S&P Global Ratings

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Summary:

Mesa, Arizona; Combined Utility; Water/Sewer

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Credit Profile		
US$111.835 mil util sys rev bnds ser 2019A due 07/01/2043		
Long Term Rating	AA-/Stable	New
US$85.47 mil util sys rev rfdg bnds ser 2019C due 07/01/2035		
Long Term Rating	AA-/Stable	New
US$49.335 mil util sys rev rfdg bnds ser 2019B due 07/01/2033		
Long Term Rating	AA-/Stable	New
Mesa util sys		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed

Rationale

S&P Global Ratings assigned its 'AA-' long-term rating to the City of Mesa, Ariz.'s series 2019A utility systems revenue bonds, 2019B utility systems revenue refunding bonds, 2019C utility systems revenue refunding 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 issued for the combined utility system. The outlook is stable.

The ratings reflect, in our opinion, the system's extremely strong enterprise risk profile and strong financial risk profile.

We have applied our primary water and wastewater utility revenue bond criteria to determine the combined utility system's general creditworthiness, as the drinking water and sewer business lines represent 64% of pledged revenue, electric and gas represent 20%, and solid waste account for about 16%. The ratings also take into consideration risks associated with the utility's other business lines, including the potential impact of commodity price volatility to the natural gas and electric enterprises, although this risk is largely mitigated by the pass-through mechanism for electric and gas commodity prices, which is adjusted monthly to recover changes in costs and customer consumption.

The ratings further reflect the combined utility's relatively sizable historical transfers to the general fund, which we believe could pressure the system's affordability and market position over time. Although management has taken city council's direction by only increasing the dollar amount of general fund transfers by the Consumer Price Index, we see future risk given the lack of formalized restrictions on how much can be transferred out, and we believe the large transfers could pressure the availability of funds for utility capital investment given that the utility system has moderately large capital needs over the upcoming five year period. Moreover, state law requires that the issuance of utility bonds be authorized by a majority of the city's voters; the system has not had a bond election since 2014 and has about $183 million outstanding authorizations.

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

- Service area participation in the strong Phoenix-Mesa-Scottsdale metropolitan statistical area (MSA);

- Exposure to drought conditions in the Colorado River basin and Salt and Verde River watersheds, which are the city's primary source of water supply, although the city has accumulated long-term storage credits to meet water demand during a shortage;
- Very low industry risk as a monopolistic service provider of essential public utilities; and
- Good operational management policies and practices and management's continued focus on long-term water and wastewater capacity to ensure long-term reliability and redundancy.

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

- Adequate to good coverage metrics that we believe may continue to fluctuate during the next five years depending on future debt, general fund transfers and capital contributions;
- Strengthening liquidity position, including unrestricted cash plus legally available repair and replacement fund reserves totaling $128 million, or 166 days' cash on hand, as of June 30, 2018; which we expect could be drawn down if future bond issuances are not authorized;
- Highly leveraged system based on a pro forma debt-to-capitalization ratio of about 73%; and
- $1.1 billion capital improvement program (CIP), which will be primarily be funded with additional debt, subject to voter approval.

The series 2019A utility systems revenue bonds are being issued to fund combined utility system capital improvements. About 58% of the bond proceeds will be used for wastewater and 28% for water; the remainder will be used to fund natural gas, electric, and solid waste capital improvements. The series 2019B utility systems revenue refunding bonds will be used to refund a portion of the series 2004 utility system revenue refunding bonds and the remainder of the series 2009 taxable utility systems revenue bonds. The series 2019C utility system revenue refunding bonds will be used to refund a portion of the series 2004 utility system revenue refunding bonds and a portion of the series 2012 taxable utility systems revenue refunding bonds.

We view the bond provisions as credit neutral. The bonds are secured by the net revenue of the city's water, wastewater, electric, natural gas, and solid waste utilities. The series 2019A,B, and C bonds will be on parity with $1.3 billion of outstanding utility system debt. Key bond provisions include a rate covenant set at 1.2x annual debt service and an additional bonds test set at 1.2x maximum annual debt service. A debt service reserve fund will not be funded unless net revenue before transfers do not provide coverage of 1.75x annual debt service.

