

# RatingsDirect®

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**Summary:**

## Cottonwood Municipal Property Corp., Arizona Cottonwood; Water/Sewer

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## Summary:

# Cottonwood Municipal Property Corp., Arizona Cottonwood; Water/Sewer

### Credit Profile

#### Cottonwood Mun Prop Corp, Arizona

Cottonwood, Arizona

#### Cottonwood Mun Prop Corp sr lien wtr sys

*Unenhanced Rating*

A(SPUR)/Stable

Upgraded

Many issues are enhanced by bond insurance.

## Rationale

Standard & Poor's Ratings Services raised its long-term rating and underlying rating (SPUR) to 'A' from 'BBB+' on Cottonwood Municipal Property Corp., Ariz.'s series 2006 water revenue bonds, issued for Cottonwood. The outlook is stable.

The upgrade reflects the application of the revised criteria titled "U.S. Public Finance Waterworks, Sanitary Sewer, And Drainage Utility Systems: Rating Methodology and Assumptions," published on Jan. 19, 2016, on RatingsDirect. The upgrade is also reflective of the city's adoption of rate increases in 2016 that should result in higher coverage at the end of fiscal 2016.

The ratings and outlook reflect our opinion of the water system's very strong enterprise risk profile and strong financial risk profile. The very strong enterprise risk profile includes:

- A stable and diverse customer base that participates in the Prescott metropolitan statistical area,
- Adequate income metrics and moderate rates, and
- Ample water supply and overall good operational management.

The strong financial risk profile includes:

- The improvement in all-in debt service coverage (DSC) to 1.5x at the end of fiscal 2015 from insufficient levels in fiscal years 2012 and 2013;
- Sustained strong liquidity during the past three years;
- High debt-to-capitalization ratio, with some additional debt plans in the near term; and
- Overall good financial management.

The bonds are secured by the net revenues of the water system. We view the bond provisions as adequate, with a rate covenant of 1.35x annual debt service and an additional bonds test of 1.35x maximum annual debt service (MADS). Impact fees are considered part of the revenues for satisfying the rate covenant. Additional liquidity is provided by a debt service reserve fund that is funded at the least of 10% of par, MADS, or 1.25x average annual debt service. The city was unable to meet the rate covenant between fiscal 2010 and fiscal 2013, but did meet the rate covenant in fiscal

2013 and after.

### **Enterprise risk profile**

Cottonwood, with a population of approximately 12,100, is situated approximately 50 miles south of Flagstaff and borders the Verde River to its north. The city is a popular tourist destination, attracting visitors to the Verde Canyon Railroad and benefiting from its proximity to the Grand Canyon, as well as other camping and backpacking areas. The population has stayed relatively stable during the past five years, declining slightly, by about 1.3%, since 2010. Income indicators, are, in our opinion, adequate, with the 2014 median household effective buying income (EBI) at 75% of the national median. The county's unemployment rate has been higher than the state and national rates in recent years and is currently 5.6%, according to September 2015 data, which is lower than the state rate of 6.4%.

The city serves a stable, primarily residential, and diverse customer base. In the past five fiscal years, water accounts have been about 9,000. We consider the customer base to be primarily residential, with residential customers accounting for about 93% of water meters. The system's customer base is also diverse, in our opinion, as the 10 leading customers make up about 15% of water service charges. However, there is some concentration in the leading two customers -- Verde Valley Medical Center (5.2%) and Granite Pine Shadows (4.2%), or 9.4% of water service charges combined.

Residential customers currently pay a base charge that is dependent on meter size and a five-tiered volumetric charge. Using our benchmark monthly usage of 6,000 gallons, we calculate an in-city 2016 monthly bill of \$48.70. When annualized, this represents about 1.6% of 2014 median household EBI, which is moderate but still affordable. With coverage below its rate covenant in both fiscal 2012 and fiscal 2013, the city developed multiyear financial projections, which included proposed rate increases. On Jan. 1, 2015, the city proposed an additional, 6% rate increase following the 19% rate increase in 2014. In addition, the city is planning to raise rates by 5% annually for fiscal 2017 through 2019 and 2% annually through 2021. About 0.5% of customers are delinquent at 60 days past due, and management expects that approximately 0.1% of these customers will never pay. Once a bill is past due, the water is turned off unless the total past due bill is paid.

The system provides water treatment, storage, and delivery services to some households and businesses within and adjacent to the city and some limited outlying areas of Yavapai County. In 2004, the city entered into the water utility business after acquiring three private water companies. Its only source of supply is groundwater, which is pumped through wells. According to city management, Cottonwood has ample water supply at 3.8 million gallons per day (mgd), and management indicated that the city has a 100-year water supply designation, which means the city will have enough water supply to meet the water demand for the next 100 years. In fiscal 2015, the average daily demand was 2.1 mgd, with a peak day demand of 2.6 mgd. The five-year average daily demand is about 58% of the capacity, and peak daily demand is 76%. Management indicates that the system is in compliance with all regulatory requirements, and it does not anticipate any regulatory changes that may impact the system.

