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Fitch: Sizzling Pace of U.S. Utility Refundings May Slow on Rates.

Fitch Ratings-New York-15 September 2016: The volume of public power and water utility bond refundings remains high and has provided considerable budget flexibility in recent years, as debt-service expenditures have dropped, says Fitch Ratings. However, we forecast that long-term US interest rates will rise over 100 bps by year-end 2018. In our view, a rise of that magnitude could reduce refunding volume and limit the budget headroom from which utilities have benefitted.

According to "The Bond Buyer," which utilizes Thomson Reuters data, refunding again represents the largest use of debt proceeds so far this year. Of the $33 billion of issuance by municipal power and water utilities during first-half 2016, over $16.8 billion of the proceeds, or 51%, were used exclusively for refunding. Moreover, $7.5 billion in proceeds, or 23%, were classified as combined-use, suggesting that some portion was also used for refunding. In 2010, only 21% of issuance proceeds were used exclusively for refunding.

The replacement and refunding of debt at lower rates has allowed public power and water utility issuers to reduce interest expense, thereby creating headroom to recover increasing costs related to environmental compliance, demand-side management initiatives, resource acquisitions and the replacement of aging infrastructure, while limiting rate increases for service.

Lower debt service expenditures have also helped water issuers to address budget shortfalls and recover fixed costs, as consumption patterns have stagnated due to greater appliance efficiencies and drought curtailments. Difficulties in recovering all costs stem from rate structures that traditionally have generated the bulk of revenues from customer usage, while the vast majority of utility costs are fixed in their nature. Together, the trends of declining debt service and greater revenue flexibility have broadly resulted in sustained improvement in financial medians in recent years.

Going forward, the benefits of refunding could decline if a rise in interest rates materializes. Fitch expects the Fed to raise rates once this year and twice in 2017, and our forecast is for 10-year US Treasury yields to reach 2.2% by year-end 2017 and 2.8% by year-end 2018. These increases are manageable and would result in rates that are still low by historical standards; however, we believe the gains from refunding are finite and that even a small rise in interest rates could retard recent improvements and result in additional upward pressure on electricity and water rates.

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The above article originally appeared as a post on the Fitch Wire credit market commentary page. The original article can be accessed at www.fitchratings.com. All opinions expressed are those of Fitch Ratings.