Summary:

Austin, Texas; Water/Sewer

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US$202.46 mil wtr and wastewtr sys rev rfdg bnds ser 2020C due 11/15/2050

Long Term Rating AA/Stable New

Rating Action
S&P Global Ratings assigned its 'AA' rating to Austin, Texas' $202.46 million series 2020C water and wastewater system revenue refunding bonds. The outlook is stable.

The city will use bond proceeds to convert about $200 million of outstanding commercial paper notes to long-term debt, as well as to refund eligible maturities of the city's water and sewer system's—d.b.a. Austin Water Utility (AWU)—series 2010A revenue bonds for savings purposes.

Prior to 2002, the electric, water, and sewer utilities operated as a single entity, with debt secured by the net revenues of all three systems. Since then, the electric system (Austin Energy, AA/Stable) and AWU have issued separate-lien debt, secured by electric-only and water and sewer-only net revenues, respectively, but subordinate to any remaining combined utility prior-lien debt. Both Austin Energy and AWU will continue to issue separate-lien revenue bonds when management chooses to retire existing notes with long-term debt. AWU has just over $2.0 billion in separate-lien debt outstanding. There also remains about $78 million in previous combined-lien debt; that lien has long since been, closed so no additional debt will be issued.

Credit overview
AWU serves more than 236,000 customers throughout and just outside the city of about one million people. 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 normally has more than 50,000 students and 23,000 employees. The technology sector, which includes chip manufacturing, hardware development, and software and application companies like Dell, IBM, Oracle, and Google, has been a key driver of economic growth for several decades. The sector has increased median household effective buying income (MHHEBI) in the metropolitan statistical area (MSA) to 116% of that of the U.S. AWU's 10 largest customers comprise only about 5% of operating revenues.

Factors that support our view of AWU's general creditworthiness include:

• Service area, which has among the strongest and most diverse economies in the state and has shown good resilience throughout the pandemic-related recession;

• Water supply agreement with the Lower Colorado River Authority (LCRA) since 1999, which effectively secured a senior-priority 100-year water supply at a reasonable cost;

• All-in coverage metrics and available reserve levels that have grown stronger as the city is now beyond a very
capital-intensive period; and

- Strong financial management practices that are on par with the same robust level of internal financial controls as the general fund.

The stable outlook reflects our expectation that the ratings are unlikely to change in the next two years. We note that the city has been very aggressive at recognizing the impact of the recession on its customer base, even if it means a very modest softening of the near-term financial results. Still, management has represented that it remains committed to maintaining AWU’s improved financial risk profile over the long term, including consideration of rate adjustments if necessary.

Environmental, social, and governance factors
We view environmental risk factors as a key strength, with major programs completed a number of years ago to address both water supply diversity and sanitary sewer overflows. 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 has also been a leader in addressing utility-related social risks, specifically affordability concerns. In 2017, the city implemented a bill surcharge for dedicated, ongoing funding for customer assistance bill-pay programs for economically vulnerable customers, as well as lowering the rates for qualified customers. In addition to suspending shutoffs and disconnections, when the pandemic initially triggered the recession, city council temporarily lowered portions of the water rate structure, in place through at least October 2020. As of the beginning of the fourth quarter of fiscal 2020, management is projecting only a 3.5% unfavorable variance to budget in its water operating fund, although consumption is further diminished by ongoing drought conditions and outdoor watering restrictions that remain in place. Lastly, because of what we deem as strong financial management practices, including transparency and disclosure that are generally timely and detailed, and established policies that include climate resilience and sustainable development, we also view governance as a strength.

Stable Outlook

Downside scenario
We believe downside risk is lower given that the total annual debt service requirements have plateaued and the scope of the city's capital commitments has greatly diminished in the past five years; and the city appears committed to an annual review of its rates and charges. General factors that could pressure the rating include an unforeseen new regulatory mandate that causes the capital plan to sharply increase, over-reliance on available reserves, or what we view as recurring weakening of total financial capacity as measured by our adjusted debt service coverage (DSC) metric.

