S&P Global
Ratings

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Summary:

Cascade Water Alliance, Washington; Water/Sewer

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US$29.505 mil wtr sys rfdg rev bnds ser 2020 due 09/01/2037		
Long Term Rating	AAA/Stable	New
Cascade Wtr Alliance wtr		
Long Term Rating	AAA/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AAA' long-term rating to the Cascade Water Alliance, Wash.'s approximately $29.5 million water system revenue refunding bonds, series 2020. At the same time, S&P Global Ratings affirmed its 'AAA' rating on Cascade's existing water system revenue bonds. The outlook is stable.

Net revenue and money held in the debt service account, reserve fund, connection fee fund, and construction fund secure the bonds. The series 2012 and 2014 bonds have a reserve fund, but the series 2019 and 2020 do not. The proceeds will be used to advance refund certain callable portions of Cascade's water system revenue bonds, series 2012. Cascade currently has outstanding about $73 million of series 2012, 2014, and 2019 bonds.

The long-term rating on Cascade is above that of the U.S. Cascade has a predominantly locally derived revenue base. Member agency payments under long-term water supply contracts, using a cost recovery methodology, represent virtually all of its revenue. This, coupled with operating expense flexibility, limits Cascade's exposure to federal revenue, in our view.

Bond provisions include the following:

- A rate covenant requires Cascade to generate net revenue, excluding regional capital facilities charges (RCFCs), but including funds in the debt service account, to provide at least 1.00x debt service coverage (DSC), or 1.25x DSC including RCFC revenue;
- A future parity obligations covenant at 1.0x DSC on outstanding bonds and bonds being issued; and
- The lack of a debt service reserve for the series 2020 obligations, which we consider credit neutral given Cascade's very strong cash position.

Credit overview

Cascade is a regional wholesale water provider to seven members in central Puget Sound. The region is growing and centers economically on various high-tech clusters, including biotech and telecommunications, as well as the aviation and manufacturing sectors. The rating reflects our view of Cascade's general creditworthiness including very strong all-in coverage, extremely strong cash, and strong financial management practices and policies to ensure long-term water supply reliability in the region. The rating also reflects our assessment of the extremely strong enterprise and financial risk profiles of the system's two largest retail purveyors, Bellevue and Redmond (AAA/Stable), in addition to the extremely strong enterprise profile and very strong financial risk profile of the third-largest retail provider, Kirkland. In 2019, the three largest retail purveyors together represented a heavy concentration of about 84% of total demand. Our rating reflects our opinion of the three largest participants' ability to step up under short notice to cover a defaulting member's share of Cascade's debt service.

Cascade sells water to seven separate retail water purveyors: Bellevue (53% of total demand in 2019), 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.

We expect revenues, specifically RCFCs, to be lower in fiscal 2020 due to the COVID-19 pandemic and given the 44% decline in RCFCs in 2019, generating very strong all-in coverage of 1.4x. We understand management reduced their growth-related assumptions by 40% and prioritized projects to provide flexibility. The biggest credit risk is continued decline in RCFCs without an offset in either direct revenues from rate increases or lower expenses. While we continue to monitor events related to the COVID-19 pandemic, we do not currently expect the pandemic to affect Cascade's ability to pay debt service costs. S&P Global Ratings believes there remains a high degree of uncertainty about the evolution of the coronavirus pandemic. ("Potholes On The Road To Recovery," published Sept. 29, 2020). As the situation evolves, we will update our assumptions and estimates accordingly.

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

- Broad and diversified service territory in the Seattle-Tacoma-Bellevue metropolitan statistical area, 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 previous years' water use and customer count rather than on a current per-volume basis;
- Rising all-in coverage projected to reach 2x in fiscal 2021 through fiscal 2026, a figure we consider extremely strong;
- Very strong unrestricted liquidity profile, at about $13.5 million (fiscal 2019) and when including restricted but legally available funds upon board approval less the debt service account of about $29.4 million; and
- Current water supplies reliant on wholesale purchases from Seattle through a long-range declining block structure agreement, supplemental long-term water supply agreement with Tacoma, 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 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.

The stable outlook reflects our view of Cascade's ample 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.

