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Ratings

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Summary:

Louisville and Jefferson County Metro Sewer District, Kentucky; CP; Note; Water/Sewer

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Credit Profile		
US$225.0 mil swr and dr sys rev bnds ser 2020A due 05/15/2050		
Long Term Rating	AA/Stable	New
Louisville & Jefferson Cnty Metro Swr Dist (ASSURED GTY)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AA' rating to Louisville and Jefferson County Metro Sewer District (MSD), Ky.'s series 2020A sewer and drainage system revenue bonds. At the same time, we affirmed our 'AA' long-term ratings on the district's outstanding debt, as well as our 'SP-1+' rating on its series 2019 subordinate bond anticipation notes (BANs), which will potentially be retired with the proceeds of the series 2020 BANs later this year. We also affirmed our 'AA-' long-term rating on potential subordinate obligations. Lastly, we affirmed our 'A-1+' commercial paper (CP) program rating. The outlook, where applicable, is stable.

MSD will be using 2020A bond proceeds to pay down the CP program. Our analysis of the district's debt also includes a $96.927 million loan from the Environmental Protection Agency's Water Infrastructure and Innovation Act (WIFIA). The loan, which is intended to fund MSD's Morris Forman Water Quality Treatment Center biosolids process solution project, will be made later this summer. The loan is expected to be on parity with the district's outstanding senior lien debt.

Revenues of the sewer district secure the bonds and the notes; however, payment of debt service on the BANs is subordinate to payment on the bonds and all other outstanding parity bonds.

Additional bond provisions include the following:

- The district covenants to maintain rates that generate at least 1.1x coverage on senior-lien debt.
- Additional bonds can only be issued if net revenues for any 12 consecutive of the last 24 months are at least 110% annual debt service on existing bonds for that same period, and either net revenues for any 12 consecutive of the last 24 months or net revenues for the last 12 consecutive months are at least 110% pro forma maximum annual debt service (MADS). Adjustments for the MADS calculation can be made for approved rate increases and system expansion. BAN principal payments are excluded from the additional bonds test (ABT) because they are effectively not paid for from the net revenues of the district, but additional notes or bonds.
- The district established a debt service reserve at the lesser of 10% of par, MADS, or 125% of average annual debt service.
- The par amount of the BANs roughly matches the amount originally outstanding from the district's series 1999A

variable-rate bonds maturing from 2024 to 2033. The district is currently using two outstanding floating- to fixed-rate swaps as a hedge against interest rate fluctuations on the BANs. It is our understanding that it will issue new BANs each year to retire the previous year's BANs (or refinance with long-term bonds once the financing terms are favorable), and then start to pay down the debt in 2024 corresponding with the original 1999A maturity schedule. The series 2019 BANs will mature Oct. 23, 2020.

- The district's long-term rating and low market risk profile score are reflected in our rating on the BANs. The low market risk profile mainly reflects the district having the legal authority present with no material concerns about debt capacity thresholds being breached, nor does it need voter approval or have to meet additional preconditions before issuing take-out debt. Administrative approvals may be necessary but we consider them noncontroversial. There may be debt limits or an ABT, but we don't expect either to represent a limitation on the district's practical ability to issue take-out debt.

Credit overview

The long-term rating reflects, in our opinion, the combination of very strong enterprise and financial risk profiles. It also reflects a strong conservative management team, which has enabled the district to maintain strong coverage levels despite an increasing debt burden. With the fiscal year ending on June 30, 2020, management has indicated that revenues will be right on budget. The district is more concerned with fiscal 2021 for any potential disruptions but at this point, it has proposed a 5% rate increase and is reducing some capital expenditures and other expenses.

While we still believe the utility's revenues may experience some declines for fiscal 2021, ultimately, our expectation is that management will continue to manage the system, whether in delaying self-funded capital projects or by developing operational efficiencies to maintain sound coverage levels. MSD's sewer utility system also has over 253 days' cash on hand, which we believe provides a cushion for short-term disruptions. Additionally, management has instituted its contingency plans to ensure minimal service disruptions. The utility system has indicated that it will not need to make additional transfers to the general fund. While we continue to monitor events related to the COVID-19 pandemic, we do not currently expect it to affect the utility's ability to maintain budgetary balance and pay debt service costs. For more information, see "COVID-19's Potential Effects In U.S. Public Finance Vary By Sector" (published March 5, 2020, on RatingsDirect) and "All U.S. Public Finance Sector Outlooks Are Now Negative" (published April 1, 2020).

The enterprise risk profile reflects our view of the system's:

- Service area participation in the broad and diverse Louisville and Jefferson County metropolitan statistical area (MSA), which we consider strong;
- Very low industry risk;
- Adequate market position assessment; and
- Good operational management practices and policies.