Upside scenario
If, as S&P Global Economics projects, credit conditions for all governments and their related utilities face headwinds into 2021 and possibly 2022, this could increase the likelihood of unfavorable variances to budget for those years. Given the resilience demonstrated by the Austin MSA economy and capital budget pressures that have greatly eased, a higher rating would therefore be predicated mainly on consistently outperforming financial projections, specifically driven by our all-in DSC metric.
Credit Opinion

Enterprise risk profile
Even during the COVID-related recession, the Austin MSA has remained one of the most economically resilient in the state. As of August 2020, the unemployment rate had already returned to 5.5% and was markedly better than the state's and nation's. The State of Texas indicated that initial fiscal 2020 results, while unfavorable versus budget, were not as bad as feared, lessening the likelihood of deep and long-lasting job cuts. The University of Texas campus did open in August 2020 for on-campus instruction and will remain open until Thanksgiving. The school—the largest of a number of four- and two-year campuses in the MSA—offered traditional, hybrid, and online options to students, although the administration estimates that as many as 75% of students have opted for online learning.

AWU 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. The city is a priority customer of LCRA. For example, during a severe drought in 2012-2015, 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 the beginning of October 2020, LCRA's system of reservoirs was about 79% full; Lake Travis—the system's largest—was at 71% of capacity, which is much lower than the previous year, but only slightly below long-term historical averages given the time of year.

The city has generally had a long record of making regular rate adjustments, although there have been none since 2017. In fact, during fiscal 2018 city council implemented a rate adjustment that was largely revenue-neutral, but it had the practical effect of lowering the bill for customers that typically use less water. We understand that future rate increases will still be considered, but none are included in the fiscal 2021 budget. Rates are reviewed regularly, with the aforementioned consideration of affordability, and supplemented by periodic updates to the city's cost-of-service study. The current average residential bill is about $79, or 1.54% of MHHEBI, reflecting the slight decrease implemented in 2018. 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, management anticipates that the magnitude of any future rate increases will be much smaller than during the city's peak annual growth.

Based on our Operational Management Assessment (OMA), we view AWU to be a '2' on a six-point scale, 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 the contractual relationship with LCRA, a sanitary sewer system that has already completed a regulatory mandate, and a commitment to demand-side management reflected in AWU's water conservation ordinances and public education campaigns.

Financial risk profile
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' operating expenses and targeting total DSC of all liens at least at 1.5x; internal targets are even more robust at 245 days and 1.85x, respectively. During fiscal 2019, senior-lien DSC and all-in
DSC were about **2.1x** and **1.5x**, respectively. All-in DSC is S&P Global Ratings’ adjusted DSC metric that includes all use of operating revenues regardless of lien or accounting treatment. Based on projected results for fiscal 2020 and the proposed 2021 budget, we believe that it is likely that AWU can achieve similar, if only slightly lower, financial results.

The city's management team also maintains 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 previous first- and prior-subordinate liens. The city also approved the creation of a surcharge that established 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 toward future capital projects. All told, total available reserves are an identified strength, equivalent to about seven months of operating expenses and projected to grow during fiscal 2021. Recent draws on reserves have instead come from using restricted capital recovery fees to cash defease maturities in order to make debt service more level.

Similar to the strong financial management policies of the general fund, the water rate stabilization reserve—funded with 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 more than 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 about $971 million in capital expenditures through fiscal 2025, much lower than the rolling five-year average at the peak of the capital budget a decade ago. About 60% of that is expected to be financed with additional debt, including $276 million in state loans. AWU already executed two loans for about $120 million with the Texas Water Development Board earlier in 2020 for general capital improvement plan projects.

As of Dec. 31, 2018, the net pension liability for the City of Austin Employees' Retirement System (COAERS) was $1.53 billion and the Governmental Accounting Standards Board (GASB) funded ratio was 67.6%. As of Dec. 31, 2019, the net pension liability is $1.56 billion, with a funded ratio of 63.5%. Based on updated actuarial assumptions including a 7.0% discount rate (down from 7.5%), the plan is expected to amortize over an extended 40-year period. AWU has an allocable share of about 10% of the net pension liability.

**Related Research**

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020, April 28, 2020

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