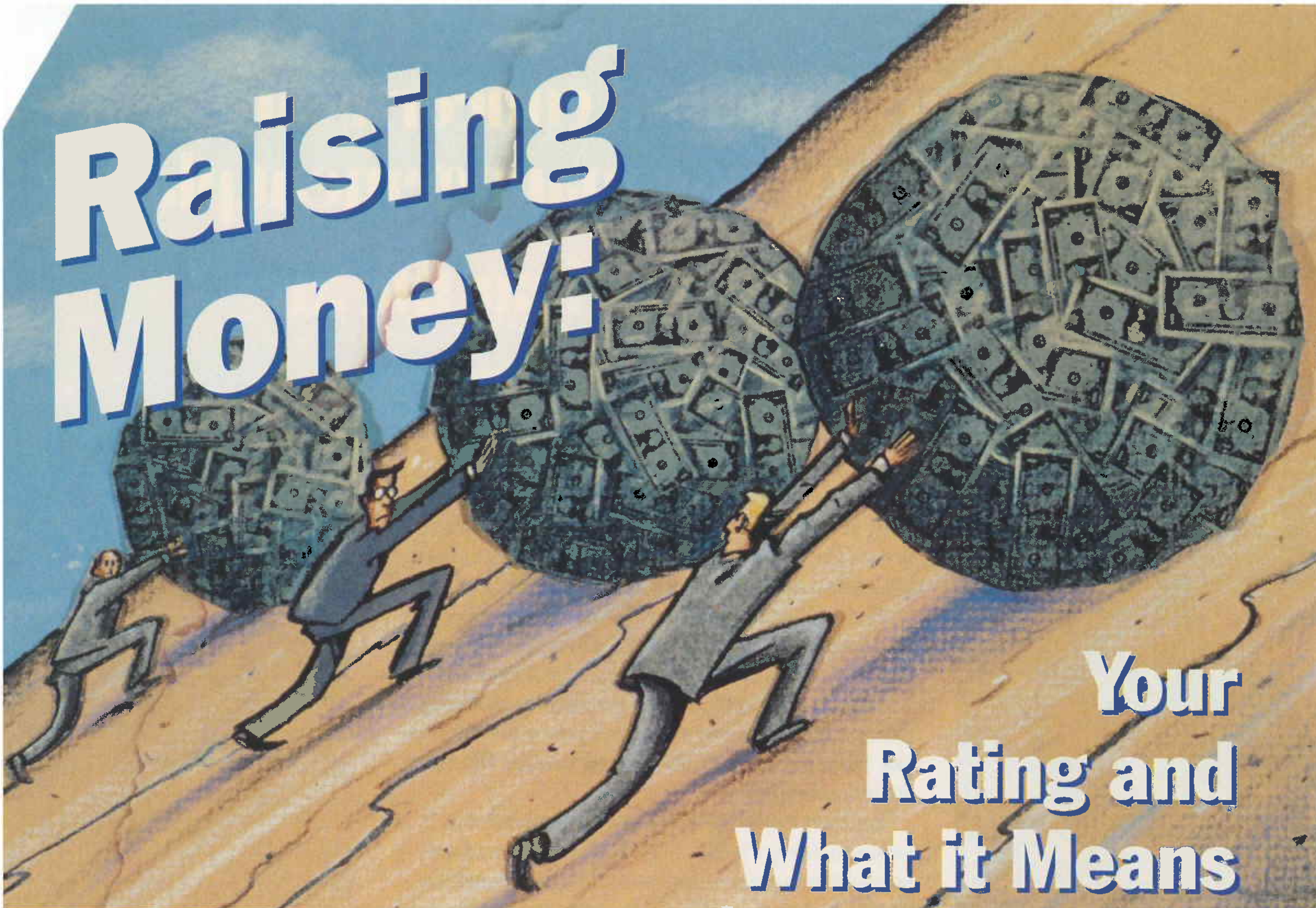

Raising Money: Your Rating and What it Means

Public entities are increasingly involved in financing solid waste disposal as resource needs and related costs grow. Public officials and MSW managers are expected to find environmentally sound and politically acceptable means of disposal, often without regard to the expense.

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As federal and state regulation evolves and the amount of available landfill space decreases, the historically inexpensive alternative of landfilling has become much more costly and capital-intensive. In addition to site purchase costs, a state-of-the-art landfill requires extensive capital investment.

