New Issue: Moody's affirms City of Austin's, TX Aa1/Aa2 utility rev bonds; outlook revised to negative

Global Credit Research - 15 May 2014

Action affects $2.5 billion in debt

AUSTIN (CITY OF) TX WATER & SEWER ENTERPRISE
Combined Water & Sewer Enterprise
TX

Moody's Rating

ISSUE	RATING
Water and Wastewater System Revenue Refunding Bonds, Series 2014	Aa2
Sale Amount $271,170,000	
Expected Sale Date 06/03/14	
Rating Description Revenue: Government Enterprise	

Moody's Outlook NEG

Opinion

NEW YORK, May 15, 2014 --Moody's Investor's Service has assigned a Aa2 rating to the City of Austin's, TX $271.2 million Water and Wastewater System Revenue Refunding Bonds, Series 2014. The outlook has been revised to negative. At the same time, we have affirmed the Aa1 on prior first lien obligations, as well as the Aa2 on parity debt including the prior subordinate lien, and the separate lien obligations. The rating action affects a total of $2.5 billion.

SUMMARY RATING RATIONALE

The negative outlook reflects a historically challenged financial profile that is expected to decrease materially at fiscal year end 2014. Future credit reviews will focus on the system's ability to execute rate increases sufficient to improve the liquidity position, as well as effectively implement the other aspects of its financial plan. Inability to improve the current liquidity levels will likely result in downward rating action.

The Aa2 rating on the system's separate lien (open lien) reflects a historically challenged liquidity position, much weaker than similarly rated credits, which is expected to improve over the near term given planned rate increases, as well as the already established rate stabilization fund. The rating also reflects the utility's strong demand supported by a vibrant and growing service area, ample water supply provided by the Lower Colorado River Authority, and adequate legal provisions. Also incorporated is a manageable capital plan with needs expected to be addressed by future debt issuance, as well as, cash reserves.

The Aa1 rating on the prior lien reflects the relatively small amount of debt outstanding under the prior lien and strong debt service coverage that will continue given that the lien is closed. The Aa2 rating on the prior subordinate lien, which is also closed, is on par with the water and sewer separate liens (working lien) given that the net revenues available to the two lines are the same on the water and sewer system.

STRENGTHS

State capital with a strong and robust economy and service area

Ample water supply to meet demand in growing service area

CHALLENGES

Challenged liquidity position; narrow liquidity compared to other highly rated systems

Need for ongoing rate increases to fund large capital plan, and improve liquidity; rate increases subject to council approval

Extreme weather conditions pressure financial operations

CHALLENGED FINANCIAL POSITION; LIQUIDITY EXPECTED TO DECREASE AT FYE 2014

The system's liquidity position remains challenged and weaker than similarly rated credits. Despite modest growth over the past two years, the liquidity position measured by unrestricted reserves is weak, averaging 12.4% of operating revenues over the past five years. In fiscal year 2013, the unrestricted reserve was a thin 10.8%, with the net working capital slightly higher at 25.6%; both as a measure of operating revenues. Expectations for fiscal year end 2014, are that reserves will be reduced further given a $35 million revenue shortfall, the driver of the outlook.

The system has taken significant steps to increase its liquidity position. In fiscal year 2015, the system expects a significant 15% rate increase, which should generate $50 million in revenues. Additionally, the system expects rate increases will continue past 2015, in line with its long history of raising rates. Also, the system recently increased the net working capital target to 60 days from 45, and changed the rate structure to reduce volatility. Officials also created a rate stabilization reserve (RSR), funded with a surcharge to all customers, which is expected to be built to 120 days of operating costs over five years ending in fiscal year 2017. The RSR can be accessed with council approval if the system experiences a revenue shortfall of 10%. Additionally, the system can only access 50% of reserves in any one year with replenishment required over the following five years. The plan is expected to provide the additional liquidity the system needs to be consistent with other highly rated utility systems.

