S&P Global
Ratings

RatingsDirect®

Summary:

Seattle; Water/Sewer

Primary Credit Analyst:
Chloe S Weil, San Francisco (1) 415-371-5026; chloe.weil@spglobal.com

Secondary Contact:
Alexandra Rozgonyi, Centennial 3037214824; alexandra.rozgonyi@spglobal.com

Table Of Contents

Summary:

Seattle; Water/Sewer

Credit Profile		
US$195.8 mil wtr sys imp and rfdg rev bnds ser 2017 due 08/01/2046		
Long Term Rating	AA+/Stable	New
Seattle wtr		
Long Term Rating	AA+/Stable	Affirmed
Seattle wtr (BHAC) (SEC MKT)		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed
Seattle wtr sys		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings assigned its 'AA+' long-term rating to the city of Seattle's $195.9 million series 2017 water system improvement and refunding revenue bonds. At the same time, S&P Global Ratings affirmed its 'AA+' rating on the city's outstanding water system improvement and refunding revenue bonds. The rating reflects, in our opinion, the combination of a very strong enterprise and financial risk profile. The outlook is stable.

The enterprise risk profile reflects our view of the water system's:

- Service area participation in the broad and diverse Seattle metropolitan area economy;
- Affordable service rates that provide management with good revenue-raising flexibility, which is critical as the city ramps up capital spending through 2019; and
- Very low industry risk as a monopolistic service provider of an essential public utility;
- Strong operational management practices and policies.

The financial risk profile reflects our view of the water system's:

- Stable and consistent all-in coverage metrics, of about 1.5x over the last three years, even as the city managed through the second worse drought on record in 2015;
- Good-to-adequate liquidity position, equivalent to about 139 days' of operations, which we expect will decline to about 86 days' by 2018;
- Highly leveraged capital structure with 70.1% debt-to-capitalization as of Dec. 31, 2015;
- Well-defined financial management practices and policies.

A very strong enterprise risk profile and a very strong financial risk profile map to an indicative rating in our revenue debt criteria matrix of 'aa/aa-', and we have selected the 'aa' anchor based on the water system's history of adopting rate increases to support stable financial performance. We have also applied a one-notch positive adjustment from the initial indicative rating to arrive at the final rating based on the water system's role as a major regional water supplier

1778879 | 302253520

to retail customers within Seattle and to wholesale customers in the Puget Sound area.

The series 2017 bonds are being issued to fund $104 million of system improvements and to refund certain outstanding water revenue bonds for debt service savings. The bonds are secured by a pledge of net revenues of the city's water system. Additionally securing all parity bonds is a reserve, funded at $75.1 million, with about 64% of this requirement funded with surety bonds. A rate covenant requires the system to generate debt service coverage of 1.25x, though withdrawals from a rate stabilization fund can be included in this calculation. As of Jan. 1, 2017, the system had $810 million in parity bonds outstanding plus $24.7 million in subordinate-lien state loans.

Enterprise risk

Seattle sits at the center of the large, diverse Puget Sound regional economy. The center of a 3.6 million-resident region, the city has benefited from a deep reservoir of human capital and exposure to export markets, anchored by such major regional employers as Boeing, Amazon.com, and Microsoft. City income levels are above average, with median effective household buying income at 121% of the national average in 2015. The city's unemployment rate has historically been below the state and national rates. As of October 2016, the unemployment rate was 3.4%, below the state rate of 5.0% and the national rate of 4.7%.

The water system serves a population of about 1.4 million, and is operated by Seattle Public Utilities, a department of the city. It provides retail service to customers in Seattle and in portions of the cities of Shoreline, Burien, and Lake Forest Park, as well as in unincorporated King County. Of the approximately 165,000 direct residential accounts and 22,300 commercial or multifamily account served by the water system, there is no concentration in the customer base. The 10 leading retail customers for the water system account for about 10.7% of total operating revenues. The largest, the city of Seattle, accounts for about 2.5% of revenues. Seattle Public Utilities bills its retail customers for water, sewer, and solid waste services on a combined bill.

In our opinion, the water system's willingness and ability to impose regular rate increases is a significant credit strength because we consider rate increases critical to funding the utility's upcoming capital improvements and planned bond issuance. Rate adjustments have been timely historically, and management undertakes periodic rate studies. Rates were increased 9.9% in 2012, 9.7% in 2013, and 3.4% in 2014. While rates did not change in 2015 (except for some retroactive cost allocation adjustments for wholesale customers), rates are set to increase by 2.6% on January 1, 2017.

Retail customers are charged a flat rate plus a volume-based rate that is higher and tiered during summer months. A monthly bill using our benchmark of eight hundred cubic feet (ccf) of summer water use would be about $59.44 for a single-family residential customer, or about 1.3% of MHHEBI. The city uses 5 ccf for its representative water bill, which would be about $42 monthly in the summer, which we consider very affordable, at about 0.9% of MHHEBI, especially in the context of Seattle's strong household income levels, and King County's relatively low county poverty rate, last measured at 11.3% by the U.S. Department of Agriculture. We understand that there have not been any material payment delinquencies, and write-offs for uncollectible accounts are well under 1%.

