

# **FITCH AFFIRMS NEW ORLEANS, LA'S WATER AND SEWERAGE REVS AT 'A-'; OUTLOOK REVISED TO NEGATIVE**

Fitch Ratings-Austin-30 October 2018: Fitch Ratings has affirmed the 'A-' rating on the following ratings on bonds issued by the City of New Orleans, LA (the city) on behalf of the New Orleans Sewerage and Water Board (SWB):

- \$200.7 million water revenue and refunding bonds series 2014 and 2015;
- \$216.5 million sewerage service revenue and refunding bonds series 2014 and 2015.

The Rating Outlook is revised to Negative from Stable.

## **SECURITY**

The sewerage service revenue bonds are payable from net revenues of the city's sewer utility system. The water revenue bonds are payable from net revenues of the water utility system.

## **KEY RATING DRIVERS**

**DETERIORATING FINANCES DRIVE OUTLOOK REVISION:** Flooding in August 2017 resulted in unanticipated capital spending, which drew down cash reserves. Decreased collections resulting from disputed bills related to a new billing system compound the deterioration in finances. Neither an audit for 2017 (fiscal year-end December 31), nor projected 2018 results are available. Management reports that as of August 2018 the sewer system maintained only 36 days cash on hand (DCOH).

**APPROVED RATE INCREASES THROUGH 2020:** Annual 10% rate increases for both the water and sewer utilities are already approved and expected to be implemented for fiscals 2019 and 2020. The rate increases should result in increased revenue collections, which could stabilize the Outlook.

**OPERATIONAL CHALLENGES:** Water supply is ample, but unmetered and unaccounted for water loss (typically around 70%) remains a long-term cost challenge for the water system and reflects a water distribution system in serious disrepair. The sewer collection system exhibits similar disrepair, but SWB received some timing relief on capital projects required under its consent decree, and reports full compliance with the consent decree. Sufficient staffing remains an ongoing issue for both systems.

**MASSIVE CAPITAL NEEDS:** Capital needs for both systems are extremely large following decades of deferred investment, in addition to repairs needed after Hurricane Katrina in 2005. Debt levels are expected to increase in the future as SWB begins supplementing federal capital spending on the systems with its own debt issuances, but the timing and sizing of any issuance is still being determined.

**INTERDEPENDENCE OF TWO SYSTEMS:** Fitch's maintenance of the same rating on the separately secured bonds reflects a common governance structure, rate setting process, customer base, billing system and management team. In addition, the two systems have a close financial relationship as demonstrated by past intra-fund borrowings and reallocation of costs and assets between the systems.

## **RATING SENSITIVITIES**

**IMPROVED REVENUE COLLECTION:** The outlooks for the New Orleans Sewerage and Water Board's water and sewerage revenue bonds could stabilize if revenue collections increase as billing disputes are resolved and rate increases are implemented. Failure to implement the approved rate increases would likely result in a downgrade of both ratings. Unresolved billing system complications that result in a sustained deferral of revenue collection could also place downward pressure on the ratings.

## CREDIT PROFILE

SWB is an independent legal entity from the city of New Orleans (A+/Stable). However, both the New Orleans city council and the Board of Liquidation (the board), have approval responsibilities over debt issuance and rate setting. The board serves as the debt service custodian for all SWB debt. SWB provides retail water and sewerage service to nearly 135,000 customers in the city. The combined customer base grew by an average of 1% annually from 2013 to 2016.

New Orleans is a major tourism destination and has a significant commercial presence, which support growth prospects of the city. The local economy continues to diversify from its historical reliance on shipping and energy. The population of New Orleans is estimated at 395,000, about 90% of the population prior to Katrina, up from a low point of around 30% immediately following the storm.

## NEGATIVE OUTLOOK DRIVEN BY DECREASED LIQUIDITY, REVENUES

A flood in August 2017 and the rollout of a new billing system that resulted in billing errors - and increased delinquent accounts - have eroded finances that were previously on a positive trajectory. The flooding in 2017 was the result of insufficient power and pumping capacity to drain portions of the city after heavy rainfall. Since the flood, SWB has spent about \$80 million on projects to restore pumping capacity and create redundant power supplies. The unexpected and accelerated capital spending resulted in a draw-down of cash reserves.

Compounding the drop in liquidity are decreased revenues resulting from a spike in delinquent accounts. A new billing system rolled out in late 2016 is suspected of generating incorrect bills, which customers began disputing. Shut off of past due accounts was suspended in November 2017 as the billing issues were investigated. Shut offs were reinstated in August 2018, but if customers filed a formal dispute with SWB a delinquent account would not be shut off. As of September 2018, management reports that about \$30 million is due to SWB on nearly 23,000 delinquent accounts. The majority of the balance due (\$22 million) is on accounts more than 60 days past due.

SWB is actively working at reducing operating expenditures through the end of the year by an estimated \$10 million to \$15 million. Additionally, SWB expects to receive a Federal Emergency Management Agency (FEMA) reimbursement for up to \$24 million by year end. Both measures are expected to improve the systems' liquidity position. Positively, funds for next year's debt service payments are already accrued at the board and SWB has not missed any of its monthly accrual payments to the board.

