S&P Global
Ratings

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Summary:

Seattle, Washington; Water/Sewer

Primary Credit Analyst:
Chloe S Weil, San Francisco (1) 415-371-5026; chloe.weil@spglobal.com

Secondary Contact:
Edward R McGlade, New York (1) 212-438-2061; edward.mcglade@spglobal.com

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Summary:
Seattle, Washington; Water/Sewer

Credit Profile		
US$240.015 mil dr and wastewtr sys imp and rfdg rev bnds ser 2017 due 07/01/2047		
Long Term Rating	AA+/Stable	New
Seattle drainage & wastewtr		
Long Term Rating	AA+/Stable	Affirmed
Seattle drainage & wastewtr (AGM)		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed
Seattle drainage & wastwtr bnds		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings assigned its 'AA+' long-term rating to Seattle, Wash.'s series 2017 drainage and wastewater improvement and refunding revenue bonds. At the same time, S&P Global Ratings affirmed its 'AA+' rating on Seattle's existing drainage and wastewater system parity debt. The outlook on all ratings is stable.

The long-term rating reflects, in our opinion, the combination of a very strong enterprise risk profile and a very strong financial risk profile.

The very strong enterprise risk profile reflects our view of:

- Solid regional economy, with access to the broad and diverse Seattle-Tacoma-Bellevue metropolitan statistical area (MSA);
- City council's demonstrated ability and willingness to increase drainage and wastewater rates and pass through the county's rising sewer treatment costs, although, in our view, the average residential monthly utility bill in the city is moderately high;
- Very low industry risk as a monopolistic service provider of an essential public utility; and
- Comprehensive asset management practices, which we consider good under our operational management assessment (OMA) methodology.

The very strong financial risk profile reflects our view of:

- Consistent financial performance which we believe is sustainable, based on the city's two-year financial forecast and approved rate adjustments through fiscal 2018;
- Improved liquidity position ($121 million) equivalent to about five months of operating cash, as of Dec. 31, 2016;
- High leverage based on a debt-to-capitalization ratio of 72.4% following this transaction;
- Moderately large capital improvement plan (totaling $952.7 million through 2022) including deadline-certain regulatory mandates for the city to reduce uncontrolled combined sewer overflows (CSO) and remove stormwater pollutants; and

- Financial policies and practices, which we consider strong, well embedded, and likely sustainable under our financial management assessment (FMA) methodology.

The series 2017 bonds are being issued to provide $186 million in capital funding and to refund $57.9 million of the system's series 2006 bonds for debt service savings. The series 2017 bonds are secured by a pledge of net revenues of the city's drainage and wastewater system. Additionally securing all parity bonds is a reserve, funded at the lesser of maximum annual debt service (MADS), 125% of average annual debt service, or 10% of proceeds. A rate covenant requires the system to generate coverage of 1.25 times (x) average annual debt service, although withdrawals from a rate stabilization fund can be included in this calculation. At year-end 2016, the system had $665.4 million of drainage and wastewater debt and $16.7 million in subordinate state loans outstanding.

Enterprise risk

The city of Seattle (population: 680,000) sits at the center of the large, diverse Puget Sound regional economy. Overall, the population in the city has grown by a very strong 2.9% per year since 2012, which reflects the region's high performing economic clusters such as aviation manufacturing, information technology, and biotechnology. Income levels within the city are strong, with the median effective household buying income at 128% of the national average in 2016. At the same time, unemployment as of March 2017 was 2.8%, well below that of both the state (4.9%) and nation (4.6%).

The drainage and wastewater system is one of three enterprises operated by Seattle Public Utilities (SPU), a department of the city. SPU provides retail wastewater services to about 176,875 accounts within Seattle. The drainage system, which handles stormwater runoff, serves about 214,149 accounts in Seattle. Residential customers make up approximately 69% of the total drainage and wastewater accounts. The top customer of the drainage system is the city of Seattle, at 6.5% of 2016 revenues, and the top customer of the wastewater system is the University of Washington at 3.0% of 2016 revenues.

Nearly all sewage within the city is treated on a wholesale basis by King County's regional wastewater treatment system, (with about 1% treated by Southwest Suburban Sewer District). Seattle is the largest customer of the regional system (40.2%), based on the number of residential customer equivalents (RCEs) served. While the county is principally responsible for sewage treatment and disposal, the city is responsible for its own local collection and transmission. Each participating agency of the regional system, including Seattle, pays a monthly sewer charge to King County for its proportionate operating and capital costs associated with the system. The agreement between Seattle and the county to provide wholesale sewage treatment expires in 2036, although negotiations are underway to extend the agreement.

As of Dec. 31, 2016, King County had $2.9 billion of sewer revenue bonds (largely associated with the $1.9 billion Brightwater treatment facilities which entered commercial operation in 2012), as well as $759 million of general obligation debt supported by the sewer system and $206 million of state loans. We estimate Seattle's share if the county's debt burden to be about $1.5 - $1.6 billion (although some of this we expect will be paid by future developer contributions and not by existing customers of the system).

The county's wholesale treatment costs are a major portion of the city's operating expenses, representing 53% of the city's drainage and wastewater operating expenses in 2016. City ordinance allows SPU to pass through increases in

King County's wastewater treatment charges based on adopted wholesale rates and projected billed consumption. The county has regularly increased its wholesale treatment rates to recover its rising costs and typically increases its wholesale treatment rate every two years. In 2017, the county increased its wholesale treatment rate 5.2%, after previous rate increases of 5.6% in 2015 and 10.2% in 2013. We understand the county council is expected to review a 2019 rate increase in the summer of 2018. We expect the county's wholesale rates to continue to rise, as the county has an additional $1 billion in capital expenditures planned through 2030, including $400 million in conveyance system improvements and $600 million in CSO improvements.

