

MOODY'S

INVESTORS SERVICE

Rating Update: Moody's affirms the Baa2 rating on Cottonwood MPC, AZ's water revenue bonds; negative outlook removed

Global Credit Research - 03 Dec 2015

\$21.1M in rated debt affected

COTTONWOOD MUNICIPAL PROPERTY CORPORATION, AZ WATER ENTERPRISE
Water Enterprise
AZ

NEW YORK, December 03, 2015 --Moody's Investors Service has affirmed the Baa2 rating on Cottonwood Municipal Property Corporation Water Enterprise, Arizona's water revenue bonds. The negative outlook has been removed. The rating action affects \$21.1 million in rated debt outstanding.

SUMMARY RATING RATIONALE

The rating reflects the system's adequate debt service coverage due to two annual rate increases following the recent history of the city council failing to implement prudent rate increases. Recent rate increases improved operating performance and returned the enterprise to compliance with its rate covenant. The rating also incorporates the potential risk that coverage could decline if rate additional increases are not adopted. The rating also incorporates the system's strong liquidity position, stable customer base and strong legal provisions.

OUTLOOK

The removal of the negative outlook reflects the approved rate increases in both 2014 and 2015 which resulted in satisfactory debt service coverage above the rate covenant. It also reflects our view that council will continue to approve rate increases as necessary to maintain coverage that is at least compliant with its rate covenant.

WHAT COULD MAKE THE RATING GO UP

- Trend of sustained coverage levels above the rate covenant and aligned with higher-rated peers

WHAT COULD MAKE THE RATING GO DOWN

- Failure to implement rate increases necessary to maintain coverage above the rate covenant
- Deterioration of liquidity

STRENGTHS

- Strong liquidity
- Two years of adopted rate increases resulting in improved debt service coverage

CHALLENGES

- Rate increases must be approved annually by city council
- Elevated debt burden

RECENT DEVELOPMENTS

Recent Developments are incorporated in the Detailed Rating Rationale.

DETAILED RATING RATIONALE

SERVICE AREA AND SYSTEM CHARACTERISTICS: STABLE, RESIDENTIAL CUSTOMER BASE;
ADEQUATE WATER SUPPLY IS DEPENDENT ON GROUNDWATER

The system serves a primarily residential customer base with a total population of 22,870 in the City of Cottonwood and to areas outside of the city limit including Bridgeport, the Verde Villages and Verde Santa Fe. The City of Cottonwood is located 50 miles south of the City of Flagstaff (general obligation rated Aa2) and about 20 miles southwest of the City of Sedona. Recreational tourism and services for retirees are important economic drivers for the region that includes surrounding Verde Valley communities. The city has below average wealth levels with median family income at 69% of the US average due partly to a sizable retiree population and a rural service area.

The system services approximately 9,300 accounts of which 93.1% are residential. Water is supplied entirely by groundwater through 23 wells and supported by 23 storage tanks. All of the groundwater is treated by the system with the use chlorination and arsenic removal technologies and are recharged through natural aquifer. The system has average daily usage of 2.2 million gallon per day (MGD) and has peak demand of 3.2 MGD which is well below the system's total pumping capacity of 8 MGD. The system has total storage capacity of about 4.1 million gallons. System wide daily storage is approximately 2 days during high demand (summer) and 4 days during low demand (winter). Top customers represent a moderately concentrated 10.3% of user fees, however given the nature of the customers, which include medical service, education, and government entities, that mitigates any concentration risk.

DEBT SERVICE COVERAGE AND LIQUIDITY: IMPROVED DEBT SERVICE COVERAGE IN FY14 AND FY15 DUE TO RATE INCREASES; STRONG LIQUIDITY

The system's debt service coverage significantly improved in fiscal 2014 and fiscal 2015 due to adopted rate increases. In fiscal 2014, city council approved a rate increase of 27.2% for inside the corporate city limit and 65.4% for outside the corporate city limit, this was the first rate increase since 2010. The rate increase went into effect on October 1, 2013 and resulted in debt service coverage of 1.40 times in fiscal 2014 which is a significant improvement from 0.93 times in the prior year.

