MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns Aa1 to Seattle, WA's $340M water revenue bonds; stable outlook

Global Credit Research - 13 May 2015

Affirms Aa1 ratings on $850M of parity bonds

SEATTLE (CITY OF) WA WATER ENTERPRISE
Water Enterprise
WA

Moody's Rating

ISSUE	RATING
Water System Improvement and Refunding Revenue Bonds, 2015	Aa1

Sale Amount	$338,215,000
Expected Sale Date	05/19/15
Rating Description	Revenue: Government Enterprise

Moody's Outlook STA

NEW YORK, May 13, 2015 --Moody's Investors Service has assigned Aa1 to Seattle, Washington's $338 million Water System Improvement and Refunding Revenue Bonds, 2015. Moody's has affirmed the Aa1 ratings on approximately $850 million of outstanding parity revenue bonds. The outlook is stable.

SUMMARY RATING RATIONALE

The Aa1 rating reflects the enterprise's broad and economically diverse service area, strong supply profile and sizeable capacity margin, satisfactory and recently improving debt service coverage, liquidity that is supported by access to the city's $1.6 billion investment pool, and a moderately elevated debt burden that is declining and will continue to do so given a transition in capital spending following the recent completion of major capital projects.

OUTLOOK

The stable outlook reflects our view that the credit profile will remain supported near-term by approved rate increases in FY 2016 and FY 2017, continued economic vitality and stability in the customer base, and the dynamic of a healthy existing operating margin combined with a level debt service structure and limited additional borrowing in the six-year capital improvement plan (CIP).

WHAT COULD MAKE THE RATING GO UP

-Growth in revenues and expanded operating margins

-Significant increase in debt service coverage, or significant reduction of debt

WHAT COULD MAKE THE RATING GO DOWN

-Significant weakening of debt service coverage

-Material increase in debt

STRENGTHS

-Service area is economically diverse, relatively affluent and growing

-Under several demand scenarios, no new source of supply is needed prior to 2060

CHALLENGES

-Consumption has decreased 30% since 1990 and remains weak

-15.5% city utility tax represents a sizeable expense and limits the enterprise's flexibility

RECENT DEVELOPMENTS

Incorporated in Detailed Rating Rationale.

DETAILED RATING RATIONALE

SERVICE AREA AND SYSTEM CHARACTERISTICS: BROAD AND STABLE SERVICE AREA

The enterprise's broad service area divides into a retail service area and a wholesale service area. Retail service is provided to a population of approximately 682,000, through 191,000 metered accounts, in the City of Seattle (Aaa stable) and portions of the cities of Shoreline, Lake Forest Park and Burien, as well as portions of unincorporated King County (Aaa stable) south of Seattle. Wholesale service is provided to 21 suburban water districts and municipalities, plus the Cascade Water Alliance, which indirectly serve a population of approximately 655,000 in King County and portions of Snohomish County (Aa2 stable).

The combined area is economically diverse, affluent and growing. The regional economy is experiencing strong growth in jobs, incomes and property values and has been one of the best performing, and strongest recovering, metropolitan areas in recent years. There is a high level of educational attainment in King County and an increasing amount of high value-added employment in the Seattle, Bellevue (Aaa stable) and Redmond (Aa2) areas. The region's job growth has maintained the strong pace evident throughout FY 2014, ahead of the prior year's pace and well ahead of the US average. Unemployment has returned to pre-recession levels while the labor force is at a record high, and the labor force participation rate is above its pre-recession level and well above the US average. Incomes are growing faster than the state and US, consistent with the region's growing employment in relatively high-wage sectors. The strength in employment and income growth is translating to demand in the real estate market, creating strong price appreciation and attracting new commercial and residential construction.

HIGH-QUALITY, LONG-LIVED SUPPLY

The enterprise's current supply portfolio is forecasted to be sufficient through 2060, and supply pressure is even less of a concern in the immediate term given the flat to slightly declining consumption trend of recent years. Supply is derived primarily from two surface water diversions: one located on the Cedar River and one on the Tolt River. The Cedar River system provides two-thirds of total supply and the Tolt River system provides one-third. Two well fields supply up to 10 MGD to meet drought or emergency needs. Water from the Cedar River is treated at the 180 MGD Cedar Treatment Facility. Water from the Tolt River system is treated at the Tolt Treatment Facility, which has a capacity of 120 MGD. The enterprise owns and has land use agreements for, and is therefore able to safeguard, the watershed areas upstream of the intakes on these rivers. The enterprise's ability to access these water supplies is constrained, in part, by the firm yield of the system. The firm yield is what the enterprise is able to supply system-wide for a given delivery pattern while meeting a 98% supply reliability standard, meaning the firm yield is the amount of water that is assured for delivery in all but the driest 2% of years (without lowering reservoirs below normal minimum operating levels). The firm yield is also affected by instream flow requirements, treatment and transmission capacity, and other system constraints, including diversion limits for the Cedar River. Long-term forecasted demand is projected to remain below the existing firm yield through 2060, with headroom expanding in 2039 as the Cascade Water Alliance block begins declining. The enterprise has additionally modeled potential impacts on supply and demand due to climate variability and climate change, which would affect snow accumulation, melt and runoff, as well as consumption patterns. None of the modeled scenarios necessitates new supply prior to 2060.

