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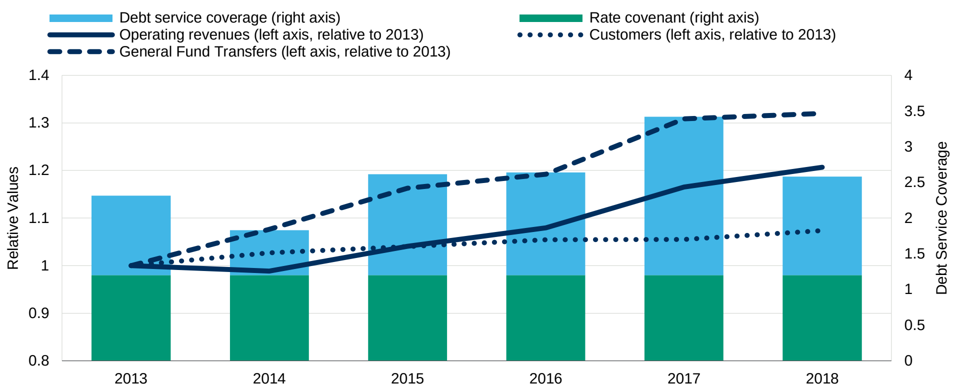
Mesa Combined Utility Enterprise, AZ

Update to credit analysis

Summary

Mesa, Arizona's Combined Utility Enterprise (Aa2 stable) is primarily supported by stable and well-managed finances, with substantial net revenues to provide strong debt service coverage for the utility's somewhat elevated debt levels. The utility is constrained by the credit profile of the City of Mesa, Arizona's (Aa2 stable) general government operations as the city transfers approximately 30% of the utility's total operating revenues to the General Fund, where utility transfers represent 26% of fiscal 2018 General Fund revenues. Positively, the transfers are a long-standing practice with a recently stable and largely predictable growth trajectory. Additionally, the City Council has utilized its unlimited rate-setting authority to collect revenues that are sufficient to pay debt service, make transfers to the General Fund, and pay for capital reinvestment with the remaining funds. Still, the transfers remain a credit weakness as the city is heavily reliant on that revenue to support general operations.

Exhibit 1
Despite growing transfers out, system is healthy with increasing revenues, healthy customer growth, and strong debt service coverage



Source: Moody's Investors Service

Credit strengths

» Strong financial management and consistent, well-planned rate increases drive stable financial operations, including above-average debt service coverage for a system of this size

» Capital planning and water resource management are healthy for the system that supports a growing residential population

Credit challenges

» Sizeable transfers to support the city's general government operations constrain the otherwise good credit fundamentals, and rates are above-average, reflecting the subsidy to the general government

» System debt is elevated, though strong debt service coverage and relatively fast payout balance the leverage

» Modest socioecomic profile

Rating outlook

The stable outlook reflects our expectation that management will continue to make appropriate financial and operational adjustments to maintain the strengths of the system, including strong debt service coverage supported by proactive rate management policies.

Factors that could lead to an upgrade

» Significant reduction in the general government's reliance on transfers from the combined utility to pay for general city services

» Substantially lower leverage compared to operating size

» Significant appreciation in socioeconomic measures

Factors that could lead to a downgrade

» Significant growth in transfers to support the city's general operations or sustained credit stress on the city's general government that reduces the financial health of the utility

» Drought conditions or other resource pressures that materially impact the system's health

Key indicators

Exhibit 2

Mesa (City of) AZ Combined Utility					
System Characteristics					
Asset Condition (Net Fixed Assets / Annual Depreciation)	23 years				
System Size - O&M (in $000s)	$185,569				
Service Area Wealth: MFI % of US median	88.9%				
Legal Provisions					
Rate Covenant (x)	1.20				
Debt Service Reserve Requirement	DSRF funded at less than 3-prong test OR springing DSRF (A)				
Management					
Rate Management	Aa				
Regulatory Compliance and Capital Planning	Aaa				
Financial Strength					
	2014	2015	2016	2017	2018
Operating Revenue ($000)	$304,554	$320,650	$332,663	$359,060	$371,794
System Size - O&M ($000)	$155,833	$164,025	$169,562	$173,673	$185,569
Net Revenues ($000)	$123,315	$79,486	$84,987	$99,437	$101,437
Net Funded Debt ($000)	$1,114,814	$1,223,530	$1,289,753	$1,415,097	$1,304,944
Annual Debt Service ($000)	$67,337	$67,556	$70,629	$61,072	$82,093
Annual Debt Service Coverage (x)	2.5x	2.1x	1.9x	1.6x	1.4x
Cash on Hand	65 days	161 days	159 days	267 days	194 days
Debt to Operating Revenues (x)	3.7x	3.8x	3.9x	3.9x	3.5x

Source: Moody's Investors Service

Profile

Mesa's combined utility system includes the city's retail water, wastewater, solid waste collection, natural gas and electric distribution enterprises. The systems provide service to residential, commercial and industrial customers in Mesa, Arizona and portions of the surrounding area in central Arizona.

