S&P Global
Ratings

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Summary:

United Water Conservation District, California; Water/Sewer

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Table Of Contents

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Credit Profile		
United Wtr Conserv Dist WTRSWR		
Long Term Rating	AA-/Stable	Outlook Revised

Credit Highlights

- S&P Global Ratings revised its outlook to stable from negative and affirmed its 'AA-' rating on United Water Conservation District, Calif.'s existing water revenue certificates of participation (COPs).
- The outlook revision reflects the importance of the district's primary water supply to regional demand and its very strong financial position, with more than 6x coverage and over one year's cash on hand available as of June 30, 2022 (unaudited). Nevertheless, we believe these strengths are partially offset by the heightened business risks from drought and water scarcity challenges that its agricultural customers increasingly face, which we consider a constraining credit factor.

Security

We view the COP provisions as adequate and credit neutral. The COPs are payable and secured by the net revenues of the district's water system, including the district's share of Ventura County's 1% ad valorem property tax revenues. COP provisions include an annual debt service rate covenant of 1.2x including rate stabilization fund transfers and 1.0x without such transfers. Although the COPs are not supported by a debt service reserve fund for the series 2020 COPs, we do not view this as a material credit risk given the system's very strong liquidity position.

Credit overview

The district has no direct retail customers and provides raw water primarily to agricultural customers and municipal groundwater pumpers in Ventura County. Although we consider the district's near-term debt needs to be relatively manageable, we believe its deadline-certain environmental, seismic, and regulatory-driven capital needs will influence the district's cost of operations during the next decade. We understand that the district also maintains a strong liquidity position, in part to enable it to opportunistically acquire water rights or otherwise firm up its water supply.

The rating is underpinned by the district's competitive position as a water provider in a region with strong water demand and scarce water resources. Groundwater users in the service area do not have the legal ability to "detach" from the district if they expect to continue pumping from the groundwater basin, which we consider credit supportive. However, we believe the more elastic demand for water from agricultural production constrains the district's pricing power in a rising cost of service environment. Ongoing litigation with Ventura regarding the district's groundwater extraction charges could affect the district's entire rate structure, which we consider an added risk.

The rating further reflects our view of the district's:

- Concentrated revenue base, with about 60% of revenues and 75% of groundwater usage derived from agricultural production. The population within the district's service area is estimated at about 310,000. Food processing and agriculture production are significant components of the local economy. According to the latest Ventura County Agricultural Commission Crop and Livestock Report, the gross crop value for calendar year 2020 was $1.98 billion, approximately $4.7 million less than in calendar year 2019. Major crops include strawberries, lemons, oranges, and avocados. The Port of Hueneme (which is located within the boundaries of the district) is California's smallest port, but is the only deep-water port between Los Angeles and San Francisco and plays a significant role in the local economy.
- Operational management policies and practices that we view as good, with conservative hydrological forecasting, comprehensive vulnerability assessment of critical assets, maintenance of succession plans for key staff, and annual rate review by the board, tempered by the district's deadline-certain environmental, seismic, and regulatory-driven capital needs.
- Extremely strong historical all-in debt service coverage (DSC) and liquidity, with DSC exceeding 6.0x in fiscal 2022 (unaudited) and available reserves totaling $46.1 million, or over one years' cash of operating expenses, based on our calculations.
- Current projections, which we consider reasonable, assume about $93 million of capital spending through 2026, about half of which will be funded through a low-cost WIFIA loan in 2023. While we don't anticipate a significant draw down in reserves to fund the remainder of the capital improvement plan, we understand that the district has about $350 million of identified projects commencing in 2027 and beyond, which we consider significant relative to its outstanding debt.
- Financial management policies that we view as good, which include monthly budget updates to the board, long-term financial and capital plans, and audits based on generally accepted accounting principles (GAAP).

