

## Fitch Expects to Rate Jefferson County, AL, Sewer Revs 'BB+'/'BB'; Outlook Stable

Written by Australian Business

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AUSTIN, Texas--( [BUSINESS WIRE](#) )--Fitch Ratings expects to assign the following ratings to Jefferson County, AL's (the county), warrants:

--\$375 million senior lien sewer revenue current interest warrants, series 2013-A 'BB+';

--\$55.7 million senior lien sewer revenue capital appreciation warrants, series 2013-B 'BB+';

--\$69.3 million senior lien sewer revenue convertible capital appreciation warrants, series 2013-C 'BB+';

--\$750.2 million subordinate lien sewer revenue current interest warrants, series 2013-D 'BB+';

--\$71.9 million subordinate lien sewer revenue capital appreciation warrants, series 2013-E 'BB+';

--\$416.3 million subordinate lien sewer revenue convertible capital appreciation warrants, series 2013-F 'BB+'.

The final ratings are contingent upon the receipt by Fitch of executed documents and legal opinions conforming to information already received and reviewed; the final pricing of the warrants; and confirmation of the county's plan of adjustment (the plan) - including the further amended financing plan and debt structure from this issuance - by the bankruptcy court overseeing the case that would allow the county to emerge from chapter 9 bankruptcy protection by the end of the year.

The county expects to sell the warrants in a negotiated sale the week of Nov. 18. Proceeds will be used to refund and retire the county's sewer system (the system) outstanding warrants, which are currently in default; pay the premium for an insurance policy relating to the senior lien warrants; pay the costs associated with debt service reserve letters of credit for the senior and subordinate lien warrants; provide funding for certain accounts; and pay costs of issuance.

The Rating Outlook is Stable.

## SECURITY

The senior lien warrants are secured by a pledge of gross system revenues. The subordinate lien warrants are secured by a pledge of system revenues after payment of the senior lien warrants.

## KEY RATING DRIVERS

**PRIOR BANKRUPTCY TRIGGERS SUFFICIENTLY MITIGATED:** The onerous regulatory requirements, risky financing structures, and corruption - among other things - that led to the county's filing for chapter 9 bankruptcy protection in Nov. 2011 and the need to seek concessions for a significant portion of system obligations appears to be either actually or effectively eliminated. General concerns remain regarding pressures the system faces post bankruptcy, but these concerns are not anticipated to affect system operations or debt repayment going forward beyond what is contemplated at the currently expected rating level.

**OUT-YEAR FINANCIAL CONCERNS:** System cash flows appear sufficient to generate favorable debt service coverage (DSC) and meet capital demands from surplus revenues over the next 10 years. However, projected cash flow shortfalls for capital beginning in fiscal 2024 (despite anticipated sound DSC) are a significant concern.

**VERY HIGH DEBT BURDEN:** System debt levels will remain high even with a

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substantial reduction in system obligations resulting from the county's plan to emerge from chapter 9 bankruptcy protection. Further, the anemic amortization of the proposed financing will leave the system's debt burden elevated for decades even without additional borrowings.

**ADOPTED ADJUSTMENTS BUT POSSIBLE CHALLENGES:** The approved rate structure (ARS) adopted by the county commission, which calls for annual rate adjustments through the life of the warrants, is a key credit positive as it provides more certainty to the projected cash flows. However, rates are already high and ongoing adjustments contemplated under the ARS could spark increased political concerns, litigation, and elasticity in usage, any of which might erode actual financial results.

**STRONG AND DIVERSE SERVICE AREA:** The service territory is broad and has grown into a diverse economy over the previous decades with a stable population base. Major sectors now include finance, medical and education along with the county's more traditional manufacturing roots. Unemployment continues to post favorable results, although income levels in the county remain meaningfully lower than the U.S.

### RATING SENSITIVITIES

**HINDRANCES TO IMPLEMENTING THE ARS:** Any litigation or political action which limits or repeals the ARS would be viewed as materially weakening the system's ability to operate and meet its obligation to warrant holders. Downward rating pressure would be expected to follow in turn.