Detailed credit considerations

Service area and system characteristics: stable systems and operating performance; systems have healthy capacity

All of the utility's systems will continue to have sufficient capacity and supply to meet near-term forecasted demand from the primarily residential customer bases they serve. No system has a material level of customer concentration. The combined utility system includes the city's retail water, wastewater, solid waste collection, natural gas and electric distribution enterprises.

The largest system by revenues is the water utility (40% of combined enterprise revenues). The water utility provides retail water service to a population of over 496,000 within a service area of 158 square miles, supplying an average of 87 million gallons per day (mgd) to about 146,000 customers. About 90% of water utility accounts are single-family residential, followed by commercial and multi-family accounts. No individual water customer comprises more than 2% of water system operating revenues.

The system can supply 269 mgd of water from three sources: the Salt and Verde River System (36% of water deliveries), the Colorado River via the Central Arizona Project (CAP, 41%), and 32 local groundwater wells. Treatment capacity is more than ample. Water from the Salt and Verde River System is treated at the Val Vista Water Treatment Plant, a joint venture with the city of Phoenix. Mesa owns 90 mgd of the plant's 220 mgd total capacity. Total treatment capacity for Mesa's system is approximately 245 mgd, in relation to a peak daily demand in 2005 of 138 mgd (2018 peak was 121 mgd). The utility benefits from additional stored water in underground aquifers equivalent to nearly 5-times annual demand as well as 19 reservoirs and other storage facilities capable of holding 109 million gallons of treated water.

The second largest system is the wastewater system (22% of revenues) which serves a primarily residential customer base. The utility owns and operates three reclamation plants, and jointly owns one treatment plant with four other municipalities. The aggregate capacity of the system is 60 mgd in relation to 34.6 mgd average flow and 36.9 mgd peak flow in calendar year 2018. The water reclamation process is efficient and compliments the water system's supply. Water from the Northwest reclamation plant is delivered to the Granite Reef Underground Storage Project, where it is converted into additional water rights. Water from the other two reclamation plants is delivered to the Gila River Indian Community for irrigation, where it is converted to potable water from CAP at a ratio of four acre-feet for every five acre-feet delivered for irrigation, another notable water resource innovation.

The third largest system is the solid waste system (16% of revenues), which is the exclusive provider of solid waste collection to residential customers in the city, providing once-per-week collection of trash, recyclables and green yard waste. The system serves 128,000 customers across all categories (98% residential customers) in fiscal 2018, and has a total diversion rate of 29%. The city has agreements with 11 landfills, transfer stations, and recycling centers for the disposal of its solid waste.

The natural gas system, the 11th largest publicly owned system in the US with 63,969 customers (96% residential), consists of two service areas: one is approximately 90 square miles and within the city limits, and the other is the Magma service area, a 236 square mile area southeast of the city in Pinal County. The system's natural gas supply is provided by Shell Energy North America mainly from well fields in New Mexico and West Texas, and is transported via pipeline under contract with the El Paso Natural Gas Company. The system receives gas priced at a discount to the monthly index, and rates include a monthly adjustment for cost recovery. The system does not have concentrated revenue sources, with no single customer constitutes more than 3% of 2017 revenues and the top 10 customers presenting 8% of revenues.

The electric system provides distribution to an area of six square miles in downtown Mesa to 17,066 customers (85% residential). The system's portfolio of electricity supply comes from various providers, including the Western Area Power Administration (hydroelectric), Shell Energy North America, and Exelon Generation Company. All electric purchase contracts provide firm power, with 74.7 MW of contracted power during summer months in relation to Fiscal 2018 peak demand of approximately 84 MWs. Western Area Power Administration (WAPA, a program of the federal Department of Energy) purchases supplemental power for the system, as needed. Power and transmission resource scheduling and utilization are managed by participation in the Resources Management Services (RMS) program administered by WAPA. As part of the RMS group, participating entities pool loads and resources to achieve the benefits of diversity and greater economies of scale in purchased power transactions. The electric system also has rates that adjust to meet cost recovery for purchased supplies.

Debt service coverage and liquidity: strong rate management and customer growth support continued healthy coverage; large transfers to general government are constraint on credit profile

Debt service coverage will continue to be strong for the large system. Annual debt service coverage by net revenues is healthy and has averaged a strong 2.9 times across the past five years, before considering the large transfers made to the city's General Fund. Maximum annual debt service (fiscal 2031) coverage is solid at 2.3 times using fiscal 2018 net revenues on a pro forma basis including additional debt service from the current offering.

