

Rating Update: Moody's affirms Aa1 for Sunnyvale, CA water revenue bonds

Global Credit Research - 14 Apr 2015

Affecting \$22.7 million in debt

SUNNYVALE (CITY OF) CA
Water Enterprise
CA

NEW YORK, April 14, 2015 --Moody's Investors Service affirmed the Aa1 rating on Sunnyvale (City of), CA Water Enterprise's Water Revenue Bonds. The parity bonds are secured by a senior pledge of net revenues.

SUMMARY RATING RATIONALE

The Aa1 rating continues to reflect the system's sound Silicon Valley customer base and strong financial operations which incorporates timely rate increases to generate strong debt service coverage. The affirmation also reflects our expectation that the drought will not have a material effect on the system's rating due its supplier's sufficient water supply and the systems strong financial flexibility to buy water from other sources if need be.

OUTLOOK

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

WHAT COULD MAKE THE RATING GO UP

- Substantial improvement in water supply
- Significant increases in system size and asset condition

WHAT COULD MAKE THE RATING GO DOWN

- Prolonged water supply cost increases that weaken the system's fiscal position
- Significant cut in water supply
- Deterioration of strong financial operations

STRENGTHS

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

CHALLENGES

- Dependence on imported water and other supply challenges related to the drought
- Increasing water supply costs

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 Water Enterprise is a modestly sized system located in Silicon Valley that provides water to over

147,550 residents in the City of Sunnyvale (Aaa Issuer Rating). The system's 28,904 accounts are primarily residential (61% in 2014), with no customer concentration in any specific industry.

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.

Water Supply Remains Sufficient

Despite drought conditions, we expect that Sunnyvale's water supply will remain sufficient over the near-term, though the price of water is expected to rise. Sunnyvale receives the majority of its water from San Francisco Public Utility Commission (SFPUC) (Aa3 Stable) and Santa Clara Valley Water District (SCVWD) (Aa1). In fiscal year 2014, SFPUC provided about 48% of the city's water and SCVWD 49%.

The city's contract with SFPUC runs through 2034 and obligates the city to purchase 8.93 million gallons per day (MGD) and guarantees up to 12.58 MGD; in 2014 the city purchased the minimum of 8.9 MGD due to SFPUC's increased rates. SFPUC is currently undergoing a multi-billion capital improvement project, the cost of which is being passed on to its customers. SFPUC's scheduled rate increases are a significant 20.2% in fiscal 2015 followed by another significant 28% in fiscal 2016.

The city's contract with SCVWD runs through 2050, and entitles the city to 17.66 MGD, of which it used an average 9 MGD in fiscal 2014. SCVWD will increase its rates by 19% in fiscal 2016 and is proposing larger increases around 30% in future years. The city plans on passing part of these rate increases on to its customers and meeting the remaining portion of its increased costs through conservation. The water system's current rating weighs on its ability to manage these sizable rate increases without drawing down reserves. The city's budget accounts for annual rate increases over the next 20 years that range from 4%-5%, so its ability to manage increased costs seems reasonable.

Action Plan to Address the Drought

To address the drought, the city's primary plan is to conserve water, by encouraging efficient water use and adding penalties for overuse. 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 water districts.

It is important to note that SFPUC and SCVWD are both well positioned to handle the drought and have some of the stronger water supplies in the state. SFPUC alone has over three years of water supply in storage, which should last for several years assuming similar rainfall levels in the next few years. Sunnyvale's water supply position is therefore better relative to other water districts across the state. The city also has ample liquidity and an affluent tax base that could pay for imported water sources, if needed.

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 9.3% per year due to timely rate increases. Net revenues accordingly have increased by an impressive 86% from fiscal 2009 to fiscal 2014 due to annual rate increases. The system also maintains a healthy operation ratio of 73.5% 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 5.6 times. Going forward, management projects debt service coverage will remain strong due to budgeted rate increases and conservation. Given the district'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 \$21 million, or a strong 268 days cash on hand. The system also has ability to borrow cash from the Aaa-rated City. The system's sound

liquidity and ability to borrow somewhat mitigates the risk of increased water costs brought on by the drought, while additionally allowing the system to easily manage its near-term capital needs.

DEBT AND LEGAL COVENANTS: SECURITY FEATURES ARE COMPARATIVELY WEAK

The system's capital needs have historically been cash funded. As such, the system maintains a very low debt burden that's 0.58 times operating revenues. The system has no near-term capital needs that would require additional debt.

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): \$28,713
- Service Area Wealth (MFI): 171.2% of the US
- 2014 Annual Debt Service Coverage: 5.57 times
- Days Cash on Hand: 268 days
- Debt to Operating Revenues: 0.58 times
- Rate Management: Aa
- Regulatory Compliance and Capital Planning: Aaa
- Rate Covenant: 1.20 times
- Debt Service Reserve Requirement: A

OBLIGOR PROFILE

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LEGAL SECURITY

The revenue bonds are secured by a senior lien pledge of net water 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.moody's.com for a copy of this methodology.

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