

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

Fitch Ratings-Austin-22 July 2016: Fitch Ratings has assigned a 'AA+' rating to the following Massachusetts Water Resources Authority, Massachusetts (MWRA) bonds:

--Approximately \$105 million general revenue refunding bonds, 2016 series D (Green Bonds).

The bonds are scheduled to sell via negotiation as early as the week of Aug. 1. Bond proceeds will be used to 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 MWRA ratings:

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

--\$906 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 MANDATED CAPITAL PROJECTS: The authority's capital improvement program (CIP) has transitioned from costly court-mandated projects to ongoing rehabilitation and system redundancy.

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 DEBT: Rising capital costs that lead to escalating debt levels, particularly if it results in lower debt service coverage, could result in downward rating pressure for the Massachusetts Water Resource Authority.

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'/Outlook Stable), which contributes approximately one-third of MWRA's revenue derived from rates and charges. Fitch currently rates the Boston Water and Sewer Commission's (BWSC) revenue bonds 'AA+'/'Outlook Stable'. 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 based on the authority's advisory board's most recent rate survey for fiscal 2015 were around \$1,500 per year (based on 120 hundred cubic feet of water usage), registering at 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 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 and just 3.34% in fiscal 2017.

MWRA's long-term rate forecast also continues to trend below prior estimates. Rates forecasted to climb by as much as 5.2% annually by 2021 are now estimated to increase by 3.8% through fiscal 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 2023 debt service carrying costs begin to drop off, which should afford the authority 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 audited 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 same period. 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.

Preliminary fiscal 2016 results are also favorable. DSC is similar to historical norms and a \$45 million positive variance allowed the authority to defease over \$30 million in debt related to fiscal 2017-2022 maturities. 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 \$661 million (down from \$711 million in fiscal 2016) and includes a significant shift in funding priorities from regulatory compliance projects to renewal and replacement (R&R) of system assets and water redundancy. Estimated spending for asset protection and water redundancy is now almost 80% of the CIP compared to 46% in the fiscal 2009-2013 capital cycle. Conversely, costs related to the ongoing court-mandated combined sewer overflow (CSO) control plan will drop to around 10% 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.

Over the next 15 years or so, the capital program is expected to ramp up from current levels as the authority concentrates capital spending on R&R and water redundancy projects. Preliminary capital needs for fiscal 2019-2023 total \$1.2 billion and an additional \$900 million in spending related to redundancy projects alone has been tentatively slated for beyond fiscal 2023, with most of this spending currently expected to occur by fiscal 2032. Despite the uptick in expected spending over the next several years, 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 for at least several additional years beyond fiscal 2018, even with the planned capital spending, which should help to improve the authority's debt profile over time and position the authority to handle the additional debt associated with R&R and redundancy projects.

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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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