Fitch 2018 Outlook: Water and Sewer Sector

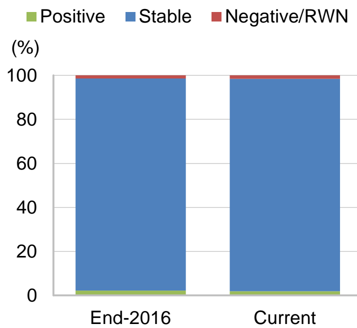
Outlook Report

Rating Outlook

STABLE

(2017: Stable)

Rating Outlooks



Source: Fitch.

Sector Outlook

STABLE

(2017: Stable)

- Financial strength continues
- Near-term capital spending down
- Debt levels manageable
- Affordability remains but diminishing

Related Research

Other Outlooks
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Other Research
Global Economic Outlook (December 2017)
2018 Water and Sewer Medians (December 2017)

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Strong Financial Results to Continue: Planned ongoing moderate rate adjustments should offset flat sales and incremental costs to preserve favorable cash flows and coverage of debt service through the outlook period. Strong balance sheets provide an added layer of flexibility in meeting operating and capital demands.

Lower Capital Spending: Fitch Ratings' latest medians point to a slight decrease in planned capital spending in 2018 and in the immediate years thereafter from recent levels. Consequently, spending sectorwide during the outlook period should continue a trend of only moderately exceeding the level of annual depreciation. Sustained capital investment increases will be necessary to address deferred maintenance and preserve service levels over the long term.

Manageable Debt Profile: Fitch expects growth in debt levels to be muted for 2018, rising 0%–3% based on planned borrowings by rated utilities. The limited issuance level should preserve the sector's moderate debt profile. New money borrowings will continue to focus efforts on asset maintenance and regulatory compliance. Low interest rates and robust access to capital are broadly positive for this capital-intensive sector in minimizing additional carrying costs. Expectations for higher interest rates should not pose a material risk to issuers given the sector's high concentration of fixed-rate debt.

Environmental Regulations Uncertain: The U.S. Environmental Protection Agency (EPA) could issue revisions to the long-delayed Lead and Copper Rule (LCR) in 2018 related to drinking water utilities. Depending on the scope of the final changes, added capital and operating expenses could be meaningful, although any costs would be expected to be phased in over several years. Wastewater utilities will continue to face pressure from enhanced nutrient removal requirements as discharge permits are renewed periodically.

Affordability Continues but Diminished Capacity: User charges across the country remain affordable overall, but historical adjustments have outpaced inflationary growth for many years and are expected to continue doing so for the foreseeable future. Balancing affordability concerns, particularly for lower income users, against utilities' need for revenue generation to cover operating and capital needs will become an increasing focal point.

Outlook Sensitivities

Stable Sector Outlook on Sound Fundamentals: The essential services provided by the sector, monopolistic business nature and local rate-setting authority are key factors in the sector's historical performance stability. Given the sector's fundamentals and Fitch's expectation for modest economic growth in the national economy, an overall shift in the sector's stable outlook in 2018 is unlikely.

Unwillingness to Support Metrics: A widely observed unwillingness of public water and sewer utilities to raise rates to support current and projected financial metrics in response to economic weakness, increased cost pressures or declining water supplies and consumption could lead to accelerated changes in the Stable Rating Outlook for individual credits. Such an event is not expected.

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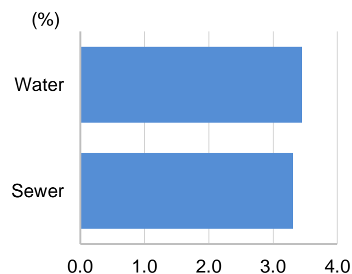
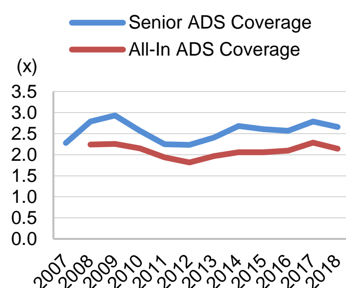
Projected Average Annual Rate Increase Medians



Source: Fitch.

Debt Service Coverage Medians



ADS – Annual debt service.
Source: Fitch.

Key Issues for 2018

Sector Fundamentals Unchanged

Fitch believes strong sector characteristics and a conservative business model provide U.S. water and sewer issuers with stability, even during periods of uncertainty. The fundamental hallmarks of the sector include: essentiality of service; lack of competition; and generally autonomous rate-making authority. These underpinning strengths continue to produce favorable financial results and reliable cash flows. Sector stability is further evidenced by the current distribution of rating outlooks among Fitch-rated issuers. As of Oct. 31, 2017, 97% of the water and sewer ratings assigned by Fitch maintained a Stable Rating Outlook.