The financial risk profile reflects our view of the system's:

- Strong coverage of all-in debt service, both historically and projected;
- Very strong liquidity position, with over 250 days' cash on hand;

- Weak debt and liability assessment as its debt-to-capitalization ratio is 76% with additional debt expected within five years; and
- Strong financial management practices and policies.

The stable outlook on MSD reflects our expectation that future rate increase will be sufficient to maintain the financial metrics that the city currently maintains, as well as fund the substantial capital improvement plan (CIP).

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 authority's other ESG risk factors as on par with those of other similarly rated utilities. There are some factors, which have increased risk as compared to other utilities. In our view MSD's governance factors have increased risk as the district must have rate increases above 7% approved by the Louisville-Jefferson County Combined Government's 26-member council, which in the past, has not made it easy to get larger rate increases passed. This risk is somewhat mitigated in that the district's board could still approve rate hikes up to 7%.

MSD'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. Management continues to try and lower its social risk beyond COVID by instituting a number of diversity and affordable programs, including a Disparity Study completed in July 2018 to provide a factual predicate for its Supplier Diversity Program. MSD offers a 30% senior citizen discount on wastewater charges for customers over age 65 who have gross household incomes of $35,000 or less. Currently there are approximately 6,800 customers participating in this program. MSD will offer a 10% Emergency Wastewater Rate Assistance Program to customers who are at 150% or less of the federal poverty level beginning Aug. 1, 2020. This is a one-year program that will need to be reauthorized by the board annually. MSD expects about 5,500 customers to apply for this program. It makes annual contributions to the Association of Community Ministries, which assists customers who are unable to pay their utility bill. Customers who do not qualify for one of these discount programs are referred to Community Ministries for assistance.

Stable Outlook

Downside scenario

Should the district coverage levels and liquidity position fall to levels commensurate with a lower rating due to increasing debt service requirements or changes in operations, it is possible we would consider a lower rating.

Upside scenario

Over the longer term, a higher rating would still be possible should the district improve its financial margins and should the local economy's growth and diversification directly lead to improved wealth levels. These latter would improve the district's market assessment and lead to a higher rating.

Credit Opinion

Enterprise risk

Our assessment of the system's enterprise risk profile as very strong reflects Louisville and Jefferson County MSD serving a population of 766,757 with a customer base of about 259,125 (90% of whom are residential). The service area is large and diverse, with the top 10 wastewater customers representing just 6% of total operating revenue. Larger employers include United Parcel Service Inc. (23,533 employees), Humana Inc. (12,000), Norton Healthcare Inc. (12,579), Ford Motor Co. (13,042), and Amazon.com (5,700). We consider median household effective buying incomes for the city and county adequate at 95%. In addition, the unemployment rate for April 2020 was 16.2%.

Consistent with our criteria, titled "Methodology: Industry Risk" (published Nov. 19, 2013), we consider industry risk for the system very low, the most favorable assessment possible on a '1' to '6' scale, with '1' being the best.

Residential wastewater rates are currently low at $58.20 for 6,000 gallons of use, including a monthly consent decree surcharge of over $12.87. In fiscal 2008, the district increased rates by 33% to begin funding some of its needs related to a consent decree and its own capital needs. From fiscal years 2009-2013, it raised rates 6.5%; then in fiscal 2014, rates rose 5.8%; for fiscal years 2015 and 2016, the annual increase was 5.5%. The increase for fiscal years 2017 to 2019 (which became effective on Aug. 1) was 6.9% each year. The district can avoid political involvement by the city/county metropolitan government in its rate-making process through an ordinance that permits rate increases of up to 7% annually without political approval, provided available revenues in any six-month period are below the 1.1x rate covenant. With the 33% increase, the district obtained political approval from the metropolitan government. We expect the current low rates to steadily rise over time, given that projections indicate about a 6.9% annual rise in rates. Management is potentially looking at a significant hike sometime in the next couple of years for additional work cited in its 20-year facilities plan. The plan calls for over $4.3 billion in projects through 2036. Due to the COVID-19-induced recession, management will raise rates on Aug. 1, 2020 by 5% instead of the planned 6.9%, but all indications are that next year's increase will return to 6.9%.

Based on our operational management assessment (OMA), we view MSD to be a '2' on a scale of '1' to '6', with '1' being the strongest. This indicates, in our view, that operational and organizational goals are generally well aligned, even if some challenges exist. The OMA of good includes the authority's well-embedded asset adequacy identification program and a comprehensive operational risk-reduction plan. It also reflects the challenges the district faces under the consent decree.

