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S&P: Detroit Water & Sewerage Department Bonds Undergo Various Rating Actions after Expiration of Tender Period.

(Editor's note: Standard & Poor's Ratings Services intends to assign a 'BBB+' rating to the untendered portion of the cusips of Detroit's outstanding bonds issued for the Detroit Water and Sewerage Authority (DWSD). In our media release related to the issue of series 2014C&D Michigan Finance Authority (MFA) bonds, published Aug. 26, 2014, we indicated that the rating on certain Detroit tendered cusips would be revised to 'D' and then withdrawn because we considered the tenders a distressed exchange. We now understand that these same cusips have been partially tendered and that no new cusips will be assigned to the untendered portion. Therefore, at closing of the 2014C and 2014D MFA bonds, we currently intend to revise the rating on the partially tendered portion of the affected cusips to 'D', and then assign a 'BBB+' rating to the untendered portion of the cusips. A corrected version of our media release follows.)

CHICAGO (Standard & Poor's) Aug. 26, 2014–Standard & Poor's Ratings Services has taken numerous rating actions on Detroit's outstanding sewage disposal and water supply revenue bonds, including the following:

We have lowered the rating to 'CC' from 'CCC' on tendered bonds purchased by Detroit below par or accreted value and considered impaired for most of the duration of the tender invitation period that began on Aug. 7, 2014. We have removed the ratings from CreditWatch, where they were placed with negative implications on July 3, 2013. The outlook on these bonds is negative. We have raised the rating to 'BBB+' from 'CCC' on all other tendered and untendered bonds and removed the ratings from CreditWatch; the outlook on these bonds is stable.

In addition, we assigned our 'BBB+' rating to Michigan Finance Authority's series 2014C and 2014D bonds (the MFA 2014C and D bonds), which are payable primarily from payments on Detroit Water and Sewerage Department (DWSD) obligations to be purchased with the proceeds of the MFA 2014C and D bonds. The DWSD obligations are secured by a statutory lien on pledged assets of each system separately (prioritized by the lien status), which include:

- Net revenues of the city's sewage disposal or water supply system,
- Investments credited to the sewer or water system, and
- Earnings on those investments.

DWSD has also entered into a trust agreement related to all sewer and water revenue debt. The trustee is Wilmington Bank N.A.

While we understand that the MFA 2014C and D bonds will be issued in various subseries as senior-lien and second-lien bonds, there is no difference in the ratings because our analysis is based on our opinion of DWSD's creditworthiness with regard to covering all fixed costs, and DWSD has indicated it plans to fund capital expenditures with bonds secured by all of its existing liens.

Proceeds of the DWSD obligations will be used to purchase tendered and redeemed bonds, and in the case of series 2014C-1 and C-2 bonds, to fund capital improvements for the sewage department. As the result of a tender invitation that started was effective on Aug. 7, 2014, and expired on Aug. 21, 2014, the city has agreed to purchase $1.468 billion of outstanding sewerage and water revenue bonds.

"All ratings that are 'CC' are considered to involve a distressed exchange in which bondholders are receiving less than the original promise," said Standard & Poor's credit analyst Scott Garrigan. At closing, we would expect to change the rating on the affected cusips to 'D'. We understand that these same cusips were partially tendered and that no new cusips will be assigned to the untendered portion. Therefore, at closing of the MFA 2014C and D bonds we currently intend to revise the rating on the partially tendered portion of the affected cusips to 'D', and then assign a 'BBB+' rating to the untendered portion of the cusips. Generally, we consider an exchange offer to be distressed if we believe that the bondholders receive less than originally promised, and if the bondholders are accepting the offer because of the risk that the issuer will not fulfill its obligations. Accordingly, we applied the 'CC" rating to those cusips that were considered both impaired prior to the tender invitation period and will be tendered at less than par.

Ratings on bonds with all other outstanding cusips, whether senior or second lien, are 'BBB+', as noted below.

