

RatingsDirect®

Summary:

Seattle; Water/Sewer

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Table Of Contents

Rating Action

Stable Two-Year Outlook

Credit Opinion

Related Research

Summary:

Seattle; Water/Sewer

Credit Profile

US\$84.63 mil wtr sys imp and rfdg rev bnds ser 2021 due 08/01/2051

<i>Long Term Rating</i>	AA+/Stable	New
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Seattle wtr

<i>Long Term Rating</i>	AA+/Stable	Affirmed
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Seattle wtr (BHAC) (SEC MKT)

<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Affirmed
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Many issues are enhanced by bond insurance.

Rating Action

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

Proceeds will be used to fund \$79 million of the water system's upcoming capital needs and to refund all or a portion of the series 2010B bonds for debt service savings. At year-end 2020, the system had \$728.5 million of parity water system bonds outstanding as well as \$24.8 million of subordinate state loans.

The bonds are secured by a pledge of net revenues of the city's water system. A rate covenant requires the system to generate debt service coverage of 1.25x, though withdrawals from a rate stabilization fund can be included in this calculation. Additionally, securing all parity bonds is a reserve, funded at \$75.1 million, with about 72% of this requirement funded with surety bonds.

Credit overview

The rating reflects our assessment of Seattle Public Utilities' (SPU) proposed six-year rate plan, which we believe sets a credible trajectory for the water system's future financial performance, our assessment of the water system's recent and projected all-in coverage, its healthy unrestricted cash and investments, and the overall economic considerations of the customer base. 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.

While the size and scope of the upcoming capital improvement program (CIP) in our view is somewhat favorable relative to those of its peers at the current rating level, the system's upcoming six-year CIP is primarily debt-funded (78%) which we consider a potential credit stressor. While leverage increases, management does not expect financial margins to deteriorate. Moreover, SPU's current projections only indicate a \$10 million increase in annual debt service through 2026, based on the amount of debt amortized or defeased over this period. Although the water system has an

abundant water supply (the city's projections indicate that it has sufficient water resources through 2060), we recognize that climate risks resulting in extreme weather events, sea-level rise, and drought could also pressure system operations over time. Pacific Northwest winters are projected to become warmer and wetter, and summers warmer and drier. That means more rain than snow falling on the Cascade Mountains and eventually more prolonged periods of drought; at the same time, recent years have presented some of the wettest winters on record, which could add costs related to flooding or mudslides.

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, which supports future rate affordability, given the projected rate increases. While the population served has grown by 41% over the past 25 years, demand has been flat as per capital consumption has decreased rapidly and is projected to continue declining with increased density and continued conservation, consistent with consumption declines experienced in other large water systems;
- Improving economic indicators. The unemployment rate in February 2021 was down to 4.6%. The service area's annual unemployment rate stood at 6.9% for calendar year 2020, below the state's 7.6% rate and the nation's 8.1% rate, respectively. ;
- City council's demonstrated ability and willingness to increase service rates, with multiyear rate schedules that we believe promote cost recovery and revenue stability. Management has 3.4% annual water rate increases planned through 2026 to offset rising costs of service;
- The city's annualized residential water bill we consider comparable to those of its peers in the Pacific Northwest (averaging about \$45.69 per month or less than 1% of MHHEBI). However, SPU bills its retail customers for water, sewer, and solid waste services on a combined bill; in aggregate we consider SPU's bill to be somewhat elevated but somewhat offset by the high-income levels in Seattle. 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;
- Sound projected financial metrics. The water system's historical all-in coverage has exceeded 1.5x over the past three years and is projected to remain consistently strong through 2022 then decline to about 1.3x thereafter based on management's forecast, which we consider reasonable. Our calculation of all-in debt service coverage (DSC) considers the payment of taxes (\$46.0 million in fiscal 2020) to the city as an additional fixed cost. The city currently levies a 15.5% tax on gross water charges, which under the city charter are paid only after debt service is covered;
- Extremely strong liquidity, with over \$149.7 million (or 323 days' cash on hand) available as of Dec. 31, 2020. We expect SPU to deploy a portion of its cash reserves to defease existing debt later this year, but not draw cash down to less than \$120 million (including both its operating fund and rate stabilization reserve), which we consider a key credit strength. 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 several notches;
- Moderate leverage with a 57.8% debt-to-capitalization as of Dec. 31, 2020; the CIP is primarily focused on renewal and replacements to existing infrastructure through 2026 and is anticipated to result in modestly 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; and

- Adequate financial policies. Water rates are set to achieve "generally positive" net income, cash balances equal to 30 days' of operating expenses, 20% of capital expenditures financed with current revenue, and a minimum debt service coverage ratio on parity bonds of 1.7x annual debt service (the city's calculation excludes the utility tax).

The stable outlook reflects our anticipation that the underlying economic strengths that benefit SPU should continue to produce financial metrics consistent with the current rating level. Even with the additional planned debt over the next five years layered in, the system's financial capacity should not diminish to the point that metrics would become inconsistent with the current rating.

Environmental, social, and governance

Our rating action incorporates our view of the health and safety risks from the COVID-19 pandemic. Absent the implications of COVID-19, we consider the utility's social risks to be in line with those of the sector. The system's affordable rates mitigate any increased social risks but should rates increase faster than wealth and income levels for the area, social risks for affordability could rise. We consider the environmental risk slightly higher, given that the city lies adjacent to Puget Sound and is exposed to storm-surges and other extreme events related to sea-level rise. Drought management planning is robust (the city also has multiple water conservation programs to encourage water efficiency as well as aggressive leak detection procedures, which we also view favorably) and management has generally succeeded in executing its 10-year strategic plans. Finally, we view the system'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

Upside scenario

A higher rating would be predicated mainly on an improved financial risk profile, specifically driven by our all-in DSC metric as well as demonstrated management acumen and financial transparency commensurate with its 'AAA' rated peers.

Downside scenario

We do not anticipate lowering the rating during the two-year outlook horizon as long as management produces financial metrics that are consistent with or exceed historical trends while successfully funding the upcoming CIP. However, any unexpected economic or financial shocks, which could potentially significantly disrupt the system's operations, or any unanticipated and extraordinarily large change in the CIP that could alter related financial metrics, could present downward pressure on the rating or outlook at any time.

Credit Opinion

The water system serves a population of about 1.5 million, providing retail service to customers in Seattle and water on a wholesale basis to 21 suburban water districts and municipalities plus the Cascade Water Alliance. Although over 50% of water is sold on a wholesale basis, only about 22% of system revenue come from this customer class, which may slightly understate coverage. The top two wholesale customers by revenue are Cascade (AAA/Stable; 7.9% of

total operating revenue) and Northshore Utility District (2.0% of total operating revenue.) Most of the wholesale customers have entered into long-term agreements with Seattle through at least January 2062, requiring the city to meet the customers' water demands not met by local sources. Seattle's contract with its largest customer, Cascade Water Alliance, requires Seattle to provide 33.3 mgd annually through 2039, and thereafter at a declining annual volume. We understand the system is primarily addressing its aging distribution system infrastructure in its upcoming CIP. Management has a formal asset management program that addresses the long-term sustainability of its infrastructure and facilities.

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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