

CREDIT OPINION

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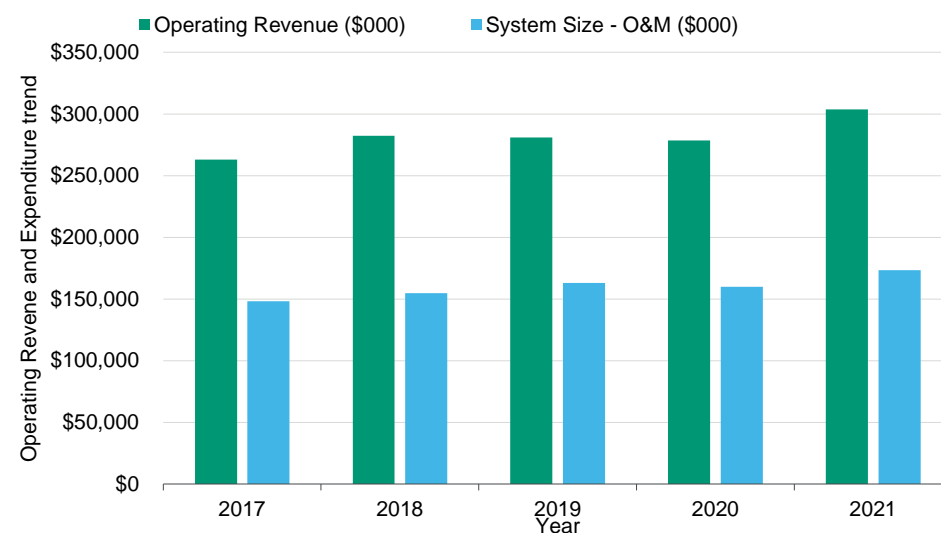
Seattle (City of) WA Water Enterprise

Update to credit analysis

Summary

[The City of Seattle, Washington's Water Enterprise](#) (Aaa stable) benefits from a large and wealthy service area that includes the [City of Seattle](#) (Aaa stable) and surrounding communities. The utility's credit profile is further supported by a healthy financial profile. Debt service coverage was stable in fiscal 2021 and the utility will continue to benefit from access to the city's shared liquidity pool. Regulatory compliance and capital planning are overseen by a strong management staff. Affordability will be a long-term challenge as water consumption remains stable and rates are increased to pay for system operations, maintenance and improvements.

Exhibit 1

Steady revenue growth and expenditure controls highlight proactive system management


Source: Seattle Public Utilities and Moody's Investors Service

Credit strengths

- » A large and wealthy service area that includes the City of Seattle
- » Solid debt service coverage and healthy liquidity bolstered by access to the city's shared liquidity pool
- » Ample water supply

- » Strong management

Credit challenges

- » High customer utility bills relative to regional and national peers
- » Long-term trend of declining water consumption

Rating outlook

The stable outlook reflects sound debt service coverage that is expected to remain at satisfactory levels given regular rate increases. The utility has sufficient cash and ample access to additional liquidity that offers financial flexibility.

Factors that could lead to an upgrade

- » N/A

Factors that could lead to a downgrade

- » Deterioration in pledged revenue and coverage
- » Substantial increase in debt beyond current expectations

