S&P Global Ratings

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Summary:

Virginia Beach, Virginia; Water/Sewer

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Summary:

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Credit Profile		
US$48.375 mil wtr and swr sys rfdg rev bnds ser 2020B due 10/01/2035		
Long Term Rating	AAA/Stable	New
US$41.915 mil wtr and swr sys rev bnds ser 2020A due 10/01/2045		
Long Term Rating	AAA/Stable	New
Virginia Beach WS		
Long Term Rating	AAA/Stable	Affirmed

Rating Action

S&P Global Ratings has assigned its 'AAA' rating to Virginia Beach, Va.'s series 2020A water and sewer system revenue bonds and the city's series 2020B 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. Bond proceeds from the series 2020A bonds will fund capital projects. Proceeds from the series 2020B bonds will fund a refunding of selected maturities of the system's series 2010A-2, 2010B, and 2010C bonds. After the 2020 issuance, the system will have an estimated $214.8 million in debt outstanding.

Due to the system's limited exposure to federal revenue, we believe our 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.

Credit overview

A long history of conservative management has led to strong financial metrics, which generally exceed management projections. Management has developed a capital improvement program (CIP) that deals with aging infrastructure, regulatory compliance, and resiliency. Almost 54% of the water system capital plan and 83% of the sewer system capital plan is for projects related to aging infrastructure and compliance. Many of these projects are also dealing with rising sea levels.

S&P Global Ratings acknowledges a high degree of uncertainty related to the effects of COVID-19, including the rate of spread and peak of the outbreak. We believe measures to contain COVID-19 have pushed the economy into a deep downturn, but management indicates that the Norfolk/Virginia Beach market has seen hotel occupancy rates recover more quickly than other markets. Although we consider the system's financial flexibility could likely be affected by reduced economic activity in the region depending on the length of the downturn or additional shutdowns, in our view, this risk is somewhat mitigated by the system's strong liquidity position, which we believe provides sufficient cushion for short-term disruptions. While we continue to monitor events related to COVID-19, we do not currently anticipate it affecting the system's ability to maintain budgetary balance and make debt service payments. For more information, see "All U.S. Public Finance Sector Outlooks Are Now Negative" (published April 1, 2020) and "The U.S. Economy Reboots, With Obstacles Ahead" (published Sept. 24, 2020).

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 is our view of 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 $189.3 million, six-year 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).

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.

Environmental, social, and governance factors

Overall, we believe that management has mitigated most of the system's environmental, social, and governance (ESG)-related risk by adopting, adhering to, and adjusting its operating and financial policies and procedures. We view most of the district's other ESG risk factors as being on par with those of other similarly rated sewer utilities. There are some factors, which have increased risk as compared to other utilities. Virginia Beach's social risk, while elevated due to increased pressures on the service area economy because of higher public health and safety risks related to COVID-19, will directly increase the system's overall social risks factors. Environmental risk factors, including sea-level rise, are an elevated risk for the system, given its location on the Virginia coastline. This risk is mitigated by the city completing a Comprehensive Sea Level Rise and Recurrent Flooding Study and then using this study to develop plans for both sea-level rise mitigation and stormwater management.

Stable Outlook

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.

Credit Opinion

Enterprise risk profile

Virginia Beach, with a population of 452,643, 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. In previous recessions, tourism remained solid, in our view. Additionally, management has indicated that hotel occupancy rates, which had fallen to 27.8% in April 2020, have risen to 73.4% in July as the economy as begun to open up more. Tourism and several military facilities anchor the economy. Income indicators for the city are strong, in our opinion, with median household effective buying income (MHHEBI) equal to 121% of the national average in 2019. Virginia Beach's unemployment rate has historically been lower than state and national averages. For August 2020, it had fallen to 7.9% from near all-time highs in April and May. The military presence in the city is what we believe to be significant, with more than 32,000 service and civilian employees.

As of June 30, 2020, Virginia Beach provided water services to 134,665 customers and sewer collection services to 131,747 customers within its boundaries. Most of the customer base is residential (80% in fiscal 2020), 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 2011-2020. We consider the customer base very diverse, with the top 10 customers accounting for only 3% of fiscal 2019 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 $47 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 raised water rates for fiscal years 2010 and 2011, and sewer rates for fiscal years 2010 and 2012-2015. The last sewer rate hike 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 for both the water and sewer systems remained unchanged until July 1, 2019, when water commodity rates were lifted to $4.90 per 1,000 gallons from $4.41. Rates are expected to not go up in fiscal year 2021. However, projections indicate annual increases of 3.5% for fiscal years 2022 through 2026, primarily to deal with rising debt service requirements from debt issuance in 2020, 2023, and 2025. 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 $64.62 (residential rate for 6,000 gallons) and 1.21% of Virginia Beach's 2019 MHHEBI, 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 2011-2019, debt service coverage (DSC) after payment in lieu of taxes (PILOT) payments (S&P Global Ratings' 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 2019 was a strong 1.54x and projections indicate that coverage will remain above 1.46x for the foreseeable future. Although PILOT payments are subordinate to debt service under the master bond resolution, S&P Global Ratings, 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 Virginia Beach's financials.

The system has maintained what we view as a historically strong liquidity position. From fiscal years 2011-2019, the audited fiscal year-ended unrestricted cash and investments balance ranged from $76.8 million-$123.3 million, providing 373-586 days' cash on hand. We expect the system's liquidity to remain strong. As of June 30, 2019, audited unrestricted cash and investments totaled approximately $96.1 million, which equaled 413 days' cash on hand, based on budgeted operating expenses of $84.8 million. The system's fiscal year-end unrestricted cash balance is budgeted at $73.9 million for fiscal 2021 and is projected to be no less than about $72.7 million from fiscal years 2022-2026, 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 2060. The sewer system is collection-only, with flows conveyed to and treated by HRSD. The six-year CIP to 2026 totals $189 million, of which approximately $43.5 million is for water projects and $145.8 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. Expected water and sewer CIP funding sources for fiscal years 2022-2026 include unrestricted cash, current operating revenues, and additional debt issuances. We expect that debt will fund approximately $99 million of the CIP in these years, with unrestricted cash and current operating revenues funding approximately $88 million. We consider the city's water and sewer system leverage low, with a debt-to-plant ratio of approximately 23.3%, based on audited fiscal 2019 results.

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.

Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020