

# Research

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## Summary:

# Seattle, Washington; Water/Sewer

### **Primary Credit Analyst:**

James M Breeding, Dallas (1) 214-871-1407; james.breeding@standardandpoors.com

### **Secondary Contact:**

Paul J Dyson, San Francisco (1) 415-371-5079; paul.dyson@standardandpoors.com

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## Summary:

# Seattle, Washington; Water/Sewer

### Credit Profile

US\$338.215 mil wtr rev rfdg bnds ser 2015 due 05/01/2045

*Long Term Rating*

AA+/Stable

New

## Rationale

Standard & Poor's Ratings Services assigned its 'AA+' rating to Seattle, Wash.'s series 2015 water system improvement and refunding revenue bonds. At the same time, Standard & Poor's affirmed its 'AA+' rating on Seattle's existing water system parity debt. The outlook is stable.

The rating continues to reflect our view of the water system's:

- Role as a major regional water supplier to retail customers within Seattle and to wholesale customers in the Puget Sound area;
- Deep and diverse service area economic base; and
- History of adopting rate increases to support stable financial performance.

These strengths are partially offset by our view of the water fund's maintenance of a historically low unrestricted cash position. However, access to loans from the city's large investment pool under Seattle's municipal code significantly mitigates the low liquidity held in the water enterprise fund.

The series 2015 bonds are being issued to fund system improvements and to refund certain outstanding water revenue bonds for debt service savings. The bonds are secured by a pledge of net revenues of the city's water system. Additionally securing all parity bonds is a reserve, funded at \$70.9 million, with about 76% of this requirement funded with surety bonds. A rate covenant requires the system to generate debt service coverage of 1.25x, though withdrawals from a rate stabilization fund can be included in this calculation. As of Dec. 31, 2014, the system had \$853.5 million in parity bonds outstanding plus \$16.1 million in subordinate-lien state loans.

The water system is operated by Seattle Public Utilities, a department of the city. It provides retail service to customers in Seattle and in portions of the cities of Shoreline, Burien, and Lake Forest Park, as well as in unincorporated King County. The system additionally provides wholesale water service to 21 suburban water districts and municipalities plus the Cascade Water Alliance. It serves a population of about 1.3 million, through those wholesale customers and the approximately 165,000 residential accounts and 22,300 commercial or multifamily accounts. There is no concentration in the customer base, as the top 10 retail customers account for less than 10% of operating revenue. Seattle sits at the center of the large, diverse Puget Sound regional economy. City income levels are above average, with median effective household buying income at 120% of the national average.

The system primarily derives its water supply from surface water diversions on the Cedar River and on the South Fork of the Tolt River, each about 25 miles east of Seattle. It also operates two wellfields. The city estimates it has a firm

supply yield of 172 million gallons per day (mgd) compared with recent average demand of about 114 mgd. The system also has substantial storage in eight reservoirs. Although the population in the service area has steadily risen, increased conservation has actually lowered water demand during the past 20 years.

In 2014, about 22% of operating revenue was derived from sales to the system's wholesale customers. Most of the customers have entered into long-term agreements with Seattle through at least December 2060, requiring the city to meet the customers' water demands not met by local sources. Seattle's contract with its largest customer, Cascade Water Alliance, requires the system to provide 33.3 mgd annually through 2039, and at a declining annual volume thereafter. Cascade represents about 44% of wholesale consumption. The top three wholesale customers by revenue are Cascade, Northshore Utility District, and Highline Water District.

The city has a history of raising water rates annually. Retail customers are charged a flat rate plus a volume-based rate that is higher and tiered during summer months. We still view current rates as relatively high, though affordable when viewed in the context of the household income levels. A monthly bill for 10 hundred-cubic feet (ccf) of summer water use would be about \$71.00 for a single-family residential customer. The city uses 5 ccf for its representative water bill, which would be just under \$40.00 monthly in the summer.

The system's financial performance has been relatively stable, with past rate increases helping to boost operating revenue. In the past five years (audited fiscal 2010 through unaudited fiscal 2014), total operating revenue has ranged from \$194.6 million to \$242.9 million. Operating expenditures, less depreciation, have ranged from \$108.4 million to \$133.0 million. In its debt service coverage calculations under its rate covenant, the city excludes taxes paid to it from operating expenses. City taxes were approximately \$30.7 million in 2014, and under city charter are paid only after provisions have been made to pay debt service. Based on those calculations, total lien debt service coverage, including the small amount of subordinate-lien debt service, has ranged from 1.5x (2011) to 1.9x (2014). If city taxes are included in operating expenses, debt service coverage is lower, ranging from about 1.2x to 1.5x during that same time period. Management's projections show total coverage ranging from 1.7x to 1.9x through 2017 when excluding city taxes as an expense, and approximately 1.3x to 1.5x when including them as an expense.

We view the water fund's unrestricted liquidity position as good, as liquidity has improved in the past few years. As of Dec. 31, 2014 (unaudited), unrestricted cash and investments totaled \$42.1 million, which is a significant increase from the \$7.3 million balance in 2011. However, projections show cash levels declining to about \$15.0 million by 2016. This would equate to less than 60 days of operations. There is also an additional \$27.9 million in the rate stabilization fund, which is currently well above the \$9.0 million minimum requirement. In addition, provisions in the city's municipal code that allow the finance director to make interfund loans for up to 90 days partially mitigate the system's relatively low liquidity. Longer-term loans require city council approval. According to management, the city's investment pool balance is currently about \$1.6 billion; however, these funds are available to support all municipal functions.

The water system's capital program totals about \$450 million over the next six years (current year through 2020), which we view as manageable relative to the size of the system. The city plans to issue about \$178 million in additional debt to finance a portion of this and to fund the remainder with existing bond proceeds (including this issue), internally generated funds, and grants. The additional debt service associated with the capital program has been included in the projections for debt service coverage.

## Outlook

The stable outlook reflects our expectation that system management will continue to set rates to provide good debt service coverage and sufficient capital funding. Given the system's relatively low unrestricted cash position, we do not anticipate raising the rating during the next two years. If cash levels or debt service coverage were to fall significantly, we could lower the rating, though this is not anticipated.

## Related Criteria And Research

### Related Criteria

- USPF Criteria: Key Water And Sewer Utility Credit Ratio Ranges, Sept. 15, 2008
- USPF Criteria: Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011

### Related Research

- U.S. State And Local Government Credit Conditions Forecast, April 2, 2015
- U.S. Municipal Water And Sewer Utilities 2014 Sector Outlook: Learning To Do More With Less, Jan. 9, 2014
- 2014 Review Of U.S. Municipal Water And Sewer Ratings: How They Correlate With Key Economic And Financial Ratios, May 12, 2014

### Ratings Detail (As Of May 13, 2015)

Seattle wtr rev		
<i>Long Term Rating</i>	AA+/Stable	Affirmed
Seattle wtr (BHAC) (SEC MKT)		
<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Affirmed
<b>Seattle wtr sys</b>		
<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

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