S&P Global Ratings

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Summary:

Alderwood Water & Wastewater District, Washington; Water/Sewer

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Credit Profile		
US$51.94 mil wtr and swr rev and rfdg bnds ser 2020A due 12/01/2029		
Long Term Rating	AA+/Stable	New
US$23.03 mil wtr and swr rev rfdg bnds ser 2020B due 12/01/2043		
Long Term Rating	AA+/Stable	New
Alderwood Wtr & Wastewtr Dist WTRSWR		
Long Term Rating	AA+/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AA+' long-term rating to Alderwood Water and Wastewater District, Wash.'s anticipated $51.9 million series 2020A water and sewer revenue and refunding bonds and its 'AA+' long-term rating to the district's $23.0 million series 2020B taxable water and sewer revenue refunding bonds. At the same time, we affirmed our 'AA+' long-term rating on the district's existing water and sewer revenue bonds. The outlook on all ratings is stable.

Bond proceeds will fund $22.0 million of capital projects and refund $68.5 million of outstanding bonds for debt service savings. As of Dec. 31, 2019, the combined utility had about $66.9 million outstanding parity obligations and $17.0 million of subordinate-lien loans.

We view the bond provisions as adequate. The bonds are secured by the net revenue of the district's water and sewer systems, and utility local improvement district assessments. The district has covenanted to set rates and charges to yield net revenues equal to at least 1.25x annual debt service.

To issue additional parity obligations, the district is required to demonstrate that net revenue will be at least 1.25x annual debt service upon issuance of the additional obligations. For the purpose of the additional bonds test, gross revenue may be adjusted to take into consideration revenue-generating system improvements to be constructed from bond proceeds, and to annualize rate increases that were in effect for less than the full test period. For the purpose of these bond provisions, gross revenue may also be increased by amounts transferred from a rate stabilization fund, and no minimum performance levels are required when excluding these transfers. We view this level of flexibility to be permissive, but not a material credit risk in the district's case, given its track record of strong financial performance. In particular, Board policy requires a minimum of 1.75x debt service coverage (DSC), which we consider credit supportive. We understand there is a springing debt service reserve fund covenant that allows its reserve funds to be released after the series 2013 bonds mature.

Credit overview

The rating reflects our opinion of the district's general creditworthiness and a combination of its extremely strong enterprise risk and very strong financial risk profiles. The district is the largest water and sewer district in Washington and serves a population of over 300,000. The service area has a strong local economy, and residents have access to employers such as Boeing, Amazon, and Microsoft. The district is compliant with all environmental regulations and has sufficient water supply and sewer system capacity to meet its long-term demand. In our opinion, strong management practices and policies, specifically a history of timely rate increases, have resulted in very strong all-in DSC--our measure that reflects off-balance sheet obligations--and a robust cash position.

Partially offsetting these credit strengths, in our view, are the district's reliance on its wholesale providers for 100% of potable water supply and 73% of wastewater treatment services, and the corresponding exposure to wholesale rate increases from these service providers. This, in our view, adversely affects the district's market position assessment and financial flexibility, given that a significant portion of its cost structure is outside of its direct control.

In our view, the primary near-term risks to the district's credit profile center on the likelihood that sufficient rate adjustments are implemented to offset wholesale costs, or, if operating margins are otherwise unexpectedly eroded due to reduced consumption stemming from conservation, weather, or economic contraction. To date, the service area has been less adversely effected by COVID-19 and the pandemic than the more densely populated urban areas in Seattle, which is typical of suburban communities across the country.

If, as S&P Global Economics projects in "The U.S. Economy Reboots, With Obstacles Ahead" (published Sept. 24, 2020, on RatingsDirect), credit conditions for all governments and their related utilities face headwinds into 2021 and beyond because of a potentially uneven recovery, the district's well-defined financial policies should help preserve the trend of very strong total financial capacity, limiting unfavorable variances to budget in the near term. Moreover, as of Dec. 31, 2019, the district had $95.5 million of total unrestricted liquidity, equivalent to 462 days' of operating expenses, which we believe is sufficient to deal with any short-term disruptions related to the COVID-19 pandemic.

