S&P Global Ratings

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Summary:

Newport News, Virginia; Water/Sewer

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Credit Profile		
US$53.56 mil wtr rev bnds ser 2021 due 07/15/2041		
Long Term Rating	AAA/Stable	New
Newport News wtr rev rfdg bnds ser 2016 due 07/15/2036		
Long Term Rating	AAA/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AAA' long-term rating to Newport News, Va.'s water revenue new issue bonds, series 2021, and affirmed its 'AAA' long-term rating on the city's parity revenue bonds outstanding. The outlook is stable.

The series 2021 water revenue bonds will have a par amount of approximately $53.6 million and will be used to finance capital projects consisting of extensions, capital improvements, and renewal and replacement of infrastructure. As of June 30, 2020, the water system supported approximately $81.8 million of outstanding obligations paid by the water fund. The Newport News Waterworks Department has no direct purchase or other nontraditional financing obligations.

We view the bond provisions as credit neutral. A rate covenant and additional bonds test provide for a minimum 1.2x coverage of annual debt service on senior-lien debt, and a minimum 1.0x coverage including subordinate and other general obligation (GO)-related supported debt. We understand that the series 2021 bonds will not have a debt service reserve account. In our opinion, the utility's strong operations and cash on hand are sufficient to support debt service coverage without a debt service reserve fund.

Credit overview

The city provides water services to a population of 407,000 through 123,000 active connections in the broad and diverse Virginia Beach-Norfolk-Newport News metropolitan statistical area. The city serves customers directly in the following areas: Newport News (44%), Hampton (30%), York County (15%), James City County (9%), and Poquoson (2%). The city has below-average income indicators at 88% of median household effective buying income (MHHEBI); however, we recognize that for other areas the city serves, specifically York County, James, City County, and Poquoson, income indicators are stronger, exceeding 130% of MHHEBI. Huntington Ingalls Industries (or Newport News Shipbuilding) and Joint Base Langley-Eustis remain major economic drivers provide stability in the region. We understand that shipbuilding, military, and defense-related activities have remained resilient through the recent economic recession and the COVID-19 pandemic. Credit strengths include the water system's extremely strong all-in coverage at above 2.0x for the past three fiscal years and extremely strong liquidity position at over $80 million for fiscal 2020. We understand that the city has consistently made a $9.5 million transfer to the general fund as return on investment since fiscal 2015. We would view an increase in the transfers amount to the general fund to be a credit weakness.

We rate the bonds higher than our issuer credit rating on the sovereign because the system has a predominantly locally derived revenue base from local service charges, derived through an autonomous rate-setting process. This, coupled with operating expense flexibility, limits exposure to federal revenues.

The enterprise risk profile reflects our view of the water utility's:

- Service area economy in the broad and diverse Virginia Beach-Norfolk-Newport News metropolitan statistical area, with below-average income indicators and an unemployment rate for November at 6.3%, in line with the national level;
- Affordable water system rates at 1.04% of MHHEBI, or approximately $40.36 a month when assuming the typical use of 5,000 gallons, however in combination with a city poverty rate of 17%; and
- Strong operational management assessment, represented by sufficient water supply and treatment plant capacity to meet long-term demand, strong organizational effectiveness, and history of reviewing water system rates with plans for a rate study in the near term.

The financial risk profile reflects our view of the water utility's:

- Extremely strong all-in coverage at about 2.4x in fiscal 2020 (including transfers out to general fund and general fund water debt service) that we expect to decline as the water system issues new debt but to stay extremely strong;
- Extremely strong liquidity position at $83.2 million, equivalent to over 500 days of operating expenses, that we expect to stay extremely strong despite the planned 43% cash-funded portion of the capital plan;
- Low debt-to-capitalization ratio at approximately 20%, in addition to a moderate capital improvement plan of $124 million with future debt plans within the five-year horizon; and
- Strong financial management, which includes a detailed capital improvement program that identifies funding sources, and well-delineated policies.

The stable outlook reflects the water system's historically stable and strong financial position and expectation that management will complete another formal rate study in the near term and approve rates needed to sustain comparable financial metrics. Further supporting our stable outlook is the decline in the system's debt obligations, which presents flexibility for future debt needs.

