

# RatingsDirect®

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## Summary:

# Snohomish County Public Utility District No. 1, Washington; Water/Sewer

### Primary Credit Analyst:

Tim Tung, San Francisco (1) 415-371-5041; [tim.tung@standardandpoors.com](mailto:tim.tung@standardandpoors.com)

### Secondary Contact:

Robert L Hannay, CFA, San Francisco (1) 415-371-5038; [robert.hannay@standardandpoors.com](mailto:robert.hannay@standardandpoors.com)

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## Summary:

# Snohomish County Public Utility District No. 1, Washington; Water/Sewer

### Credit Profile

Snohomish Cnty Pub Util Dist #1 (Wtr)

*Long Term Rating*

AA/Stable

Affirmed

**Snohomish Cnty Pub Util Dist #1 wtr**

*Unenhanced Rating*

AA(SPUR)/Stable

Affirmed

Many issues are enhanced by bond insurance.

## Rationale

Standard & Poor's Ratings Services affirmed its 'AA' long-term rating and underlying rating (SPUR) on Snohomish County Public Utility District No. 1, Wash.'s water system revenue bonds. The outlook on all ratings is stable.

The rating reflects our view of the water system's:

- Strong service area economy that fully participates in the Seattle metropolitan area economy;
- Primarily residential and very diverse customer base that we anticipate will remain stable going forward;
- Affordable rates in the context of the service area's very strong incomes;
- Manageable capital improvement program (CIP) that does not require any additional borrowing; and
- Strong financial performance that we believe is sustainable.

Partly offsetting these credit strengths, in our view, are the water system's reliance on the city of Everett for wholesale water supply and its corresponding exposure to wholesale rate increases.

We view the bond provisions as adequate. The bonds are secured by the net revenues of the district's water system. Covenants include a rate covenant and an additional bonds test both set at 1.25x annual debt service. A standard cash-funded reserve provides additional liquidity.

The district is located in Snohomish County, and the water system's service area is primarily located in the Lake Stevens area about 35 miles north of Seattle. During the past five years, the county's population grew at an average annual rate of 1.7% to approximately 746,000 in 2013, and the district estimates that about 50,000 are served by its water system. The service area has a strong local economy, and residents have access to employment opportunities in the Seattle metropolitan area as well as in Everett, home to Naval Station Everett and Boeing's assembly plant for a variety of wide-body aircraft, including the 787 Dreamliner. Snohomish County's unemployment rate declined during the past three years in concert with the improving local economy, and most recently stood at 4.5% (preliminary, not seasonally adjusted) in December 2014. We consider the service area's income levels to be very strong based on the county's median household effective buying income (EBI), which was 131% of the national median for 2013.

The customer base is primarily residential and very diverse, and we anticipate that it will remain stable following the transfer of about 10% of the customer base to another public agency. The district reports that the service area is largely residential with a limited number of commercial customers. We consider the customer base to be very diverse based on the leading 10 customers contributing about 6.1% of total operating revenues in 2013. During the past five years, the customer base has generally grown at an average annual rate of about 2%; however, pursuant to an agreement with the city of Marysville, the district transferred about 2,100 customers to the city at the end of 2013. The customer count is currently about 19,200, and the district does not anticipate any further customer transfers going forward.

The water system has access to an ample water supply from Everett, and the district completed a water supply project in 2012 to begin diversifying its sources of supply. The district has a long-term agreement to purchase water from Everett although the district is not contractually obligated to pay any surcharges or other fixed charges to Everett. We understand that Everett recently completed a water supply plan, which indicated that its ample water resources could support long-term regional growth. Historically, the district purchased more than 90% of its water supply from Everett, but in 2012 the district completed its Lake Stevens water treatment and filtration facility. The district has been gradually increasing production from this facility -- producing about 13% and 20% of the system's total supply in 2013 and 2014, respectively -- and management anticipates that this facility could provide up to 25% of the system's total supply. Average daily demand has been about four million gallons per day (mgd) with peak day demand of about 10 mgd. Management reports that there have not been any material service interruptions during the past three years.

The district's water rates are affordable in the context of the service area's very strong incomes. The rate structure is composed of a monthly customer charge and a commodity charge per 100 cubic feet of water usage. Based on our benchmark usage of 1,000 cubic feet, we calculate a monthly residential bill of \$54.74, which we consider affordable at 1.2% of median household EBI when annualized. The district raised service rates by 13% annually from 2009 through 2012 and more recently raised rates by about 4.3% annually during the past three years. We understand that an additional 4.3% rate increase has already been approved for 2016, and we anticipate that future rate increases will be necessary to continue passing through wholesale rate increases from Everett to the customer base. Management reports that there have not been any material payment delinquencies by the customer base.

The CIP is manageable and does not require any additional borrowing during the next five years. Capital spending through 2019 totals about \$17.9 million, the majority of which (\$12.2 million) is focused on pipeline projects as the district is currently in the eighth year of a 20-year main replacement program. These projects are anticipated to be funded on a pay-as-you-go basis from service charge revenues, cash reserves, and developer fees. Beyond the five-year horizon, the district may consider implementing an automated meter reading system, which could cost about \$8 million.

Financial performance has been strong, and we anticipate that this level of performance will be sustainable. Based on the district's audited financial statements and preliminary estimates for 2014, we calculate that during the past five years senior-lien debt service coverage (DSC) ranged from 1.6x in 2011 to 2.6x in 2012, and the preliminary unaudited estimates indicate that DSC will be in the lower half of this range for 2014. Financial performance peaked in 2012 due to a one-time land sale to the district's power system, but senior-lien DSC would have remained strong at 2.3x even

without taking into consideration this transaction. The water system was historically somewhat reliant on developer fee revenue to generate strong metrics, but this has diminished following the double-digit rate increases from 2009 through 2012. When excluding one-time developer fees, senior-lien DSC has improved to about 1.6x in 2013 and 2014 from just 1.1x, which we consider adequate, in 2010. Financial performance during this period was primarily driven by growing operating revenues from implemented rate increases that were partly offset by rising operations expense as a capital intensive period tapered and a greater proportion of staff time was expensed rather than capitalized and new facilities became operational.

The water system's liquidity position has historically been strong and was significantly boosted by a one-time payment from Marysville. During the past five years, unrestricted liquidity ranged from \$6.4 million in 2011, equivalent to 381 days of operating expenses, to \$12.2 million, or 653 days, in 2013. The district reports an unaudited balance of \$11.6 million, or 605 days, at the end of 2014. Liquidity improved at the end of 2013 primarily due to a \$4.6 million payment from Marysville for water system facilities related to the customer transfer. Management intends to gradually draw down this elevated level of liquidity to pay for capital projects during the next five years, but we anticipate that it will remain strong at the conclusion of the drawdown period.

## **Outlook**

The stable outlook reflects our view of the water system's primarily residential customer base coupled with ample supply capacity and affordable service rates that provide management with revenue-raising flexibility. During the two-year outlook period, we anticipate the district will implement the approved rate increase for 2016 and conduct a cost-of-service study to form the basis for future rate increases -- in particular to pass through wholesale rate increases from Everett to the customer base. We could take a positive rating action if the system is able to further diversify its water supply portfolio and reduce its reliance on Everett, and if the system materially outperforms its financial forecast. Conversely, we could take a negative rating action if the water system materially underperforms its financial forecast or if liquidity is drawn down to a level no longer commensurate with 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, Dec. 10, 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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