FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades Spotsylvania County, VA's Water & Sewer Revs to 'AA+' from 'AA-'; Outlook to Positive

Thu 08 Oct, 2020 - 2:34 PM ET

Fitch Ratings - New York - 08 Oct 2020: Fitch Ratings has assigned an 'AA+' rating to the following bonds issued by Spotsylvania County, VA:

--$48.1 million water and sewer revenue refunding bonds, series 2020.

The bonds are scheduled to sell via competition the week of Oct. 19, 2020. Proceeds will be used to finance capital improvements to the water and sewer system (the system), advance refund the series 2010A and 2010B bonds and pay costs of issuance.

In addition, Fitch has upgraded the rating on the following parity bonds:

--Approximately $115 million water and sewer revenue bonds, series 2010A, 2010B (pre-refunding) 2013, 2015 and 2019A to 'AA+' from 'AA-'.

Fitch has assessed the Standalone Credit Profile (SCP) of the system at 'aa+'.

The Rating Outlook has been revised to Positive from Stable.

ANALYTICAL CONCLUSION

The upgrade of the bond rating to 'AA+' from 'AA-' and assessment of the SCP at 'aa+' reflect exceptionally low net leverage of 1.2x in fiscal 2019 (measured as net adjusted debt-to-adjusted funds available for debt service [FADS]) within the framework of very strong revenue defensibility and very low operating risks, both assessed at 'aa'. The upgrade reflects an improved and stronger than anticipated financial position, and the Positive Outlook reflects Fitch's view that, should net leverage materialize as currently projected amid an uncertain rate of annual capital spend, upward rating could be warranted over the next two years. The CIP will be financed in large part by the system's strong cash balances and a limited amount of additional debt, as well as planned rate adjustments and ongoing customer growth.

CREDIT PROFILE

Spotsylvania County (Issuer Default Rating [IDR] AAA/Stable) is a mostly residential community located in northeastern Virginia along the I-95 Interstate corridor, within commuting distance of the Washington, D.C. (55 miles) and Richmond, VA (55 miles) metropolitan areas. Proximity to these two large employment centers has helped develop the county into a wealthy bedroom community, with development especially prevalent in the northeast portion of the county closest to I-95.

While many residents commute outside of the county for work, employment trends inside the county are positive. Over the past six years the county has continued to add jobs in healthcare, construction, retail and wholesale trade, local government, and professional and other services on par with the rate of the rest of the growing state economy.

The system provides retail service to approximately 29,300 mostly residential water and sewer accounts, as well as wholesale water service via a perpetual contract since 1995 to the city of Fredericksburg, VA (the city) and wholesale wastewater treatment (since 1981). The current wastewater agreement will dissolve upon the decommissioning of the county's FMC wastewater treatment plant (WWTP) that currently services the city. The agreement will be reestablished on a perpetual basis concurrent with the expansion of the county's Massaponax WWTP, a bigger plant that can more efficiently accommodate the city wastewater flows and an overall expanding customer base. Customer concentration is minimal and wholesale revenues from Fredericksburg account for a moderate 5% of system revenue on average.

Coronavirus Considerations

The recent outbreak of coronavirus has not resulted in material changes in the system's revenue and cost profile to date. Nonetheless, in the interest of coronavirus customer relief, the county postponed a planned fiscal 2021 rate increase and will revisit rate increase proposals during calendar year 2021. Average consumption rates remain stable with pre-coronavirus levels. Positively, the county experienced a 57% increase in new connections yoy from 2019 to 2020, largely attributable to the construction of several large multifamily buildings. However, Fitch's ratings remain forward-looking in nature, and the agency will continue to monitor developments related to the severity and duration of the virus outbreak, as well as revise expectations for future performance as appropriate.

KEY RATING DRIVERS

Revenue Defensibility 'aa'

Very Strong Rate Flexibility; Expanding Customer Base

Revenue defensibility is very strong, supported by a growing service area with very favorable demographics and demand characteristics. Rates are considered affordable to more than 89% of the population.

Operating Risks 'aa'

Low Cost Burden; Manageable Capital Needs Driven by Expansion

The system's operating cost burden is less than $4,900 per million gallons produced in fiscal 2019. Continued investment in the system should keep the life cycle ratio low.