In the context of these ample resources, the enterprise's supply profile is strong and a noted credit strength. FY 2014 average daily consumption of 114 MGD stood in relation to an average firm yield of 172 MGD and a maximum firm yield of 335 MGD. The system additionally has 64 billion gallons of storage, which equates to 560 days of supply based upon FY 2014 average daily consumption.

From 1990 to 2010, water consumption declined 30%, despite a 15% increase in population over the same period. The consumption declines, affected in part by conservation efforts on the part of the enterprise and its wholesalers, have levelled off in recent years. The region has experienced, and is forecasted to continue to experience, population growth, which will remain supportive of demand going forward. Population in each service area has increased by 1% per year over the last 10 years, and active metered accounts in the retail service area have increased by 0.5% per year over the same period.

Wholesale customers consist of 21 water districts or municipalities and the Cascade Water Alliance (Aa2). 13 wholesale customers receive water under full-requirements contracts that extend through 2060. Four wholesale customers purchase water under partial-requirements contracts, in which the purchased water supplements their own supplies. These contracts carry the same terms and duration as the full-requirements ones. The enterprise also provides water under block contracts with Cascade Water Alliance (CWA) and Northshore Utility District, which have been established on a take or pay basis. The enterprise provides CWA a specified minimum block (base block) and supplemental water (supplemental block) through 2039, at which point the block volume begins to decline.

DEBT SERVICE COVERAGE AND LIQUIDITY: DEBT SERVICE COVERAGE HAS BEEN IMPROVING; LIQUIDITY IS SUPPORTED BY ACCESS TO CITY INVESTMENT POOL

The enterprise's financial metrics have improved in recent years. After our adjustments to account for the city tax payment as a subordinate debt obligation, senior lien debt service coverage has improved for the last three years, from 1.73 times in FY 2012 to 2.03 times in FY 2014, and over the last five years, average senior lien debt service coverage has exceeded 1.7 times, in keeping with the utility's policy. Coverage is supported by this financial policy, which plans for a minimum coverage level of 1.7 times annual debt service, and by policies to cash fund a minimum of 15% of capital spending in a given year and a minimum average of 20% of capital spending over a planning horizon, which provide additional cash flow and margin to cover debt service.

Post-tax debt service coverage, including prior payments on the enterprise's second-lien public works loans, is less robust but has also improved in recent years, from 1.11 times in FY 2011 to 1.5 times in FY 2014. Over the last five years, average post-tax debt service coverage has exceeded 1.3 times.

The city utility tax is levied at the rate of 15.5% on the gross revenues of the enterprise's retail operations. At $30.7 million in FY 2014, the tax payment represents a sizeable cash outflow for the enterprise, regardless of it being subordinate to prior debt service. We note, however, that the tax is applied as a percentage of gross revenues, and thus the burden generally grows and shrinks in line with gross revenues and poses less of a constraint than would a fixed payment that was independent of revenue performance.

The enterprise has enacted modest rate increases of 2.1% in FY 2016 and 2.8% in FY 2017, which are smaller than the increases implemented in recent years. Retail consumption has been nearly level for the last five years, and wholesale consumption, although a smaller contributor to total revenues, has been increasing at just under 2% per year. Near-term, we expect the enterprise will continue to add customers, which will support demand. Debt service is level at approximately $80 million and the enterprise currently has $27.8 million on deposit in a rate stabilization fund to support revenues.

