

RatingsDirect®

Summary:

Austin, Texas; Water/Sewer

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US\$314.57 mil wtr and wastewtr sys rev rfdg bnds ser 2017 dtd 08/22/2017 due 11/15/2046

Long Term Rating

AA/Stable

New

Rationale

S&P Global Ratings assigned its 'AA' rating and stable outlook to the city of Austin, Texas' series 2017 water and wastewater system revenue refunding bonds. In addition, S&P Global Ratings affirmed its 'AA' rating on the water and wastewater system's, doing business as Austin Water Utility (AWU), separate lien water and wastewater revenue bonds outstanding, and its 'AA+' rating on the prior first-lien combined electric, water, and wastewater revenue bonds.

The water utility is also supporting two series of 2011 special assessment revenue bonds that S&P Global Ratings rated two notches below the utility's separate lien, due to both the subordination and the appropriation risk if the city has to step up to fund them. The special assessment bonds are related to developments along the eastern periphery of the Austin metropolitan statistical area (MSA), near state highway 130; we understand that infrastructure for the initial phases of both projects are in place and development has started. The outlook is stable.

The ratings reflect our opinion of the system's general creditworthiness, including its extremely strong enterprise risk profile and its very strong financial risk profile. Factors which in our view support AWU's enterprise risk profile include its:

- Service area, which has among the strongest and most diverse economies in the state and is stabilized by a number of public institutions;
- Water supply agreement with the Lower Colorado River Authority (LCRA) since 1999, effectively securing a 100-year water supply at a reasonable cost, and one which was not interrupted by LCRA even during the recent severe and prolonged drought; and
- Continued willingness to review and adjust rates, even as some of the previous commitments towards supporting operations have made the nominal cost of the monthly residential bill above-average versus peer systems.

A pledge of the water and wastewater system's net revenues secures the separate-lien system revenue bonds, which are junior to roughly \$18.6 million of prior first-lien combined electric, water, and wastewater revenue bonds; these bonds also have a pledge on par with \$110 million of prior subordinate-lien combined electric-water-wastewater utility revenue bonds outstanding as of June 2017, and roughly \$2.2 billion of previously issued separate-lien (parity) water and wastewater revenue bonds outstanding, including a small state loan executed late in 2016. We understand management plans to use proceeds mainly to convert outstanding commercial paper notes to long-term debt, as well as to refund eligible maturities of the water and wastewater utility's series 2009 and 2009A revenue bonds for savings purposes. While there is a fully funded debt service reserve available for the prior-lien debt, the city will not establish one for the 2017 refunding bonds.

Enterprise Risk Profile

AWU serves about 227,000 water customers. The customer base grew rapidly during the economic expansion's peak, prior to the Great Recession, and continues to see steady increases in the number of metered accounts because the MSA remains one of the state's most economically robust. The broad and diverse employment base is led by the city's role as the state's capital as well as being home to a number of higher education institutions, including the flagship campus of the University of Texas system which has more than 50,000 students and 23,000 employees. The vibrant technology sector includes microchip manufacturing, hardware development, and software and application companies like Dell, IBM, Oracle, and Google. The MSA has held up well even as other areas in south Texas have seen economic stagnation with the fall in oil and natural gas commodity prices and production.

The system obtains water from the Colorado River through the city's own water rights and purchases from LCRA. The system then treats the water at three plants, the latest of which became fully operational in 2014. In 1999, city officials secured a long-term water supply through an amendment to the water agreement with LCRA that put a 50-year water supply in place with an option to renew for an additional 50 years. The city is a priority customer of LCRA. During a severe drought in 2012 through 2015, the authority curtailed certain interruptible customers in favor of its obligation to Austin. Still, the city has had, for many years, aggressive water conservation and drought management programs, including inclining block rates, public education, and environmentally sensitive practices. As of July 2017, LCRA's system of reservoirs were about 90% full; Lake Travis, the system's largest, was at 89% of capacity—strong for this time of the year—after being 37% full as of May 2015.

The city has a long record of making rate adjustments, which typically happen annually, to support continued investment in the system. The most recent adjustments, a 2.9% water and 3% sewer rate increase, were implemented in November 2016. The five-year financial forecast provided to us projects smaller rate adjustments in 2019 and beyond, and is supplemented by periodic updates to the city's cost of service study. While the current average residential bill is about \$83, or 2% of median household effective buying income, is relatively high versus peer cities, the rates are not unreasonable. In addition to the prepaid water rights and related capacity reservations, other very large capital programs have been completed such as a \$400 million program related to a sewer consent decree. With recent major capital programs behind it, the magnitude of future rate increases will be much smaller than during the city's peak annual growth, and we believe it is likely that other peer systems that are dealing with capital pressures will soon have rates comparable to Austin's.

Based on our operational management assessment (OMA), we view Austin Water to be a '2' on a scale of 1-6, with '1' being the strongest. In our opinion, this indicates good alignment of operations and organizational goals. The OMA includes a 100-year firm water supply, given its contractual relationship with LCRA, a sanitary sewer system that has already completed a regulatory mandate, and a commitment to demand-side management reflected in its water conservation ordinances and public education campaigns. The city will also be phasing in a meter replacement program, replacing old meters with advanced metering infrastructure.

Financial Risk Profile

Factors which in our view support AWU's financial risk profile include its:

- All-in coverage metrics that have begun to rebound from recent years that have been pressured by both large

capital commitments as well as profound water conservation measures;

- Liquidity that while adequate now is expected to increase given management's commitment to bolster reserves and cash flow; and
- Strong financial management practices that on par with the same robust level of internal financial controls as the general fund.

