

FITCH AFFIRMS KEY WEST, FLORIDA'S SEWER SYS REVS AT 'AA-'; OUTLOOK STABLE

Fitch Ratings-Austin-10 November 2011: Fitch Ratings affirms the following Key West, Florida (the city) bonds:

--\$22.8 million in outstanding sewer system revenue bonds, series 2003 at 'AA-'.

The Rating Outlook is Stable.

SECURITY

The bonds are secured by a pledge of net sewer system (the system) revenues excluding connection fees.

KEY RATING DRIVERS

Sound Financial Profile: System financial performance remains strong, projected to remain over 1.8 times (x) all-in coverage, in spite of modest declines in coverage over the past five years.

High Debt Load: Leverage ratios are above the category 'AA' rating medians and projected to remain high with an anticipated debt issuance to repay a Federal Emergency Management Agency (FEMA) grant. Rapid debt amortization helps to somewhat mitigate the system's high debt load.

Limited Rate Flexibility: Charges are high as a percentage of median household income (MHI), though comparable to rates in neighboring communities in the Florida Keys.

Tourism Based Economy: The city relies heavily on tourism and on the military.

Exposure to Severe Weather: The city's continued exposure to severe weather could adversely affect system assets and tourism.

CREDIT PROFILE

Although total coverage has declined annually from a high of 3.0x in fiscal 2006, financial operations for the system remain sound. The system's senior-lien debt service coverage for fiscal 2010 was strong at 2.9x. Including the system's subordinate-lien state revolving fund loan payment, total coverage was still strong at 2.5x for the year. System financial projections show debt service coverage remaining above 1.8x through fiscal 2016.

Liquidity levels remain robust with \$6.9 million in available reserves equal to nearly 420 days of cash on hand in fiscal 2010. While system capital needs remain moderate and the city continues to fund ongoing capital projects from pay-go, Fitch expects the system's liquidity position to remain favorable.

The system's five-year capital improvement plan (CIP) totals a manageable \$20.5 million. The city plans to entirely cash-fund the CIP. Planned improvements include a force main project which will improve capacity flows throughout the system and projects for system rehabilitation and repair. Although the city does not anticipate issuing any debt for capital projects, a grant (in the approximate amount of \$6.2 million) the city received from hurricane damage in 1999 requires repayment. The city is looking to issue system debt in the next year to repay the grant. System debt per customer is currently 1.4x category 'AA' rating median levels; the median for outstanding debt per customer is \$1,502. With the anticipated issuance, Key West's debt per customer is projected to increase to approximately \$2,280. Thus, debt levels are anticipated to remain elevated with the potential debt issuance plans.

The system experienced an environmental crisis in 1999 when Hurricane Irene hit Florida. Leaky

sewer lines caused the near-shore water pollution that led to the closure of most city beaches from May 1999 to May 2000. The city spent \$67 million on consent order capital improvements to rebuild the system, replace the system's ocean outfall discharge method with a class V deep injection well and upgrade the wastewater treatment plant. A combination of grants, including a FEMA grant, loans, and a bond anticipation note were used to help fund the improvements. FEMA is now requiring repayment of a portion of the grant used for system repairs, contending that a section of pipe it funded was already damaged. The city appealed but is having to repay the grant and is now working out a payment plan.

The city's wastewater treatment plant has a designed treatment capacity of 10 million gallons per day (mgd). Historical average daily flows have been between 4-5 mgd or 50% of capacity levels. The system's national pollutant discharge elimination system permit was recently renewed and expires in 2014. There are no regulatory issues to report.

The system has limited rate flexibility as charges are relatively high at 1.2% of MHI. Sewer rates have been raised about 2.9% annually over the past five years. Projected rates are expected to increase 2.4% for fiscal 2012 then rise to 2.8% annually from fiscal 2013 to 2016. In comparison to neighboring communities, rates are comparable for the Florida Keys, which are above state and national averages. The system remains under the private management of Operations Management International (OMI), which has had a 20-year history of operating the wastewater system.

The system serves the city of Key West, the southernmost city in the continental U.S. The city's population of approximately 24,000 has declined by about 1% annually over the 2006 to 2009 period, although projected population and customer base are expected to remain flat. The city's economy relies heavily on tourism and military (both the U.S. Navy and U.S. Coast Guard have a presence). The city's 2009 median income levels were 110% above the state average.

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Additional information is available at 'www.fitchratings.com'. Please review and approve the minor attached edits. If there are no additional changes then this can go right to being submitted for business approval

In addition to the sources of information identified in Fitch's Revenue-Supported Rating Criteria, this action was additionally informed by information from Creditscope.

Applicable Criteria and Related Research:

- 'Revenue-Supported Rating Criteria', dated June 20, 2011;
- 'U.S. Water and Sewer Revenue Bond Rating Criteria', dated Aug. 10, 2011;
- '2010 Water and Sewer Medians', dated Jan. 18, 2011;
- '2010 Water and Sewer Sector Outlook', dated Jan. 18, 2011

Applicable Criteria and Related Research:

2010 Water and Sewer Sector Outlook

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=499482

2010 Water and Sewer Medians

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=509146

U.S. Water and Sewer Revenue Bond Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=647331

Revenue-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=637130

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