Fitch Ratings-Austin-12 May 2017: Fitch Ratings affirms its 'AA+' rating assigned to the following obligations issued by the Vallecitos Water District, California (the district):

--Approximately $45.3 million water and wastewater enterprise 2015 refunding revenue bonds;
--Approximately $1.9 million water and wastewater enterprise 2005-RMKT certificates of participation.

The Rating Outlook is Stable.

SECURITY

The bonds are secured by a first lien on net water and wastewater system revenues after payment of operating and maintenance expenses.

KEY RATING DRIVERS

STRONG FINANCIAL PROFILE: Despite conservation-driven consumption declines, all-in debt service coverage (DSC) remains strong. Fiscal 2016 finished at a healthy 2.9x versus Fitch's 'AA' median of 2.3x. Liquidity was also sound in 2016, finishing at 405 days of cash on hand.

MANAGEABLE DEBT BURDEN: Direct debt levels are low versus its peers and are declining swiftly. However, the system's wholesale providers carry significant debt burdens that are ultimately borne by the system's rate payers, offsetting the otherwise favorable debt profile.

SUPPLY DIVERSIFICATION POSITIVE: The district is largely dependent on imported water supplies, as is much of the region, that are subject to availability challenges and cost pressures. Recent investments in alternative sources are viewed as a credit positive.

ELEVATED RATES: Rates are somewhat high in comparison to Fitch's affordability threshold but consistent with regional peers. Strong regional support for the supply diversification efforts and associated costs mitigate concerns regarding the high rates.

SOLID SERVICE AREA: The district is the monopoly provider of essential water and sewer services to a significant suburban residential service area with solid income levels and access to the large, diverse San Diego employment market.

RATING SENSITIVITIES

MANAGEMENT OF COST PRESSURES: The rating is sensitive to rising costs pressures and the Vallecitos Water District's ability to preserve a strong financial profile while at the same time keeping rates mostly competitive with its regional peers.

CREDIT PROFILE

Vallecitos Water District provides retail water and wastewater services to about 97,000 residents in the city of San Marcos and adjacent areas in northwestern San Diego County. The district purchases the majority of its treated water supply from the San Diego County Water Authority.
(SDCWA; revenue bonds rated 'AA+','Stable Outlook). Half of the district's wastewater flows are treated at the Encina Wastewater Authority (of which the district is a 23% stakeholder) and the other half at the Meadowlark Water Reclamation Facility.

**STRONG FINANCIAL PROFILE**

Financial performance has been consistently strong despite revenue declines driven by state-mandated water usage curtailments in fiscals 2015 and 2016, which are no longer in effect. Due to these curtailments, year-over-year water usage declines were nearly 18% in fiscal 2016. However, total operating revenues only decreased by 7% resulting in all-in DSC of a still very healthy 2.9x in fiscal 2016 (down from 3.8x the year prior). The reason for this relative revenue stability is the district's revenue structure, which includes stable property taxes, fixed water charges, and a largely flat-rate sewer charge, all of which combined to provide 59% of total revenues in fiscal 2016. The district also offset lower sales by reducing the amount of imported water purchases from SDCWA.

Going forward, management's forecast point to all-in DSC falling to a low but still sufficient level of 2.4x in fiscal 2020 and then slightly improving to 2.5x by the end of the forecast period in 2022. Forecast assumptions, which appear reasonable to Fitch, include proposed rate increases that will soon go to the district board and somewhat significant increases in operating expenses linked to increasing water purchase costs.

At the end of fiscal 2016, unrestricted cash was approximately $48.2 million, equaling 405 days of operational expenses. The district's cash position, which consists largely of its capital reserves and operating reserves, has been steadily rising over the past several years and is considered to be supportive of the rating level.

**IMPROVED SUPPLY POSITION**

The district has historically relied on imported water from the SDCWA for all of its supply but has recently secured a regional drought-proof supply of water through the Carlsbad Desalination Plant, which was completed in late 2015. However, the district's water supply remains vulnerable to SDCWA cost pressures and rate increases. SDCWA is a member agency of the Metropolitan Water District of Southern California (Metropolitan; revenue bonds rated 'AA+','Stable Outlook).

**CONSISTENT RATE RECOVERY**

The district's board of directors has consistently raised rates as necessary to maintain sound financial performance. Resulting from the recent increases, the combined water and sewer bill equaled 2.1% of median household income (MHI) in 2017. While rates are above Fitch's affordability threshold of 2.0% of MHI, rates are consistent with the district's regional peers and reflect water diversification efforts that the district and SDCWA (governed by a member board) have determined are necessary.

**LOW DIRECT DEBT BURDEN, MANAGEABLE CAPITAL PLAN**

The district's direct debt burden of $1,575 per customer at the end of fiscal 2016 was below Fitch's median for 'AA' category water and sewer entities of $1,823. Also, debt ratios are declining rapidly. About 53% of outstanding debt will be retired over the next decade.

The district's $70.8 million 2018-2022 capital improvement program (CIP) is up slightly from $63.4 million in 2015. Projects continue to revolve around building to support the district's growth. A relatively small $13.4 million debt issue to fund the CIP is possible in the next few years but it is not expected to have a significant effect on the district's overall debt profile.
The retail provider's capital infrastructure and debt account for only a portion of the debt burden ultimately borne by ratepayers. Including a proportionate amount of overlapping debt from SDCWA and Metropolitan, the debt burden would jump to above average.

SOLID SERVICE AREA

The district benefits from a fundamentally sound regional northern San Diego County economy, serving the city of San Marcos and nearby portions of Carlsbad, Escondido, Vista and unincorporated San Diego County. The region typically experiences below-average joblessness and above-average job growth. San Marcos' unemployment rate of 3.3% in March 2017 was below both the nation's (4.6%) and state's (5.1%). The city's MHI is healthy at about 107% of the national level.

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In addition to the sources of information identified in Fitch's Revenue-Supported Rating Criteria, this action was additionally informed by information from Lumesis.

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Applicable Criteria
Revenue-Supported Rating Criteria (pub. 16 Jun 2014)
https://www.fitchratings.com/site/re/750012
U.S. Water and Sewer Revenue Bond Rating Criteria (pub. 30 Nov 2016)
https://www.fitchratings.com/site/re/890402

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