Management already had a number of best practices to support the utility's financial performance, such as maintaining cash reserves equivalent to at least 60 days' of operating expenses, and targeting total **debt service coverage** (DSC) of all liens at least at 1.5x; internal targets are even more robust at **245 days** and **1.85x, respectively**. Management also maintained for years a strict allocation of all combined utility revenue requirements to either AWU or to Austin Energy, its municipally-owned electric counterpart. The cost allocation ensures that both utilities fully support its allocable share of combined utility debt service on both the prior first- and prior-subordinate liens. In fiscal 2013, those policies were strengthened, including the creation of a surcharge. The rate surcharge is for the purpose of building and maintaining a rate stabilization reserve fund in the amount of 120 days of water operating expenses, as well as increasing the ability of the system to deploy more internally generated funds towards future capital projects. The city is well on its way to fully funding this designated reserve with the intent to reduce the surcharge over time, and thus offsetting a portion of the planned future base rate adjustments.

Management expects the rate stabilization reserve to reach its targeted funding level by fiscal 2018. Similar to the strong financial management policies of the general fund, the water rate stabilization reserve--funded with what is currently a 19 cent per 1,000 gallon surcharge--can only be used in the event of a significant revenue shortfall, and no more than half of the balance can ever be used at one time. A city ordinance in place for over a decade also caps transfers to the general fund, further providing the ability to maintain liquidity in the utility fund. In addition, AWU has been gradually making largely revenue-neutral adjustments to the base rate such that it generates a much larger portion of total cash from operations. This should help better manage fixed costs out of recurring revenues, as opposed to cash on hand, thereby reducing cash flow volatility associated with seasonality and weather conditions.

Management has identified roughly \$890 million in capital expenditures through fiscal 2022, about 13% lower than the capital improvement program (CIP) for 2013-2017. While the service area remains among the most economically vibrant in the state, which could cause growth pressures to reemerge, AWU completed in the past several years two major capital-intensive programs. This includes nearly \$400 million in projects related to an administrative order on sanitary sewer overflows that was closed out in 2009. AWU also brought online a water treatment plant in December 2014, nearly meeting its original budget and construction deadline even as the final site identification was delayed to study the environmental sensitivity of the Lake Travis location. The remainder of the CIP is focused on current growth and rehabilitation projects. Management currently expects any increase in the CIP to be largely attributable to accelerated growth. The wastewater treatment plants are not facing permit renewals until the end of the decade.

We expect all-in **DSC** to remain **steady**, even if periodically affected by weather; fiscal 2016 coverage of all system obligations was about 1.55x by our calculation, and averaged **1.29x over the past three years**. All-in coverage is our adjusted debt service metric that treats fixed charges (if applicable) as if they hypothetically were debt and transfers and as if they were operating expenses, since in our view they are all recurring uses of utility operating revenues. Management's forecast, which we believe is attainable, is for **all-in DSC of all liens between 1.5x and 1.6x through 2022**.

and actual annual DSC between 1.70x and 1.86x.

Outlook

The stable outlook reflects our expectation that the ratings are unlikely to change in the next two years. We recognize management's commitment to improving AWU's financial risk profile and maintaining it at current levels. We believe, however, that the improvements will be gradual. While the rating could still be raised higher, even with a stable outlook, an upgrade would be predicated mainly on the system continuing to improve its all-in coverage and further bolstering its available reserves to a level more in line with an 'AA+' rating. Given that the system's largest projects have been completed and that the CIP is manageable despite stronger economic growth, we believe this is achievable.

Upside scenario

While we acknowledge management's accomplishments, such as building and maintaining stronger cash reserves, and the 2013 adoption of what we consider very robust financial management policies, it may still be several more years before the financial profile of the system is more in line with that of higher-rated utilities. It is important to note that we view the slip in DSC in fiscal 2014 as an anomaly from its history of strong performance, attributable to a prolonged drought that only lessened in 2015. In 2013, we revised the rating outlook to positive based on the expectation that the enhanced financial management policies adopted by the city would bolster the already-solid financial risk profile of AWU. Management had projected total DSC of all liens of at least 1.5x and available reserves—including its revenue stability reserve—equivalent to 245 days of operating expenses. We believe the system's financial profile continues to move in that direction. A higher rating would be predicated mainly on continued progress towards that end.

Downside scenario

Given that the total annual debt service requirements have plateaued and the scope of the capital commitments has greatly diminished in the past five years, and that the city appears to remain committed to an annual review of its rates and charges, we view downside risk as extremely remote, and likely predicated on a precipitous change in the system's financial risk profile, perhaps by the introduction of more risky debt instruments or an unforeseen new regulatory mandate that causes the capital plan to sharply increase.

Ratings Detail (As Of July 24, 2017)

Austin wtr and wastewtr sys rev rfdg bnds ser 2016 due 11/15/2045		
<i>Long Term Rating</i>	AA/Stable	Affirmed
Austin WS		
<i>Long Term Rating</i>	AA/Stable	Affirmed
Austin WS (BHAC) (SEC MKT)		
<i>Unenhanced Rating</i>	AA(SPUR)/Stable	Affirmed
AustinWS		
<i>Unenhanced Rating</i>	AA(SPUR)/Stable	Affirmed
Austin WS		
<i>Unenhanced Rating</i>	AA(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

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