Based on our operational management assessment (OMA), we view the city to be a '2' on a scale of 1-6, with '1' being the strongest. This indicates, in our view, that operational and organizational goals are generally well aligned, even if some challenges exist. The OMA of good includes ample water supply with a 100-year water supply designation and the city's indirect potable reuse program. The city also maintains a water shortage preparedness plan and provides

education programs to the community.

### **Financial risk profile**

During fiscal years 2012 and 2013, the system's financial performance had weakened due to rates being insufficient to cover operating expenditures and consequently not satisfying the system's rate covenant on the bonds. We calculate all-in DSC including impact fees and resource development fees for fiscal years 2012 and 2013 at 0.96x and 0.94x, which we consider insufficient based on the system's rate covenant of 1.35x. However, we believe significant rate increases enabled the system to improve its financial performance in fiscal 2014. Based on the audited results, we calculate all-in DSC to be about 1.1x, a level we consider adequate. When including impact fees and resource development fees, which are allowable for meeting the rate covenant, coverage rises to about 1.40x in fiscal 2014. At the end of fiscal 2015 data, all-in DSC, when including impact and resource development fees, was 1.54x, which we consider good. Based on management's forecast for fiscal 2016, which includes the recently approved rate increase, we expect coverage to increase to about 2.2x. Projections beyond fiscal 2016, which account for the proposed rate increases and anticipated additional debt, anticipates all-in DSC to be at strong levels above 1.6x in the next few years.

Liquidity has ranged from good to strong levels in the past four fiscal years, and we expect it will remain good. Cash on hand at the end of fiscal 2015 was \$8.1 million. Of this total, Cottonwood considers more than \$2.6 million to be unrestricted, which translates into 300 days' operating expenses. The remainder is earmarked for water resource development and has been placed under a self-imposed restriction by city council. Management projects the unrestricted cash and investment to increase to \$7.5 million, or 721 days of operating cash, in fiscal 2021 from \$2.6 million, or 308 days, in fiscal 2015. However, these projections are predicated on the proposed rate increases. Management's policy is to maintain the fund balance, including maintenance, operations, and administration, at 25% to 33% of budgeted operating expenses.

Cottonwood's capital improvement plan (CIP) for the next six years is moderate. For the period from 2016 through 2021, capital project costs total about \$7.6 million. Management reports that city refinanced its series 2004 water revenue bonds in June 2015 and issued \$1.0 million of additional debt to replace approximately 5,300 linear feet of water line. The refinancing was accomplished through a Water Infrastructure Finance Authority (WIFA) loan. The refinancing resulted in savings of approximately \$1.75 million in interest payments over the term of the loan and also came with \$550,000 in forgivable principal. We understand that management is looking to refinance the series 2006 water revenue bonds in 2016 and add \$2 million in debt for the development of a water line; it expects similar savings results using WIFA as well as a potential forgivable principal arrangement. Apart from the \$3 million in additional debt, management anticipates that the projected rate increases should enable the water system to raise adequate revenue to build up sufficient cash reserve to fund the planned capital improvements through fiscal 2021. In our view, the system has a highly leveraged debt position, at 91% debt-to-capitalization, with \$33.7 million of bonds outstanding at the end of fiscal 2015.

Based on our financial management assessment (FMA), we view the city to be a '2' on a scale of 1-6, with '1' being the strongest. An FMA of good indicates that practices are deemed currently good, but not comprehensive. The government maintains many best practices deemed as critical to supporting credit quality, particularly within the finance department. These practices, however, may not be institutionalized or formalized in policy, may lack detail or long-term elements, or may have little recognition by decision-makers outside of the finance department. The FMA of

good includes regulatory reporting of intra-year budgets vs. actuals and maintenance of long-term financial and capital plans. The city also has specific reserve policies for the water fund, as well as an investment policy that adheres to state guidelines. However, the city does not have formal debt management policies, and relies on legal covenants to guide coverage requirements.

## Outlook

The stable outlook reflects our view that management's recently adopted rate increases that will improve the water fund's financial position. Through this action, we anticipate that the city will be able to meet its rate covenants while also increasing its liquidity position. In our opinion, the improved financial management and ample water supply capacity are positive factors for the credit rating.

### Upside scenario

We may raise the ratings if the city is able to meet its financial projections and sustain stronger coverage and liquidity metrics while addressing its CIP needs and anticipated additional borrowing.

### Downside scenario

If projections are not met, rate covenant violations occur again, or overall financial metrics or the local service economy materially erodes, we may lower the ratings.

## Related Criteria And Research

### Related Criteria

- USPF Criteria: Rating Methodology And Assumptions For U.S. Municipal Waterworks And Sanitary Sewer Utility Revenue Bonds, Jan. 19, 2016
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

### Related Research

- U.S. State And Local Government Credit Conditions Forecast, Jan. 11, 2016
- U.S. Municipal Water And Sewer Utilities 2014 Sector Outlook: Learning To Do More With Less, Jan. 9, 2014

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](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.globalcreditportal.com](http://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](http://www.standardandpoors.com). Use the Ratings search box located in the left column.

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