

# RatingsDirect®

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## Summary:

# Spokane, Washington; Water/Sewer

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## Summary:

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### Credit Profile

US\$200.0 mil wtr and wastewtr rev bnds ser 2014 dtd 11/19/2014 due 12/01/2034

*Long Term Rating*

AA/Stable

New

## Rationale

Standard & Poor's Ratings Services assigned its 'AA' long-term rating to Spokane, Wash.'s series 2014 water and wastewater system revenue bonds. The outlook is stable.

The bonds are being issued for the city's water, wastewater, and stormwater system. The rating is based on our view of the system's:

- Very diverse customer base anchoring a regional economy;
- Past rate increases, which have led to historic net revenues that provide strong debt service coverage on future maximum annual debt service (MADS) after this issue; and
- Strong liquidity position, with the fund ending 2013 with more than 400 days of operating expenses on hand.

These strengths are partly offset by our view of the system's very large capital needs, a portion of which are driven by increasing environmental regulations. The capital needs will lead to a large increase in the system's debt level and higher annual debt service.

The bonds will provide \$200 million in proceeds for water, sewer, and stormwater system capital projects. A large portion of the proceeds will be used for the city's Integrated Clean Water Plan (ICWP) -- a series of projects aimed at improving the water quality of the Spokane River.

The bonds are secured by a pledge of net revenues of the water, wastewater, and stormwater system. The operating expenses in the net revenues calculation exclude taxes paid to the city. The system pays a tax of 20% of gross revenues to the city's general fund. The tax payments are subordinate to debt service. A reserve fund will not be funded at closing. However, the city is required to fund a reserve in the future if debt service coverage falls below 1.5x. In this case, the reserve must be funded over three years at a requirement of the lesser of 10% of principal amount, MADS, and 125% of average annual debt service. A rate covenant requires the system to generate debt service coverage of at least 1.25x, with rate stabilization fund withdrawals included in net revenues. Additional bonds can be issued if the city certifies that historic net revenues plus certain allowances for projections provide at least 1.25x debt service coverage. The city currently has no senior lien water and sewer revenue bonds outstanding, though it does have \$16.3 million in outstanding subordinate-lien state loans.

Spokane is the second-largest city in Washington, after Seattle, and has a population of about 212,000. The city serves as a market center for an approximately 1.7 million-person area stretching into western Montana, northeast Oregon, and southern British Columbia. The city's median household effective buying income is adequate, in our view, at 86%

of the national median.

The water system provides service to about 74,000 accounts within the city and certain incorporated and unincorporated areas outside the city. The system serves almost all customers within the city boundaries, with about 6% of its customer base located outside the city. Water supply comes from groundwater pumped from a large underlying aquifer. The city has more than adequate water supply, with groundwater rights that are almost twice the current level of demand.

The wastewater system provides service to about 71,000 customers within the city. Wastewater is treated at the city's 75 million gallons per day (mgd) treatment plant, known as the Riverside Park Water Reclamation Facility. Spokane County has rights to 10 mgd of treatment capacity at the plant and pays 10/44th of its ongoing capital costs. Treated effluent is discharged to the Spokane River. According to the city, the plant has ample hydraulic capacity for current demand, with an average daily flow of 34 mgd. About half of the collection system is a combined system, with both wastewater and stormwater sharing the same pipes. Because of this, during some storm events the system is unable to fully treat all flows, leading to overflows to the Spokane River (known as combined sewer overflows (CSOs)). Under its discharge permit, the city is required to reduce CSOs substantially by 2017 and add tertiary treatment to its plant by 2021. A large part of the system's capital improvement program is aimed at reducing CSOs and adding the tertiary treatment.

Stormwater within the city is collected through the combined system in half of the city and through separated stormwater facilities in other areas. Part of the city's capital plan includes projects that reduce stormwater runoff to the Spokane River.

The city has raised rates annually in recent years, and management expects to implement inflationary-based increases going forward. Water, wastewater, and stormwater rates are collected on a combined bill. Currently, a customer using 1,000 cubic feet of water would pay \$75.21 per month for all services. Recent water rate increases have been modest -- between 2.9% and 4.5% during the past six years. Wastewater and stormwater rates have seen considerably higher increases, including 15% in 2010, 15% in 2011, and 13.7% in 2012. The increases were adopted in anticipation of the capital needs for the system. Going forward, the city anticipates it will increase rates by about 2.9% annually. We view the largely residential customer base as diverse, with the top 10 customers representing less than 4% of total operating revenue in 2013.