Environmental, social, and governance factors

We believe the city's environmental risks are above average relative to those of peers given the city's proximity to the coast, which in our view makes Newport News more susceptible to natural weather-related disasters and various climate risks, including sea level rise. However, city management indicates that sea level rise is not expected to have a significant impact on Newport News given that it sits on a ridge on the peninsula, with elevations of at least 10-20 feet along much of the three-mile shoreline. Nevertheless, the water utility serves customers in city's surrounding the peninsula, which could be negatively affected by extreme weather events. We understand as part of management's resiliency strategies, the utility has flood protection and emergency response plans, as well as plant backup power generation. We believe management is taking actions to ensure water system resiliency during potential climate risks. Furthermore, the water system is in compliance with all environmental regulations. We understand management continues to monitor for Perfluorooctanoic acid contamination but has not identified any material contamination.

We consider Newport News' social risks, including the health and safety risks arising from the COVID-19 pandemic that could temporarily affect the city's economy and financial profile, to be in line with those of the sector. In addition, we evaluated the city's governance factors relative to Newport News' economy, financial measures, management, and debt and long-term liability profile, and view these factors as being consistent with those of the sector.

Stable Outlook

Downside scenario

We could lower the rating if all-in coverage consistently declines below 1.6x as a result of increased payments to support general fund water debt, increased transfers out to the general fund, or the potential loss of a leading customer. In addition, we could lower the rating if unrestricted cash declines to a level no longer consistent with extremely strong metrics under our rating methodology of at least $75 million and over 150 days cash.

Credit Opinion

We consider the customer base to be diverse, with the leading 10 customers accounting for less than 20% of total water sales. Anheuser Busch Inc.'s bottling facility continues to be the largest customer by revenue, at about 5%. We understand the bottling facility built its own recycling facility; however, it still continues to purchase a portion of its supply from the city. It is our understanding management uses conservative projections for this customer, which we view positively as there is a potential for decline in demand from this customer.

The city's water supply is abundant from a combination of groundwater, surface water, and reservoirs and is sufficient to meet long-term demand through 2050. The two water treatment plants and the one reverse osmosis facility have a combined total capacity of 91 million gallons per day (mgd), which compares favorably to the average daily demand of about 32.5 mgd in 2020. Additionally, the water system has experienced low water loss at only 4%, signifying that the infrastructure is in good condition. It is our understanding that the capital plan includes implementation of advanced meter infrastructure to eliminate monthly visits from meter readers, reduce the number of truck rollouts, remotely track water usage, and identify leaks sooner.

In our opinion, the system's financial performance has been extremely strong in the past three years, and we expect it will decline modestly but remain extremely strong. Our all-in coverage metrics incorporate GO bonds given debt is paid for from the water fund even though this fund is not a security for the GO bonds. The city's general fund does receive annual transfers from the water fund, and management expects these transfers (about $9.5 million annually) to continue, and so we have included these as expenses in our all-in coverage calculations. When incorporating these payments, all-in coverage has been above 2.0x the past three fiscal years, and based on budgetary projections for fiscal 2021, we expect all-in DSC to remain around 2.2x. We also project all-in coverage will dip modestly in 2022 and 2023 because of higher debt service in those years, though debt service drops after 2023 as the existing GO debt rolls off. Regardless of security type, 60% of all the debt (including the series 2021 bonds) will be repaid within 10 years, leaving the city with flexibility to issue planned debt while maintaining metrics.

Furthermore, unrestricted cash and investments rose to about $83 million in fiscal 2020 from about $56 million in

2016, given rate implementations and restructuring. We understand about 43% of the $124 million (2021-2025) capital plan will be cash funded and believe the water fund will be able to maintain metrics in line with historical results, given management's plans to undergo another formal rate study and implement rates as needed to sustain sound financial metrics. The remaining capital projects will be funded from the series 2021 proceeds and future debt. The capital plan is front loaded, with annual costs falling from over $40 million in 2021 to about $10 million by 2025. About 64% of the capital plan will be for projects related to equipment and information technology, 31% for distribution and technology, and the remaining on water supply and water facilities.

Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020