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Ratings

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Summary:

Napa Sanitation District, California; Water/Sewer

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Credit Profile		
US$14.025 mil rfdg rev bnds ser 2017 dtd 12/28/2017 due 08/01/2027		
Long Term Rating	AA/Positive	New
Napa San Dist rfdg rev COPs (1998 rfdg proj)		
Long Term Rating	AA/Positive	Outlook Revised

Rationale

S&P Global Ratings has revised its outlook on Napa Sanitation District, Calif.'s certificates of participation (COPs) to positive from stable, and affirmed its 'AA' rating on the COPs. At the same time, S&P Global Ratings assigned its 'AA' long-term rating to the district's $14 million series 2017 refunding revenue bonds. The rating reflects the combination of a very strong enterprise risk profile and an extremely strong financial risk profile.

The outlook revision reflects the district's pre-approved rate plans and well-defined financial forecast, which we believe will result in very stable, and extremely strong, financial metrics over both the two-year outlook period and upcoming 10-year planning period. Although the district has a relatively sizable capital improvement plan (CIP) through 2027, the majority of the upcoming capital projects will be funded through surplus rate revenue (as well as state loans) without a material drawdown in liquidity. While the Napa Metropolitan Statistical Area has experienced almost double the U.S. average employment growth in the past five years, in our view, the service territory remains somewhat centered on wine production and related leisure and hospitality sectors, which we consider highly cyclical. Therefore, an upgrade would be predicated on continued diversification and broadening of the service area economy.

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

- Stable, and primarily residential, customer base with strong income indicators;
- Affordable sewer service rates with pre-authorized rate increases through fiscal 2021;
- Very low industry risk as a monopolistic service provider of an essential public utility; and
- Comprehensive asset management practices, which we consider very strong under our operational management assessment methodology.

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

- Extremely strong all-in debt service coverage (DSC) metrics that we expect to be sustained even with about $20 million of additional debt plans over the two-year outlook period;
- Very strong liquidity position that we believe is sustainable;
- Relatively low leverage, with 26% debt-to-capitalization as of June 30, 2017; and
- Well-defined financial management practices and policies.

The series 2017 bonds are being issued to refund the district's series 2009B COPs for economic savings. The bonds are on parity with $31.1 million of series 2012A refunding revenue COPs and $1.3 million of California State Water Resources Control Board loans. We view the series 2017 bond covenants to be neutral. There is a 1.25x rate covenant and additional parity obligations test for net revenue for the most recent fiscal year. There is no debt service reserve requirement for the series 2017 bonds.

Enterprise risk

Napa Sanitation District is located in southern Napa County (AA+/Stable appropriation rating), approximately 50 miles northeast of San Francisco. The district's service area includes the City of Napa and some surrounding unincorporated areas. The city's population remained stable during the past five years and was most recently estimated at 80,716 in 2016, up about 1.4% per year over the past five years. The local economy is driven primarily by wine production and related tourism but in our view is increasingly diversifying. According to data from the California Employment Development Department, the city's unemployment rate most recently stood at 3.4% in September 2017, below the state and national rates (4.7% and 4.1%, respectively) over this period. Income levels are strong, in our opinion, based on the city's median household effective buying income (MHHEBI) at 119% of the national level in 2016.

We understand the Atlas Peak fire (which occurred in October 2017) resulted in the destruction of 140 homes in the district's service area, but in our view, the damage caused by the wildfires will not have a protracted impact on the local economy.

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, and believe they provide management with revenue-raising flexibility. The residential rate structure is a flat annual fee, currently at $638.10, or a monthly equivalent of $53.18, 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 15% in fiscal years 2017 and 2018, which in 2016 were pre-approved as part of a multiyear rate plan that also includes additional annual rate increases of up to 6% through 2021. Despite the approved increases, we believe the rate continues to be affordable, given the strong income levels in the service area economy.