DEBT SERVICE COVERAGE FLUCTUATES DUE TO NET REVENUES SUSCEPTIBLE TO ERRATIC WEATHER; COVERAGE EXPECTED TO DECREASE BUT REMAIN SATISFACTORY IN FY 2014

The utility's financial profile is challenged, and remains weaker than similarly rated credits across the nation. Due to erratic weather patterns, the system's net revenues and resulting debt service coverage have fluctuated within the past years. Following wet weather conditions in fiscal year 2012, debt service coverage decreased to 1.43 times for all debt, following the 1.88 times reported in the prior year. In fiscal year 2013, the system implemented a rate increase. Despite increased expenditures from increased power and chemical costs, the system reported a total debt service coverage of 1.38 times. Current estimates for fiscal year 2014 reflect a significant ($35 million) decrease in revenues due to decreased consumption attributed to conservation efforts from a stage two water restriction which has been ongoing during the two and a half year drought. At fiscal year end, officials project a reduced total debt service coverage of 1.31 times. The utility has articulated plans to address its coverage with planned rate increases, subject to council approval, over the next five years. Projections starting in fiscal year 2015 reflect an increase in coverage to 1.53 times, and growing to 1.60 times in fiscal year 2019. Inability of the system to improve its financial projection or a subsequent year of decreased, or meager coverage will result in downward rating action.

LARGE CAPITAL PROGRAM; RATE INCREASES EXPECTED TO CONTINUE

The system's capital needs are expected to be met with a combination of debt issuance and cash reserves driven by planned rate increases and continued demand. Over the next five years, the system's capital needs call for a total of $839.8 million over the next five years with $365.8 million for water, $438.9 million for wastewater, and $35.1 million for reclaimed water. The system has a long history of passing annual rate increases to support operations and its capital needs. The most recent increase averaged 5% for both the water and wastewater systems. A significant increase of 14.8% on the average for both systems is expected in fiscal year 2015. After which, planned increases average 3.2% annually through 2019.

ADEQUATE LEGAL PROVISIONS

Bond holder protection is adequate. The bonds include a satisfactory rate covenant of 1.25 times from a three year rolling coverage for prior lien, and 1.1 times for prior subordinate lien and other debt. The debt service reserve fund for the separate lien is funded at one-half average annual debt service, satisfied with a combination of cash and surety bond. Two issues: Series 2013A and the current issue, are not supported by a debt service reserve. The common debt service reserve fund on the prior lien and prior sub lien debt is cash funded, and equal to average annual debt service. The additional bonds test on the separate lien is 1.25 times the average annual debt service requirements.

INTEREST RATE DERIVATIVES

Including the current sale, the system will have one outstanding variable rate issue. The Series 2008 variable rate bonds have $125.1 million outstanding (5.9% of total debt), and are supported by two letters of credit with expiration dates of May 8, 2015. Sumitomo Mitsui Banking Corporation (Aa3/stable), and Bank of Tokyo-Mitsubishi UFJ (Aa3/stable) each support 50% of the outstanding principal. In association with the 2008 bonds, the system entered into a swap agreement with Goldman Sachs Group, Inc. (Baa1/stable). The system pays a fixed rate of 3.6% and receives SIFMA. The mark to market for this swap was a negative $12 million, as of April 30, 2014. The system exposes itself to some interest rate risk. However, we believe this is manageable given the modest debt amount.

NEGATIVE OUTLOOK

The negative outlook reflects a historically challenged financial profile that is expected to decrease materially at fiscal year end 2014. Future credit reviews will focus on the system's ability to execute rate increases sufficient to improve the liquidity position, as well as effectively implement the other aspects of its financial plan. Inability to improve the current liquidity levels will likely result in downward rating action.

WHAT COULD MAKE THE RATING GO UP (revise the outlook to stable)

Significantly improved financial profile; strong growth in liquidity

Improved debt service coverage ratios

WHAT COULD MAKE THE RATING GO DOWN

Financial results that are match or are worse than expected for fiscal year 2014

Further decreases in debt service coverage

Diminished liquidity position

Inability to pass rate increases to improve overall financial profile

KEY STATISTICS

2013 Water Customer Count: 216,000

2014 Wastewater Customer County: 204,000

FY 2013 Operating Ratio: 45.4%

FY 2013 Debt ratio: 66.9%

FY 2013 annual debt service coverage on all debt: 1.52 times

Principal retirement for all W&S obligations (10 years): 28%

Post-sale separate lien debt outstanding: $2.3 billion

Total prior lien debt outstanding: $30.6 million

Total prior subordinate lien debt outstanding: $148.1 million

RATING METHODOLOGY

The principal methodology used in this rating was Analytical Framework For Water And Sewer System Ratings published in August 1999. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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