

# Comparing City Light Financial Policies to Peer Utilities

January 2016

## What is a debt service coverage ratio?

Debt service coverage ratio (DSCR) is a common financial metric used in the utility industry that represents a utility's ability to repay its debt obligations. Debt service coverage ratio is the ratio of revenues, net of operating expenses, to annual debt service on revenue bonds.

Many bond covenants specify a minimum coverage ratio that the utility must maintain to avoid being in technical default on the supported debt; City Light's minimum ratio is 1.25 times. The debt service coverage ratio is used by rating agencies and investors to determine the ability of a utility to fulfill its debt obligations and to ensure that the utility generates sufficient revenues to make its debt secure. As a planning target, the metric drives the portion of capital expenses that are debt-financed and how much are paid with cash. However, there are variations in the formula for debt coverage ratio, and this can cause confusion.

## What is Seattle City Light's debt service coverage ratio?

City Light's planning debt service coverage ratio is 1.8 times. However, Moody's debt service coverage ratio formula is different from City Light's; their method yields a significantly lower ratio of about 1.5 times.

The main difference is the treatment of city taxes. City Light assumes taxes paid to the City of Seattle would be paid after debt service, and so they are not deducted from revenues. This is consistent with the legal requirements set in the City charter which states that City taxes are subordinate to debt service payments. Moody's, on the other hand, assumes that during adverse conditions taxes will be paid before debt service and correspondingly Moody's deducts City taxes when computing net revenue available for debt service, thus yielding a lower net revenue. The table below shows how taking out city taxes changes the debt coverage ratio.

	2014	2015	2016	2017
Net Revenue, \$M	\$341.4	\$321.7	\$352.2	\$375.7
Debt Service, \$M	\$184.8	\$189.7	\$199.2	\$208.8
<b>Debt Coverage (City Light method)</b>	<b>1.85</b>	<b>1.70</b>	<b>1.77</b>	<b>1.80</b>
City Taxes, \$M	\$ 44.6	\$ 45.9	\$ 52.6	\$ 55.3
Net Revenue, net of City Taxes, \$M	\$296.8	\$275.9	\$299.5	\$320.5
<b>Debt Coverage (Moody's* method)</b>	<b>1.61</b>	<b>1.45</b>	<b>1.50</b>	<b>1.54</b>

*\*Approximate; Moody's makes additional minor adjustments*

## How does City Light's debt service coverage ratio compare with other Northwest peer utilities?

The table below shows a few example peer utilities and their debt service coverage ratio targets and 2014 actuals. As you can see, City Light's targets and results are actually not quite as strong as these peers. Percentage of capital expenditures funded with cash is another metric that relates closely to debt service coverage target. City Light debt-finances more of its capital program than its neighbors.

Utility	Debt Service Coverage Ratio	2014 DSCR	% of CapEx funded with cash
Seattle City Light	1.8x target w/ normal water	1.85x / 1.61x	40%
Tacoma Power	1.5x minimum 1.8x target w/ adverse water <sup>1</sup>	2.4x / 1.9x	50%
Snohomish PUD	1.75x target w/ blend water <sup>2</sup>	2.9x	60%
Chelan PUD	1.25x w/ 95% confidence 2.0x target, expected 2.25x-2.75x	2.52x	na

(1) Adverse Water is the quantity of water mathematically midway between critical and median water availability; it is roughly equivalent to 75% exceedance.

(2) Blend Water is the average of critical water and normal water- roughly equivalent to 85% exceedance.

One of the reasons Seattle is able to maintain a strong credit rating despite our weaker financial policy targets is the additional stability afforded by our RSA mechanism and liquidity from the Aaa-rated \$1.8 billion city of Seattle cash pool.

### What is the impact of reducing Seattle City Light's short-term and long-term debt service coverage ratio?

In Moody's December 2015 ratings report, it noted:

*In May 2015, Washington State declared a statewide drought emergency due to substantially below average regional snowpack. Below average water conditions, low wholesale power prices, and lower demand due to a mild winter have resulted in lower revenue including net wholesale revenue almost 50% lower than budgeted for Seattle City Light. Based on updated forecasts, we now expect Seattle City Light will have adjusted DSCR of 1.3 times and 112 days cash on hand compared to our expectations of 1.6 times and 142 days cash on hand for 2015. This highlights the volatility that hydrology and wholesale market prices can have on SCL's financial performance. However, SCL's RSA mechanism was designed as a key risk mitigant to address such volatility and the utility expects a retail surcharge taking effect in 2016 to bring the RSA balance back to \$100 million. We also expect SCL will return closer to their long term expected financial performance including adjusted DSCR improving to 1.5 times by 2017 assuming average water conditions.*

