

FITCH UPGRADES NEW ORLEANS, LA'S WATER & SEWERAGE REVS TO 'A-'; OUTLOOK STABLE

Fitch Ratings-Austin-04 November 2016: Fitch Ratings has upgraded 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 (NOSWB):

--\$203.5 million water revenue and refunding bonds, series 2014 and 2015 to 'A-' from 'BBB+';
--\$247.8 million sewerage service revenue and refunding bonds, series 2014 and 2015 to 'A-' from 'BBB+'.

The Rating Outlook is 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

UPGRADE REFLECTS FINANCIAL AND SYSTEMS IMPROVEMENTS: The rating upgrades reflect strengthening cash flow at each of the systems, positive governance changes, improved financial practices and investment into utility management systems.

HEALTHY FINANCIAL MARGINS AND LIQUIDITY: Sewer fund debt service coverage is over 2.0x while the water system is more modest at 1.6x. Liquidity is adequate with Fitch-calculated unrestricted funds equal to 266 and 129 days cash on hand at the sewer and water system, respectively.

OPERATIONAL CHALLENGES: Water supply from the Mississippi River is ample but a high 72% water-loss rate in the distribution system is a cost and operational challenge. The sewer collection system exhibits similar disrepair, but NOSWB received some timing relief from regulators on the capital repairs required. Sufficient staffing is 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 increasing as NOSWB begins supplementing federal capital spending on the systems with its own debt issuance.

APPROVED RATE INCREASES THROUGH 2020: A series of eight 10% annual rate increases (2013 - 2020) for both the water and sewer systems are generating healthy financial margins and should fund rapidly increasing debt service being used to fund the most critical of capital needs. Rate levels are high as a percentage of median household income.

INTERDEPENDENCE OF TWO SYSTEMS: Fitch's maintenance of the same rating on the separately secured bonds reflects the close financial relationship of the water and sewer funds as demonstrated by past intra-fund borrowings and reallocation of costs and assets between systems.

GROWTH IN SERVICE AREA: NOSWB's service area exhibits customer growth averaging 1.8% annually and solid future growth prospects as the city continues its recovery from Katrina.

RATING SENSITIVITIES

CONTINUED FINANCIAL DISCIPLINE: The Stable Outlook reflects Fitch's expectation that the New Orleans Sewerage and Water Board will consistently achieve increased revenues necessary to support the growing debt service costs while executing its large capital plan.

CREDIT PROFILE

NOSWB is an independent legal entity from the city of New Orleans (general government Issuer Default Rating 'A+'). However, both the New Orleans city council and the Board of Liquidation, City Debt have approval responsibilities over debt issuance and rate setting. The board serves as the debt service custodian for all NOSWB debt. NOSWB provides retail water and sewerage service to around 130,000 customers in the city. Average annual customer growth has been 1.8% over the past five years.

New Orleans is a major tourism destination and has a significant commercial presence, which support solid 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 an estimated 390,000, around 85% of the population prior to Katrina, up from a low point of around 30% immediately following the storm.

POSITIVE GOVERNANCE CHANGES AND SYSTEM INVESTMENTS

A new Board of Directors was seated in summer 2014 as well as a new executive director. The changes were recommended as part of the 2012 rate package to reform the governance of the utility by requiring professional qualifications of board members, shortening the terms, reducing the number of directors, and imposing term limits. The new board has redefined board and senior management roles. The executive director is prioritizing execution and acceleration of the capital improvement plan and the board has moved into a policy-setting role and delegated more responsibility to NOSWB management for day-to-day decision making.

Utility management has worked to improve fiscal discipline, achieve quick and high quality disclosure of financial information and to refine the budget and accounting processes. Financial planning is viewed by Fitch as prudent and includes timely updates of long-term financial, rate and capital models that inform capital spending. Management is expanding its traditional five-year financial plan into a 10-year financial plan to consider longer-term rate, capital and financial trends. Recent management system investments include the implementation of a new billing system (replacing a system that was installed in 1984) and an upcoming roll-out of a human resources and payroll system. The investment of capital into enterprise systems should facilitate internal processes and mitigate, to a degree, some of the pressures relating to the hiring and retention of adequate staffing.