Enterprise risk

Mesa (population: 488,985) is Arizona's third-largest city located about 16 miles east of Phoenix the largest city in Arizona. City residents participate in the strong Phoenix-Mesa-Scottsdale MSA. The city's major economic sectors are manufacturing, government, commercial activities (including construction and commerce), and tourism. Leading local employers include Banner Health Systems, Mesa Public Schools, Boeing Inc., and the city's government. The Phoenix-Mesa airport is also a leading employer located in the southern portion of the city, employing about 2,300 people. We consider the service area's income levels good based on the city's median household effective buying income (MHHEBI), which was 92% of the national median for 2017. The city's unemployment rate in January 2018 was 4.9%, which was lower than the state rate (5.7%) and higher than the national rate (4.4%).

The combined utility's customer base is primarily residential and very diverse. During the past five years, water and wastewater customers modestly grew at an average annual rate of 1% and 2% which management expects will continue to modestly grow. The city currently expects to reach buildout in 2040. In 2018, there were about 130,000 water customers and 120,000 wastewater customers, representing more than 90% residential customers. The electric and natural gas systems serve a significantly smaller portion of the city's total customer base with about 17,000 and 64,000 customers in 2018. The solid waste system served 128,000 customers in 2018. We consider the total combined customer base to be very diverse, given the 10 leading water and wastewater customers represented about 5% of total operating water revenue and 7% wastewater operating revenue in 2018. Leading water and wastewater customers consist of Mesa Public Schools, The Church of Jesus Christ of Latter-day Saints, the Cal-Am Properties, Inc. and the town of Gilbert. Management indicated that it does not expect any material changes to the leading customers that would cause revenue concentration.

We view the combined utility's market position as good, represented by generally affordable service rates in the context of the service area's good income metrics. Residential customers are billed for utility services on a monthly cycle. The most recent rate increase took effect in July of 2018 and increased water rates by 2% and wastewater rates by 2.5%.Based on the city's typical residential water use of about 9,000 gallons per month, we view rates to be affordable at about 2.2% of MHHEBI. However, we recognize that these rates may be less affordable for a material portion of the customer base given the county's poverty rate of 17.1%. Electric rates are below the state's, according to the Energy Information Administration Electric system; the utility's weighted average revenue per kilowatt-hour was 88.3% of the state average in 2017, the most recent year of available comparative information. Rates are reviewed annually and have been increased regularly during the past five years.

Based on our operational management assessment, we view the combined utility to be a '2' on a six-point scale, with '1' being the strongest. This indicates, in our view, that operational and organizational goals are generally well aligned and comprehensive. The city is in compliance with all regulations and has sufficient water rights and treatment capacity to meet water demand over the near to intermediate term. Water supply is produced mainly from three sources: surface water from the Salt and Verde River systems (36%), Colorado River water via the Central Arizona Project (CAP; 54%), and groundwater (10%). Mesa delivers highly treated wastewater to the Gila River Indian Community and receives 80% of that water returned as raw CAP water. The city last completed a comprehensive water system master plan in 2018 that identifies water production and distribution infrastructure and water resources to take the city through buildout. Average daily demand is forecast to rise to 137 million gallons per day (mgd) at buildout from 85 mgd in fiscal 2018, while the city's supplies are expected to expand to 146 mgd from 130 mgd over this period. We believe that implementation of the Colorado River Drought Contingency Plan could affect the city's CAP supplies over the longer term. The city has rights to stored groundwater in an amount equal to approximately five times its annual water demand to mitigate future drought.

The city also has enough wastewater treatment plant capacity to meet current demand. The city's average daily flow in 2018 was about 57% of total treatment capacity, and the city is expanding treatment capacity at the Greenfield facility (a joint venture between the town of Gilbert and Queen Creek) to produce more reclaimed water, which the city can then use to exchange for additional CAP water. Furthermore, the city's electric system experienced a peak summer demand of about 84.2 megawatts and had total energy requirements of about 334,479 megawatt hours. The city's electric supply consists of long-term power purchase agreements and short-term seasonal daily power market purchases. Mesa employs a purchased electric energy cost adjustment factor that is determined on a forward fiscal year basis for each month therein and is reviewed each month and adjusted as necessary to reflect known and measurable changes to costs and customer consumption, which we view as a credit positive.

