FITCH RATES VIRGINIA BEACH, VA WATER AND SEWER SYSTEM REVS 'AAA'; OUTLOOK STABLE

Fitch Ratings-New York-10 May 2016: Fitch Ratings has assigned an 'AAA' rating to the following Virginia Beach, VA (the city) revenue bonds:

--$42 million water and sewer system (the system) revenue bonds series 2016A; and,

--$42.5 million water and sewer system refunding revenue bonds series 2016B.

In addition, Fitch has affirmed the following ratings:

--Approximately $184 million in outstanding water and sewer system revenue bonds at 'AAA'.

The Rating Outlook is Stable.

SECURITY

The bonds are payable from a first lien pledge of the net revenues of the system including connection fees.

KEY RATING DRIVERS

STRONG FINANCIAL MANAGEMENT: Financial performance remains strong with debt service coverage (DSC) consistently above 2.0x. Liquidity is also strong with unrestricted cash in excess of 540 days cash on hand as of fiscal 2015.

MANDATED CAPITAL; DEBT REMAINS FAVORABLE: The system's capital improvement program (CIP) totals $209 million for fiscals 2017 - 2022 and focuses on aging sewer infrastructure related to the regional consent order to reduce sewer system overflows (SSOs). Approximately 50% of the program is expected to be debt-funded but debt ratios should remain manageable.

STABLE ECONOMY AND CUSTOMER BASE: The economy, traditionally tied to the government (military) and tourism sectors, continues to diversify and has remained stable. The system's customer base is large and mostly residential.

LIMITED SYSTEM OPERATIONS: The system consists of water distribution and sewer collection and conveyance assets only, limiting longer-term operating issues and capital needs to renewal and maintenance.

RATING SENSITIVITIES

SUCCESSFUL CIP IMPLEMENTATION, STRONG FINANCES: The 'AAA' rating and Stable Outlook on the city of Virginia Beach's water and sewer system will remain sensitive to the city's continued capital spending to address its aging sewer infrastructure and successfully meet its consent order requirements regarding sanitary sewer overflow mitigation while maintaining solid financial metrics consistent with 'AAA'-rated utility systems.

CREDIT PROFILE

The city of Virginia Beach is the commonwealth's largest city, with an estimated 453,000 residents in 2015.

LIMITED OPERATING PROFILE, ABUNDANT WATER SUPPLY

The city's water system consists of water distribution assets only. In the 1990s, the city constructed a pipeline and obtained rights to pump surface water from Lake Gaston to address water supply needs.

The Lake Gaston Project, completed in 1997, includes a 76-mile, 60-inch diameter pipeline extending from a tributary of Lake Gaston to the city of Norfolk's treatment facilities, and provides Virginia Beach with an ample long-term independent water supply source. Virginia Beach pays Norfolk for a proportional share of operations and maintenance (O&M) expenses, depreciation, and a rate of return on assets. The city's long-term contract with Norfolk expires in 2030.

The sewer system is a collection and conveyance system only. The sewer system includes collector lines, force mains, and pump stations which are used to collect and transport wastewater to the treatment facilities operated by the region's highly rated sewer treatment provider, the Hampton Roads Sanitation District (HRSD, senior lien revenue bonds rated 'AA+' by Fitch). HRSD provides wastewater treatment services to 17 cities and counties in the state and operates nine total treatment facilities in the region. HRSD bills customers directly for treatment service.

STRONG FINANCIAL OVERSIGHT, CAPITAL NEEDS MAY PRESSURE COVERAGE

The system's financial profile has historically been strong, with solid margins leading to both ample liquidity levels and high DSC. Coverage of senior lien bonds (the sole source of system debt) from all available revenues remained strong in fiscal 2015 at 2.8x including annual transfers out of the system, and days cash on hand was a very robust 543 days. Excluding connection fees, DSC was a still strong 2.5x in fiscal 2015. Annual transfers to the general fund are accounted for as an operating expense of the system, but are legally paid after debt service.

The system ended fiscal 2015 with approximately $116 million in unrestricted cash, a 50% increase in cash from fiscal 2011 levels. Liquidity may decline as the city uses a portion of the system's existing cash and annual cash flows to fund roughly 50% of the CIP but Fitch expects cash levels should remain solid assuming the city raises rates as projected in its financial forecast.

Pro forma financial results show a steady rise in debt service and a corresponding decline in DSC, similar to prior forecasts. The projections appear reasonable and include additional bonds, manageable rate increases, and a slight decline in demand. Historically, the system has generated better financial results than prior projections have indicated, providing a track record that the projections are conservative and likely will be surpassed. Fitch expects the city to outperform projections during implementation of its sizable CIP.

The city has complete rate-setting authority and has incrementally raised sewer rates over the past several years to address consent-related capital needs. Sewer charges consist of a flat fee for service while water charges include a base fee for service and volumetric rates. Water rates have not been increased since 2010.

Overall, the average monthly bill for residential customers using 7,000 gallons of water are an affordable $66 per month in fiscal 2016, or just 1.2% of median household income (MHI). Actual residential use is closer to 5,500 gallons per month. When separate sewer treatment charges from HRSD are included the average monthly bill rises to about $106. Additional water and sewer rate increases are projected beginning in fiscal 2018.

LEVERAGE TO REMAIN MANAGEABLE

Debt levels have historically been modest. In 2015, debt-to-net plant totaled 28%, which is in line with similarly-rated systems, and debt was an affordable $698 per customer. Debt carrying costs were just 15% of gross revenues, which is quite modest for a utility system, and amortization of existing bonds is fairly rapid.

After issuance of the 2016 bonds, the system will have approximately $225 million in debt outstanding, consisting of fixed-rate long-term bonds. The system's modest debt burden is a credit positive, although debt related to HRSD and the city of Norfolk's facilities are not included in the ratios (Norfolk's service charges are an O&M expense of the system, and HRSD bills city customers directly for treatment services).

Debt levels are projected to rise but remain manageable with metrics that will continue to approximate the medians for 'AAA' water and sewer systems once the capital plan is fully implemented, including the issuance of approximately $100 million in additional bonds. The city has spent approximately $190 million on capital acquisition over the past six years, helping to lower the system's average plant age and keep the system in a good state of repair. The system's large cash balances and the projected $10 million - $12 million in excess cash flow (after O&M, debt service, and transfers have been paid) provides significant resources for pay-go funding.

STABLE ECONOMY AND CUSTOMER BASE

The city is located within the Hampton Roads region of Virginia. The economy has traditionally been concentrated in the military and tourism sectors, and both remain significant to the employment base. Several military bases, including the east coast's master jet base, provide significant economic activity to the region with an annual payroll of approximately $1.7 billion and over 32,000 jobs. Efforts to diversify the economy continue as the city works to attract service industries including professional services, telecommunications and marine-related services.

The system serves a predominantly residential customer base. In fiscal 2015, retail service was provided to approximately 133,000 water and 130,000 sewer customers, with little customer concentration. The region's unemployment rate in Feb. 2016 was 4.9% and has been on a steady decline for the past several years. Income levels are above average with median household income at 128% of the U.S. average.

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Additional information is available at 'www.fitchratings.com'.

In addition to the sources of information identified in Fitch's Revenue-Supported Rating Criteria, this action was additionally informed by information from Creditscope.

Applicable Criteria
Revenue-Supported Rating Criteria (pub. 16 Jun 2014)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=750012
U.S. Water and Sewer Revenue Bond Rating Criteria (pub. 03 Sep 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869223