The system additionally provides wholesale service (treated water) to 21 suburban water districts and municipalities plus the Cascade Water Alliance. Wholesale customers pay a rate to Seattle that represents only the costs of Seattle's water supply and treatment system, and are responsible for managing and billing customers for costs associated with their own distribution systems. About 22% of total operating revenue in 2015 was derived from sales to the system's wholesale customers. The top three wholesale customers by revenue are Cascade (7.9% of 2015 total operating revenue), Northshore Utility District (2.03% of 2015 operating revenue), and Highline Water District (1.8% of 2015 operating revenue). Most of the wholesale customers, representing about 53% of wholesale consumption, have entered into long term agreements with Seattle through at least January 2062 requiring Seattle to meet the customers' water demands not met by local sources. Seattle's contract with its largest customer, Cascade Water Alliance, requires Seattle to provide 33.3 mgd annually through 2039, and thereafter at a declining annual volume. We understand that the Highline Water District has given notice that it intends to reduce purchases from the city by up to 975,900 ccf beginning in 2018, which management projects will result in a reduction in revenue to Seattle of approximately $1.7 million, which will be absorbed into the rate structure for the existing customer base.

Based on our operational management assessment, we score the water system a '2' on a six-point scale on which '1' is the strongest. The system primarily derives its water supply from surface water diversions on the Cedar River and on the South Fork of the Tolt River, each about 25 miles east of Seattle. It also operates two wellfields. The city estimates it has 300 mgd of water treatment capacity, a firm supply yield of 172 million gallons per day (mgd) compared with recent average demand of about 119 mgd. The system also has substantial storage in eight reservoirs. Although the population in the service area has steadily risen, increased conservation has actually lowered water demand during the past 20 years. Management reports no new supply is projected to be needed until at least 2060.

We understand the system is primarily addressing its aging distribution system infrastructure in its upcoming capital improvement plan (CIP). Management has a formal asset management program that addresses the long-term sustainability of its infrastructure and facilities. The program includes evaluating the condition and expected useful life of each asset, and developing a strategy for the rehabilitation and replacement of these assets. Management regularly communicates its strategic goal internally and to outside parties. Drought management planning is strong and management has generally succeeded in executing strategic plans.

Consistent with "Methodology: Industry Risk," published Nov. 19, 2013, we consider industry risk for the water system to be very low, the most favorable assessment possible on a '1' to '6' scale, with '1' being the best.

Financial risk

Management did not provide financial projections or a rate plan beyond 2018. As such, our assessment of the water system's financial risk profile as very strong reflects our view that the system's all-in coverage will remain stable during the next two years. All-in coverage is our internally adjusted debt service coverage metric that we believe best tracks the use of every dollar of utility operating revenues, regardless of lien position, accounting treatment, or ultimate purpose. We also recognize the water system's good liquidity position that we anticipate will be maintained at no less than $30 million through Dec. 31, 2018.

The system's historical financial performance has been relatively very consistent, with the 2015 drought causing minimal impact to the system's all-in coverage, and we anticipate that all-in coverage will continue to be in line with historical metrics, assuming a 2.6% rate increase effective January 1, 2017. Additional rate increases beyond 2018 have not yet been identified or approved. Based on the city's audited financial statements, we calculate all-in coverage (including debt service on both the water system's outstanding revenue bonds and subordinate lien state loans) of 1.5x in fiscals 2013-2015. The city currently levies a tax of 15.54% on total gross income of the water system from its retail business within and outside the city. Our calculation of all-in coverage includes the water system's annual payments to the city as a fixed cost of operations; although the city represents that the taxes are subordinate to the water system's own debt service payments. Excluding the city taxes, coverage ranged between 1.7x and 2.0x over the last three years, which we consider extremely strong.

The water system held about $42.3 million of unrestricted cash as of Dec. 31, 2015, which we consider good at about 108 days' of operations. Projections show unrestricted cash levels declining to about $30 million. This would equate to approximately 83 days of operations. Management represents that there are provisions in the city's municipal code to allow the finance director to make interfund loans (from other departments) for up to 90 days, which would partially mitigate the system's relatively low liquidity. Longer-term loans require city council approval. The city's investment pool balance is currently about $1.9 billion; however, these funds are available to support all municipal functions. The system does not have a track record of borrowing on an interim basis from the pooled fund; therefore, we would expect the system to rely on the capital markets in lieu of interfund borrowing.

The water system's upcoming CIP is large, and totals $556.8 million through 2022. The majority of projects in the CIP focus on distribution system improvements ($171.7 million) and transportation related improvements such as buried pipe rehabilitation and replacement projects ($185.9 million). Approximately $370.4 million in long-term debt, or 67% of projected capital spending, is expected to be financed by the issuance of parity bonds or loans through 2022. Accordingly, annual debt service is expected to rise from approximately $83 million in 2016 to approximately $99 million in 2022; failure to adopt additional rate increases commensurate with this rise in debt service would put downward pressure on the rating. With a 70.8% debt-to-capitalization ratio as of Dec. 31, 2016, we consider the water system to by highly leveraged.

Based on our financial management assessment, we view the water system to be a '2' on a scale of 1-6, with '1' being the strongest. We believe that the financial management practices are strong, comprehensive, and support high credit quality. Revenue and expenses assumptions are reasonable, and interim financial reporting is provided to city council through quarterly budget reports. The water system is currently in the process of updating its strategic business plan, at present, management represents that the CIP will be about 30-35% cash funded. Shortly after approval of the strategic plan, a rate study recommending new rates for 2018-2020 will be proposed. This is expected to be completed by mid-2017. The system's reserve policy is well defined and articulates a rationale for maintaining a good liquidity position. Financial planning and operational data are easily obtained, as the budget, financial statements, and projections are readily available on the city's website.

Outlook

The stable outlook reflects our expectation that management will complete a rate study over the next year to set in place a rate plan for 2018-2020, and will continue to set rates to provide consistent financial metrics and sufficient capital funding. Further support for the outlook reflects our view of the system's extremely strong local economy, reasonable demand forecast, and amply water supply.

Upside scenario

Given the city's relatively high leverage positon and additional debt needs, we do not anticipate raising the rating during the next two years.

Downside scenario

If cash levels or all-in coverage were to fall significantly, we could lower the rating, though this is not anticipated.