Spotsylvania County, Virginia

Revenue Bonds
New Issue Report

Ratings

New Issue

Water and Sewer System Revenue Refunding Bonds, Series 2015	AA–

Outstanding Debt

Water and Sewer System Revenue Bonds	AA–

Rating Outlook

Stable

Related Research

2015 Water and Sewer Medians (December 2014)

2014 Outlook: Water and Sewer Sector (December 2013)

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New Issue Details

Sale Information: $59,000,000 Water and Sewer System Revenue Refunding Bonds, Series 2015, via competitive sale the week of July 27.

Security: A senior lien pledge of the net revenues of the water and sewer system (the system).

Purpose: To current refund the outstanding principal amount of the system's revenue refunding bonds, series 2005, to advance refund a portion of the county's system revenue bonds, series 2007, and to pay certain costs of issuance of the 2015 bonds.

Final Maturity: October 2044.

Key Rating Drivers

Excellent Liquidity Mitigates Low Coverage: The system's very high cash balances provide a high degree of financial flexibility and a significant offset to low annual debt service coverage (DSC) and free cash flow (FCF) levels.

Rates Remain Affordable: Average customer charges remain low despite a recent rate restructuring to provide for greater fixed-charge coverage. The county has significant rate-setting flexibility and will likely enact an additional multiyear rate plan in early 2016.

Elevated Debt Burden: While system debt is manageable, most ratios exceed Fitch Ratings' 'AA' rating category medians. The expected issuance of additional bonds coupled with below-average payout of existing debt will leave the debt profile somewhat elevated.

Manageable Capital Program: System infrastructure is well maintained and current treatment capacity and water resources are sufficient to meet intermediate-term needs. The capital plan will focus on system upgrades and replacement projects.

Stable Suburban Residential Service Area: Spotsylvania County is a growing residential suburban community with strong income and wealth characteristics, low unemployment and a stable customer base.

Rating Sensitivities

Change in Financial Profile: Improved operating margins generated by recurring revenues may warrant upward rating action on Spotsylvania. The magnitude of liquid resources makes negative rating action unlikely absent significant financial deterioration.

Rating History

Rating	Action	Outlook/ Watch	Date
AA–	Affirmed	Stable	7/16/15
AA–	Affirmed	Stable	6/26/15
AA–	Affirmed	Stable	7/1/13
AA–	Affirmed	Stable	6/11/12
AA–	Affirmed	Stable	7/30/10
AA–	Revised	Stable	4/30/10
A	Affirmed	Stable	6/11/12
A	Affirmed	Stable	7/30/10
A	Affirmed	Stable	8/11/09
A	Affirmed	Stable	7/18/07
A	Assigned	Stable	2/8/05

Related Criteria

Revenue-Supported Rating Criteria (June 2014)

U.S. Water and Sewer Revenue Bond Rating Criteria (July 2013)

Credit Profile

Stable Operating Profile, Suburban Service Area

Spotsylvania County (GOs rated 'AA+'/Stable by Fitch) is a mostly residential community located in northeastern Virginia along the I-95 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 the interstate. Most of the middle and southern portions of the county remain largely rural; residents in those areas are served by individual septic and well systems.

The system consists of several independent raw water supply sources, distribution and collection assets (pipes), and water and sewer treatment facilities that provide retail service to approximately 30,000 mostly residential water and sewer accounts. The county also has been providing wholesale water service to the city of Fredericksburg via a long-term (perpetual) contract since 1995. Customer concentration is minimal and wholesale revenues from Fredericksburg account for roughly 6% of system revenue.

Financial Performance Improving, Strong Liquidity Remains Key

The system's financial profile is mixed. Relatively slim DSC and FCF compare poorly with 'AA' rating category medians, but cash balances are very strong. Fiscal 2014 net revenues yielded 1.6x DSC and 1.2x coverage excluding availability fees, falling considerably below the 'AA' rating medians of 2.5x and 2.3x, respectively. FCF, or net operating revenues available after paying debt service, is fairly low and unable to fully support annual depreciation expenses without available cash and debt resources.

Management historically relied heavily on new customer connection fee revenue as a source of debt service repayment and cash accumulation. However, during the national economic and housing downturn, new customer growth slowed considerably, resulting in a substantial decline in DSC levels. These slim margins prompted management to modify its billing structure to include higher fixed costs and inclining volumetric tiers. Over time, these changes have led to improved, albeit still-narrow, DSC margins.

Financial projections provided by management anticipate that fiscal 2015 will yield 1.6x DSC from all revenues and 1.2x excluding connection fees. Through fiscal 2020, including conservative rate increases and additional debt, DSC is projected to average 1.3x from all revenues and 1.1x excluding connection fees. Coverage projections are weak for the rating category and include increased annual debt service from future anticipated borrowings (occurring as soon as fiscal 2017) and reasonable assumptions in demand and customer growth. Fitch's rating reflects the expectation that strong liquidity will continue to offset low expected coverage levels. Improved DSC relative to projections could lead to a rating upgrade given other credit factors.

Cash on hand has averaged more than three years of operations over the past five fiscal years, and in fiscal 2014 nearly $68 million in unrestricted cash and cash equivalents equated to 1,462 days.