Strong Financial Results Expected; Reserves Maintained

Fitch expects revenues will climb between 2% and 4% in 2018 based on anticipated adjustments by rated credits, continued flat consumption patterns and ongoing incremental improvement in economic conditions nationally. These revenue gains will help to offset expected marginal increases in operating and debt service carrying costs and preserve solid debt service coverage levels generated historically. Fitch also expects that reserve levels, which have trended upward over the past decade, will remain very strong and will continue providing more than sufficient insulation to any downside operational risk during the year.

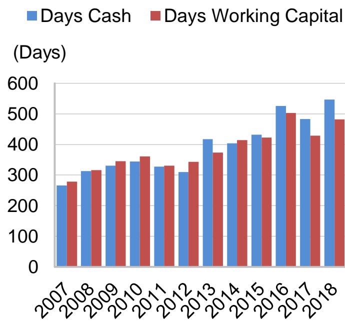
Utilities by and large will continue to face challenges in fully recovering capital replacement costs. However, Fitch has observed a trend of improving sector cash flows in general over the past six median cycles and, since the 2017 medians, most credits rated by Fitch are now generating surplus net revenues that fully cover annual depreciation expense. This development leads Fitch to believe that utilities across the county may see some additional incremental improvement in surplus revenues relative to depreciation expense for the year based on the expected revenue gains and cost containment.

Challenges in recovering all costs stem from rate structures that traditionally have generated the bulk of revenues from customer usage despite the vast majority of utility costs being fixed in nature. As consumption patterns have stagnated in recent years from ongoing increases in fixture efficiencies and customer conservation (Fitch data point to declines in usage during the recession and flat levels since that time), utility managers have been aligning rate structures to recover greater amounts of revenues from fixed charges and/or have increasingly utilized pass-through mechanisms to ensure better revenue certainty. These changes to rate structures, along with the prospects of continuing realignment, have and should continue to bolster financial results.

Debt Escalation in Check; Capital Spending Flat to Down Slightly

Fitch expects that capital spending within the sector during 2018 will be relatively flat and possibly even less than in recent years. Fitch also expects utility debt burdens sectorwide will remain moderate in 2018, with key debt ratios rising only incrementally during the year at between 0% and 3%. Over the past several years, Fitch-rated issuers have signaled a pullback from borrowable sources to finance their multiyear capital programs, relying instead on excess cash flows and internal resources. Fitch's latest medians point to a continuation of this trend, with rated entities expecting just 35% of capital programs to be financed by borrowable resources over the next five years or so. Fitch's latest medians also point to lower actual spending as of late and reduced planned capital spending over the next few years relative to historical results, especially since prior to the recession.

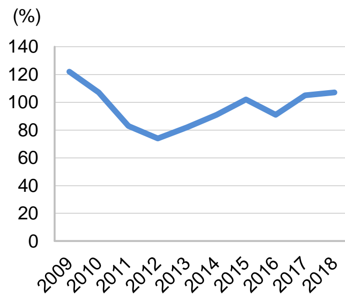
Liquidity Medians



Source: Fitch.

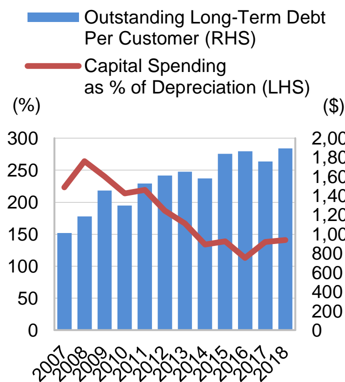
Cost Recovery Median

(Free Cash As % of Depreciation)



Source: Fitch.

Capital Spending and Debt Medians



Source: Fitch.

U.S. Interest Rates

(%)	2016	2017F	2018F	2019F
GDP	1.50	2.30	2.50	2.20
CPI Inflation (Year End)	2.10	2.10	2.20	2.20
Policy Interest Rate (Year End)	0.75	1.50	2.50	3.25

F – Forecast.
Source: Fitch.

The prospects of relatively stable debt levels are favorable, but there is an offsetting concern over the trend in capital spending within the sector. Fitch's 2018 medians point to a lack of improvement in the age of facilities from last year's medians, which, together with the 2018 medians, mark the oldest that facilities in the sector have been (15 years) since Fitch began publication of its medians over a decade ago. Aging infrastructure is a prevailing theme for water and sewer utilities nationwide, with various industry studies pointing to replacement needs on the order of hundreds of billions to trillions of dollars over the coming decades. Utility operators on a broad basis continue to provide a high-quality product but steady investment in maintenance activities will be critical to preserving existing service levels and positioning utilities to meet future customer demands.