The report also noted what would make City Light's rating go down:

#### WHAT COULD MAKE THE RATING GO DOWN

*SCL's ratings could be downgraded if the RSA mechanism is removed or weakened, the city council's willingness to increase rates diminishes or if financial metrics drop into the 'Baa' category including days cash on hand below 90 days or Moody's adjusted DSCR below 1.5 times on a sustained basis. SCL's rating also can be downgraded if SCL does not have liquidity support through the City of Seattle's money pool, if SCL's financial policy targets were to be downwardly revised or if the underlying regional economy were to severely deteriorate.*

Therefore, if City Light were to reduce our debt service coverage target below our current 1.8x (comparable to Moody's adjusted 1.5x), a credit downgrade would be likely, resulting in higher financing costs for the utility, and higher rates for customers in the long run.



## WHAT COULD MAKE THE RATING GO UP

In light of the capital spending program, limited prospects exist for the rating to be upgraded. The ratings could be upgraded if SCL is able to sustain financial metrics in the 'Aa' category including internal liquidity comfortably exceeding 150 days cash on hand and adjusted DSCR exceeding 2.0 times.

## WHAT COULD MAKE THE RATING GO DOWN

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## STRENGTHS

- Strong and diverse service area anchored by the City of Seattle
- Demonstrated willingness to set rates including RSA mechanism
- Ownership of low cost hydro and contracted power from BPA
- Competitive retail rates
- Liquidity support through City of Seattle's consolidated money pool

## CHALLENGES

- Hydrology and wholesale market risk
- Forecasted 'A' category financial metrics post 2016
- Very large capital spending program

## RECENT DEVELOPMENTS

In November 2015, Seattle's mayor nominated Larry Weis as the new general manager for Seattle City Light. Seattle City Council approval is required, which is anticipated in early 2016. Larry was the head of Austin (City of TX Electric Enterprise (Austin Energy, Aa2 stable). James Baggs, previously the utility's chief compliance officer, has been serving as the interim general manager since Jorge Carrasco retired as the general manager in May 2015.

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## DETAILED RATING RATIONALE

Please see Moody's new sale report on Seattle City Light dated June 9, 2015 for detailed rating rationale.

## OTHER CONSIDERATIONS: MAPPING TO THE GRID

Moody's evaluates Seattle City Light under the U.S. Public Power Electric Utilities with Generation Ownership Exposure methodology, and, as depicted below, the grid indicated rating is Aa2, in line with its current Aa2 rating.

The grid is a reference tool that can be used to approximate credit profiles for public power with generation ownership in most cases. However, the grid is a summary that does not include every rating consideration. Please

see U.S. Public Power Electric Utilities with Generation Ownership Exposure for more information about the limitations inherent to grids.

#### METHODOLOGY SCORECARD FACTORS

1. Cost Recovery Framework in Service Area: (25% weight) (Aaa)
  2. Willingness to Recover Costs and Maintain Sound Financial Metrics (25% weight) (Aa)
  3. Management of Generation Risk- (10% weight) (A)
  4. Rate Competitiveness: (10% weight) (A)
  5. Financial Strength:
    - Sub factor a) Adjusted Days Liquidity on Hand: (10% weight) (192 3-yr avg) (Aa)
    - Sub factor b) Debt Ratio: (10% weight) (61% 3-yr avg) (A)
    - Sub factor c) Adjusted Debt Service Coverage: (10% weight) (1.50x 3-yr avg) (A)
- Grid Indicated Rating: Aa3

Notching: +1 (liquidity support through Seattle's consolidated money pool)

Scorecard Indicated Rating: Aa2

#### KEY STATISTICS

Total Unrestricted Cash and Investments, 2014: \$243 million

Boundary Project Hydro Capacity (Nameplate): 1,022 MW

Skagit Projects Hydro Capacity (Nameplate): 802 MW

Moody's Total Debt Service Coverage, 2014: 1.88 times (not adjusted) / 1.63 times (adjusted)

Senior Debt Service Coverage, 2014: 1.85 times (per resolution)

Cash to Debt Ratio, 2014: 13.4%

Debt Ratio, 2014: 59.4%

Consolidated Days Cash on Hand, 2014: 166 days

City of Seattle's Cash and Investment Pool, 2014: \$1.6 billion (\$791 million net of enterprise funds)

Average System Rate, 2014: Approximately 7.7 cents/kwh

Revenue Bonds, 2014: \$1.9 billion

#### OBLIGOR PROFILE

Seattle City Light is a department of the City of Seattle, which operates a utility system that primarily generates and delivers electricity to approximately 415,056 customers in the City of Seattle and several surrounding communities under franchise agreements. The City of Seattle is located in the western part of Washington State and is commercial hub for the Pacific Northwest. SCL's service area comprises of 131 square miles and has a population of approximately 776,000.

