S&P Global
Ratings

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Summary:

# Austin, Texas; Combined Utility; Water/Sewer


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## Summary:

# Austin, Texas; Combined Utility; Water/Sewer

| Credit Profile | | |
|---|---|---|
| US$251.855 mil wtr and wastewtr sys rev rfdg bnds ser 2016 due 11/15/2045 | | |
| *Long Term Rating* | AA/Stable | New |
| **Austin** | | |
| *Long Term Rating* | AA+/Stable | Affirmed |

## Rationale

S&P Global Ratings assigned its 'AA' rating and stable outlook to the city of Austin, Texas' series 2016 water and wastewater system revenue refunding bonds. In addition, S&P Global Ratings affirmed the 'AA' ratings 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 standing behind 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. The outlook on all debt 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 $28.6 million of prior first-lien combined electric, water, and wastewater revenue bonds; these bonds also have a pledge on par with $119 million of prior subordinate-lien combined electric-water-wastewater utility revenue bonds outstanding as of May 2016, and roughly $2.2 billion of previously issued separate-lien (parity) water and wastewater revenue bonds outstanding. We understand management plans to use proceeds to refund savings for various maturities of the separate-lien water and wastewater revenue bonds (including an $18 million equity contribution to defease debt and further the savings), as well as convert outstanding commercial paper notes to long-term debt. While there is a fully funded debt service reserve available for the prior-lien debt, the city will not establish one for the 2016 refunding bonds.

## Enterprise Risk Profile

AWU serves about 222,000 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 as 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 home to a number of higher education institutions, including the flagship campus of the University of Texas system with 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. When 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 May 2016, LCRA's system of reservoirs has essentially returned to full given heavy rains since spring 2015; Lake Travis, the system's largest, is at 100% of capacity after being 37% full as recently as May 2015.

The city has a long record of rate adjustments-typically annually-to support the continued system investment. The most recent adjustment, a 4.9% rate increase, was implemented in November 2015. The financial forecast provided to us projects for smaller 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 point of sensitivity for the city council. However, the rates are not unreasonable because there are long-term water supply agreements, and other very large capital programs have been completed; the magnitude of future rate increases is 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 '1' on a scale of 1-6, with '1' being the strongest. In our opinion, this indicates the strongest alignment of operations and organizational goals. The strong 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.

## Financial Risk Profile

Factors which in our view support Austin Water'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 grow given management's commitment to bolster reserves and cash flow; and
- Strong financial management practices, 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 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 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 another 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.

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 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 $884 million of capital expenditures through fiscal 2021, almost 40% lower than just five years prior. While the service area remains among the most economically vibrant in the state, which could cause growth pressures to 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 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 final site identification was delayed to study the environmental sensitivity of the Lake Travis location. The remainder of the capital improvement program (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 annual DSC to remain steady, even if periodically affected by weather; fiscal 2015 coverage of all system obligations was about 1.29x by our calculation, and averaged 1.20 over the last 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 as if they were operating expenses since in our view they are all recurring uses of utility operating revenues. The drop was attributable to the prolonged impact from water conservation measures during a drought that lasted from 2011 until spring 2015 for most of central Texas. Fiscal 2016 DSC is budgeted to be more in line with the forecasted 1.5x, as is the forecast through the remainder of the decade. Management's forecast, which we believe is attainable, is for annual DSC of all liens between 1.5x and 1.7x through 2021.

## 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 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 reasonably achievable.

### Upside scenario

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 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 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 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 just in the last five years, and that the city appears to remain committed to an annual review of its rates and charges, we would likely 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 regulatory mandate that causes the capital plan to sharply increase.

## Related Criteria And Research

Related Criteria

- USPF Criteria: Rating Methodology And Assumptions For U.S. Municipal Waterworks And Sanitary Sewer Utility Revenue Bonds, Jan. 19, 2016
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- USPF Criteria: Appropriation-Backed Obligations, June 13, 2007
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

### Related Research

- U.S. State And Local Government Credit Conditions Forecast, Jan. 11, 2016

**Ratings Detail (As Of May 5, 2016)**

| Ratings Detail (As Of May 5, 2016) (cont.) | | |
|---|---|---|
| Austin WS | | |
| *Long Term Rating* | AA/Stable | Affirmed |
| Austin WS (wrap of insured) (AGM & BHAC) (SEC MKT) | | |
| *Unenhanced Rating* | AA(SPUR)/Stable | Affirmed |
| Austin WS (BHAC) (SEC MKT) | | |
| *Unenhanced Rating* | AA(SPUR)/Stable | Affirmed |
| Austin (Indian Hills Pub Imp Dist) WS | | |
| *Long Term Rating* | A+/Stable | Affirmed |
| Austin (Whisper Vy Pub Imp Dist) WS | | |
| *Long Term Rating* | A+/Stable | Affirmed |
| **AustinWS** | | |
| *Unenhanced Rating* | AA(SPUR)/Stable | Affirmed |
| **Austin WS** | | |
| *Unenhanced Rating* | AA(SPUR)/Stable | Affirmed |

Many issues are enhanced by bond insurance.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on the S&P Global Ratings public website at www.standardandpoors.com. Use the Ratings search box located in the left column.