S&P Global
Ratings

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Summary:

Seattle, Washington; Water/Sewer

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Summary:

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Credit Profile		
US$192.885 mil drainage and wastewtr sys imp and rfdg rev bnds ser 2016 due 04/01/2046		
Long Term Rating	AA+/Stable	New
Seattle drainage & wastewtr (AGM)		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed
Seattle WTRSWR		
Long Term Rating	AA+/Stable	Affirmed

Rationale

S&P Global Ratings assigned its 'AA+' long-term rating to Seattle, Wash.'s series 2016 drainage and wastewater improvement and refunding revenue bonds. At the same time, S&P Global Ratings affirmed its 'AA+' issuer credit rating (ICR) on Seattle's existing drainage and wastewater system parity debt. The outlook on all ratings is stable.

The series 2016 bonds are being issued to provide $107.8 million in capital funding and to refund up to $93.3 million of the system's series 2006 bonds and series 2008 bonds. The 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 2015, the system had $601 million in parity revenue bonds plus $15 million in subordinate state loans.

The extremely 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);
- Stable and predictable revenue from the city's wastewater collection and transmission system;
- 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; 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, based on the city's two-year financial forecast and approved rate adjustments through fiscal 2018;
- The city's improved liquidity position with over four months of operating cash as of Dec. 31, 2015;
- High outstanding leverage based on a debt-to-capitalization ratio of 64.6% as of fiscal 2015; and
- Moderately large $994.9 million in planned capital spending through 2021 including deadline-certain regulatory

mandates for the city to reduce uncontrolled combined sewer overflows (CSO) and remove stormwater pollutants;
- Financial policies and practices, which we consider strong, well embedded, and likely sustainable under our financial management assessment (FMA) methodology.

Enterprise risk

The city of Seattle (population: 662,400) sits at the center of the large, diverse Puget Sound regional economy. Income levels within the city are strong, with the median effective household buying income at 121% of the national average in 2015. The drainage and wastewater system is one of three enterprises operated by Seattle Public Utilities, a department of the city. The system 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.

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). 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 the city, pays a monthly sewer charge to the county for its proportionate operating and capital costs associated with the system. Seattle is the largest customer of the regional system, based on the number of residential customer equivalents (RCEs) served. The agreement between Seattle and the county to provide wholesale sewage treatment expires in 2036, although negotiations are underway to extend the agreement.

The county has approximately $3.8 billion of wastewater treatment system debt outstanding, of which we estimate Seattle's share to be about $1.5 billion, as the city represents 40% of the county's total RCEs based on billed consumption. Accordingly, wholesale treatment costs are a major portion of the city's operating expenses, representing 54% of total expenses in 2015. The county has regularly increased its wholesale treatment rates to recover its rising costs. City ordinance allows the city to pass the county's wastewater treatment charges to its retail customers, which we view to be a key credit strength for the city.

In our view, following the completion of construction of the $1.9 billion Brightwater treatment and reclaimed water plant in 2013, the peak years of the county's debt-financed capital expenditures are now behind them. We expect wholesale rates to continue to rise, albeit at a more moderate pace, 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.

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. In addition to the county's planned CSO improvements, we understand that CSO projects represent about 44% of the city's planned capital spending, or $437.9 million, from 2016 through 2021. Other key projects in the city's six-year capital plan focus on rehabilitation and replacement of existing drainage and wastewater assets, $159.8 million, and projects to reduce flooding, sewer back-up, and landslides, $118.9 million.

We believe Seattle's drainage and wastewater system has a strong market position based on a natural monopoly in its service area and affordable service rates that provide management with revenue-raising flexibility. Most sewer customers are billed by the city bi-monthly based on water consumption (winter water consumption for residential customers). The city has increased wastewater rates in each of the past six years to cover increasing system costs and to pass through the county's wholesale treatment costs.

In 2015, the city council adopted annual rate increases through Jan. 1, 2018. The city collects wastewater rates on the same bill as water and can shut off water service for nonpayment. According to management, the typical monthly-equivalent residential sewer charge to residents in 2016 is $52.76 for 4.3 hundred-cubic feet (ccf) of consumption, including wastewater treatment costs. We consider this rate to be affordable in the context of the service area's strong income levels based on the annual bill representing about 1.2% of the city's median household effective buying income. However, S&P Global Ratings typically uses 8 ccf for a representative single-family residence, and using this benchmark we calculate a monthly residential sewer bill of $98.16, which we consider high.

Storm water charges are based on parcel size and, for larger residential and commercial parcels, the proportion that is impervious surface. The charge is billed on the county property tax statement. For 2015, a typical residential customer's annual charge is $336, or the equivalent of $28 per month. Unpaid storm water charges become a lien on customer's property.

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, progress in reducing CSOs. 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. Rates are reviewed and adjusted regularly.

Financial risk

The drainage and wastewater system's financial performance has been relatively stable during the past three years. In 2015, operating revenue totaled $363.8 million, up 6.4% from 2014, compared to a 1.5% increase in consumption over this period. 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, were $42.9 million in 2015, up from $40.3 million in 2014. Operating expenses excluding depreciation totaled $278.7 million, up 6.3% from 2014. Ordinance-based DSC (which removes the payment of taxes from operating expenses) was a very strong 2.8x in 2015 compared to 3.0x in 2014.

In recent years, coverage of all the fixed obligations of the utility system, including debt, loans, and transfers to the general fund (the payment of taxes), has been adequate. We view the utility system's "all-in" debt service coverage (DSC) of the city's fixed obligations 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. 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 to the city as an additional fixed cost. All-in DSC including the city's share of the county's wastewater treatment debt service and taxes has been consistently about 1.2x during the past three years.

In the city's projections, ordinance-based DSC declines to about 2.0x in 2016 and 2017, and all-in DSC is at or above 1.1x, which we consider somewhat thin at this rating level. However, we view the projections as reasonable, with revenue growth based on planned rate increases and assumed increases in system expenses and wholesale treatment expenses.

In the past, the city has maintained unrestricted cash and investments in the drainage and wastewater fund at a level we view as adequate but low for the 'AA+' rating although liquidity has improved during the past two years to a level we view as strong. As of Dec. 31, 2015, unrestricted cash and investments totaled $100.9 million, representing about 132 days' of operating expenses on hand. We understand the city plans to spend a portion of the current cash balance for capital projects. While liquidity has fluctuated in recent 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 provide adequate all-in DSC, generate sufficient capital funding, and continue to bolster its liquidity position.

Upside scenario

We could take a positive rating action if our calculation of all-in DSC improved materially during the next two years. However, given the potential future large capital expenses (including those of the county) we do not anticipate raising the rating during the two-year outlook period.

Downside scenario

If liquidity is drawn down to a level we view as low for the rating category and we believe the system will sustain a low liquidity level going forward, we could lower the rating.

Related Criteria And Research

Related Criteria

- USPF Criteria: Rating Methodology And Assumptions For U.S. Municipal Waterworks And Sanitary Sewer Utility Revenue Bonds, Jan. 19, 2016
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- U.S. State And Local Government Credit Conditions Forecast, April 19, 2016
- U.S. Municipal Water Utilities: No News is (Probably) Good News; The Outlook is Stable, Jan. 20, 2016

Ratings Detail (As Of May 16, 2016)		
Seattle drainage & wastwtr bnds		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed
Many issues are enhanced by bond insurance.		

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.