Financial risk

Our assessment of the combined utility system's financial risk profile as strong reflects our view of the utility's historical all-in coverage which has fluctuated between levels we consider adequate to good, combined with its improved liquidity position and what we consider to be a highly leveraged capital structure. For the combined utility, we incorporate the fixed costs associated with electric system demand charges in addition to the CAP capital charges for our all-in coverage calculation. Furthermore, we include the city's transfers to the general fund in our coverage calculation. We calculate all-in coverage of 1.17x, 1.40x, and 1.20x for fiscal years 2016 through 2018; which range from adequate to good. We view the historic transfers to the general fund to pay for public safety expenses as a credit risk. When adding the transfers out above the line, total transfers out as a percent of total operating expenses is 39%, in 2018.

Based on our analysis of management-provided projections, we expect coverage to continue to range between adequate and good levels during the next five years, barring an unforeseen transfers out to the general fund or shifts in gas and electric expenses. In our view, commodity price volatility is largely mitigated by pass through mechanisms for electric and gas commodity costs (with a month lag), therefore we assume gas and electric operating margins will remain consistent with current forecasts. Although projected coverage during the next five fiscal years will range between adequate and good levels, there is uncertainty around future bond authorizations and the timing of future debt issuances. If management does not continue to raise rates in a timely manner, coverage metrics could be pressured in the future.

The combined utility's cash position has improved during the past five fiscal years to a level we consider to be extremely strong. The rise in cash was related to annual rate increases between 3% and 5% and a land sale. At the end of fiscal 2018, the combined utility fund held about $98 million in unrestricted cash and investments, and an additional $30 million of available cash in a replacement and reserve fund. Total unrestricted cash was about $128 million, equivalent to about 166 days of operating expenses, which we consider an extremely strong level. As mentioned, if management is not able to approve future bond issuances we would expect more of the capital plan to be funded from cash and could potentially see a more significant drawdown.

Based on our Financial Management Assessment (FMA), we view the combined utility to be a '3' on a six-point scale, with '1' being the strongest. An FMA of good indicates that the city has formalized policies in some, but not all, areas. While the city updates its long-term capital and financial plans annually, which we view positively, the lack of a clearly defined funding plan for its upcoming capital needs is a risk, especially as certain projects may require future voter authorization. Moreover, the general fund transfers are not formula based and are subject to city council's discretion, so an additional risk is that operating margins are transferred out of the utility and not sufficiently reinvested into the system. In our opinion, a further credit weakness is Mesa's large pension and other postemployment benefit obligation, without a plan in place that we think will sufficiently address it. The city complies with Generally Accepted Accounting Principles; however, the inclusion of unrelated revenue and expenses in the utility fund as reported in the city's audited financial statements creates some transparency issues.

The combined utilities' five-year CIP is sizable, in our view, and totals about $1.1 billion, of which 66% is anticipated to be funded with additional debt. Major projects in the CIP include installing advanced meters throughout the system and water and wastewater treatment plant upgrades, which we understand are primarily growth related. Beyond the capital projects to be funded with series 2019 proceeds, the city has identified an additional $636 million in debt issuance through 2023. Moreover, the city has only $183 million in remaining bond authorizations, and the lack of timely vote approval could cause projects to be delayed or stalled, which we view as a risk.

Outlook

The stable outlook reflects our expectation that management will continue to increase rates as needed to support current and future debt obligations. In addition, we expect that management will maintain at least a strong liquidity position given a portion of the capital plan will be funded from unrestricted cash and reserves. Furthermore, the robust service area economy provides the credit with additional stability.

Upside scenario

We could take a positive rating action if the utility outperforms its forecast and produces all-in coverage metrics at stronger levels on a sustainable basis, and posts and maintains an extremely strong cash position through the life of the capital plan. In addition, we could raise the ratings if there is increased clarity in regard to long-range capital planning and funding sources of the combined utility enterprises.

Downside scenario

We could take a negative rating action if the utility consistently maintains just adequate all-in coverage metrics and also spends down a significant portion of its cash reserves for capital projects, transfers to the general fund, or any other purpose.

Ratings Detail (As Of April 18, 2019)		
Mesa util sys rev bnds ser 2018 due 07/01/2042		
Long Term Rating	AA-/Stable	Affirmed
Mesa util sys		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.