Environment, social, and governance

The district is faced with several ongoing ESG risk factors that affect our analysis of the rating. The district's surface water supply is susceptible to elevated environmental risk related to climate change and natural cycles of drought. Additionally, the district faces significant regulatory scrutiny associated with the Endangered Species Act (related to Steelhead trout) as well as its Federal Energy Regulatory Commission (FERC) license at Santa Felicia Dam. Wildfire has periodically affected the district's service area, although none of the district's wells or assets were affected in recent fires, and we believe the district has well-defined emergency preparedness plans.

The district operates its water facilities with the objective of replenishing the various groundwater basins within the district's boundaries so that they can be utilized during prolonged periods of below-average precipitation. During wet periods, surface water is captured and routed into strategically located facilities (i.e., settling ponds and reservoirs) where it is used to recharge the groundwater basins within the district's boundaries. Nevertheless, the groundwater basins within the district's boundaries are, with one exception, subject to the provisions of the Sustainable Groundwater Management Act (SGMA). While SGMA should not adversely affect the district's direct water supply (because it is sourced from surface water), because the affected groundwater basins are overdrafted, the groundwater pumpers within the district's boundaries may be required to reduce their pumping to comply with SGMA. Since the district's cost of service is largely recovered on a per acre-foot volumetric basis, if SGMA leads to reduced pumping, there would be a smaller base upon which the district will need to spread its fixed costs, which would thus raise its volumetric costs.

Governance risk largely centers on the ongoing litigation with Ventura regarding the district's groundwater extraction charges. The city of Ventura has challenged the district's groundwater extraction charges in court in each year since fiscal 2012. In 2020, a trial court ruled that the district's charges violated Proposition 26 and the district reached a settlement to pay the city $1 million. With the Supreme Court's August 2022 denial to review the district's appeal, the statute requiring the current 3-to-1 rate structure (municipal and industrial rates are three times that of agricultural users) has been ruled unconstitutional and a new rate structure must be developed, which could result in additional refunds. We cannot predict the timing or outcome of the new rate structure, but persistent negative public sentiment (e.g., from agricultural customers to balance out lower municipal rates) or rising political pressure would affect our view of the district's future credit quality.

Outlook

The stable outlook reflects our view that the district's financial performance is sustainable during the outlook period based on historical results and projected cost of service that includes an anticipated WIFIA loan anticipated to be funded in 2023.

Downside scenario

Should there be sustained deterioration in the district's credit fundamentals, particularly a weakening in its financial capacity due to the ongoing litigation or a significant increase in near-term capital needs that pressure the overall financial profile, we could revise the outlook to negative or lower the rating.

Upside scenario

We believe several factors constrain upward potential for the rating, including the lack of a clearly delineated financial plan to address capital spending during the next decade, and a possible future reduction in groundwater production due to SGMA, seawater intrusion, or drought. We also consider the district's revenue concentration in agricultural production to be a limiting rating factor.

Credit Opinion

The district's water supply includes runoff from Piru Creek that is stored in Lake Piru, as well as surface water from the Santa Clara River. As the district's water resources are used primarily to recharge the groundwater basins within the district's boundaries, the district recovers its costs through groundwater extraction charges (and in-lieu fees) to a customer base that includes the incorporated cities of Oxnard, Santa Paula, Fillmore, and Port Hueneme, as well as approximately half of the city of Ventura. Within the district's boundaries, agriculture remains especially important along the coastal Oxnard Plain and the interior Santa Clara Valley communities of Santa Paula, Fillmore, and Piru.

The district collects charges on all groundwater that is pumped within its service area and delivers potable and nonpotable water to 85 customers. There are more than 1,200 active water wells within the district that are owned by about 750 individuals. The district also operates potable and nonpotable water delivery systems to distribute water to its wholesale customers. The district has an annual allotment of 3,150 acre-feet surface water from the State Water Project (funded through property taxes and not pledged to certificate holders) through an agreement with Ventura

County Flood Control District, which expires in 2035.

Related Research

Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022