

FITCH RATES MASSACHUSETTS WATER RESOURCES AUTHORITY REVS 'AA+'; OUTLOOK STABLE

Fitch Ratings-Austin-18 March 2016: Fitch Ratings assigns an 'AA+' rating to the following Massachusetts Water Resources Authority, Massachusetts (MWRA, or the authority) bonds:

- Approximately \$85 million general revenue bonds, 2016 series B;
- Approximately \$348 million general revenue refunding bonds, 2016 series C (Green Bonds).

The bonds are scheduled to sell via negotiation the week of April 4. Bond proceeds will be used to fund a portion of the authority's capital program, refund certain outstanding bonds of the authority for interest savings without extension of maturity, and pay costs of issuance.

In addition, Fitch affirms the following ratings of the authority:

- \$3.4 billion (pre-refunding) general revenue bonds at 'AA+';
- \$963 million subordinate general revenue bonds at 'AA'.

The Rating Outlook is Stable.

SECURITY

The bonds and parity general revenue bonds are payable from a first lien on net revenues of the authority, derived largely from wholesale rates and charges assessed on local units of government. The subordinate lien bonds are payable from a second lien on net authority revenues, subordinate only to the authority's lien securing its senior lien obligations.

KEY RATING DRIVERS

REGIONAL PROVIDER OF ESSENTIAL SERVICE: MWRA provides essential wholesale water and wastewater services to a large and diverse service area that encompasses 61 communities located primarily in eastern Massachusetts, including the City of Boston. The service area benefits from strong economic underpinnings.

STRONG PROTECTIONS ENSURE PAYMENT: Local governments served by the authority are required to pay for MWRA services as a general obligation, and non-payment is subject to a tested state aid intercept.

ABILITY TO SET RATES INDEPENDENTLY: The authority maintains independent and unlimited rate-setting authority, prudent budgetary practices, comprehensive long-term planning, and vigilant project oversight and prioritization of its capital program.

DIMINISHED FLEXIBILITY: Financial flexibility has diminished over time due to significant leveraging. As the authority enters into the peak years of debt service costs, end user charges will escalate further but should stabilize over time.

DECLINE IN CAPITAL PROJECTS: The authority's capital improvement program (CIP) has transitioned from costly court-mandated projects to ongoing rehabilitation.

IMPECCABLE COLLECTIONS: MWRA has achieved strong collection rates of 100% since its inception.

ABUNDANT CAPACITY: The wholesale system benefits from an ample long-term water supply and sufficient excess water and sewer treatment capacity.

RATING SENSITIVITIES

ESCALATION IN CAPITAL COSTS: A reversal to increased capital expenses and corresponding debt funding that increases the Massachusetts Water Resources Authority's leverage and reduces debt service coverage could result in put downward rating pressure.

CREDIT PROFILE

LARGE SERVICE TERRITORY WITH STRONG ENFORCEMENT MECHANISMS

MWRA provides wholesale water and wastewater services to 61 communities located primarily in eastern Massachusetts. Almost 2.8 million people (or over 40% of the population of the commonwealth) reside in the authority's service area. The largest of these is the City of Boston (general obligation bonds 'AAA'/Stable Outlook), which contributes approximately one-third of MWRA's revenue derived from rates and charges. Fitch rates the Boston Water and Sewer Commission's (BWSC) revenue bonds 'AA+'/Stable Outlook. The service area generally is economically diverse, and wealth levels tend to be above state and national averages.

The 61 local communities included in the service area are required to pay for MWRA services as a general obligation, and rate-setting is not subject to any limitations, including the state's Proposition 2 1/2. These protections, coupled with the authority's ability, pursuant to its enabling act, to utilize a local aid intercept to recover amounts unpaid by one of its member communities (excluding revenues of the BWSC), provide significant operating flexibility and are important credit considerations.

HIGH RATES LIMIT FLEXIBILITY

MWRA's high rates are an ongoing credit concern as flexibility continues to diminish. Average combined rates within MWRA are \$126.30 (based on 120 hundred cubic feet of water usage) and register 2% of median household income (MHI), which is also Fitch's affordability threshold. However, the size of needed rate hikes has trended downward in recent years as annual capital spending has begun to decline to a more manageable level. Over the last five years through fiscal 2015 the authority raised rates on average a moderate 2.98% annually. Rates were increased by 3.4% annually in fiscals 2015 and 2016. The authority anticipates annual increases of 3.9% for fiscal 2017 to 2019.

