MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns Aa2 to $425M New York City Muni Water second resolution bonds; outlook stable

Global Credit Research - 08 Sep 2014

$6.6B of first resolution and $23.7B of second resolution bonds outstanding

NEW YORK CITY MUNICIPAL WATER FINANCE AUTHORITY, NY
Combined Water & Sewer Enterprise
NY

Moody's Rating

ISSUE		RATING
Water and Sewer Sysem Second General Resolution Revenue Bonds, Fiscal 2015 Series CC		Aa2
Sale Amount	$200,000,000	
Expected Sale Date	09/10/14	
Rating Description	Revenue: Government Enterprise	
Water and Sewer Sysem Second General Resolution Revenue Bonds, Fiscal 2015 Series DD		Aa2
Sale Amount	$225,000,000	
Expected Sale Date	09/10/14	
Rating Description	Revenue: Government Enterprise	

Moody's Outlook STA

Opinion

NEW YORK, September 08, 2014 --Moody's Investors Service has assigned a Aa2 rating to the New York City Municipal Water Finance Authority's Water and Sewer System Second General Resolution Revenue Bonds, Fiscal 2015 Series CC and DD. The bonds are scheduled to price on September 10. Proceeds of the $200 million Series CC bonds will be used to take out maturing commercial paper and to help finance capital costs. Proceeds of the $225 million Series DD bonds will refund first resolution bonds into the second resolution for net present value savings with no extension of maturity.

SUMMARY RATING RATIONALE

The authority's Aa1 first resolution and Aa2 second resolution ratings reflect strong bondholder protections provided by a strong legal structure; healthy debt service coverage provided by a gross lien on the system's revenues and enhanced by independent rate-setting ability; the essential nature of New York City's water and sewer system and the monopoly the city and the authority have in providing that service; the challenges of operating and maintaining the system given its size, age and density of the population it serves; a high debt burden; and the ongoing need for rate increases although at lower levels than in recent years. The outlook is stable.

STRENGTHS

-- Legal structure that provides strong bondholder protections, including: bankruptcy protection and legal separation from the fiscal condition of New York City; autonomous rate-setting authority; and a gross revenue pledge

-- A long history of regular, independently-set rate increases that maintain financial stability, support a substantial capital program, and provide healthy debt service coverage

-- Ample water supplied from the city's own extensive reservoir network; low transmission costs relative to other large systems; water rates that currently are moderate compared to other large cities; and authority to sell liens to monetize unpaid bills and provide incentive to delinquent customers to pay

CHALLENGES

-- The water and sewer system's size, age and density pose operating and maintenance management challenges

-- The overall leverage of the system and additional planned issuance, although debt service coverage remains sound

-- A history of state and federal regulatory mandates which on average total approximately 18% of the system's 10-year capital improvement program. While smaller than in recent years, the water and sewer sector is heavily regulated and new mandates could substantially increase the authority's future borrowing needs

DETAILED CREDIT DISCUSSION

DEBT SERVICE COVERAGE INCREASES BASED ON STRONG PERFORMANCE IN FISCAL 2014

Debt service coverage continues to strengthen based on strong revenue performance and as debt service costs are lower than projected, partly as the authority continues to cash defease outstanding bonds. Fiscal 2013 audited results (the most recent audited figures available) reflect Moody's adjusted coverage by gross revenues (operating revenues plus investment and subsidy income) of 10.9 times for the first resolution and 3.9 times for aggregate debt service. Coverage by net revenues on Moody's adjusted basis is 6.9 times for first resolution bonds and 2.4 times in aggregate. Preliminary results for fiscal 2014 (which ends June 30) show coverage strengthening even more; based on the authority's estimates first resolution gross coverage will increase to 12.4 times and aggregate coverage to 4.8 times, and net coverage to 6.7 times and 2.6 times, respectively. Positive financial performance has continued in the first two months of fiscal 2015; revenues are 1.1% higher than projected. Through fiscal 2018 the authority's forecasts, which are generally conservative, show first lien coverage declining slightly but remaining very strong at more than 10 times and aggregate coverage of no less than 3.7 times, similarly robust.

