

MOODY'S

INVESTORS SERVICE

New Issue: Moody's assigns Aa2 rating to Seattle's new electric revenue bonds. Rating outlook is stable

Global Credit Research - 23 May 2013

Approximately \$2 billion of debt affected

SEATTLE (CITY OF) WA
Electric Distribution and Generation
WA

Moody's Rating

ISSUE	RATING
Municipal Light and Power Improvement and Refunding Revenue Bonds, 2013	Aa2
Sale Amount	\$188,000,000
Expected Sale Date	05/31/13
Rating Description	Revenue: Government Enterprise

Moody's Outlook STA

Opinion

NEW YORK, May 23, 2013 --Moody's has assigned Aa2 ratings to \$188 million of City of Seattle's (Seattle) Electric Enterprise's (Seattle City Light or SCL) Municipal Light and Power Improvement and Refunding Revenue Bonds, 2013. Moody's also affirmed Seattle City Light's Aa2 rating on outstanding revenue bonds. The rating outlook is stable.

SUMMARY RATING RATIONALE

The Aa2 rating considers SCL's financial policies including the Rate Stabilization Account (RSA), strong historical willingness to raise rates when necessary, and SCL's access to the City of Seattle's (UTGO: Aaa/stable) consolidated money pool. The rating is also supported by SCL's ownership of low cost hydro, long-term contract with Bonneville Power Administration (BPA, Aa1/stable), attractive service area, and competitive retail rates.

The Aa2 rating also incorporates SCL's material wholesale price exposure, hydrology risk, and expected sizeable increases in debt over time to fund SCL's 6-year capital improvement plans (CIP) totaling \$2 billion. The rating further considers debt service coverage improving to at least 1.5 times (post city tax) by 2014 and liquidity stabilizing around 120 days cash on hand over the longer term.

DETAILED CREDIT DISCUSSION

Seattle City Light is a department of the City of Seattle, which operates a utility system that primarily generates and delivers electricity to approximately 402,608 customers in the City of Seattle and several surrounding communities under franchise agreements. The City of Seattle is located in the western part of Washington State and is commercial hub for the Pacific Northwest. SCL's service area comprises of 131 square miles and has a population of approximately 780,800. The major economic activities in the greater Puget Sound region are technology, manufacturing, healthcare, military and education.

In 2012, SCL received approximately 42% of its power from owned generation, 34% from BPA, 16% from the wholesale market, and the remainder from various long-term contracts and exchange agreements. Owned generation totals 1,872 MW of nameplate capacity and primarily comprises of the 1,022 MW Boundary hydro project (Boundary Project) and the 802 MW Skagit Hydro projects (Skagit Projects). The Boundary Project is located in Pend Oreille county in Washington state and its FERC license was recently renewed to 2055. The Skagit Projects comprise of three hydro projects that operate as one system since they are located on the same

ten-mile section of the Skagit River. SCL also has smaller hydro facilities totaling 48 MW.

SCL is subject to ordinances and resolutions adopted by Seattle's city council and approved by the mayor. Seattle's mayor and city council also approves SCL's budget, sets rates and approves financing. In March 2010, the City Light Review Panel (Review Panel) was established to review and assess SCL's strategic plan, financing policies and rates. Review Panel members are drawn from SCL's customers and are appointed to staggered 1 to 3 year terms by Seattle's mayor and the city council.

SCL pays a utility tax (city tax) to the City of Seattle equal to 6% of gross revenues from retail sales, less certain adjustments. The City of Seattle's Charter does not permit SCL to pay taxes to the City of Seattle's general fund until ample provision has been made for the servicing of the debts and obligations of the utility and for necessary betterments and replacements for the current year. SCL also pays a separate state public utility tax equal to 3.8734% of Gross Revenues from sales within the State, less certain adjustments.

As of December 31, 2012, Seattle City Light had total debt of approximately \$1.78 billion.

USE OF PROCEEDS:

SCL anticipates to issue above par resulting in gross proceeds of around \$200 million. Approximately \$186 million of the issuance represents new money and the proceeds are expected to be used to pay transaction costs, fund a portion of SCL's large capital program and provide for incremental funding of the debt service reserve. Seattle City Light's CIP includes major expenditures on the distribution system, generation improvements and general plant. The remaining funds are expected to refund existing revenue bonds and pay transaction costs.

