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Summary:

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

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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)/Negative

Downgraded

Many issues are enhanced by bond insurance.

Rationale

Standard & Poor's Ratings Services has lowered its long-term rating on Cottonwood Municipal Property Corp., Ariz.'s water revenue bonds, series 2004 and 2006, to 'BBB+' from 'A', reflecting the city's recent trend of insufficient annual debt service coverage from net revenues while relying on cash reserves to make sufficient coverage. The outlook is negative.

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

- Inability to meet debt service requirements using net available revenues, which has led to the system using cash reserves to sufficiently cover debt service payments;
- Infrequent rate increases to sufficiently support annual debt service payments and future rate increases, which, while projected, have not been approved;
- Extremely high debt to plant ratios, with the city potentially adding additional debt to support its moderate capital plan; and
- Affordable rates in comparison to the city's underlying economic characteristics.

We view the bond provisions as adequate. The bonds are secured by the net revenues of the water system. Covenants include a 1.35x rate covenant and a 1.35x maximum annual debt service additional bonds test. Impact fees are considered part of the revenues for satisfying the rate covenant, but the system has been insufficient even in recent years to meet the coverage requirements.

In our view, the system's financial performance has been weakened due to rates being insufficient to cover operating expenditures and consequently not satisfying the system's rate covenant on the bonds. Based on audited results, we calculate debt service coverage (DSC) for fiscal 2012 at 0.96x, which we consider insufficient based on the system's rate covenant of 1.35x; this follows weak DSC at 0.87x and 1.16x for fiscal years 2010 and 2011, respectively. Based on the city's fiscal 2013 budget, we estimate that fiscal 2013 DSC will be about 0.98x. The city believes it will be more than 1x annual debt service when including impact fees. Additionally, when the city was below its rate covenant, it had to use reserves to cover some of the debt service as well as to address its capital needs. According to management, pending approval of the city's proposed rates, it is expecting to reach 1.35x coverage in fiscal 2014 and stay between

1.35x and 1.40x for the next five years. To reach this goal, according to management, the city will have to make one substantial increase in fiscal 2014 and then make smaller annual increases to maintain coverage. However, given that rates have been raised infrequently, with the last one in 2010, we believe this creates additional pressure to maintain even sufficiency coverage. Although the city has been in violation of the system's 2004 and 2006 revenue bond covenants, no action has been taken to make the city meet its coverage requirements.

Liquidity has ranged between good and strong during the past four fiscal years and we anticipate that it will remain good. Cash on hand at the end of fiscal 2012 totaled \$7 million. Of this total, the city considers only \$2 million to be unrestricted, which translates to 201 days' unrestricted cash and investments, which we consider good. The remainder is earmarked for water resource development. Based on the city's audited financial statements, liquidity during the past four fiscal years was no lower than 113 days. As of May 30, 2013, unrestricted cash and investments totaled \$5.1 million out of which \$1.56 million is available. Management's goal is to maintain at least 60 days of operating expenditures. Cash has fluctuated in recent years, with levels at more than \$2.3 million in fiscal 2011 (273 days) but just over \$1 million (113 days) in fiscal 2010.

Cottonwood Municipal Property Corp. is part of Yavapai County in central Arizona, 50 miles south of Flagstaff, and borders the Verde River to its north. Cottonwood City's population increased during the past five years from 2008 to 2012 by 7.6% to 11,827. Management reports that it expects moderate growth in the area over the next five years. Yavapai County's unemployment rates were moderately high during the past three years, ranging from 7.9%-11.4% and most recently stood at 8.1% in April 2013. We consider Cottonwood and Yavapai County's income levels to be adequate based on the median household effective buying income (EBI) at 76% and 86% of the national level in 2012, respectively.

The city serves a stable, primarily residential, and very diverse customer base. During the past five fiscal years, water accounts decreased by 0.4% to 9,000 accounts in fiscal year 2012 from 9,040 accounts in fiscal year 2008. We consider the customer base to be primarily residential, with residential customers accounting for about 93% of water meters. The district's customer base is also very diverse, in our opinion, as the 10 leading customers pay about 0.78% of water service charges and the leading customer, Verde Valley Medical Center, pays 0.33% of water service charges annually.

The system provides water treatment, storage, and delivery services to some households and businesses within and adjacent to the city and includes 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. In fiscal 2012, the average daily demand was 2.1 million gallons per day (mgd) with a peak day demand of 2.7 mgd. According to city management, Cottonwood has ample water supply.

Water rates are moderate but are anticipated to increase in the future, assuming city council approval. Customers pay their water service charges along with their sewer charges monthly. The water charge is \$39.53 per 8,000 gallons for fiscal year 2013. The city last raised rates by 8% in 2010, but continues to review them annually. Total water and sewer bills total \$53.26, which translates to an affordable 2.2% of underlying median household EBI. As of fiscal 2014, monthly water rates are proposed to increase by 16% to \$50.32. Water rates are projected to increase by 2% from fiscal years 2015 through 2019. According to management, the city is still discussing future water rates and will be proposing these plans to council in June and implementing them Oct. 1, 2013 at the earliest. Management is also

planning on scheduling its rate committee to meet regularly on rate issues as well as report to council over the year. The city currently has 3,250 closed accounts that total \$358,610 in delinquencies, which management doesn't believe it will collect. Once a bill is past due, the water is turned off unless the total past due bill is paid.

Cottonwood's capital improvement plan for the next five years is, in our view, moderate but could add to an already highly leveraged debt position at 175% debt to plant with \$33 million of bonds outstanding in fiscal 2012. The city could also seek additional funding for continued improvements to the water system and has plans to refinance through the state's Water Infrastructure Finance Authority. These two actions are dependent on future water rate increases and the city maintaining its rate covenant. In aggregate, over the next five years management anticipates capital project spending about \$8 million, of which \$5 million would be new debt issuance.

Outlook

The negative outlook reflects our view of the city's historical inability to meet debt service requirements from net available revenues and our opinion that this trend could continue if the city does not make timely budget adjustments to meet at least sufficient coverage. If the city still fails to take the necessary budgetary action, whether through the more likely appropriate revenue enhancements or expenditure reductions, to meet its coverage requirements, we could lower the rating during the current two-year outlook. Meeting at least sufficient coverage from net available revenues could lead us to revise the outlook to stable at the current rating level. Upward rating movement is limited during the current outlook period.

Related Criteria And Research

- USPF Criteria: Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008
- USPF Criteria: Key Water And Sewer Utility Credit Ratio Ranges, Sept.15, 2008

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