Liquidity

Seattle's utilities have historically maintained low levels of cash on their own balance sheets. This is mitigated by their ability to access liquidity in the city's government-wide cash pool, which stood at $1.6 billion at the end of FY 2014. Short-term liquidity (up to 90 days) can be accessed with approval of the city's finance director. For long-term liquidity, the enterprise must receive approval of the city council. The loans bear interest at the yield of the investment pool, which is low given the relatively short-term investment profile. This cash management approach has been tested and demonstrated successful, with the city's electric enterprise borrowing in excess of $100 million from the cash pool during the 2001 power crisis. The water enterprise generates healthy operating cash flow, and while a considerable portion of this cash flow is contributed toward capital spending and therefore does not accumulate on the balance sheet, the enterprise would be able to quickly build cash reserves if it chose to limit the extent of capital outlay. The enterprise ended FY 2014 with more than 150 days of cash on hand, a level that is satisfactory and excludes the $27.8 million held in the rate stabilization fund.

DEBT AND LEGAL COVENANTS: DEBT BURDEN SHOULD DECLINE LONG-TERM; LEGAL PROTECTIONS ARE SATISFACTORY

We expect the enterprise's moderately elevated debt levels, which are already moderating, to decline further in the years to come. From 1999 to 2009, the enterprise spent more than $310 million to implement UV disinfection and filtration at the Cedar and Tolt treatment facilities, respectively, and to cover eight of its ten reservoirs, including all seven of its treated transmission system reservoirs. This spending resulted in elevated debt levels, but with these projects having been implemented, the capital plan has increasingly shifted toward less capital intensive uses, with a primary focus on the distribution system. The enterprise's debt ratio has fallen every year from FY 2010 (84.7%) to FY 2014 (69.3%), and we expect this trend will generally continue in the long term given the recent completion of these major projects and a sizeable capacity margin coupled with long-lived developed supply, which allow it to accommodate a range of growth scenarios.

The six-year CIP is manageable at $450 million, or $75 million annualized, and the composition of funding is nearly 40% cash, which is much higher than what prevailed in the last decade. The scheduled amortization of existing principal (inclusive of the current sale) will basically match the projected new debt incurred through FY 2020, negating any increase in debt while identified capital investment is projected to exceed depreciation in each year.

SATISFACTORY LEGAL PROVISIONS

Legal provisions are satisfactory. The bonds are secured by a rate covenant of 1.25 times annual debt service, adjusted for transfers from the rate stabilization fund. The bonds are also secured by a common debt service reserve fund, presently funded with cash and investment-grade sureties. We view as positive the fact that the enterprise deposited cash, of its own volition, to mitigate the credit risk associated with its AMBAC sureties. We note that, under certain conditions, the utility can enter into contract resource obligations (CROs), which are structurally senior to the bonds and therefore would subordinate existing bondholders, and that the conditions permitting the incurrence of CROs are not especially restrictive. CROs can be related to water supply, transmission, treatment, or other commodity or service contracts relating to the water system, and only require a five-year net revenue test to ensure coverage will still be met.

Debt Structure

All of the enterprise's debt is fixed rate, fully amortizing, long-term debt. Annual debt service (senior and second lien) is level at approximately $80 million through FY 2023, with maximum annual debt service occurring in FY 2016, although additional bonds are expected within the six-year capital improvement plan (CIP). After FY 2023, annual debt service is scheduled to decline rather significantly through the final maturity in FY 2045, and while additional borrowing is likely to occur within the same horizon, the enterprise's future capital needs are significantly lower than they were in prior years. As a result, we expect debt service will in fact follow a level, if not declining, trend over the long term.

Debt-Related Derivatives

None.

OPERATING ENVIRONMENT AND GOVERNANCE

Management is strong and experienced. Operating and capital budgets are planned over a multi-year horizon, and internal coverage, liquidity and reserve policies guide planning decisions.

KEY STATISTICS

-Asset Condition (Remaining Useful Life): 23 years

-System Size (O&M in $000s): $102,322

-Annual Debt Service Coverage: 2.03x (senior), 1.5x (post-tax)

-Cash on Hand: 151 days

-Debt to Operating Revenues: 3.6x

-Rate Covenant: 1.25x

-Debt Service Reserve: Lesser of MADS or 1.25x AADS

OBLIGOR PROFILE

The enterprise, through its retail and wholesale activities, provides water to a population of 1.3 million within the greater Seattle metropolitan area.

LEGAL SECURITY

The bonds are secured by a priority lien on the net revenues of the water system. Additional security is provided by a rate covenant and additional bonds test, each established at 1.25 times adjusted annual debt service, and a common debt service reserve fund that consists of cash and investment-grade sureties.

USE OF PROCEEDS

Approximately $50 million will provide new money to finance a portion of the enterprise's ongoing capital program. The balance of the issue will refund existing bonds for net present value savings, estimated to exceed 10% of refunded par, with no extension of maturity.

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was US Municipal Utility Revenue Debt published in December 2014. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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