Fitch Ratings

06 Sep 2019 | Upgrade

Fitch Upgrades Indiana Finance Auth CWA Project First Lien Wastewater Revs to 'A+'; Outlook Stable

Fitch Ratings-Austin-06 September 2019: Fitch Ratings assigns an 'A+' rating to the following Indiana Finance Authority (IFA) bonds issued on behalf of CWA Authority, IN (CWA):

--Approximately $40.5 million first lien wastewater utility revenue bonds, series 2019A (CWA Authority Project) (Green Bonds).

The 2019A bonds are being sold to fund various CWA wastewater system (the system) capital improvements, repay draws under a line of credit, fund a debt service reserve surety policy and pay costs of issuance. The bonds are expected to sell via negotiation the week of Sept. 23, 2019.

Fitch also upgrades to 'A+' from 'A' the rating on the following outstanding IFA bonds issued on behalf of CWA:

--$559.8 million in outstanding first lien wastewater utility revenue bonds, series 2014A 2015A and 2016A (CWA Authority Project);
--$41.9 million in outstanding second lien wastewater utility refunding revenue bonds, series 2016B (CWA Authority Project).

The Rating Outlook is Stable.

SECURITY

IFA's series 2019A bonds are secured by CWA's first lien wastewater revenue bonds, series 2019A, which are senior lien obligations of CWA's system and are payable from net system revenues, on parity with CWA's other senior lien obligations. IFA's second lien bonds are secured by CWA's second lien wastewater bonds which are payable from net system revenues on a basis that is subordinate to the senior lien obligations.

KEY RATING DRIVERS

UPGRADE ON APPROVED RATES, FINANCIAL IMPROVEMENT: The rating upgrade reflects a recent three-step rate action approved by the Indiana Utility Regulatory Commission (IURC) that will improve financial margins while also providing for the bulk of remaining consent decree (CD) debt issuances and positioning CWA to fund most ongoing renewal and replacement (R&R) capital on a pay-go basis.

HIGH DEBT BUT MANAGEABLE LEVERAGE: Existing debt metrics are high and CWA's capital program is driven by regulatory requirements that rely on significant additional issuances over the next four years. While debt metrics will continue to increase over the near term, overall leverage as measured by debt relative to funds available for debt service (FADS) is more manageable and is expected to remain relatively stable through the fiscal 2024 forecast.

STABLE, IMPROVING FINANCIAL RESULTS: First and second lien debt service coverage (DSC) remains solid, although margins considering coverage of full obligations (COFO) are narrower. COFO has trended incrementally upward in recent years and is expected to achieve somewhat higher results through the forecast period. Surplus cash flows, which historically have been weak, have greatly improved with recent base rate adjustments.

RATE-REGULATED UTILITY: Despite being a rate-regulated utility, CWA has maintained a good track record of achieving positive and timely outcomes of its rate cases filed with the IURC. Recent legislation and an expedited filing process for CD-related debt costs also help to limit timing delays between incurred costs and rate recovery.

RATE AFFORDABILITY PRESSURE: The average monthly wastewater utility bill is well above Fitch's affordability threshold of 1% of median household income (MHI). Additional approved and forecasted rate adjustments, while modest, will further pressure customers.

FAVORABLE SERVICE TERRITORY: The service territory includes the city of Indianapolis (IDR AAA/Stable) and certain outlying areas. Indianapolis has a large and well diversified economy, although wealth levels are weaker than national averages.

LACK OF NOTCHING: The lack of notching between the first lien and second lien bonds reflects Fitch's view that the risk profile for second lien bondholders is largely the same as for first lien bondholders. Second lien debt accounts for only 16% of current total debt and is expected to decline in the future given all additional debt is anticipated to be issued as first lien obligations, limiting the differential in senior and second lien DSC.

RATING SENSITIVITIES

STABLE OUTLOOK ON FINANCES, LEVERAGE POSITION: The rating on CWA Authority's sewer system revenue bonds is sensitive to shifts in its sound financial margins and leverage profile. Declining leverage coupled with steady financial performance could lead to further rating improvement over time while lower than expected financial results and/or an unforeseen rise in leverage would be viewed negatively.

