S&P Global
Ratings

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## Summary:
# Richmond, California; Water/Sewer

**Primary Credit Analyst:**
Alexandra Rozgonyi, Centennial +1 (303)-721-4824; alexandra.rozgonyi@spglobal.com

**Secondary Contact:**
Tim Tung, San Francisco (415) 371-5041; tim.tung@spglobal.com

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**Summary:**

# Richmond, California; Water/Sewer

| Credit Profile | | |
|---|---|---|
| US$35.41 mil wastewtr rev bnds ser 2017A due 08/01/2047 | | |
| *Long Term Rating* | AA-/Stable | New |

## Rationale

S&P Global Ratings assigned its 'AA-' long-term rating to Richmond, Calif.'s series 2017 wastewater revenue bonds. At the same time, S&P Global Ratings affirmed its 'AA-' long-term rating and underlying rating (SPUR) on the city's existing parity-lien bonds. The outlook is stable.

The rating reflects, in our opinion, the wastewater system's very strong enterprise risk and financial risk profiles.

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

- Built-out service area in the San Francisco Bay area, with good income metrics and access to the broad and diverse San Francisco-Oakland-Hayward metropolitan statistical area (MSA);
- Stable, primarily residential, and very diverse customer base;
- Affordable sewer service rates, with reduced exposure to delinquencies through a strong collection mechanism; and
- Very low industry risk as a monopolistic service provider of an essential public utility; and
- Standard operational management assessment based on the system's continual efforts to decrease sewer system overflows during wet weather events and exposure to increasingly stringent regulatory requirements.

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

- Strong all-in coverage metrics that we believe will continue during the next five years;
- Very strong liquidity, with about $20.7 million of cash as of June 30, 2016;
- Highly leveraged system based on a pro forma debt-to-capitalization ratio of about 84.8%, which we believe is manageable given the city's strong all-in coverage and very strong liquidity; and
- Good financial management practices and policies that consist of comprehensive long-term financial and capital planning.

We have applied a one-notch negative adjustment from the initial indicative rating to arrive at the final rating based on the city's continual efforts to comply with stringent regulatory requirements. In addition, to comply with regulatory requirements, the city will need additional financing, which may increase annual debt service payments.

The city is issuing the series 2017 bonds to finance $31.7 million of wastewater system capital improvements and to refund $7.1 million of remaining series 2006A.

We view the bond provisions as credit neutral. Key bond provisions include a rate covenant and additional bonds test set at 1.25x annual debt service. The series 2017 will not have a debt service reserve fund, and we do not view as a credit weakness based on the system's strong liquidity position.

## Enterprise Risk

Richmond is located in Contra Costa County about 16 miles northeast of San Francisco. The city encompasses about 34 square miles, and we understand that it is substantially built out. We characterize the service area as broad and diverse in the San Francisco-Oakland-Hayward, CA (MSA). Income levels within the service area are good with the median effective household buying income (MHHEBI) at 103% of the national average in 2016. We expect that local economic growth will be good, with the average annual change in gross county product about 3.6% compared with the national metric of about 2.5%. The city's unemployment rate in 2016 was 5.1%, which was lower than the state's 5.4% and higher than the nation's 4.9%.

The wastewater system serves a stable, primarily residential, and very diverse customer base. Residential parcels account for about 93% of total parcels served. During the past five fiscal years, the number of parcels served has remained stable at about 19,600, with only minor fluctuations from year to year. We consider the customer base very diverse in that the leading 10 wastewater customers represent approximately 4.2% of revenue. The leading customer, Atchison Village Mutual Homes Corp., contributes less than 1% of total operating revenues annually. In addition, the leading employer in the city is Chevron Refinery, an oil refinery and research facility.

We view the system's rates as affordable given the good income indicators and adequate poverty rate of the service area in comparison with peers in the state. The rate structure for residential customers is composed of a flat annual charge per sewer service unit (SSU). The city last approved a schedule of rate increases in July 28, 2015; it included 6.8% annual rate increases for 2016 through 2020. The current annual charge per SSU is $722, or a monthly equivalent of $60.17 or 1.5% of MHHEBI, which we consider affordable. Management anticipates analyzing the need for future rate increases after fiscal 2020 and possibly implementing another preapproved five-year rate increase. The annual service charges are collected on the county property tax bill and, given the city's participation in the county's Teeter Plan there is reduced exposure to delinquencies.

Based on our Operational Management Assessment (OMA), we view the system as a '4' on a six-point scale on which '1' is strongest. The assessment as 'standard' is based on the system's continued efforts to decrease sewer system overflows during wet weather events and exposure to increasingly stringent regulatory requirements. The wastewater system is in compliance with its regulatory permit, but faces challenges as the city anticipates permit requirements becoming more stringent in the medium term. The city entered into a 20 year agreement in 2002 with Veolia Water North America Operating Services, Inc. (Veolia) to design and construct improvements, operate and maintain the city's treatment plant. The city pays an annual service fee to Veolia which allows for Veolia to make annual adjustments to the Veolia's service fee based on changes in the Consumer Price Index (CPI). Typically, wastewater that is conveyed to the city's treatment plant is required to undergo both primary treatment and secondary treatment before discharge into San Francisco Bay. The treatment plant has 40 million gallons per day (mgd) of primary treatment capacity and 20 mgd of secondary treatment capacity.

Due to the age and condition of the collection system, a significant amount of water enters the collection system during periods of heavy rainfall, thereby overwhelming the treatment plant's secondary treatment capacity and available storage capacity. Under these circumstances, a portion of the wastewater inflows undergoes primary treatment, but then bypasses the secondary treatment process, and instead is blended into secondary treated wastewater before it is discharged into San Francisco Bay. In recent years, peak wet-weather flows of 21.1 mgd to more than 40 mgd have led to blending, and we understand that this occurs on average about five times per year. Although the current regulatory permit, which was renewed on July 1, 2013, and expires on June 30, 2018, continues to allow blending, we understand that the regulatory permit will likely include more stringent requirements in the future.

