Fitch Ratings 2019 Outlook: U.S. Water and Sewer Sector

Fitch's Sector Outlook: Stable

Fitch Ratings' 2019 stable outlook for the U.S. water and sewer sector reflects strong sector characteristics and a conservative business model that provides utilities with stability, even during periods of uncertainty. The fundamental hallmarks of the sector include: essentiality of service; lack of competition; and generally autonomous rate-making authority. These underpinning strengths continue to produce favorable financial results and reliable cash flows.

Rating Outlook: Stable

The rating outlook for the sector is Stable, and only limited rating changes in 2019 are expected. At Oct. 31, 2018, 93% of the water and sewer ratings assigned by Fitch maintained a Stable Outlook. Approximately 5% maintained a Positive Outlook or Watch and 2% a Negative Outlook or Watch. Ratings trending negative relate primarily to issuers whose financial profiles have weakened, while ratings trending positive relate to a mix improving financial margins and decreasing capital pressures.

Rating Distribution Weighting

Sector ratings continue to be among the highest of all asset classes, with a median rating of 'AA', reflecting the sector's strong characteristics and conservative business model.

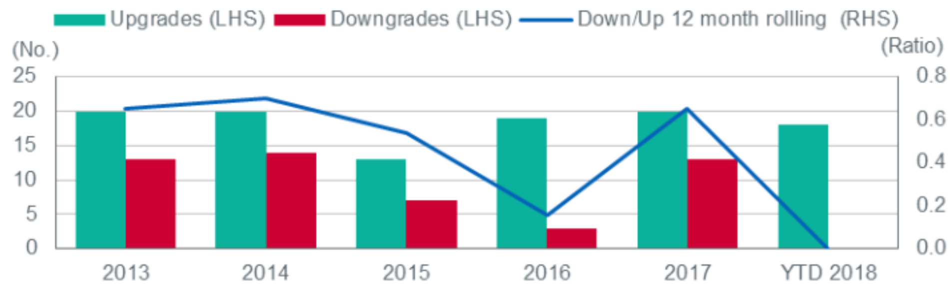
Doug Scott, Managing Director

"Fitch forecasts a stable operating performance for the U.S. Water and Sewer sector in 2019 as utilities continue to enact steady rate adjustments to accommodate operating cost increases and capital needs."

What to Watch

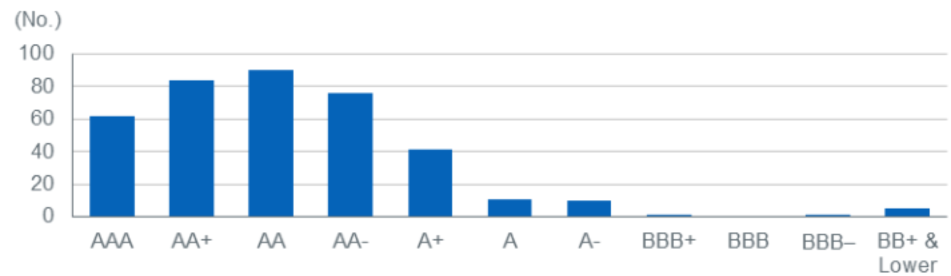
- Maintenance of solid financial cushion and robust balance sheets.
- Steady to slight uptick in capital outlays but stable leverage profiles.
- Trends in service affordability.
- Changes to Lead and Copper Rule (LCR), continued discharge tightening.
- Rising interest rates.

Water & Sewer - Rating Changes



Note: As of Oct. 31, 2018.
Source: Fitch Ratings.

Water & Sewer - Rating Distribution



Note: As of Oct. 31, 2018.
Source: Fitch Ratings.

Sustained Financial Cushion

Fitch expects revenues will climb between 2% and 4% in 2019 based on anticipated adjustments by rated credits, relatively flat consumption patterns and continued moderate economic expansion nationally. These revenue gains will help to offset expected marginal increases in operating and debt service carrying costs and preserve solid debt service coverage levels at or near existing levels. Surplus cash flows are also expected to continue the positive trend Fitch has observed in recent years and exceed annual depreciation expenses. Finally, Fitch expects reserve balances, which have moved higher over the past decade and posted their highest levels with Fitch's 2019 medians, will remain very robust and will continue providing more than sufficient insulation to any downside operational risk during the year regardless of planned drawdowns for capital.

