



## RATING ACTION COMMENTARY

# Fitch Affirms North Hudson Sewerage Auth, NJ Lease Certificates at 'A'; Outlook Stable

Thu 22 Oct, 2020 - 10:28 AM ET

Fitch Ratings - New York - 22 Oct 2020: Fitch Ratings has affirmed the following ratings for North Hudson Sewerage Authority, NJ (the authority) certificates:

--Approximately \$306 million in outstanding gross revenue pledge senior lease certificates, series 2012A, 2012B and 2019, at 'A'.

Fitch has also assigned the authority an Issuer Default Rating (IDR) of 'A'.

The Rating Outlook is Stable.

## ANALYTICAL CONCLUSION

The 'A' IDR and 'A' issue rating reflect the authority's low net leverage, as measured by net adjusted debt to adjusted funds available for debt service (FADS), in the context of its strong revenue defensibility and very low operating risk profile. The authority's operating risk profile is supported by a very low operating cost burden and moderate life-cycle

investment needs with annual capital spending greatly outpacing annual depreciation costs. While the impacts from rate legislation and consent order needs are largely unknown at this time, they are expected to affect future financial performance. Nevertheless, Fitch expects that the authority's net leverage, which registered 8.7x in fiscal 2020, should remain relatively consistent over the forward look.

## **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. The system has approximately 24,100 connections, the majority of which are multifamily units spread out over four densely populated cities. The four municipalities served by the authority include Union City (which accounts for about 34% of annual flows); Hoboken (31%); West New York (27%); and Weehawken (8%). Flows from each municipality have been relatively stable for the past several years. The customer and revenue bases are diverse with no single customer accounting for more than 1% of demand or revenue. Two wastewater treatment plants (WWTPs) service the area, the Adams Street WWTP and the River Road WWTP, with combined treatment capacity of 35.8 million gallons per day.

### Coronavirus Considerations

The recent outbreak of coronavirus has not had a significant effect on the authority's revenue and cost profiles, although the authority reports some decrease in water consumption and an increase in accounts receivable. Fitch's ratings are forward-looking in nature; as such, Fitch will monitor developments in the sector as a result of the outbreak as they relate to severity and duration, and incorporate revised expectations for future performance and assessment of key risks as needed.

## **KEY RATING DRIVERS**

### **Revenue Defensibility 'a'**

Service Area Variability, Divergent Characteristics

The authority services four municipalities with widely differing MHI and unemployment rates, but overall, the demographics are deemed as favorable. As a result of the demographic variability, affordability also varies from area to area but generally is deemed to be affordable to most customers.

### **Operating Risks 'aa'**

#### **Very Low Operating Cost Burden; Continual Capital Investment**

The authority's very low operating cost burden is strengthened by capital spending that has continually exceeded the pace of annual depreciation. Implementation of a long-term control plan addressing combined sewer overflows should keep the life-cycle ratio below 45%.

### **Financial Profile 'a'**

#### **Strong Financial Profile**

Net leverage has remained stable the past few fiscal years and is forecast to remain relatively stable over the rating cycle. Future capital needs and revenue realization will influence results, but Fitch currently expects that these pressures are manageable at the current assessment level.

### **ASYMMETRIC ADDITIVE RISK CONSIDERATIONS**

No asymmetric additive risk considerations affected this rating determination.

### **RATING SENSITIVITIES**

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Net leverage that is sustained below 9x on a historical basis and over the forward look, coupled with successful management of the rate-raising legislative limitations.

--Changes in service area characteristics that lead to an improvement in the revenue defensibility assessment.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Legislation limiting rate flexibility that proves to have an adverse effect on the authority's ability to manage its operations would be viewed as an asymmetric additive risk consideration.

--Further capital needs for regulatory compliance resulting in net leverage sustained above 11x.

## **BEST/WORST CASE RATING SCENARIO**

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [<https://www.fitchratings.com/site/re/10111579>].

## **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 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.

## **REVENUE DEFENSIBILITY**

Revenue defensibility is strong, assessed at 'a' with all the authority's revenue derived from services or business lines exhibiting monopolistic characteristics. Customer growth is considered midrange in a largely built out service area. Growth expectations are minimal, with consumption expected to decline at a rate of 1% annually.