Consequently, the importance of preserving existing landfill space has increased. Volume-reduction methods, such as WTE plants, are viable options, but they, too, are expensive. Even recycling requires significant capital and operating expenditures.

Clearly, the costs, and by extension, the capital needs associated with waste disposal have grown substantially over the last decade. As a result MSW professionals increasingly look to the capital markets to meet their funding needs.

Access to the capital markets, and for MSW systems, the issuing of bonds, requires the issuing entity to get a rating from a credit rating agency. The credibility associated with a rating enhances the liquidity of the issuing organization's bonds through increased investor acceptance. Faced with thousands of alternatives and increasingly rapid change, market participants rely on objective measures of credit quality to make investment decisions. Standard & Poor's instantly recognizable letter-grade rating symbols (AAA to D) assure investors of the expert analysis and uninterrupted credit surveillance required to make informed investment decisions.

The Role of a Rating Agency

Despite the explosion in the number and complexity of financial products over the last decade, the role of a credit rating agency has not changed; to provide the financial markets with high quality, objective analytical information. Credit rating agencies operate under the basic principles of independence, objectivity, credibility, and full disclosure of criteria and rationales.

A credit rating is an opinion of the creditworthiness of debt based on relevant risk factors. This opinion is stated by a recognizable letter-grade rating symbol. Over the years, credit ratings have achieved wide investor acceptance as easily usable tools for differentiating credit quality based on a rating that is judged by the market to be reliable and credible.

A rating agency operates with no government mandate and is independent of any investment banking firm, bank, or similar organization. Recognition as a rating agency ultimately depends on investors' willingness to accept its judgement.

How Debt Ratings Are Established

Long-term debt ratings are divided into two broad categories, commonly known as "investment grade" and "speculative grade." Issues rated in the four highest categories — "AAA," "AA," "A," "BBB," are recognized as being investment grade. Obligations rated "BB" or below are referred to as speculative grade. The term investment grade was originally used by regulatory bodies to connote obligations eligible for investment by institutions such as banks, insurance companies, and S&Ls.

Ratings from "AA" to "CCC" may be modified by the addition of a plus or minus sign to show the relative standing within the major rating categories.

S&P rates a debt issue only when there is adequate information available to form a credible opinion and only after extensive quantitative, qualitative, and legal analyses, if appropriate, are performed. New municipal debt is rated on the request of the issuer or its financial or legal advisor.

Municipal debt ratings remain in effect as long as financial and economic information is furnished regularly. All public ratings are monitored on an ongoing basis by specialists assigned to cover the debt of a group of entities, such as solid waste systems, or a geographic region, in the case of municipal issuers. New developments and economic trends are reviewed regularly, and a formal written review is conducted for larger municipal issuers at least once a year.

MSW System and Project Financings

S&P has rated both system and project financings for solid waste facilities. Credit assessment of solid waste financings focus on four related factors: legal provisions, service-area economy, operations, and financings and costs.

The analysis takes into account the operating and regulatory conditions of solid waste management in each state. In addition to disposal rate regulation, other areas that often vary from state to state include environmental laws, waste-flow control, the power of franchise haulers, and government involvement in implementing solid waste disposal plans.

Legal provisions are defined through the bond indenture and other documents, which outline the basic structure of the financing. The analysis focuses on security for the bonds and identification of the revenue stream. All service, operation, construction, and energy sales contracts are reviewed for possible credit implications. A mixture of special taxes, disposal fees, and a municipality's credit can be pledged in addition to other revenues, such as those from the sale of by-products.

Waste flow control, the ability to direct waste to the project or system's facilities, provides an important link between the waste generator and the disposal system

A detailed analysis begins with identification of the source of cash flow for debt service payments. Although by-product revenues may be pledged, they are considered a secondary revenue stream; the ultimate credit strength is the primary revenue stream, such as tipping fees or a general fund pledge.

Through a service agreement, a municipality might covenant to make payments from general fund appropriations or pledge its full faith and credit. In these cases, a general obligation (GO) assessment is established, which is critical to the rating determination.