## NEW MANAGEMENT TEAM TO FOCUS ON REVENUE COLLECTION

Since August 2017, SWB has had multiple interim executive directors and was also without a permanent CFO until this past summer. Both positions are now filled with permanent hires and Fitch believes both executives bring relevant and demonstrated experience to SWB. Management reports that SWB's primary focus is stabilizing revenue collections and addressing the billing issues. After a state-approved delay in publishing 2017 audited results (unavailable as of the date

of this publication), management indicated its intent to return to timely audit publication for fiscal 2018. Filling vacancies, currently estimated at about 350, is also reported as a high priority by the new management team.

## RATE INCREASES THROUGH 2020; AFFORDABILITY PRESSURES

A multi-year rate plan approved in 2012 included 10% annual rate increases for both the water and sewer systems. Rate increases began in 2013 and were approved through 2020. The remaining two years of implementation provide the opportunity for SWB to return to an adequate level of revenue generation. Actual recognized revenue will still be dependent upon successful billing and collection of customer accounts. A new rate study is expected to begin in 2019, which should allow ample time to obtain the necessary approvals should rate increases be proposed for 2021 and beyond.

A combined monthly bill totaled about \$100, as of 2016, based on Fitch's usage metrics of 7,500 gallons and 6,000 gallons for water and sewer, respectively. The bill equates to a high 3.2% of median household income (MHI), materially higher than Fitch's affordability threshold of 2% of MHI. Rate increases since 2016 will have pushed the monthly bill higher, and additional increases through at least 2020 result in increasing affordability concerns. Positively, actual usage in the service area is lower (about 5,000 gallons) resulting in lower monthly charges. Fitch believes rate increases beyond 2020 will be necessary to support planned capital projects and adequate financial margins, suggesting affordability will remain a concern for the foreseeable future.

## AMPLE WATER SUPPLY; LARGE, UNACCOUNTED FOR WATER LOSS

The city has ample water supply provided by the Mississippi River, with four raw water intakes and two water treatment plants (one located on each side of the river). Treatment capacity is well in excess of the system average daily demand, generally less than 40 million gallons per day (mgd), but flows through the plants are much higher (141 mgd in 2016) given the very high amount of water loss in the distribution system.

Water losses were high prior to Katrina at around 55%, reflecting an aging system of water mains and distribution pipelines, underground pipes below sea level and years of deferred investment in the system. Additional leaks and ruptures occurred after Katrina and the rate is now typically around 70%. While this figure dropped to 62% in 2017 it is unclear whether the downward trajectory will continue. The water loss represents a cost to the system in terms of water treatment and delivery (pumping) costs. It also represents a significant cost to the drainage utility that must regularly pump all excess water out of the city's service area. SWB, with the aid of FEMA funding, continues to detect and repair leaks and replace distribution pipelines.

## CONSENT DECREE PROJECTS REMAIN ON TRACK

The sanitary sewer system also consists of two treatment plants: one on the west bank of the Mississippi (40 mgd) and one on the east bank (122 mgd). Similar to the water system, the treatment capacity is in excess of current flows (average flows were 106 mgd in 2016). The sewer system is under a consent decree from the U.S. Environmental Protection Agency to reduce sanitary sewer overflows, which can occur during wet-weather events when the treatment plants are overwhelmed from high levels of influent. Management reports that 95% of projects related to the consent decree have completed the design phase, and all projects are currently on track with stipulated timelines.

## EXTREMELY LARGE CAPITAL NEEDS; DEBT METRICS VARY BY SYSTEM

Estimated five-year capital costs for the water system (2018-2022) total around \$381 million, while costs for the sewer system during this period total \$334 million. An additional \$534 million is also identified as "combo" projects, which are attributed to all three systems (water, sewer, drainage). With liquidity currently strained, capital expenditures have been suspended through the end of the year, except for consent decree projects.

Management previously expected to support limited amounts of pay-go funding from its approved 10% rate increases, but Fitch expects any increase in revenue in fiscal 2019 would be used to restore cash balances, with a minimal amount available for pay-go funding. Funding sources for the current CIP have not been finalized, but SWB does expect to issue additional debt to fund capital projects. The timing and amount of any such issuance(s) is unknown. Fitch believes rate increases beyond 2020 will be necessary to generate sufficient cash flows for pay-go funding and/or increased debt service resulting from future issuances.

Debt/customer metrics of \$1,726 and \$2,440 (as of 2016) for the water and sewer system, respectively, are both acceptable for the rating category. As of 2016, debt/funds available for debt service (FADS) of 6.9x for the sewer system compares favorably with the 'A' category median. With tighter margins at the water system, debt/FADS is very elevated at 25.8x. Increased margins will be necessary, specifically for the water system, to prevent an escalation in debt/FADS that would no longer support the current rating.

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In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

A January 2018 district court ruling that dismissed claims regarding payment of Puerto Rico Highways and Transportation Authority debt has raised questions about the scope of protections provided by Chapter 9 of the U.S. bankruptcy code to bonds secured by pledged special revenues. Fitch's rating criteria treat special revenue obligations as independent from the related municipality's general credit quality. The outcome of the litigation could result in modifications to Fitch's approach. For more information, see "What Investors Want to Know: The Impact of the Puerto Rico Ruling on Special Revenue Debt" available at [www.fitchratings.com](http://www.fitchratings.com).

Additional information is available on [www.fitchratings.com](http://www.fitchratings.com)

## Applicable Criteria

Rating Criteria for Public-Sector, Revenue-Supported Debt (pub. 26 Feb 2018)

<https://www.fitchratings.com/site/re/10020113>

U.S. Water and Sewer Rating Criteria (pub. 30 Nov 2017)

<https://www.fitchratings.com/site/re/10010508>

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