Service area characteristics and thus affordability exhibit great variability among the municipalities. Focusing on the two largest entities by flows; Hoboken, with MHI 226% above the nation's and unemployment 49% of the nation's, represents stronger service area characteristics with rates that are affordable for the vast majority of customers. In contrast, Union City has MHI registering 76% of the nation's while unemployment is slightly above. Rates within Union City are also high for a significant portion of customers. The 'a' subassessments for both service area characteristics and rate flexibility take these variations into account.

The authority has independent legal ability to increase service rates without external approval. Charges consist of a fixed facilities charge and a flat usage charge. In any given year the authority can raise one or both. While management has been increasing the facilities charge so that the system is less reliant on usage, the fixed portion still only accounts for about 9% of a bill.

Rate legislation approved by the state is expected to be implemented shortly. This legislation limits growth in fee-funded revenue to 2% annually, which could limit overall rate flexibility and the authority's financial performance. The authority is assuming rate increases of no more than 2% of gross revenues going forward, which it believes are more than sufficient to meet financial policies and covenants.

## OPERATING RISKS

The authority's operating risk is assessed at 'aa', which takes into consideration a very low operating cost burden with moderate life-cycle investment needs. At \$3,783 per million gallons in fiscal 2020, the operating cost burden remains comfortably below Fitch's \$6,500 threshold and is expected to remain there throughout the rating period. About half of the authority's operating expenses are attributable to Jacobs Engineering, charged with operating and maintaining the system. Costs increase annually via inflationary factors and have been relatively stable (below 3%) the past few years.

The \$100.1 million capital improvement plan (CIP) largely addresses combined sewer overflows. The authority is party to two administrative consent orders (COs) related to effluent discharges. To date, the authority is in full compliance. New permitting requirements include submitting a long-term control program to reduce combined sewer overflows to the state. The authority submitted plans (one for each WWTP) in June 2020, which are presently pending review.

Close to 80% of the CIP is expected to be funded by low-interest (subordinate lien) state loans, with about 20% funded from reserves. Significant capital expenditures, with a five-year average to depreciation of 245%, should keep the life-cycle ratio low and support the 'aa' subassessment.

## FINANCIAL PROFILE

The financial profile is assessed at 'a'. Fitch's net leverage calculation of 8.7x in fiscal 2020 is largely in line with that of prior years. With 717 days cash on hand and coverage of full obligations at 1.4x, the liquidity profile is considered neutral to the rating. The Fitch-calculated total debt service coverage for fiscal 2020 was 1.4x.

### Fitch's Analytical Stress Test (FAST)

The FAST considers the potential trend of key ratios in a base case and a stress case. The stress case is designed to impose a capital cost increase of 10% above expected levels and evaluate potential variability in projected key ratios. Fitch also considers a sensitized downside scenario as a result of the pandemic and corresponding shutdowns. However, given the issuer's assumptions included pandemic-related expectations, this was less of a consideration in the rating.

Net leverage expectations were produced considering the issuer's provided CIP and financials for fiscal years 2021 and 2022, along with historical growth estimates for the ensuing years. Results show net leverage reaching a high of 9.3x in the base case, falling to about 8.1x by fiscal 2025. The stress case largely mirrors the base case results, leveling to 8.4x by fiscal 2025. Uncertainty surrounding potential regulatory constraints could lead to variability in the metric over the cycle. However, should financial results remain in this range following implementation of the legislation, positive rating action could occur over time.

## **ASYMMETRIC ADDITIVE RISK CONSIDERATIONS**

No asymmetric additive risk considerations affected this rating determination.

## **SOURCES OF INFORMATION**

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

## **REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING**

The principal sources of information used in the analysis are described in the Applicable Criteria.

## **ESG CONSIDERATIONS**

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg).

## **RATING ACTIONS**

ENTITY/DEBT	RATING		PRIOR
North Hudson Sewerage Authority (NJ)	LT IDR	A Rating Outlook Stable	New Rating
● North Hudson Sewerage Authority (NJ) /Water & Sewer Revenues/1 LT	LT	A Rating Outlook Stable	Affirmed
			A Rating Outlook Stable

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## APPLICABLE CRITERIA

[Public Sector, Revenue-Supported Entities Rating Criteria \(pub. 27 Mar 2020\) \(including rating assumption sensitivity\)](#)

[U.S. Water and Sewer Rating Criteria \(pub. 03 Apr 2020\) \(including rating assumption sensitivity\)](#)

## ADDITIONAL DISCLOSURES

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North Hudson Sewerage Authority (NJ)

EU Endorsed

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