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Seattle; Retail Electric

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Credit Profile		
US$125.595 mil mun lt and pwr rfdg rev bnds ser 2016B due 04/01/2029		
Long Term Rating	AA/Stable	New
US$32.0 mil mun lt and pwr rev bnds (Taxable New Clean Renewable Energy Bnds) ser 2016A due 01/01/2041		
Long Term Rating	AA/Stable	New
Seattle muni lt & pwr rev bnds		
Long Term Rating	AA/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services has assigned its 'AA' rating and stable outlook to Seattle, Wash.'s 2016A municipal light and power improvement revenue bonds, and its 2016B municipal light and power refunding revenue bonds. The utility does business as Seattle City Light (SCL). At the same time, Standard & Poor's affirmed its 'AA' underlying rating on SCL's parity debt. The outlook is stable.

We believe credit strengths include:

- A low-cost hydro-based generation portfolio that can meet demand under most water conditions, including less-than-normal water conditions;
- A strong and diverse customer base; and
- Competitive retail rates, despite significant increases in the past few years.

In our view, offsetting factors include some reliance on wholesale sales, and what we view as a large capital improvement program (CIP) that management expects will add about $1.42 billion of debt in the next six years.

Seattle pledges the light system's gross revenues to pay debt service on the 2016A and B bonds, and expects bond proceeds will be used to fund energy capital improvements to SCL's Skagit hydroelectric project, and to refinance $128 million of bonds outstanding.

SCL is a municipally owned electric utility that provides service to approximately 415,000 customers in Seattle and surrounding areas within King County, Wash., covering a population of 776,000. Debt totaled about $2.1 billion at year-end 2015.

We believe SCL's business position is satisfactory ('3' on our scale of '1' to '10', '1' being excellent) due to SCL's ability and willingness to adjust rates to support the utility's financial health, a large and diverse customer base with low industrial concentration, and a supply of low-cost hydroelectric power that is sufficient to cover demand and wholesale sales. In our view, challenges include managing hydrology and market risks related to the system's high dependence on hydroelectric power generation for wholesale sales. Rates are about average for the state but we believe they are very competitive relative to the national average and those of other large utilities in the region.

Historically, SCL has relied on wholesale sales for strong debt service coverage (DSC) levels. Wholesale sales revenue has ranged from 9%-20% of total operating revenue in the past 10 years, although the number has been declining. Management has taken steps to lower its reliance on wholesale sales to reduce volatility of financial performance, and intends to continue to do so. As part of its strategy, beginning in 2010, city council has enacted a series of annual base rate increases. It also established a rate-stabilization account, which has an estimated balance of about $85 million as of year-end 2015. Seattle most recently raised rates 4.2% in 2015, and has adopted increases of 4.9% for fiscal 2016.

In 2015, a $30 million shortfall in budgeted wholesale revenues is expected to reduce the balance of the rate stabilization fund. A surcharge is likely to be triggered in 2016. SCL management projects surcharge revenues during 2016-2018 of about $28 million, and that the rate-stabilization account balance will be restored to $100 million by 2018. A portion of wholesale net revenues comes from forward sales of typically nine months or less, and SCL maintains strict limits on the portion of its surplus position made available for forward sales to avoid potentially high replacement power costs in low-water years. Standard & Poor's believes the system's risk-management policies are conservative, and adequately reduces the risk related to its forward sales.

We believe SCL's overall financial performance is sound, with strong DSC of 1.5x-1.6x during fiscal years 2012-2014 (year ended Dec 31). Standard & Poor's calculates fixed coverage by including city taxes as an expense, and imputes a portion of long-term purchased power expenses, mainly from Bonneville Power Administration, as debt-like. Fixed charge coverage has also typically been strong, in our view, exceeding 1.30x in the past three fiscal years, including 1.35x in fiscal 2014 (audited). Bond provisions are what we consider adequate, and include a 1.25x additional bonds test, and a sufficiency rate covenant.

The 2016A Clean Renewable Energy Bonds (CREBs) bonds will fund renewable energy investments, and will benefit from an interest subsidy from the U.S. Treasury during the 25-year life of the 2016A issue. SCL previously issued series 2015 bonds as Securities Industry and Financial Markets Association (SIFMA) index bonds in the amount of $100 million to fund capital improvements. These bonds are subject to mandatory tender, which SCL expects will occur within three years of issuance. These bonds will be remarketed or refunded, and a failed remarketing does not result in an event of default. Rather, the bonds will be subject to a stepped rate of interest. As such, the SIFMA bonds do not need liquidity support.

Outlook

The stable outlook reflects Standard & Poor's expectation that SCL will maintain adequate liquidity and DSC levels through rate-stabilization policies, and continued conservative wholesale revenue forecasting. Rate stabilization, in conjunction with the automatic surcharge triggers, has contributed and should continue to contribute to credit stability, in our view.

