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Summary:

Tulare, California; Water/Sewer

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Credit Profile

US\$23.0 mil wtr rev bnds ser 2017 due 06/30/2029

Long Term Rating

A+/Stable

New

Rationale

S&P Global Ratings assigned its 'A+' rating to Tulare, Calif.'s series 2017 water revenue bonds. The rating reflects the system's strong enterprise risk profile and very strong financial risk profile. The outlook is stable.

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

- Service area participation in the Visalia-Porterville metropolitan statistical area (MSA) and primarily dairy farming and agricultural economic base;
- Water rates that we generally view as moderately affordable when benchmarked against Tulare's median household effective buying income (MHHEBI) and Tulare County's poverty rates;
- Very low industry risk as a monopolistic service provider of an essential public utility; and
- Good operational management practices and policies.

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

- Extremely strong all-in debt service coverage for the last three years, exceeding 2.3x in each year, with projected coverage sustained at this level through fiscal 2022;
- Improved liquidity position, with \$4.8 million, or over a year's cash on hand, as of June 30, 2016 (up from zero cash balances in fiscals 2012 and 2013), and anticipation that liquidity will not drop below \$4 million through fiscal 2022;
- Sizable, \$69.2 million capital improvement program (CIP), which will result in an increase in system leverage (with a 57% debt-to-capitalization ratio) following this transaction and the system's planned 2019 transaction; and
- Strong financial management practices and policies.

The proceeds of the 2017 bonds will be used to finance capital improvements in the water system as well as fund a reserve account for the bonds. The water system currently expects to issue an additional \$13.5 million in fiscal 2019 to fund the remainder of its capital improvement plan (CIP). We understand that the city may also refinance the outstanding water portion of its 2006 water meter lease with a principal balance of \$3.9 million if the city determines it would be beneficial to the city.

We view the bond provisions as credit neutral. The bonds are secured by the water system's net revenues. Key bond provisions include a rate covenant set at 1.2x annual debt service and an additional bonds test (ABT) set at 1.2x maximum annual debt service. To demonstrate compliance with the rate covenant, the city may include transfers from a rate stabilization fund to meet the portion of the requirement in excess of 1.0x of the ABT. The city intends to provide a standard debt service reserve fund for the series 2017 bonds.

Enterprise risk

Tulare, with an estimated population of 64,660 as of Jan. 1, 2017, is the second-most populous city in Tulare County. The city encompasses about 16 square miles and is located along U.S. Highway 99; approximately 175 miles north of Los Angeles and 200 miles southeast of San Francisco. Its population grew at an average annual rate of about 1.5% since 2010. The county is one of the leading dairy production regions in the country; and the local economy is engaged primarily in agricultural production, food processing, and manufacturing related to the dairy industry. We view the service area's income levels to be adequate based on the city's MHHEBI, which was 78% of the national median for 2016. The city's unemployment rate has historically exceeded the state and national averages yet remains lower than the county's rate. As of August 2017, the city's rate of 8.9% was lower than the county rate of 10.7%, yet remained higher than the state and national rates of 5.1% and 4.4%, respectively.

The city provides water services to residential, commercial, and industrial customers within the city limits and 336 single-family residences in the Matheny Tract, and we view the customer base as stable, primarily residential, and diverse. Changes in the customer base are driven primarily by economic development in the residential, commercial, and industrial sectors. Management reports that the College of the Sequoias' newly opened campus, to which the city provides water and sewer services, has a planned expansion that will increase total student capacity by 4,000. The city anticipates that the campus will eventually be annexed into the city and provide additional revenues for the water system. Residential customers represent about 91% of the water system's 17,702 accounts, which we believe promotes revenue stability. We consider the customer base to be diverse based on the leading 10 customers contributing about 18.5% of total operating revenues for fiscal year 2016. The largest customer, a cheese producer, accounted for about 9% of total operating revenues.

Although the city has adequate water supply to meet growing demand, it is faced with challenges related to groundwater quality. The city's water supply is sourced primarily from the Kaweah groundwater basin. The city's groundwater system includes 24 active wells for potable water production. Total production for all of the system's water facilities in fiscal 2017 was approximately 5.1 billion gallons pumped. The water system's average daily demand is 13.3 million gallons per day (mgd), and the peak day demand is 19 mgd as of fiscal 2017. We understand that the city's 2009 master plan called for 10 million gallons of storage; however, the city currently has only a 125,000-gallon water storage tank. The city plans to construct two 2-million-gallon water tanks and is planning to secure additional sites for wells and water storage to boost system capacity in anticipation of population growth.

