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Fayetteville Public Works Commission, North Carolina; Combined Utility; Retail Electric; Water/Sewer

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Credit Profile

US\$98.28 mil rev bnds ser 2021 due 03/01/2051

<i>Long Term Rating</i>	AA/Stable	New
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Fayetteville pub works comm rev bnds

<i>Long Term Rating</i>	AA/Stable	Affirmed
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Fayetteville Public Works Commission, North Carolina

Fayetteville, North Carolina

Fayetteville Public Works Commission (Fayetteville) COMBUTIL

<i>Long Term Rating</i>	AA/Stable	Affirmed
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Rating Action

S&P Global Ratings assigned its 'AA' long-term rating to the City of Fayetteville Public Works Commission, N.C.'s (PWC) series 2021 revenue bonds. At the same time, S&P Global Ratings affirmed its 'AA' long-term rating on the PWC's parity obligations outstanding. The outlook is stable.

The 2021 bonds include about \$98.3 million in new money (primarily for water and wastewater extensions and improvements). Net revenue of the combined electric, water, and wastewater utility system secures the bonds. At fiscal year-end 2021 (unaudited), the utility had \$286 million of debt outstanding.

The rating reflects our opinion of the utility's very strong enterprise risk profile and financial risk profile. Key factors supporting the rating include the PWC's deep and diverse service area, credit supportive policies, and robust financial metrics. Partly offsetting the above strengths, in our view, are the PWC's substantial capital needs associated with the water and sewer systems, which are expected to significantly increase the utility's long-term debt outstanding; above-average electric rates (mitigated by moderate water and sewer rates); and weak demographics (low median household effective buying income, high poverty rates, and an above-average unemployment rate).

Because the water and wastewater systems account for the preponderance of net operating revenue of the combined utility, we have applied our "U.S. Public Finance Waterworks, Sanitary Sewer, And Drainage Utility Systems: Rating Methodology And Assumptions" criteria, published Jan. 19, 2016, on RatingsDirect. However, our analysis incorporates our view of the electric system's creditworthiness, including the regulatory risks it faces with regard to its power supply from Duke Energy Progress Inc. (DEP), including those related to carbon emissions and coal ash costs.

Credit overview

The enterprise risk profile reflects our view of the PWC's:

- Very strong operational and management assessment, highlighted by what we view as an experienced and

sophisticated management team engaged in credit-supportive planning and in adopting a robust set of financial policies and reserves;

- Adequate market position with rates that we generally consider affordable given that average residential water use of 5,000 gallons represents about 2.3% of median household effective buying income, although we note an elevated county poverty rate at 18% and electricity rates that have historically been slightly higher than the state average; and
- Strong service area economic fundamentals, reflecting our view that the utility benefits from the economies of scale afforded by a large, diverse, and primarily residential combined customer base, which, in our view, promotes stability.

The financial risk profile reflects our view of the utility's:

- Healthy all-in coverage metrics by our calculations at more than 1.55x over each of the past five audited years, with projections indicating a slight decline to 1.45x in fiscal 2022 but a rebound to more than 1.5x in the following years;
- Ample liquidity and reserves, with more than \$180 million in unrestricted and designated cash and investments measuring over 242 days of operating expenses in 2020 (we expect the days' cash to stabilize within the 220- to 260-day range over the next four years); and
- Healthy debt and liabilities profile for fiscal year-end 2020 debt to capitalization of 29%, while incorporating the expectation for around \$304 million in new money debt following this issuance.

The stable outlook reflects our view that, although the utility is exposed to a sizable capital program, it will continue to adjust rates as it deems necessary to maintain strong financial metrics, including robust all-in debt service coverage and ample liquidity.

Environmental, social, and governance factors

We believe that the PWC's power supply from DEP presents moderate environmental exposures through DEP's carbon emitting assets. DEP's fuel mix is 43% natural gas, 29% nuclear, and 26% coal. The PWC is exposed to environmental costs that DEP incurs related to addressing coal combustion residuals (coal ash). We believe that management has not only been extremely diligent in conservatively forecasting and budgeting for the costs, but that it has shown sophistication in the tools it has used to mitigate the uncertainty of these expenses.

We believe the PWC's social factors are in line with those of rated peers, as management reports that the COVID-19 pandemic's effects on the utility's customer base have generally been muted.

Finally, the PWC's governance factors, including its rate-setting authority, robust financial policies and forecasting practices, are strong, which we view favorably.

Stable Outlook

Upside scenario

We do not expect to raise the rating during the two-year outlook horizon, given the utility's significant capital spending needs and the expectation that debt and debt service requirements will increase.

Downside scenario

We could lower the rating during the next two years if capital or operating pressures significantly deteriorate the PWC's financial profile to a level well below forecast for a sustained period.

Credit Opinion

Fayetteville PWC provides water, wastewater, and retail electric service within Cumberland County and its surrounding areas. With a population above 385,000, the Fayetteville metropolitan service area ranks as the sixth largest in North Carolina.

