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Summary:

Napa Sanitation District, California; Water/Sewer

Primary Credit Analyst:

Chloe S Weil, San Francisco (1) 415-371-5026; chloe.weil@spglobal.com

Secondary Contact:

Malcolm N D'Silva, Centennial +1 (303) 721-4526; malcolm.dsilva@spglobal.com

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Credit Profile

Napa San Dist rfdg rev COPs (1998 rfdg proj)

Long Term Rating

AA/Stable

Upgraded

Rationale

S&P Global Ratings raised its long-term rating and underlying rating to 'AA' from 'AA-' on Napa Sanitation District, Calif.'s existing revenue certificates of participation (COPs). The outlook is stable.

The raised rating reflects our view of the district's very strong economic and financial metrics, as well as the application of our revised criteria, "Rating Methodology And Assumptions For U.S. Municipal Waterworks And Sanitary Sewer Utility Revenue Bonds," published Jan. 19, 2016, on RatingsDirect. A very strong enterprise risk profile and a very strong financial risk profile map to an indicative rating in our revenue debt criteria matrix of 'aa/aa-', and we have selected the 'aa' anchor based on our assessment of the district's extremely strong projected debt service coverage (DSC) through fiscal 2021, with further support for the rating derived from the district's pre-approved rate increases and detailed long-term planning.

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

- Diverse and stable customer base with strong income indicators;
- Very low industry risk as a monopolistic service provider of an essential public utility;
- Affordable service rates, with pre-authorized rate increases through fiscal 2021; and
- Good operational management practices and policies.

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

- Historically extremely strong all-in DSC metrics that we expect to be sustained even with the additional debt plans;
- Very strong liquidity position that we believe is sustainable in the near term;
- Low leverage presently with an upcoming capital improvement plan (CIP) that will require additional borrowing in the near future; and
- Strong financial management practices and policies.

The COPs have an interest in installment payments to be made by the district to the Napa Sanitation District Public Financing Corporation, a non-profit public benefit corporation, payable from net revenue of the district's wastewater system. The outstanding parity debt totals \$58 million and includes three state revolving fund loans, the series 2009B and series 2012A refunding revenue COPs. The installment purchase agreement allows for the issuance of additional parity obligations if the net revenue for the most recent fiscal year, and allowances for estimated net revenue provides 1.25x coverage of annual debt service. In addition, net revenue may be adjusted for increases or decreases in revenue sources that have been adopted and are in effect at the time of the calculation. There is no debt service reserve

requirement for the COPs.

Enterprise Risk

Napa Sanitation District is located in southern Napa County, an agricultural community approximately 50 miles northeast of San Francisco. The district's service area includes the city of Napa and some surrounding unincorporated areas. The district's population remained stable during the past five years and was most recently estimated at 82,700 in 2016. The area's economic base is rooted in wine production and tourism, with major employers in the city itself being mostly governmental or retail in nature. Income indicators are strong, in our opinion, based on the city's median household effective buying income (MHHEBI) at 118% of the national median. The city's unemployment rates have been historically lower than the national and state rates and last stood at 4.4% based on November 2016 data.

The district provides service to a stable, primarily residential, and very diverse customer base. The number of system connections increased by a 0.3% average annual rate during the past five years to 36,901 in fiscal year 2016. We consider the system's customer base to be primarily residential, given that residential customers make up about 88% of system connections. The system's customer base is also very diverse, in our opinion, as the leading 10 customers only comprise about 9.9% of service charges, with the leading customer, Napa State Hospital, paying 3.3% of service charges in fiscal 2016.

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

We view the district's residential rates as relatively affordable, in the context of the service area's strong MHHEBI and low county poverty rates, both of which provide management with revenue-raising flexibility. The residential rate structure is a flat annual fee, currently at \$482.50, or a monthly equivalent of \$40.21, which we consider moderate. Sewer service charges are collected on the county property tax bill; however, the district does not participate in the county's Teeter Plan. The district increased rates by an annual average rate of 2.5% over the past three years through fiscal 2016. We understand the district's board has pre-approved rate increases of 15% annually in the subsequent two fiscal years through 2018, and additional rate increases of up to 6%, 5%, and 4% in the next three fiscal years through 2021 to fund the district's 10-year CIP for the collection system and treatment plant. We consider the district's CIP manageable. In the near-term, we note that the residential bill will increase to \$638 annually (\$53.20 monthly) in fiscal 2018. Despite the approved rate increases, we believe the rate continues to be affordable, given the strong income levels in the service area economy.

