STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

RatingsDirect®

Summary:
Austin, Texas; Combined Utility; Water/Sewer

Primary Credit Analyst:
Theodore A Chapman, Dallas (1) 214-871-1401; theodore.chapman@standardandpoors.com

Secondary Contact:
Peter V Murphy, New York (1) 212-438-2065; peter.murphy@standardandpoors.com

Table Of Contents

Summary:

Austin, Texas; Combined Utility; Water/Sewer

Credit Profile		
US$253.09 mil Water and Wastewater Sys Rev Rfdg Bnds ser 2015A due 11/15/2035		
Long Term Rating	AA/Stable	New
US$36.405 mil Water and Wastewater Sys Rev Rfdg Bnds ser 2015B due 11/15/2035		
Long Term Rating	AA/Stable	New
Austin WS		
Long Term Rating	AA/Stable	Outlook Revised

Rationale

Standard & Poor's Ratings Services revised to stable from positive its outlook and affirmed its 'AA' long-term rating and underlying rating (SPUR) on Austin, Texas' separate-lien water and wastewater system debt and the 'A+' rating on the system's special assessment bonds. We also assigned an 'AA' rating and stable outlook to Austin's' series 2015A and 2015B taxable water and wastewater system revenue refunding bonds. In addition, we raised to 'AA+' from 'AA' our rating on the prior first-lien combined electric, water, and wastewater revenue bonds. The outlook is stable. The upgrade reflects our opinion of the extremely strong debt service coverage, which we view as sustainable given that all prior first-lien debt will be repaid by fiscal 2019.

The outlook revision for the separate-lien debt is based on our view that the utility's financial metrics are not yet commensurate with those of 'AA+' rated systems. While we acknowledge management's commitment, for example, to 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 – which does business as Austin Water Utility (AWU) - is more in line with that of higher-rated utilities. It is important to note that we view the slip in debt service coverage (DSC) in fiscal 2014 as an anomaly from a history of otherwise strong performance, attributable to a prolonged drought that only very recently lessened.

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. While management had projected total DSC of all liens of at least 1.5x, recent actions have targeted improving both cash flow and cash reserves. We believe the system's financial profile continues to move in that direction. While it may take more than two years for the system's financial position to be fully in line with management's goals, a higher rating would be predicated mainly on continued progress toward that end.

The ratings reflect the system's general creditworthiness, including its:

- Service area, which has among the strongest and most diverse economies in the state and is anchored 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
- Five-year capital improvement plan (CIP) that includes about $860 million of capital expenditures, about two-thirds of which will be funded with additional debt. This level of planned improvements is roughly 60% of what it was just a decade ago as the system winds down from a recent capital-intensive phase.

A pledge of the water and wastewater system's net revenues secures the separate-lien system revenue bonds, which are junior to roughly $29.5 million of prior first-lien combined electric, water, and wastewater revenue bonds; these bonds also have a pledge on par with $137 million of prior subordinate-lien combined electric-water-wastewater utility revenue bonds outstanding as of June 2015, and roughly $2.1 billion of previously issued separate-lien (parity) water and wastewater revenue bonds outstanding. The utility is also standing behind two series of 2011 special assessment revenue bonds that we rate two notches below the utility's separate lien, given both the subordination and the appropriation risk if the city has to step up to fund them. The special assessment districts are related to developments along the eastern periphery of the Austin metropolitan statistical area (MSA), near state highway 130.

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 of all liens of at least 1.5x. Management also for years has maintained 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 their 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 another 120 days of water operating expenses. The city also tweaked the rate structure such that a higher percentage of operating revenues are now coming from the base rate of the customer bill.

We understand management plans to use proceeds from both series 2015 bond to refund for savings various maturities of the separate-lien water and wastewater revenue bonds. While there is a fully funded debt service reserve available for the prior-lien debt, the city will not to establish one for the 2015 refunding bonds.

Management expects the rate stabilization reserve to reach its targeted funding level by fiscal 2018, which we view as key to achieving a higher rating. 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 adjusting 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.