"The 'BBB+' rating reflects our opinion of the underlying creditworthiness of the sewer disposal and water supply systems," continued Mr. Garrigan. "Even though the rating on bonds secured by the pledged assets of each system could diverge, at this time we believe the creditworthiness of each system is the same, regardless of lien position.

The rating is supported by our view of the following characteristics:

- The legal framework includes a statutory lien on net revenues, provisions under the city's current Plan of Adjustment (POA) that consider all DWSD-related bond claims as unimpaired, and an order entered by the bankruptcy court that, among other things, both precludes the city from filing future POA amendments that would impair any DWSD-related bond claims and that overrules all objections to the order and documents related to the 2014 DWSD bonds.
- Significant economic stress within Detroit partly offsets a much more diverse revenue stream from a large number of wholesale customers.
- Historical financial performance has been generally adequate as measured by days' operating cash and investments and total fixed-cost coverage, but the amount of accounts payable and allowances for doubtful accounts is significant.
- There is upward pressure on rates, in our view, due to the need to fund a large capital program and additional debt needs. Based on income indicators for the Detroit metropolitan area, we deem

the rates affordable although, based on the significantly lower income indicators for the city of Detroit, we consider the rates high for customers located in Detroit.
- System leverage is high, and we do not believe that will abate given the large amount of debt needs to fund the current capital improvement program.

We also note that DWSD has been in the process of implementing many policies and procedures that we view as supportive of credit quality, especially as they relate to collecting delinquent bills, recovering a higher percentage of fixed costs, simplifying the wholesale contract and rate structures, and controlling operating expenses. DWSD's financial projections show generally better overall financial performance than has been attained over the past several fiscal years. Before raising the rating further, we would look for the systems to achieve and, in our view, to be able to maintain better financial performance over multiple fiscal years.

The negative outlook on the bonds rated 'CC' reflects our expectation that the rating will be lowered to 'D' once the tendered bonds are purchased.

The stable outlook on the bonds rated 'BBB+' reflects our expectation that the financial performance of both the sewer and water systems should be consistent with or better than projections. We base this expectation on our belief that as DWSD management continues to implement various policy and procedural changes, financial performance will likely improve because of the specific efforts aimed at improving collections, stabilizing the operating revenue stream, and controlling costs.

However, actual financial performance could be worse than projected, based on numerous events occurring. Economic pressures that limit collection rates and rate affordability could continue. Billed water volumes could decline due to a combination of weather or economic events. Additional environmental compliance mandates could lead to unforeseen capital and debt expenses. If one or more of these events occurred, and a direct negative impact on financial performance resulted, we could lower the ratings.

At present, the various events listed are possible causes of financial stress for nearly all public utilities. But we are pointing them out in this case to indicate that future upward movement in the rating would most likely be predicated on our belief that financial performance can be sustained in a fashion that insulates the utilities from the negative impacts these unforeseen events can have on credit quality. Most notably, sustained levels of unrestricted liquidity and coverage of all fixed costs that meet or exceed the current projections would be two performance metrics we would expect to have a significant positive impact on credit quality. For upward rating movement to occur, we expect these to be sustainable in future fiscal years, and to occur without significant additions of debt not currently identified in the CIP (of course, we do understand that beyond the current scope of the CIP, which ends in 2019, there could be additional, currently unforeseen debt issued).

The rating on the bonds secured by net revenues of the sewage disposal and water supply systems could diverge if we determine that there is enough of a difference in the relevant credit factors. However, it is difficult to foresee at this time whether that would occur or what the precipitating factors leading to such a divergence would be.

RELATED CRITERIA AND RESEARCH

USPF Criteria: Key Water And Sewer Utility Credit Ratio Ranges, Sept. 15, 2008
USPF Criteria: Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008
USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011
Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
Rating Implications Of Exchange Offers And Similar Restructurings, Update, May 12, 2009
Related Research
U.S. State And Local Government Credit Conditions Forecast, July 8, 2014

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