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## Summary:

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

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## Summary:

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### Credit Profile

#### Cottonwood Mun Prop Corp, Arizona

Cottonwood, Arizona

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

*Unenhanced Rating*

BBB+(SPUR)/Positive

Outlook Revised

Many issues are enhanced by bond insurance.

## Rationale

Standard & Poor's Ratings Services revised its outlook to positive from stable and affirmed its 'BBB+' long-term rating and underlying rating (SPUR) on Cottonwood Municipal Property Corp., Ariz.'s series 2004 and 2006 water revenue bonds, issued for Cottonwood.

The revised outlook reflects the recent rate increases that, in our view, have improved the city's coverage metrics such that the city did not violate its rate covenant in fiscal 2014 and is not expected to violate the covenant in fiscal 2015. The unrestricted cash position is also projected to strengthen through the two-year outlook period.

The ratings and outlook reflect our opinion of the water system's:

- Improved debt service coverage (DSC) supported by significant recent rate increases;
- Good liquidity position that we anticipate will increase and be sustained at stronger levels going forward;
- Sufficient water supply to satisfactorily meet its customer needs; and
- Affordable rates compared to Cottonwood's underlying economic characteristics.

Partly offsetting these strengths are the city's high debt-to-plant ratios, with the city potentially adding additional debt to support its moderately high capital needs that are estimated to be about \$1.2 million each year.

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.

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 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 2014, the average daily demand was 2.2 mgd with a peak day demand of 3.1 mgd. The average daily demand is about 59% of the capacity, and peak daily demand is 83%. 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.

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 8,000 gallons, we calculate a 2014 monthly bill of \$46.73. When annualized, this represents about 1.7% of 2014 median household EBI, which is moderately high 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.

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 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 total 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. From unaudited fiscal 2015 data, we estimate total DSC, when including impact and resource development fees, to be about 1.44x, which we consider good. The forecast provided by management, which accounts for the proposed rate increases, anticipates

total 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 2014 was \$7.3 million. Of this total, Cottonwood considers more than \$1.1 million to be unrestricted, which translates into 111 days' operating expenses, which we consider good. 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 167% debt-to-plant, with \$33.8 million of bonds outstanding at the end of fiscal 2014.

## Outlook

The positive outlook reflects our view of management's recent rate increases to slowly improve the water fund's financial position. Through these actions, 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 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 erode, we may lower the ratings.

## **Related Criteria And Research**

### **Related Criteria**

- USPF Criteria: Water And Sewer Ratings, June 25, 2007
- USPF Criteria: Key Water And Sewer Utility Credit Ratio Ranges, Sept. 15, 2008
- USPF Criteria: Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008
- 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, Oct. 20, 2015
- U.S. Municipal Water And Sewer Utilities 2014 Sector Outlook: Learning To Do More With Less, Jan. 9, 2014
- 2014 Review Of U.S. Municipal Water And Sewer Ratings: How They Correlate With Key Economic And Financial Ratios, May 12, 2014

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