

WATER DISTRICTS DESERVE STRONG CREDIT RATINGS

BY ROBERT PORR, VICE PRESIDENT

Earlier this year, I was at a meeting with a client and the investment banking team working on a strategy for the client's credit presentation when my BlackBerry blurred out the William Tell Overture, signaling yet another e-mail. This one was from Standard & Poor's Ratings Direct. "Who got downgraded now?" I wondered. Expecting the worse, I opened the e-mail. To my surprise the headline read, "130 Municipal Water and Sewer Issuers are Upgraded After Recent Criterion Revision." That's great news I thought: instead of calling my clients to discuss yet another bond insurance company or bank downgrade, I had good news to report from the municipal market.

This glowing report on water district credit ratings provided a welcome break from the bulk of bad financial news of the past year. Indeed, in the past year many of us specializing in water district finance have had a front row view to the financial crisis and the resulting turmoil in the municipal market. As a reminder, we've seen Bear Stearns, UBS and Lehman Brothers leave public finance, Merrill Lynch be acquired by Bank of America, and the demise of the municipal bond insurance industry.

Because of the rapid demise of the formerly "AAA" rated bond insurance companies such as MBIA and Ambac, our water district clients were once again issuing debt solely based on their own credit instead of "enhancing" their bonds by purchasing a bond insurance policy. This brought fresh attention to municipal credit ratings. Both municipalities and investors openly questioned whether many municipal credit ratings were too low, given municipal bonds' track record of default rates being significantly lower than corporate bonds.

Whether this charge is appropriate or not is not the topic of this discussion. The fact of the matter is that water districts, for the large part, are strongly positioned, stable enterprises with significant operating flexibility that deserve high credit ratings. But don't take my word for it -the S&P report seems to make the same case, if one looks at many of the upgrades contained in the report. Most notably, S&P raised sixteen water districts throughout the nation to AAA.

The S&P report identifies three important credit characteristics: (i) financial metrics; (ii) economic fundamentals; and (iii) solid management. These three characteristics are essential to a rating analyst's work and good marks in these areas will result in high credit ratings. Higher credit ratings mean more than just less interest expense; it may, under tumultuous market conditions, mean access to capital, period.

I'll elaborate on each of the criteria mentioned in the report. First, economic fundamentals start with the most basic question: can ratepayers afford the service? But it goes beyond that: this criterion is an assessment of the district's ability to withstand high unemployment in its customer base, turmoil in the real estate market, and rising costs of delivering the service to ratepayers. The amazing thing is that we are for the most part experiencing all three negative factors today and yet S&P is upgrading water and wastewater issuers. This suggests that the rating agencies are responding favorably to the results of water district's customer base's ability and willingness to pay being "stress-tested" in the current environment.

Financial metrics include the ability to pay bond debt service (including debt service coverage) and cash reserves measured by number of "days' cash" on hand to cover operating expenses and other contingencies. This boils down to the revenue generated by rates and charges and whether they are sufficient to operate and maintain the system both today and into the future. In general, water districts operate with strong cash flow positions (to account and pay for depreciation of the existing system), and maintain substantial cash resources for contingencies and future capital needs.

Third, there's management. Management comes in two parts—the first is staff. S&P looks for staff that emphasizes long-range financial planning both operating needs and the funding of critical projects—for instance water supply or regulatory compliance. The second part of management is the governance of a district's elected board. S&P wants to see, above all, a "demonstrated willingness to adjust rates." Nowhere is this perhaps more important than in California, where drought and environmentally-driven pumping restrictions have increased the cost of water significantly in the past few years. This presents yet another significant challenge seemingly at odds with the recent credit rating upgrades! However, many water districts have turned it into a positive by demonstrating they can plan and make the case for rate increases at the staff level and implement such needs aggressively at the board or governance level.

Taking the three criteria together, it's not surprising water districts come out favorably in upon close scrutiny of credit analysts. In looking at the last two years of financial turmoil, I have seen numerous rating downgrades and numerous institutions struggle with financial challenges. What I have not seen is water districts' credit negatively impacted in a significant way, although there have been financial and industry challenges. Instead, water districts have largely been able to maintain good operating positions, raise or make plans to raise their rates, and maintain strong cash balances. Ratepayers have demonstrated once again they will pay their bills even in trying times and, further, appear to generally trust their governing body to raise rates as required. In some respects, the recent turmoil has provided a good opportunity to demonstrate why water districts deserve strong credit ratings. ♦

** The information in this newsletter is intended to be general in nature. The facts and circumstances of each agency are different. Seek specific advice before implementing any recommendation. For reprint permission contact Tom Johnson at (949) 660-7311.*