S&P Global
Ratings

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Summary:

Cascade Water Alliance, Washington; Water/Sewer

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Summary:

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Long Term Rating	AAA/Stable	Upgraded

Rationale

S&P Global Ratings raised its long-term rating to 'AAA' from 'AA+' on the Cascade Water Alliance, Wash.'s outstanding water system revenue refunding bonds. The outlook is stable.

The raised rating reflects our opinion of Cascade's financial forecast, which we believe is reasonable and achievable, given the agency's lack of additional debt plans and modest annual wholesale water rate increases (of about 3% per annum) anticipated through fiscal 2023. Cascade's general creditworthiness also reflects our assessment of the extremely strong enterprise and financial risk profiles of its three largest retail purveyors, Bellevue, Redmond and Kirkland, which together represent a heavy concentration of about 80% of total demand.

Cascade does not sell water from its wholesale water system directly to retail users but instead sells water to seven separate retail water purveyors: the city of Bellevue (53% of total demand in 2017), followed by Redmond (18%), Kirkland (14%), Tukwila (7%), Sammamish Plateau Water and Sewer District (3%), Issaquah (4%), and Skyway Water and Sewer District (1%). Each member owns and operates its own water distribution system and bills customers directly. With limited or no local supply of their own, purveyors are reliant upon Cascade's water supply.

Under our primary criteria, if a wholesale agency is comprised of 10 or fewer participants, and there are contractual provisions that require non-defaulting members or participants to increase their payments to account for such delinquency, our analysis of the wholesale agency is not constrained by an individual member. In this instance, our rating reflects our opinion of the three largest participant's ability to step up under short notice to cover a defaulting member's share of Cascade's debt service.

The ratings further reflect our view of Cascade's:

- Broad and diversified service territory located in the Seattle-Tacoma-Bellevue MSA, as demonstrated through the service area's very strong income levels;
- Relative predictability in the majority of its revenue sources, with a rate-setting mechanism based on prior years' water use and customer count rather than on a current per-volume basis;
- Stable financial metrics, which we forecast will be maintained over our two-year outlook period, even with a one-time $12 million capital payment planned for fiscal 2018, and no additional debt-financed capital expenditures over this period; and
- Ownership of a long-term supply source through its purchase of Lake Tapps.

These strengths are offset by our view of Cascade's:

- Sizable fixed contract payments to Seattle and Tacoma;
- Moderate dependency on one-time regional capital facilities charges (RCFCs) to cover fixed costs; and
- Substantial long-term capital needs to bring the Tacoma and Lake Tapps water supply sources online although the need for these projects has been delayed.

We view the bond provisions as permissive. The bonds are secured by Cascade's net revenues and money held in the debt service account, reserve fund, connection fee fund, and construction fund. A pooled reserve is pledged to the series 2014, 2012, and 2006 bonds, with a funding requirement of the lesser of maximum annual debt service (MADS) and 125% of average annual debt service. The series 2009 bonds have a separate reserve. A rate covenant requires that rates are set to generate gross revenue covering operating expenses and debt service and to generate net revenues, excluding RCFCs but including funds in the debt service account, to provide at least 1.00x debt service coverage, or 1.25x including RCFC revenue. Cascade's fixed contract payments related to water supply are excluded from the rate covenant, but should also be considered, in our opinion, to fully capture Cascade's true cost of service.

The members together serve a population of approximately 350,000 located in King County, outside the city of Seattle. The region is broad, diverse, and growing, and is largely derived from various high-tech clusters, including biotech and telecommunications, as well as the aviation and manufacturing sectors. Member income levels are on average extremely strong, in our view, with median household effective buying incomes (MHHEBI) well above 165% of the national median in almost all communities served, with the city of Tukwila as an exception, which last reported income levels at about 89% of the national median. King County's unemployment rate was 3.9% in November 2017, which compares to a state average of 4.4% and national average of 3.9% over this period. The service area is mature and largely built out, although densification around light-rail extensions (e.g. around transit hubs in Bellevue) and new development in the outer suburbs (primarily in Issaquah and Sammamich) continues to result in very strong RCFC revenues for Cascade. Cascade estimates annual system-wide new customer account growth of between 0.80%-0.95% per year through 2022, resulting in RCFC revenues roughly in line with recent receipts. Members pay Cascade RCFCs for each additional equivalent residential unit added to the member's system in that year.