#### LEGAL SECURITY

SCL's bonds are secured by a pledge of the gross revenues of SCL and covenants require that the City of Seattle set rates to fund debt service, operating costs and other costs to maintain the system. Moody's considers the rate covenant to be weaker than typical for similar issuers. For additional indebtedness, SCL is required to meet a 1.25 times DSCR based on net system revenues incorporating draws from and deposits into the RSA. Furthermore,

the bonds have a debt service reserve for all parity bonds sized to the lesser of maximum annual debt service or reasonably required reserve or replacement fund per the tax code. The reserve is currently sized to 125% of average annual debt service (excluding variable rate debt). After debt issuance, the reserve is expected to be funded with a \$77 million surety from Assured Guaranty Municipal Corp (insurance strength: A2-stable) and \$72.8 million of cash.

#### USE OF PROCEEDS

Approximately \$32 million of the issuance will fund a portion of SCL's capital spending plans and pay for transaction costs. The remaining funds are expected to refund a portion of the 2008 series revenue bonds and SCL will provide for incremental funding of the debt service reserve.

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#### PRINCIPAL METHODOLOGY

The principal methodology used in this rating was U.S. Public Power Electric Utilities with Generation Ownership Exposure published in November 2011. Please see the Credit Policy page on [www.moodys.com](http://www.moodys.com) for a copy of this methodology.