Additionally, management from year to year provides information and assistance for a green infrastructure program, and some of these programs are eligible for incentives through the Louisville Metro Government's Office of Sustainability. Green infrastructure solutions include rain gardens and barrels, vegetated roofs, and permeable pavement sidewalks and parking lots. Other programs include an urban reforestation program with the planting of over 1,000 trees per year as these trees keep 1.35 million gallons of stormwater out of the sewer system.

Financial risk

Our assessment of the system's financial risk profile as very strong reflects financial performance, as measured by both debt service coverage (DSC) and operating liquidity, which has remained at least good. Coverage of annual debt service has fluctuated somewhat over the prior four fiscal years, but net revenues have been no less than 1.2x since 2008; coverage was 1.44x for the 2019 fiscal year. Through 2020, most recent available projections indicate net revenues will cover annual debt service by 1.61x-1.65x; this factor includes subordinate debt and net swap payments. Regarding unrestricted cash and investments, since 2008, the equivalent days of operating expenses has been at least 120 days, which we consider strong; for 2019, the district had $80.4 million of unrestricted cash and investments, or 253 days of operations.

The district's total five-year CIP (2020-2024) totals $926 million. It is our understanding that it will continue to fund about 60% of these projects with debt. About 20% of the five-year CIP is related to the consent decree, which is down from about 40% in the past.

The debt burden is high as the debt-to-capitalization ratio is above 76%, and management indicates that it will issue an additional $600 million in debt by fiscal 2024.

We view the district's swap portfolio as low risk, given the remoteness of termination risks, low counterparty risk bolstered by counterparty guarantees/collateral posting provisions, and good overall management with an adopted swap policy. The district has two floating-to-fixed swap agreements with Wells Fargo N.A. (AA-/Stable/A-1+) and Bank of America N.A. (A/Positive/A-1). Both of these help hedge BAN interest rate risk. All of the swaps have collateral posting requirements if the counterparty ratings drop below 'A+', and there are automatic termination provisions if the rating on the district falls below 'BBB'. Given the district's 'AA' category rating, we view the termination risk as remote. Regarding management of the swap portfolio, management's debt policy includes a swap management plan. The plan indicates that the counterparties must maintain good market access, and that all swaps are to be analyzed by district staff, an independent financial advisor, and the district's legal counsel. The outstanding notional amount of the bonds related to the district's swap portfolio as of June 2019 was $226 million, and the swaps have a fair value of negative $83.5 million.

In June 2018, the district started a CP program, which S&P Global Ratings rated 'A-1+'. The series 2018A-1 has a total program authorization of $250 million. Liquidity support for the series 2018A-1 notes is provided through a revolving credit agreement with Bank of America that expires July 1, 2021. The series 2018A-2 notes have a total program authorization of $250 million. Liquidity support for the series 2018A-2 notes is provided through a revolving credit agreement with JP Morgan Chase Bank that expires on July 1, 2021. Currently, the district estimates that there is $230 million drawn under this program, which is intended to be refunded with long-term bonds in 2020. It originally planned to issue between $150 million and $175 million each year from fiscal 2018-2022, but now, with the CP program in place, it plans to issue $200 million in fiscal years 2022 and 2024.

The district has a strong financial management assessment, meaning that policies and procedures are well embedded in the operations of the system that we consider likely to continue. Management does a significant amount of long-term planning and, as mentioned above, has policies in place to deal with the swaps.

Related Research

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

Ratings Detail (As Of June 29, 2020)		
Louisville & Jefferson Cnty Metro Swr Dist subord		
Short Term Rating	SP-1+	Affirmed
Louisville & Jefferson Cnty Metro Swr Dist sub CP		
Short Term Rating	A-1+	Affirmed
Louisville & Jefferson Cnty Metro Swr Dist sub CP		
Short Term Rating	A-1+	Affirmed
Louisville & Jefferson Cnty Metro Swr Dist swr		
Long Term Rating	AA/Stable	Affirmed
Louisville & Jefferson Cnty Metro Swr Dist swr (BAM) (SECMKT)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Louisville & Jefferson Cnty Metro Swr Dist swr (BAM) (SECMKT)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Louisville & Jefferson Cnty Metro Swr Dist ws		
Long Term Rating	AA-/Stable	Affirmed
Louisville & Jefferson Cnty Metro Swr Dist (wrap of insured) (FGIC & BHAC) (SEC MKT)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Louisville & Jefferson Cnty Metro Swr Dist (FGIC) (National)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Louisville & Jefferson Cnty Metro Swr Dist (MBIA) (BHAC)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Louisville & Jefferson Cnty Metro Swr Dist (MBIA) (National)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.