debt that will have to be paid down by fiscal 2017.

**DIVERSE, AFFLUENT SERVICE AREA:** The district serves a suburban residential service area in Orange County, California. Median household income is strong at about 150% of the national level, while unemployment runs well below state and national averages.

**MIXED MANAGEMENT ASSESSMENT:** Fitch's view of managerial quality is weighed down by an unusually high degree of managerial turnover in recent years and heightened political risk following a 40% rate increase in 2010 that casts doubt on the district's capacity to approve future large rate hikes, if required. However, the district prudently implemented modest rate increases over the past three years, improved the district's supply position through the OCWD annexation, and recently implemented two additional reserve policies.

**SOUND DEBT PROFILE:** The district's manageable capital improvement plan (CIP) is expected to be predominantly pay-as-you-go financed with a limited amount of related short-term debt issuances. Debt levels are moderate overall and are projected to fall as debt matures.

### **RATING SENSITIVITIES**

**MANAGERIAL CONTINUITY:** Demonstrated managerial stability with continued prudent financial management policies and sound financial operations could lead to positive rating action.

### **CREDIT PROFILE**

## ANNEXATION TO OCWD IMPROVES THE DISTRICT'S SUPPLY, FINANCIAL POSITIONS

The district's annexation of its service area to OCWD will positively impact the district's cost structure and supply reliability. The annexation provides the district with access to a portion of OCWD's groundwater basin, which will increase the district's local water sources to about 70% from less than 50% of the system's total supply once pumping facilities have been fully constructed in a few years. The remainder of the district's supply derives from imported treated water from the Metropolitan Water District of Southern California.

In exchange for pumping rights, the district will pay OCWD an annexation fee of \$250,000-\$300,000 annually in perpetuity. This fee will be more than offset by lowered expenditures from reduced imported water consumption. The district estimates that groundwater will cost approximately one-third of imported water.

## SOLID FINANCIAL OPERATIONS OVERALL

The district's financial performance has been strong overall, despite some year-over-year liquidity volatility. Fiscal 2013 debt service coverage registered a satisfactory 1.97x, a slight decline from prior years due to expenditure growth slightly outpacing revenue growth. This dynamic is estimated by the district to have reversed in fiscal 2014, with coverage rising to a robust 2.76x. The improved estimated coverage reflects higher water sales, a moderate water rate increase, and a significant \$500,000 increase in connection fees stemming from a rebounding property market.

Although debt service coverage has remained at high levels, liquidity fell in fiscal 2013 to a somewhat weak 123 days cash on hand due to significant capital spending and a delayed draw on the district's line of credit (LOC) with Wells Fargo. The district estimates that fiscal year end 2014 cash balances increased to robust levels of \$23.7 million (347 days cash on hand), which is fairly consistent with historical performance. The higher cash levels derive from a \$5 million legal settlement, a \$4.5 million draw from the district's LOC, and solid free cash flow.

Financial projections have been conservatively drafted, assuming no further rate increases, no capital contributions, and lower consumption levels than the historical norm. Despite the forecast's conservative tendencies, senior debt service coverage averages a strong 2.7x from fiscal years 2015 - 2019. All-in coverage drops to an inadequate 0.80x in fiscal 2017; however, reflecting the forecasted repayment of the district's \$7 million subordinate LOC that expires that year. Fitch does not view this as a material credit negative given the one-time nature of the draw, the district's solid cash position, and the subordination status of the LOC payment to the Fitch-rated water revenue bonds.

## STRONG SERVICE AREA

The district is located in the northeastern portion of Orange County approximately 35 miles southeast of downtown Los Angeles, and 11 miles north of Santa Ana, the county seat. The service area predominantly covers the city of Yorba Linda, an upper income suburban community, in addition to portions of Anaheim, Brea, and Placentia, and unincorporated county areas.

