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Rating Update: Moody's affirms Aa3 on Topeka, KS's Combined Utility Improvement Bonds; outlook stable

Global Credit Research - 13 Nov 2015

Rating applies to $132 million of outstanding junior lien revenue debt

TOPEKA (CITY OF) KS COMBINED UTILITY ENTERPRISE
Combined Utilities
KS

NEW YORK, November 13, 2015 --Moody's Investors Service has affirmed the Aa3 rating on the city of Topeka, KS's combined utility revenue bonds, which includes $132 million of outstanding rated debt. The rating outlook is stable.

SUMMARY RATING RATIONALE

The Aa3 rating reflects the system's large and stable service area, healthy system liquidity, history of intermittent rate increases to support operations and capital improvement plans, and moderate debt burden expected to remain stable based on future debt plans. The rating also takes into account the narrowed debt service coverage ratio when considering subordinate lien pledge to bondholders.

OUTLOOK

The stable outlook reflects the expectation that a new round of multi-year rate increases will provide for improved operating results and debt service coverage in the near term, reflecting willingness to adjust revenues as needed to support operations and capital improvements.

WHAT COULD MAKE THE RATING GO UP

-Significantly increased combined system cash balance

-Sustained increases to debt service coverage including senior and subordinate lien debt

WHAT COULD MAKE THE RATING GO DOWN

-Further sustained decreases in debt service coverage

-Material liquidity declines

STRENGTHS

-Stable service area encompassing the Kansas state capital of Topeka (Aa3)

-Healthy system liquidity

CHALLENGES

-Narrowed debt service coverage based on senior and subordinate lien debt

-Moderately leverage and manageable future debt plans

RECENT DEVELOPMENTS

Recent developments are incorporated in the Detailed Rating Rationale.

DETAILED RATING RATIONALE

SERVICE AREA AND CUSTOMER BASE: STABLE SERVICE AREA IN STATE CAPITAL

The service area is expected to remain stable given the city of Topeka's role as state capital. Government-related employment represents approximately one-fifth of jobs in the city, and with the state closing the budget gap in the current fiscal year, employment in this sector is considered stable. Two large medical centers in the city provide additional stability. The region is seeing growing in food manufacturing due to its proximity to agricultural inputs and strong transportation infrastructure that benefits manufacturing and distribution.

The combined utility system includes the water, wastewater and stormwater utilities. The water system possesses five senior water rights to the Kansas River granted by the Kansas Department of Agriculture's Water Office. The system provides water treatment and distribution to approximately 57,000 customers, and sewer and stormwater services to approximately 47,000 customers. The enterprises have more than sufficient capacity to address these systems' demand. Among the water system's largest customers are several rural water districts that receive raw water via long-term contracts. The top retail customers are relatively diverse, representing a variety of industries, including manufacturing, government, service and healthcare.

DEBT SERVICE COVERAGE AND NET WORKING CAPITAL: NARROWED BUT STILL ADEQUATE COVERAGE AND LIQUIDITY POSITION

We expect stability in the system's operating results and debt service coverage despite recent narrowing over the past two fiscal years when management temporarily ceased annual rate adjustments. Following drought conditions in 2010 through 2012, wetter weather since 2013 has led to decreased system revenues, while operating expenses have significantly increased. Positively, the city council has independent rate-setting authority, and rate increases have historically been implemented for multiple years at a time based on projected capital expenditures and rate covenants. System rates and fees were increased in all years 2008-2011. Following no increases in 2012-2014, council adopted another round of multi-year increases which include an increase of 6% in 2015, 5% in 2016 and 5% in 2017.

With an increased operating ratio, debt service coverage has narrowed over the past two fiscal years although it remains adequate. Debt service coverage including both the senior state revolving fund (SRF) loans and the junior lien revenue bonds was 1.27 times in fiscal 2014, similar to the 1.23 times coverage ratio in fiscal 2013, but significantly lower than fiscal years 2010-2012 when coverage ranged from 1.78 - 1.91 times. However, $6.7 million of the system's $42 million of operating expenses (net of depreciation) is attributable to payments in lieu of taxes (PILOTS) to the city's General Fund. Discounting the PILOTS, which are subordinate to debt service in legal provisions, coverage increases to a stronger 1.67 times aggregate senior and junior debt service.

