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OUTLOOK
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Municipal water and sewer utilities – US

Outlook remains stable despite coronavirus challenges and economic slowdown

The outlook for the US municipal water and sewer utility sector remains stable in spite of the coronavirus outbreak and resulting economic downturn. The sector benefits from strong liquidity and sound debt service coverage leading into the crisis, autonomous rate-setting authority and its role as a provider of essential services. The weaker economy will likely prevent the sector's coverage and liquidity from increasing in 2020-21, largely due to reduced commercial demand and the elimination of service shutoffs and late fees. Also, some utilities will face challenges if a parent government requires financial support. Despite these potential challenges, the sector's fundamental strengths will preclude material declines in credit quality.

» **Most utilities have stable and diverse customer bases.** Residential customers typically account for more than half of the sector's revenue and will support continued demand for water and sewer services. Utilities with outsized reliance on certain commercial and institutional customers are more vulnerable to credit deterioration.

» **Debt service coverage will remain sufficient, though narrower than pre-crisis levels.** Going into the crisis, municipal water and sewer utilities boasted strong debt service coverage. The closure of nonessential businesses related to the virus will temper our previously anticipated coverage growth, as will the elimination of service shutoffs and late fees. Customer rate increases will be less politically palatable. Still, the essentiality of water and sewer services will support steady demand from residential customers, which in turn will prevent material declines in coverage.

» **The sector's robust liquidity will provide a significant buffer against revenue declines.** Median days cash on hand (DCOH) was exceptionally strong heading into 2020 at over 500 days. In lieu of rate increases, many utilities will rely on rate stabilization reserves, when available, as well as existing unrestricted cash balances to maintain budgetary stability. In addition to unrestricted reserves, most utilities we rate have debt service reserve requirements that provide further protection for bondholders.

» **Satisfactory asset conditions will allow for some deferred capital investment.** The median remaining useful life of capital assets for the sector is adequate at 27 years. Some utilities may postpone capital projects in 2020-21 to help manage cash flow, but infrastructure conditions should remain satisfactory unless capital underinvestment continues beyond 2021.

» **Contagion risk from parent governments will pose credit challenges for some utilities.** Fiscal stress at the city or county government level has the potential to lead to cash transfers or other forms of support from utilities to parent governments in states where this is allowed, but we expect instances of material support for parent governments to be rare.

» **What could change the outlook.** We could revise the outlook to negative if restrictions on nonessential business operations continue for a prolonged period, leading to a longer and more substantial disruption in coverage and liquidity.

This outlook represents our forward-looking view on credit conditions in the sector over the next 12 to 18 months. This sectorwide outlook, however, does not imply the likelihood or direction of rating actions for individual issuers.

Most utilities have stable and diverse customer bases

Most water and sewer utilities benefit from diverse customer bases that provide a high degree of stability. Many utilities' customer bases are primarily residential, which will support continued demand for water and sewer usage. As a result, most utilities will not see significant shifts in overall consumption or any material service area contraction.

Commercial and industrial demand has waned with the coronavirus pandemic because of stay-at-home orders and restrictions on operations by nonessential businesses. However, declines in nonresidential usage will be partially offset by increases in residential consumption. Utilities with a high concentration of commercial and institutional customers that struggle to rebound from the economic downturn, as well as systems that operate in areas with particularly weak economies, are more vulnerable to the pandemic's effects. Industries highly exposed to the pandemic's impact include the service industry, automobile manufacturing, and oil and gas production.

While the impact will vary by region, we project that US GDP will contract by 5.7% in 2020, followed by a rebound of 4.5% in 2021. This projection incorporates our view that economic activity will experience severe contraction in the second quarter and that a gradual recovery will commence in the second half of 2020. Our forecasts may change in the event that the pandemic continues and lockdowns extend beyond current expectations. Longer-term lockdowns would cause greater reductions in demand by nonresidential customers.

