Fitch Ratings Assigns 'AA-' Rating to Austin Water and Wastewater Revenue Bonds

Fitch Ratings-New York-03 May 2016: Fitch Ratings assigns an 'AA-' rating to the following Austin, Texas (the city) revenue bonds:

--Approximately $251,855,000 water and wastewater system revenue refunding bonds, series 2016.

The series 2016 bonds are scheduled for a negotiated sale the week of May 10. The bonds will be used to retire outstanding commercial paper obligations and refund portions of outstanding parity bonds for interest cost savings.

In addition, Fitch affirms the ratings for the city's remaining revenue bonds:

--$28.6 million combined utility systems (prior first-lien) revenue bonds at 'AA';
--$119 million combined utility systems (prior subordinate lien) revenue bonds at 'AA-';
--$2.3 billion water and wastewater system revenue bonds at 'AA-'.

The Rating Outlook for the series 2016 bonds and outstanding parity water and wastewater revenue bonds is revised to Stable from Negative.

The Rating Outlook is Stable for outstanding combined utility system prior- and subordinate-lien bonds based on the strength of the joint-and-several pledge of net revenues of the combined utility systems, consisting of Austin Water Utility (AWU) and Austin Energy (AE).

SECURITY

The series 2016 bonds are secured by net revenues of AWU, after provision for the prior first-lien obligations of the combined utility systems. The bonds are on parity with the prior subordinate-lien obligations of the combined utility systems and all outstanding water and wastewater revenue bonds. The series 2016 bonds will not carry a debt service reserve.

The prior first- and subordinate-lien obligations are secured by a joint-and-several pledge of net revenues of the combined utility systems, consisting of AWU and AE (electric revenue bonds rated 'AA-'/Stable Outlook). The issuance of additional bonds secured by a joint-and-several pledge of net revenues of AWU and AE is no longer permitted by the master bond ordinance, effectively closing both liens. A default on the prior subordinate-lien obligations and water and wastewater bonds would not trigger a default on the prior first-lien bonds.

KEY RATING DRIVERS

IMPROVED FINANCIAL PERFORMANCE: Fitch's revision of the Outlook to Stable from Negative reflects modest but notable improvement in AWU's financial performance. Fitch expects improvement to continue at least through the current forecast period ending in fiscal 2021.

STRONG SERVICE AREA: AWU provides water and wastewater treatment service to a sizable service territory that includes the city (general obligation [GO] bonds rated 'AAA'/Stable Outlook) and neighboring areas beyond the city limits. Austin has a broad and diverse economy, as reflected by exceptionally low unemployment, above-average wealth levels and a highly diversified, expanding customer base.
FAVORABLE DROUGHT RESPONSE: Measures taken at the height of the recent drought have begun to yield positive results and offset continued declines in water sales. An expected easing of water use restrictions currently in place, coupled with ongoing rate increases, improved cost recovery through recent rate structure changes, efforts to cut costs and more conservative financial forecasting, should ensure continued improvement in cash flow and liquidity metrics.

LEVERAGED UTILITY SYSTEM: The system's debt levels are high for the rating category, although planned capital spending levels have moderated in recent years to a more manageable level; borrowing plans are not expected to result in a meaningful increase in current leverage.

SUFFICIENT RESOURCES: Water supply and treatment capacity of the overall system are anticipated to be sufficient for the foreseeable future.

HIGHER RATING ON PRIOR LIEN DEBT: The ‘AA’ rating on the prior first-lien bonds reflects the closed nature of the lien, the very modest portion of the bonds that make up AWU's and Austin Energy's (AE; 'AA-'/Stable Outlook) overall debt profile, and the strong debt service coverage provided by the pledge of the combined utilities.

RATING SENSITIVITIES

SUSTAINED FINANCIAL METRICS: Financial metrics for the city of Austin's (TX) combined water and wastewater system remain weak for the rating category but are forecast to continue strengthening. Continued stability in the rating will be determined largely by AWU's ability to achieve and sustain projected financial targets.

CREDIT PROFILE

RATE ADJUSTMENTS ENHANCE FINANCIAL RESULTS

Cash flow and liquidity metrics exhibited solid improvement in fiscal 2015, with all-in debt service coverage climbing to 1.34x and days cash on hand (DCOH) more than doubling to 116 days. The healthier operating performance was driven primarily by an 8.1% rate increase, coupled with modest changes in the rate structure designed to bring about better recovery of fixed costs given the ongoing trend of declining water sales.

Operating projections demonstrate sustained improvement in the overall health of AWU's financial profile. With annual rate increases averaging about 2.5%, debt service coverage after making an annual transfer to the city's general fund should approximate 1.60x through the current forecast period, while liquidity grows to well beyond 450 DCOH over the next several years. Forecast assumptions appear reasonable with level consumption, modest rate hikes, annual customer growth of 1% and additional debt issuance.

AMPLE SUPPLY AND TREATMENT CAPACITY

AWU provides water and wastewater service almost entirely on a retail basis. The system's 10 largest water customers accounted for just 6% of total water and wastewater revenues in fiscal 2015, evidencing the utility's highly diverse customer base and related revenues. AWU has an ample, long-term water supply, pursuant to an agreement with the Lower Colorado River Authority (LCRA, revenue bonds rated 'A'/Stable Outlook) that runs through 2050 and is extendable through 2100 at AWU's option. Existing water and wastewater treatment capacity is reportedly sufficient for the foreseeable future.

STRONG SERVICE AREA
The strength and diversity in both AWU's customer base and the city's economy underpin the utility's overall credit profile. The city's role as the state capital and home to seven colleges and universities, including the flagship campus of the University of Texas (University of Texas System revenue bonds rated 'AAA'/Stable Outlook), anchors the region's economy and provides a solid buffer from economic downturns. Wealth indicators for the area are comparatively high, and the city's February 2016 unemployment rate of 2.7% is exceptionally low relative to state and national averages. Accordingly, customer delinquencies are minimal and revenue collection is consistently strong.

MANAGEABLE CAPITAL NEEDS
Fitch expects capital needs through 2021 will remain manageable, despite modest increases over the prior two years in the overall size of AWU’s capital program. The current five-year program is up by approximately $44 million, or 5%, over the prior 2015-2019 plan. Cost increases are being driven in large part by plans to expand the utility's reclaimed water program and implement automatic meter reading, both of which Fitch views as constructive developments.

The city expects to fund about two-thirds, or close to $600 million, of its capital program with borrowings every one-two years through 2021. The city's commercial paper program will continue to be used as an interim funding source that will ultimately be retired with long-term bonds. Excess cash flow is projected to cover the balance of planned expenditures.

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Applicable Criteria
Revenue-Supported Rating Criteria (pub. 16 Jun 2014)
U.S. Water and Sewer Revenue Bond Rating Criteria (pub. 03 Sep 2015)

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