FitchRatings

Fitch Affirms North Hudson Sewerage Auth, NJ's Gross Rev Pledge Lease Certificates at 'A'

Fitch Ratings-Austin-08 January 2018: Fitch Ratings has affirmed the 'A' rating on the following North Hudson Sewerage Authority, NJ's (the authority) obligations:

--$153.5 million gross revenue pledge senior lease certificates series 2012A;
--$134.3 million gross revenue pledge senior lease certificates series 2012B;
--$40 million gross revenue pledge senior lease certificates series 2012C.

The Rating Outlook is revised to Positive from Stable.

SECURITY

The certificates are secured by fixed monthly rental payments payable by the authority pursuant to a master lease agreement. All revenues of the authority are irrevocably pledged to the payment of the rental payments, which are an unconditional obligation and are not subject to appropriation. Such pledge is a first lien on the authority's gross system revenues, and includes all fees and charges for service and annual charges, if any, received from the municipalities served by the authority pursuant to the terms of an existing service agreement (ESA).

Under the ESA each municipality is obligated to fund any shortfall in authority revenues based on pro rata usage. This characteristic of the ESA provides some additional bondholder security, although the operations of the authority provide the basis for the rating.

KEY RATING DRIVERS

SUSTAINED FINANCIAL IMPROVEMENT DRIVES OUTLOOK REVISION: The authority's debt service coverage (DSC) has come in stronger than projected for the last three fiscal years, even as annual debt service requirements increased. Fiscal 2017 results (ended January 2017) produced all-in DSC of 1.6x, while senior lien DSC was a stronger 2.3x. Liquidity has been robust for the last five fiscal years, coming in at 685 days cash on hand (DCOH) in fiscal 2017.

HIGHLY LEVERAGED SYSTEM: Debt metrics are elevated and weaker as compared to similarly rated systems. However, metrics have been gradually improving over the last five fiscal years, and are expected to continue on this trajectory for the next several years.

MANAGEABLE CAPITAL NEEDS: The capital improvement plan (CIP) spanning fiscals 2018 to 2022 totals $59 million and is focused on renewal and replacement (R&R) projects. About 80% of the CIP is expected to be debt financed with subordinate state loans, but the additional borrowing is not expected to adversely impact leverage ratios.

AFFORDABILITY VARIES WITHIN SERVICE AREA: Median household income (MHI) and poverty rates vary greatly within the four municipalities served by the authority. Affordability concerns may arise for some customers given the disparate wealth levels.

ESSENTIAL SERVICE PROVIDER: The authority provides an essential service to a demographically mixed, but stable service area proximate to New York City. The system remains in regulatory compliance and the operating profile is sound.

RATING SENSITIVITIES

CONTINUED FINANCIAL TRENDS: North Hudson Sewerage Authority's rating is sensitive to sustaining financial metrics near current levels. If liquidity remains robust and DSC continues to outperform management's budgeted projections as planned borrowings are effected further positive rating action could occur.

CREDIT PROFILE

The authority was established in 1988 to provide retail sewer conveyance and treatment services to four cities located in the northern part of Hudson County, NJ along the Hudson River, directly across from New York City. Prior to the creation of the authority, the sewer systems of the four cities had fallen into substantial disrepair, resulting in the need for significant capital investment upon the authority taking ownership and control of the assets. The substantial capital spending left the authority's combined system highly leveraged, but it is now at a favorable point in its capital cycle.

The four municipalities served by the authority include Union City (which accounts for about 35% of annual flows); Hoboken (30%); West New York (27%); and Weehawken (8%). Flows from each municipality have been relatively stable for the last several years. The authority serves an estimated population of approximately 192,000.

ROBUST LIQUIDITY BOLSTERS AVERAGE COVERAGE

The authority's ability to consistently outperform budget projections, in conjunction with its strong cash position is a key driver to the Outlook revision to Positive. All-in DSC the last two fiscal years (2016 and 2017) has come in at 1.6x, exceeding management's budgeted projections of 1.2x. Senior lien DSC was stronger and beat management's budgeted 1.8x for fiscal 2017, reaching 2.3x, which is better than similarly rated systems. (While the senior lien certificates contain a gross pledge of revenues, Fitch calculates DSC using net revenues.)

