

**Rating Update: Moody's affirms Aa2 for Sunnyvale, CA sewer revenue bonds**

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Global Credit Research - 14 Apr 2015

**Affecting \$32.8 million in debt**

SUNNYVALE (CITY OF) CA  
Sewer Enterprise  
CA

NEW YORK, April 14, 2015 --Moody's Investors Service affirmed the Aa2 rating on Sunnyvale (City of), CA Sewer Enterprise's Sewer Revenue Bonds. The bonds are secured by a senior pledge of net revenues.

**SUMMARY RATING RATIONALE**

The Aa2 rating reflects the system's wealthy service area and healthy financial operations including a strong operating ratio and ample liquidity. The affirmation also reflects Moody's opinion that the drought will not have a material effect on the enterprise's rating due to strong financial forecasting and a high concentration of flat rate accounts, not metered. The rating also reflects the system's significant capital needs which will be mitigated by sound debt service coverage and budgeted rate increases.

**OUTLOOK**

Outlooks are usually not assigned to local government credits with this amount of debt outstanding.

**WHAT COULD MAKE THE RATING GO UP**

- Sustained improvements in financial operations
- Increases in system size and asset condition

**WHAT COULD MAKE THE RATING GO DOWN**

- Deterioration of financial operations

**STRENGTHS**

- Wealthy and diverse revenue generating base
- Prudent rate increases generating strong debt service coverage
- Healthy reserve balances

**CHALLENGES**

- Significant, near-term capital needs
- System size is small compared to similarly rated sewer districts

**RECENT DEVELOPMENTS**

Recent developments are incorporated in the Detailed Rating Rationale.

**DETAILED RATING RATIONALE**

**SERVICE AREA AND SYSTEM CHARACTERISTICS: STABLE AND AFFULENT CUSTOMER BASE**

Sunnyvale Sewer Enterprise is a modestly sized system located in Silicon Valley that provides tertiary treatment to over 147,550 residents in the City of Sunnyvale (Aaa Issuer Rating) and portions of the Cities of Cupertino and San Jose (Aa1 GO rating). The system's 29,368 accounts are primarily residential (72% in 2014), with no

customer concentration in any specific industry. Residential rates are also fixed (not metered), which protects the system from treatment flow declines due to the drought or water conservation. Over the past five years, connections grew while average daily treatment steadily declined due improvements in plumbing codes requiring more water efficient appliances in new buildings. Average daily treatment in fiscal 2014 was 12.8 MGD, down from 15.5 MGD in 2006. Management believes that average treatment will stabilize due to growing accounts and continued water conservation.

The city's treatment facility was last updated in 1984, but still has sufficient capacity at 29.5 MGD compared to average usage. The treatment facility is currently undergoing major renovations that are estimated to cost the system \$340 million over the next ten years. To date, updates have been cash funded, but the system may seek out a state loan to fund portions of the project.

The city's economy is large and home to many technology, biotechnology, and "green" technology firms. Sunnyvale is located 45 miles south of San Francisco and 10 miles north of San Jose in California's Silicon Valley. Largest employers include Lockheed Martin, Apple, NetApp Inc., Yahoo! Inc. As of December 2014 the city had an impressively low unemployment rate of 3.8%. Wealth levels are correspondingly high. As of 2012 the city had a median family income (MFI) represented 158.3% and 171.2% of the state and nation, respectively.

#### Drought

Moody's believes that the drought will not have a material effect on the sewer system's operations since the vast majority of its connections are fixed rate, not metered. Treatment flow declines have actually benefited the system in recent years as new connections have increased revenues while declining treatment flow has kept expenditures stable. Treatment declines also prolong expensive treatment facility expansion projects.

On June of 2014, the city declared a drought emergency to implement mandatory restrictions and additional conservation measures, including rebates for rain barrels and piloting a smart meter program. The city successfully cut consumption by 18% in 2014 from the previous year, which is unique among California cities.

#### DEBT SERVICE COVERAGE AND LIQUIDITY: FINANCIAL OPERATIONS EXPECTED TO REMAIN STRONG

Strong financial performance continues to bolster the system's credit profile. The system has been able to increase total revenues by an average of 8.3% per year due to timely rate increases. Net revenues accordingly have increased by an impressive average of 13% per year due to annual rate increases. The system also maintains a healthy operation ratio of 62.2% and continues to reinvest in its infrastructure.