Upside scenario

Given the hydrological variability, we do not expect to raise the rating in the next two years

Downside scenario

We could lower the rating if hydrological conditions and/or market prices have a negative impact on wholesale revenues, or likewise, if net revenues from retail operations result in a significant decline in financial performance.

Diverse Customer Base

SCL's service area consists principally of Seattle, but it also has franchise agreements with several cities within King County and some unincorporated areas that in total account for about 16% of energy sales. Management estimates the population of its service area at 776,000. Although the customer base is primarily residential, two-thirds of retail sales are to commercial and industrial customers. Total 2014 retail sales of 9,340 gigawatt-hours reflect 1.7% decline from 2013 figures. SCL forecasts modest annual growth, held back in part due to Seattle's ongoing conservation efforts, which offset 1.3% of demand growth annually, according to management's estimates. Peak demand of 1,867 megawatts (MW) in 2014 is just 1.9% below 2008's peak of 1,901, reflecting a combination of conservation efforts and rebounding economic activity. The customer base is what we consider diverse, with the 10 leading customers accounting for about one-sixth of revenues and no single customer exceeding 3.1% of sales revenue.

Strong Hydrological Assets Provide Low-Cost Power

Low generating costs, a very high reliance on hydroelectric generation, and large surplus generation capacity in most months characterize SCL operations. The system's hydroelectric generating assets are distributed between the Columbia River-based Federal System and two other independent river systems. Owned-generating assets include the Boundary and Skagit River projects, representing 29% and 18% of total resources, respectively. In 2014, the Federal Energy Regulatory Commission extended the boundary project's license to 2055, which provides the utility with greater cost certainty regarding the project. Additional resources include a maximum of 175 MW from the Stateline Wind Project.

SCL's block-and-slice allocations under its current contract with the Bonneville Power Administration (BPA) contract are sized to bring the utility into load-resource balance under critical water conditions, with the goal of considerably reducing its supply risk for its retail operations. The system's 17-year contract with Bonneville took effect October 2011 and provides SCL with BPA's block-and-slice products that are designed to more closely balance its firm resource requirements. Nevertheless, this reliance introduces a measure of hydrological and wholesale power market risk to SCL in achieving its financial targets. A significant portion of wholesale net revenues comes from forward sales of typically nine months or less. The system has adopted risk-management policies and forward sales guidelines, which establish limitations on the timing and quantity of forward sales to avoid potentially high replacement power costs when hydroelectric power supplies fall short of expectation. Standard & Poor's also believes that the recent rate-stabilization account ordinance will offset much of the budgetary risk, because rate surcharges happen automatically should the account balance fall below $90 million.

Finances

Financial flexibility is adequate, in our view, given the city council's ability and willingness to set rates to support SCL's financial position. Seattle has adopted modest retail rate increases for fiscal years 2014-2016, and its forecast indicates a continuation of this trend through 2020, with an annual average base rate increase of 4.4% per year. Separately, SCL's policies include pass-through of any wholesale rate increases from its Bonneville contract.

Following strong operating results from 2011-2014, unrestricted cash and investments and other available reserves in the rate-stabilization account as of fiscal year-end 2014 totaled $242 million, or what we consider a sound 141 days of expenditures. However, in fiscal 2015 mild weather was a factor in a budget variance of about$30 million in SCL's retail sales, and market conditions also contributed to a similar gap in wholesale revenues, which will cause a drawdown of the balance of the rate stabilization fund. An automatic surcharge is projected by management to be triggered in 2016 to restore the rate stabilization fund. Management currently forecasts the surcharge to remain in effect into 2018, and that the fund's balance will reach $100 million by then. We believe debt leverage is high but stable, and expect it to remain around management's target of 60%-61% through 2018. However, capital requirements are what we view as high, at about $2.37 billion for 2016-2021, of which the system will fund $1.4 billion with debt. No specific project dominates, although distribution related projects are the largest category. A city resolution specifies that capital funding contain not less than 40% from operations, which we expect will result in debt leverage consistent with Seattle's target. Besides the 2015 SIFMA Index bonds, SCL has no floating-rate debt exposure. However, we believe the $100 million par of floating rate notes is matched with at least that amount of cash and investments on hand, which hedges SCL's floating-rate exposure.

Management projects consistently strong coverage at slightly above recent levels. Given the CIP's debt plans, ongoing financial performance will influence the extent to which SCL is able to generate sufficient net income to support its capital program and incorporate rate increases according to plan. The increased rates will support coverage levels that are consistent with ratings in the 'AA' category.

Related Criteria And Research

Related Criteria

- USPF Criteria: Electric And Gas Utility Ratings, Dec. 16, 2014
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- U.S. State And Local Government Credit Conditions Forecast, Oct. 20, 2015
- U.S. Public Power 2015 Outlook: Despite Several Looming Issues, Credit Quality Should Remain Stable, Jan. 9, 2015

Ratings Detail (As Of December 22, 2015)		
Seattle mun lt & pwr (BHAC) (SEC MKT)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.