

MOODY'S

INVESTORS SERVICE

New Issue: Moody's assigns Aa2 first and Aa3 second lien ratings to Portland Sewer Enterprise (OR) revenue bonds; outlook is stable

Global Credit Research - 21 Jul 2014

\$1.9 billion of debt affected

PORTLAND (CITY OF) OR SEWER ENTERPRISE
Sewer Enterprise
OR

Moody's Rating

ISSUE	RATING
Second Lien Sewer System Revenue Bonds 2014 Series B	Aa3
Sale Amount	\$201,140,000
Expected Sale Date	08/05/14
Rating Description	Revenue: Government Enterprise
First Lien Sewer System Revenue Refunding Bonds 2014 Series A	Aa2
Sale Amount	\$94,015,000
Expected Sale Date	08/05/14
Rating Description	Revenue: Government Enterprise

Moody's Outlook STA

Opinion

NEW YORK, July 21, 2014 --Moody's Investors Service has assigned a Aa2 rating to Portland Sewer Enterprise, Oregon's First Lien Sewer System Revenue Refunding Bonds, 2014 Series A in the estimated amount of \$94 million and also a Aa3 rating to Second Lien Sewer System Revenue Bonds, 2014 Series B in the amount of \$201.1 million. At this time, Moody's affirms the Aa2 rating on the enterprise's first lien revenue bonds outstanding in the amount of \$765.7 million and also Aa3 rating on the enterprise's second lien revenue bonds outstanding in the amount of \$824.2 million. The outlook on the enterprise is stable. Proceeds of the Series A bonds will refund certain maturities of the outstanding Sewer System Revenue Bonds, 2004 Series A. Proceeds of the Series B bonds will fund a portion of the enterprise's current five-year capital plan.

SUMMARY RATING RATIONALE

The enterprise's ratings primarily reflect its large and stable metropolitan service area, prudent operating policies, and a sizable but manageable debt burden. Willingness to consistently adopt annual rate increases leads to satisfactory operating performance and debt service coverage. Sound management maintains full compliance with state and federal regulations, and continued capital investments maintain the integrity of the system. Additionally, legal provisions are overall satisfactory.

The stable outlook reflects our expectations that the sewer enterprise will continue to benefit from a large and healthy economy that is in expansion mode. Management is also expected to maintain satisfactory performance over the medium term, including continued adoption of annual rate increases sufficient to meet operating and capital needs. Lastly, we expect operating results will continue to comply with planning standards for 1.5x coverage of first lien debt service and 1.3x combined debt service (on an ordinance basis including transfers to the rate stabilization fund).

STRENGTHS

- Large and stable metropolitan service area
- Continued willingness to regularly increase user rates to support debt and operations
- Strong management, including prudent forecasts and successful execution of capital plans
- Completed prudent mitigation of combined sewer overflows, and without a consent decree or other regulatory intervention

CHALLENGES

- Debt service coverage below many peers nationally on net revenue basis
- Still sizable capital plan that include additional debt issuances within the next five years

DETAILED CREDIT DISCUSSION

LARGE AND DIVERSE SERVICE AREA RECOVERED FROM RECESSION

Moody's expects continued improvement in the Portland metro economy due to the presence of a skilled work force and advanced industries such as technology manufacturing. The economy also benefits from international trade ties, particularly air and marine exports to Asia. The unemployment rate was 6% as of April 2014 and remains favorable compared to statewide levels and comparable to the U.S. The greater metro area has a large workforce greater than one million and has led Oregon's economic recovery. Further, the city's office and industrial vacancy rates remained around 9-10% through the fourth quarter of 2013 as business activity rebounds from the recent downturn. Wealth measures are moderate and include median family income of 103% of U.S. levels per American Community Survey from 2012 and are similar to some other large, urban cities.

The Portland sewer system's capacity is able to meet demand of an estimated service population that includes 592,000 residents. Average flows for secondary treatment to the system's two treatment plants were 69 million gallons daily (MGD) as of 2013 and the five-year average was 78 MGD, although usage is declining at a modest pace over time. The system has ample capacity given its ability to treat up to 108.3 MGD, and also user growth is modest since the city is mostly built-out but experiencing some in-fill development. On peak days, primary and secondary flows may be blended to manage system-wide capacity, prior to treatment and discharge. User concentration remains low as the ten largest customers combined for less than 5% of service revenues as of FY2013.

The enterprise meets all federal Environmental Protection Agency (EPA) and state Department of Environmental Quality standards. Permits under the Clean Water Act for the system's treatment facilities remain in place as one does not expire until 2016 while the other remains administratively extended due to regulatory backlog. The city's permit for stormwater discharge is effective until 2015.

The enterprise completed large combined sewer overflow mitigation projects in 2012 that bolster compliance with the federal Clean Water Act and qualifications for a National Pollutant Discharge Elimination permit. Management proactively undertook these projects and was not subject to a consent decree; some other large sewer systems now operate under long-term regulatory decrees following historic capital under-investment and compliance failures.

ADEQUATE DEBT SERVICE COVERAGE SUPPORTED BY REGULAR RATE INCREASES

The enterprise continues to demonstrate satisfactory coverage of debt service requirements due partly to prudent adoption of annual rate increases most recently in the mid single-digit range. Annual coverage levels have been below many large systems nationally in recent years, including 1.71 times net revenues for first lien debt service and 1.14 times combined debt service for FY2013 as presented on a GAAP basis.

From a practical standpoint, coverage levels are managed by the enterprise's planning standards that are more stringent than legal covenants, as presented on an ordinance basis, including 1.5 times first lien debt service and 1.3 times combined debt service including transfers to and from the rate stabilization fund. For FY2013, ordinance basis coverage was 1.9 times first lien debt service and 1.3 times combined debt service. Management sizes transfer to and from the rate stabilization fund to comply with its planning standards.