The system has consistently maintained healthy debt service coverage, exceeding 3.8 times in each of the last six years. In fiscal 2014 coverage was a strong 5.3 times. Going forward, management projects debt service coverage will remain healthy due to budgeted rate increases and new connections. Given the system's trend of raising rates and generating very strong debt service coverage, the projections seem reasonable.

#### Liquidity

The system has historically maintained sound unrestricted reserves in its rate stabilization fund and contingencies fund. Per city policy, the system must maintain reserves levels that are least 25% of next year's expenditures. In fiscal 2014, the system's total unrestricted reserve balance, including the two funds, was \$30.4 million, or a strong 638 days cash on hand. The system also has ability to borrow cash from the Aaa-rated City and has done so in the past. The system's sound liquidity and ability to borrow somewhat mitigates the risk of decreased treatment revenues brought on by the drought, while additionally allowing the system to easily manage its near-term capital needs.

#### DEBT AND LEGAL COVENANTS: SIGNIFICANT NEAR-TERM CAPITAL NEEDS

The system's significant capital needs should be easily met due to strong financial operations, easy access to the market and a currently low debt burden. The sewer systems is in the process of renewing its Water Pollution Control Plant which will cost \$340 million over the next ten years. The system plans on funding the project from a combination of cash, reserves, traditional debt, and from a sizable state revolving fund loan. The system's capital needs have historically been cash funded. As such, the system currently maintains a very low debt burden that's 1.02 time operating revenues.

The legal covenants of the bonds are typical, with the exception of a below-standard reserve requirement. The reserve requirement is just 50% of maximum annual debt service, a material weakness compared to similarly

rated enterprises. However, given the other strengths of the system, this weakness is not sufficient to warrant a rating distinction. The legal covenant requires 1.20 times annual debt service, while the additional bonds test calls for 1.20 times maximum annual debt service.

#### Debt Structure

All of the system's debt obligations are fixed-rate revenue bonds.

#### Debt-Related Derivatives

The authority has no exposure to debt-related derivatives.

#### MANAGEMENT AND GOVERNANCE

Effective management demonstrated by strong financial operations, timely rate increases and sound capital planning. City charter requires the enterprise to produce a ten year budget but it produces a twenty year budget which is a unique credit strength. The enterprise is also up-to-date with regulatory compliance and the remaining life of its capital assets is consistent with the national average.

#### KEY STATISTICS

- Asset Condition (remaining useful life): 24 years
- System Size (O&M in 000s): \$17361
- Service Area Wealth (MFI): 171.2% of the US
- 2014 Annual Debt Service Coverage: 5.26 times
- Days Cash on Hand: 638 days
- Debt to Operating Revenues: 1.02 times
- Rate Management: Aa
- Regulatory Compliance and Capital Planning: Aaa
- Rate Covenant: 1.20 times
- Debt Service Reserve Requirement: A

#### OBLIGOR PROFILE

Sunnyvale Sewer Enterprise is a modestly sized system located in Silicon Valley that provides tertiary treatment to over 147,550 residents in the City of Sunnyvale (Aaa Issuer Rating) and portions of the City of Cupertino. The system's 29,368 accounts are primarily residential (72% in 2014), with no customer concentration in any specific industry.

#### LEGAL SECURITY

The revenue bonds are secured by a senior lien pledge of net sewer revenues.

#### USE OF PROCEEDS

N/A

#### PRINCIPAL METHODOLOGY

The principal methodology used in this rating was US Municipal Utility Revenue Debt published in December 2014. Please see the Credit Policy page on [www.moodys.com](http://www.moodys.com) for a copy of this methodology.

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#### **Analysts**

Shelby Schwabauer  
Lead Analyst  
Public Finance Group  
Moody's Investors Service

Christian Ward  
Additional Contact  
Public Finance Group  
Moody's Investors Service

Robert Azrin  
Additional Contact  
Public Finance Group  
Moody's Investors Service

#### **Contacts**

Journalists: (212) 553-0376  
Research Clients: (212) 553-1653

Moody's Investors Service, Inc.  
250 Greenwich Street  
New York, NY 10007  
USA

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