If a GO pledge is offered in addition to a revenue or user fee pledge, an analysis for self support will be performed to determine the level of debt, if any, that should be included in the debt ratios of the municipality. When a backup user fee is pledged, the history of the fee and how it is collected and assessed is examined.

The legal structure must provide a sufficient revenue stream to cover both operating costs and debt service payments under different operating scenarios including lower throughput, reduced energy output or price, and outages caused by either system failure or environmental requirements.

The primary revenue stream must have the flexibility to make up for any declines in revenue flow from a more unpredictable secondary stream. Reserve funds may be required to provide a bridge from one budget year to the next depending on the flexibility of the primary revenue stream.

It is critical that the solid waste issuer have a workable and effective arrangement for the transportation of solid waste. Waste flow control, the ability to direct waste to the project or system's facilities, provides an important link between the waste generator and the disposal system. Without legal flow control, the competitiveness of tipping fees, and the ability of systems to shift costs to non-tipping fee charges, e.g. user fees or residential/commercial assessments, will be an increasingly important rating factor.

Effect of Service Area Economy on Ratings

Employment, and population trends, as well as wealth and income indices are reviewed to establish the underlying economic strength of a service area and its capacity to repay the financing. Service demand (garbage flow) typically reflects the service area's economic activity. As a starting point, historic garbage disposal alternatives, tonnage, and costs are reviewed. Per capita disposal rates can be indicative of the waste flow's volatility and the effectiveness of recycling and reduction programs.

Next, a review of the area's future disposal alternatives and reliability of facilities is performed. Competition from alternatives is assessed to understand tonnage projections. The capacity of all available facilities, both on an annual and lifetime basis, is then compared to the forecasted service area demand. If surplus capacity exists, an analysis is performed of the additional costs and exposure inherent in carrying that excess. If the facilities are inadequate to handle current or projected service area demand, the evaluation includes the cost of financing additional facilities.

Another concern is waste quality, which can be affected by economic activity. Quality is measured in terms of its energy value, which can fluctuate because of recycling, commercial and industrial activity, and seasonal influences.

In evaluating the operations of a solid waste system or project, the service provider's flexibility in handling changeable industry requirements, while efficiently fulfilling its primary purpose, is examined. Waste disposal methods must be capable of addressing a number of environmental issues. A system that has the flexibility — through an integrated disposal system, for example — to respond to changes in environmental regulation is viewed favorably.

A key consideration in the analysis is bond amortization versus the useful life of the facilities. The expected life of the landfill should match the term of the debt, and the financing should provide the flexibility to respond to changes in the landfill life resulting from an increase or decrease in waste-flow levels.

A system, by its nature, has an advantage over project financings in handling these risks. However, a project can also be structured to manage them effectively. For example, a disposal contract provides project backup disposal capacity. Contracts generally allow less control than system-owned capacity and can be subject to legal, regulatory, and performance concerns.

An independent consulting engineer's report, historical operating record, and a meeting with management provide information to evaluate management's ability to construct and operate the facilities. If a private operator contracts to run the system or facility, the incentives for efficient operation are scrutinized. In all cases, an equitable agreement for both parties and termination clauses for nonperformance are essential.

System or project operations are evaluated against demand for disposal over the term of the bonds. If components of a system or facility are temporarily or permanently out of service, the ability to dispose of waste elsewhere is reviewed.

The entire waste stream and disposal process is assessed to ascertain whether changes, for example, growth in service area, have been adequately addressed. Then questions about the proper size of facilities or plans for expansion are evaluated.

Effect of Finances and Costs on Ratings

In evaluating finances, the main concern is quality of coverage. A review of different operating and nonoperating scenarios that demonstrate sufficient debt coverage in all cases is required. Costs are viewed relative to the capacity to pay. Also, the effectiveness of the chosen disposal options is measured against the cost of future alternatives. By operating a solid waste system, a community generally has more cost control. It also assumes more risk in ownership and/or operation than if a private enterprise provides disposal.

Costs are reviewed in terms of tipping fees per ton and household costs. The former is a relevant measure for systems that rely on tipping fees paid by franchised and private haulers for their major cash-flow component.

Clearly, the competitive position of the tipping fee affects the financial performance and the effectiveness of flow control. However, total household costs also provide an important basis for evaluating the costs of the system. Household costs should include not only disposal cost but also the expense of collection and transportation to the disposal site. **MSW**

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