Research Update:

Orange County Sanitation District, CA's Series 2025A Wastewater Refunding Revenue Obligations Assigned 'AAA' Rating

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Overview

- S&P Global Ratings assigned its 'AAA' long-term rating to Orange County Sanitation District, Calif.'s approximately $96.4 million series 2025A wastewater refunding revenue obligations.
- At the same time, we affirmed our 'AAA' long-term rating on the district's parity obligations.
- The outlook is stable.

Rationale

Security

The bonds are payable from installment payments secured by the district's net revenue. Key bond provisions include a rate covenant set at 1.25x annual debt service (ADS) on senior obligations and 1.0x ADS on all obligations. The bonds also have an additional bonds test set at 1.25x maximum ADS. The district also has its own debt service reserve policy set at 10% of outstanding certificate of participation issues.

Proceeds of the 2025A obligations will be used to refund the district's series 2016 obligations. Post-issuance, the district will have roughly $558 million in long-term debt outstanding.

Credit highlights

The rating is underpinned by the district's affordable service costs, low leverage, and consistent track record of conservative budgeting and comprehensive asset management, which together have resulted in exceptionally strong financial metrics that we believe are sustainable. Through a long-standing partnership with the Orange County Water District, the groundwater replenishment system produces 130 million gallons per day of drinking water from wastewater that the district would have previously discharged into the Pacific Ocean. The process meets all state and federal drinking water standards, and the district's upcoming capital improvement plan has limited regulatory-driven projects, which we consider credit supportive. The district's current rate structure enables it to fund approximately $250 million of pay-as-you-go capital improvements annually, primarily for renewal and replacement, with no additional debt plans currently in place. Further credit stability is provided by the district's sewer charges, which are collected under the county property tax roll and serve as a fixed customer charge, guaranteeing 100% payment under the Teeter Plan.

Credit risks are limited in our view but primarily centered on Orange County's relatively slow economic recovery following the pandemic. The district's customer counts have declined slightly over the past five years, as the total equivalent dwelling units served decreased to 886,879 in 2024 from 904,886 in 2020. Additionally, Orange County's projected gross county product is forecast to lag that of the U.S. modestly, according to data from Claritas. This risk, however, is mitigated by the district's diverse revenue stream and healthy growth in property tax receipts over this period, which account for approximately 21% of overall revenues. Moreover, the district's service charges are significantly lower than those of most similarly sized coastal utilities in Southern California, thereby bolstering its overall financial flexibility.

The enterprise risk profile reflects our view of the district's:

- Primarily residential customer base in an affluent and diverse service area, with above-average incomes at 136% median household effective buying income (MHHEBI) in 2024, serving approximately 2.6 million residents, or 81% of the county's population;
- Very affordable sewer rates at 0.4% of MHHEBI, which we project will remain affordable despite board-approved rate increases averaging 3.5% annually through fiscal 2028; and
- Operational management practices and policies that we consider strong, reflecting the district's robust asset management program and overall system integrity and planning, including regularly updated strategic initiatives, a climate resiliency study, emergency response programs, and an updated biosolids master plan. The assessment also reflects preapproved rate increases and management's expectation to update and perform rate studies for the system. Cybersecurity protocols are also embedded in managerial practices.

The financial risk profile reflects our view of the district's:

- Extremely strong all-in coverage at 5.4x in fiscal 2024, which is expected to be sustained based on management's forecast, as service rates are adjusted to meet rising operating expenses and the district's pay-as-you-go capital needs;
- Historically healthy liquidity position, with unrestricted cash and investments totaling $833 million at fiscal year-end 2024, equivalent to three years' of operating expenses, which we view as a key credit strength and consider sufficient to fund ongoing capital in lieu of bonding; based on management's projection of annual capital spending, reserves will be modestly spent down to $696 million by 2029, still healthy at about two years of operating expenses;
- Pay-as-you-go funded capital program totaling $3.6 billion through fiscal 2035, which primarily centers on improvements at its two treatment plants (46%), joint facilities (20%), and collection system (19%), as well as future renewal and replacements (14%); and
- Robust and transparent long-range financial planning, which includes quarterly financial reports to the board, well-defined reserve policies, and formal investment and debt management policies that all support our assessment of management's forward-looking practices and continued strength in its financial profile.

