MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns Aa1 rating and stable outlook to City of Seattle Drainage and Wastewater (WA) revenue bonds

Global Credit Research - 06 Jun 2014

Approximately $632.7 million of parity debt affected including current sale

SEATTLE (CITY OF) WA
Combined Water & Sewer Enterprise
N/A

Moody's Rating

ISSUE	RATING
Drainage and Wastewater Improvement and Refunding Revenue Bonds, 2014	Aa1

Sale Amount	$140,475,000
Expected Sale Date	06/11/14
Rating Description	Revenue: Government Enterprise

Moody's Outlook

Opinion

NEW YORK, June 06, 2014 --Moody's Investors Service has assigned an Aa1 rating and stable outlook to the City of Seattle's Drainage and Wastewater Improvement and Refunding Revenue Bonds, 2014 in the amount of approximately $140.5 million. At the same time, Moody's affirms the Aa1 rating on the city's $525.3 million of parity senior lien obligations. The outlook is stable. The bonds are secured by combined net revenues of the city's drainage and wastewater utility and any utility improvement district assessments (ULID assessments). Proceeds will be used for the utility's capital improvement program and to refund portions of the city's Series 2004 and 2006 parity obligations.

SUMMARY RATINGS RATIONALE

The Aa1 rating primarily reflects the utility's strong service area, which covers the City of Seattle (UTGO bonds rated Aaa/stable), and its well-maintained financial operations which benefit from active city management oversight. Also important to the rating assignment is the utility's sound debt service coverage, consistently above the internal target policy of 1.80 times.

The stable rating outlook is based on Moody's expectation that the city will continue to raise utility rates as necessary to maintain sound coverage levels in light of ongoing borrowing activity and increasing treatment costs.

STRENGTHS

-Stable, established customer base and service area

-Strong management with proven commitment to rate increases; access to sizable city-wide cash pool for liquidity

-Solid coverage levels maintained above internal target of 1.80 times

CHALLENGES

-High debt ratio relative to peers

-Additional borrowing plans related to combined sewer overflow (CSO) projects

DETAILED CREDIT DISCUSSION

UTILITY BENEFITS FROM MATURE AND STABLE SERVICE AREA

The combined wastewater and drainage system serves the City of Seattle (Aaa/STA). and the city's population growth has recently accelerated. Water demand, however, has been decreasing as a result a greater focus being placed on conservation by Seattle and its wholesale customers. Improving regional economic conditions contributed to an increase in 2012 consumption, and slower rate of decline of 0.7% per year for projected average consumption through 2020. Despite wastewater volumes declining by an average of 1.0% per year from 2002-2013 due to ongoing programmatic water conservation, utility managers have been proactive in appropriately reviewing rates and increasing as necessary. Monthly residential wastewater bills are still in line with other large cities in the area, although drainage bills are slightly elevated relative to peers. This is somewhat mitigated by the strong wealth measures of the city's residents with 2010 estimated median family income of $87,987, or 139.7% of the U.S.

The service area is comprised of the City of Seattle, the commercial and tourist hub of the Puget Sound region, and the county seat for King County (UTGO rated Aaa/stable). The software development and aerospace industries are key components of the diverse regional economy. Seattle's economy has passed the worst of the recession as a construction boom which began in multifamily housing has now spread into the commercial sector as well. With employment at 95,000 in the region, Boeing continues to lead the aerospace industry as the area's largest employer. A recent ten-year agreement with machinists securing jobs in the area enhances economic stability in the region. Development in the South Lake Union area has been spurred by Amazon's 3.3 million sq. foot expansion project and aggressive hiring. Global trade has begun flowing again due to sustained Asian demand, mostly for transportation equipment and agricultural goods. The city's lower exposure to euro zone export markets compared with the U.S. continues to be a key strength for the city. The city's continued growth, development, and in-migration is a strong benefit for the utility.

STRONG FINANCIAL PERFORMANCE CONTINUES AS ACTIVE MANAGEMENT REVIEWS RATES AND CONSERTAVELY BUDGETS OPERATIONS OF THE UTILITY

Moody's expects the utility to continue to outperform its conservative budget, and adhere to its strong fiscal policies including an internal debt service coverage target of 1.80 times. As of 2013 the utility's senior lien debt service coverage was the highest it had been in recent years at 2.92 times, in line with rated peers. Net income continues to grow year over year, as a result of management's conservative budgeting practices and implementing rate increases as appropriate to keep in line with the capital needs of the system. Year-end liquidity was also sound at $75.1 million, with net working capital representing 36.2% of O&M. Additional liquidity is also available through the city-wide investment pool totalling $1.4 billion. Based on 2013 results, maximum annual debt service coverage in 2017 ($47.7 million) is also strong at 2.51 times. Projected results for 2014 are conservative and reflect flat operating revenues relative to 2013 with coverage levels dropping slightly to 2.73 times; these projections reflect adopted rate increases of 0.9% for wastewater and 10.3% for drainage. The city has also adopted similar rate increases for 2015. These rate increases do not include a projected rate increase from the King County wastewater treatment facility. Historically, these rate increases have been passed through to utility ratepayers. The city's proven willingness to raise rates and adhere to its strong fiscal policies are key strengths of the utility.

