[Bond Case Briefs]

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[S&P Credit FAQ: Proposed Criteria Changes Will Bring Greater Transparency to U.S. Municipal Water and Sewer Systems.]

Standard & Poor's Ratings Services is currently seeking comments on proposed changes in the criteria it uses to rate debt from publicly owned waterworks, sanitary sewer, and drainage utility systems. Our initial testing of the effects of these proposed changes—which will apply only to revenue-backed debt—indicate that roughly 75% of our more-than 1,500 ratings in this sector will remain the same if we adopt the criteria revisions. Of the remaining 25% of ratings, we are likely to see an even split between upgrades and downgrades, and nearly all will be no more than one notch. We don't expect any rating to shift to speculative-grade status from investment-grade status, or vice versa. We view this sector as relatively safe and stable, and most of our ratings are in the 'A+' and 'AA-' categories. Moreover, because several very large issuers dominate issuance in this sector, we expect the criteria changes to affect ratings on less than 25% of the par value of public water and sewer debt now in the market.

Standard & Poor's last revised the criteria for public water and sewer facilities in 2008, and before, that in, 2002. The changes we're considering now will increase the transparency and replicability of our criteria across the sector and more accurately reflect current and potential future risks associated with these debt issues, which are issued by cities, counties, or other public entities of widely divergent size and in all regions of the country. These new criteria will include some significant changes in how we assess water and sewer debt issues. (See [“Request For Comment: U.S. Public Finance Waterworks, Sanitary Sewer, And Drainage Utility Systems: Methodology And Assumptions”], published Dec. 10, 2014.) We ask interested parties to send their comments on the proposed criteria revision [HERE] or [HERE] by Feb. 28, 2015, and we will take them into consideration before issuing a definitive update to our criteria.

Here are answers to some frequently asked questions about the most significant changes we're proposing to our criteria for these ratings.

Frequently Asked Questions

Can you explain the new "operational management" assessment in the proposed criteria?

As proposed, this assessment will account for 10% of an issuer's total enterprise risk assessment and will take into account several factors pertaining to an entity's day-to-day operations that can have an impact on credit quality. One of these factors, for instance, would be a water utility's drought management plan—a factor that has taken on more importance in some states, such as California. Some questions to consider include "Does the issuer have a clear plan to address a prolonged decline in water availability?" and "Does the utility have the management expertise to fulfill its drought planning and to communicate effectively to its stakeholders?"

Another factor that we'll now explicitly and separately consider as part of the operational management assessment is the utility's rate-setting practices. Although municipal water and sewer systems tend to have wide latitude in their rate-setting ability, they must still comply with state and federal environmental regulations to ensure public health and safety, and doing so may sometimes require rate adjustments.

The operational management assessment is designed to not only assess the adequacy of the water supply or treatment capacity, but will also take a hard look at the physical integrity and capacity of a system's assets, its ability to meet peak demand in its service area, along with its compliance with all environmental regulations.

How will the proposed "financial management" assessment section of the criteria work?

The financial management assessment will account for 10% of an issuer's total financial risk assessment. This assessment will consider the robustness of a utility's financial policies and internal controls and evaluate whether its long-term planning is well-constructed and realistic, and will also look at the assumptions that go behind that planning. We will also, as part of this assessment, consider the quality, transparency, and timeliness of the utility's financial reports. The financial management assessment would be in line with a similar assessment that Standard & Poor's currently performs for local government general obligation (GO) ratings.

The financial management assessment analyzes how a utility makes financial decisions, including how it identifies and addresses both ordinary and extraordinary costs, its ability to fund them, and whether it transparently reviews and publicly reports those risks. We assume that financial results manifest themselves in other visible ways and address them elsewhere in the criteria, specifically in coverage and liquidity assessments.

What is the "market position" assessment in the proposed criteria?

The market position assessment will essentially look at the rate affordability within a utility's service area. It will account for 25% of the total enterprise risk assessment. Affordability has been an increasingly important factor in some localities, despite the long-held contention that because people can't live without water, they'll always find a way to pay for it. We've recently seen instances where a significant percentage of water bills are going unpaid and management is struggling with collections in light of public health concerns. Affordability has also been an issue for other systems facing consent decrees and rising capital costs. The affordability of water has also come under discussion by the U.S. Conference of Mayors and the Environmental Protection Agency.

This assessment will look at typical water usage in a utility's service area and its cost to consumers, both on an absolute basis and as a share of median household income in that area. And recognizing that there will be households living well below an area's median income, the proposed criteria change will also take into consideration the poverty rate in the utility's service area. These measures will allow us to assess affordability across an area's income spectrum to give a more complete picture of overall affordability.

Will evaluating affordability be separate from looking at an area's local economy?

Although household income is clearly related to an area's economy, we will continue to use a separate assessment of economic fundamentals as the largest part of an issuer's total enterprise risk assessment score, at 45%. The economic fundamentals will continue to include assessments of a utility's customer base, the demographics of its service area, the major employers located there, and trends in the local economy.

Can you explain the changes to coverage metrics in the proposed criteria?

We will now evaluate the total financial capacity of water and sewer bonds using a single metric of "all-in" coverage, regardless of the specific nature of the debt or its lien position. That means we will include any debt or debt-like instruments that are ultimately supported by ongoing utility revenues, whether on- or off-balance-sheet, in our calculation of all-in debt service coverage. We propose to include any debt that receives regular support from surplus net operating revenues, whether specifically pledged or not. We would also include any net revenue transfers from the utility to other jurisdictions (which we now treat as an operating expense) as part of this calculation.

We thus define all-in coverage as: (Revenues-Expenses-Net Transfers + Fixed Costs)/ (All Revenue Bond Debt Service + Fixed Costs + Self-Supporting Debt).

The effect of this change could, in many cases, reduce the debt service coverage we calculate for a utility. For instance, the coverage of its senior debt might be 2x, but when all-in coverage is the measurement, the ratio might fall to 1.5x. The use of a single metric for all-in debt coverage is, under the proposed criteria, similar to Standard & Poor's treatment of coverage for U.S. public power utilities.

Will other major rating factors in your criteria remain the same?

Yes. We will continue to heavily weight economic fundamentals when rating these issues, and a utility's liquidity and reserves—both the number of days of cash on hand and actual cash in dollar terms—will remain significant rating factors. A utility's total debt will also continue to be a major rating factor, including not just the dollar figure, but also the allocation of debt by lien and how quickly or slowly that debt matures. And we will still evaluate how aggressive management has been in the type of debt it has selected, and whether its choices have introduced any contingent risks for the utility.

Will ratings that come out of the proposed criteria be subject to the same caps as before?

We are introducing several specific ratings caps into the rating process. These generally relate to very weak management or exceptionally poor financial performance that threatens timely bond repayment. We will base these caps on the presence or absence of particular characteristics or events that pose extreme risks, which likely have already indicated extraordinary credit weakness.

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