In July 2017, the State Water Resources Control Board proposed drinking water regulations on 1, 2, 3-trichloropropane (TCP), which is a carcinogenic byproduct of an agricultural fumigant that was historically--although is no longer -used in the central San Joaquin Valley. The state board set a maximum contaminant level (MCL) of 5 parts per trillion, and of the city's 24 groundwater wells, 14 wells exceed the proposed MCL for TCP. The city intends to implement granular activated carbon vessel systems to remediate the TCP-contaminated wells. The city has also reported arsenic in its Well 40 and is using a \$2 million state grant to 1) remediate the well and 2) construct a new well that will extend the water line north to the Matheny Tract.

Under the state's Sustainable Groundwater Act (SGMA), the city has been a member of the Mid-Kaweah Groundwater Sustainability Agency since 2015 and has begun data collection for the agency's groundwater sustainability plan due in 2020. In our view, the implementation of SGMA will have a neutral credit impact on the water system because the city

is targeting a net-zero withdrawal from the underlying aquifer and is already well on its way to achieving this goal through 1) recharge of treated effluent from its wastewater treatment plant and 2) its participation in groundwater recharge facilities with Tulare Irrigation District (TID). In 2009, the city entered into an agreement with TID in which the two agencies jointly purchased land to develop new recharge basins (the Swall Basin). Management reports that the Swall Basin is currently operational and that TID purchases water for recharge when available.

We view the system's market position to be adequate based on the system's moderately affordable service rates, but weakened somewhat by the county's high poverty rate. The rate structure includes a monthly water fixed charge and three usage-based rate tiers. As of Oct. 1, 2017, the average monthly bill is \$34.55 for a typical residential customer using an average of 13,000 gallons of water per month. After annualizing this amount, we consider the system's service rates to be moderately affordable in the context of the service area's income levels at 1.1% of the city's MHHEBI. The county's poverty rate as reported by the U.S. Dept. of Agriculture is 28.1%, which we view as extremely elevated and a weakening credit factor.

We understand that the city previously commissioned a five-year utility rate study for its water system that was adopted in 2016 and established a funding plan for its impending regulatory and capacity capital improvements projects. The study recommended an aggregate 90% rate increase over the next five years; a 41% increase went into effect on Oct. 1, 2016, with smaller increases effective each Oct. 1 through 2021. Management reports that due to extensive community outreach, the city's Proposition 218 public hearing process was well supported by the public and its board.

Based on our operational management assessment, we score the water system a '3' on a six-point scale in which '1' is the strongest. This indicates, in our view, that operational and organizational goals are well aligned, even if some challenges exist. Vulnerability assessments are performed with the drilling of new wells, consistent with state guidelines, and the city is anticipating a new asset management system that will have an enhanced geographic information system, or GIS, module. Though no formal succession plan exists, training is addressed on a department-by-department basis. The water enterprise has been operating in compliance with all applicable regulations, and management reports unaccounted water of 5%-7%. Management also reports that there has not been any material service interruptions during the past three years.

Financial risk

The water system's financial performance during the past three years has been very strong despite thinner margins in fiscals 2012 - 2014, and we anticipate that coverage will remain above 2.3x through fiscal 2022. Based on the city's audited financial statements, we calculate all-in coverage of 4.3x in fiscal 2017 (unaudited), up modestly from 3.6x for fiscal 2016, compared to a relatively thin 1.6x in fiscal 2014. To calculate all-in coverage, we take into consideration the water system's subordinate-lien obligations and treat the water fund's portion of the 2006 equipment lease payments and interfund loan payable as debt-like in nature. Operating revenues have steadily increased due to the implementation of rate increases. Management reports that water sales rebounded in 2017 by 7% following a decrease during the drought periods. Operating expenses have fluctuated considerably over the last five years due to noncapitalized costs largely due to the city's new street replacement program.

