S&P Global
Ratings

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Summary:

Virginia Beach, Virginia; Water/Sewer

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Summary:

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US$42.485 mil wtr & swr sys rfdg rev bnds ser 2016B due 10/01/2031		
Long Term Rating	AAA/Stable	New
US$42.075 mil wtr & swr sys rev bnds ser 2016A due 10/01/2041		
Long Term Rating	AAA/Stable	New
Virginia Beach WS		
Long Term Rating	AAA/Stable	Affirmed

Rationale

S&P Global Ratings has assigned its 'AAA' rating to Virginia Beach, Va.'s series 2016A water and sewer system revenue bonds and its series 2016B water and sewer system refunding revenue bonds. At the same time, we affirmed our 'AAA' rating on parity debt outstanding. The outlook is stable.

Securing the bonds are net revenues of the system, which serves a 160-square-mile area that had a customer base of approximately 438,702 as of June 30, 2015. Bond proceeds from the series 2016A bonds will fund capital projects. Proceeds from the series 2016B bonds will fund a refunding of the system's series 2002 and 2005 bonds.

The ratings reflect our view of the system's extremely strong enterprise risk profile, which is indicated by:

- Stable, largely residential, and very diverse service area economy;
- Very low industry risk;
- Very strong market position based on very affordable rates, and
- Very strong operating risk assessment.

Also reflected in the rating in our view is the extremely strong financial risk profile, which is indicated by:

- A history of maintaining strong financial metrics, with annual debt service coverage (DSC) we consider strong;
- Strong cash reserves, supported by a formal policy to maintain working capital equal to 80%-100% of annual operating expenses;
- A strong debt and liability profile highlighted by a low debt-to-capitalization ratio;
- A $209 million, six-year capital improvement plan (CIP), of which we believe the utility will fund 52% with debt and 48% from operating cash flows; and
- A very strong financial management assessment (FMA).

Due to the system's limited exposure to federal revenue, we believe the rating on the authority's sewer system revenue debt, which exceeds our sovereign rating on the U.S., is warranted (For more information, please see the criteria article, titled, "Ratings Above The Sovereign: Corporate And Government Ratings—Methodology And Assumptions," published Nov. 19, 2013, on RatingsDirect). We believe the water and sewer system's operating expense flexibility and locally derived revenue base, which represents all system revenue, support the higher rating.

Enterprise risk profile

Virginia Beach, with a population of 453,500, is on Virginia's southeastern coast in the Hampton Roads region, and is the state's largest city. With 38 miles of shoreline, it is a prime tourist destination, for East Coast vacationers in particular. Despite the recession, tourism remained solid, in our view. Retail sales are positive and more in line with prerecession figures. Tourism and several military facilities anchor the economy. Income indicators for the city are strong, in our opinion, with median household effective buying income equal to 126% of the national average in 2015. Virginia Beach's unemployment rate has historically been lower than state and national averages. For 2015, it was 4.%, below state and national averages. The military presence in the city is what we believe to be significant, with more than 32,000 service and civilian employees. Although the military provides stability to the economy, the Defense Department reduced spending in the Hampton Roads region following the Budget Control Act of 2011. Its effects are unknown. The sequestration legislation prohibits reductions in active-duty military personnel to achieve required cuts. The region is home to about 100,000 active-duty military personnel. The areas where sequestration cuts are most likely to be felt are in civilian defense employment and ship repair and maintenance. There are about 35,000 civilian defense employees in the Hampton Roads area. However, the majority of the ship repair and maintenance activities in the area are not within the city.

As of June 30, 2015, Virginia Beach provided water services to 132,940 customers and sewer collection services to 129,908 customers within its boundaries. Most of the customer base is residential (80% in fiscal 2015) followed by commercial (17.0%) and governmental (3%). Customer base growth in the past three years has been relatively flat, with a 0.1%-0.2% increase per year in water connections from fiscal years 2011-2015. We consider the customer base very diverse, with the top 10 customers accounting for only 3% of fiscal 2015 total operating revenues. Sewer treatment is provided by the Hampton Roads Sanitation District (HRSD). Customers in the city receive a separate bill from HRSD for $33.17 per month based on 6,000 gallons of water usage.

The city has autonomous rate-setting ability, and has historically implemented multiyear rate increases. Management increased water rates for fiscal years 2010 and 2011, and sewer rates for fiscal years 2010 and 2012-2015. The most recent rate increase occurred July 1, 2014 (the beginning of fiscal 2015). This was the fourth and last increase in a series of four that began in fiscal 2012. Rates are expected to not increase in fiscal years 2016 and 2017. However, projections indicate annual increases of 3.8% for fiscal years 2018 through 2022, primarily to deal with the issuance of $100 million in debt over that period. The increases supported capital and operating budget effects related to complying with the regional consent orders issued to Hampton Roads jurisdictions by the U.S. Environmental Protection Agency and the Virginia Department of Environmental Quality.