The city's policy is to target a rate stabilization fund balance of 10% of operating expenses (equivalent to \$11.7 million as of FY2013). This fund was spent down to smooth the magnitude of rate hikes amid an active period of

large capital investments and debt issuance to a balance of \$4.9 million as of FY2013 after accruing a large balance of \$68.6 million as of FY2009. Projections indicate that the fund will grow overall in the coming years to \$20.5 million by FY2019.

SATISFACTORY OPERATING PERFORMANCE PROJECTED TO CONTINUE

Operating performance is supported by consistently adopting annual rate increases. The city council approved rate increases that ranged between moderate 5.3-7% annually from 2010-14. Data indicate that combined sewer and stormwater charges on average are amongst the most expensive for monthly residential bills compared to other large, urban systems nationally. Nevertheless, the city has demonstrated its commitment to implementing prudent annual rate hikes to support large capital plans and debt service coverage.

Reasonable projections through FY2019 anticipate that operating performance will improve modestly compared to recent years. Assumptions include relatively smaller rate hikes of 3.5-4% annually, inflation of between 1-3% per expense category, slow growth in customers of 0.25-0.5% annually, and modest declines in sewage flows. Operating expenses are expected to fluctuate modestly with the impact of capitalized overhead costs. Revenues also anticipate that system development charges will be in the \$12-13 million range annually, though these have been somewhat volatile in recent years with economic cycles. Projections also include estimated debt service for anticipated issuances of second lien debt on a biannual basis to support the enterprise's rolling capital plan.

Projections also indicate that debt service coverage will improve despite additional issuance. On a net revenue basis, annual debt service coverage will improve by FY2019 to almost 2.7 times for first lien bonds and 1.3 times combined debt service. On an ordinance basis, projected coverage for first lien bonds is also anticipated to improve to 2.7 times through FY2019 while combined coverage is expected to remain at 1.3 times annually including the impact of planned second lien issuances and transfers out to rebuild the rate stabilization fund balance.

The enterprise's recent operating metrics are satisfactory compared to other large sewer systems across the nation. The operating ratio of 41.2% as of FY2013 was favorably low and denotes some financial flexibility but is somewhat mitigated by sizable debt requirements and coverage targets under the city's planning standards. The enterprise's liquidity is somewhat weak with unrestricted reserves of only 23%, or the equivalent of 84 days of operating expenses, as of FY2013. Liquidity will likely benefit over the forecast period with cash set asides to the rate stabilization sub-fund and a modestly smaller capital plan after recent completion of combined sewer overflow mitigation projects.

SATISFACTORY LEGAL PROVISIONS

Rate covenants are modest and require 1.2 times coverage of first lien debt service, and either 1.0 times combined debt service or 1.1 times stabilized net revenues with rate stabilization fund transfers. However, actual coverage levels are more aligned to management's more stringent planning standards (detailed above). Additionally, the current offerings feature debt service reserves sized at the standard three-prong test; the requirement for the Series A bonds is expected to be satisfied with a surety while the requirement for Series B will be funded with cash from proceeds. Some outstanding bonds have surety supported debt service reserves provided by either National Public Finance Guarantee Corp. (A3 negative) or Assured Guaranty Municipal Corp. (A2 stable).

SIZABLE CAPITAL PLAN INVESTS IN SYSTEM INTEGRITY

The Portland sewer enterprise's rolling capital plan totals \$538.4 million for FY2015-19 and is smaller than prior plans due to recent completion of large combined sewer overflow projects. In particular, the majority of capital needs are for prudent system maintenance and reliability projects (\$332.5 million) while the remainder is mostly for treatment and surface water management. Capital needs are projected to be funded mostly with additional second lien debt currently projected for a total of \$390.8 million that will be issued as needed to finance scheduled projects. The system's debt ratio of 55.4% as of FY2013 was in the range of many other large sewer systems nationally.

Of note, Portland Harbor was designated a Superfund site by the EPA in 2000. The sewer enterprise, Portland's other utilities and departments, and various private entities are considered potentially liable for prior sediment contamination. The EPA continues to analyze remediation options and has not yet named the liable parties or allotted shares of remediation costs. The agency's record of decision is anticipated no sooner than in 2017, and there are currently no estimates for remediation costs. The sewer enterprise's capital and debt issuance plans could be altered by its share of costs for future cleanup efforts.

WHAT COULD CHANGE THE RATING UP

- Consistently higher debt service coverage
- Stronger operating position, including more liquidity

WHAT COULD CHANGE THE RATING DOWN

- Significantly weakened debt service coverage
- Unwillingness to implement prudent rate increases to support large capital needs and debt service
- Deterioration of the enterprise's operating position

KEY STATISTICS

Estimated service population: 592,000 residents (166,189 residential and 13,569 commercial accounts)

Median family income, 2012 American Community Survey: 103% of U.S. (\$66,523)

Debt service coverage, FY2013 (ordinance basis): 1.9 times first lien / 1.3 times combined

Debt service coverage, FY2013 (net revenue basis): 1.7 times first lien / 1.1 times combined post-issuance

Maximum annual debt service coverage, FY2013 (net revenue basis): 1.7 times first lien / 0.96 times combined (pro forma to current issuance)

Debt ratio, FY2013: 55.4%

Operating ratio, FY2013: 41.2% of operating expenses

Unrestricted reserves, FY2013: 23% of operating expenses

The principal methodology used in this rating was Analytical Framework For Water And Sewer System Ratings published in August 1999. Please see the Credit Policy page on www.moody.com for a copy of this methodology.

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