Financial Profile 'aaa'

Very Strong Financial Profile with Extremely Low Leverage

System leverage has been declining and was 1.2x in fiscal 2019. Coverage of full obligations is over 2x and cash balances were 1,754 days at the end of fiscal 2019. Moderate debt plans over the next five years will increase leverage above recent historical levels, but sustained revenue growth at currently robust levels should keep leverage below 5x and favorable to the rating in Fitch's base and stress scenarios.

ASYMMETRIC ADDITIVE RISK CONSIDERATIONS

No asymmetric additional risk considerations affected this rating.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Sustained leverage below 5x amid the projected ramp-up in spending expected in the next two years during implementation of an expansion-related capital program, in the context of 'aa' Revenue Defensibility and Operating Risk assessments;

--Maintaining operating costs below $6,500 per million gallons produced as the expansion-related capital program proceeds.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Higher debt or lower cash balances that result in leverage in excess of 5x on a sustained basis, in the context of 'aa' Revenue Defensibility and Operating Risk assessments;

--Increases in operating costs above $6,500 per million gallons produced.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

SECURITY

The bonds are payable from a senior lien pledge of the net revenues of the county's water and sewer system (the system), including connection fees.

REVENUE DEFENSIBILITY

Revenue defensibility is assessed at 'aa'. The system serves as a monopoly provider and the county has independent rate-raising authority. Residential charges are considered affordable for the vast majority of the population, with monthly charges based on Fitch's standard 7,500 gallons per month (gpm) and 6,000 gpm of flow equating to an average residential bill of around $90. In-county consumption levels are closer to 5,000 gpm, resulting in even greater rate affordability and flexibility.

Rates have been consistently raised by around 2%-3% annually in recent years. The county typically sets rates in three-year increments with the option to go back to the board at any time, if needed. In fiscal 2021 (July 1, 2020-June 30, 2021), in consideration of the adverse impacts of the coronavirus on the customer base, the county kept rates flat at the same level as fiscal 2020. Beginning in fiscal 2022, the county plans to revisit the rate-setting process, likely raising rates annually by around 4%-5% over several years in order to support rising capital needs.

Customer growth is historically strong (1.5% in each of the past two years) and remains ongoing. Additional residential and commercial development continues to occur mostly in the northern sections of the county and in pockets along the I-95 corridor where the bulk of county infrastructure and service is already provided. The county's unemployment rate remained low even during the 2009 recession, and at 2.9% in 2019 remained well below the national rate (3.7%). Median household income is approximately 142% of the U.S. average. Poverty levels are well below those of the state and the U.S.

OPERATING RISKS

The system's operating risks are assessed at 'aa' which takes into consideration a very low operating cost burden with moderate life cycle investment needs supported by adequate capital investment. The system's operating cost burden has averaged about $4,965 per million gallons (mg) of flows over the last five years, below Fitch's $6,500 per mg threshold for the current 'aa' subassessment. The current capital improvement program (CIP) will provide for the expansion of the system's largest treatment plants, potentially resulting in higher operating costs. Management's ability to sustain an operating cost burden below the $6,500/mg should sustain the subassessment at the 'aa' level.

The capital planning and management subassessment of 'aa' reflects a life cycle ratio of 37% as of fiscal 2019, comfortably below Fitch's 45% 'aa' subassessment threshold. Declines in capital spending as a percent of depreciation since fiscal 2015 have resulted in a steadily rising lifecycle ratio (up from 31% in fiscal 2015) that nonetheless remains below the 45% threshold.

The system's five-year CIP totals an approximate $155.6 million and represents an increase in annual spending over prior years that should likely reverse the rising lifecycle trend. Much of the spending will expand current capacity for water and sewer treatment from 21.0 million gallons per day (mgd) and 13.7 mgd to 24.0 mgd and 18.4 mgd, respectively. Current capacity levels are sufficient to meet existing demand, however given the county's ongoing and prospective growth rates, future treatment capacity will be necessary. Existing water supply is derived from the Ni and Rappahannock Rivers and stored in two reservoirs. Available supply from these resources is considered robust and supportive of long-term demand expectations, inclusive of ongoing growth trends.