Members receive water from Cascade under a Joint Municipal Utilities Services Agreement. Pursuant to the agreement, the members must treat payments to Cascade as operating expenses. Members are obligated to make full payments to Cascade, even in the case of interrupted or reduced service. If a member fails to pay member charges under the agreement, the other members are required to step up and cover the delinquent amount. A member can withdraw from Cascade but must pay Cascade its allocable share of its member obligations, including debt service. Most recently, Covington Water District, one of the original members of Cascade, withdrew from the district in December 2012. Covington made a $6 million payment to Cascade to complete the withdrawal.

Cascade's current water supply comes from purchases from Seattle under an agreement expiring in 2063, and we understand that Cascade is currently drawing about 85% of its maximum contracted amount from Seattle. Cascade also has a water supply agreement with Tacoma, although Cascade will need to develop additional transmission facilities to take this water. The Seattle agreement is a take-or-pay contract, with the amount of water available to Cascade stepping down over time through 2063. Cascade currently purchases 33.3 million gallons per day (mgd) from

Seattle, with a step down to 31.1 mgd in 2040, 29.3 mgd in 2041, and 27.3 mgd in 2042. The contract then steps down by 1 mgd a year thereafter. Under its agreement with Tacoma, Cascade has a capacity commitment of 8 mgd through 2042. In return, Cascade makes payments of about $5 million annually to reserve the capacity, and must pay Tacoma's wholesale water rate for any water taken. With no connection in place, Cascade does not currently purchase water from Tacoma.

For its long-term water supply needs, Cascade purchased Lake Tapps in Pierce County from Puget Sound Energy in 2009 with plans to develop it into a major water source. Cascade established annual average water rights from the source of 48.5 mgd in December 2010. Cascade will need to make substantial capital investments before it can utilize the water source, including constructing intakes, a treatment plant, and pipelines. Declines in demand from members and increased available water supplies through the amended Seattle contract have delayed these investments until at least 2030, according to Cascade's 2012 transmission and supply plan. With the current supply from Seattle, lower per-capita water use from conservation, and the lower capital costs associated with connecting to Tacoma's supply, we understand that the Lake Tapps supply may not be needed until well after 2040.

Cascade's primary source of revenue is demand share charges, which are allocated to each member based on average water use over the three previous years, and are designed to cover Cascade's wholesale water costs, which are adjusted each year by Seattle. Each member also pays administrative dues and conservation program charges based on the number of equivalent residential units served by the member's water system. Technically, Cascade's pre-determined fixed payments to Tacoma and Seattle are not covered in demand charges (and are instead paid out of a "construction fund") however, this fund is effectively funded with surplus rate revenue and RCFCs so we consider these costs as a fixed component when we look at Cascade customer's all-in debt service coverage. Seattle has a three-year rate cycle and each true-up period is based on actuals year to year.

Cascade's direct debt service coverage has been consistently strong, and is expected to remain a clear credit strength. In fiscal 2017, pledged revenues totaled $50.4 million (unaudited), compared to $48.1 million the prior year. In both years, Cascade's coverage of total (senior and subordinate) debt service was a very strong 2.1x as calculated by S&P Global; excluding strong one-time RCFC receipts (of about $9.4 million in each of the past five years) coverage was about 1.3x. In addition to its on balance sheet debt service, Cascade also makes about $5 million in annual fixed payments to the city of Tacoma funded from a construction fund that is replenished with transfers from the operating and RCFC funds. In addition, the Seattle contract amendment calls for three transition payments from the construction fund, of $5 million on July 31, 2013, $12 million on Dec. 31, 2018 and $5 million on Dec. 31, 2024. In the event that future RCFC revenues were to decline from the very strong levels achieved over the past five years, we would expect management to adjust its wholesale water rates accordingly to avoid a protracted draw-down in cash reserves to fund these obligations.

