2015-2016 PROPOSED BUDGET
RESPONSE TO REQUEST FOR INFORMATION

DEPARTMENT: Austin Water

REQUEST NO.: 207

REQUESTED BY: Gallo

DATE REQUESTED: 08/18/15

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REQUEST: What is required of Austin Water (AW) to maintain the 1.50 debt coverage ratio? What cash reserves is AW anticipating? Is AW creating a new fund to manage the debt coverage requirement?

RESPONSE:

Bond Rating Background

Austin Water has been working to improve the Utility's financial performance over the last few years as revenues and cash reserves have been significantly impacted by decreased water consumption in response to ongoing drought conditions. Austin Water has taken several steps as part of the plan to improve financial performance, including modifying our rate structure to increase the percentage of fixed fee revenue to reduce revenue volatility; reducing the 2015 operating budget by $30 million and increasing rates to offset revenue loss due to decreased consumption. During the rating process for the last few years, the financial performance improvement plan has been communicated to our rating agencies. The rating agencies have all been supportive of Austin Water's financial performance improvement plan. Below are excerpts from the June/July 2015 bond rating updates:

> Fitch Ratings- Affirmed AA-, Maintained Negative Outlook
>
> Maintenance of the Negative Rating Outlook reflects the increasingly weak trend in financial performance over the prior three fiscal years, resulting in cash flow and liquidity metrics that are increasingly inconsistent with the current rating. Additional negative rating action is likely absent a measured near-term improvement in AWU's financial profile, particularly its unrestricted cash balances, to a level more consistent with the current rating category.
>
> Moody's Investor Service- Affirmed Aa2, Maintained Negative Outlook
>
> The negative outlook reflects a weakened liquidity position at fiscal year-end 2014. Future credit reviews will focus on the impact of recent rate increases, as well as other improvements of the system's financial plan, on the overall financial health of the system and near-term improvement in liquidity.
>
> > WHAT COULD MAKE THE RATING GO UP
> > - Sustained trend of strong financial performance and improvement of liquidity
> > - Trend of improving debt service coverage
> > - Reduction of system debt profile
> >
> > WHAT COULD MAKE THE RATING GO DOWN

- Continued narrowing of liquidity or debt service coverage
- Weak financial performance
- Significant increase in debt profile

Standard & Poor's Rating Services – Affirmed AA, Revised Outlook from Positive to Stable
The stable outlook reflects Standard & Poor's expectation that the ratings are unlikely to change in the next two years. We recognize management's commitment to improving AWU's financial risk profile and maintaining it at those improved levels. We believe, however, that the improvements will be gradual. While the rating could still go higher, even with a stable outlook, an upgrade would be predicated mainly on the system building cash reserves to a level more in line with an 'AA+' rating.

All three rating agencies commented on Austin Water's commitment to improving its financial profile especially the need to improve cash reserve balances and debt service coverage. Declining water consumption has significantly impacted Water cash flows and operating cash reserves. The proposed rate increases for Fiscal Year 2016 are necessary to improve cash reserve levels and debt service coverage, not just to maintain Austin Water's current debt ratings but to put Austin Water on stronger financial footing.

Debt Service Coverage
Debt service coverage is the ratio of net revenues available for debt service (revenues less operating requirements) over annual debt service requirements. Austin Water's financial policies establish a debt service coverage target of at least 1.50, which means that net revenues available for debt service are 1.50 times annual debt service requirements.

As shown in the chart below, the median debt service coverage according to Fitch Ratings is 2.0 for water utilities with a AA or A rating, which is well above Austin Water's current level of coverage. In addition, Austin Energy's financial policies require a minimum debt service coverage of 2.0 for the Electric Utility Bonds. Austin Water has targeted 2.0 as a long-term debt service coverage goal to be in line with the industry median and Austin Energy's minimum debt service coverage.

	Rating Category		
Fitch Ratings	**AA**	**A**	**All Credits**
Median Debt Service Coverage	**2.0**	**2.0**	**2.1**