**DIVERGENCE BETWEEN FORECASTED AND ACTUAL RESULTS:** Operating and/or capital pressures from regulatory or other actions that impair the system's ability to achieve at least forecasted financial results over the next 10 years could weaken the system's credit quality given the system's limited ability to support additional requirements without further straining its rate base.

### CREDIT PROFILE

## CURRENT OFFERING PART OF PLAN FOR EMERGING FROM BANKRUPTCY

The county is located in the north central portion of Alabama and has an estimated population of around 660,000 people. Beginning in 2008, a series of events occurred which led to the county's insolvency and filing for chapter 9 bankruptcy protection on Nov. 9, 2011 (the filing date). Since the county's bankruptcy filing there has been significant litigation between and amongst the county, county creditors, and other stakeholders. However, in recent months the county has filed its plan with the bankruptcy court for confirmation after reaching concession agreements with the majority of the county's creditors to reduce system obligations. The current financing is a component of the plan and entails achieving \$1.7 billion in proceeds which, along with other items, will retire and eliminate \$3.1 billion in system obligations.

## SYSTEM CAUSES CONTRIBUTING TO BANKRUPTCY SUFFICIENTLY MITIGATED

Fitch believes the events that ultimately led to the county's bankruptcy filing have been addressed and any threat of a subsequent bankruptcy filing is sufficiently mitigated because of the plan and the supporting components of the plan, as well as the internal changes to county operations. Consequently, the expected ratings on the system warrants solely reflect the credit risks of the system that exist post-bankruptcy.

The initial cause of the county's bankruptcy stems from the system's consent decree (the CD) between the county and the U.S. Environmental Protection Agency in 1996. Originally estimated to cost between \$250 million and \$1.2 billion, debt obligations ballooned to over \$3.1 billion by the time of the filing date. The escalation in costs and the financial products used to pay for capital projects were attributable at least in part to corruption by government officials and private individuals and firms, several of which were convicted of criminal offenses. With the collapse in the financial markets in 2008 and because of the county's extensive use of variable-rate products and third-party agreements (including swaps and liquidity facilities) to finance the CD, the county experienced rapid increases in interest costs as well as the acceleration of principal on numerous obligations for which it was unable to pay.

The system's new debt structure will be 100% fixed rate with no swap contracts following the issuance of the 2013 warrants and defeasance of the system's prior obligations. The elimination of interest rate variability and exposure to third-party credit risks

provide greater clarity as to the system's obligations going forward and the revenues needed to support these obligations.

## NEW GOVERNANCE STRUCTURE

In 2009 the Alabama Legislature approved a change in the county's governing structure such that county commissioners now serve purely legislative roles and the executive function is vested in a county manager. The county commissioners previously retained both legislative as well as executive duties, with each commissioner managing at least one of the county's departments directly. The new governing structure should help to alleviate possible conflicts of interest and avoid the lack of balanced spending oversight previously experienced.

## PROJECTED CASH FLOW SHORTFALLS FOR CAPITAL

The system projects solid financial results for fiscals 2014-2023 as rate increases are implemented. Net revenues are forecasted to cover DSC on combined senior and subordinate lien warrants by 1.6x-1.8x through fiscal 2018 and then increase to above 2.0x during fiscals 2019-2023. Equally positive, surplus revenues net of operating fund deposits during fiscals 2014-2023 are projected to total \$670 million. These surplus revenues, combined with \$160 million of certain existing cash balances, are sufficient to meet all expected and identified capital needs during this 10-year period.

A back-loaded debt structure is a key reason anticipated financial performance through fiscal 2023 is favorable. Debt service expenses from this transaction are projected to increase nearly 70% in fiscal 2024 from the prior year to over \$140 million and then continue to escalate 3% annually through fiscal 2040. This large jump in debt service costs is concerning not only because total DSC drops to 1.25x but because the elevated carrying costs significantly erode surplus revenues necessary to fund ongoing system maintenance, without identification of additional capital funding sources.