In the event utilities begin to ramp up debt funding to address infrastructure needs over the near term, prevailing low interest rates and favorable access to the capital markets are a positive. Fitch expects the Fed to tighten monetary policy through 2018 to 2.50%, although borrowing rates for utilities should remain low by historical standards and should not lead to any sudden upward swings in price movement given traditional debt issuance within the sector has been predominately fixed rate in nature. Within Fitch's own rated portfolio, 2018 median data point to 10% of all outstanding water and sewer debt being variable rate in nature. The expected increase in rates would limit potential refunding savings but this should have only a marginal effect on issuer debt profiles. Similarly, successful tax reform that eliminates tax-exempt advance refundings could also marginally erode gains.

Utilities should also benefit from expansion of capital financing alternatives as a result of the Water Infrastructure Finance and Innovation Act (WIFIA) legislation that was signed into law in 2015 by the president. Besides allowing utilities to access funds from the U.S. Treasury at essentially Treasury rates, WIFIA specifically will help larger infrastructure projects to proceed that may have had difficulty moving forward as a result of capacity constraints by state and federal programs like the state revolving funds given WIFIA's minimum project cost for large projects is $20 million.

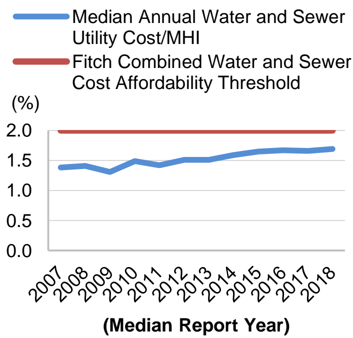
Congress has appropriated a total of $25 million to date for WIFIA subsidy costs, which EPA anticipates will allow the program to provide approximately $1.5 billion in credit assistance for infrastructure projects. For the first round of applications which occurred in 2017 EPA received requests for $6 billion in funding from 43 prospective borrowers of which 12 projects totaling $2 billion in loans have been selected to apply for WIFIA funding. The application process and loan funding will occur through 2018.

Environmental Regulations Uncertainty

Federal and state regulations affect all aspects of utility operations. The regulatory environment in the U.S. has been relatively stable with incremental new requirements instituted over time. For 2018, the pace of new rules by the EPA is expected to be limited, although proposed revisions to the LCR, which have been long delayed, may be forthcoming, which could have significant implications for water utilities. The EPA published a white paper in October 2016 announcing a comprehensive list of potential elements being considered as part of any LCR rule promulgation, including potential operational changes as well as the possibility of mandating lead service line (LSL) replacements for which the full cost was estimated by EPA to be as much as $80 billion nationwide.

The credit effect of the LCR revision to issuers will depend on the scale and timing of operating and capital costs as well as the responsibility of and legal ramification to utilities for replacement of LSLs if required. LSLs typically are owned by the property owner as opposed to the utility and, with up to an estimated 10 million residences nationwide potentially with LSLs,

Residential Water/Sewer Costs



MHI – Median Household Income.
Source: Fitch.

account for much of what likely would be targeted for replacement. Utilities could also face credit implications in that capital spending associated with the LCR could possibly be largely additive to existing capital programs. Consequently, individual utility debt burdens could escalate and/or affordability concerns could accentuate if existing capital projects cannot be delayed. Alternatively, needed capital projects could be postponed if utilities are required to prioritize LCR projects ahead of other projects and revenue constraints limit a utility's ability to fund both the LCR and existing planned projects.

Apart from the LCR's possible ramifications to water purveyors, Fitch expects wastewater providers will continue to see enhanced phosphorous and nitrogen nutrient removal criteria incorporated into discharge permits when renewed; discharge permits are subject to renewal on a five-year cycle. In many cases, these additional restrictions require limited operating changes or capital outlays. However, in some cases, the nutrient reductions can result in significant additional costs to utilities, which could have a direct bearing on the utility's credit quality.

Rate Affordability Remains but Pressures Increasing

Over the past few decades, water and sewer charges have escalated at a much faster pace than the consumer price index (CPI). The American Water Works Association reports that while the CPI slightly more than doubled from 1988–2014, typical residential water bills more than tripled and wastewater rates more than quadrupled. This rate of increase in utility charges has not only outpaced CPI growth but also overall gains in median household income (MHI), as demonstrated within Fitch's own medians, which point to user charges steadily climbing toward Fitch's 2% of MHI affordability benchmark. Affordability cushion remains overall for Fitch-rated credits but with utilities anticipating ongoing rate adjustments to outpace CPI increases, the issue of affordability is becoming an increasing focus among sector stakeholders and could pressure finance and debt ratios beyond the outlook period.

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