S&P Global
Ratings

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Summary:

Artesia, New Mexico; Water/Sewer

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Credit Profile		
US$6.8 mil wtr & wastewtr sys rfdg bnds ser 2019 due 06/01/2029		
Long Term Rating	A+/Negative	New
Artesia WTRSWR		
Long Term Rating	A+/Negative	Outlook Revised

Rationale

S&P Global Ratings revised its outlook to negative from stable and affirmed its 'A+' long-term rating on Artesia, N.M.'s series 2010 water and wastewater system revenue bonds. At the same time, S&P Global Ratings assigned its 'A+' long-term rating to the city's series 2019 water and wastewater system refunding revenue bonds.

The outlook revision reflects our view of volatile revenue and increasing expenses over the past three audited fiscal years have thinned all-in debt service coverage (DSC) to 1.0x in fiscal 2017 from 4.8x in fiscal 2015.

The strong enterprise risk profile reflects our view of the city system's:

- Average economic indicators, as evident with median household median income level at 102% of the national average with revenue concentration from its top customer;
- Very low industry risk as a monopolistic service provider of an essential public utility;
- Average rates based on the average residential bill, with average poverty rates; and
- Standard operational management assessment (OMA).

The strong financial risk profile reflects our view of the city system's:

- Declining all-in debt service coverage (DSC) to levels we consider thin;
- Very strong liquidity levels however on low nominal levels;
- Limited outlined capital needs, with no debt plans; and
- Standard financial management assessment (FMA).

The proceeds of the series 2019 will refund the 2010 joint utility bonds. The series 2019 in amount of roughly $7.1 million will be the only outstanding revenue debt after the refunding.

We view the bond provisions as adequate. The bonds are secured by the net revenue of the city's water and wastewater system, plus up to the first $1 million of gross receipts tax (GRT) received by the city from the state for Artesia's sixth increment of local option GRT, imposed at a rate of 0.25% on people engaging in business in the city. The GRT is separate from the 1.225% GRT pledged to the city's separately secured series 2009 gross receipts tax bonds. We understand that the ordinances establishing the city's GRTs do not include sunset clauses. Bond provisions include a rate covenant of 1.20x annual DSC by total pledged revenue, and an additional parity bonds test of 1.20x MADS coverage by the city's projection of future water and wastewater net revenue following completion of new projects and an adjustment for rate increases. A surety policy will be provided in lieu of a cash reserve at the lessor of the three-prong test.

For more information on the city's GRT revenue, see the article published in March 2019 on RatingsDirect.

Enterprise Risk

Artesia (population: 12,411) is located in southeastern New Mexico, 241 miles southeast of Albuquerque, and between Roswell, about 42 miles to the north, and Carlsbad, 40 miles to the south. The area economy is limited and has historically been dominated by oil and gas production, and farming and dairy to a lesser extent. The city is home to a federal law enforcement training center (one of four such centers in the U.S.), which trains about 2,500 students annually. The city also provides retail and health services for the surrounding area, which includes agricultural regions. The city's median household effective buying income is adequate, in our opinion, at 102% of the national level. Per capita retail sales are very strong, in our view, at 139% of the national average. In addition, the county's unemployment rate (3.2%, not seasonally adjusted) is better than the state and national rates. We view the customer base as concentrated. The leading water customer is Navajo Refining Co., which accounted for about $702,000, or roughly 28% of water system operating revenue and 17.6% of combined system operating revenue, in fiscal year 2018. In aggregate, the leading 10 water customers pay about 39% of water revenue. In contrast, the wastewater system customer base is diverse, with the leading 10 wastewater customers paying about 67% of wastewater revenue in fiscal year 2018.

For residential customers, the city indicated the average water bill is $52. As a percentage of median household effective buying income, the average water and sewer bill is about 1.27%, which we consider below average. The county's poverty rate is 14.1%, which we consider average. The city started reviewing its rates annually in 2017, maintains rate autonomy.

Consistent with "Methodology: Industry Risk," published Nov. 19, 2013, we consider industry risk for the water system to be very low or '1', the most favorable assessment possible on a six- point scale.