LEGAL SECURITY:

SCL's bonds are secured by a pledge of the gross revenues of Seattle City Light and covenants require that the City of Seattle set rates to fund debt service, operating costs and other costs to maintain the system. Moody's considers the rate covenant to be weaker than typical for similar issuers. For additional indebtedness, SCL is required to meet a 1.25 times debt service coverage ratio based on net system revenues incorporating draws from and deposits into the RSA. Furthermore, the bonds have a debt service reserve for all parity bonds sized to the lesser of maximum annual debt service or reasonably required reserve or replacement fund per the tax code. The latter threshold has been interpreted as 125% of average annual debt service and the reserve is currently based on 125% of average annual debt service. After debt issuance, the reserve is expected to be funded with a \$77 million surety from Assured Guaranty Municipal Corp (insurance strength: A2-stable) and \$37 million of cash.

Interest Rate Derivatives:

SCL does not have any derivatives other than those for power hedging.

KEY RATING FACTORS

1. HISTORICAL WILLINGNESS TO RAISE RATES TO MAINTAIN FINANCIAL CONDITION IS A STRONG FUNDAMENTAL CREDIT FACTOR

SCL's rate process is not regulated by the state regulatory board and Seattle's city council has shown a demonstrated willingness to use its authority to raise retail rates to support SCL's financial condition. For example, SCL raised rates 39% in 2001 and 13% in 2002 in response to extremely low hydro and high power prices during the 2001 power crisis. Seattle City Light subsequently implemented a net decrease in rates over time resulting in rates 11% less in 2008 than in 2002. In January 2010, SCL implemented a 13.8% increase primarily due to lower wholesale revenues and higher operating costs. In March 2010, the city council also adopted the RSA with a target balance of \$100-125 million and an automatic quarterly surcharge ranging from 1.5% to 4.5% to achieve a \$100 million balance (see factor 3 for further analysis of the RSA). For 2011 and 2012, the city council implemented 4.3% and 3.2% base rate increase, respectively. Looking forward, the city council approved SCL's Strategic Plan, which calls for a 4.7% average annual increase from 2013 to 2018 for the base rate. A separate automatic rate adjustment mechanism exists for any BPA cost increases. The city council's continued willingness to implement rate increases, the BPA pass through adjustment, and the RSA mechanism are considered strong credit support factors. A material weakening of the willingness to raise rates, BPA pass through or the RSA mechanism would be credit negative.

Even with the rates increases, Seattle City Light's average system rates of around 7 cents/kwh are well below Puget Sound Energy, the main investor owned utility in the area and they remain modestly below Washington

State's average of 7.2 cents/kwh based on EIA data. The combination of competitive rates and very strong service area further supports SCL's rate raising ability and willingness. The low rates also supports Moody's assumption that the franchise agreements with neighboring communities currently set to mature between 2014 to 2018 will be extended.

2.SCL HAS A MEANINGFUL EXPOSURE TO MARKET BASED REVENUES AND HYDROLOGY RISK WHICH HAS CONTRIBUTED TO VOLATILE CREDIT METRICS

Prior to 2009, SCL relied on market-based revenues estimated at around 20% of consolidated revenues (gross basis) and net wholesale revenue (i.e. net of market purchases) averaged \$124 million per year from 2006 to 2008. Market prices in the region and associated wholesale revenues have declined steeply since mid-2008 given the recession and the decline in natural gas prices. Over the last three years, gross wholesale revenues have been around 10% of total revenues due to significant growth of retail revenue and net wholesale revenue has averaged around \$67 million during this period. Looking forward, gross wholesale revenue is expected to remain around 10% of total revenue.

Since dropping to 1.0 times (post city tax) for senior debt service coverage ratio (DSCR) in 2009, SCL's debt service coverage metrics significantly improved to 1.5 times (post city tax) and 2 times (post city tax) for 2010 and 2011, respectively. The improvement was based on a combination of rising retail sales, RSA surcharges and SCL's 13.8% base rate increase. For 2012, SCL's DSCR dropped to slightly below 1.5 times due to lower wholesale revenue and higher debt service. The drop in DSCR was anticipated and we expect Seattle City Light's financing metrics to improve over time as SCL implements its planned rate increases, net wholesale revenue increases, and RSA surcharges take effect in 2014. Starting in 2014, consolidated debt service coverage ratios are expected to be in excess of 1.6 times. Seattle City Light also assumes approximately \$18 million in efficiency savings by 2015 and significantly rising interest income over time, which Moody's views as aggressive. That said, SCL should be able to average around 1.5 times post 2014 even with reduced efficiency savings and lower interest income assumptions though it could indirectly pressure SCL's expected liquidity.

