MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns Aa3 to Seattle, WA's $34M solid waste revenue bonds

Global Credit Research - 26 May 2015

Affirms Aa3 on $167M of outstanding parity bonds; stable outlook

SEATTLE (CITY OF) WA SOLID WASTE ENTERPRISE
Solid Waste
WA

Moody's Rating

ISSUE	RATING
Solid Waste Improvement and Refunding Revenue Bonds, 2015	Aa3
Sale Amount $34,200,000	
Expected Sale Date 05/28/15	
Rating Description Revenue: Government Enterprise	

Moody's Outlook STA

NEW YORK, May 26, 2015 --Moody's Investors Service has assigned Aa3 to Seattle, Washington's $34.2 million Solid Waste Improvement and Refunding Revenue Bonds, 2015. Moody's has affirmed the Aa3 ratings on $167 million of outstanding parity revenue bonds.

SUMMARY RATING RATIONALE

The Aa3 rating reflects the solid waste enterprise's broad, economically diverse and relatively affluent service area that is experiencing healthy economic performance and population growth, although customer accounts have generally been declining in recent years given a move toward higher-density development. The enterprise's operating profile is favorable, with a strong and court-tested flow control ordinance and a comparatively low level of complexity and risk in day-to-day operations. Collection and disposal are contracted out, the enterprise has no active landfill and is indemnified from related liabilities in its third-party disposal contract, and operating revenues derive nearly entirely from recurring fixed charges for mandatory collection services. Bond ordinance and post-tax debt service coverage ratios are ample and satisfactory, respectively, and the enterprise's low on-balance sheet liquidity is supported by access to the city's $1.6 billion cash pool. The current sale represents the third issuance to finance replacement of the city's two transfer stations; beyond the current sale, very little additional debt is expected over the intermediate term.

OUTLOOK

The stable outlook is based upon our expectation that the enterprise's operating profile will remain stable in the near-term as the majority of outsourced contracts are in place for the next several years and extendable at the option of the city, the enterprise's approved rate increases over the next two years will likely exceed inflation-linked cost increases, and debt service coverage ratios will likely narrow but be maintained at satisfactory levels given support from recent sizeable deposits to the rate stabilization account and expected annual rate increases necessary to meet peak debt service in the next several years.

WHAT COULD MAKE THE RATING GO UP

- The rating could be upgraded if the enterprise were to achieve and sustain significantly higher debt service coverage ratios in tandem with stable or declining debt levels

WHAT COULD MAKE THE RATING GO DOWN

- The rating could be downgraded if financial metrics were to drop materially below forecasted levels

STRENGTHS

- Demonstrated willingness to raise rates

- Strong flow control provisions

- Healthy service area

- Declining capital requirements

CHALLENGES

- Near term pressure on coverage ratios

- Above average rates compared to peers

- Declining customer accounts and non-recyclable waste volumes

RECENT DEVELOPMENTS

Incorporated in Detailed Rating Rationale.

DETAILED RATING RATIONALE

SERVICE AREA AND SYSTEM CHARACTERISTICS: STRONG FLOW CONTROL AND SERVICE AREA REMAIN KEY CREDIT FACTORS

The enterprise provides curbside waste collection through private haulers for residential and commercial customers in Seattle. City ordinance prohibits collection of non-recyclable waste within the city by companies that are not under contract with it. Another city ordinance requires all residents to subscribe to solid waste collection.

Together, these two ordinances create a strong flow control mechanism for the enterprise and enable it to secure residential collection fees, which are its largest revenue stream and accounted for 60% of total solid waste revenue in FY 2014. For commercial customers, Seattle's ordinances and contract provisions require commercial customers to either use the enterprise's contracted commercial haulers or self-haul. While businesses may choose to self-haul their waste, most use the contracted commercial haulers. Commercial service represented about 30% of revenues in FY 2014.

In addition to strong flow control, the enterprise benefits from a strong residential bill collection process as residential customers receive a combined bill for solid waste, water, drainage and sewer services. If a partial payment is made, the funds are credited first to the solid waste utility and last to the water utility. This internal prioritization of payments provides incentive for residential customers to pay given the greater essentiality of water and sewer services, which receive monies last and thus remain delinquent if only partial payment is made. Commercial customers receive bills directly from private haulers and thus are not subject to a combined bill.

