

Rating Update: Moody's downgrades Terre Haute Sanitation District's (IN) revenue bonds to A1 from Aa3; outlook negative

26 Sep 2014

\$24 million of outstanding debt affected

TERRE HAUTE SANITATION DISTRICT, IN
Sewer Enterprise
IN

Opinion

NEW YORK, September 26, 2014 --Moody's Investors Service has downgraded Terre Haute Sanitation District's (IN) revenue bond rating to A1 from Aa3. We have assigned a negative outlook. Debt service on the bonds is secured by the net revenue of the district's sewer system. The district has \$220.8 million in outstanding debt, of which \$24 million is rated by Moody's.

SUMMARY RATING RATIONALE

The A1 rating reflects the enterprise's elevated debt levels driven by borrowing from the State Revolving Fund (SRF) Loan Program; narrow liquidity; recent rate increases that should support a continuation of satisfactory debt service coverage; and stable customer base.

STRENGTHS

- Recent rate increases have led to improved debt service coverage
- Stable customer base supported by the presence of federal corrections facility and higher education facilities
- Unlimited rate-setting authority

CHALLENGES

- Extremely high debt ratio
- Limited liquidity
- While the customer base is stable, the Terre Haute region exhibits weak socio-economic indices

DETAILED CREDIT DISCUSSION

WASTEWATER INFRASTRUCTURE UPDATES FUNDED THROUGH STATE BORROWING

The system's debt levels have significantly increased in recent years in order to address capital needs. The district's debt ratio for fiscal 2012 was a considerable 147.6%, and Moody's expects the debt ratio to remain elevated given the size of recent borrowing. In response to a U.S. Environmental Protection Agency (EPA) and Indiana Department of Environmental Management (IDEM) mandate to comply with the 1972 Clean Water Act, Terre Haute agreed to implement a Long-Term Control Plan (LTCP) to manage its combined sewer overflows (CSO). The system's aging infrastructure consists of underground sewer pipes that collect sewage from local drains, as well as several street and downspout drains which flow into the combined sewer system. As storm water empties into the system, it mixes with sanitary sewage, creating additional flow that the wastewater treatment plant cannot handle. In this event, the system automatically overflows to the Wabash River through CSOs.

In December 2012, the district entered into the largest single loan financed by the State Revolving Fund (SRF) Loan Program to replace their outdated Waste Water Treatment Plant (WWTP). Nearly all aspects of the plant will be replaced, and will include energy efficient turbo blowers to provide the City of Terre Haute approximately 29% to 34% energy use savings per year. The system's WWTP provides treatment using the

activated sludge process before discharging treated overflow into the Wabash River. Per the LTCP, the district's goal is to reduce the number of CSOs per year from its current average of 37 to 7.

IMPROVED DEBT SERVICE COVERAGE DUE TO RECENT RATE INCREASES; CAPITAL INVESTMENT WILL KEEP LIQUIDITY NARROW

Going forward, we expect the system's finances to remain narrow. Fiscal operations improved in 2012, with unrestricted reserves of the system as a percentage of operations and maintenance (O&M) of 97.2%, up from a low of 11.4% in fiscal 2010. Net working capital as a percentage of O&M also increased to 97.8% in fiscal 2012 from a low of 18.1% in fiscal 2010. While audited figures are not yet available, fiscal 2013 estimates indicate a decline in net working capital to 27.9% of O&M due to capital expenditures.

The enterprise derives the majority of its revenue from service charges, and the City Council has the authority to set rates, recently implementing a series of 15% annual rate increases to support SRF borrowing. The most recent increase of 15% took place in July 2014. While rate increases in fiscal 2012 improved debt service coverage to a sound 4.8 times, estimated financial results for fiscal 2013 show that coverage fell to 1.6 times. Moody's believes that 1.6 times coverage should remain adequate for the rating category, though coverage ratios are highly dependent on the enterprise's ability to maintain sufficient rate increases as debt service costs continue to grow. Fiscal 2012 generated net revenues of approximately \$10 million, providing a narrow maximum annual debt service (MADS) coverage of 0.9 times. Estimated financial results for fiscal 2013 suggest MADS coverage of 0.7 times.

STABLE CUSTOMER BASE DESPITE LOW RESIDENT INCOME INDICES

The system's customer base should remain stable, although the area's socio-economic profile remains weak. Located 70 miles southwest of Indianapolis (Aaa/stable outlook), Terre Haute Sanitation District serves residents of the city of Terre Haute, the town of Seelyville, and portions of Honey Creek, Linton, Lost Creek, Otter Creek, and Riley townships. The system is managed by a Wastewater Director and the Board of Public Works, consisting of five appointed members. Unemployment in the city of Terre Haute is high at 8.2% (as of July 2014), and remains above state and national levels (5.8% and 6.5%, respectively), for the same time period. Resident income levels are below those of the nation, with per capita and median family income levels decreased to 62.1% and 64.7% of the nation, respectively.

Terre Haute benefits from the presence of several higher educational institutions, including Indiana State University (approximately 12,500 enrolled or 20.4% of City's population), as well as a high security federal corrections facility. The U.S. Federal Penitentiary is the system's largest user, comprising 10.3% of total system revenues, and the ten largest customers account for 18% of total system revenues.

OUTLOOK

The negative outlook incorporates the expectation the system's liquidity will remain narrow and debt will remain high given ongoing capital project expenses. While we expect that recent rate increases should improve debt service coverage, instability in coverage levels could pressure the rating.

WHAT COULD MOVE THE RATING UP (OR REMOVE THE NEGATIVE OUTLOOK)

- Sustained improvement in debt service coverage
- Increased liquidity
- Moderation of debt levels

WHAT COULD MOVE THE RATING DOWN

- Increased debt burden
- Weakening liquidity
- Declining debt service coverage

KEY STATISTICS

Fiscal 2012 Operating Ratio: 46.4%

Fiscal 2012 Debt Service Coverage: 4.8x

Fiscal 2012 Debt Service Safety Margin: 42.4%

Fiscal 2012 Debt Ratio: 147.6%

Fiscal 2012 Unrestricted Reserves as % of O&M: 97.2%

The principal methodology used in this rating was Analytical Framework For Water And Sewer System Ratings published in August 1999. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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