We understand that the city is currently making improvements to its collection system to reduce the number of sanitary sewer overflows that occur annually -- as required under a settlement agreement with San Francisco Baykeeper and West County Toxics Coalition -- we anticipate that these improvements will reduce the amount of inflow and infiltration into the collection system during periods of heavy rainfall. The city was compliant with the settlement agreement through 2014. Since 2014, the city has built a 5 million gallon wet weather storage tank to mitigate future sewer system overflows (SSOs). Although the storage facilities have helped decrease the number of events, SSOs have still exceeded the settlement agreements targeted amount during wet weather events. The city has initiated discussions with Baykeeper regarding an extension of the settlement agreement pertaining to SSOs to allow for additional time to achieve SSO reduction compliance.

Consistent with "Methodology: Industry Risk," published Nov. 19, 2013 on RatingsDirewct, 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 strongest.

## Financial Risk

In our view, the system's financial performance has been strong and we anticipate that performance will remain very strong. Based on the city's audited financial statements, we calculate the system's all-in coverage metrics for fiscal years 2014 through 2016 at about 1.73x, 1.60x, and 1.61x, which we consider to be strong. Revenue and expenditures have been stable given the predictable nature of Veolia water expenses and annual sewer rate increases. In fiscal 2016, operating expenses increased because two positions were filled. Based on management-provided projections, we expect coverage to remain what we would consider strong at more than 1.4x through fiscal 2021. Our projections include two state loans in the amount of $7.1 million and $24.4 million, which we understand management is anticipating using for additional funding. We believe that management's assumptions are reasonable because they include adopted rate increases and expected operating expense increases for key items. Management expects to continue to review rates annually and has expressed willingness to increase rates as needed to maintain stable coverage metrics.

In our view, the system's liquidity position has been very strong during the past four years, and we anticipate that it will likely remain very strong. At the end of fiscal 2016, the system's unrestricted liquidity was about $20.7 million, or 750 days of operating expenses. For fiscal years 2013 to 2015, the system's liquidity was at $18.2 million, $22.3 million, and $22.3 million, all of which we consider very strong. The city is still determining future funding sources for capital improvements but at this point does not plan to materially draw down cash. The city does not have a formalized liquidity policy for the system but has an informal policy of maintaining a cash balance of $3 million to $5 million. The system has consistently maintained liquidity above the city's informal target. We do not believe the system's liquidity will be drawn down by the city's general fund because the system has not historically transferred money to the general fund. In addition, council approval is needed to transfer any funds and we understand management has no plans to transfer money out of the sewer system fund.

The system's leverage is high at about 84.8% based on a pro forma debt-to capitalization ratio, which we believe is manageable given the system's continual strong all-in coverage and very strong liquidity position. The CIP for fiscal years 2017 through 2022 includes about $63.2 million for sewer collection and sewer treatment projects. In addition to the five-year CIP, the city has identified approximately $40 million of capital projects expected to be completed beyond fiscal 2021. From the five-year CIP about one-third will be used for collection system improvements and about two-thirds for treatment plant improvements. The city will fund about $31.7 million from the 2017 bond proceeds and $31.5 million from expected State Revolving Fund loans. We understand that the city will continue to evaluate future funding sources. Furthermore, the CIP is updated annually per the sewer system and treatment master plan.

Based on our Financial Management Assessment (FMA), we view the system as a '3' on a six-point scale, with '1' being the strongest. An FMA of good indicates our view that practices transparent and primarily comprehensive in nature. Revenue and expense assumptions are reasonable, and interim financial reporting is reviewed monthly informally by council. In addition, the council is briefed on the performance of the system during the mid-year budget presentation in February, as well as in connection with the adoption of the next year's budget. We understand that long-term financial projections are reviewed annually and are updated on an as-needed basis. The city looks forward 10 years with a 10-year wastewater treatment facilities plan and updates a five-year capital improvement plan annually. The city has formalized debt policies and informal liquidity targets that it has met for the past five fiscal years. Management produces annual audited financial statements that comply with general accepted accounting principles. Our FMA assessment differs from the general obligation management assessment because the system's financials have been consistently managed with strong financials and management has been willing to increase rates as needed to maintain strong system financials.

## Outlook

The stable outlook reflects our view that the system will maintain strong financial metrics through preapproved rates and continue to move forward with its CIP to decrease SSOs and stay ahead of regulatory requirements.

### Upside scenario

We could take a positive rating action if the system's financial metrics stay stable during the system's planned capital improvements and future funding plans. In addition, we could take positive rating action if we believe there is more certainty when it comes to the Baykeeper settlement agreement, capital improvement plan, and future funding sources.

### Downside scenario

We could take a negative rating action if significant additional borrowing is required to fund capital improvements to meet regulatory requirements, and rates are not sufficiently raised to maintain strong all-in coverage levels.

| Ratings Detail (As Of July 7, 2017) |
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| Ratings Detail (As Of July 7, 2017) (cont.) | | |
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| Richmond wastewtr (AGM) | | |
| *Unenhanced Rating* | AA-(SPUR)/Stable | Affirmed |
| **Richmond wastewtr** | | |
| *Unenhanced Rating* | AA-(SPUR)/Stable | Affirmed |
| **Richmond Wastwtr** | | |
| *Unenhanced Rating* | AA-(SPUR)/Stable | Affirmed |

Many issues are enhanced by bond insurance.

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.globalcreditportal.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.