Cascade's liquidity position is strong, in our view. Unrestricted cash and investments as reported in the draft audit totaled $13.1 million as of Dec. 31, 2017 (unaudited), representing about 138 days' of operating expenses on hand. This is up from $12.4 million, or 137 days, as of Dec. 31, 2016. According to management, a portion of Cascade's cash and investments that are classified as restricted in its financial statements are available to cover operating expenses or debt service at the board's discretion. These available funds include cash and investments in the rate-stabilization fund, RCFC collection fund, construction fund (excluding bond proceeds), and bond repayment account. This larger balance totals $35.6 million as of Dec. 31, 2017, according to management, representing 372 days of operating expenses on hand.

Cascade has a large long-term capital improvement program related to water supply projects, though construction of major elements of the plan will not commence for some time due to Cascade's currently ample water supply from Seattle. Over the long term, Cascade plans to construct a pipeline connecting it to Tacoma, develop the Lake Tapps supply source, and complete a regional distribution system. According to internal estimates, capital needs over the next 50 years are sizable, and total $1.09 billion in 2018 dollars. Cascade's more immediate capital needs, however, are manageable in our opinion and total about $13.8 million through 2023. The larger identified projects over the upcoming five-year period include improvements to the Lake Tapps conveyance system as well as security and Supervisory control and data acquisition (SCADA) system upgrades.

In general, we believe Cascade's financial practices are strong, comprehensive, and supportive of high credit quality. Revenue and expenses assumptions are reasonable, and the board receives interim financial reporting on a regular basis throughout the fiscal year. The long-term planning process is rigorous, and the detailed financial and capital improvement forecasts are annually updated. Cascade does not participate in the state PERS program, instead, the agency has a defined contribution program, which we view as neutral to Cascade's overall credit quality.

Cascade's long-term ratings are above that of the United States. Cascade has a predominantly locally derived revenue base. Member agency payments under long-term water supply contracts, utilizing a cost-recovery methodology, represent virtually all of its revenue. This, coupled with operating expense flexibility, limits Cascade's exposure to federal revenues, in our view.

Member Agencies

We consider the financial stability of Cascade's member agencies to be a key credit factor. However, member charges are heavily concentrated in Bellevue's water system, which represent about 53% of the total. If Bellevue were to be unable to make its payments, the large required step up from the other members upon short notice could be difficult to cover. This risk is largely mitigated by the extremely strong credit quality of Bellevue's water system, with no long-term debt outstanding of its own, sound all-in coverage (2.3x in fiscal 2016 including fixed charges to Cascade), and robust cash reserves ($76 million as of Dec. 31, 2016).

We also view the credit quality of the second and third largest members as extremely strong. The second largest, Redmond, which represents 18% of Cascade's member charges, has a combined water, sewer, and drainage system. This system is characterized by extremely low leverage (8% debt-to-capitalization as of Dec. 31, 2016) and sound all-in coverage (including fixed charges to both Cascade and King County for wastewater treatment) of 1.5x in fiscal 2016. The system held unrestricted cash reserves of $79.2 million as of Dec. 31, 2016.

The third-largest member, Kirkland, is also a combined water and sewer system, with extremely low leverage (3% debt-to-capitalization as of Dec. 31, 2016), all-in coverage of 1.6x (including fixed charges to both Cascade and King County) and $31.8 million of unrestricted cash reserves as of Dec. 31, 2016.

Outlook

The stable outlook reflects our view of Cascade's adequate water supply and very strong projected financial metrics, as well as our assessment that each of the three largest members' financial performance will remain consistent over the two-year outlook period.

Downside scenario

While unexpected, we could take a negative rating action if the underlying credit quality of any of three retail purveyors were to weaken or if the agency's cash balances materially decline from current levels.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.