

RatingsDirect®

Summary:

Seattle, Washington; Water/Sewer

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Summary:

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Credit Profile

US\$114.305 mil drainage and wastewtr sys imp and rfdg rev bnds ser 2021 due 09/01/2051		
<i>Long Term Rating</i>	AA+/Stable	New
Seattle drainage & wastewtr		
<i>Long Term Rating</i>	AA+/Stable	Outlook Revised
Seattle drainage & wastewtr (AGM)		
<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Outlook Revised

Many issues are enhanced by bond insurance.

Rating Action

S&P Global Ratings revised its outlook to stable from negative and affirmed its 'AA+' rating on Seattle, Wash.'s existing drainage and wastewater system parity debt. At the same time, S&P Global Ratings assigned its 'AA+' long-term rating to the city's series 2021 drainage and wastewater system improvement and refunding revenue bonds.

The revised outlook reflects our assessment of Seattle Public Utilities' (SPU) proposed six-year rate plan, which we believe sets a credible trajectory for the drainage and wastewater system's future financial performance, which we expect will remain at levels we consider consistent with the current rating. The pandemic has had a relatively modest effect on utility operating margins to date. With many jobs able to happen remotely and the city's largest employer, Amazon, surging on robust demand for online retail and cloud computing services, we think a significant portion of the city's economic life has adapted to the pandemic with minimal disruption.

Proceeds will be used to fund \$108 million of upcoming drainage and wastewater system capital needs and refund all or a portion of the series 2009B bonds for debt service savings. At year-end 2020, the system had \$934 million of drainage and wastewater debt (including authorized but not yet drawn borrowing under an \$192.2 million Water Infrastructure Finance and Innovation Act (WIFIA) loan) and \$56.1 million in subordinate state loans outstanding.

The series 2021 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.

Credit overview

The ratings reflects our assessment of the drainage and wastewater system's recent and projected all-in coverage, its healthy unrestricted cash and investments, and overall economic considerations of the customer base. Credit risks center on the drainage and wastewater system's sizable \$1.3 billion six-year capital improvement program (which will be approximately 60% debt funded) with current projections indicating annual capital spending is expected to roughly

double from historical levels over the upcoming five-year period. The city's wastewater treatment provider, King County, also has an additional \$1.6 billion in capital expenditures planned through 2024, a portion of which will be passed through to the city.

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). City ordinance 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.

The rating further reflects:

- The underlying economic strength, diversity, and wealth of the customer base. The city of Seattle (population: 761,100) 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) at over 142% of the national level in 2020. While the population served has grown by 41% over the past 25 years, per capita demand has been flat to declining due to conservation and is projected to decrease modestly annually, consistent with sales declines experienced in Portland and other large wastewater systems at this rating level;
- The annual unemployment rate in the service area stood at 6.9% for calendar year 2020, below the state rate of 7.6% and the national rate of 8.1%, respectively. However, the unemployment trend was down by the start of fiscal 2021 and the unemployment rate in the service region was 4.6% in February 2021;
- 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 5.8% per annum and drainage rate increases 8.7% per annum through 2026 to fund the upcoming capital improvement plan (CIP);
- The city's annualized residential drainage and wastewater bill we consider elevated on a nominal basis relative to those of its peers in the Pacific Northwest (averaging about \$122 per month) but given the high-income levels in Seattle, the system's rates we believe are more affordable at about 2.0% of MHHEBI. To address affordability risks, the city offers a rate program that provides a 50% discount to income-qualifying households, with an enrollment of about 30,000 households;
- Adequate projected financial metrics. The drainage and wastewater system's historical financial performance has been relatively stable as regular rate increases have offset rising operating and maintenance costs over this period. Even so, in our view, the system's financial metrics are below average compared to that of similarly rated wastewater enterprises, when considering the system's fixed obligations to King County as well as the tax payments made to the city of Seattle.
- In fiscal 2020, the drainage and wastewater system produced \$460.3 million of revenues, of which the wastewater enterprise generated \$299.1 million, or 65%, while the drainage enterprise produced the \$155.0 million, or 34%, with the remainder from other sources, 2%. We consider the drainage fund to have more stable revenue, as service charges are collected on the property tax roll, while wastewater charges are billed bimonthly and are volumetric in nature, thus could decline with a reduction in usage.
- Based on management's forecast, which we consider reasonable, we anticipate that our calculation of all-in coverage will remain at levels that we consider sound through fiscal 2025 (above 1.25x) Our calculation of all-in debt service coverage (DSC) takes into account Seattle's imputed debt resulting from the city's participation in the county's regional wastewater treatment system, and also views the payment of taxes (\$61.0 million in fiscal 2020) to the city as an additional fixed cost. The city currently levies a tax on gross drainage and wastewater charges of

11.5% and 12.0%, respectively, which under the city charter are paid only after debt service is covered;

- Extremely strong liquidity, with over \$218 million (or 231 days' cash on hand) available as of Dec. 31, 2020. We expect SPU to deploy a portion of its cash reserves to fund a portion of the upcoming CIP over the next several years. We believe SPU's robust liquidity position is critical to the current rating level and a material drawdown in cash would likely pressure the rating downwards. While unexpected, increased transfers (which would violate the Washington State Accountability Act) to the general fund would weaken the system's credit rating, potentially by one or more notches; and
- High leverage with a 72% debt-to-capitalization as of Dec. 31, 2020; and a very large (\$1.3 billion) regulatory driven CIP through 2026 that requires significant additional debt that will result in escalating debt service requirements. SPU employees participate in the Seattle City Employees Retirement System (SCERS). The plan's funded ratio is below average (as a percentage of expenditures) but is expected to be manageable over the near-term for SPU.

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

Environmental, social, and governance

We think Seattle's direct environmental risks are substantial, 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 capital plan, which we expect will pressure rates, which are already relatively high compared to its peer utilities. In our view, the service area's above-average income levels partially mitigate this risk. The city saw prolonged and often violent interactions between law enforcement officers and protestors in 2020 relating to the role of police in communities across the U.S., and not specifically to local drainage or wastewater. However, in our view there is the potential that local leaders have outsize sensitivities to their constituency when making any important decision in the next few years, such as consideration of future rate adjustments and the affordability of user rates and charges. Finally, we view the utility's governance factors as credit supportive as they include full rate-setting autonomy; strong policies and planning; and robust interaction between management and the city council.

Stable Two-Year Outlook

Downside scenario

We could take a negative rating action if liquidity is unexpectedly and substantially drawn down, or project delays result in significantly more leverage than required to complete the CIP. Further, if the city changes its pension funding methodology resulting in an erosion in SPU's operating margins, or if liquidity were impaired by a related government, we could lower the rating.

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

About two-thirds of the city system is a combined or partly combined storm water and wastewater system. This type of system leads to heavy flows and potential system overflows during wet weather events. A significant portion of the drainage and wastewater system's capital plan, 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 overflows (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 (King County owns the other two), per a joint agreement, SPU will be responsible for 65% of the project costs and King County will be responsible 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.

Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

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