CREDIT OPINION
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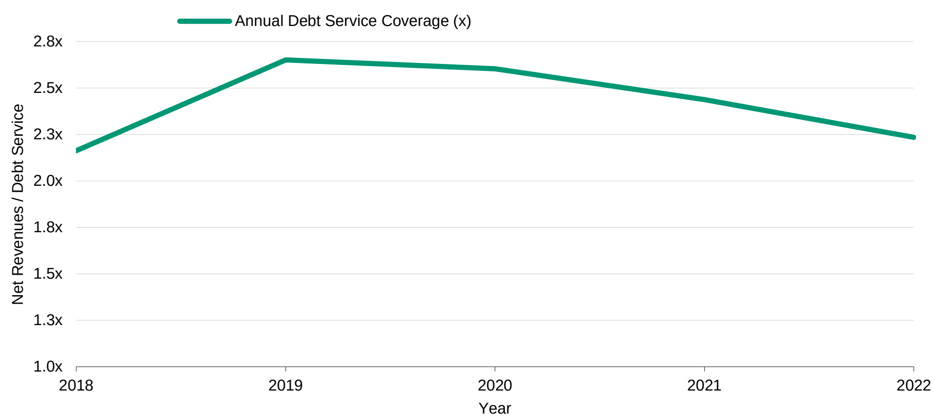
Seattle (City of) Sewer Enterprise, WA

Update to Credit Analysis

Summary

The City of Seattle, Washington's sewer enterprise (Aa1 stable) benefits from a large and wealthy service area, which is mostly coterminous with the boundaries of the City of Seattle, WA (Aaa stable). The utility is further supported by healthy financial operations and strong liquidity levels, enhanced by access to the city's shared liquidity pool. While debt service coverage is expected to decline slightly, it will remain satisfactory as the system continues to raise rates to meet growing operational and debt service expenses. Regulatory compliance and capital planning are overseen by a strong management team. Rate affordability will be a long-term challenge for the city as water consumption remains stable and rates are increasing.

Exhibit 1
Debt Service coverage is strong, despite expected declines



Source: Audited Financial Statements, Moody's Investor Service

Credit strengths

- Stable, established customer base and service area
- Demonstrated willingness to increase utility rates
- Access to citywide cash pool for liquidity purposes
- Solid debt service coverage

Credit challenges

- » Significant capital needs related to sewer overflow project and consent decree
- » High customer utility bill relative to regional peers

Rating outlook

The rating outlook is stable based on the expectation that the city will maintain sound coverage levels considering its sizable capital needs. Affordability may be a long-term challenge for the city as water consumption continues to decline and rates are increased to pay for system operations, maintenance and improvements.

Factors that could lead to an upgrade

- » Material increase in debt service coverage
- » Reduction in future capital needs related to environmental compliance issues

Factors that could lead to a downgrade

- » Deterioration in pledged revenue and coverage
- » Substantial increase in debt levels to address environmental compliance issues and consent degree

Key indicators

Exhibit 2

Seattle (City of) Sewer Enterprise, WA					
System Characteristics					
Asset Condition (Net Fixed Assets / Annual Depreciation)	37 years				
System Size - O&M (in $000s)	$358,990.05				
Service Area Wealth: MFI % of US median	176.00%				
Legal Provisions					
Rate Covenant (x)	1.25x				
Debt Service Reserve Requirement	DSRF funded at lesser of standard 3-prong test (Aa)				
Management					
Rate Management	Aa				
Regulatory Compliance and Capital Planning	Aa				
Financial Strength					
	2018	2019	2020	2021	2022
Operating Revenue ($000)	$419,876	$454,382	$460,295	$502,517	$519,029
System Size - O&M ($000)	$317,601	$330,092	$349,925	$353,905	$358,990
Net Revenues ($000)	$113,271	$141,196	$123,354	$153,746	$152,947
Net Funded Debt ($000)	$843,409	$814,620	$798,085	$871,234	$873,092
Annual Debt Service ($000)	$52,370	$53,252	$47,360	$63,055	$68,450
Annual Debt Service Coverage (x)	2.2x	2.7x	2.6x	2.4x	2.2x
Cash on Hand	212 days	255 days	228 days	226 days	275 days
Debt to Operating Revenues (x)	2.0x	1.8x	1.7x	1.7x	1.7x

Sources: US Census Bureau, Seattle (City of) Sewer Enterprise, WA's financial statements and Moody's Investors Service

Profile

The combined drainage and wastewater system serves the City of Seattle and its rapidly growing urban population of roughly 760,000. The drainage system conveys stormwater runoff through various modes, including storm drains, a combined stormwater and wastewater system and a ditch, culvert and creek system. The wastewater system is responsible for the collection and transmission of wastewater to regional treatment facilities that are operated by King County, WA (Aaa stable).

Detailed credit considerations

Service area and system characteristics: Key utility service provider to Seattle

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). Income measures are strong and will continue to be a positive component of the utility's credit profile. Median family income of 176% of the US level is among the highest for large urban areas.

The drainage system conveys stormwater runoff through various modes, including storm drains, a combined stormwater and wastewater system and a ditch, culvert and creek system. The drainage system is principally residential (70%), though revenue generation is more evenly split with commercial activities as drainage fees are based on a property's estimated impact on the drainage system. The largest customer of the drainage system is the city of Seattle (6.6% of revenue in 2022) and the top 10 customers generated 16.8% of 2022 revenue, similar to figures from prior years.