The system has historically had a low debt burden, leading to very high past debt service coverage. Financing for the capital improvement program will lead to lower coverage, although coverage will likely remain strong in our view. In 2013, operating revenues totaled \$115.3 million, up 5.2% from 2012. Operating expenses, excluding depreciation and including the 20% tax paid to the city's general fund, were down 3.2% to \$76.5 million. Net revenues, including net operating income, interest income, connection fees, capital payments from the county, and other non-operating revenue totaled \$42.8 million in 2013. State loan debt service was \$1.5 million in 2013, leading to total debt service coverage of 28.46x. Pro-forma MADS after this issuance and the planned state loan draws is \$13.6 million on the senior lien and \$17.0 million for both liens. Pro-forma MADS coverage is 3.14x on the senior lien and 2.52x on both liens, based on 2013 net revenues when including taxes in operating expenses. Excluding city taxes of \$23.4 million from operating expenses (city taxes are subordinate to debt service), MADS coverage is higher at 3.90x. The city's rate

covenant is based on a coverage calculation that excludes the subordinate tax payments.

In its financial projections, the city is forecasting strong debt service coverage during the next three years. By 2016, the city anticipates that total debt service will increase to about \$17 million, and net revenues (including the utility tax in operating expenses) will provide debt service coverage of about 2.9x. Excluding the taxes from operating expenses, projected coverage is higher at 4.35x. We view the projections as reasonable, with operating revenues increasing at an inflationary rate based on planned rate increases and operating expenses, on average, increasing at a higher rate. In our view, given the recent large wastewater increases, strong coverage can likely be maintained with modest rate increases in the intermediate term.

The system has a strong liquidity position in our view. We believe unrestricted cash could come down as the city implements its capital program but under its projections, it remains at a level we would still consider strong. As of Dec. 31, 2013 the water and wastewater fund had an unrestricted cash balance of \$84.6 million, representing 404 days of operating expenses on hand. The system has ended each of the past four years with liquidity of more than 365 days. Under the city's long-term projections, the low point in unrestricted cash is \$51 million and occurs in 2020. We would still view this level of liquidity as strong.

The majority of the system's capital program is dedicated to the Integrated Clean Water Plan, although the city has capital needs outside of this that it also plans to fund during the next five years. The city anticipates that the ICWP will cost \$311 million and will largely be completed by 2017. Between 2014 and 2018, the city anticipates spending a total of \$475 million on capital projects, including the integrated plan and other projects. The series 2014 bonds are providing \$200 million in proceeds for the capital program. The city is also planning to draw on \$50 million in subordinate lien state loans to provide additional funding. After this, the city has no plans for additional debt for the system. In its projections, the city is also planning for \$60 million in state grant revenue, although the city does not yet have a commitment for these funds. We understand that if the city is unable to get the grant, it will likely delay or forego elements of the integrated plan that are not currently required by regulation.

## Outlook

The stable outlook reflects our anticipation that past rate increases and the city's planned future inflationary-based increases will lead to strong debt service coverage and maintenance of at least good liquidity despite the system's relatively large capital needs. If the capital plan leads to coverage at a level lower than the city anticipates or if liquidity falls substantially below the current level, we could lower the rating. Given the system's high capital needs, we do not currently anticipate raising the rating during the next two years. However, if capital funding sources are fully identified and committed, including the anticipated grant revenue, and if the system maintains strong coverage and liquidity despite increasing debt levels, we could raise the rating.

## Related Criteria And Research

### **Related Criteria**

- USPF Criteria: Key Water And Sewer Utility Credit Ratio Ranges, Sept. 15, 2008
- USPF Criteria: Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011

### **Related Research**

- U.S. State And Local Government Credit Conditions Forecast, Oct. 15, 2014
- U.S. Municipal Water And Sewer Utilities 2014 Sector Outlook: Learning To Do More With Less, Jan. 9, 2014
- 2014 Review Of U.S. Municipal Water And Sewer Ratings: How They Correlate With Key Economic And Financial Ratios, May 12, 2014

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