CREDIT PROFILE

The system is largely a retail provider of sanitary sewer service to nearly all the territory of the consolidated city (Indianapolis-Marion County). The system has approximately 245,000 customer accounts as well as six wholesale customers in neighboring communities.

CWA is a segment unit of Citizens Energy Group (CEG), which is the trade name under which the city of Indianapolis, by and through the Board of Directors of the Department of Public Utilities, provides utility services to customers in and around Marion County. On Aug. 26, 2011, CWA acquired the system's assets from the city and sanitary district (excluding the city's stormwater system assets). In addition, CWA assumed the existing debt of the wastewater system. CWA also assumed the city's obligations under the CD.

RATE ACTION, FINANCIAL IMPROVEMENT DRIVE UPGRADE

Since CWA's acquisition of the system, financial results have been sound and relatively steady despite sizeable CD-related debt issuances and resulting escalation in carrying costs. For fiscals 2017 and 2018, margins improved somewhat following a 2016 IURC two-step rate order, with total DSC for fiscal 2018 at 1.6x and COFO (which includes CWA's PILOT payments) at 1.4x; fiscal 2016 total DSC and COFO were 1.4x and 1.2x, respectively.

The IURC recently approved an additional three-step rate order (first step effective Aug. 1, 2019), which should further enhance CWA's financial position while also covering debt service costs for planned issuances through fiscal 2022. Beginning in fiscal 2020, total DSC and COFO are expected to rise to 1.7x and 1.5x, respectively, and be maintained at this level throughout the fiscal 2019-2024 forecast.

The incremental improvement in DSC and COFO as a result of the recent rate actions is a positive, but more important is the enhanced margin in surplus cash flows that will be generated. This added level of surplus revenues well-positions CWA to ultimately meet its capital needs completely on a pay-go basis in the years following completion of the CD, which in turn should allow leverage ratios to decline over time.

Prior to the IURC's last two rate orders, CWA's surplus revenues were relatively weak, equaling just $25 million in fiscal 2016 or 39% of depreciation expense for the year. However, as rates have been increased, surplus cash improved to around $55 million (70% of depreciation) in fiscal 2018. As the third step of the most recent IURC rate order becomes effective in fiscal 2022 surplus cash is anticipated to exceed $79 million (or over 115% of depreciation), compared to the $85 million-$89 million CWA anticipates in ongoing system R&R capital needs.

SIZABLE CAPITAL NEEDS DRIVEN BY REGULATORY REQUIREMENTS

The system's substantial capital costs continue to be driven by a CD that requires CWA to implement a $2 billion combined sewer overflow (CSO) long-term control plan (LTCP) by 2025. To date, CWA has completed 59 of the 64 CSO milestones and is in full compliance with the CD requirements. The current six-year CIP covers fiscals 2019-2024 and totals approximately $1.1 billion. The vast majority (approximately $790 million or 74%) of all remaining CD project costs are included in the CIP. Other projects in the current CIP are related to R&R spending, which is expected to increase from around $44 million in fiscal 2019 to over $66 million by fiscal 2024 as CD-related costs wind down. The necessary CSO-LTCP projects include the construction of several deep underground tunnels and storage facilities designed to capture 95%-97% of wet weather CSO and result in no more than two to four overflow events per typical year.

Approximately 63% of the current CIP is expected to be funded with existing and future bond proceeds (including proceeds from the current transaction). The remaining amount will be funded by pay-go sources. The significant borrowing amounts will largely be supported by the step increases approved as part of the IURC's 2019 rate order, which included debt service costs for planned issuances through fiscal 2022. CWA's final planned debt issuance of around $154 million in fiscal 2023 is expected to be supported by an additional increase in rates.

The system's debt ratios are already very high with debt per customer at over $7,950, and debt per capita at over $2,040, more than double the 'A'-category medians for utility credits. Amortization of existing debt is very slow with just 71% of principal maturing within 20 years. Despite the high debt position, overall leverage as measured by debt/FADS is more reasonable and was 9.2x in fiscal 2018, only moderately above the 8.0x 'A'-category median.