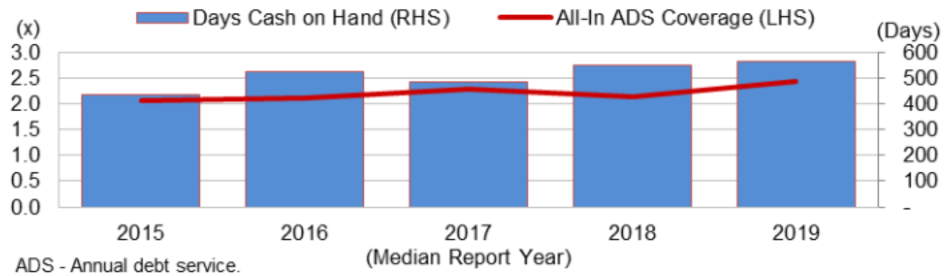
Leverage Profiles Steady; Capital Spending Flat to Up Slightly

Fitch expects capital spending within the sector during 2019 will approximate or see a slight increase from 2018 levels as issuers continue to push forward on a measured basis with renewal and replacement of assets, address regulatory requirements and diversify supply resources. Given the strong financial position of most utilities, issuers by and large are expecting to fund roughly two-thirds of their capital funding from surplus cash flows and balance sheet resources, keeping sector leverage in check or even pushing debt levels down somewhat from their currently moderate range. The mix of debt to equity funding for capital could shift marginally to more borrowed resources to accommodate rising steel costs, but overall Fitch expects key leverage metrics to rise by no more than 2% during 2019.

Affordability Adequate But Diminishing

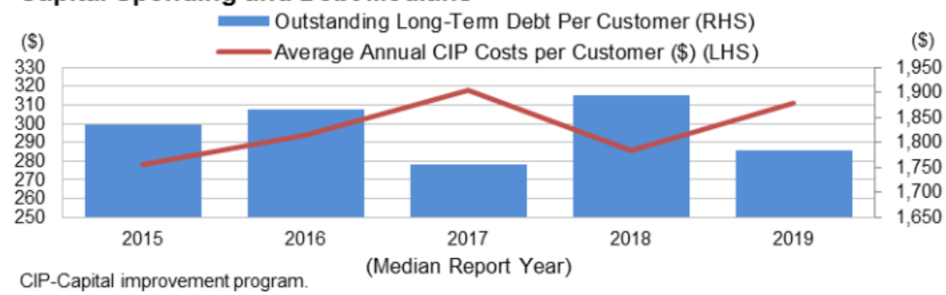
Water and sewer charges have escalated at a much faster pace than the consumer price index (CPI) over the past few decades. The American Water Works Association reports that while the CPI slightly more than doubled from 1988–2014, typical residential water bills more than tripled and wastewater rates more than quadrupled. This rate of increase in utility charges has not only outpaced CPI growth but also overall gains in median household income (MHI), as demonstrated within Fitch's own medians, which point to user charges steadily climbing toward Fitch's 2% of MHI affordability benchmark. Affordability cushion remains overall for Fitch-rated credits but with utilities anticipating ongoing rate adjustments that are expected to outpace CPI increases, the issue of affordability is becoming an increasing focus among sector stakeholders and could pressure finance and debt ratios over time.