Also supporting the enterprise risk profile is a very strong operational management assessment, which, in our view, indicates a favorable alignment of operations and management's strategic goals. The district owns and operates a collection system and treatment plant that provides adequate capacity to meet demand for the medium-term horizon. The average daily flow of the system is about 8.1 million gallons per day (mgd), or about 53% of the district's wastewater treatment plant's 15.4 mgd dry weather permitted capacity. Wastewater is treated and discharged in various manners, depending on the source of the wastewater and the time of year. 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 100 user sites. The treatment plant operates under a regulatory permit that was last renewed in July 2016 and expires in August 2021. Management reports that there have been no regulatory fines for at least a decade. There is a 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.

We understand peak flows during wet weather events can vastly exceed the plant's design capacity, and at times may reach 50 mgd. This is primarily due to inflow and infiltration (I&I) of stormwater and groundwater, which leaks into the wastewater collection system in the rainy months. While excess flows can be stored in stabilization ponds until capacity is available, during heavy rainstorms sewer system overflows can occur. Accordingly, the bulk of the district's $176.2 million 10-year CIP is focused on collections system projects and pipeline expansions to reduce I&I and associated wet weather overflows.

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 six-point scale, with '1' being the best.

Financial risk

The district's financial performance has improved to levels we view as extremely strong during the past three fiscal years, and we anticipate that it will remain consistently strong. Based on the district's audited financial statements, we calculate that all-in DSC improved to 2.9x for fiscal 2016 from 2.2x for fiscal 2014 and rose further to 3.4x in fiscal 2017, all of which 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 2.3x in fiscal 2017. Revenue performance was driven largely by recent rate increases in the past three fiscal years, as well as very strong capacity charge receipts (which rose to $5.4 million in fiscal 2017 from $1.8 million in fiscal 2014).

The district's financial forecast is achievable, in our view, because on the revenue side, it assumes limited system growth, modest rate increases beyond what have been approved through 2021, and future capacity charge receipts (non-reoccurring revenue) only reflect currently known developments within the city. Likewise, operating expenses and construction costs escalate at levels either at or above the consumer price index or ENR's construction cost index for the San Francisco Bay Area.

As such, we expect all-in DSC to exceed 3x over the upcoming 10-year period, even with about $20 million of planned state loans (and $23.5 million of additional long-term debt in fiscal 2023). When excluding one-time capacity charges, all-in DSC will also remain strong, and exceeds 2.0x during the forecast period. The very strong DSC is by design, as the district's funding plan for the upcoming 10-year CIP assumes about $2.3 million in potential state and federal grants, but the remainder ($135.9 million) will be funded on a pay-as-you-go basis from the system's net revenue.

In our view, the planned $43.5 million of borrowing will not have a material credit impact for the district, as the issuance coincides with the amortization of about 60% of the district's bonds. Maximum annual debt service declines in August 2027 from about $4.6 million to $2.5 million, which we believe provides reasonable capacity for the additional debt that is currently planned.

The district's liquidity position is also an area of strength, with about $22.5 million in unrestricted cash and investments at the end of fiscal 2017, equal to about 612 days of operating expenses. During the past three years, the district's liquidity position was no lower than 500 days. Based on the district's financial forecast, which we view as achievable, liquidity is not anticipated to decline below $12 million during the next 10 years, which would represent about 300 days of projected operating expenses.

Outlook

The positive outlook reflects our anticipation that the district will maintain its extremely strong financial profile evidenced by its proactive rate-setting approach to increase revenue, and our view that the district will benefit from new residential and commercial development and employment growth in the service area.

Upside scenario

We would consider raising the rating if the service territory economy further broaden and diversifies, and the district manages its upcoming CIP while increasing its cash reserves to levels we consider extremely strong.

Downside scenario

We could return the outlook to stable in the next two years if all-in DSC and liquidity were to deteriorate significantly due to capital-related pressure, there is greater reliance on one-time capacity charges to fund the CIP, or if the district significantly increases its debt burden beyond the anticipated amount without making adjustments to operating revenues.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.