Liquidity as measured by DCOH has remained robust, averaging over 1,000 days over the last five years. Unrestricted cash decreased in fiscal 2017 as the authority defeased partial maturities from its series 2012A and 2012B issuances totaling nearly $23 million. Despite the drop in cash, DCOH still came in at a very strong 685. Fitch considers the defeasance, which targeted maturities spanning 2018 through 2029, a prudent use of cash as it reduced the authority's maximum annual debt service requirement by about 10%.

DEBT METRICS REMAIN HIGH, DEFEASANCE ACTIVITY VIEWED POSITIVELY

After producing very slim financial margins in the late 2000s the authority issued the 2012 certificates to refinance and restructure all of the previously outstanding debt. The restructuring, concurrent with rate increases, allowed the authority to post improved financial metrics, but resulted in currently outstanding debt that amortizes slower than similarly rated systems. About 30% of the authority's debt amortizes over the next 10 years, with 65% amortized over 20 years. The 'A' category medians are 39% and 75%, respectively.

As of fiscal 2017, debt per capita was over $2,000 and nearly three times higher than comparably rated systems. Other debt metrics are also weak with debt/net plant at 113% and debt/funds available for debt service at 10x. Positively, these metrics have all been on a gradual descent since fiscal 2013 and are expected to continue gradually improving over the upcoming years.

The current CIP totals $59 million and focuses on R&R projects. Management expects about 80% ($47 million) of the CIP will be financed with low-interest (subordinate) state loans, and the balance will be funded on a pay-go basis. Despite the additional debt, metrics should continue to improve slightly over the upcoming five years with debt per capita decreasing to approximately $1,850 by fiscal 2022. Favorably, management expects to defease an additional $10 million of debt in fiscal 2019. Additionally, it is possible the authority could be granted principal forgiveness on some of its state loans, as has occurred in the past.

In previous reviews Fitch cited the debt burden as a credit weakness. While debt metrics remain quite high, and are expected to remain high for the foreseeable future, Fitch views the recent defeasance in fiscal 2017 and planned defeasance in fiscal 2019 positively and recognizes the authority's efforts at reducing its debt burden. Continued progress on decreasing its debt burden while simultaneously maintaining strong liquidity could warrant additional positive rating action.

ADEQUATE CAPACITY, STABLE OPERATIONS AND CUSTOMER BASE

The system is divided into two geographical areas with assets consisting of about 100 miles of sewer mains and two wastewater treatment plants.

Combined treatment capacity totals 30.8 million gallons per day (mgd), which provides sufficient capacity to meet relatively stable average flows of 21 mgd. The system serves approximately 23,400 retail accounts, many of which are multi-family units spread out over the four densely populated cities. The customer and revenue bases are diverse with no single customer accounting for more than 1% of demand or revenue.

AFFORDABILITY AFFECTED BY DISPARATE WEALTH LEVELS

Customers are billed quarterly with the bill comprised of a fixed fee (which accounts for less than 10% of the charge) and a volumetric fee charged per 1,000 gallons of water usage. Current rates, if converted to a monthly charge, result in an approximate bill of $61 (based on Fitch's measure of 6,000 gallons). Affordability is greatly affected by the varied wealth metrics throughout the four municipalities. The monthly charge equates to about 0.6% of MHI in Hoboken City, which has above average MHI. Conversely, Union City's much lower MHI results in the monthly charge well over 1% of MHI. Despite the variance in affordability throughout the service territory, customer collection rates have improved in recent years and are on par with national norms. The authority anticipates a moderate increase in customer charges in 2019 and possible additional adjustments thereafter, although the pace of future adjustments are not expected to materially weaken future affordability levels.

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Applicable Criteria
Rating Criteria for Public Sector Revenue-Supported Debt (pub. 05 Jun 2017) (https://www.fitchratings.com/site/re/898969)
U.S. Water and Sewer Rating Criteria (pub. 30 Nov 2017) (https://www.fitchratings.com/site/re/10010508)

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