In addition to the automatic pass through of King County's treatment charges, the city council's willingness and ability to impose rate increases is significant credit strength because we consider rate increases critical to funding the funding the city's own capital needs and associated bond issuance plans. In 2015, the city council adopted annual wastewater rate increases through Jan. 1, 2018, including 3.6% rate increase on Jan. 1, 2016, a 5.4% increase on Jan. 1, 2017 and 1.2% rate increase effective Jan. 1, 2018. The city collects wastewater rates on a bimonthly basis on the same bill as water and solid waste and can shut off water service for nonpayment. Drainage charges are billed on the county property tax statement based on parcel size and, for larger residential and commercial parcels, the proportion that is impervious surface.

According to management, the typical monthly-equivalent residential sewer charge to residents in fiscal 2017 is $55.60 for 4.3 hundred-cubic feet (ccf) of consumption, including wastewater treatment costs, and the typical drainage charge is $36.04 based on the square footage of the residence. Together, we impute a combined sewer and drainage charge of $91.64 per month (although as mentioned above, the drainage charge is billed separately, on the property tax roll).

On a combined basis, the city's charges for wastewater and drainage are well above average compared to national medians (in part due to the county's treatment costs), but in our view remain generally affordable in the context of the service area's strong income levels based on the annual bill representing about 2.5% of the city's median household effective buying income. The city currently levies a tax on gross drainage and wastewater charges of 11.5% and 12.0%, respectively, which under the city charter are paid only after debt service is covered; these taxes are excluded from our analysis of the utility system's market position.

Based on our operational management assessment, we view the city to be a '2' on a six-point scale, where '1' is the strongest. Our assessment reflects the city's long-range water resources planning and progress in reducing CSOs. About two-thirds of the city system is a combined or partly combined storm water and wastewater system. This type of system leads to heavy flows and potential system overflows during wet weather events. Under a 2013 consent decree between the city, state, and federal government, the city is required to develop plans, programs, and infrastructure to further reduce overflows. As such, the city prepares a six-year internal drainage wastewater system capital improvement program and funding plan in connection with the consideration of longer-term projects. The city's six-year capital plan (CIP) between 2017 and 2022 totals $952.7 million, with the largest portions ($285.0 million) focusing on CSO projects and rehabilitation and replacement of existing drainage and wastewater assets ($188.2 million).

Consistent with "Methodology: Industry Risk," published Nov. 19, 2013, we consider industry risk for the system to be very low, the most favorable assessment possible on a '1' to '6' scale, with '1' being the best.

Financial risk

The drainage and wastewater system's financial performance has been relatively stable during the past three years, due to a rise in consumption attributable to population growth and construction activity, as well as regular rate increases which have offset the rising fixed obligations of the utility over this period. In fiscal 2016, the drainage and wastewater system produced $375 million of revenues, of which the wastewater enterprise generated $262 million, or 70%, while the drainage enterprise produced the remaining $108 million.

Even so, in our view, the system's financial metrics are below average compared to that of similarly rated wastewater enterprises, when considering the system's fixed obligations to both King County as well as the payments made to the city of Seattle. Our calculation of all-in DSC takes into account Seattle's imputed debt resulting from the city's participation in the county's regional wastewater treatment system, and also views the payment of taxes ($49.1 million in fiscal 2016) to the city as an additional fixed cost. We view all-in DSC to be important because it provides what we think is the best picture of total use of all utility operating revenues and therefore ultimate financial capacity. In fiscal 2016, we calculate adequate "all-in" debt service coverage (DSC) of 1.19x, compared to 1.22x in fiscals 2015 and 2014, respectively. Based on the city's projections, we calculate all-in DSC will be at or above 1.1x over the next several years.

We view the wastewater and drainage system's financial projections as reasonable; with revenue growth based on planned rate increases and assumed increases in system expenses and wholesale treatment expenses. We understand that management current anticipates issuing about $124 million in additional bonds in fiscal 2018, followed by $334 million to cover capital needs between fiscals 2020 - 2022; and is currently projecting a 15% drainage and wastewater rate increase in 2019.

System liquidity has improved during the past year to levels we consider very strong. As of Dec. 31, 2016, unrestricted cash and investments totaled $121 million, representing about 151 days' of operating expenses on hand, up from $101 million, or 132 days' of operating expenses in 2015. While liquidity has fluctuated in prior years, the system has access to the city's $1.8 billion pooled investments, if needed. Under the city's municipal code, the finance director is permitted to make interfund loans for up to 90 days. Longer-term loans require city council approval.

Based on our financial management assessment, we rate the city a '1' on a six-point scale on which '1' is the strongest. We believe that the city's practices are strong, comprehensive, and supportive of high credit quality. Revenue and expenses assumptions are reasonable, and interim financial reporting is provided. The long-term planning process is rigorous, and the detailed forecast is annually updated. Financial planning and operational information are relatively easily obtained, as the department's budget, financial statements, and other important operational and financial information are readily available on its web site.

Outlook

The stable outlook reflects our anticipation that Seattle will continue to make progress on its CIP and continue to bolster its liquidity position. Further support for the rating is provided by the city's extremely strong employment and economic base.

Upside scenario

Although we don't anticipate it during the two-year outlook horizon, we could take a positive rating action if the utility is able to produce wider margins and stronger coverage metrics that we believe will be sustainable.

Downside scenario

We could take a negative rating action if the utility system's liquidity position is materially spent down or if economic indicators supporting the system's market position were to decline.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.