The stable outlook reflects our view that even with reduced commercial consumption and a modest rise in receivables due to COVID-19, the district's current rate structure will result in continued stable and very strong financial metrics over the next two years.

Environmental, social and governance (ESG) factors

Overall, we believe that management has mitigated most of its direct ESG-related risk through compliance with all relevant environmental regulations, regular rate-setting, and well-defined operational and financial policies. Although we expect climate change and more extreme weather conditions to be an ongoing challenge for communities across Washington, we understand the district has sufficient water supplies in storage to mitigate risks related to drought and wildfire. However, we note that the district's primary sewage treatment provider, King County, faces substantial direct environmental risks, as the county is subject to deadline-certain regulatory mandates to reduce the number of sewage backups and untreated sewage overflows. The district will be responsible for a share of the county's upcoming capital costs, which in aggregate, exceed $1.2 billion through 2026. Rising wholesale costs also contribute to elevated social risk and affordability pressure. In our view, the service area's above-average income levels partly mitigate affordability pressures.

According to discussions with management, the district is taking precautions to minimize the spread and impact of the virus on staff and the community. Nevertheless, we believe the district faces social risk related to COVID-19, as efforts to protect the health and safety of the community may affect the system's financial metrics. The management team is tenured and experienced and maintains above-average infrastructure maintenance policies which contributes to a strong governance position.

Stable Outlook

Downside scenario

We could lower the rating if the district's all-in DSC falls materially short of recent historic levels for an extended period, in the event the district is unable to maintain sufficient cost recovery. While unexpected, a sustained decline in total available reserves would also pressure the rating downward.

Upside scenario

S&P Global Economics projects credit conditions will not fully return to pre-pandemic levels until late 2021. Therefore, we do not anticipate raising the rating during our two-year outlook horizon. We would consider raising the rating if all-in coverage is sustained at an extremely strong level.

Credit Opinion

Enterprise risk

Alderwood Water and Wastewater District encompasses about 44 square miles in southwestern Snohomish County, and is about 19 miles north of downtown Seattle and immediately south of Everett. The district's retail service area includes the cities of Brier and Bothell, and portions of the cities of Mill Creek and Mukilteo. The district's more expansive wholesale service area also includes the cities of Lynnwood, Mountlake Terrace, and Edmonds. We consider the service area's income levels to be strong based on the median household effective buying income for the county at 137% of the national level in 2019. After peaking at 16.6% in April 2020, unemployment in the Seattle-Tacoma-Bellevue, WA MSA declined to 7.9% in August 2020, well above the relatively low 3.3% annualized rate in 2019.

The retail customer base is stable, primarily residential, and very diverse. At the end of 2019, the district had 55,196 retail water accounts and 42,581 retail sewer accounts, and during the past four years (fiscals 2015-2019) the number of accounts grew by an average annual rate of 2.1% and 2.8%, respectively. We consider the retail customer base to be primarily residential based on these customers accounting for more than 90% of each system's accounts. We view the retail customer base as very diverse based on the leading 10 water customers paying about 3.5% of water system total operating revenues, and the leading 10 sewer customers paying about 4.4% of sewer system total operating revenues in 2019.

In our view, the district's current and projected water and sewer service rates are moderate, at about 1.6% of MHHEBI on a combined basis. The water rate structure is composed of a bimonthly charge based on water meter size and three usage-based rate tiers. For a residential customer, we calculate a monthly-equivalent water bill of $28.98 assuming a

5/8-inch water meter and 700 cubic feet of water consumption. The sewer rate structure is composed of a bimonthly base charge and a commodity charge for water consumption in excess of 1,500 cubic feet during a bimonthly billing cycle, we calculate a monthly-equivalent sewer bill of $65.81.

In 2019, the district completed an internal rate study to identify necessary rate increases for 2020 through 2022. The rate study recommended a relatively modest 2.0% water rate increase per year for fiscals 2020 through 2022 to cover operational expense capital plans and maintain reserves. The rate study also recommended a 5.0% increase per year for fiscals 2020 and 2021 for sewer service and a 4.5% increase in fiscal 2022. Although the district's rate structure does not automatically incorporate wholesale cost increases, we understand that these sewer increases incorporate King County's near-term rate plans.