Coverage remains weaker, though still sufficient, if transfers to the city's General Fund are deducted from net revenues before calculating coverage. In fiscal 2017, coverage net of transfers is a materially lower at 1.2-times; the three-year average is also weak at 1.4-times. This calculation reflects the political reality that the general operations of the city are heavily dependent on the utility's transfers, which represent 27% of General Fund revenues.

Average rates are generally higher, though still reasonable, compared to other service providers in the region, a reflection of the city's longstanding practice of making large transfers from the combined enterprise to the city's General Fund. The city's general government does not levy an operating property tax, and the utility transfers are generally perceived as a replacement for the operating property levy.

Rate increases are expected to keep pace with cost pressures and transfers to the general government. After a few years of relatively small or stagnant rate increases, the city began to increase rates across the board in fiscal 2015 and has continued to increase rates, with the most recent rate increases in August 2018 (fiscal 2019, the fifth year of increases).

While management uses a minimum 1.75 times debt service coverage target for planning, debt service coverage is equally supported by the need for the utility to annually generate sufficient post-debt service cash flow in order to fund the sizeable transfers to the General Fund.

As the regional economy continues to grow, the moderately growing customer base combined with modestly increasing rates will support stable financial operations for the utility. All of the component services have experienced healthy annual customer growth rates: over the last three years, average annual account growth was 1.6% for water, 1.8% for wastewater, 2.6% for gas and 0.7% for electric. Solid waste customer accounts dropped an average of -0.8% over the past three-years, with a large drop in customers in fiscal 2017 due to a change in the way solid waste customer accounts are measured, as well as the loss of some multifamily customers due to a change in state law. Positively, the number of solid waste customers grew 2% in fiscal 2018.

LIQUIDITY

Net cash is healthy, with fiscal 2018 net cash of a strong 456 days of cash on hand ($231.6 million) including pooled cash invested in long-term investments, or a still-strong 194 days ($99 million) using only current cash and investments.

Debt and legal covenants: moderately elevated debt; satisfactory legal covenants

The system has a moderately elevated but manageable to revenues ratio at 3.4 times, after the issuance expected in May 2019, with $1.3 billion in outstanding debt, all on parity. Rate increases and customer growth is expected to balance the increased debt service requirements of the utility's debt. Substantial additional debt not met with adequate revenue growth, or decreased transfers to the city's General Fund, could create negative credit pressure.

The city has additional voter authorization for parity debt in the total amount of $183.7 million, spread among the water ($48 million), wastewater ($70 million), gas ($48 million), electric ($16 million), and solid waste ($700,000) systems. The system does not expect to issue any subordinate obligations.

Legal features are satisfactory, with a rate covenant of 1.2-times annual debt service and an additional bonds test of 1.2-times maximum annual debt service. Bonds issued post-2002 are secured by a common debt service reserve fund, established at the standard lesser of test, but which springs only if net revenues fail to provide at least 1.75 times coverage in a given year. The reserve funding would be triggered if net revenues were below the 1.75 times threshold, but the reserve balance can subsequently be released if net revenues meet or exceed 1.75 times debt service in two consecutive years.

DEBT STRUCTURE

The aggregate debt profile has a 25-year term, and all obligations are fixed rate. Annual debt service is $85 million in fiscal 2019, before climbing to $91.2 million in 2020, and then holding between $90-95 million until it drops starting in 2035 to final maturity in 2043. MADS is 2031 at $95.9 million, and expected debt service coverage using fiscal 2018 revenues is 2.29-times.

DEBT-RELATED DERIVATIVES

The enterprise system is not party to any debt-related derivatives.

PENSIONS AND OPEB

Though the city's pension and OPEB liabilities are high, those liabilities have only limited effect on the city's enterprises' credit profile. The enterprise system made contributions of $3.6 million in fiscal 2018 (just under 1% of total system revenues) to the Arizona State Retirement System (ASRS) plan, which covers civilian employees. This represents 21% of the city's total ASRS contribution in fiscal 2018. ANPL for the enterprise, using the proportional share of contributions, would be $122.1 million, or a manageable 0.3-times operating revenues.

Management and governance: strong financial management and adequate mitigation of risks

Management engages in multi-year financial, operational and capital planning and has proposes rate increases necessary to maintain established financial targets, which have been approved by the City Council. The council can increase utility rates and charges for any of the systems without additional regulatory approval or oversight, though a 2006 state law requires water and wastewater rates charged by cities and towns to be “just and reasonable.”

The enterprises are operated under the direction of the City Manager, who is appointed by an at-large mayor and six City Council members elected by district. The City Manager is solely responsible for appointing department heads and other management staff and oversees the delivery of general city and enterprise services.

City management has appropriately mitigated risks, where possible, in operating electric and natural gas systems using management agreements and partnerships with other providers in the region. In particular, the electric enterprise is supported by participation in the Resources Management Services (RMS) program administered by Western Area Power Administration. As part of the RMS group, participating entities pool loads and resources to achieve the benefits of diversity and greater economies of scale in purchased power transactions.

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