MWRA's long term rate forecast also continues to trend downward. Rates once forecast to climb by 5.2% by 2021 are now forecast to increase by 4.5% in 2022. Actual rate adjustments may be less, though, as MWRA has prudently been applying surplus revenues to level off near-term escalations in debt service costs. Beyond fiscal 2022 debt service carrying costs begin to drop off, which should afford the authority ample capacity to limit growth in rate adjustments in future years.

STABLE FINANCIAL PERFORMANCE

The authority's financial operations have remained very stable despite escalating debt service and a reliance on moderate rate hikes. Historical DSC on senior lien obligations has averaged a strong 1.9x over the five years through fiscal 2015 (based on Fitch's calculation of DSC, which includes certain accruals from the income statement). All-in DSC, which includes subordinate public debt and privately-placed state revolving fund loans, has been low but adequate at 1.1x over the last five

fiscal years. Liquidity, while still solid, dipped slightly to 274 days cash on hand in fiscal 2015, just under the 300 days it has averaged since 2011.

Fiscal 2015 ended with a sizeable budgetary surplus that was prudently applied to the retirement of approximately \$36 million of outstanding bonds in the fiscal 2016-2020 timeframe, providing budgetary relief during those years. Fiscal 2016 year-to-date results also show a positive variance and are expected to allow the authority to defease approximately \$25 million in debt targeting fiscal 2020 annual debt service. MWRA's positive variances are driven by conservative budgeting estimates (particularly with regards to variable interest rate costs) and tight expenditure controls.

SUBSTANTIAL LEVERAGE TEMPERED BY IMPROVING CAPITAL CYCLE

The projected base-line spending cap for capital projects spanning fiscal years 2014-2018 is now estimated at \$711 million (down from \$765 million last year) and includes a significant shift in funding priorities from regulatory compliance projects to renewal and replacement (R&R) of system assets. Estimated spending for asset protection is now over 55% of the CIP compared to 31% in the fiscal 2009-2013 capital cycle. Conversely, costs related to the ongoing court-mandated combined sewer overflow (CSO) control plan will drop to just 7% of capital spending versus 38% over the last five years.

The authority's CIP remains sizeable but is significantly below historical spending levels, which were driven by the cleanup of Boston Harbor in the 1990s and the completion of the majority of the CSO master plan in recent years. In December 2015 courts declared MWRA's long-term CSO Control Plan to be substantially complete. As the authority's focus shifts from regulatory compliance projects to system maintenance and asset protection, the focus will be on providing water redundancy in the system. This accounts for a significant amount, roughly 40%, of the planned spending in fiscal 2019-2023 proposed CIP. Fitch believes future capital costs will remain manageable given MWRA's vigilant project oversight and its board's self-imposed spending cap for capital projects.

Funding for capital needs will continue to come almost entirely from long-term borrowings, including revenue bonds and state revolving fund loans. The authority's debt levels have been and will remain high for the foreseeable future due to past borrowings. Debt to net plant is notably high at 100%, and annual debt service costs consume over one-half of gross annual revenues. Fitch expects this trend to continue for the intermediate term. Favorably, more debt is expected to roll off through fiscal 2018 than will be issued. This positive variance of amortization to debt issuance is expected to continue beyond fiscal 2018, which should help to improve the authority's debt profile over time.

Contact:

Primary Analyst
Teri Wenck
Director
+1-512-215-3742
Fitch Ratings, Inc.
111 Congress, Suite 2010
Austin, TX 78701

Secondary Analyst
Doug Scott
Managing Director
+1-512-215-3725

Committee Chairperson
Dennis Pidherny
Managing Director
+1-212-908-0738

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email:
elizabeth.fogerty@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.

In addition to the sources of information identified in Fitch's Revenue-Supported Rating Criteria, this action was additionally informed by information from Creditscope.

Applicable Criteria

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

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=750012

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

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869223

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