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Summary:

Sedro-Woolley, Washington; Water/Sewer

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Credit Profile

Sedro-Woolley swr (AGM)

Unenhanced Rating

AA-(SPUR)/Stable

Affirmed

Many issues are enhanced by bond insurance.

Rationale

Standard & Poor's Ratings Services affirmed its 'AA-' underlying rating (SPUR) on Sedro-Woolley, Wash.'s sewer revenue refunding bonds. The outlook is stable.

The rating action reflects our view of the sewer system's:

- Stable, primarily residential, and very diverse customer base;
- Ample treatment capacity and recently renewed regulatory permit;
- Manageable five-year capital improvement plan (CIP) of \$2.4 million that does not require any additional borrowing;
- Strong senior-lien debt service coverage (DSC) during the past five years, most recently at 3.14x (excluding connection fees) in fiscal year 2013; and
- Historically strong liquidity position.

Partly offsetting the above strengths, in our view, is the service area's limited local economy.

We view the bond provisions as adequate. The bonds are secured by the net revenues of the city's sewer system. Bond provisions include a rate covenant set at 1.25x annual debt service and an additional bonds test set at 1.25x maximum annual debt service. For the purpose of the additional bonds test, the city may adjust gross revenues to take into consideration adopted rate increases and new facilities under construction at the time of issuance or financed with new debt. A standard debt service reserve fund provides additional liquidity.

The system serves a population of about 10,600 located in northern Skagit County, approximately 60 miles north of Seattle. The city's local economy is somewhat limited and historically based in wood processing, but we understand that some residents engage in long-distance commuting for employment opportunities. We view the service area's income levels as good based on the city's median household effective buying income, which was 102% of the national median in 2013. The county's unemployment rate was 5.8% as of July 2014 (not seasonally adjusted), which was higher than the state's unemployment rate of 5.4%, but lower than the national unemployment rate of 6.5%. However, the county's unemployment rate experiences significant seasonality and was recently as high as 8.7% in February 2014.

The customer base is stable, primarily residential, and very diverse. During the past five years, the customer base grew at an average annual rate of just 0.3% to 4,181 in 2013 from 4,120 in 2008. Residential customers make up about 94% of the customer base and account for about 80% of system billings. We view the customer base to be very diverse

based on the leading four customers paying about 5.5% of system billings.

Treatment capacity is ample, and future capital needs are manageable. Existing facilities have a designed average daily flow of 2.1 million gallons per day (mgd) and provide 3.5 mgd of peak day treatment capacity. These levels compare favorably with 0.9 mgd average daily flow and 1.9 mgd peak day flow in 2013. Management estimates that the treatment plant has sufficient capacity to meet needs through at least 2025. The treatment plant's regulatory permit was last renewed on Nov. 27, 2013, and is set to expire on Nov. 30, 2018. Management reports that there have not been any material service interruptions during the past three years. Capital spending in recent years has focused on transmission infrastructure extensions and upgrades, including the completion of a critical sewer interceptor replacement. The five-year CIP totals \$2.4 million and focuses primarily on collection system renewal and replacement projects. Management expects to pay the majority of the CIP from surplus revenues or cash on hand; no additional borrowing is required. Management reports that the sewer system master plan will next be updated in 2016.

Sewer rates are moderately high, but affordable in the context of the service area's income levels. A residential customer pays \$55.45 per month for sewer service, following effective rate increases of 2.7% in 2013 and 1.4% in 2014. Previously, the city implemented a 9.8% rate increase in 2010 to generate additional revenue to repay subordinate-lien debt service, which also provides the senior lien with additional DSC. We understand that the city is contemplating making annual inflationary rate adjustments, or possibly restructuring rates in the future to be based on usage.

Financial performance has been good to strong during the past five years, and we expect it will remain so. From fiscal year 2009 through fiscal year 2013, the system's net revenues provided senior-lien DSC ranging from 3.24x in fiscal year 2011 to 3.67x fiscal year 2009, and total DSC ranging from 1.38x in fiscal year 2011 to 1.87x in fiscal year 2009. After excluding one-time fees associated with growth, senior-lien DSC during this period was no less than 3.01x, which we consider strong, and total DSC was no less than 1.27x, which we consider good. We expect system revenues will continue to generate similar coverage levels going forward. Available cash at the end of fiscal year 2013 stood at \$2.7 million, equivalent to 532 days of operating expenses, which we consider strong. We anticipate that cash balances will fluctuate as funds are spent on capital projects and reserves are rebuilt from surplus revenues, consistent with a pay-as-you-go capital program.

Outlook

The stable outlook reflects our view of the system's stable customer base, which is not exposed to any significant concentration, and the treatment plant's ample treatment capacity and recently renewed regulatory permit. During the two-year outlook period, we anticipate that management will continue to adjust rates to provide financial margins consistent with past performance. We could take a negative rating action if financial performance materially degrades. We do not anticipate taking a positive rating during the outlook period given the service area's somewhat limited economy.

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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