HEALTHY FINANCIAL PERFORMANCE; STRONGER CASH FLOW

Financial metrics have improved in the past three years, with the 10% annual rate increases on each system beginning in 2013. While continued revenue increases will be required to support existing debt issuance, NOSWB's track record of actual revenues received from the rate increases indicates financial margins should remain healthy. Debt service coverage of water revenue bonds in fiscal 2015 was 1.65x. While 2015 revenues were insufficient to coverage maximum annual debt service (MADS) on existing debt, which will occur in 2018, additional revenues from the annual rate increases are expected to provide sufficient net revenues.

The water system produced free cash flow to annual depreciation of 26% and 6% in 2015 and 2014, respectively. The increase resulted from a decrease in annual depreciation in 2015 following a one-time clean-up reallocation of certain assets from the water system to the sewer system. Free cash flow to depreciation is weak for the water system; Fitch's sector median is 94%. While the ratio should improve during the five-year forecast, it is not projected to reach annual depreciation levels through fiscal 2018, limiting the amount of free cash available for pay-as-you-go capital sources. Water system unrestricted cash was \$26.3 million at the end of 2015 (including unrestricted cash and cash in the designated capital fund), or equal to 129 days operating cash.

Debt service coverage of sewer revenue bonds in 2015 was 2.35x. The 2015 sewer fund revenues were sufficient to cover MADS on existing debt, which will occur in 2017. Debt service coverage is projected to remain above 2.0x in upcoming years, including planned debt issuance.

The sewer system produced free cash flow to annual depreciation of 94% and 96% in 2015 and 2014, respectively, and is projected to exceed 100% in management's financial forecast. Fitch expects this to generate funds to contribute to sewer system capital. Cash reserves at the end of 2015 were \$39 million, equal to 266 days operating cash.

AMPLE WATER SUPPLY; LARGE, UNACCOUNTED FOR WATER LOSS

New Orleans 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 of 37.8 million gallons per day (mgd) in fiscal 2015, but flows through the plants are much higher (140.6 mgd in 2015) given the very high amount of water loss in the distribution system.

Water losses were high prior to Katrina at around 56%, reflecting an aging system of water mains and distribution pipelines, underground pipes below sea level, and years of deferred investment in the system. Many additional leaks and ruptures have occurred post-Katrina, bringing the rate up to 72%. This represents a cost to the water system in terms of water treatment and delivery (pumping) costs. However, it also represents a significant cost to the board's drainage utility that must continuously pump all excess water out of the city's service area. The board, with the aid of Federal Emergency Management Agency (FEMA) funding, continues to detect and repair leaks and replace distribution pipelines.

CONSENT DECREE DRIVES SEWER CAPITAL SPENDING

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 (combined treated flows were 140.6 mgd in 2015 while metered sewer sales were 31.8 mgd in 2015). The sewer system is under a consent decree from the U.S. Environmental Protection Agency (EPA) to reduce sanitary sewer overflows, which can occur during wet-weather events when the treatment plants are overwhelmed from high levels of influent.

EXTREMELY LARGE CAPITAL NEEDS; DEBT LEVELS WILL INCREASE

Estimated five-year capital costs for the water system (2016-2020) total around \$426 million, while costs for the sewer system during this period total \$439 million. The sewer system has been more successful at accelerating capital spending than the water system. Much but not all of the spending on the sewer system is related to a consent decree. Management expects that based on its approved 10% rate increases for both systems through 2020, it can support limited amounts of pay-as-you-go funding in the next five years for capital for each system (2% for water and 34% for sewer).

However, continued funding for a portion of the capital plan is expected to come from outside sources, primarily FEMA.

Debt levels on both systems will increase over the next five years. Management expects to issue another \$124 million in water revenue bonds and \$162 million in sewerage service revenue bonds. Based on these issuance levels, debt per customer is expected to increase to around \$2,100 and \$2,400 per customer for the water and sewer systems, respectively, within five years. In comparison, Fitch's median for the sector is around \$1,800 debt per customer. Capital needs extend beyond the current five-year capital plans, with higher amounts for the water system related to needs at the treatment plants. Continued debt increases are likely beyond the five year forecast timeframe.

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Applicable Criteria

Revenue-Supported Rating Criteria (pub. 16 Jun 2014)

<https://www.fitchratings.com/site/re/750012>

U.S. Water and Sewer Revenue Bond Rating Criteria (pub. 03 Sep 2015)

<https://www.fitchratings.com/site/re/869223>

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