Environmental, social, and governance (ESG) factors

Overall, we believe that Cascade has mitigated most of the water system's ESG-related risk through compliance with all relevant environmental regulations, long-term water supply planning, long-term financial planning, and regular rate-setting practices. The biggest risk is long-term water supply, given Seattle's declining block structure; however, mitigating this risk is the long-term water supply agreement entered into with the city of Tacoma and the purchase of Lake Tapps to ensure water to meet demand through 2060. Severe weather across the Pacific Northwest--characterized by five consecutive years of hotter-than-average summers and some of the wettest winters on record--continues to challenge utility managers across the region. However, Cascade has maintained financial reserves to manage through short-term shifts in both water supply costs and demand, as well as, in some cases, added costs related to flooding or mudslides. While we have not seen a material decline in credit quality as a result of recent weather events, these events highlight the critical importance of Cascade's long-range asset adequacy, drought planning, and water supply management. For now, there are increased pressures on the service area economy due to higher public health and safety risks related to COVID-19, leading to an increase in the system's overall social risk factors. Furthermore, ESG factors are in line with other peers.

Stable Outlook

Downside scenario

While unexpected, we could take a negative rating action if the underlying credit quality of any of three retail purveyors weakens.

Credit Opinion

Enterprise risk

Members receive water from Cascade under a joint municipal utilities services agreement. In accordance with 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 charges under the agreement, the other members are required to step up and cover the delinquent amount. A member can withdraw from the system, but must pay Cascade its allocable share of its obligations, including debt service. Management indicated no members have asked to exit their agreement.

The system's water supply comes from purchases from Seattle under an agreement expiring in 2063, and we understand that Cascade is drawing about 81% of its maximum contracted amount from the city. Cascade also has a water supply agreement with Tacoma, although the system 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. The contractual maximum is 33 million gallons per day (mgd), stepping down to 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. Cascade has an annual take-or-pay with Tacoma that started at $5 million annually with a 2% escalator and is currently at about $6 million. Cascade does not utilize Tacoma's water supply yet.

For its long-term water supply needs, Cascade purchased Lake Tapps. Cascade will need to make substantial capital investments before it can use the water source, including constructing intakes, a treatment plant, and pipelines.

Financial risk

Cascade's DSC declined in fiscal 2019 to 1.4x, which we consider very strong, from above 1.6x which we view as extremely strong, in fiscal 2018. When excluding one-time RCFC receipts (of about $5.8 million in fiscal 2019), all-in coverage was below 1.0x. The decline is a result of lower RCFC revenue. We understand management has reduced its assumption by 40% for these revenues to ensure rate revenue is sufficient to maintain at least very strong coverage. Based on our analysis of management-provided projections, we expect all-in coverage to rise to an extremely strong level through 2026 at above 1.6x. This is a result of declining annual debt payments, lack of future debt plans until 2036, and 2.2% annual rate increases approved by the board.

Cascade's liquidity position is very strong, in our view. Another credit strength is Cascade's new Water Supply Investment Fund and funding policy (under Board consideration). This fund would be used to accumulate equity funding toward the construction of the Lake Tapps water supply. The sources of revenue that will be used to fund this account include, 50% of savings from the series 2020 refunding, a portion of RCFC revenue, and a portion of rate revenue. Cascade anticipates building this fund up to $300 million by the time the project is scheduled.

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. Based on Cascade's updated capital plan, near-term Lake Tapps costs are about $18.6 million through 2024, which in our opinion are manageable. Long-term capital needs for the Lake Tapps project over the next 20 years are sizable, and total $1.4 billion in 2019 dollars. Cascade plans to begin debt-funding a portion of the capital needs in fiscal 2036, and all current debt rolls off in 2037, following a large drop in fiscal 2029 when the series 2014 bonds are paid off.

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 represents 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 (2.9x in fiscal 2019 including fixed charges to Cascade), and robust cash reserves ($101 million as of Dec. 31, 2019).

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 (7% debt-to-capitalization as of Dec. 31, 2019) and sound all-in coverage (including fixed charges to both Cascade and King County for wastewater treatment) of 1.8x in fiscal 2019. The system held unrestricted cash reserves of $105 million as of Dec. 31, 2019.

The third-largest member, Kirkland, is also a combined water and sewer system, with extremely low leverage (3.6% debt-to-capitalization as of Dec. 31, 2019), all-in coverage of 1.57x (including fixed charges to both Cascade and King County), and $2.2 million of unrestricted cash reserves as of Dec. 31, 2019.

Related Research

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