Based on our operational management assessment, we view the district to be a '2' based on a six-point scale, with '1' being the strongest. We view the district's operational management as good. The district owns and operates a collection system and treatment plant that provides adequate capacity to meet demand for the medium term. The system's average daily flow is about 8.1 million gallons per day (mgd), or about 53% of the wastewater treatment plant's 15.4 mgd dry weather design capacity. Management notes that the average dry weather flow is about 6.0 mgd, and all flow above this rate is due to inflow and infiltration related to wet weather and groundwater. Management reports that peak flows during wet weather events can reach 50 mgd; however, during these periods wastewater can be stored in stabilization ponds until capacity is available. The next expansion of the treatment plant is estimated to be initiated in about five years. During the wet season, effluent treated to a secondary level is disinfected and discharged

to the Napa River. During the dry season, effluent treated to a secondary level is either stored in oxidation ponds or treated to a tertiary level for beneficial reuse by one of 27 user sites. The treatment plant operates under a regulatory permit that was renewed in July 2016 and expires in August 2022. Management reports that there have been no regulatory fines for at least a decade. There is formal succession plan for key staff members, and staff is trained to be able to step up as needed. Rates are reviewed and adjusted regularly and management has routinely engaged external consultants to perform in-depth rate analyses.

Financial Risk

The district's financial performance has been very strong during the past three fiscal years, in our view, and we anticipate that it will remain very strong going forward. Based on the district's audited financial statements, we calculate that all-in DSC improved from 2.2x for fiscal 2014 to 2.9x for fiscal 2016, coverage levels we consider extremely strong. Excluding one-time capacity charges, coverage levels were still extremely strong in our view, and ranged from 1.8x for fiscal 2014 to 2.2x for fiscal 2016. Revenue performance was driven largely by modest annual rate increases in the past three fiscal years (through 2016) while operating expenses remained largely flat, aside from a 6% decline in fiscal 2016 related to a reclassification of pension contribution expenses. Management's forecast, which reflects the approved rate plan, indicates all-in DSC will exceed 2.5x over a 10-year period even with additional debt anticipated in the forecast period. When excluding one-time capacity charges, all-in DSC will exceed 2.0x during the forecast period.

The district's liquidity position has been consistently very strong, with about \$16.4 million in cash and investments at the end of fiscal 2016, equal to about 547 days of operating expenses. During the past three years, the district's liquidity position was no lower than 511 days. Based on the district's expectations for cash-funded capital projects, we expect it to sustain its strong cash levels in the near term. Management's 10-year forecast indicates that a portion of cash reserves will be spent down on capital projects, but liquidity is not anticipated to decline below \$12 million during the next 10 years, which would represent about 300 days of projected operating expenses.

In our view, the district's debt-to-capitalization ratio of 26% indicates a lower leverage position. Over the next 10 years, the district expects to cash fund approximately \$139 million in capital projects and plans to issue an additional \$43 million. The anticipated debt plans include: \$17 million in state loans within the next three years to fund projects related to the collection system, about \$18.5 million in COPs proceeds in fiscal 2022 to finance projects related to expanding treatment capacity, and about \$7.5 million of federal loan for the implementation of recycled water expansion project in fiscal year 2025. Given the pre-approved rate increases and the district's historical financial performance, we anticipate the district to maintain its very strong financial profile—even with its additional debt plans.

Based on our financial management assessment (FMA), we view the district's management practices to be a '1' on a six-point scale, with '1' being the strongest. An FMA of 'strong' indicates that practices are strong, well embedded, and likely sustainable. The district maintains many best practices deemed as critical to supporting credit quality, particularly within the finance department. These strong practices include regular financial reporting to the board and the maintenance of long-term financial forecasts and capital plans. The district maintains a 15% emergency operating reserve, pursuant to its adopted reserve policy, and a formal debt management policy. Financial and operational information is relatively easily obtained, as budget and financial statements are readily available on the district's website.

Outlook

The stable outlook reflects our anticipation that the district will maintain its very strong financial profile, as evidenced by its proactive rate-setting approach to increase revenue. Also, we do not anticipate any significant impact to coverage metrics despite additional debt plans, due in part to the expected rate increases. We do not anticipate changing the rating within our two-year outlook period.

Upside scenario

While not likely, we could consider raising the rating if the district manages its large capital needs while increasing its cash reserves to levels we consider extremely strong.

Downside scenario

We could lower the rating in the next two years if coverage and liquidity were to deteriorate significantly due to capital-related pressure, or if the district significantly increases its debt burden beyond the anticipated amount without making adjustments to operating revenues.

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