Financial Summary

($000, Audited Fiscal Years Ending June 30)	2010	2011	2012	2013	2014	2015[a]	2016[a]	2017[a]	2018[a]	2019[a]	2020[a]
Operating Statement											
Operating Revenues	24,242	25,350	25,687	27,731	28,425	29,929	30,500	30,100	32,400	34,900	37,400
Non-Operating Revenues	671	1,868	978	797	896	825	3,600	2,400	2,400	2,400	2,400
Availability Fees	3,518	2,187	3,215	2,899	3,740	3,300	2,400	2,500	2,700	2,700	2,700
Build America Bonds Subsidies	0	413	539	516	500	500	500	500	500	500	500
Gross Revenues	32,108	32,005	30,419	31,942	33,563	34,554	37,000	35,500	38,000	40,500	43,000
Operating Expenses (Excluding Depreciation)	(15,269)	(18,243)	(16,996)	(18,113)	(16,963)	(17,942)	(19,400)	(19,800)	(20,300)	(21,000)	(21,700)
Net Revenues Available for Debt Service[b]	16,839	13,762	13,423	13,829	16,600	16,612	17,600	15,700	17,700	19,500	21,300
Senior Lien Debt Service	8,344	9,969	10,555	10,699	10,607	10,702	11,145	12,200	13,700	15,200	15,200
All-In Debt Service	8,344	9,969	10,555	10,699	10,607	10,702	11,145	12,200	13,700	15,200	15,200
Coverage Ratios											
Senior Lien Debt Service Coverage (DSC) (x)	1.58	1.19	1.27	1.29	1.56	1.55	1.58	1.29	1.29	1.28	1.40
All-In DSC (x)	1.58	1.19	1.27	1.29	1.56	1.55	1.58	1.29	1.29	1.28	1.40
Senior Lien DSC (x) Excluding Availability Fees	1.16	0.97	0.97	1.02	1.21	1.24	1.36	1.08	1.09	1.11	1.22
All-In DSC (x) Excluding Availability Fees	1.16	0.97	0.97	1.02	1.21	1.24	1.36	1.08	1.09	1.11	1.22
Other Financial Statistics											
Days Cash on Hand	1,551	1,288	1,416	1,301	1,462	—	—	—	—	—	—
Days Working Capital	1,537	1,901	1,836	1,652	1,783	—	—	—	—	—	—
Debt to Net Plant (%)	40	51	49	48	49	—	—	—	—	—	—
Outstanding Long-Term Debt per Customer ($)	2,157	2,675	2,594	2,501	2,503	—	—	—	—	—	—
Outstanding Long-Term Debt per Capita ($)	973	1,199	1,158	1,112	1,125	—	—	—	—	—	—
Free Cash to Depreciation (%)[c]	96	72	45	42	59	—	—	—	—	—	—

[a]Projected. [b]Equals gross revenues less operating expenses. [c]Equals net revenues available for debt service less operating transfers out, less total debt service, divided by depreciation. Note: Numbers may not add due to rounding.

Low Rates Provide Flexibility

Significant financial flexibility is provided by the county's low rate structure. According to management, the average residential county customer consumes approximately 4,400 gallons per month (gpm) and paid a combined water/sewer bill of about $46 in 2014. This amount equates to only 0.7% median household income (MHI). When scaled up to the national consumption average of 7,500 gpm, the bill is closer to $66, or about 1% of MHI. In either scenario the county's rates are considered very low, as they fall well below Fitch's affordability threshold of 2% of MHI for combined rates.

The county's most recent approved rate plan will conclude in fiscal 2016 with a 5% rate increase. Management and the county board will convene this fall and likely propose additional rate increases beyond fiscal 2016 to sustain DSC levels at or above 1.3x including availability fees and 1.0x excluding fees through fiscal 2020. Fitch expects customer charges to remain very affordable despite anticipated increases.

Capital Plan Manageable, But Leverage to Remain Elevated

The system's five-year, fiscal years 2016–2020 capital plan totals $75.7 million. The largest projects include improvements to the system's largest water treatment plant and source, the Ni River. Additional projects include constructing new laboratory space and various water and sewer renewal and upgrade projects. Management expects to fund 83% of the capital plan with parity bonds and the remainder from internal sources.

The system's roughly $133 million debt outstanding yields fairly elevated debt metrics relative to other systems rated in the 'AA' rating category by Fitch. In fiscal 2014, debt to net plant was 49%, consistent with the 50% 'AA' rating category median, but debt per customer totaled

$2,503, exceeding the median of $1,934. Debt carrying costs are high, with all-in annual debt service equal to 34% of fiscal 2014 gross revenues, or over twice the 'AA' rating category median. However, other debt ratios are more favorable relative to the rating category medians in fiscal 2014, including debt to equity of 1.9x and funds available for debt service (total debt/net revenues) of 8.8x ('AA' rating category medians are 3.5x and 6.5x, respectively).

System leverage is projected as likely to remain above the 'AA' rating category medians through the five-year forecast, as additional parity bonds totaling $63 million are forecast to be issued in fiscal years 2017, 2018 and 2019. Inclusive of this projected new debt and accounting for the amortization of existing debt, debt per customer is shown to approach $3,000 by fiscal 2019 and annual debt service will consume roughly 40% of gross revenues by that year. The expected payout rate, also inclusive of the additional potential debt, aligns fairly well with the 'AA' rating category medians, as 43% of principal is amortized over the next 10 years and 86% is paid out within 20 years ('AA' rating category medians are 39% and 81%, respectively).

Positive Economic Profile, Manageable Growth

Wealth and income levels are well above both the state and national averages. While most residents commute outside the county for work, local employment is growing with ties to healthcare, construction, retail and wholesale trade, local government, and professional and other services. The county's historically low unemployment rate was undisturbed by the recession, and at 5.2% in March 2015 is well below the national average. MHI levels are nearly 150% of the U.S. average.

Customer growth remains positive, but the rate of growth has slowed in recent years. 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. Management projects this primarily infill development trend to yield roughly 250 new connections annually over the next several years. Although infrastructure capacity is currently solid, the county expects to double the capacity at the Ni River plant from six million gallons per day (mgd) to 12 mgd over the next five years to maintain ample supply amid anticipated customer growth as well as to improve the system's water supply delivery service amid the phase-out of smaller county water treatment plants.

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.