Research Update:

Palo Alto, CA Series 2026A Water Revenue Refunding Bonds Rated 'AAA'; Outlook Stable

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Overview

- S&P Global Ratings assigned its ‘AAA’ rating to the City of Palo Alto, California’s $13.8 million series 2026A water revenue refunding bonds, which the city will use to refund the series 2009 water revenue bonds outstanding, also currently rated ‘AAA/Stable’.
- The outlook is stable.

Rationale

Security

The bonds are secured by net revenues from the water system. We view the bond provisions, including the rate covenant and additional bonds test of 125%, as credit neutral. The utility has elected not to fund a debt service reserve fund. We do not consider the lack of a debt service reserve fund as a credit risk because of the utility’s robust liquidity levels and proactive cash management policies as it cash-finances capital projects. After the retirement of the water fund’s portion of the series 2011 utility revenue refunding bonds as of June 2026, the series 2026A bonds will represent the entirety of Palo Alto’s water revenue debt service profile with a nine-year maturity.

Credit highlights

The rating reflects our forward-looking view of the utility’s financial health, supported by a diverse and affluent economic base with extraordinarily high income levels (top 10% in the U.S.) that provide significant financial flexibility. Management’s robust asset management and financial planning also help mitigate unexpected operational and financial challenges.

The utility’s debt levels are low as a result of the city’s practice of funding most of its capital needs with cash, which Palo Alto expects to maintain in the next few years as it progresses through its $73 million capital plan (annual costs $11 million-$17 million) focusing on system improvements and main replacements. Management is open to using bond proceeds for potential reservoir tank updates but that is yet to be assessed in the near term; however, even with the potential additional bonds, we do not see it as materially affecting the water fund’s low debt-to-capitalization ratio.

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The water system also has an ample financial cushion of nearly $24 million in liquidity in 2025 equivalent to six months of operating expenses and well within its target level of 90 days. Given the pay-as-you-go strategy in completing capital projects balanced by rate increases to generate more cash flow, we expect liquidity levels will remain robust at about $20 million over the next few years. Management is currently reviewing a utility reserves study to assess whether targets are aligned with current financial expectations.

The rating also reflects the following credit factors:

- An ample water supply through an agreement with the San Francisco Public Utilities (SFPUC) that runs through 2034.
- Rates, inclusive of passthroughs from the SFPUC, that are generally affordable at about 1% of median household effective buying incomes, and that we expect will remain so after approved rate increases ranging from 8%-10% in the near term, followed by potential additional adjustments pending another cost-of-service study expected to be completed in 2028.
- Although we believe that the utility is exposed to elevated physical risk factors, including periodic droughts, flooding, sea level-rise, seismic activity, and wildfire risk, management has taken several measures to mitigate risks including drought planning and urban water management. Nevertheless, we will continue to monitor the service area for environment-related credit pressures.

Partially limiting the above credit strengths are the utility’s recent all-in coverage figures. Despite posting more than 1.5x of senior-lien debt service coverage in the past three years, our S&P Global Ratings-adjusted all-in coverage calculations, which include fixed costs related to SFPUC, have posted figures as low as 1.07x in 2023 and that have improved to 1.4x in 2025. Management noted that the recent declines were a confluence of drought conditions (less usage) and lack of drought surcharge revenues. We expect all-in coverage figures to improve given the additional rate increases and decreasing annual debt service obligations (series 2011 debt service will have fully matured in 2026).

Rating above the sovereign

We rate the bonds above the sovereign, as the system has a predominantly local revenue base. Local service charges, derived through an autonomous rate-setting process, represent virtually all revenue. This, coupled with operating expense flexibility, precludes exposure to federal revenue, allowing S&P Global Ratings to assign a higher than that on the U.S.

Outlook

The stable outlook reflects our expectation that the utility will sustain historically robust liquidity, supported by diverse revenue streams, an ample water supply with emergency connections, and a stable, affluent customer base. We also anticipate that rate adjustments--already approved and additional when needed--will be sufficient to fund capital needs within the two-year outlook period without a material draw on unrestricted reserves.

Downside scenario

We could lower the rating over the next two years if the utility’s debt service coverage or liquidity materially decline to levels observed in the past few years, either due to insufficient rate adjustments or unexpected capital needs that require additional debt or significant cash draws.

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Palo Alto, California--economic and financial data

	Most recent	Fiscal year-end 2025	2024	2023	Median (AAA)
Economic data					
MHHEBI of the service area as % of the U.S.	251.0				114.0
Unemployment rate (%)	3.8				3.4
Poverty rate (%)	7.1				10.3
Water rate (6,000 gallons or actual) ($)	125.2				33.3
Sewer rate (6,000 gallons or actual) ($)	0.0				37.2
Annual utility bill as % of MHHEBI	0.9				1.0
Operational management assessment	Good				Good
Financial data					
Total operating revenues ($000s)		55,545	48,820	42,717	73,371
Total operating expenses less depreciation ($000s)		47,171	47,987	39,579	53,231
Net revenues available for debt service ($000s)		11,872	4,954	4,578	--
Debt service ($000s)		3,219	3,220	3,223	--
S&P Global Ratings-adjusted all-in DSC (x)		1.4	1.1	1.1	2.6
Unrestricted cash ($000s)		23,789	26,263	34,369	90,711
Days' cash of operating expenses		184	200	317	713
Total on-balance-sheet debt ($000s)		20,706	22,060	24,297	140,491
Debt-to-capitalization ratio (%)		12.2	13.5	14.6	26.0
Financial management assessment	Good	--	--	--	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$13.770 mil wtr rev rfdg bnds ser 2026 A due 06/01/2035	
Long Term Rating	AAA/Stable
New Rating	
Water & Sewer	
Palo Alto, CA Water 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.

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