The service area economy is experiencing strong ongoing growth in jobs, incomes and property values, and has been one of the nation's best performing and strongest recovering metropolitan areas in recent years. There is a high level of educational attainment in the area and an increasing amount of high value-added employment in the cities of Seattle, Bellevue (Aaa stable) and Redmond (Aa2). Job growth has maintained the strong pace evident throughout FY 2014, ahead of the prior year's pace and well ahead of the national 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 national average. Incomes are growing faster than the state and nation, consistent with the growing employment in relatively high-wage sectors. The strength in employment and income growth is translating into demand in the real estate market, creating strong price appreciation and attracting new commercial and residential construction. Median family income within Seattle is healthy at 145.5% of the nation. The combination of strong flow control and an economically vital service area are considered material strengths for the enterprise.

FINANCIAL AND OPERATING PERFORMANCE: STRONG SERVICE AREA AND RATE SETTING RECORD; DECLINE IN NON-RECYCLABLE VOLUMES CONTINUES

The city's demonstrated willingness to raise rates is an important credit strength. Solid waste rates have increased

annually since FY 2007, including a large 27% increase in FY 2009 to correspond to more expensive waste collection contracts that started in April 2009. We also view as credit positive the March 2014 approval of a stronger financial policy targeting 1.5 times debt service coverage ratio (post city tax). The strengthened financial policy demonstrates the enterprise's commitment to ensuring financial metrics consistent with its historical performance despite the recent undertaking of a large capital program that has raised debt service and will likely necessitate future rate increases. Our rating incorporates the assumption that the enterprise will continue to raise rates as necessary and will adhere to its financial policies.

While the willingness to raise rates is strong, the enterprise's average monthly bill is high relative to many of its regional peers. This is similarly the case with the city's water, drainage and sewer utilities, the result of which is a high composite utility rate for users and potentially constrained flexibility for individual utilities as rates, and the financial burdens on users, are evaluated on a combined basis by the city.

Additionally, non-recyclable waste volumes have been declining since at least FY 2004, while recyclable waste streams continues to rise. This has followed from the city's aggressive targets for recycling, which in the last 10 years have driven a 4% average annual decline in non-recyclable tonnage compared to a 2% average annual increase in recyclable tonnage. This dynamic generally benefits financial performance in the short-run. The city does not purchase landfill capacity and only pays per ton disposed on a take-and-pay basis, with no minimum delivery requirement. Further, the enterprise derives a substantial amount of its revenues from fixed charges on non-recyclable collection activities. The enterprise has very little exposure to waste volumes, except to the extent that customers choose to downsize their collection containers. The city is able to adjust rates to derive necessary revenues from the smaller containers, but this approach may have its limits in the long-run, such as political challenges if users perceive they are being charged more for less. Further, in contrast to non-recyclable tonnage, recyclable waste is not charged and the city earns only a minimal amount from the sale of processed materials. Thus, the growing recyclable waste volumes are subsidized by shrinking non-recyclable waste volumes from a slightly but steadily declining account base, which is credit negative as the dynamic necessitates continued rate increases on the part of the enterprise to maintain targeted financial margins.

While above average rates and declining volumes are viewed as weaknesses, we view the city's demonstrated willingness to raise rates in addition to the strong service area and flow control mechanism as meaningful mitigants.

DEBT SERVICE COVERAGE AND LIQUIDITY: POST-TAX DEBT SERVICE COVERAGE HAS IMPROVED IN RECENT YEARS; NEAR-TERM COMPRESSION IS LIKELY

From FY 2010 through FY 2013, the enterprise achieved annual debt service coverage (post city tax) of close to 2.5 times under Moody's calculation, which treats city taxes as operating expenses consistent with other municipal infrastructure issuers. Further, we exclude deposits to the rate stabilization account (RSA), which otherwise have the effect of lowering reported operating revenues even though deposits to the RSA are made after the application of revenues and payment of debt service in the flow of funds.

These financial metrics represent a substantial improvement from post-tax debt service coverage of 0.1 times in FY 2009, a year in which costs increased significantly due to new waste collection contracts and internal liquidity dropped by over $10 million to $3.9 million. The recent four years are also stronger than the long-term average post-tax debt service coverage of between 1.6 and 1.7 times. Positive financial performance continued in FY 2014, with the enterprise achieving post-tax debt service coverage of just under 2.4 times and adding close to $12 million to operating liquidity. Excluding the sizeable city tax, which is levied at 11.5% of revenues, debt service coverage has averaged 4.4 times over the last five years. Pursuant to both the bond resolution and the city charter, the city tax payment is subordinate to debt service on the bonds.