FINANCIAL PROFILE

The financial profile is assessed at 'aaa'. Fitch's calculated net leverage is currently very low at 1.2x for fiscal 2019 and has declined from 3.6x since fiscal 2015. The decline in leverage resulted from an amortizing debt burden and steadily growing cash levels. Additional debt issuances planned to support the growing CIP and a reduction of the very high cash balances to fund a portion of capex needs should result in increased leverage over the next five years that should nonetheless remain below Fitch's 5x threshold for the 'aaa' leverage subassessment. The Positive Outlook reflects Fitch's view that should net leverage materialize as currently projected amid an uncertain rate of annual capital spend, upward rating could be warranted over the next two years.

The liquidity profile is neutral to the rating with Fitch's calculation of coverage of full obligations (COFO) at 2.5x and an exceptionally high liquidity cushion of 1,754 days at the close of fiscal 2019. Cash balances have historically been very high due in part to an internal policy to maintain a utilities fund balance of at least 100% of the average of the last three years' total revenues. Additionally, the rate of cash-funded capex relative to annual depreciation has fallen below 100% in recent years, resulting in the future accumulation of liquid resources. Fitch calculated all-in debt service coverage for the year was 2.5x.

Connection fee revenues have averaged approximately $5.6 million over the past five years given continued growth in the service area. COFO excluding connection fee revenues was materially lower at 1.9x in fiscal 2019, albeit still sound and neutral to the rating. COFO excluding connection fees has remained substantially below COFO over time given the robust rate of customer growth driving connection fee collections upward. However, despite a strong history of connection fee revenue, management conservatively budgets in regards to variable revenue sources and has raised in-system customer rates over time to fortify recurring revenues should growth eventually subside.

Fitch Analytical Stress Test (FAST)

The FAST base case was informed by the system's financial forecast. Assumptions include an estimated $155.6 million CIP, financed in part with around $57 million in additional debt over the next five years, rate increases ranging from 3-5%, and connection fee revenue of around $16.5 million. The base case results point to net leverage increasing to 4.2x by fiscal 2022 but declining thereafter. The increase in leverage results from an increase in assumed outstanding debt but also the planned reduction in cash balances that are netted against debt balances in the ratio. Cash is expected to remain over an estimated $48 million, at levels well in excess of annual operations. Given the county's conservative budgeting of connection fee revenue, available cash is likely to exceed current expectations as connection fee revenue is applied towards capital spending.

The FAST stress case, which layers a stress of an additional 10% in capital spending on the base case, also shows a one-year spike to 4.8x in fiscal 2022 before subsiding through the five-year look. Management expects the rate of capex beyond the current five-year horizon to subside, resulting in a steady reduction in net leverage levels.

The issuer's operating forecast accounted for potential effects of the coronavirus pandemic in fiscal 2021, therefore Fitch did not consider an additional sensitized scenario specifically incorporating pandemic-related risks.

SOURCES OF INFORMATION

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Eva Rippeteau
Director
Primary Rating Analyst
+1 212 908 9105

Fitch Ratings, Inc.
Hearst Tower 300 W. 57th Street New York 10019

Allison Clark
Associate Director
Secondary Rating Analyst
+1 646 582 4562

Kathy Masterson
Senior Director
Committee Chairperson
+1 512 215 3730

MEDIA CONTACTS

Sandro Scenga
New York
+1 212 908 0278
sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

U.S. Water and Sewer Rating Criteria (pub. 03 Apr 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Spotsylvania County (VA)	EU Endorsed

DISCLAIMER

READ LESS

COPYRIGHT

of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.
For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001
Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see https://www.fitchratings.com/site/regulatory), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

READ LESS

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's approach to ratings endorsement so that ratings produced outside the EU may be used by regulated entities within the EU for regulatory purposes, pursuant to the terms of the EU Regulation with respect to credit rating agencies, can be found on the EU Regulatory Disclosures page. The endorsement status of all International ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for all structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

US Public Finance   Infrastructure and Project Finance   North America   United States