MOODY'S INVESTORS SERVICE

New Issue: Moody's assigns Aa2 rating to City of Seattle's (WA) Electric Enterprise's new electric revenue bonds. Rating outlook is stable

Global Credit Research - 10 Oct 2014

Approximately $2.3 billion of debt affected

SEATTLE (CITY OF) WA ELECTRIC ENTERPRISE
Electric Distribution and Generation
WA

Moody's Rating

ISSUE	RATING
Municipal Light and Power Improvement and Refunding Revenue Bonds, 2014	Aa2

Sale Amount	$267,200,000
Expected Sale Date	10/30/14
Rating Description	Revenue: Government Enterprise

Moody's Outlook STA

Opinion

NEW YORK, October 10, 2014 --Moody's Investors Service has assigned Aa2 ratings to $267 million of City of Seattle's (WA) (Seattle) Electric Enterprise's (Seattle City Light or SCL) Municipal Light and Power Improvement and Refunding Revenue Bonds, 2014. Moody's also affirmed Seattle City Light's Aa2 rating on outstanding revenue bonds. The rating outlook is stable.

SUMMARY RATING RATIONALE

Seattle City Light's Aa2 rating considers SCL's strong historical willingness to raise rates when necessary, wealthy and diverse service area covering the City of Seattle (UTGO Aaa/stable) and surrounding communities, and credit supportive financial policies including the Rate Stabilization Account (RSA). Other credit supportive factors are SCL's ownership of low cost hydro generation, long-term power supply contract with Bonneville Power Administration, OR (BPA, Aa1/stable), competitive retail rates, and SCL's access to the City of Seattle's consolidated money pool.

However, the Aa2 rating also captures credit challenges including material wholesale price exposure, hydrology risk, and forecasted financial metrics in the 'A' category under Moody's US Public Power with Generation Ownership methodology. The rating further considers SCL's continued growth in debt to fund its $2 billion, 6-year capital improvement plan (CIP).

Outlook

The stable outlook considers the benefit of the RSA mechanism, expected 'A' rating category financial metrics in 2014 and thereafter with 120 days cash on hand and adjusted debt service coverage ratio (DSCR) north of 1.5 times, 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 continued access to the City of Seattle's consolidated money pool.

What could move the rating - UP

The ratings could be upgraded if SCL is able to sustain financial metrics in the 'Aa' category including internal liquidity comfortably exceeding 150 days cash on hand and adjusted DSCR exceeding 2.0 times.

What could move the rating - DOWN

SCL's ratings could be downgraded if the RSA mechanism is removed or weakened, the city council's willingness to increase rates diminishes or if financial metrics drop into the 'Baa' rating category including days cash on hand below 90 days or Moody's adjusted DSCR declining below 1.5 times. SCL's rating also can be downgraded if it no longer had access to the City of Seattle's money pool, if SCL's financial policy targets were to be downwardly revised or if the underlying regional economy were to severely deteriorate.

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 408,055 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 776,000. The City of Seattle's wealth levels are fairly high for a large city, with 2010 estimated median family income of $87,987, or 139.7% of the U.S. Full value per capita, at $207,957, also remains very high for a major metropolitan city. The major economic activities in the greater Puget Sound region are technology, manufacturing, healthcare, military and education.

In 2013, SCL received approximately 42% of its power from owned generation, 35% from BPA, 14% 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 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 consist of three hydro projects that operate as one system since they are located on the same ten-mile section of the Skagit River. FERC licenses for SCL owned Skagit River dams expire between 2025 and 2029. SCL also has smaller hydro facilities totaling 48 MW.

Seattle's mayor and city council have ultimate authority over SCL and approve SCL's budget, sets rates, and approves any financing. A separate, customer comprised City Light Review Panel reviews and assesses SCL's strategic plan, financing policies and rates.

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 an 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, 2013, Seattle City Light had total debt of approximately $1.86 billion.

USE OF PROCEEDS:

Approximately $153 million of the issuance represents new money and 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 DSCR 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 reserve is currently sized to 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 $51 million of cash.

Interest Rate Derivatives:

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

KEY RATING FACTORS

1.HISTORICAL WILLINGLESS TO RAISE RATES TO MAINTAIN FINANCIAL CONDITION IS CREDIT SUPPORTIVE

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. 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). Since then, the city council implemented stead base rate increases with the last increase of 5.6% in January 1, 2014. Looking forward, the city council approved SCL's Strategic Plan, which calls for a 4.4% average annual increase from 2015 to 2020 for the base rate and the rates for 2015 and 2016 have been approved. A separate automatic rate adjustment mechanism exists for any BPA cost increases and the RSA mechanism. 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 7.3 cents/kwh are well below Puget Sound Energy, the main investor owned utility in the area and they remain modestly below Washington State's weighted average rate. 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 under negotiation will be extended as planned.