In fiscal 2021, the PWC's water and wastewater systems each served 91,000 connections respectively with residential accounts representing 93% of customers, while residential electric customers represented 88% of 85,000 accounts.

The total operating revenue of the water and wastewater systems accounted for around 30% of the combined system's operating revenue based on unaudited fiscal 2021 figures, with the top 10 customers representing 2.5% of all three segments' operating revenue. In our view, the utility faces substantial capital cost pressures but we believe that management has been proactive in its approach by both building reserves and margins to insulate financial metrics and raising rates. For the water and wastewater systems, the PWC has adopted rate increases of 3.5% and 6.8%, respectively, during fiscal 2022 and 3.7% and 7.4% for fiscal 2023.

The PWC operates a transmission and distribution electric system, purchasing the vast majority of energy requirements from DEP under a full-requirements contract that expires June 30, 2042. Water and wastewater systems have ample treatment capacity to meet demand for the foreseeable future. Energy and capacity pricing is determined annually, which, in our opinion, enhances budgetary stability. We also view the PWC's access to DEP's diverse set of assets and fuel sources as a credit positive.

We believe that management's diligence in forecasting and budgeting for the costs shows its sophistication and discipline in combating the uncertainty of these expenses. In the wake of the initially estimated coal ash liability of \$75 million to \$80 million over fiscal years 2018 to 2026, management accumulated excess reserves in its electric rate stabilization fund and designated coal ash reserves fund, and established a coal ash rider in fiscal 2018 to cover these projected costs. Management has had success in offsetting the risks associated with these uncertain costs through a combination of increasing reserves and implementing the rider.

With the PWC meeting about one-third of energy needs through DEP's coal units, we expect that the PWC will remain exposed to future environmental regulations, which we view as inevitable. The DEP power supply agreement, which was renewed in November 2019, now extends through 2042. The PWC expects that modifications to the agreement should generate \$313 million in net present value savings from decreased power supply payments over the remaining 21 years, with the bulk of the impact starting in fiscal 2025. The PWC also leases its Butler-Warner Generation Plant to DEP under a separate contract that concludes fiscal 2024. Choosing not to extend the contract minimally impacts the electric system's operating revenues. Finally, the PWC receives a small allocation of federal hydropower from the Southeastern Power Administration.

The utility, which has full rate-setting autonomy for its electric system and is not rate regulated, has a good track record of adjusting rates as needed, with independent rate studies conducted every other year. We view rate setting as supportive of strong financial metrics. The PWC utilizes either its rate stabilization reserve to address small adjustments from annual true-ups of power and coal ash costs with DEP, or a power cost adjustment pass-through to ratepayers to recover larger amounts. We view these mechanisms as adequate given the strong reserves that the PWC maintains, but insofar as it is not automatically applied, we do not consider it a credit positive. Budget-to-actual variances are reviewed monthly for purchased power and fuel.

In our view, management is an experienced and capable steward of the utility. The PWC conducts comprehensive succession planning and apprenticeship programs. In our view, financial policies are robust. Unrestricted cash and investments, not including the coal ash and rate stabilization reserve, are targeted at 120 days of generally-accepted-accounting-principles-based operating expenses (and a 90-day minimum), rates are set to achieve at least 1.75x debt service coverage, and transfers to the city are set at 2.45% of the prior year's electric fund net position. Planning efforts are generally supportive of credit quality. The utility annually updates its 10-year capital improvement plan, as well as its multiyear financial forecasts and strategic plans.

We view the PWC's coverage of fixed costs as a credit strength. Fixed-cost coverage has been consistent and sustained at more than 1.55x over the past five fiscal years. By our calculations, the PWC expects some weakening in coverage in the near term to 1.45x in fiscal 2022 with a rebound to more than 1.50x in the following two fiscal years. Given the expected cost savings in the DEP power supply agreement and management's conservative forecasting with respect to coal ash costs, fixed-cost coverage could trend near 2x.

We also view the PWC's liquidity and reserves as a credit strength. In addition to \$120 million in unrestricted cash and investments, the utility has nearly \$47 million in its rate stabilization reserve (electric and water funds) and about \$13 million in other reserves that are internally designated and available to support operating requirements. In total, these reserves measured more than 320 days of operating expenses in 2017 and 2018. Given the drawdown of the coal ash reserve, days' cash declined to 260 in fiscal 2019 and 242 in fiscal 2020. We expect this metric to remain within 220 to 260 days of operating expenses over the next four fiscal years.

Debt represented 29% of the utility's capitalization in fiscal 2020 with \$286 million outstanding following fiscal 2021. Management expects that debt will fund 55% of the \$764 million capital improvement plan for fiscal years 2022 to 2026. The bulk of capital spending is for water (26%) and wastewater (51%) systems, including wastewater extensions into areas that the city previously annexed, and water and wastewater distribution, treatment facility improvements, and capacity expansions. Spending on the electric system (18%) accounts for a variety of projects, including substation rebuilds, distribution and smart grid improvements, and developing non-solar renewable energy battery storage sources at the Butler Warner plant.

Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

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