Environmental, social, and governance

We believe environmental risks are elevated given the district's coastal geography in Southern California, which is more exposed to sea-level rise, drought, tsunamis, and flooding. To address these long-term risks, management completed a Climate Resiliency Study in 2021, which identified approximately $30 million in projects. The system has experienced minimal sewer system overflows over the last few years, with no material fines or environmental mandates, and capacity constraints have not contributed to any of these incidents. To address future rolling power outages, we note that the district has central generation facilities that meet two-thirds of the power demands in the plants, primarily through biogas, battery generation, and standby generators for pump stations.

Governance is a credit strength, represented by a track record of regional collaboration through partnerships with the Orange County Water District and the County, coupled with strong community outreach, including multilingual communications. The district has long prioritized the implementation of cutting-edge technology to enhance operations and promote climate resilience. For example, the district is in the planning stages for a deep well biosolids injection program, which aims to provide carbon sequestration and reduce long-distance trucking costs. It also continues to invest in digital systems to enhance operations and deliver process improvements. Given the strength of the service area economy, rates below those of peers, and a stable revenue collection mechanism, affordability does not present heightened risk.

Rating above the sovereign

The long-term rating is above that of the U.S., reflecting the district's predominantly locally derived revenue base, with operating expense flexibility that limits its exposure to federal revenue, in our view. Given the district's exceptional management practices and very good transparency and disclosure, we view it as having strong market access, which is also supportive of its credit quality.

Outlook

The stable outlook reflects our anticipation that the district will continue to adjust service rates to meet its revenue and capital requirements, thereby producing continued wide margins and robust all-in coverage metrics.

Downside scenario

Although we do not expect it at this time, we could take a negative rating action if the district's plans materially change, particularly if the capital improvement plan funding mechanism shifts to require a significant amount of debt, resulting in diluted coverage metrics, or reserve targets decline and the district significantly spends down reserves.

Orange County Sanitation District, California--economic and financial data

		Fiscal year-end			
	Most recent	2024	2023	2022	Median (AAA)
Economic data					
MHHEBI of the service area as % of the U.S.	136.0				114.0
Unemployment rate (%)	4.1				3.4

Orange County Sanitation District, California--economic and financial data

		Fiscal year-end			
	Most recent	**2024**	**2023**	**2022**	**Median (AAA)**
Poverty rate (%)	9.2				10.3
Water rate (6,000 gallons or actual) ($)	0.0				33.3
Sewer rate (6,000 gallons or actual) ($)	30.9				37.2
Annual utility bill as % of MHHEBI	0.4				1.0
Operational management assessment	Strong				Good
Financial data					
Total operating revenues ($000s)		471,262	458,249	448,281	73,371
Total operating expenses less depreciation ($000s)		222,672	207,212	156,115	53,231
Net revenues available for debt service ($000s)		331,172	283,734	264,671	--
Debt service ($000s)		61,800	67,915	74,439	--
S&P Global Ratings-adjusted all-in DSC (x)		5.4	4.2	3.6	2.6
Unrestricted cash ($000s)		832,857	990,022	970,924	90,711
Days' cash of operating expenses		1,365	1,744	2,270	713
Total on-balance-sheet debt ($000s)		696,866	885,409	928,741	140,491
Debt-to-capitalization ratio (%)		18.0	22.9	24.8	26.0
Financial management assessment	Strong	--	--	--	Strong

Note: Most recent economic data available from our vendors. MHHEBI--Median household effective buying income. DSC--Debt service coverage.

Ratings List

New Issue Ratings

US$96.36 mil wastewtr rfdg rev oblig ser 2025A dtd 11/04/2025 due 02/01/2039	
Long Term Rating	**AAA/Stable**
Ratings Affirmed	
Water & Sewer	
Orange County Sanitation District, CA Sewer System Revenues	AAA/Stable

The ratings appearing below the new issues represent an aggregation of debt issues (ASID) associated with related maturities. The maturities similarly reflect our opinion about the creditworthiness of the U.S. Public Finance obligor's legal pledge for payment of the financial obligation. Nevertheless, these maturities may have different credit ratings than the rating presented next to the ASID depending on whether or not additional legal pledge(s) support the specific maturity's payment obligation, such as credit enhancement, as a result of defeasance, or other factors.