S&P Global
Ratings

RatingsDirect®

Summary:

Spotsylvania County, Virginia; Water/Sewer

Primary Credit Analyst:
Edward R McGlade, New York (1) 212-438-2061; edward.mcglade@spglobal.com

Secondary Contact:
Alan B Shabatay, New York + 1 (212) 438 9025; alan.shabatay@spglobal.com

Table Of Contents

Summary:

Spotsylvania County, Virginia; Water/Sewer

Credit Profile		
US$48.13 mil wtr and swr system rev and rfdg bnds ser 2020 due 12/01/2040		
Long Term Rating	AA/Stable	New
Spotsylvania Cnty WS		
Long Term Rating	AA/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AA' long-term rating to Spotsylvania County, Va.'s 2020 water and sewer system revenue and refunding bonds. At the same time, we affirmed our 'AA' rating on the county's parity system revenue debt. The outlook is stable.

Based on our review, we view the legal provisions as credit neutral. Net revenues of the county's water and sewer system secure the bonds. No debt service reserve will be pledged to the bonds.

The rate covenant is 1.15x annual debt service coverage (DSC), and 1x for outstanding debt. The additional bonds test stipulates the county's net revenues provide 1.0x maximum annual debt service (MADS) during 12 consecutive months of the last 24 months, or the county must demonstrate compliance with its rate covenant for two full fiscal years.

The proceeds of series 2020 will be used to refund a portion of the series 2010A and B bonds, finance capital improvements, and pay for cost of issuance.

Credit overview

The rating reflects our view of management's operational and financial policies that have enabled the system to generate consistently strong coverage and liquidity levels. The rating also reflects our opinion of the county's very strong enterprise risk profile and extremely strong financial risk profile. The final rating is notched down to reflect increasing capital costs, which may pressure the system's DSC and liquidity.

S&P Global Ratings acknowledges a high degree of uncertainty related to the effects of COVID-19, including the rate of spread and peak of the outbreak. We believe measures to contain COVID-19 have pushed the economy into a deep downturn, although this area has begun to show signs of a meaningful recovery. Although we consider that the system's financial flexibility could likely be affected by reduced economic activity in the region depending on the length of the downturn, in our view, this risk is somewhat mitigated by the system's strong liquidity position, which we believe provides sufficient cushion for short-term disruptions. While we continue to monitor events related to COVID-19, we do not currently anticipate it affecting the system's ability to maintain budgetary balance and make debt service payments. For more information, see "All U.S. Public Finance Sector Outlooks Are Now Negative" (published April 1, 2020, on RatingsDirect) and "The U.S. Economy Reboots, With Obstacles Ahead" (published Sept. 24, 2020).

The enterprise risk profile reflects our view of the system's:

- Service area participation in the broad and diverse Washington-Arlington-Alexandria metropolitan statistical area (MSA);
- Sufficient capacity for both water and sewer systems, and planned additional capacity expansions to meet anticipated growth needs;
- Rates that we generally view as affordable when benchmarking against Spotsylvania County's median household effective buying income (MHHEBI) and poverty rates; and
- Operational management practices and policies that we view as strong.

The financial risk profile for the underlying rating reflects our view of the system's:

- All-in DSC of at least 2.0x including availability fees, and 1.5x excluding availability fees over the last three fiscal years;
- Moderately leveraged, at 29.6% debt-to-capitalization ratio and significant additional debt needs of $51 million during the five-year capital plan;
- Strong liquidity position of unrestricted cash $81 million at fiscal year-end 2019 and a cash equivalent of over 1,754 days' cash; and
- Financial management practices and policies that we view as strong.

We expect the outlook to remain stable over the two-year outlook period. We also expect the system to maintain all-in DSC at levels we consider strong, and cash levels we consider extremely strong. In addition, the service area's participation in a broad and diverse MSA economy adds stability to the rating.

Environmental, social, and governance factors

Overall, we believe that management has mitigated most of the system's environmental, social, and governance (ESG)-related risk by adopting, adhering to, and adjusting its operating and financial policies and procedures. We view most of the district's other ESG risk factors as being on par with those of other similarly rated sewer utilities. There are some factors, which have increased risk as compared to other utilities. The county's social risk, while elevated due to increased pressures on the service area economy because of higher public health and safety risks related to COVID-19, will directly increase the system's overall social risks factors.

Stable Outlook

Upside scenario

We could raise the rating if the system is able to outperform financial projections, particularly for all-in coverage, during and following the completion of the current capital improvement plan (CIP).

Downside scenario

Conversely, should financial metrics erode materially from projected levels, we may consider a lower rating.

Credit Opinion

Enterprise risk

Spotsylvania County is about halfway between Washington, D.C., and Richmond. While nearly three-fourths of the county's labor force commutes outside the county for employment, Spotsylvania County continues to expand and diversify its employment base, targeting growth in health care, manufacturing, defense/IT/cyber, and tourism. The county's population has increased about 7.5% in the past 10 years.

