

RATING ACTION COMMENTARY

Fitch Revises Outlook to Stable; Rates Spotsylvania County, VA's Water & Sewer Revs 'AA+'

Fri 07 Oct, 2022 - 1:45 PM ET

Fitch Ratings - New York - 07 Oct 2022: Fitch Ratings has assigned a 'AA+' rating to the following Spotsylvania County, VA (the county) obligations:

--Approximately \$63.0 million water and sewer revenue bonds, series 2022.

The bonds are scheduled to sell via competitive sale the week of Oct. 17. The proceeds will be used to (a) finance a program of capital improvements to the county's water and sewer system, and (b) pay issuance costs.

In addition, Fitch has affirmed the following outstanding obligations at 'AA+':

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stand-alone basis irrespective of its relationship with and credit quality of the county (Issuer Default Rating AAA/Stable).

The Rating Outlook has been revised to Stable from Positive.

ANALYTICAL CONCLUSION


The Outlook revision to Stable from Positive reflects a capital plan that has increased materially since last review, due to inflationary costs and labor increases. Expected borrowing has nearly doubled to almost \$200 million. With these revisions, leverage is expected to be maintained close to 6.0x for a few years, consistent with the current rating.

The affirmation of the bond rating at 'AA+' and assessment of the SCP at 'aa+' reflect the system's very strong revenue defensibility and very low operating risk, both assessed at 'aa'. Leverage (measured as net adjusted debt-to-adjusted funds available for debt service), while remaining exceptionally low, rose slightly from fiscal 2020 to 1.4x in fiscal 2021. The system is well positioned to absorb planned capital spending that, while driving leverage higher than current levels, remains supportive of the 'AA+' rating.

CREDIT PROFILE

Spotsylvania County is a mostly residential community located in northeastern Virginia along the I-95 Interstate corridor, within commuting distance of the Washington, D.C. and Richmond, VA metropolitan areas. Proximity to these two large employment centers has helped develop the county into a bedroom community exhibiting above average income levels, with development especially prevalent in the northeast portion of the county closest to I-95.

Water is supplied from the county's Ni River Reservoir, the Motts Run Reservoir (jointly owned with the city of Fredericksburg [the city]) and the Rappahannock River. Production is via two water treatment plants (WTPs) with a combined capacity of 21 million gallons per day (mgd). The system provides retail service to approximately 33,600 mostly residential water and 32,500 sewer accounts supporting over half of the county's population.

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Fitch considers the system to be a related entity to the county for rating purposes given the county's oversight of the system, including the authority to establish rates and direct operations. The credit quality of the county does not currently constrain the bond rating. However, as a result of being a related entity, the issue ratings could become constrained by a material decline in the general credit quality of the county.

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 for around 90% of the population.

Operating Risks 'aa'

Very Low Cost Burden; Manageable Capital Needs Driven by Expansion

The system's operating cost burden is comfortably supportive of the operating risk assessment. Continued investment in the system should keep the life cycle ratio low.

Financial Profile 'aa'

Very Strong Financial Profile with Rising Leverage

The revision in financial profile to 'aa' from 'aaa' reflects the system's entrance into a robust capital spending and borrowing phase, which is expected to result in leverage sustained above 5.0x in Fitch's base and stress case scenarios.

Asymmetric Additive Risk Considerations

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

--Sustained leverage in excess of 7x on a sustained basis in Fitch's base and stress cases, in the context of 'aa' revenue defensibility and operating risk assessments;

--Operating costs consistently above \$6,500 per million gallons produced could pressure the operating risk assessment.

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, 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) of water use and 6,000 gpm of sewer flow. In-county consumption levels are closer to 5,000 gpm, resulting in even greater rate affordability and flexibility.

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Service area characteristics are considered very favorable. Customer growth continues to rise, with a five-year compound annual growth rate of 1.7% for the five years ended fiscal 2021. The county's unemployment rate was 72% of the nation's in 2021. Median household income is strong at approximately 140% of the U.S. average.

Connection fee revenue historically has accounted for about 15% of total revenue with robust development still anticipated. Customer concentration is minimal and revenues from Fredericksburg account for a moderate 5% of system revenue on average.

Operating Risks

The system's operating risk is 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 close to \$5,000 per million gallons (mg) of flows over the last five years. While the life cycle ratio has risen to 39%, five-year average capital expenditure to depreciation has reached a high of 96%. As the system enters a capital-intensive phase, results are expected to strengthen, lending further support to the current assessment.

The system's five-year fiscal 2023 through 2027 capital improvement plan (CIP) totals \$276.6 million, growing over 50% from the last plan. The CIP is primarily focused on expansion in order to ensure sufficient plant capacity for the next 50 years. Growth in the CIP is attributable to significant increases in construction costs for the county's three largest projects. Both the Massaponax and Thornburg WWTP expansions have been bid, and construction is underway at Thornburg. The Motts WTP expansion project has not yet been bid, leaving further cost escalation unknown. Along with the increases, an additional \$11.2 million resiliency project has been added to the Motts WTP expansion work. Revenue bonds provide for the majority of funding, with grants and pay-go also supporting the program.

Financial Profile

The financial profile is assessed at 'aa'. After declining the past four fiscal years from 2.2x in

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Given the continued service area growth, connection fee revenues registered about \$10.2 million in fiscal 2021. Projections show stabilization at average historical levels for fiscal 2022 forward. COFO excluding connection fee revenues was materially lower at 1.4x in fiscal 2021, albeit still sound and neutral to the assessment. County policy limits debt service coverage to no less than 1.0x excluding connection fee revenue.

Fitch Analytical Stress Test (FAST)

The FAST considers the potential trend of key ratios in a base case and a stress case. The stress case is designed to impose capital costs 10% above expected levels and evaluate potential variability in projected key ratios. The base was informed by the system's forecast and CIP, including fiscal 2022 unaudited results. Assumptions include full execution of the capital plan with debt issuance of about \$196.5 million.

With these considerations, Fitch's base case results show leverage gradually rising to 5.5x by fiscal 2025 as debt is added. The FAST stress case shows a similar trend, with leverage rising to about 6.4x in fiscal 2025. Both cases show declines thereafter. Management expects the rate of capex beyond the current five-year horizon to subside, after which leverage will continue to decline.

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

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ENTITY / DEBT ⇅

RATING ⇅

PRIOR ⇅

Spotsylvania County
(VA) [Water, Sewer]

Spotsylvania County
(VA) /Water & Sewer
Revenues/1 LT

LT

AA+ Rating Outlook Stable

Affirmed

AA+ Rating
Outlook
Positive

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APPLICABLE CRITERIA

[U.S. Water and Sewer Rating Criteria \(pub. 18 Mar 2021\) \(including rating assumption sensitivity\)](#)

[Public Sector, Revenue-Supported Entities Rating Criteria \(pub. 01 Sep 2021\) \(including rating assumption sensitivity\)](#)

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Spotsylvania County (VA)

EU Endorsed, UK Endorsed

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