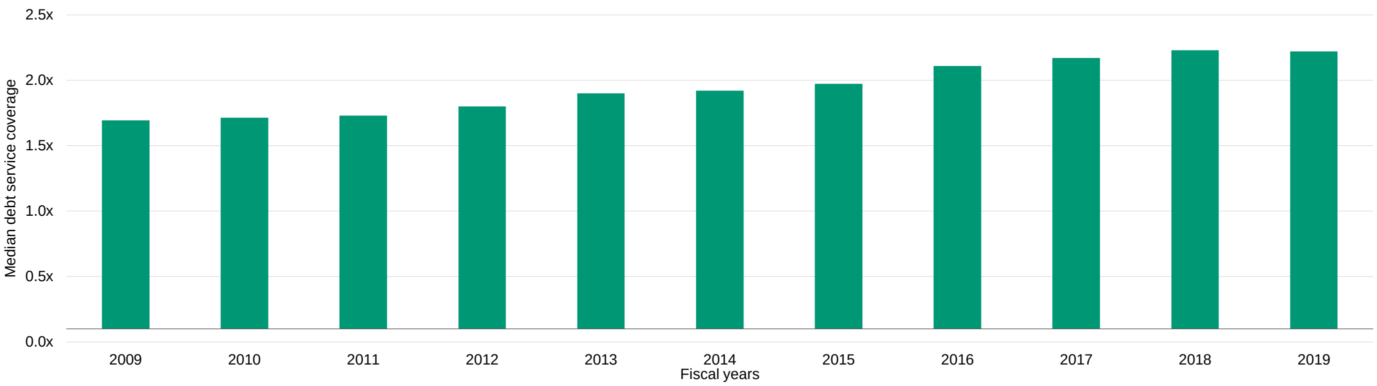
Debt service coverage will remain sufficient, though narrower than pre-crisis levels

The sector entered the crisis with a strong median debt service coverage ratio of over 2.0x (see Exhibit 1). Net revenue has grown at a faster rate than debt service, bolstering coverage over the past six fiscal years and improving financial flexibility. Net revenue will likely weaken due to immediate declines in nonresidential consumption. A rise in payment delinquencies from residential and nonresidential customers will also temper gains in debt service coverage in 2020-21.

Exhibit 1

Strong debt service coverage leading into crisis at over 2.0x

Sectorwide median debt service coverage



Source: Moody's Investors Service

While utilities benefit from autonomous rate-setting authority, social risks stemming from high unemployment will make rate increases and service shutoffs politically difficult. Some utilities have already reduced, deferred or eliminated planned rate increases. Further, material operating expenditure reductions are unlikely as cuts to nonessential personnel will be met with increases in overtime and on-call pay for essential personnel.

Despite these challenges, sectorwide median coverage levels will remain above 1.5x. Municipal water and sewer utilities provide an essential service. Residential customers will provide steady demand for utility services that will support debt service coverage.

Robust liquidity will provide a significant buffer against revenue declines

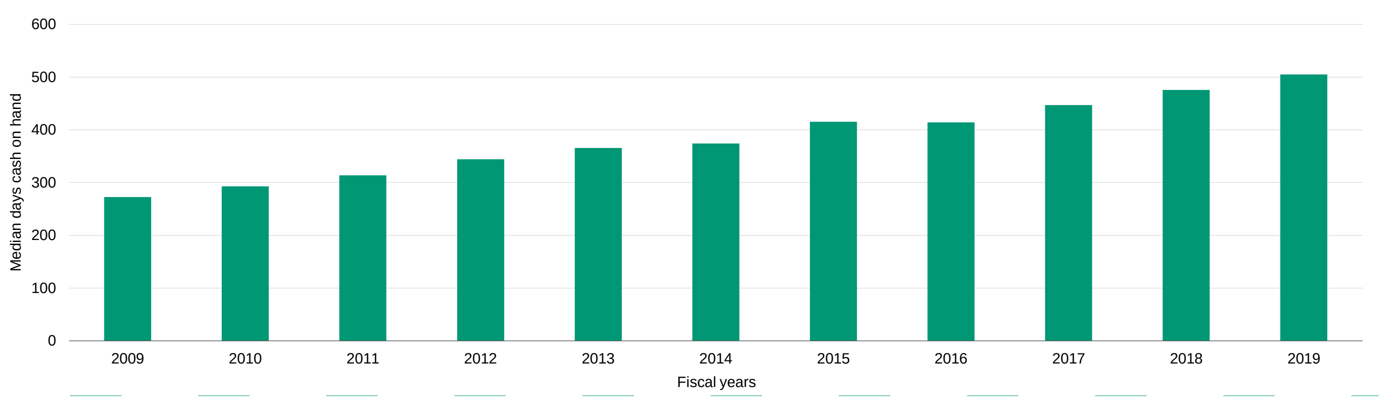
Growth in net revenue has resulted in substantially improved liquidity over the past decade. Median days cash on hand (DCOH) was exceptionally strong heading into 2020 at over 500 days (see Exhibit 2), the highest level since at least 2009. Strong liquidity will provide a significant buffer against revenue declines and allow utilities to maintain financial stability during the economic slowdown, even without rate increases.