Debt ratios are expected to increase incrementally over the next few years as CWA completes additional financings to fund the remaining components of the CD. However, based on the rate adjustments provided by the 2019 IURC order as well as a forecasted future modest adjustment in the fiscal 2023 timeframe to cover CWA's expected final debt issuance, debt/FADS is anticipated to remain relatively stable and should then decrease in future years as principal amortization occurs and future capital needs are able to be met on a pay-go basis per CWA's expectations.

STABLE REGULATORY ENVIRONMENT EXPECTED

The IURC maintains jurisdiction over the approval of rates and charges of the system. In the past, the IURC's oversight has hindered timely rate increases for certain other utility systems in the state. However, legislative actions over the last several years combined with CEG'S actual results across its business lines point to a less lengthy and more certain environment going forward. First, in 2013, the Indiana Legislature passed Senate Enrolled Act (SEA) 560, which helps to mitigate the effects of regulatory lag by requiring that rate cases take no longer than 300 days from the original filing date. Failure by the IURC to act within the 300-day time frame will result in 50% of the rate request becoming effective immediately, subject to refund if the final order authorizes less than the 50%. While still a lengthy regulatory process, SEA 560 should continue to reduce the timing lag resulting from the 426 day approval CWA experienced during its 2013 rate petition. The 2016 and 2019 orders, by contrast, were received in 297 and 290 days, respectively, in compliance with the 300-day limit.

Secondly, the IURC formally approved the details and the procedures of the Environmental Compliance Plan recovery mechanism on June 14, 2012, which became applicable beginning in fiscal 2014. This tool is designed to timely recover debt service, debt service reserve funds, and costs of issuance related to CD costs. In addition, in February 2014, utility systems received the authorization (under Indiana House Bill 1132) to petition the IURC for adjustments of basic rates for certain capital costs including wastewater system replacements and upgrades.

Finally, in March 2016, the Indiana Legislature passed SEA 383, which enables regulated utilities to adjust rates to recover IURC-approved but unearned revenue requirements that may result when, for instance, revenues are affected by weather or other factors that can alter demand, either upwards or downwards. SEA 383 is essentially a revenue requirement mechanism, providing another important offset to previous rate recovery concerns.

RATES LIMIT AFFORDABILITY

Wastewater user charges following implementation of the first step associated with the 2019 IURC rate order are now above $69 per month based on Fitch's 6,000 gallon assumption for sewer utilities. This equates to over 1.8% of MHI, which is well above Fitch's 1% of MHI affordability benchmark for individual utilities. Combined water and wastewater utilities charges are also high and exceed Fitch's 2% affordability benchmark for combined systems. However, CWA's high rates have not affected collection rates, which reportedly were over 99% for fiscal 2018.

Customer rate pressures will increase further over the next few years from the two additional step increases already approved by the IURC as well as from subsequent adjustments necessary to cover CWA's final debt issuance and potentially increase the rate base to allow 100% pay-go in future years. However, future adjustments are expected to be relatively modest, somewhat limiting the additional pressure to customers.

LARGE AND DIVERSE SERVICE AREA

The city, which serves as the state capital, has an economy that remains well diversified and serves as the economic engine for the surrounding area. The city has a large retail sector as well as a significant manufacturing presence, which includes pharmaceutical and automotive companies. The city's economy also includes health services, life sciences companies and other business and professional service companies.

County unemployment for July 2019 was favorable at 3.6% relative to the state (3.6%) and national (4.0%) figures. However, wealth levels in the county are somewhat low. MHI levels in the county are 14% and 23% lower than state and national levels, respectively, while individual poverty levels of 20% are around 35% higher than the state and nation.

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In addition to the sources of information identified in Fitch's Revenue-Supported Rating Criteria, this action was additionally informed by Lumesis and by Citigroup Global Markets (underwriter).

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Additional information is available on www.fitchratings.com

Applicable Criteria

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 28 May 2019)
U.S. Water and Sewer Rating Criteria (pub. 29 Nov 2018)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
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