Key indicators

Exhibit 2

| Seattle (City of) Water Enterprise, WA | | | | | |
|--|---|-----------|-----------|-----------|-----------|
| System Characteristics | | | | | |
| Asset Condition (Net Fixed Assets / Annual Depreciation) | 24 years | | | | |
| System Size - O&M (\$000) | \$173,182 | | | | |
| Service Area Wealth: MFI % of US median | 172.00% | | | | |
| Legal Provisions | | | | | |
| Rate Covenant (x) | 1.25x | | | | |
| Debt Service Reserve Requirement | DSRF funded at the lesser of the standard 3-prong test (Aa) | | | | |
| Management | | | | | |
| Rate Management | Aa | | | | |
| Regulatory Compliance and Capital Planning | Aa | | | | |
| Financial Strength | | | | | |
| | 2017 | 2018 | 2019 | 2020 | 2021 |
| Operating Revenue (\$000) | \$262,896 | \$282,287 | \$281,008 | \$278,578 | \$303,499 |
| System Size - O&M (\$000) | \$148,079 | \$154,756 | \$163,006 | \$159,855 | \$173,182 |
| Net Revenues (\$000) | \$124,982 | \$142,096 | \$132,841 | \$130,183 | \$139,523 |
| Net Funded Debt (\$000) | \$876,096 | \$833,086 | \$787,965 | \$740,037 | \$670,742 |
| Annual Debt Service (\$000) | \$80,139 | \$78,314 | \$77,911 | \$73,426 | \$78,882 |
| Annual Debt Service Coverage (x) | 1.6x | 1.8x | 1.7x | 1.8x | 1.8x |
| Cash on Hand | 135 days | 222 days | 291 days | 321 days | 217 days |
| Debt to Operating Revenues (x) | 3.3x | 3.0x | 2.8x | 2.7x | 2.2x |

Financial figures reflect non-cash adjustments for pension and OPEB.

Source: Seattle Public Utilities and Moody's Investors Service

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Profile

The water enterprise provides retail and wholesale water services to a combined population of 1.6 million within the greater Seattle metropolitan area. Water is primarily sourced from two watersheds east of the city. Infrastructure includes 1,800 miles of pipelines and two treatment facilities, with high water quality supported by extensive watershed protection, advanced water treatment and ongoing monitoring.

Detailed credit considerations

Service area and system characteristics: key utility service provider to Seattle with ample supply

The utility system's robust service area economy is a significant credit strength. Seattle is the commercial and tourism hub of the Puget Sound region and the economic center of the [State of Washington](#) (Aaa stable). Software development and aircraft manufacturing are key components of the local economy, and the area serves as the headquarters or major operating base to some of the world's best known international corporations, including [Amazon](#) (A1 stable), [Boeing](#) (Baa2 negative), [Microsoft](#) (Aaa stable) and [Starbucks](#) (Baa1 stable). Positively, business and leisure travel to the region has begun to rebound following the pandemic and general economic activity has improved significantly. As of April 2022, the city's unemployment rate is very low at 1.6%.

Income measures are strong and will continue to be a positive component of the utility's credit profile. Median family income of 172% of the US level is among the highest for large urban areas. This will continue to be supported by the city's high educational attainment rate.

After falling over multiple decades, long-term water consumption is expected to remain flat as population growth is offset by declines in per capita usage driven by the implementation of water conservation efforts, improved efficiency in fixtures and increased residential density. Wholesale water represents slightly more than half of water demand (54% in 2021), followed by commercial (26%) and residential (20%) use. In 2021 no single retail customer represented more than 2% of retail revenue, and the 10 largest retail customers represented just 8.1% of overall retail revenue.

Water supply comes primarily from the Cedar River and Tolt River Watersheds, providing an annual average yield of about 172 million gallons per day (MGD). The water system can also store a combined 327 million gallons (MG) of treated water within its distribution and transmission systems across its 13 reservoirs. In addition, the enterprise has access to more than 130,000 acre-feet of raw water stored in its watersheds (equal to roughly 42,345 MG, slightly less than the 42,850 billed in 2021). Given existing supply and demand forecasts, management has determined that no significant new water sources are necessary before 2060.

Debt service coverage and liquidity: coverage is solid and expected to remain healthy; liquidity bolstered by access to city's consolidated cash pool

Coverage is solid and demonstrably stable. In 2021, debt service coverage on all debt, including low interest loans through the state's Drinking Water State Revolving Fund, was unchanged at 1.8x (adjusted for non-cash pension and OPEB expenses). Operating revenue for 2021 reached \$303.5 million, a 9.2% increase from 2020 that was driven by a \$19 million withdrawal from the rate stabilization fund as well as increased consumption and recovery from the pandemic. Projected coverage through 2023 shows a modest decline because of rising O&M costs, though these projections are likely conservative.