2.EXPOSURE TO MARKET BASED REVENUES AND HYDROLOGY RISK

Prior to 2009, SCL relied on substantial amount of market-based revenues, which have declined by over 60% from the peak. The loss of wholesale revenue resulted in adjusted DSCR dropping to below 1.0 times in 2009 and led to a 13.8% base rate increase in 2010. Gross wholesale revenues have been around 10% of total revenues over the last several years and continues to contribute to financial metrics volatility. For 2013, adjusted DSCR dropped to almost 1.4 times from near 1.5 times in 2012 partly due to lower wholesale revenue. For 2014 and thereafter, adjusted DSCRs are expected to be in excess of 1.5 times partly due to stronger wholesale revenue and increases in retail rates.

Partially mitigating the revenue volatility has been the substantial improvement in SCL's liquidity since 2011. At year end 2013, SCL's liquidity had 204 days cash on hand compared to 39 days cash on hand in 2009 due to the RSA account and higher unrestricted cash balances. For 2014 and thereafter, liquidity is forecasted to drop into the 'A' category with days cash on hand averaging 120 days or higher depending on water conditions. An inability to sustain financial metrics in at least the 'A' category over time would be viewed as credit negative.

3.THE RSA MECHANISM SIGNFIICANTLY MITIGATES HYDRO AND MARKET UNCERTAINTY

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 voluntary contributions while also making withdraws to meet target the 1.8 times DSCR for 2012 and 2013.

Moody's views the RSA as a key risk management tool for SCL and its importance is demonstrated by SCL maintaining greater than expected liquidity that precludes the triggering of the RSA's quarterly surcharge. In 2013, SCL forecasted the RSA balance dropping to an estimated $81 million by year-end 2013 that would have triggered the quarterly surcharge. However, the RSA's actual year-end 2013 balance was $110 million due to discretionary transfers. Moody's views the RSA as a key mechanism to supporting SCL's financial metrics. 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 $1.44 billion ($768 million net of enterprise funds) at year-end 2013. 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.HYDRO HEAVY POWER SUPPLY PORTFOLIO PROVIDES LOW COST, NON-CARBON EMMITTING 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 77% of SCL's power in 2013. SCL's largest generation asset is the 1,022 MW Boundary Project whose FERC license expires was 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 2013 was around $29/MWh, which modestly above the five year average of $28/MWh.

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 2020. SCL plans to meet the 2016 increase in renewable requirements primarily through the purchase of RECs.

Over the longer term, SCL expects substantial investment in conservation to limit demand growth and ultimately the need for new power resources through at least 2020.

5.LARGE CAPITAL EXPENDITURE PROGRAM

SCL's forecasted capital program remains sizeable at approximately $2.1 billion from 2014 to 2019 and has grown over time. Annual capital expenditure averages around $350 million per year over 2014 to 2019 period and the largest focus of the CIP is on the distribution system at $907 million, which include capacity additions, service connections and reliability improvements. Forecasted generation related expenditures total $370 million and include environmental mitigation and plant improvements. Costs of conservation is also sizable at around $241 million.

SCL plans to fund these expenditures approximately 60% with debt, 31% from operations and 9% from 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 forecasted financial metrics in the 'A' category. If any of these credit factors were to weaken, SCL's ratings will likely be negatively affected especially given the sizeable CIP.

KEY STATISTICS:

Total Restricted & Unrestricted Cash and Investments, 2013: $413 million

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

Skagit Projects Hydro Capacity (Nameplate): 802 MW

Moody's Total Debt Service Coverage 2013: 1.63 times (not adjusted) / 1.39 times (adjusted)

Senior Debt Service Coverage 2013: 1.85 times (per bond resolution)

Cash to Debt Ratio, 2013: 16%

Debt Ratio, 2013: 62%

Consolidated Days Cash on Hand, 2012: 204 days

City of Seattle's Cash and Investment Pool, 2013: $1.44 billion ($768 million net of enterprise funds)

Average System Rate, 2013: Approximately 7.3 cents/kwh

Revenue Bonds, 2013: $1.86 billion

OTHER CONSIDERATIONS

Moody's evaluates Seattle City Light under the US Public Power Electric Utilities with Generation Ownership Exposure methodology, and, as depicted below, the grid indicated rating is Aa2, in line with its current Aa2 rating.

The grid is a reference tool that can be used to approximate credit profiles for public power with generation ownership in most cases. However, the grid is a summary that does not include every rating consideration. Please see US Public Power Electric Utilities with Generation Ownership Exposure for more information about the limitations inherent to grids.

Methodology Factors

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) (204) (Aa)

Sub factor b) Debt Ratio: (10% weight) (64%) (A)

Sub factor c) Adjusted Debt Service Coverage: (10% weight) (1.67x) (A)

Grid Indicated Rating: Aa3

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

Scorecard Indicated Rating: Aa2

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.moodys.com for a copy of this methodology.

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