S&P Global Ratings

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Summary:

Seattle, Washington; Water/Sewer

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Credit Profile		
US$119.605 mil drainage and wastewtr sys imp and rfdg rev bnds ser 2022 due 09/01/2042		
Long Term Rating	AA+/Stable	New
Seattle drainage & wastewtr		
Long Term Rating	AA+/Stable	Affirmed
Seattle drainage & wastewtr (AGM)		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

Rating Action

S&P Global Ratings assigned its 'AA+' long-term rating to Seattle, Wash.'s anticipated $119.6 million series 2022 drainage and wastewater system improvement and refunding revenue bonds. At the same time, S&P Global Ratings affirmed its 'AA+' rating on the city's existing drainage and wastewater system parity debt. The outlook is stable.

Proceeds will be used to fund $20 million of upcoming drainage and wastewater system capital needs and to refund all or a portion of the series 2012 bonds for debt service savings. At fiscal year-end Dec. 31, 2021, the system had $963 million of drainage and wastewater debt (including authorized but not yet drawn borrowing under a $192.2 million Water Infrastructure Finance and Innovation Act (WIFIA) loan) and $56.1 million in subordinate state loans outstanding.

We consider the bond provisions to be standard. The series 2022 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 1.25x average annual debt service, although withdrawals from a rate stabilization fund can be included in this calculation.

Credit overview

The rating is anchored by SPU's proposed six-year rate plan, which sets a credible trajectory for the drainage and wastewater system's future financial performance, which we expect will remain supportive of the current rating despite the system's increase in capital spending over the upcoming five-year period. The rating is further supported by the overall favorable economic considerations of the customer base, which offset retail rates that are above average for the region, especially when adding in utility taxes that SPU pays to the city and state. Credit risks center on the sizable $1.2 billion six-year capital improvement plan (CIP), which will be approximately 60% debt funded, with current projections indicating that annual capital spending is expected to roughly double from historical levels over the upcoming five-year period. We believe this could be compounded by the current inflationary pressures and supply chain constraints, depending on ongoing geopolitical unrest. The city's wastewater treatment provider, King County, also has an additional $1.3 billion in debt needs, approximately one-third of which will be passed through to the city.

Nearly all sewage within Seattle is treated on a wholesale basis by King County's regional wastewater treatment system (with about 1% treated by Southwest Suburban Sewer District). City ordinance allows SPU to pass through increases in King County's wastewater treatment charges based on adopted wholesale rates and projected billed consumption, which we consider a key credit strength.

The rating further reflects:

- The underlying economic strength, diversity, and wealth of the customer base, which continues to rebound from the effects of the pandemic. The city of Seattle (population: 761,100) sits at the center of the large, diverse Puget Sound regional economy. We view the service area's income levels as extremely strong based on the city's median household effective buying income (MHHEBI) of over 145% of the national level in 2021. While the population served has grown by 41% over the past 25 years, per capita demand has been flat to declining due to conservation and the city forecasts stable demand, consistent with other large wastewater systems at this rating level;
- Improving unemployment rate in the service area, which is approaching pre-pandemic levels at 3.2% in March 2022;
- City council's demonstrated ability and willingness to increase service rates, with multiyear rate schedules that promote cost recovery and revenue stability. Planned wastewater rate increases average 4.7% per annum and drainage rate increases 6.7% per annum through 2026 to fund the upcoming CIP;
- The city's annualized residential drainage and wastewater bill, which we consider elevated on a nominal basis relative to those of its peers in the Pacific Northwest (averaging about $149 per month, including a public utility tax of about $20 charged by the city at a rate of 12.0% for wastewater revenues and 11.5% for drainage revenues, and a 3.85% public utility tax paid to the state of Washington on a certain portion of revenues identified as sewer collection revenues). Nevertheless, given the high income levels in Seattle, we believe the system's rates are somewhat more affordable at about 2.2% of MHHEBI, although they are expected to rise from $129 to $158 per month by 2026 (before taxes, which add an additional $20 to $25 a month). To address affordability risks, the city offers a rate program that provides a 50% discount to income-qualifying households, with an enrollment of about 30,000 households;
- Adequate projected financial metrics. The drainage and wastewater system's historical financial performance has been relatively stable because regular rate increases have offset rising operating and maintenance costs over this period. Excluding fixed obligations to the city of Seattle, coverage is very strong, and improved to 3.8x in fiscal 2021, as calculated by management. Our calculation of all-in debt service coverage considers Seattle's imputed debt resulting from the city's participation in the county's regional wastewater treatment system. Our calculation is considerably weaker given the sizable amount of debt the regional wastewater treatment system has outstanding, with all-in coverage of 1.7x in fiscal 2021, which we still consider supportive of the current rating. We remove the payment of taxes ($61.0 million in fiscal 2021) because under the city charter they are paid only after debt service is covered;
- Strong financial performance in 2021, which was largely driven by the $42.2 million (9.2%) increase in operating revenues attributable to relatively sizable rate increases that averaged 7.2% for wastewater and 7.4% for drainage, resulting in additional revenues of $31.1 million and $9.8 million, respectively. Other operating revenues increased $1.4 million. In fiscal 2021, the drainage and wastewater system produced $460.3 million of revenues, of which the wastewater enterprise generated $330.2 million, or 66%, and the drainage enterprise $164.8 million, or 33%, with