The district generally maintains strong operational management practices and policies, supported by its well-defined long-range plans, good succession planning, and multi-year rate planning.

The district has access to an ample water supply through Everett pursuant to a long-term agreement. In 2005, the district and Everett entered into a 50-year agreement under which Everett agreed to provide the district with a water supply of up to 106 million gallons per day (mgd). We understand that the district pays Everett based on actual water deliveries and that there are no take-or-pay minimums associated with the agreement. The 106 mgd of supply capacity compares very favorably to the water system's average daily demand of 26.8 mgd and peak day demand of 42.5 mgd in 2019. We understand that the district pays Everett based on actual water deliveries and that there are no take-or-pay minimums associated with the agreement.

Wastewater flows within the service area are collected and then conveyed to one of three facilities for treatment and disposal. Approximately 80% of wastewater flows are conveyed to King County's Brightwater Wastewater Treatment Plant, a facility that commenced operation in 2011. King County provides treatment services pursuant to a long-term contract that expires in 2056. We understand that the district is billed based on the number of connections for single-family customers and based on flows for all other customer types. Approximately 17% of wastewater flows are conveyed to the district's Picnic Point Wastewater Treatment Plant, which was completely rebuilt in 2012. The remaining 3% of wastewater flows are conveyed to Everett's Water Pollution Control Facility.

Consistent with "Methodology: Industry Risk," published Nov. 19, 2013, we consider industry risk for the system to be very low, the most favorable assessment possible on a six-point scale, with '1' being the best.

Financial risk

The district's financial performance has historically been very strong, and we anticipate that it will remain consistent during the forecast period. Financial performance during the past three years was largely driven by rising operating revenues as the district implemented annual rate increases, offset in part by rising operating expenses as King County and Everett increased their wholesale service rates for sewer treatment and water supply services. We note that wholesale rates are outside of the district's control and this expense category typically makes up about 63% of the district's annual operating expenses.

Based on the district's audited financial results, the district's direct DSC (across both senior and subordinate liens) has been at least 1.9x during the past three years, and most recently stood at 1.9x for 2019. Based on management's forecast, which we view as reasonable, direct DSC is projected to remain consistently strong through 2024.

Nevertheless, when incorporating fixed costs associated with imported water and wastewater treatment, we calculate all-in DSC as between 1.3x and 1.4x over the past three years. Assuming wholesale costs continue to be incorporated, we expect all-in DSC to remain consistently sound going forward. Our "all-in" DSC calculation assesses all of the district's direct debt that is paid from net revenue as well as imputed debt service for imported water from Everett and wastewater treatment services provided by King County. The district's direct debt is relatively modest, with about 17% debt-to-capitalization as of Dec. 31, 2019.

In our view, the district's liquidity position has been strong during the past three years, and we anticipate that it will remain generally strong after a portion of liquidity is spent down on planned capital projects. Based on the district's audited financial statements, we calculate that unrestricted liquidity declined to $95.5 million, or 462 days, in fiscal 2019, down from $111.3 million, or 601 days, at the end of 2017. Based on management's financial forecast, which assumes about $30 million of annual capital expenditures, we anticipate that a portion of the district's unrestricted liquidity will be spent on planned capital projects, and that unrestricted liquidity will decline to about 292 days of operating expenses by the end of the five-year forecast period, which we still consider adequate for the current rating level.

Management follows financial policies and practices that are generally transparent although some policies may be more informal and follow state guidelines. Management presents budget-to-actuals to the council quarterly and updates its long-range financial and capital plans on an ad hoc basis depending on economic scenarios and at least annually. The district's reserve policy is a key credit strength and specifies requirements for operating reserves, capital reserves, and a rate stabilization fund. The operating reserve targets are 90 days of operating expenses for the water system and 60 days of operating expenses for the sewer system. The capital reserve target for each system is set at the greater of $10 million or 2% of the system's original asset value. The rate stabilization reserve target is set at 15% of annual rate revenue for the water system and 10% of annual rate revenue for the sewer system.

Related Research

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