Fitch is primarily concerned about the system's practical ability to increase rates above those contemplated in the ARS to cover the projected \$1.1 billion shortfall in meeting basic ongoing capital expenses during fiscals 2024-2040. Fitch further believes the risk of

enhanced discharge requirements prior to fiscal 2040 is likely. To the extent these regulations translate into additional capital and/or operating expenses system financial projections will be strained even further.

### SIGNIFICANT LEVERAGE REMAINS

System leverage ratios will remain excessively high despite the tremendous reduction in system obligations negotiated with creditors under the plan. Overall, the system's key debt ratios subsequent to this transaction will remain 6x-7x greater than Fitch's national medians for 'A' category and above credits. Other system debt metrics are similarly poor. No additional debt is programmed into the system's forecasted cash flows yet leverage ratios will remain notably weak for many years into the future given the generally ascending debt service requirements and anemic rate of principal amortization on these warrants - just 8% matures in 20 years.

### SHIFT AWAY FROM ARS WOULD BE CREDIT NEGATIVE

Implementation of the ARS is a key credit factor supporting the rating on the 2013 warrants. Fitch believes there is a strong likelihood the ARS will be implemented as envisioned given the adoption of the ARS by the county commission and the critical role the ARS plays in ensuring the success of the plan. However, the ARS is not without opposition.

Resistance by one of the current five county commissioners and the state attorney general, as well as the historical opposition to and litigation of system rate adjustments, raises the specter of possible stakeholder attempts to overturn the ARS and/or momentum at the commissioner level to bar the adopted rates from taking effect at some point in the future. Fitch cautions that any action that impairs the ARS as adopted almost assuredly would be viewed as a material weakening in the system's credit profile, with corresponding negative rating action expected to follow.

The adopted ARS calls for 7.89% annual rate increases beginning Nov. 2013 through fiscal 2018. These rate adjustments will push residential wastewater user charges for 6,000 gallons of flow to an estimated 2.3% of median household income (MHI) by fiscal 2018 - well above Fitch's 1% of MHI for individual utilities. Annual 3.49% hikes are included for fiscals 2019-2053 - the final maturity of the warrants - which will place added strain on the local rate base.

## DIVERSE SERVICE AREA

The system provides retail sanitary sewer collection, treatment and disposal service to county residents as well as a small number of people within two surrounding counties. The service area is broad and has grown over prior decades to become a major regional financial and medical player. The county's employment base is anchored by the University of Alabama at Birmingham, the largest employer in the county with some 23,000 workers. County unemployment trends are favorable, and for July 2013 the county's unemployment rate was 6.0% compared to 7.7% for the U.S. Somewhat offsetting this positive, personal wealth levels are about 15% weaker than the U.S.

Additional information is available at '[www.fitchratings.com](http://www.fitchratings.com)'.

In addition to the sources of information identified in the U.S. Municipal Revenue-Supported Rating Criteria, this action was additionally informed by information from Creditscope, Citigroup Global Markets, Inc. (lead underwriter) and Galardi Rothstein Group (financial feasibility consultants).

### Applicable Criteria and Related Research:

--'Revenue-Supported Rating Criteria', June 3, 2013;

--'U.S. Water and Sewer Revenue Bond Rating Criteria', July 31, 2013;

--'2013 Water and Sewer Medians', dated Dec. 5, 2012;

--'2013 Outlook: Water and Sewer Sector', dated Dec. 5, 2012.

Applicable Criteria and Related Research:

U.S. Local Government Tax-Supported Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=685314](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=685314)

Revenue-Supported Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=709499](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=709499)

U.S. Water and Sewer Revenue Bond Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=715275](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=715275)

2013 Water and Sewer Medians

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=695756](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=695756)

2013 Outlook: Water and Sewer Sector

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=695755](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=695755)

Tax-Supported Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=686015](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015)

Additional Disclosure

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