S&P Global Ratings

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Summary:

Seattle, Washington; Water/Sewer

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Credit Profile		
US$95.165 mil drainage and wastewtr sys imp rev bnds ser 2023 due 02/01/2053		
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.

Credit Highlights

- S&P Global Ratings assigned its 'AA+' long-term rating to Seattle, Wash.'s anticipated $95.2 million series 2023 drainage and wastewater system improvement and refunding revenue bonds. Seattle Public Utilities (SPU) is the city's utility system.
- At the same time, S&P Global Ratings affirmed its 'AA+' rating on Seattle's outstanding drainage and wastewater system parity debt.
- The outlook is stable.

Security

We consider the bond provisions to be standard. The series 2023 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.

Proceeds will be used to fund $107 million of upcoming drainage and wastewater system capital needs. At fiscal year-end Dec. 31, 2022, the system had $730.7 million of drainage and wastewater revenue bonds, and $142 million in subordinate state loans outstanding. SPU has entered into a $192.2 million Water Infrastructure Finance and Innovation Act (WIFIA) loan with the Environmental Protection Agency, but as of Dec. 31, 2022, had not yet begun to draw on the loan.

Credit overview

The rating is anchored by SPU's six-year rate plan, approved by city council in May 2021, which sets a credible trajectory for the drainage and wastewater system's future financial performance, even with the significant planned increase in capital spending during the upcoming five-year period. The system's historical financial performance has been relatively stable because regular rate increases have offset rising operating and maintenance costs during this period. Direct debt service coverage (as calculated by S&P Global) was very strong and improved to 2.8x in fiscals

2021 and 2022 from 2.1x in fiscal 2020.

Our calculation of all-in debt service coverage considers SPU's imputed debt resulting from the city's participation in the county's regional wastewater treatment system. Our calculation is weaker, given the sizable amount of debt the regional wastewater treatment system has outstanding--we estimate that SPU is responsible for approximately 30% of King County's annual debt service, or about $75 million – resulting in all-in coverage of about 1.7x-1.8x in fiscals 2021 and 2022, respectively, all of which we consider supportive of the current rating. We expect all-in coverage to remain at levels that we consider sound (more than 1.6x, as calculated by S&P Global Ratings) over the outlook period but could decline in 2025 and beyond as debt service associated with the Ship Canal Water Quality Project begins amortizing, absent additional rate increases.

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. Regional employment in 2022 rebounded to pre-pandemic levels, which we consider credit supportive, and as of February 2023, unemployment stood at 2.2%--well below the U.S. average of 3.9%. However, negative economic headwinds, if protracted, could potentially constrain our view of system affordability and SPU's market position over time. We continue to monitor job losses in the life sciences and information technology sectors, given their outsized presence in the local economy.

Credit risks center on the sizable $1.3 billion six-year capital improvement plan (CIP), which will be approximately 75% debt funded, with current projections indicating that annual capital spending is expected to roughly double from historical levels during the upcoming five-year period. 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). King County has approximately $3.5 billion of debt outstanding and an additional $1.3 billion in debt needs, approximately one-third of which will be passed through to the city.

About two-thirds of the SPU 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 overflow (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 related to the Ship Canal project (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.

The rating further reflects our view of the system's:

- City ordinance that 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.
- 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;

- Extremely strong liquidity, with more than $270 million (or 282 days' cash on hand) available as of Dec. 31, 2022, which we consider to be a key credit strength; and
- High leverage, with a 73% debt-to-capitalization as of Dec. 31, 2022, coupled with 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 75% funded, which we consider slightly below average (as a percentage of expenditures) but is expected to be manageable in the near-term for SPU.

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. Because the city is concerned about affordability for low-income customers, the city provides a 50% discount to income-qualifying households, with an enrollment of about 30,000 households.

In December 2021, the Washington Department of Ecology issued the Puget Sound Nutrient General Permit. The permit is on appeal and is the subject of litigation. However, the 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.

Outlook

The stable outlook reflects our anticipation that even with the additional planned debt during 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.

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

The city of Seattle (population: 791,100) 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 more than 150% of the national level in 2022. While the population served has grown by 41% in 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.

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 $153 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 to about $177 per month by 2026.

Related Research

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