The wastewater system currently serves a population of over 627,000, primarily within the city limits, with a total of 173,000 accounts in a developed urban area. Commercial accounts represent the majority of the utility's revenues, at approximately 64%; while residential accounts generated approximately 36% of total wastewater revenues in 2013. The drainage system serves approximately 213,000 accounts in a developed urban area, and has experienced limited customer growth in recent years; residential customers comprise 69% of total customers. In 2013 the ten largest customers accounted for only 7.8% of wastewater revenues, and 19.7% of drainage revenues; these included the City of Seattle, the Port of Seattle, King County, Seattle Public Schools, and the University of Washington.

King County (senior lien sewer revenue bonds rated Aa2) is responsible for sewage treatment and disposal and has entered into long-term contracts with local sewage agencies, including the City of Seattle, which remain responsible for their own local collection and transmission lines. The City's current agreement with the County expires July 1, 2036 and negotiations for a renewal or extension are currently underway. The County recently completed a new 36 MGD treatment and reclaimed water plant ("Brightwater") and associated conveyance system at an approximate cost of $1.8 billion, along with other projects including conveyance systems expanding the capacity of the South Treatment Plant, constructing 21 CSO projects, and controlling inflow and infiltration. The County finances the capital and operating costs of its sewage treatment and disposal system, with a wholesale charge to the City and other component agencies that is established by the County Council pursuant to the current agreement. Currently, the City's share of these costs is approximately 40%, and the utility passes the wholesale charge on to ratepayers. As a result of being a collection-only system and the contract with King County, the utility's operating ratio remains high relative to peers at 72.0% as the treatment cost is considered an O&M expense.

SIGNIFICANT BUT MANAGEABLE DEBT BURDEN WITH NEAR-TERM DEBT ISSUANCE; WELL-DEVELOPED CAPITAL PLAN FOCUSES ON LONG-TERM CAPITAL NEEDS

The utility is entering another period of high capital spending peaking in 2016, largely focused on combined sewer overflows (CSO), flooding, and sewer pipe rehabilitation. The adopted 2014-2019 CIP is approximately $87.8 million larger than the adopted 2013-2018 CIP, and totals approximately $612.9 million. The next debt issuance is planned for 2016, and debt totaling $300.1 million is anticipated to be issued in the 2016-2019 timeframe.

The plan is projected to be 75% funded from bond proceeds, which is consistent with the city's internal policy of 25% cash financing. Accordingly, the utility's debt level is expected to remain above-average but is unlikely to exceed the adopted 70% debt ratio policy; the city's debt ratio in 2013 is 56% of assets. The bonds are secured by a senior lien pledge of net revenues of the city's wastewater and drainage system. The rate covenant is equal to 1.25 times annual debt service (including adjustments for rate stabilization draws and deposits). The additional bonds test is also 1.25 times. The debt service reserve fund requirement is equal to the lesser of maximum annual debt service or 125 percent of average annual debt service and the incremental increase in this requirement will be funded with bond proceeds. Proceeds from the Improvement bonds will total approximately $113.0 million and will be used toward the utility's capital improvement program. Proceeds from the Refunding bonds will total approximately $40.1 million and will be used to refund a portion of the system's Revenue Bonds, Series 2004 and Series 2006.

In 2013, a consent decree was entered into between the Department of Justice and the City, on behalf of EPA and DOE, related to the City's CSO reduction program and management of its wastewater system. The consent decree supports the agreed order completion dates, but requires additional programmatic enhancements such as a Long-Term Control Plan (LTCP). It also requires the City to develop an LTCP Post-Construction Monitoring Plan by May 30, 2015 and complete construction of all CSO Control Measures by December 31, 2025. This decree also allows the City to submit an Integrated Plan that proposes storm water control projects that would result in significant benefits to water quality beyond the CSO Control Measures. If approved, the Integrated Plan could defer some CSO Control Measures beyond the 2025 compliance date. Utility managers do not anticipate any significant challenges with meeting the requirements of the decree.

WHAT COULD MOVE THE RATING - UP

-Trend of extraordinary growth in operating revenue sources resulting in sustained healthy debt service coverage

-Significant increase in liquidity and reserves

WHAT COULD MOVE THE RATING -- DOWN

-Deterioration in pledged revenues and coverage

-Significant draw on available cash reserves

-Substantial increase in already high debt levels

KEY STATISTICS:

Service area population, 2013: 626,600

2010 median family income: $87,987 (139.7% of state)

Drainage customer accounts, 2013: 213,000

Fiscal 2013 Ratios

Operating ratio: 72.0%

Annual senior lien debt service coverage (2013): 2.92 times

Maximum annual debt service coverage: 2.51 times

Net working capital as a % of O&M expenditures: 36.2%

Debt ratio: 56%

The principal methodology used in this rating was Analytical Framework For Water And Sewer System Ratings published in August 1999. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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