Management has identified roughly $863 million of capital expenditures through fiscal 2020, almost 40% lower than just five years prior. While the service area remains among the most economically vibrant in the state and therefore growth pressures could reemerge, AWU in the last several years completed two major capital-intensive programs. This includes nearly $400 million of projects related to an administrative order on sanitary sewer overflows (SSO) 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 if 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 anticipates at this time that any increase in the CIP would be largely attributable to accelerated growth. The wastewater treatment plants are not facing permit renewals until close to the end of the decade.

The city has a long record of rate adjustments - typically annually - to support the continued system investment. The most recent adjustment, an 8.1% rate increase, was implemented in November 2014. Forecasts call for similar rate adjustments in each of the next five years, with a cost of service update study anticipated to be executed within the next one to two years. The continued adjustment in rates that are already above those of comparable utilities in the state does create a challenge for elected officials. However, the rates are not unreasonable because there are long-term water supply agreements, and other very large capital programs have been completed.

We expect annual DSC to remain steady, even if periodically affected by weather; fiscal 2014 coverage of all system obligations was about 1.26x by Standard & Poor's calculation. The drop was attributable to the prolonged impact from water conservation measures during a drought that until May 2015 remained extreme for most of central Texas. Fiscal 2015 DSC is expected to be more in line with the forecasted 1.5x. Management's forecast, which we believe is attainable, is for annual DSC of all liens of between 1.5x and 1.7x through 2020 even before the savings and smoothing in the debt service schedule brought about by the series 2015 refunding.

AWU serves about 217,000 water customers and about 204,000 wastewater customers. The customer base grew more than 3% annually during the economic expansion's peak prior to the Great Recession, and has begun growing even more rapidly postrecession. 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. 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; as the authority dealt with the severe drought, it curtailed certain interruptible customers in favor of its obligation to Austin. Still, the city has had for many years an aggressive water conservation and drought management program, including inclining block rates, public education, and environmentally-sensitive practices. As of June 2015, LCRA's system of reservoirs was more than 70% full; Lake Travis, the system's largest, is 84% full, more than double its level just three months prior.

The upgrade to'AA+' of the prior first-lien combined electric, water, and wastewater revenue bonds reflects the extremely strong debt service coverage, which we view as sustainable given that all such debt will be repaid by fiscal 2019. Even with slightly lower coverage metrics in fiscal 2014, total revenues available for debt service would cover the fiscal 2018 payment – the largest remaining in the schedule – by more than 9x by Standard & Poor's calculation. The prior subordinate-lien debt also rolls off rapidly, averaging about $5.5 million per year from 2020 to its final payment in 2025. The expected savings from the 2015 refunding is $4.2 million per year.

Outlook

The stable outlook reflects Standard & Poor's 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 those improved levels. We believe, however, that the improvements will be gradual. While the rating could still go higher, even with a stable outlook, an upgrade would be predicated mainly on the system building cash 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 management's projections are sustainable.

Related Criteria And Research

Related Criteria

- USPF Criteria: Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008
- USPF Criteria: Appropriation-Backed Obligations, June 13, 2007
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- U.S. State And Local Government Credit Conditions Forecast, April 2, 2015

Ratings Detail (As Of July 1, 2015)		
Austin WS (wrap of insured) (AGM & BHAC) (SEC MKT)		
Unenhanced Rating	AA(SPUR)/Stable	Outlook Revised
Austin WS (BHAC) (SEC MKT)		
Unenhanced Rating	AA(SPUR)/Stable	Outlook Revised
Austin (Indian Hills Pub Imp Dist) WS		
Long Term Rating	A+/Stable	Outlook Revised
Austin (Whisper Vy Pub Imp Dist) WS		
Long Term Rating	A+/Stable	Outlook Revised
Austin		
Long Term Rating	AA+/Stable	Upgraded
AustinWS		
Unenhanced Rating	AA(SPUR)/Stable	Outlook Revised
Austin WS		
Unenhanced Rating	AA(SPUR)/Stable	Outlook Revised

Many issues are enhanced by bond insurance.

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.