Debt Service Coverage and Liquidity Medians



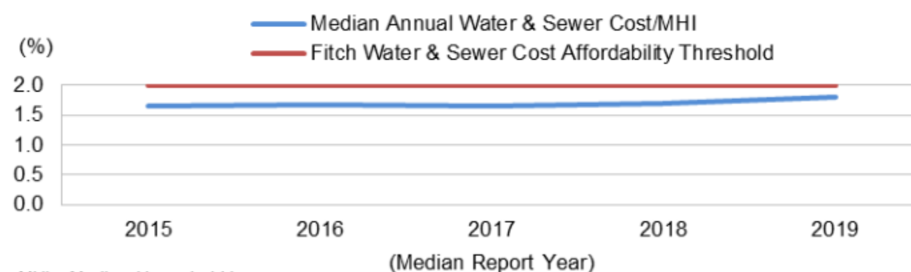
ADS - Annual debt service.
Source: Fitch Ratings.

Capital Spending and Debt Medians



CIP-Capital improvement program.
Source: Fitch Ratings.

Residential Water/Sewer Costs



MHI - Median Household Income.
Source: Fitch Ratings.

Lead and Copper Rule Changes; Wastewater Discharge Tightening

The regulatory environment in the U.S. is expected to remain largely stable in 2019. However, the U.S. Environmental Protection Agency (EPA) currently expects to release proposed revisions to the LCR in 2019Q1, which have been long delayed. The EPA published a white paper in October 2016 announcing a comprehensive list of potential elements being considered as part of any LCR rule promulgation, including potential operational changes as well as the possibility of mandating lead service line (LSL) replacements for which the full cost was estimated by EPA to be as much as $80 billion nationwide. The credit effect of the LCR revision to issuers will depend on the scale and timing of operating and capital costs as well as the responsibility of and legal ramification to utilities for replacement of LSLs if required.

Apart from the LCR's possible ramifications to water purveyors, Fitch expects wastewater providers will continue to see enhanced phosphorous and nitrogen nutrient removal criteria incorporated into discharge permits when renewed; discharge permits are subject to renewal on a five-year cycle. In many cases, these additional restrictions require limited operating changes or capital outlays. However, in some cases, the nutrient reductions can result in significant additional costs to utilities, which could have a direct bearing on the utility's credit quality.

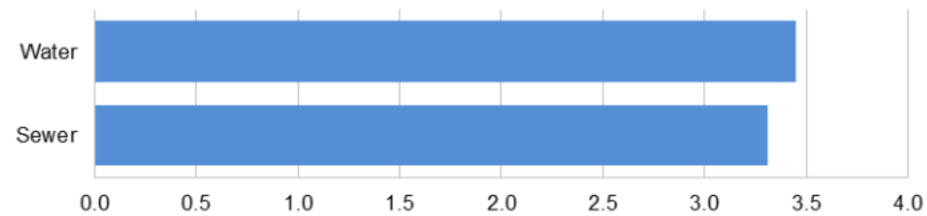
Interest Rates and Capital Access

Low interest rates and robust access to the capital markets are a positive for the capital-intensive water and sewer sector. While Fitch expects the Fed to continue tightening monetary policy through 2019 to 3.25%, borrowing rates for utilities should remain low by historical standards and should not lead to any sudden upward swings in price movement given traditional debt issuances within the sector have been predominately fixed rate in nature. Ongoing federal appropriations for state revolving fund programs as well as the federal Water Infrastructure Finance and Innovation Act program administered by EPA, both of which provide below-market interest rates for borrowers, provide effective market alternatives to utilities.

Potential Disrupting Factor

Increased volatility in weather extremes has the potential to escalate sector capital needs as utilities seek to harden assets and enhance water supply capability to ensure service delivery. Added capital demands would further erode sector affordability levels and likely drive leverage metrics higher than currently anticipated.

Projected Average Annual Rate Increase Medians (%)



Source: Fitch Ratings.

U.S. Economic Forecast				
(%)	**2017**	**2018F**	**2019F**	**2020F**
GDP	2.2	2.9	2.6	2.1
CPI Inflation (end-year)	2.1	2.4	2.3	2.4
Policy Interest Rate (end-year)	1.50	2.50	3.25	3.50
U.S. 10-Year Yield	2.43	3.10	3.75	4.10

F – Forecast.
Source: Fitch Ratings.

Outlooks and Related Research

2019 Outlooks
Global Economic Outlook (December 2018)
2019 Water and Sewer Medians (November 2018)

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