Looking forward, we expect debt service coverage to weaken to around 1.33 times in FY 2015 and 1.4 times in FY 2016, although coverage is expected to receive further uplift from planned draws on the RSA. The primary factors in the drop include increased debt service, growth in contract expenses, and planned rate increases that are modest by comparison with the increases in recent years. After FY 2016, the enterprise forecasts achieving greater than 1.5 times post-tax debt service coverage without using RSA draws as planned rate increases take effect and the North Transfer Station is complete. Our rating incorporates the assumption that the enterprise will achieve 1.5 times post-tax debt service coverage over the longer term in keeping with the utility's updated financial policy. We anticipate pre-tax debt service coverage will exceed 2.5 times from FY 2015 through FY 2018.

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 consolidated 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 short-term investment nature. 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 solid waste 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 cash-funded capital outlay. The enterprise ended FY 2014 with $32.4 million of cash in working capital, or more than 80 days of cash on hand, a level that is satisfactory and excludes $17.6 million held in the RSA.

DEBT AND LEGAL COVENANTS: MANAGEABLE DEBT LEVELS SET TO IMPROVE OVER TIME; STANDARD LEGAL COVENANTS

We expect the enterprise's existing debt levels will decline over the intermediate term. With the current sale, the enterprise will have issued nearly $170 million of its $200 million of total debt within the last five years. These borrowings have financed the demolition and reconstruction of the enterprise's two transfer stations. With the exception of a manageable $20 million additional borrowing anticipated in the next year or two, the current capital plan does not include any additional debt. The elevated debt levels that resulted from the compressed borrowing schedule of the last five years will moderate as capital needs decline going forward. Given the contract-based nature of collection and disposal services, the city has little direct capital costs associated with these activities. At 1.25 times FY 2014 operating revenues, the existing debt burden is manageable.

The enterprise expects to issue a modest amount of debt in FY 2016, after which the capital plan will be funded internally.

Debt Structure

Post-sale debt service escalates into a near-term peak of $15.4 million in FY 2016, at which it remains level through FY 2019. While debt service is scheduled to decline in FY 2020, the issuance of additional bonds in FY 2016 and potentially FY 2017 will likely result in no material reduction to overall debt service in these out years.

Debt-Related Derivatives

None.

KEY STATISTICS

- Asset Condition (Remaining Useful Life): 20 years

- System Size (O&M in $000s): $128,487

- Annual Debt Service Coverage: 4.3x (pre-tax), 2.4x (post-tax)

- Cash on Hand: 80 days

- Debt to Operating Revenues: 1.25x

- Rate Covenant: 1.25x

- Debt Service Reserve: MADS

OBLIGOR PROFILE

Seattle Public Utilities (SPU) was created in 1997 as a department of the City of Seattle (Aaa stable) and includes the city's water, drainage, sewer and solid waste utilities. The solid waste enterprise resides within SPU and is responsible for solid waste collection and disposal and owns and operates two transfer stations. Residential and commercial solid waste collection and disposal activities are contracted to Recology/Cleanscapes and Waste Management, Inc. (Baa2 stable) under contracts that expire in 2017 and 2019, respectively, with options to extend. The enterprise has contracts with third parties for handling recycling and processing organics. Long haul transportation service to landfills from the transfer stations is provided by Washington Waste Systems (WWS), a subsidiary of Waste Management under an existing contract that expires in 2028 but in which the enterprise has options to terminate in 2019 or 2021.

LEGAL SECURITY

The bonds are secured by a pledge of net revenues of the solid waste enterprise, which has a rate covenant that requires the enterprise to set rates to maintain at least 1.25 times annual debt service coverage on a pre city tax basis. The additional bonds test similarly requires that rates be set to maintain at least 1.25 times annual debt service coverage on a pre city tax basis. Furthermore, the bonds are secured by a common debt service reserve sized at maximum annual debt service. Currently, the debt service reserve is backed by a $5.9 million MBIA Insurance Corporation (B2 negative) surety policy (reinsured by National Public Finance Guarantee Corp (A3 negative)) and $6.8 million of cash. Proceeds from the current sale will fund an additional cash deposit to the reserve fund.

USE OF PROCEEDS

Proceeds will provide new money to finance portions of the replacement of the city's North Transfer Station and demolition and construction of the city's South Transfer Station. Proceeds will additionally be used to make a cash deposit to the debt service reserve fund.

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.

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