Liquidity

The system's unrestricted cash position as of fiscal 2014 was $23.3 million, approximately $900K less than fiscal 2013, and representing a still healthy 201 days of operating expenses. Net working capital has also narrowed from $51.9 million in fiscal 2013 to $41.7 million in fiscal 2014, which represents 99% of operating expenses.

DEBT AND LEGAL COVENANTS: MANAGEABLE DEBT BURDEN; ADEQUATE ALBEIT WEAKER LEGAL COVENANTS

Topeka's combined utility system's debt burden will likely remain manageable but increase in the near term due to capital projects that are planned over the next several years. Projected capital expenditures through 2020 total approximately $102 million, which includes $85 million to be financed with bonds. As of fiscal 2014 the system had $58 million of senior SRF loans outstanding and $132 million of junior lien revenue bond debt. The city has indicated that future borrowings would be on parity with the junior lien, and do not intend to issue additional SRF debt. The system is moderately leveraged, with a fiscal 2014 debt to operating revenues ratio of 2.7 times.

Debt Structure

The system's senior SRF loans mature in 2029 while the junior lien revenue bonds mature in 2044. All debt is fixed rate, and approximately 60% of principal is retired within ten years.

Debt-Related Derivatives

The system does not have any derivative agreements.

Legal Covenants

The system's revenue debt maintains adequate, albeit slightly weaker legal covenants relative to typical covenants in the sector. The bonds are security by a junior lien on system net revenues from the combined utility.

Per the bond resolution, net revenues available to pay debt service on the revenue bonds are defined as gross revenues less operations and maintenance expenses net of payments in lieu of taxes (PILOTs), and debt service payments on outstanding state revolving fund loans (SRF). While the SRF loan is considered an expense under the bond resolution, it is a loan and can be accelerated in an event of default. The SRF loan does carry bond insurance.

The legal covenants require net revenues (as defined in the resolution) to provide 1.25 times coverage on annual junior lien parity debt service and an additional bonds test of 1.25 times maximum annual debt service. While debt service coverage considering all debt in the aggregate is narrow, coverage on the junior lien bonds as of fiscal 2014 per the bond resolution is much greater at 2.35 times. The coverage test for purposes of setting rates and issuing additional bonds is based on the bond resolution. Positively, the bonds are additionally secured by a cash debt service reserve fund that is equal to the least of the standard three-prong test and based on total parity revenue bond debt.

MANAGEMENT AND GOVERNANCE

Management of the combined utilities falls under the utilities division directors, who report to the deputy city manager and finally the city manager. The city council approves budgets and policies and the city manager carries out the policies established through city departments, including the public works department. The council and city staff have generally shown a willingness and ability to adjust rates as necessary to accommodate operations and reinvestment in the combined utilities system, including recent adoption of three years of rate increases.

KEY STATISTICS

-Asset condition (remaining useful life): 25 years

-System size (O&M): $42.2 million

-Service area wealth: 83.3% of US

-Annual debt service coverage (fiscal 2014): 1.27x

-Days Cash on Hand: 201 days

-Debt to Operating Revenues (fiscal 2014): 2.7x

-Rate covenant: 1.25x annual debt service

-Debt service reserve requirement: Least of standard 3-prong test

OBLIGOR PROFILE

The combined utilities provide water (wholesale and retail), wastewater and stormwater services to the city of Topeka, KS and surrounding areas. The city of Topeka is the state capital of Kansas, and was home to approximately 127,000 people as of 2014.

LEGAL SECURITY

The bonds are secured by a junior lien on the net revenues of the system.

USE OF PROCEEDS

Not applicable.

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was US Municipal Utility Revenue Debt published in December 2014. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

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