The wastewater system is responsible for the collection and transmission of wastewater to regional treatment facilities that are operated by King County. Like the drainage system, the wastewater system is principally residential (89%). However, wastewater revenue is more heavily driven by commercial accounts (63%). The largest customer of the wastewater system in 2022 was the University of Washington (3.2%) and the top 10 customers generated 10.4% of revenue.

The city anticipates conservation efforts and slower population growth will result in stable, rather than growing, demand of over the next several decades. The utility has also been working toward resolution of a Consent Decree by the Environmental Projection Agency (EPA) related to sewer overflows since 2013. They have made significant progress, however, it remains an ongoing project and they have delayed milestones until 2024 as they have expanded the original scope while partnering with King County on major initiatives.

Debt service and Liquidity: Strong debt service, liquidity bolstered by city's consolidated cash pool

Debt service coverage is healthy despite increasing annual debt service for bond issuances to finance regulatory, renewal and optimization of existing infrastructure, and transportation projects. Top-line revenue for 2022 reached $519 million, a 3.2% increase from 2021. By ordinance, city utility taxes are remitted to the city after the payment of debt service, though in practice are remitted monthly. Net revenue available for debt service in 2022 was $152 million, sufficient to provide 2.2 times all in debt service. Debt service coverage is likely to decline slightly while remaining at satisfactory levels as rates increase to meet growing operating and debt service expenses.

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 $3.5 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 combined drainage and wastewater system generates satisfactory operating cash flow. The enterprise ended 2022 with $219.2 million of cash in working capital, or 275 days of cash on hand. The forward projection for the enterprise shows declining cash balances through 2024, closer to historical levels, though the city has historically outperformed similar projections by considerable margins.

Debt and Legal Covenants: debt to increase with sizable CPI

The drainage and wastewater enterprise is modestly leveraged with $730 million in revenue bonds outstanding and an additional $192 million WIFIA loan that they are drawing on incrementally. The City made its first draw on the WIFIA Bond on January 15, 2023, in the amount of $4.6 million, and made a second draw of $4 million on March 14, 2023. The city plans to continue making draws throughout 2023 and expects to have fully drawn the WIFIA loan by the end of 2025. Inclusive of the WIFIA loan, the enterprise's debt to operating revenue ratio is a manageable 1.7x. The utility's capital program through 2026 calls for $1.28 billion in projects, including $133 million for combined sewer overflow (CSO) projects.

The city expects to pay for these using $333.2 million of operating cash and $942.5 million in debt financing, including the WIFIA loan. The increase in leverage is material but manageable given currently strong margins and expected rate-driven revenue increases.

Legal security

The bonds are payable from the combined net revenues of the drainage and wastewater system, which has a rate covenant that requires the system to set rates to maintain at least 1.25 times annual debt service coverage on a pre-city tax basis. The additional bonds test similarly requires that rates be set to maintain at least 1.25 times annual debt service coverage on a pre-city tax basis. Furthermore, the bonds are backed by a common debt service reserve sized at the lesser of the standard three-prong test.

Debt structure

The combined drainage and wastewater debt is structured with declining debt service to allow for layering of additional bond issuances in the future. The city will not begin making principal payments on the WIFIA loan until 2026.

Debt-related derivatives

The drainage and water system does not have any debt-related derivatives.

Pensions and OPEB

Pensions and other post-employment benefits (OPEB) are not a material driver for the drainage and wastewater utility. As of fiscal 2021, the utility has an adjusted net pension liability (ANPL) of $245.1 million based on a discount rate of 2.52%, which is manageable at 0.44x operating revenue. The enterprise uses a discount of 6.75% and therefore has a lower reported pension liability. Contributions have in the last two years have been above its “tread water” mark, or the contribution level required to keep pension liabilities from growing given plan assumptions.

Reported OPEB liabilities were just $2.8 million at the end of 2022. 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

The utility’s credit exposure to environmental risks is moderately negative (E-3). Wastewater utilities have moderately negative exposure to water management considerations given the risk of potential regulatory violations associated with wastewater disposal. Wastewater operations face risks of increased operating costs or capital requirements in addressing any future violations. In addition, Seattle Sewer has neutral-to-low exposure to carbon transition, natural capital, waste and pollution, and physical climate risks. Long-term environmental challenges include sea level rise and the greater frequency of extreme rainfall, which increases the risk of severe flooding.

Social

The system’s credit exposure to social considerations is neutral-to-low (S-2), reflecting neutral-to-low exposure to customer relations, human capital, health and safety, and responsible production considerations. While rate affordability is a potential challenge, the enterprise benefits from positive exposure to demographic and societal trends, such as positive population trends and a highly education workforce .

Governance

Seattle Sewer’s governance considerations are positive (G-1). The system benefits from positive financial strategy and risk management considerations. Management credibility and track record considerations are also positive. Exposure to organizational structure and compliance and reporting considerations are neutral-to-low. Exposure to board structure, policies and procedures risk is moderately negative, reflecting the concentrated control of the system’s operations by Seattle’s city council.

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