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Baseline Strategic Assumptions Q3-2015	2015	2016 & Beyond	Notes
Ref: Seattle City Light 2013-2018 Strategic Plan - Page 16			
<b>Power Supply and Environment</b>			
Produce and purchase 10 billion kilowatt-hours of clean electricity each year to power all the homes and businesses (nearly 400,000 customers) in Seattle, Shoreline, Lake Forest Park, Burien, SeaTac, Tukwila and other small parts of King County.	Achieved	On Track	7.1 billion KWhs of electricity have been generated and purchased YTD 2015. A total of 10 billion KWhs of electricity is expected to be generated and purchased by year-end
Operate and conduct maintenance on Boundary, Skagit, Cedar Falls and Tolt Dams	Achieved	On Track	The Boundary Unit 56 Generator Rebuild was completed and the new unit is providing reliable generation. Seasonal preventive maintenance has been conducted on all machines in the fleet in preparation for the fall/winter storm season.
Incorporate environmental and wildlife habitat mitigation as part of the new Boundary plant license	Achieved	On Track	The Boundary Licensing program includes a large number of environmental and wildlife habitat projects. Notable milestones in the Sullivan Creek watershed were achieved in 2015, with completion of a landslide stabilization project and the signing of a design-build contract for the removal of Mill Pond dam.
Meet load growth with conservation and renewable power resources, including compliance with I-937 requirements to acquire renewable power resources	Achieved	On Track	A 2015 State Auditor's Office report confirmed that City Light fully complied with the requirements of I-937 during 2014. On-track to comply meet or exceed 2015 compliance requirements.
Continue strong conservation program and achieve I-937 mandated targets	Achieved	On Track	YTD 2015 City Light has achieved 12 aMW of conservation or 86% of the aMW target. It is anticipated that the target of 14 aMW will be met by year-end.
Uphold greenhouse-gas neutrality status	Achieved	On Track	For the eleventh year in a row that City Light achieved greenhouse gas neutrality.
Continue hazardous waste/Superfund cleanup, water quality testing, and the restoration of hundreds of acres of land that includes fish and wildlife habitats	Achieved	On Track	Site environmental clean-up continues on Terminal 117 and the Duwamish waterway; 223 acres of habitat have been restored for fish and wildlife in the Skagit River area. An additional 66 acres of habitat land was purchased.
<b>Reliability</b>			
Provide reliability equal to no more than one outage per year per customer lasting no more than 70 minutes per customer.	Achieved	On Track	SAIDI and SAIFI actuals have been below target each month of 2015 with YTD SAIDI at 37.2 minutes and SAIFI at 0.4.
Support operation and maintenance of 14 large substations and almost 3,000 miles of transmission and distribution lines	Achieved	On Track	All planned maintenance on the Utility's 14 large substations will be completed by year-end.
Conduct maintenance on highly reliable network system that serves customers in downtown Seattle	Achieved	On Track	City Light continues to schedule and perform regular maintenance on the network system. Equipment is inspected, repaired or replaced and tracked in the Work and Asset Management System.
Manage 500-plus miles of annual tree trimming along power lines -- a major contributor to keeping reliability at a high level	Achieved	On Track	389 line-miles of trees have been trimmed YTD in 2015. This includes 329 miles of distribution and 60 miles of transmission lines. Vegetation management expects to achieve the combined year-end target of 560 miles.
Inspect and treat City Light's 108,000 poles and annual replacement of 1,800 poles	See Note	See Note	YTD the Utility has inspected and/or treated 7,000 poles. By year-end 2015 it is projected that 8,200 will be inspected and/or treated. 1,300 poles will be replaced or reinforced in 2015. The goal of 1,800 will not be met due to crew response needed for high priority work such as the Goodell Creek fire and August windstorm.
Direct streetlight repair response within 10 working days of a reported outage, as well as replacement of about 15,000 streetlight lamps per year with energy-efficient LEDs until all residential streets have LEDs	Achieved	On Track	A 96% response rate for streetlight trouble tickets was achieved in 2015. Residential LED replacement is complete. Arterial LED replacement began in late 2013 with 6,100 replaced through 2014 and another 7,500 to be completed in 2015.
Implement a new work and asset management program to assess and prioritize work on City Light's most critical assets	Achieved	On Track	Continue to optimize the use of WAMS for more effective KPI tracking, development of efficient work processes and preparation of new efforts such as the online electrical service application and mobile workforce.
Conduct an apprenticeship program that hires and trains 10-20 new apprentices per year	Achieved	On Track	A total of 22 apprentices in the Electrical Constructor, Line worker and Cable Splicer trades were hired for the apprentice classes in 2015. There are currently 30 Apprentices in the program.
Maintain an outage management system that provides customers critical information during outage events	Achieved	On Track	Improvements in functionality and speed were made to the outage management system in 2015 as well as enhancements to the map which was accessed over 1.4 million times YTD by City Light customers. JD Power and Associates recognized City Light as the number one electric utility in the United States for having the largest percentage of customers using an online map to get outage information.
<b>Customer Service</b>			
Manage a customer metering and billing system, including an e-billing option, that provides monthly or bi-monthly bills to all customers	Achieved	On Track	2015 efforts supporting implementation of the new billing system included final system design, system integration testing, operational testing and data conversion.
Ensure new service connections are completed within 40-60 days	Achieved	On Track	Non-engineered service connections are being completed in an average of 34 days and engineered connections in 43 days in 2015.
<b>Infrastructure and Support</b>			
Continue and complete a wide variety of capital projects that maintain and upgrade City Light's power production, transmission and distribution systems	Achieved	On Track	Major CIP projects included: Denny Substation 100% substation and network design completion, Master Use permit issued and construction management contract executed; Completed over 1,500 feet of duct-banks required for relocation of system service and relocation of streetlights for Waterfront Seattle Project; City Light's portion of SDOT's Mercer West project was completed including undergrounding network and URD facilities.
Maintain the utility-wide information technology infrastructure and about 125 software applications including website, customer care, billing, energy management, inventory management and budgeting enhancements	Achieved	On Track	IT completed 22 projects in 2015 including a Regulatory Compliance Tracking System, a Human Resources Learning and Talent Management system, Microsoft Surface Pro deployment, Oracle Identity Management implementation, and upgraded Security Video Displays. Major projects in progress include replacement of the Customer Billing System, Energy Management System and upgrading the Enterprise Geographical Information System. The IT Service Desk has handled over 38,000 contacts YTD, achieving a 97% internal customer satisfaction rate.
Hold staffing to 1,811 authorized positions to perform necessary work in distribution, transmission, generation, conservation, customer service, and administration	See Note	See Note	1,861 positions were authorized in the 2015 Adopted Budget. Approximately 26 are new Strategic Initiative positions that did not impact the base number of 1,811. Approximately 24 positions were added from technical adjustments for contract-in and temporary conversion positions.
Maintain compliance with federal regulatory requirements regarding system reliability and critical asset protection	See Note	See Note	City Light was not scheduled for any federal regulator audits in 2015. During 2015 the Utility is working to prepare for a revised set of NERC Critical Infrastructure Protection (CIP) standards that will be effective April 1, 2016. In February 2015, two self-reports for minor violations were filed. Both reports are under review by WECC Enforcement.