The authority typically forecasts revenues conservatively and uses similarly conservative assumptions for debt service, both strong management practices. Long-term bonds are budgeted to bear interest between 5.5% and 6.8% and short-term bonds between 3% and 4.25%. Reflecting its conservative budgeting, the authority ended fiscal 2013 with a $750 million surplus which was applied toward fiscal 2014 debt service. Similarly, the authority ended fiscal 2014 with a $750.5 million surplus which was carried forward and applied to fiscal 2015 debt service as required by the bond resolution. That requirement provides significant bondholder protections: as of August 31, 2014, 100% of funds for first and second resolution debt service are on deposit with the bond trustee.

In another strong management practice, the authority has budgeted cash funded capital expenditures of $225 million annually through fiscal 2017 and $250 million in fiscal 2018. This can act as an additional cushion against lower revenues or higher expenses, or be used to defease bonds to lower its debt service costs. Indeed, the authority defeased another $361.1 million of bonds at the end of the current fiscal year, bringing the total it has taken out with cash since fiscal 2011 to $1.1 billion.

The history of willingness to increase rates is a strong management feature and an important component of the ratings. Rate increases in recent years have been large, in part due to the high proportion of the authority's capital plan that reflected mandated projects. While four of the rate increases in the last eight years were in the double-digits, the rate increase recently enacted for fiscal 2015 is the lowest in nine years at 3.35%, compared to the originally projected 7.8%. Projected rate increases through fiscal 2018 are 4.9% annually (compared to prior estimates of 7.9% in fiscal 2016 and 7.5% in fiscal 2017 and 5.0% in fiscal 2018). Even though currently forecasted rate increases are lower, projected coverage remains very strong and the authority is expected to continue to its pattern of conservative budgeting and debt defeasance without weakening its credit profile.

In February 2014 the city reached a labor settlement with the Law Enforcement Employees Benevolent Association which represents the environmental police officers of the city's Department of Environmental Protection. This settlement resulted in current year costs of approximately $16.8 million and $2.1 million in each fiscal year thereafter. Already included in the authority's financial plan, the increased costs are manageable in our opinion. On August 5, 2014, the city reached a settlement with the union representing the majority of DEP workers. The terms of the settlement follow the pattern established by the city's agreement with its teachers, and are consistent with the authority's forecast assumptions.

Regulations currently being considered by the state would permanently ban high volume natural gas drilling in the city's upstate watershed. Upstate water from the Catskill and Delaware watersheds, with the exception of water from the Croton watershed, is not required to be filtered, potential contamination related to drilling would likely result in substantial costs for the system. The city has recommended that the state also create substantial exclusion zones around the upstate water infrastructure to further protect it from potential drilling damage. A permanent drilling ban and exclusion zones would be a credit positive development for the authority, while permitting drilling close to the watershed infrastructure could raise credit challenges.

LEGAL STRUCTURE PROVIDES STRONG BONDHOLDER PROTECTIONS, REFLECTED IN STRONG RATINGS

The authority's Aa1-rated first resolution bonds are secured by a first lien on gross revenues of the water and sewer system, and the Aa2-rated second resolution bonds are secured by a subordinate claim on the gross revenues. Additional security provisions provide strong legal protections beyond those found in most municipal water and sewer revenue bonds. These include insulation from potential New York City fiscal stress, independent rate-setting, and (for first resolution bonds only) covenanted reserves, in addition to traditional revenue bond covenants. Neither the New York City Water Board (which sets rates) nor the authority has the ability to file for bankruptcy. A lease agreement between the board and the city establishes the board's ownership of system revenues, while a financing agreement between the board and the authority pledges those revenues first to bondholders, further protecting them from potential weakness in the city's financial position. Additionally, bond counsel has opined that system revenues could not be combined with New York City (general obligations rated Aa2 with a stable outlook) should the city file for bankruptcy protection. The lease with the city limits the annual rental payment to the greater of principal and interest on city general obligation debt issued for water and sewer purposes due in the fiscal year of the payment, or 15% of principal and interest due on the authority's bonds in that fiscal year. Importantly, the lease requires the city to operate and maintain the water and sewer system to its consulting engineer's recommendation regardless of whether or not it receives the board's rental payment.

The first resolution rate covenant requires net revenues to equal 115% of first resolution debt service, plus 100% of the sum of second resolution debt service, operating and maintenance expenses, and the city lease payment. First resolution bonds also benefit from a cash-funded debt service reserve equal to maximum annual debt service. First resolution issuance is subject to an additional bonds test that requires net revenues to equal 115% of maximum annual senior debt service for the next succeeding five years and 100% of second resolution debt service and operating and maintenance expenditures.