Based on unaudited 2015 financials, debt service coverage further improved to 1.51 times due to a 6% rate increase for both inside and outside city limit customers. For 2016, city officials are currently projecting coverage of 1.84 times without an additional rate increase. The city council has approved a notice of intent to increase rates in 2016 by 5% which if approved by council would be effective March 1st, 2016. If the rate increase is adopted, coverage is projected to improve to a healthy 2.02 times. City officials have stated they would like to maintain coverage levels around 2.0 times to add monies into reserves and for future capital projects. Future rating reports will continue to focus on council's willingness to approve annual rate increases in order to maintain coverage levels; declining coverage would lead to downward pressure on the rating.

Liquidity

The system has strong liquidity with total available cash and investments of \$7.3 million or 706 days of operating expenses on hand at the end of fiscal 2014. Based on unaudited financials, at the end of fiscal 2015, cash and investments remained strong at \$7.2 million.

DEBT AND LEGAL COVENANTS: ELEVATED DEBT BURDEN; STRONG RATE COVENANT AND ADDITIONAL BONDS TEST

The system has an elevated debt burden with a debt to operating revenues of 4.86 times. The system has a total of \$33.2 million in bonds and loans. In June 2015, the city refinanced its 2004 bonds through a \$10.7 million Arizona Water Infrastructure Finance Authority (WIFA) loan which saved the system \$2 million in reduced interest rate costs. The city may refinance its outstanding 2006 bonds through another WIFA loan in 2016 and add an additional \$2 million in order to develop a commercial corridor. Amortization is below average with approximately 43.5% of principal retired in 10 years but not inconsistent with the remaining useful life of capital assets (20 years).

Debt Structure

All of the system's outstanding debt is fixed rate. The security features of the bonds are strong with a rate covenant and additional bonds test of 1.35 times annual debt service. The debt service reserve requirement is equal to the lesser of 1.25 times average annual debt service, maximum annual debt service, or 10% of par. The debt service reserve is fully cash funded.

Debt-Related Derivatives

The enterprise does not have any debt-related derivatives.

Pensions and OPEB

Pension costs associated with the employees of the enterprise are included in the city's operating expenditures and are thus not included as a liability of the water enterprise and the enterprise does not reimburse the city for those associated costs. The city's unfunded pension liabilities are considered modest with a three-year (2011-2013) Moody's adjusted net pension liability (ANPL) of 1.42 times operating revenues.

MANAGEMENT AND GOVERNANCE: BELOW AVERAGE RATE SETTING RECORD; MAINTAIN SIX YEAR CAPITAL IMPROVEMENT PLAN

The City of Cottonwood operates under a council-manager form of government. The council consists of a mayor, vice mayor, and five council members. Any and all changes to the city's water rates and its structure must be approved by a vote of the city council. Between fiscal 2009 and fiscal 2013, the system's debt service coverage had been in violation of its rate covenant due to the city council's unwillingness to adopt prudent rate increases. However, in 2014 and 2015 the council passed rate increases with a 5-2 vote in favor of the increase.

The system is currently in compliance with all environmental standards. The system maintains a six-year capital improvement plan that totals \$7.6 million from fiscal 2016 through fiscal 2021.

KEY STATISTICS

- Asset Condition (remaining useful life): 20 years
- System Size (O&M): \$3.75M
- Service Area Wealth (average MFI): 69% of the US
- Annual Debt Service Coverage: 1.40x
- Days' Cash on Hand: 706
- Debt to Operating Revenues: 4.86x
- Rate Covenant: 1.35x
- Debt Service Reserve Requirement: Aa

OBLIGOR PROFILE

The system serves a primarily residential customer base with a total population of 22,870 in the City of Cottonwood and to areas outside of the city limit including Bridgeport, the Verde Villages and Verde Santa Fe. The City of Cottonwood is located 50 miles south of the City of Flagstaff (general obligation rated Aa2) and about 20 miles southwest of the City of Sedona.

LEGAL SECURITY

The bonds are secured by the lease purchase payments made by the City from net water utility system revenues. The security features of the bonds are strong with a rate covenant and additional bonds test of 1.35 times annual debt service.

USE OF PROCEEDS

Not applicable.

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was US Municipal Utility Revenue Debt published in December 2014. Please see the Credit Policy page on www.moody.com for a copy of this methodology.

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