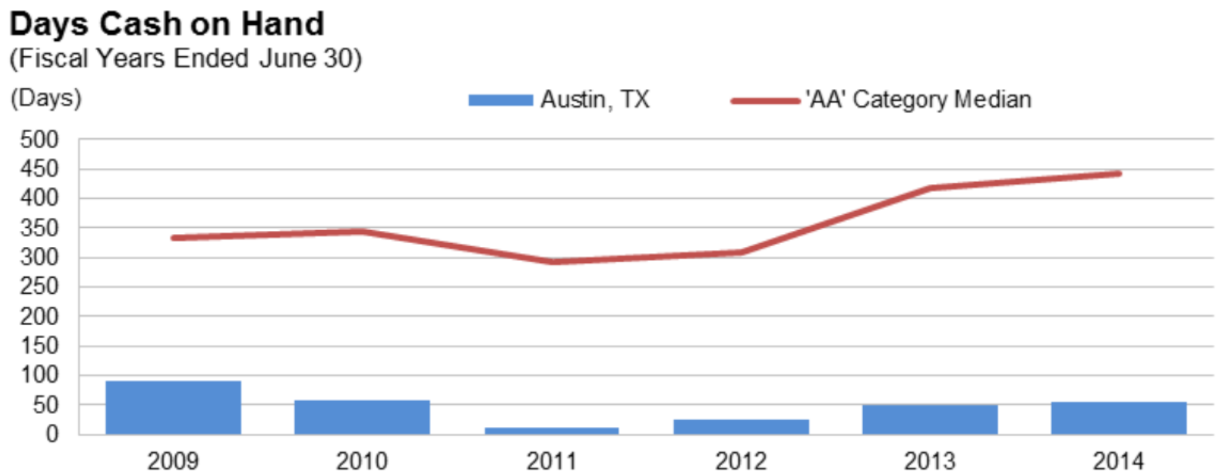
Austin Water projects debt service coverage of 1.49 for Fiscal Year 2015. Austin Water would likely maintain debt service of 1.50 at the expense of improved financial metrics, including cash reserve balances, due to savings from Austin Water's recent debt refinancing. Austin Water's projected debt service coverage is 1.69 with the proposed rate increases for Fiscal Year 2016.

A new fund is not required to manage Austin Water's debt coverage requirement since debt coverage level is a calculation of net revenues as compared to debt service requirements and is not based on amounts set aside for debt service.

Cash Reserves

Days Cash on Hand is another metric tracked closely by rating agencies and is one of the metrics that contributed to Fitch and Moody's maintaining a negative outlook related to Austin Water's bond rating in their recent rating reports. Days cash on hand, which equals total unrestricted operating cash divided by cash operating expenses per day, is a measure of unrestricted cash available to pay for operating expenditures.

The chart below from Fitch's June 2015 rating compares Austin Water's days cash on hand to the median Days Cash on Hand for AA rated utilities. For 2015, the median days cash on hand is 442 days for AA rated utilities and 366 days for A rated utilities.



Austin Water ended Fiscal Year 2014 with approximately 55 days of cash on hand and expects a slight improvement to 59 days cash on hand. Austin Water cash reserve levels are projected to increase from $33.5 million for Fiscal Year 2015 or 59 days of operating cash to $77.1M or 128 days for Fiscal Year 2016 as proposed. While Austin Water has maintained positive total operating cash balances despite decreased water consumption over the last few years, the resulting revenue volatility has significantly impacted Austin Water's cash levels. Austin Water's unrestricted operating cash decreased from $36.3 million in Fiscal Year 2012 to $21.8 million in Fiscal Year 2014 due to declining Water revenues. The proposed rate increases for Fiscal Year 2016 are necessary to reverse the declining unrestricted cash flow trend.

Impact of Rating Downgrade

If Austin Water does not improve its financial performance as planned and presented to the rating agencies, there is strong indication from the rating agencies that Austin Water's bond credit rating would be downgraded from the current AA rating. The City's financial advisor, PFM, estimates that if Austin Water's bond rating is downgraded, the interest rate for a typical bond issue would increase by approximately 1% over current interest rate levels at our current AA bond rating. Austin Water typically issues between $190 to $200 million of revenue bonds every 12 to 18 months. The interest costs on our typical current bond issue are almost $200 million over the 30-year term of the bonds. If Austin Water's bond rating would be downgraded to an A rating, the interest costs on our typical bond issue would increase by over $37 million or approximately 20% for each issue. This is an increase in debt service costs of more than $1 million per year on average for the 30-year term of each bond issue. Within a 10 year period Austin Water expects 8 new revenue bond issues. The estimated cumulative increase in interest cost for those future 8 issues over the 30-year term of each issue would be approximately $296 million. Once a bond credit rating is downgraded, it would likely take many years of improved financial performance to regain the higher credit rating. Austin Water would require even higher rate increases than are currently forecasted for future years, if we have to continue to improve our financial performance and at the same time cover the increased interest cost burden of a downgrade to our bond rating.

Summary

While Austin Water would likely maintain debt service coverage at financial policy levels without the proposed rate increases for Fiscal Year 2016, the Utility would not comply with financial performance improvement plans presented to the bond rating agencies. The rating agencies have indicated a likely bond rating downgrade if measured near-term improvement to Austin Water's financial profile is not achieved. Continued improvements in both debt service coverage and cash balance levels are necessary to improve Austin Water's financial stability and to maintain the Utility's current bond rating. Without the proposed rate increases for Fiscal Year 2016, Austin Water's debt service coverage and cash reserves would be decreased, not improved as what was projected in the financial performance improvement plan expectations of the rating agencies. A bond rating downgrade would significantly increase Austin Water's interest cost on future bond issuances. The additional interest costs for each future bond issue would compound as Austin Water continues to issue debt. After a bond rating downgrade, it would take many years of improved financial performance to return to current rating levels. However, the financial improvement necessary to return to current rating levels would be even more difficult due to the increased debt service interest costs resulting from a downgrade.