the remaining 1% from other sources. We consider the drainage fund to have more stable revenue, as service charges are collected on the property tax roll, while wastewater charges are billed bimonthly and are volumetric in nature, and thus could decline with a reduction in usage;

- Management's forecast, which we consider reasonable, indicating that all-in coverage will remain at levels that we consider sound through fiscal 2025 (above 1.5x). Actual performance has historically been stronger than forecast;
- Extremely strong liquidity, with over $218 million (or 231 days' cash on hand) available as of Dec. 31, 2021. We expect that SPU will deploy a portion of its cash reserves to fund a portion of the upcoming CIP over the next several years. We believe SPU's robust liquidity position is critical to the current rating level and a material drawdown in cash would likely pressure the rating downwards. While unexpected, increased transfers (which would violate the Washington State Accountability Act) to the general fund would weaken the system's credit rating, potentially by one or more notches; and
- High leverage, with a 72% debt-to-capitalization as of Dec. 31, 2021, and a very large ($1.2 billion) regulatory driven CIP through 2026 that requires significant additional debt that will result in escalating debt service requirements. SPU employees participate in the Seattle City Employees Retirement System (SCERS). The plan is only 71% funded, which we consider below average (as a percentage of expenditures), but is expected to be manageable over the near-term for SPU.

The stable outlook reflects our anticipation that even with the additional planned debt over the next five years layered in, the system's financial capacity will not diminish to the point that metrics would become inconsistent with the current rating. We believe that any reluctance or inability to raise rates could result in erosion of financial margins and, in turn, diminished credit quality. Nevertheless, we believe the system's rate affordability could be challenged if household incomes do not keep pace with planned rate increases.

Environmental, social, and governance

We think Seattle's direct environmental risks are substantial and factored into the rating, given that SPU is subject to deadline-certain regulatory mandates to reduce the number of sewage backups and untreated sewage overflows that enter the Duwamish River, Lake Washington, and the Puget Sound. It also faces social risk related to its sizable CIP, which we expect will pressure rates that are already relatively high compared to those of its peer utilities. In our view, the service area's above-average income levels partially mitigate this risk. The rating also takes into consideration the Washington Department of Ecology's draft nutrient removal permit (announced June 15, 2021), which could require compliance by 2036. We understand that Ecology plans to release a draft plan open for public comment in 2023 and that potential nutrient removal limits could compel the county to construct an additional wastewater treatment plant and finance significant upgrades to existing facilities, with current cost estimates in the multi-billion-dollar range, and for one-third of which Seattle would likely be responsible. We will evaluate the potential credit implications, if any, as the timing and funding mechanisms are clarified during the next several years. Finally, we view the utility's governance factors as credit neutral because they include full rate-setting autonomy, strong policies and planning, and robust interaction between management and the city council.

Stable Two-Year Outlook

Downside scenario

We could take a negative rating action if liquidity is unexpectedly and substantially drawn down, or if project delays result in significantly more leverage than required to complete the CIP.

Upside scenario

Given the size of the CIP and the system's rising costs of service, we do not anticipate taking a positive rating action during the outlook period.

Credit Opinion

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 overflows during wet weather events. A significant portion of the drainage and wastewater system's CIP, including the Ship Canal Water Quality Project, is intended to address overflows and flooding. The Ship Canal project includes a 29-million gallon offline storage tunnel, six diversion structures for diverting influent-combined sewage away from existing combined sewer overflows (CSO) outfalls to the tunnel, five drop structures to convey combined sewage into the storage tunnel, and odor control systems. Because SPU owns four of the six existing CSO outfalls (King County owns the other two), per a joint agreement SPU will be responsible for 65% of the project costs and King County for the remaining 35%. Given that the Ship Canal Water Quality Project will not enter commercial service until 2025, we assume that additional rate increases outside of the forecast period will be warranted.

Related Research

Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022