Liquidity

Seattle's utilities have historically maintained lower levels of cash on their own balance sheets because of their access to liquidity in the city's \$2.8 billion consolidated cash pool. 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 demonstrated as successful with the city's electric enterprise borrowing in excess of \$100 million from the cash pool during the 2001 power crisis.

The water system generates satisfactory operating cash flow. The enterprise ended 2021 with \$103.2 million of cash in working capital, or 217 days of cash on hand. The forward projection for the enterprise shows declining cash balances through 2023, though the city has historically outperformed similar projections by considerable margins. The impact of the pandemic to the enterprise's liquidity has been modest as delinquencies of 90+ days increased to \$17.2 million across the wastewater, drainage, water and solid waste systems, equal to about 2% of annual sales.

Debt and legal covenants: moderate debt with satisfactory legals

Most of the water enterprises's debt consists of senior lien revenue bonds. The city has seven outstanding loans with the state that are junior to the senior lien revenue bonds. Although the state loans contain language permitting acceleration in the event of default, the enforcement of these provisions is unlikely.

The water enterprise's capital improvement program through 2027 is \$708 million, a large portion of which (\$312 million) is for improvements to distribution lines. The second largest portion falls under "Shared Cost Projects," including repairs related to transportation projects. The CIP is expected to be funded primarily by debt (\$549 million).

Legal security

The bonds are secured by a pledge of the net revenue of the water system. The city has covenanted to establish rates sufficient to generate debt service coverage of at least 1.25 times. The bonds are additionally secured by a common debt service reserve equal to the lesser of the standard three-prong test, funded by a combination of cash and sureties.

Debt structure

The water enterprise's debt consists of fixed rate obligations with declining debt service through final maturity in 2052.

Debt-related derivatives

The utility does not have any debt-related derivatives.

Pensions and OPEB

Pensions and other post-employment benefits (OPEB) are not a material driver for the water utility. As of 2020, the utility has an adjusted net pension liability (ANPL) of \$249.2 million based on a discount rate of 3.22%, which is manageable at 0.9x operating revenue. The enterprise uses a discount of 7.25% and therefore has a lower reported pension liability. Contributions have historically been modestly below its "tread water" mark, or the contribution level required to keep pension liabilities from growing given plan assumptions.

Reported OPEB liabilities were just \$3.4 million at the end of 2021. The city funds its OPEB expenses on a pay-as-you-go basis and the utility's share is limited to the implicit subsidy associated with retiree healthcare.

ESG considerations

Environmental

Environmental considerations are important to the utility's overall credit quality. According to Moody's ESG Solutions, the city has limited exposure to physical climate risks. The most pressing long-term environmental challenges are sea level rise and greater frequency of extreme rainfall, which increase the risk of severe flooding.

Social

Social considerations are an important factor in the enterprise's overall credit quality. Resident income measures are among the highest in the nation for a large urban area. While the pandemic is also a factor under our ESG framework given its impact on public health and safety, the city and its utilities have demonstrated significant financial stability.

The average monthly water bill in Seattle is high relative to regional peers, contributing to high composite utility rate for users. By 2026, the utility's strategic plan projects the typical monthly single-family residence to have a combined utility bill (excluding electricity) of \$275. This will potentially constrain long-term flexibility for individual utility rates.

To help with affordability, the city offers a discount program for qualifying low-income customers. The city has also waived interest on delinquent accounts through the end of 2023 and provided bill assistance via flexible payment plans for residential and small business customers. In addition to direct customer assistance, the utility is aiming to reduce costs by making improvements to capital planning and delivery, expanding partnership opportunities and improving regulatory alignment. The city's ability to manage affordability while satisfying regulatory and service-level needs will continue to be a focus of future reviews.

Governance

Seattle's Public Utility governance is a credit strength. The city's management team has demonstrated the willingness and ability to generate additional revenue. Rates are set by the city council and are not subject to state oversight. Under the utility's current strategic

plan, combined utility rates (including water, wastewater, drainage and solid waste) are expected to increase by an average of 4.2% annually through 2026. Water rates are projected to increase by an average of 3.4%.

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