Over the last few years, SCL's liquidity has materially improved to 205 days cash on hand in 2012 compared to 39 days cash on hand in 2009 due to the RSA account and higher unrestricted cash balances. The 2012 year-end liquidity is commensurate with an 'Aa' category though we expect overall liquidity to decline over time to around 120 days cash on hand.

The long term forecasted DSCR of around 1.5 times and days cash on hand of around 120 corresponds to the low to mid 'A' category, respectively, in Moody's methodology and an inability to sustain at minimum these credit metrics over time would be viewed as negative.

3.THE RSA MECHANISM REMAINS A KEY TOOL TO MINIMIZE WHOLESAL REVENUE VOLATILITY WHILE ACCESS TO THE CITY OF SEATTLE'S MONEY POOL REMAINS AN IMPORTANT SOURCE OF LIQUIDITY

In 2010, SCL established the RSA to improve SCL's liquidity and to smooth out volatile wholesale revenue on a year-to-year basis. The RSA targets \$100 million to \$125 million in the RSA and an automatic surcharge is triggered if the cash balance drops below specific thresholds. The quarterly surcharge is 1.5% if the RSA is less than \$90 million, 3% if the RSA is less than \$80 million and 4.5% if the RSA is less than \$70 million. If the RSA drops to \$50 million or below, the city council will convene a rate review to try to bring the RSA up to \$100 million within 12 months. If the RSA is above \$125 million, excess funds could be used to refund ratepayers or be used for other purposes such as capital expenditures. A pre-existing \$25 million contingency reserve was used to initially fund the RSA in 2010 and SCL made further contributions in 2010 and 2011 resulting in \$141 million balance at year-end 2011. Seattle City Light contributed above the \$125 million target based on expected usage in 2012 and SCL used \$13 million in 2012. For 2013, the utility expects to draw another \$48 million.

Moody's views the RSA as a key risk management tool for SCL and its importance is demonstrated by its expected usage over the next several years. Seattle City Light forecasts the RSA balance will drop to an estimated \$81 million by year-end 2013 compared to \$141 million at year-end 2011. Since the RSA balance will be below set thresholds, SCL estimates the automatic surcharges will take effect for several years after 2013. Moody's views the RSA as a key mechanism to both supporting SCL's debt service coverage and liquidity. If the RSA mechanism is weakened or eliminated, SCL's rating would likely be negatively impacted.

An important additional source of liquidity is SCL's access to the City of Seattle's money pool, which totaled \$1.4 billion (\$960 million net of SCL's share) at year-end 2012. Seattle's Director of Finance is authorized to make loans to Seattle's various enterprise funds including SCL for up to 90 days. For loans beyond the 90-day period, city council approval is required. Loans bear interest at the cash pool's rate of return.

Seattle City Light's access to the money pool was demonstrated during the 2001 power crisis when SCL borrowed up to \$107 million from the money pool. More recently, the low wholesale revenues resulted in SCL borrowing approximately \$14 million from the money pool during February and March 2010 while SCL's \$25 million contingency reserve at that time was maintained.

4. BPA CONTRACT SUPPLEMENTED BY OWNERSHIP OF HYDRO SYSTEM PROVIDES LOW COST POWER

SCL benefits from ownership in 1,872 MW of low cost hydro generation and a long-term contract from BPA and these two sources provided approximately 75% of SCL's power in 2012. SCL's largest generation asset is the 1,022 MW Boundary Project whose FERC license was recently renewed to 2055. The renewed license incorporates a settlement with multiple stakeholders and SCL has incorporated into its long-term capital plan the various improvements under the settlement including environmental mitigation. The remaining assets consisting primarily of the Skagit projects have license maturities from 2025 to 2029 except for the 30 MW Cedar Falls project, which does not fall under FERC jurisdiction.

SCL also has a long-term contract with BPA that provides a 3.63% slice of the federal hydro system and 268 aMW of firm power shaped through the year. BPA's contract is considered an attractive long-term source of power and the average cost in 2012 was around \$26/MWh, though Moody's recognizes this figure benefited from the above average hydro levels in 2012. The BPA provides 531 aMW under critical water conditions and is 57 aMW less power than the previous BPA contract that expired in September 2011. Over the longer term, SCL expects to reduce future load growth through conservation to limit the need for new resources through at least 2020.