Many utilities will tap rate stabilization reserves, when available, as well as existing unrestricted cash balances to manage through cash flow issues. Additionally, most utilities have debt service reserve funds (DSRF) with requirements they be maintained at a specific levels. We expect trustees will use DSRFs for debt service in the event net revenue falls short. A reliance on existing unrestricted cash or reserve funds would come in lieu of increasing rates as a way to spread revenue losses among the customers base. Any declines in liquidity, however, are not likely to be material enough to impair credit quality.

Exhibit 2

Strong liquidity at a median over 500 days cash on hand (DCOH) provides a cushion against negative repercussions from the coronavirus

Exhibit shows sectorwide median DCOH, also known as median days of operations and maintenance expense (O&M)



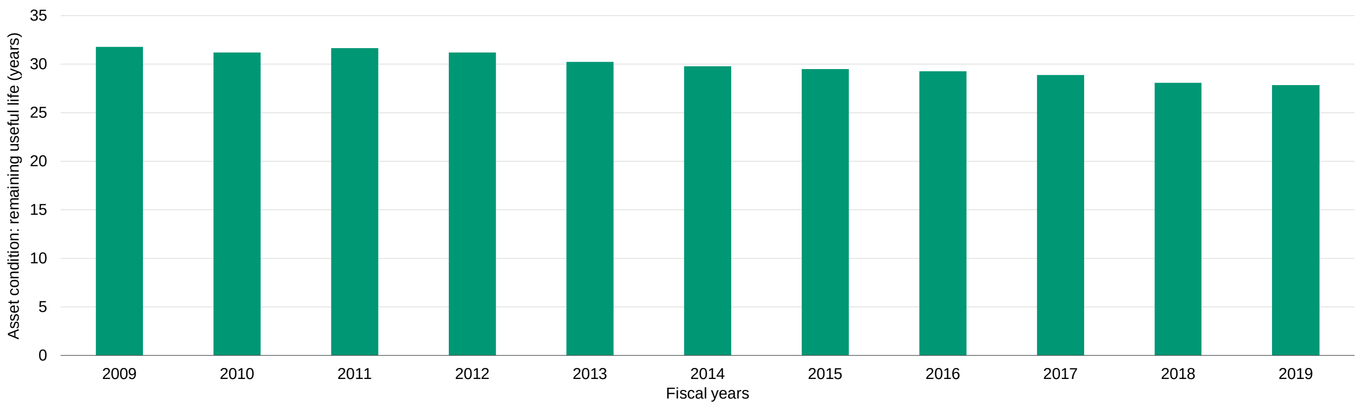
Source: Moody's Investors Service

Satisfactory asset condition will allow for some deferred capital investment

The median remaining useful life of capital assets for the sector is satisfactory at 27 years, despite some declines over the past decade (see Exhibit 3). Some utilities may delay or reduce capital projects in 2020-21 to help manage cash flow issues in the face of difficulties related to the coronavirus. Asset condition should remain satisfactory, however, with any postponement in capital investments likely short-lived. If capital spending is deferred beyond 2021, asset condition may worsen. Most utilities maintain multiyear capital improvement plans and we expect them to make continued progress toward these goals over the long term, despite any short-term disruption related to the crisis.

Exhibit 3

Depreciation outpaces investment, decreasing remaining useful life, but asset condition remains satisfactory
Median sectorwide remaining useful life (net fixed assets divided by annual depreciation expense)



Source: Moody's Investors Service

Contagion risk from parent governments will pose credit challenges for some utilities

Utilities that operate as an enterprise or component unit of a city or county face additional credit stress if a parent government encounters cash flow issues. Most utilities share the same governing body (council, board or commission) with their parent government. In some cases, the parent government may require utilities to transfer revenues or cash reserves. A decline in parent government credit quality can impair utility credit quality as well given the close linkage. However, we expect instances of material impairment of utility credit quality to be rare.

What could change the outlook

We could revise the outlook to negative if the contraction in economic activity extends beyond the second quarter of 2020, significantly delaying the gradual recovery we currently anticipate will commence in the second half of 2020. A longer disruption could lead to greater losses in demand, which would have a more negative effect on debt service coverage and liquidity. Additionally, a longer disruption could elevate contagion risk from parent city or county governments.

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