The district provides water services to roughly 24,500 customers, of which about 90% are residential. Customer growth is expected to be somewhat modest as the district is close to full build-out, however new development activity has picked up significantly from recessionary levels. District income levels and employment data are strong.

## POSITIVE FINANCIAL MANAGEMENT PRACTICES OFFSET BY POLITICAL TURBULENCE

The district's financial management practices have been historically sound, but Fitch's assessment of management is weighed down by a high degree of managerial turnover and recent years' political turbulence. The district's general manager and finance director left the district under opaque circumstances over the past few years. These concerns are somewhat offset by the long tenure of the incoming general manager and finance directors at other water districts. However, positive rating action will hinge on demonstrated managerial stability, with continued adherence to sound financial management policies.

Fitch views positively policymakers' commitment to steady annual rate increases in recent years, including rate hikes of 1.5%, 2.5% and 2.5% in fiscal years 2013, 2014, and 2015, respectively. Current water rates average a low 0.5% of median household incomes, based on a Fitch-standardized 10 hundred cubic feet of consumption. Fitch believes this provides economic flexibility to raise rates, though we have noted heightened political sensitivity to large rate hikes following a contentious and large rate hike of 40% in 2010 that led to a board shake-up. The rate increase also included automatic pass-throughs of OCWD and Metropolitan Water District of Orange County cost increases, which Fitch views as a positive. However, the district's water rate structure is highly volumetric, which exposes it to greater revenue volatility.

Management is studying the impact of recent water conservation measures before beginning its Prop 218 rate adjustment process, likely to take effect in fiscal 2016. Fitch expects the district will raise rates at a sufficient amount to maintain the district's sound financial operations over a five-year forecast period, and to avoid the use of long-term debt to finance the system's CIP.

Recent years' improvements to district financial policies include board approval of three reserve funds. In addition to the board-mandated 8% - 17% minimum operating reserve, the district must now additionally carry a \$200,000 water maintenance reserve, and a \$2.7 million reserve for debt service, which is an unrestricted resource that supplements the district's debt service reserve funds. All of these reserve policies include replenishment provisions.

## SOUND DEBT PROFILE

The district's debt burden is moderate at \$1,805 per customer and is projected to fall somewhat as amortizing debt is projected to more than offset an estimated net \$5 million short-term debt issuance over the district's five year CIP. The majority of the district's manageable \$19 million capital plan will be pay-as-you-go financed, and it consists largely of facilities required to increase groundwater pumping rights. The system is mature and largely built out, so conclusion of the current CIP likely will be followed by more modest capital plans consisting of repair and renewal needs.

### Contact:

Primary Analyst  
Scott Monroe  
Director  
+1-415-732-5618  
Fitch Ratings, Inc.  
650 California Street  
San Francisco, CA 94108

Secondary Analyst  
Andrew Ward  
Director  
+1-415-732-5617

Committee Chairperson

Laura Porter  
Managing Director  
+1-212-908-0575

Additional information is available at '[www.fitchratings.com](http://www.fitchratings.com)'

In addition to the sources of information identified in the U.S. Municipal Revenue-Supported Rating Criteria, this action was additionally informed by information from Creditscope.

Applicable Criteria and Related Research:

- 'Revenue-Supported Rating Criteria' (June 3, 2013);
- 'U.S. Water and Sewer Revenue Bond Rating Criteria' (July 31, 2013);
- '2014 Water and Sewer Medians' (Dec. 12, 2013);
- '2014 Outlook: Water and Sewer Sector'(Dec. 12, 2013).

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: [elizabeth.fogerty@fitchratings.com](mailto:elizabeth.fogerty@fitchratings.com).

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Applicable Criteria and Related Research:

Revenue-Supported Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=750012](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=750012)

U.S. Water and Sewer Revenue Bond Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=715275](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=715275)

2014 Water and Sewer Medians

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=724358](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=724358)

2014 Outlook: Water and Sewer Sector

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=724357](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=724357)

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