We consider the system's rates, which remain among the lowest in the region, affordable relative to service area wealth levels, at $61.68 (residential rate for 6,000 gallons) and 1.3% of Virginia Beach's 2015 median household income, and on the lower end compared with those of other utilities in the region.

Financial risk profile

Strong management, relatively stable demand, and multiyear rate increases have supported the system's historically strong financial performance, in our view. From fiscal years 2011-2015, debt service coverage (DSC) after payment in lieu of taxes (PILOT) payments (S&P Global-calculation) has ranged from about 1.60x (2011) to 3.07x (2014), not including Build America Bond (BAB) subsidy payments, tap fees, and other nonrecurring charges. Coverage for fiscal

2015 was a strong 2.85x and projections indicate that coverage will remain above 2x for the foreseeable future. Although PILOT payments are subordinate to debt service under the master bond resolution, S&P Global, like the audited financial reports, treats them as an operating expense. Additionally, we did not include any debt related to HRSD in the coverage calculation, as HRSD bills customers directly so none of the revenues or expenditures related to wastewater treatment are included in the Virginia Beach's financials.

The system has maintained what we view as a historically strong liquidity position. From fiscal years 2011-2015, the audited fiscal year-ended unrestricted cash and investments balance ranged from $76.8 million-$116.2 million, providing 373-543 days' cash on hand. We expect the system's liquidity to remain strong. As of June 30, 2015, audited unrestricted cash and investments totaled approximately $116.2 million, which equaled 543 days' cash on hand, based on budgeted operating expenses of $74.1 million. The system's fiscal year-end unrestricted cash balance is budgeted at $92.8 million for fiscal 2017 and is projected to be no less than about $92.8 million from fiscal 2018-2022, meeting the city's goal of retaining working capital equal to 80%-100% of annual operating expenses.

In addition to its own water supply, Virginia Beach purchases water treatment services from the city of Norfolk under a long-term water service contract that expires in 2030. The sewer system is collection-only, with flows conveyed to and treated by Hampton Roads Sanitation District. The six-year CIP to 2022 totals $209 million, of which approximately $52.5 million is for water projects and $156.4 million is allocated to sewer projects. CIP projects include rehabilitation of aging infrastructure, neighborhood improvement projects, system expansion, and roadway and storm water coordination projects. Approximately $42 million of 2016 bond proceeds will fund projects. Expected water and sewer CIP funding sources for fiscal years 2017-2022 include unrestricted cash, current operating revenues, and additional debt issuances. We expect that debt will fund approximately $109 million of the CIP in these years, with unrestricted cash and current operating revenues funding approximately $99 million. We consider the city's water and sewer system leverage low, with a debt-to-plant ratio of approximately 24%, based on audited fiscal 2015 results. The city has approximately $57.1 million in authorized but unissued bonds after this issuance.

We consider the city's financial management very strong based on its strong conservative budgeting practices, which include strong oversight and monitoring of the budget during the year. Also included in the assessment are the city's strong long-term planning practices.

We view bond provisions as weak, due to a low 1.15x rate covenant and an additional bonds test (ABT) that can include nonrecurring revenue sources as part of revenues. Virginia Beach has covenanted to maintain rates that yield net revenues equal to 115% of maximum annual debt service (MADS). Bond provisions also include a 1.15x MADS ABT and a reserve funded at MADS. The rate covenant and ABT include tap fees, connection fees, and BAB subsidy payments as part of revenues. Management reports that it will fund the debt service reserve with bond proceeds.

Outlook

The stable outlook reflects our view of continued strong financial performance, based on Virginia Beach's detailed management policies on liquidity and coverage, as well as its record of regular rate increases. The city's stable and diverse customer base further supports our assessment of the outlook. We don't expect to lower the rating within the two-year outlook period given the system's historically strong financial performance and our expectation that this will continue.

Downside scenario

We could lower the rating should the city's financial matrix begin to deteriorate over time. Given consent decree capital projects by the city and the wholesale sewer provider, we would look primarily at any negative effects on coverage levels.

Related Criteria And Research

Related Criteria

- USPF Criteria: Rating Methodology And Assumptions For U.S. Municipal Waterworks And Sanitary Sewer Utility Revenue Bonds, Jan. 19, 2016
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- U.S. State And Local Government Credit Conditions Forecast, April 19, 2016
- U.S. Municipal Water Utilities: No News is (Probably) Good News; The Outlook is Stable, Jan. 20, 2016

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on the S&P Global Ratings public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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