SCL also has long-term agreements with other hydro projects such as the Priest Rapids, Lucky Peak, and Grand Coulee Project Hydroelectric Authority projects that provide low cost power. Additionally, long-term agreements with wind, landfill and biomass projects and acquisition of renewable energy credits (RECs) allow SCL to meet Washington State's renewable portfolio standards through 2015. SCL plans to meet the 2016 increase in renewable requirements primarily through the purchase of RECs.

5. LARGE CAPITAL EXPENDITURE PROGRAM IS LIKELY TO LEAD TO INCREASED DEBT ISSUANCE OVER THE NEXT SIX YEARS

SCL's forecasted capital program remains sizeable at approximately \$2 billion from 2013 to 2018, which is higher to the previous \$1.8 billion forecasted over the 2012 to 2017. Annual capital expenditure is around \$300 million per year and over 2012 to 2017 period, the largest focus of the CIP is on the distribution system at \$906 million, which include capacity additions, service connections and transportation improvement related costs. Forecasted generation related expenditures total \$390 million and include environmental mitigation and plant improvements. Costs of conservation is also sizeable at around \$254 million.

SCL plans to fund these expenditures approximately 61% with debt, 28% from operations and 11% from grants and contributions. While the sizeable program and associated substantial increase in debt remain credit challenges for SCL, the risk remains manageable given the Seattle city council's demonstrated willingness to raise SCL's rates as necessary, the RSA and SCL's forecast of meeting 1.8 times debt service coverage (pre city tax). If any of these credit factors were to weaken, SCL's ratings will likely be negatively affected especially given the sizeable CIP.

Outlook

The stable outlook considers the benefit of the RSA mechanism, expected average DSCR of at least 1.5 times (post city tax) by 2014, expected 120 day cash on hand over the long term, and city council's demonstrated willingness to support credit quality. The stable outlook is also supported by the City of Seattle's strong economy, and SCL's access to the City of Seattle's consolidated money pool.

What could move the rating - DOWN

SCL's ratings could be negatively pressured if the RSA mechanism is removed or weakened, the city council's willingness to increase rates diminishes, if liquidity drops below 90 days cash on hand on a sustained basis or if SCL is unable to improve its DSCR to 1.5 times (post city tax) over time. SCL's rating could be also be negatively pressured if it no longer had access to the City of Seattle's money pool, if SCL's financial policy targets were to downwardly revised or if the underlying regional economy were to severely deteriorate.

What could move the rating - UP

The ratings could be positively affected if SCL is able accumulate and maintain sizeable internal liquidity comfortably exceeding 250 day cash on hand and sustain debt service coverage ratios materially exceeding 2.0 times.

KEY STATISTICS:

Total Restricted & Unrestricted Cash and Investments, 2012: \$432 million

Boundary Project Hydro Capacity (Nameplate): 1,022 MW

Skagit Projects Hydro Capacity (Nameplate): 802 MW

Moody's Total Debt Service Coverage 2012: 1.7 times (pre city tax) / 1.5 times (post city tax)

Senior Debt Service Coverage 2012: 1.8 times (per resolution)

Cash to Debt Ratio, 2012: 16%

Debt Ratio, 2012: 63%

Consolidated Days Cash on Hand, 2012: 205 days

City of Seattle's Cash and Investment Pool, 2012: \$1.4 billion (\$960 million net of SCL's share)

Average System Rate, 2012: Approximately 7 cents/kwh

Revenue Bonds, 2012: \$1.78 billion

Public Power Rating Methodology Factors-Seattle City Light

1 Cost Recovery Framework: (25% weight) (Aaa)

2. Willingness to Recover Costs and Maintain Sound Financial Metrics (25% weight) (Aa)

3. Management of Generation Risk- (10% weight) (A)

4. Rate Competitiveness: (10% weight) (A)

5. Financial Strength:

Sub factor a) Adjusted Days Liquidity on Hand: (10% weight) (172) (Aa)

Sub factor b) Debt Ratio: (10% weight) (66%) (A)

Sub factor c) Adjusted Debt Service Coverage: (10% weight) (1.64x) (A)

Grid Indicated Rating: Aa3

Notching: +1 (access to Seattle's consolidated money pool)

Scorecard Indicated Rating: Aa2

RATING METHODOLOGY

The principal methodology used in this rating was U.S. Public Power Electric Utilities with Generation Ownership Exposure published in November 2011. Please see the Credit Policy page on www.moody.com for a copy of this methodology.

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