S&P Global Ratings

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Summary:

Spotsylvania County, Virginia; Water/Sewer

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Credit Profile		
US$62.77 mil wtr and swr sys rev bnds ser 2022 due 12/01/2047		
Long Term Rating	AA/Positive	New
Spotsylvania Cnty WS		
Long Term Rating	AA/Positive	Affirmed

Credit Highlights

- S&P Global Ratings revised the outlook to positive from stable and affirmed its 'AA' long-term rating on Spotsylvania County, Va.'s parity water and sewer revenue debt outstanding.
- At the same time, we assigned our 'AA' rating, with a positive outlook, to the county's series 2022 water and sewer revenue bonds.
- Total system debt following this issuance is about $209 million.
- The outlook revision reflects our belief that historic financial metrics are sustainable in the long term due to continued growth in the service area that has bolstered the system's debt service coverage and liquidity position. We believe this financial position is sustainable given the willingness to increase rates, which we view as affordable, and because the system has sufficient financial capacity to undertake its $276.6 million capital improvement plan.

Security

Net revenues of the county's water and sewer system secure the bonds. The rate covenant for the Series 2022 bonds is 1.15x annual debt service coverage (DSC) and 1x for outstanding debt. The additional bonds test stipulates that the county's net revenues provide 1.0x maximum annual debt service (MADS) during 12 consecutive months of the previous 24 months, or the county must demonstrate compliance with its rate covenant for two full fiscal years. No debt service reserve will be pledged to the bonds.

Proceeds of the approximately $63 million issuance will be used to provide funding for growth-related capital projects to better service the I-95 Corridor. We view the bond provisions as credit neutral.

Credit overview

The rating reflects the district's well-embedded strategic and financial planning efforts, which have led to financial performance that remains consistent with the 'AA' rating level, in our view. This is reflected within the long-term financial profile of the utility system and management's practice of continually posting strong financial metrics through consistent rate increases. These factors, combined with the large and growing customer base, have helped Spotsylvania County, in our view, achieve consistent financial results through economic cycles. Offsetting this and weakening our view of overall credit quality for the county's water and sewer system are increasing capital costs from the system's $276.6 million capital improvement plan (CIP). In our view, this CIP, which is both debt- and cash-financed, may pressure the system's DSC and liquidity in the medium term.

Environmental, social, and governance

Overall, we believe that utility management has mitigated most of the system's environmental, social and governance (ESG) risk by adopting, adhering to, and adjusting its operating and financial policies and procedures. Water loss and infiltration & inflow (I&I) are minimal for the system, with both metrics below 10%. Due to the economic strength of the service area, we view positively the affordability of rates despite plans to increase rates by 8% to 12% annually over the next three years. The county has not detected PFAS in its water and sewer system, and this, if continued, would reduce future increased treatment costs associated with achieving regulatory compliance. As with most of the state of Virginia, the utility is continuously monitoring changes in legislation and permitting to ensure compliance with existing and future regulatory requirements. ESG credit risk is considered neutral in our analysis.

Outlook

The positive outlook reflects our expectation that the pattern of historically good financial operations is likely to continue despite the extensive CIP. Supporting this view is the stable and mostly residential user base located in the broad and diverse Washington-Arlington-Alexandria metropolitan statistical area (MSA) and the county's willingness to raise rates to meet its financial obligations. County long-term planning efforts, in our view, will help foster a more predictable framework for future financial performance.

Downside scenario

We could return the outlook to stable or lower the rating if the service area economy deteriorates, leading to a worsening of our market position and overall enterprise risk profile scores. We could also do so should coverage levels and liquidity consistently fall to lower levels due to a lack of timely rate increases to recover increased debt service and capital costs.

Upside scenario

As mentioned above, we could raise the rating if the system is able to meet or outperform financial projections, particularly for all-in coverage and liquidity, during and following the completion of the current CIP.

Credit Opinion

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

- Stable and primarily residential customer base that is expected to continue to grow. Income levels are very strong, in our opinion, based on the county's median household effective buying income (MHHEBI) of 133% of the national level in 2021. Service area participation in the broad and diverse Washington-Arlington-Alexandria MSA economy adds further diversity and stability. In addition to serving Spotsylvania County, the utility system provides wholesale water and wastewater treatment to the neighboring city of Fredericksburg, although it has only accounted for $2.2 million in revenues as of 2022;
- Combined water and sewer rates that we believe are affordable in the context of the service area's very high MHHEBI and low county poverty rate (6.6%), and with three more years of rate adjustments adopted at this time. The total combined rate is $83.12 for 6,000 gallons of monthly usage, or about 1.3% of county MHHEBI; and
- Good operational management assessment, as the utility has adequate capacity for both systems to meet demand

for the medium-term horizon, although there have been some growth concerns over the past few years. The utility follows a training plan and has been actively planning for potential emergencies, including cyber attacks. Rates are typically reviewed and adjusted every three years with the option to be revisited by the board at any time.

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

- Financial metrics that have remained extremely strong over the past five years because of sufficient cost-control measures and regular rate increases. As of fiscal year-end 2021, coverage has slightly declined to 2.4x, from 2.9x in fiscal 2020. Declines in coverage were driven by availability fees returning to normalized levels following a spike in 2020 from two new large apartment complexes and other development growth. Management projects coverage will remain at or above 1.5x DSC, with conservative assumptions regarding future revenues and expenditures. Included in our calculation of Spotsylvania County's DSC are the aforementioned availability fees, which bolster coverage on a yearly basis. When excluding availability fees, coverage remains robust on a historic basis, but we note that excluding availability fees makes DSC reach a low of 1.1x when looking at coverage on a projected basis. Management has expressed that over time, they intend on increasing debt service recovery charges so that DSC will still be high even when excluding these availability fees, which supports our coverage assessment in the long term;
- Extremely strong liquidity and reserve position that we believe is sustainable in the near term despite the utility's using cash to fund capital needs. Unrestricted cash and unrestricted investments at the end of fiscal 2021 totaled about $98.2 million, equivalent to 1,642 days of operating expenses, which we consider robust. Reserves will decline to a low of about $70.7 million in 2026, or about 890 days' cash;
- Significant outlined capital needs, with $196.5 million in debt plans over the next five years. In our view, the utility's debt-to-capitalization ratio of 40.4%, including this issuance, is moderately low. The CIP for fiscal years 2022-2027 totals $276.6 million. In addition to this issuance, the utility has plans to issue additional debt through FYE 2026 for growth-related purposes, which may change based on economic conditions; and
- Well-defined and comprehensive financial management practices and policies that we consider good under our Financial Management Assessment (FMA) methodology. We view positively the utility's financial policies and robust long-range capital and financial planning, which ultimately support a stable financial profile.

Related Research

Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022