S&P Global
Ratings

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Summary:

Lawrence, Indiana; Water/Sewer

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Summary:

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Credit Profile		
Lawrence taxable wtrwks (BAM)		
Unenhanced Rating	A-(SPUR)/Positive	Upgraded
Lawrence wtrwks (BAM)		
Unenhanced Rating	A-(SPUR)/Positive	Upgraded

Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings has raised its rating on the City of Lawrence, Ind.'s waterworks utility debt outstanding two notches to 'A-' from 'BBB'. The outlook is positive.

The upgrade reflects our opinion of the system's continued improvements in operational and financial management, which we expect will continue given recent and planned rate increases that will generate strong operating margins and improved liquidity. The city has approximately $17.85 million in existing waterworks utility debt.

The rating also reflects our opinion of the combination of the city's strong enterprise risk and adequate financial risk profiles.

The enterprise risk profile reflects our opinion of the system's:

- Service area participation in the broad and diverse Indianapolis metropolitan statistical area (MSA) economy;
- Very low industry risk as a monopolistic service provider of an essential public utility;
- Adequate utility rates when factoring in a 68% rate increase implemented, effective June 2017; the city's median household effective buying income (MHHEBI) at 89% of the national average; and the county's moderately high poverty rate of 21.3%; and
- Good operational management practices and policies.

The financial risk profile reflects our opinion of the system's:

- All-in debt service coverage (DSC), which improved to more than 2.0x in fiscal 2017, and which we expect to continue to improve following implemented and planned rate increases;
- Weak liquidity, albeit improving liquidity; and
- Good financial management practices and policies.

Net waterworks utility revenue secures the bonds. Other bond provisions include:

- A rate covenant that stipulates rates that can generate net revenue of at least 100% of debt service;

- An additional bonds test that only limits additional bond issuance if net revenue for the previous fiscal year represents, at least, 125% of pro forma maximum annual debt service (MADS); and
- A debt service reserve funded at the least of MADS, 125% of average annual debt service, or 10% of par.

The water system primarily serves residents of Lawrence, 10 miles northeast of downtown Indianapolis in Marion County, with an estimated 2017 population of 49,700. City wealth indicators are good, in our view, but below average with MHHEBI at 89% of the national average. The system has approximately 14,600 customers, a number management does not expect will change materially over the next few years. The 10 leading customers account for a diverse 18.8% of total system revenue, in our opinion.

Lawrence's city council adopted a rate ordinance on May 1, 2017, with first-phase rate increases effective June 2017. The rate ordinance increased water utility rates in three phases: The first phase is an approximate 68% increase (effective June 2017), the second phase increases rates by approximately 6.8% (effective Jan. 1, 2019), and the third phase increases rates by approximately 11% (effective Jan. 1, 2020). The ordinance also requires the completion of another cost-of-service study by August 2018, and phase-two and three rate increases are subject to changes pending the cost-of-service study's findings. Following the phase-one rate increase, water utility rates increased to $37.66 for 4,000 gallons used--the average usage for residential customer reported by management. We consider rate affordability adequate since new water rates account for 1.1% of income. Following the phase-two and three rate increases in 2019 and 2020, respectively, rates will increase $44.65 or approximately 1.2% of MHHEBI.

Reflecting our Operational Management Assessment, we view the system's operational management as good. The water utility has a total capacity to produce 7.72 million gallons per day (mgd) between three water treatment plants, with a firm rated capacity of 5.32 mgd. This sufficiently meets average daily flows of approximately 3.99 mgd and peak flows of 5.54 mgd. The system has approximately five million gallons of water storage capacity, at least one days' average demand. Due to management completing a cost-of-service study, the city approved significant rate increases that we expect will reverse a trend of structural imbalance. Lawrence anticipates further rate increases of 6.8% in fiscal 2019 and 11% in fiscal 2020.

Consistent with the article titled "Methodology: Industry Risk," published Nov. 19, 2013, on RatingsDirect, we consider the system's industry risk very low, the most favorable assessment possible on a six-point scale, with '1' being the best.

The utility's operations-and-maintenance fund has been in structural imbalance since fiscal 2010; therefore, its cash balance declined to negative $1.475 million at fiscal year-end 2015 from $1.6 million as of Dec. 31, 2009. The utility's cash improved to $106,000, or eight days' cash on hand, in fiscal 2016 following a $1.5 million interfund loan from the wastewater utility. Excluding the interfund loan from the wastewater utility, the operating fund balance was negative $1.375 million. Following the 68% rate increase, effective June 2017, the water utility's operating fund improved to more than $1.1 million, or 89 days' cash. This improvement only included half a fiscal year of the effective 68% rate increase. We expect liquidity to improve significantly as the utility posts strong positive operating margins.

The utility's net revenue produced insufficient all-in DSC in fiscal years 2014 and 2015, in our view. We base our all-in DSC on the utility's net revenue, including payments and transfers into other funds, taken against all debt obligations of the utility. Following years of volatile net revenue, insufficient DSC, and structural imbalance, management commissioned a cost-of-service study, which was approved by the city council in May 2017.

Significant rate increases will, in our opinion, have a continued positive material effect on the city's water utility fund. All-in DSC--taking into account debt obligations, interfund loans, payments in lieu of taxes, and additional debt--improved to more than 2.0x in fiscal 2017. The projected all-in DSC of more than 2.0x in fiscal 2018 accounts for management's plan to repay approximately $875,000 of the remaining interfund loan from the wastewater utility, which was repaid in March of 2018. However, improvement in financial operations allowed the utility to begin repayment of the interfund loan in late fiscal 2017. Projections for fiscal years 2019-2020 show DSC increasing to well above 2x.

Lawrence has approximately $17.8 million in water system revenue debt outstanding. The city is planning to issue approximately $10.6 million in debt in fiscal 2019 to fund phase-two capital projects, which include improvements to the city's remaining two water treatment plants and distribution system improvements.

Phases two and three of the implemented water rate increases will allow the utility to have capacity to service the additional debt planned in 2019, as well as operate and cash fund capital projects beyond phase two, while maintaining strong operational margins and improved liquidity.

Reflecting our FMA methodology, we view the system's financial management as good. Management highlights include its use of historical trends for budget and operational performance analysis and monthly budget-to-actual reports to the utility board and council. Management completed a cost-of-service study that includes projections through fiscal 2020. The utility identifies capital needs, and it has updated the 20-year master plan. Management targets the maintenance of a minimum two months' operating expenses on hand, which it has not historically met. However, due to recent changes in rates and improved financials, we believe this will likely be achievable. Management presents audits on a cash basis.

Outlook

The positive outlook reflects our opinion there is a one-in-three chance the rating could improve within the two-year outlook period, should the water utility's financial operations--in terms of all-in coverage and liquidity--increase and be sustained at very strong levels.

Downside scenario

If the utility's operations revert to what we consider insufficient levels or produce coverage and liquidity that are significantly below projected levels, we could revise the outlook back to stable or lower the rating.

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