Based on our OMA we view the water system as a '4' on a six-point scale with '1' being the strongest. An assessment of standard, in our view, implies generally standard alignment between the system's operational characteristics. The water and wastewater systems have adequate capacity to meet demand. Water is pumped from the underlying groundwater basin, and this source of supply is generally of good quality. The city owns water rights of about 7,560 acre-feet per year, equivalent to about 6.8 million gallons per day (mgd). During the past five years, water demand has grown at an average annual rate of 8.9% to 5 mgd, or 75% of water rights, in 2018 from 3.5 mgd in 2007. Management reports that the city has budgeted funds for future water rights acquisition, but the city has not purchased any water rights during the past three years because water rights have not been readily available. We understand that management plans to extend the existing water supply through customer conservation in the coming years. Wastewater system capacity was last expanded in 2010 and is anticipated to be adequate to meet demand for the foreseeable future. The city's wastewater treatment plant operates under a regulatory permit that allows it to discharge treated effluent to the Pecos River. Permitted capacity is 2.6 mgd, which compares favorably with average daily flows that have ranged from 1.1 mgd to 1.5 mgd during the past five years. Management reports that the regulatory permit is in place. Management also reports that there have not been any significant service interruptions during the past three years.

Financial Risk

The declining coverage has been a result of raising expenses averaging over a 20% increase from fiscal 2015 to 2017. Additionally revenue has been volatile or declining from decreased water sales from the oil industry in this region of the state. All-in DSC is an S&P Global Ratings metric that only incorporates reoccurring revenue and expenses, including the city's sixth increment of municipal local option gross receipts tax, however excluding grant proceeds. In conclusion, our assessment of all-in DSC will differ from coverage outlined in the bond documents as S&P Global Ratings evaluates utilities financial sustainability to incorporate reoccurring revenue and expenses. In fiscal 2017, the city's all-in DSC was 1.00x, which we consider thin or just sufficient. Based on a recent rate increase, unaudited 2018 all-in DSC rebounded to 1.16x. Prior to fiscal 2017, all-in DSC has ranged from 1.70x to 4.80x since 2012. We don't foresee any material changes to the financial picture based on our internal projections because debt service is decreasing from the savings by refunding series 2010, but an unexpected change in revenue or expenses could alter this assessment.

Liquidity has been the strength of the financial profile over the past three fiscal years, which we view as very strong, although it is nominally slightly higher than some peers in the 'A+' rating category. Unrestricted cash and investments have grown to roughly 679 days' cash on hand or $6.9 million in fiscal 2017. Officials intend to maintain good unrestricted cash going forward.

The city identified a list of projects totaling $900,000 and about $500,000 of annual replacement for both water and sewer funds funded by system revenue with an emphasis on the short-term. The city's leverage position is low (when incorporating all of its debt with its net position) and, in our opinion, based on a debt-to-capitalization ratio of 19.2%, including the series 2019. In addition, the city is a part of the Public Employees Retirement Association for its pension plan, and as of 2018 had a 69% net position as a percentage of the total liability.

Based on our financial management assessment (FMA), we view the city as a '4' on a six- point scale, with '1' being the strongest. A FMA of standard indicates we deem financial practices good for the size of the utility, but not comprehensive. The city reviews its budget monthly and reports to the board. The city does not produce financial projections beyond the annual budget. The city follows states statues investment policy. Those strengths are partly offset by the absence of financial forecasting or a formal debt management policy. Management also produces annual audited financial statements that comply with generally accepted accounting principles (GAAP). Additionally, the city does not bifurcate debt service in their audits. In addition flows money from there water and sewer fund into the capital fund before transferring into a pooled debt service fund, making the flow of debt service payments difficult, which we view as a negative for our transparency assessment of the FMA.

Outlook

The negative outlook reflects the downward trend of debt service coverage. This incorporates the tax revenue that flows into the wastewater fund, which has been volatile over the past three years.

Downside scenario

If all-in DSC is maintained below 1.4x when only incorporating reoccurring revenue, which we deem not commensurate with the current rating, we could maintain or lower the rating, depending on the severity.

Return to stable

We could return the rating to stable if coverage levels are maintained at historic levels or at levels we view as very strong.