Spotsylvania County's water and sewer system customer service base is primarily residential, (93% and 94%, respectively, as of 2019) and covers a service area of 400 square miles. The county's 10 leading customers consist primarily of apartment complexes and hospitals. The top 10 represent nearly 5% of operating revenues in fiscal 2019, which we consider a diverse customer base. Over the past 10 years, demand in water supply has increased an annual average of 1.1% and sewer flows by 5.06%. In response to this modest growth and management's expectation for that growth to continue, the system is expanding capacity of both the water and sewer systems.

The water system consists of two water treatment plants, the Ni River water treatment plant (WTP) and the Motts Run WTP, with a combined treatment capacity of 21 million gallons per day (mgd), with an average daily demand of 10.6 mgd and a peak of 15 mgd in 2019. After the expansion of Motts Run WTP, total capacity will be 24 mgd. The county also serves the city of Fredericksburg. The county permanently reserves capacity for the city, in accordance with the joint ownership agreement for the Motts Run Water WTP; revenue (combined water and sewer) from Fredericksburg represents 5% of operating revenue.

The sewer system includes three wastewater treatment plants (WWTPs)--Massaponax, FMC, and Thornburg WWTPs--which provide total treatment capacity of 13.7 mgd. Combined daily flows in 2019 were an average 10.3 mgd. To accommodate growth and the decommissioning of the FMC WWTP, the Massaponax WWTP will expand about 18 mgd, providing the system with a combined capacity of 18.2 mgd.

We benchmark our analysis of market position, which is an input to the enterprise risk profile, to both MHHEBI and the county poverty rate. MHHEBI for Spotsylvania County is 133% of the national average. The monthly equivalent of a combined residential water and sewer bill is $83.12 using our benchmark of 6,000 gallons of usage, or only 1.41% of MHHEBI when annualized in 2018. Given the high income levels and that the county's 6.9% poverty rate is below the U.S. average (15%), we view rates as generally affordable. We believe rates will remain so after the combined bill rate increases of 4% to 5% go into effect in 2022. Due to COVID-19-related pressures, management postponed the fiscal 2021 rate increase and instead has kept rates where they were in fiscal 2020.

We have assigned an operational management score of '2' on a six point scale, with '1' being the strongest. The county has operational policies and practices that we consider good. Both water and sewer systems have sufficient capacity in the near term and will be expanded to meet future demand growth. Management reports the water and sewer system complies with all state and federal regulations. The system maintains an emergency interconnection with Stafford County through Fredericksburg and has emergency and drought management plans in place. The utility performs in-house modeling of assets to prioritize maintenance needs. The board has rate-setting autonomy and pre-approves rate adjustments in three-year cycles. In addition, the system has succession planning for personnel and uses Spotsy

Alert, where customers can sign up for emergency alerts.

Financial risk

Our assessment of the system's financial risk profile as extremely strong reflects the county's historically extremely strong DSC and liquidity, and a good financial management framework. Net available revenues from operations (including availability fees) during 2016-2019 have yielded 2.0x-2.1x DSC. Excluding availability fees, coverage is 1.8x in 2019, which we consider very strong. We think continued strength in coverage without availability fees is very important to our rating on the utility because one-time sources of revenue can be particularly volatile and vulnerable to changes in economic conditions. Based on management's forecast, S&P Global Ratings calculates all-in coverage based solely on recurring revenues to range between 1.04x–1.08x during the five-year forecast.

Liquidity remains extremely strong at ending fiscal 2019 with $81.0 in unrestricted reserves, or 1,754 days' cash in hand. The county has built up reserves through rate adjustments in advance of planned capital projects, an average annual increase in water consumption of 1.1%, and sewer flows of 4.4% over the last 10 years, coupled with rate adjustments in advance of the 2021 CIP for plant expansions. Management indicates that it does plan to draw down on cash, about $38 million, for capital purposes over five years.

The total CIP is $52.7 million for 2021. Management, because of COVID-19 and the potential related economic downturn, has adopted a capital plan for just one fiscal year at this time. It continues to update its five-year CIP and will revisit whether to adopt the full five-year plan later this year. The previous five-year plan (fiscal years 2020-2024) totaled $162 million. Management expects it will need to issue $51 million in new debt in fiscal years 2022 through 2025. We view the CIP as manageable given the planned rate increases, and the projected level debt service payments. The system is moderately leveraged at 29.6%, with $115 million in debt outstanding as of June 30, 2019; we anticipate that the leverage position will increase during the water and wastewater treatment plants expansion project.

We have assigned a financial management score of '2', with '1' being the strongest. Assumptions incorporate rate increases and planned debt issuances. The board receives quarterly budget reports. Management performs five-year financial projections, has a liquidity policy that targets maintaining net revenues of an average of past three years, a debt policy of 1.3x coverage, and has transparent disclosures.

Related Research

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