

April 21, 2008

**Summary:**

**Sedro-Woolley, Washington;  
Water/Sewer**

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## Summary:

# Sedro-Woolley, Washington; Water/Sewer

### Credit Profile

US\$3.915 mil swr rev rfdg bnds ser 2008 due 06/01/2018

<i>Long Term Rating</i>	A+/Stable	New
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Sedro-Woolley swr rev rfdg bnds ser 1998 dtd 06/01/1998 due 06/01/1999-2014 2018

<i>Unenhanced Rating</i>	A+(SPUR)/Stable	Upgraded
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Many issues are enhanced by bond insurance.

## Rationale

Standard & Poor's Ratings Services raised its underlying rating (SPUR) to 'A+' from 'A-' on Sedro-Woolley, Wash.'s series 1998 sewer revenue refunding bonds. The rating change reflects the utility's consistently strong parity debt service coverage (DSC) during the past five years (the latter year unaudited) and our expectation that such performance will continue due to the need to implement regular rate increases to meet planned new subordinate-lien obligations. In addition, Standard & Poor's assigned its 'A+' rating to the city's series 2008 sewer revenue refunding bonds.

The bonds are secured by net revenues of the sewer system.

Key rating factors include the utility's:

- Economic base on the periphery of the Seattle regional economy;
- Record of strong parity DSC, which could be reinforced by planned subordinate-lien borrowing from the state;
- Maintenance of good, if diminished, liquidity levels during a period of significant replacements of transmission infrastructure; and
- Above-average combined water and sewer rates paid by the city's households, which could constrain revenue flexibility.

Series 2008 will be used to achieve interest cost savings by refunding the city's outstanding series 1998 sewer revenue and refunding bonds.

The utility serves a population of about 10,036 located in northern Skagit County, approximately 70 miles north of Seattle. Local economic activity over the past generation has shifted toward income from long-distance commuting and local employment in logging and wood products manufacturing. Successfully adapting to this change was the city's largest employer, Janicki Industries, which now produces aerospace, boat, and other transportation components and this year is expanding its facilities by approximately 160,000 square feet. The city's median household effective buying income is good at 97% of the U.S. level and the countywide unemployment rate was comparable to the national average in 2007 at 5.0%.

The sewer customer base is primarily residential and is growing rapidly. Even after excluding a major boost among its multifamily housing customers in 2005, the utility's customer count has grown by a strong 2.8% average annual rate during the past five years to 4,034 in 2007. The city is planning for a buildout population of about 25,000.

Treatment capacity is good, with the ability to process 3.5 million gallons per day (mgd) compared to average usage of about 0.8 mgd average and 2.9 mgd peak flow in 2007. After a treatment facility upgrade 10 years ago, capital spending has focused on transmission infrastructure extensions and upgrades. In 2006, the state's Public Works Trust Fund awarded the utility \$7 million in subordinate-lien financing at a nominal interest rate to pay for trunk line replacements; this year the utility secured another \$5.2 million for an interceptor replacement. Management expects the utility's capital spending to slow considerably by 2010, and the tenure of the state loans will depend in part on how rapidly it receives one-time system development charges associated with growth.

Financial performance has been strong, though diminished operating liquidity has accompanied a capital spending surge. From 2003-2007 (the latter year unaudited) the utility generated net revenues of 2.47x-5.25x parity debt service, most recently 4.22x, or \$2.1 million. Excluding one-time fees associated with growth, DSC during this period ranged from 1.91x-3.47x, most recently a still-strong 2.67x. We expect the utility to continue to generate strong coverage levels in the medium term should the utility fully draw on its state loan capacity, as it will need to generate sufficient net revenues for both its senior- and subordinate-lien obligations. Available cash at the end of 2007 (unaudited) stood at \$542,100, or a good 112 days' operations, but is down substantially from an extremely strong two years' or more in 2003 and 2004. Management has budgeted for the utility's operating cash at the end of 2008 to be virtually unchanged from 2007.

Management indicates that additional subordinate revenue debt is likely to require annual moderate rate increases, which have been uncommon during the past 10 years. A residential customer currently pays \$45.75 per month for sewer service, following a significant 11% increase for 2005 and a 10% increase for 2007. Another increase is under consideration for this year. Given local households' above-average total monthly bill for water and sewer service -- \$87.46 per month based on 1,000 cubic feet of water consumption -- the utility may not have substantial scope for major additional rate increases, but we would view small but more consistent increases as maximizing the utility's revenue flexibility.

Legal provisions include a standard reserve fund and a covenant to maintain net revenues of at least 1.25x of the current year's debt service after allowing for any contributions to a rate stabilization fund. Also present is a 1.25x maximum annual debt service additional bonds test that allows for adjustments for adopted rate increases and new facilities under construction at the time of issuance or financed with new debt.

## Outlook

The stable outlook reflects our expectation that the city will adjust its rates as necessary to meet both its senior and subordinate debt service obligations. Its new subordinate debt capacity, if substantially exercised, will likely translate into a significant coverage margin for series 2008 debt service in the medium term. Likely to constrain further upward movement is the utility's untested ability to make regular rate increases in the context of above-average monthly combined sewer and water bills.

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