The second resolution rate covenant requires that net revenues on a cash basis be sum sufficient to cover combined debt service, operations and maintenance expenses and city lease payments. There is no debt service reserve on the second resolution bonds. The second resolution additional bonds test requires revenues to equal 110% of aggregate debt service for both first and second resolution bonds in either of the prior two fiscal years.

The authority pledges the gross system revenues to repayment of its debt obligations; revenues flow to the city (which operates the system through its Department of Environmental Protection) for operations and maintenance expenses only after debt service is funded monthly on a one-fifth of interest, one-eleventh of principal basis. In the event that revenues are insufficient to cover monthly debt service requirements, bondholders have the right to claim all revenues of the system until debt service obligations are met. The strength of this gross revenue pledge and the system's legal protections are key considerations reflected in the credit rating.

CAPITAL PROGRAM: EXTENSIVE CIP REFLECTS SIZE, AGE AND DENSITY OF THE SYSTEM; MANDATED PROJECTS A SECTOR-WIDE RISK BUT REFLECT SMALLER PORTION OF PLAN

The city's ten-year capital improvement program (CIP) includes $13.7 billion of capital improvements to the water and wastewater system between fiscal years 2014 and 2023. Approximately 23% of the city's total capital commitments for fiscal 2015 are for water and sewer-related projects. Bond issuance by the authority in the current version of the CIP averages $1.3 billion annually from fiscal 2015 through 2018.

The CIP includes $5.5 billion of water supply and water distribution projects, $4.7 billion for water pollution control, and $2.5 billion for sewers. Notably, the percentage of the capital plan that reflects mandated projects has decreased significantly, which provides significant flexibility to adjust to fluctuations in revenues and expenses. While mandated capital spending was 89.7% of the total in fiscal 2007, it declined to 17.9% in fiscal 2012 and will average about 17% through fiscal 2023. However, the water and sewer sector is a highly regulated one and mandated capital projects and related uncontrollable costs are always possible.

The New York system benefits significantly from a determination by the federal government that it does not have to filter its upstate Catskill and Delaware drinking water supplies. That ruling expires in 2017 and if it is not renewed or if the renewal includes additional conditions beyond those currently in force, the systems' capital costs could be increased substantially.

VARIABLE RATE DEBT AND INTEREST RATE DERIVATIVES

The authority has $4.7 billion of variable rate obligations outstanding (both hedged and unhedged), as well as a $600 million commercial paper program ($400 million of which is extendible commercial paper without external liquidity support). Including the full amount of authorized commercial paper, the variable rate portfolio reflects 17% of the authority's total outstanding debt. Standby bond purchase agreements with a diverse portfolio of liquidity providers contain favorable legal provisions, most notably a lack of term-out requirements that would accelerate principal in the event that any bond becomes a bank bond.

The authority has two outstanding swap agreements with two different counterparties in an aggregate notional amount of $401 million. As of June 30, 2014 the mark-to-market value was -$86.5 million. Termination of the swaps by the counterparties is limited to highly unlikely events. In the event that the authority should owe a termination payment, the swaps include provisions that allow the rate setting process to occur before the payment is due.

OUTLOOK

The outlook for the New York City Municipal Water Finance Authority is stable. Implementing the authority's capital plan requires substantial issuance of new debt, which in turn requires sizeable rate increase to support. Additionally, like water and sewer systems throughout the nation, regulatory mandates also could drive future capital costs upwards and create other uncontrollable spending needs.

WHAT COULD MAKE THE RATING GO UP

-- A stronger additional bonds test or other stronger limitations on leveraging the pledged revenues

-- A significant and sustained improvement in collection rates and sustained stability in consumption levels

WHAT COULD MAKE THE RATING GO DOWN

-- Failure to continue to set rates at levels needed to afford the system's sizeable capital program, large debt load and the water and sewer system's significant operating costs that result in weakened financial ratios or debt service coverage

-- New state or federal regulations that require especially large capital expenditures or that create uncontrollable costs for the authority

The principal methodology used in this rating was Analytical Framework For Water And Sewer System Ratings published in August 1999. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

Please see the ratings tab on the issuer/entity page on www.moodys.com for additional regulatory disclosures for each credit rating.

Analysts

Baye Larsen
Lead Analyst
Public Finance Group
Moody's Investors Service

Emily Raimes
Additional Contact
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653

Moody's Investors Service, Inc.
250 Greenwich Street
New York, NY 10007
USA