In our view, management's revenue projections are reasonable, as they assume 1.5% customer growth and

preapproved rate increases. Revenues also reflect the elimination of drought surcharges, which were superseded by the 2016 rate study. Operating expenses have a built-in 3.5% cost escalator and have been adjusted for additional treatment costs for chemicals in later years due to well treatment project, but could be choppy in the event of additional noncapitalized costs. We calculate that coverage through fiscal 2022 (assuming \$13.5 million of additional bonds in 2019) will remain at above 2.5x absent any additional unforeseen operational expenses.

The system's liquidity position has improved substantially over the last three years, and according to management's forecast will remain strong through fiscal 2022. The city's unrestricted cash balance at the June 30, 2016 was \$4.8 million, equal to 405 days' cash on hand. This is a vast improvement from levels in fiscal 2012 and 2013 when the water system lacked any cash balances. Management attributed a culmination of factors for the system's weakened position. First, the 2008 recession hurt financial performance due to reduced revenues and development charges. Around 2012, the city was mandated by the State Water Resources Control Board to provide water services to communities outside of its boundaries (including the Matheny Tract) and bore the costs of expanding its system with cash on hand. The system's weakened cash position in 2012 prompted phased-in rate increases over the last few years. However, we view the two-year lack of water fund cash balances as reactionary management practices and a credit negative. As of June 30, 2017, the water fund had approximately \$4.2 million of unrestricted cash (unaudited); the amount is anticipated to increase to \$7.1 million by the end of fiscal 2022, inclusive of management's anticipated pay-as-you go funding of a portion of the water system's upcoming CIP.

The city's five-year CIP through 2022 is large and totals \$69.2 million. Planned system improvement includes the drilling and construction of up to seven wells, two 2-million-gallon water storage tanks, treatment facilities and equipment for the remediation of 1,2,3-TCP in its existing wells, and funding for the state-mandated groundwater sustainability act (costs related with the development and submittal of the groundwater sustainability plan due to the California Department of Water Resources by January 1, 2020). In addition, the city also anticipates some renewal and replacement projects of five miles of water pipes annually. The city plans to fund roughly 48% (\$34 million) from the series 2017 and proposed 2019 series bonds, 25% (\$17 million) on a pay-as-you-go basis, 22% (\$15 million) from reserved funds for its TCP project (coming from the city's groundwater management fund that has been established for the remediation project), and the remaining 5% (\$3 million) from state grants. Apart from the city's debt issuance in 2019, management does not anticipate any further borrowing for the water system.

Although the water system does not have any senior-lien obligations outstanding (beyond the series 2017 bonds), subordinate obligations exist. The city has an equipment lease payable in which the water fund's portion has an outstanding principal amount of \$3.9 million and is due to expire in fiscal 2023. The city may refinance its lease obligation at its discretion if doing so generates adequate savings. In addition to the equipment lease, a \$1.2 million interfund loan with a maturity of June 2029 is due to the city's solid waste fund for the purchase of two wells from the College of the Sequoias in 2014. We have reviewed the terms of interfund loan repayment schedule and believe repayment of the loan as scheduled will not materially affect the city's ability to repay its other debt service obligations, but full repayment on an accelerated basis could weaken the systems' overall financial profile

Based on our financial management assessment, we view the water system to be a '2' on a six-point scale, with '1' being the strongest. In our view, financial policies and practices exist in most areas, but management may not

formalize or monitor all of them on a regular basis. We believe that the city's revenue and expense assumptions are reasonably conservative, and interim financial and operational reports are presented to its board on a regular basis. In addition to the water system's reserve policy which establishes a minimum of 60 – 120 days' operating reserves, the city has an adopted reserve policy and debt management policy. The city's budget and financial statements are readily available on its website. The city participates in the California Public Employees' Retirement System and reports no challenges in meeting its annual required contribution. Management reports that starting in January 2018, employees will begin mandatory 3% contributions to the city's share of the retirement system and that other postemployment benefits are paid on a pay-as-you-go basis.

Outlook

The stable outlook reflects our view of the water system's recent financial performance, which we believe is sustainable over the two-year outlook period based on the city's adopted rate plan.

Downside scenario

We could take a negative rating action if financial performance does not meet management-provided projections or if liquidity is materially spent down due to unforeseen capital expenditures associated with the remediation of the water system's TCP-contaminated wells.

Upside scenario

While not anticipated in the near term, we could take a positive rating action if there is a demonstrated improvement in the local area economy, and future financial performance exceeds management's current expectations.

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