

WTD Capital Program Cash-Funding Approach

MWPAAC Rates & Finance
September 1, 2022

Agenda

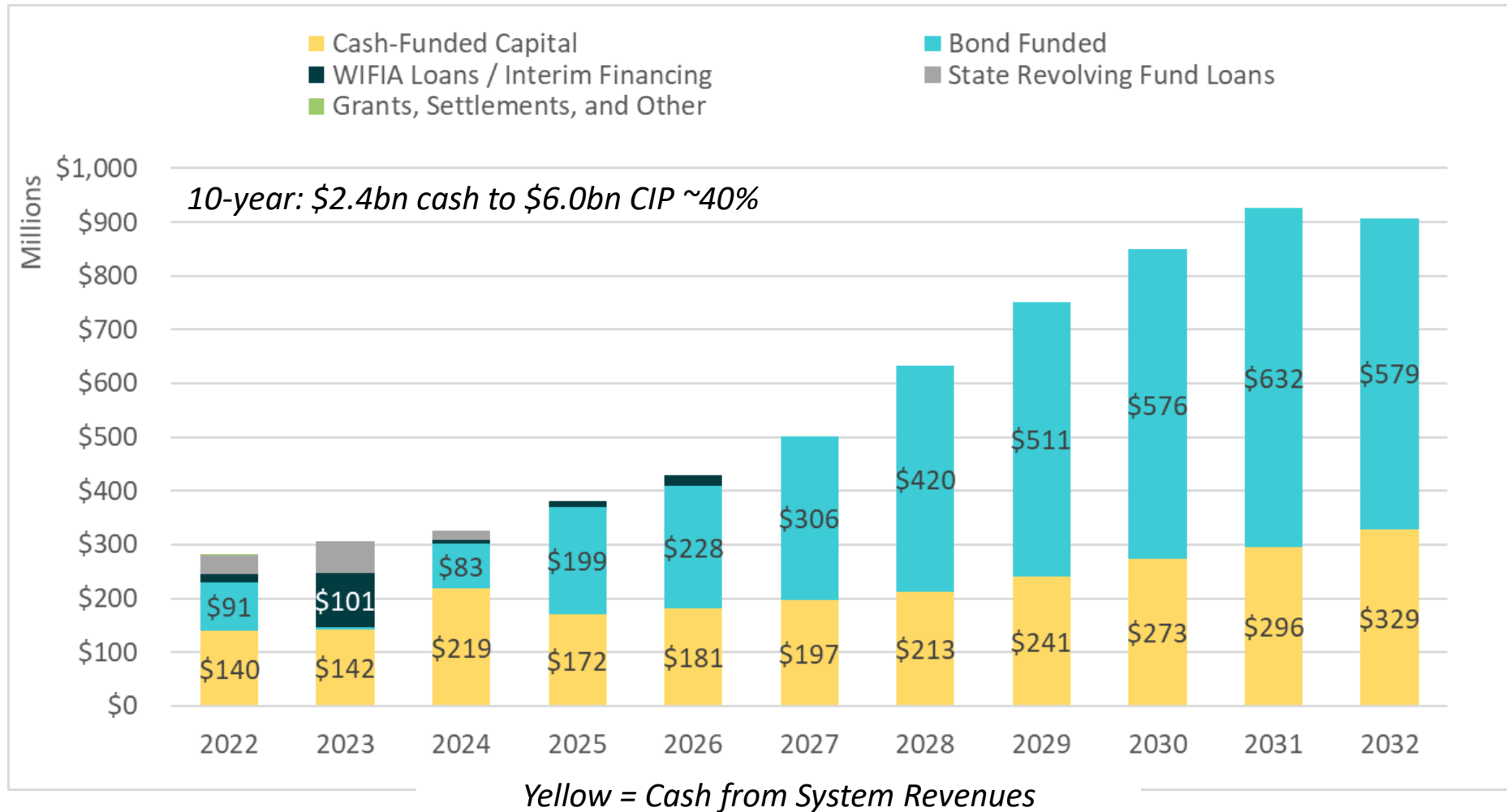
1. Background
2. Capital Funding and Sewer Rate Setting
3. 2017 Implementation – Debt Reduction Initiative
4. Cash-Funding and Debt Service Coverage
5. Rating Agency Perspectives
6. Takeaways and Next Steps

Background

- In December 2021, WTD presented an overview of its capital program cash-funding practices to MWPAAC Rates & Finance subcommittee in response to MWPAAC's 2022 Rate Recommendation Letter.
- Today's presentation is an updated overview of WTD's current cash-funding practice and key definitions using the 2023 Adopted 10-year (2023-2032) Rate Plan.

Cash-Funding Capital Projects

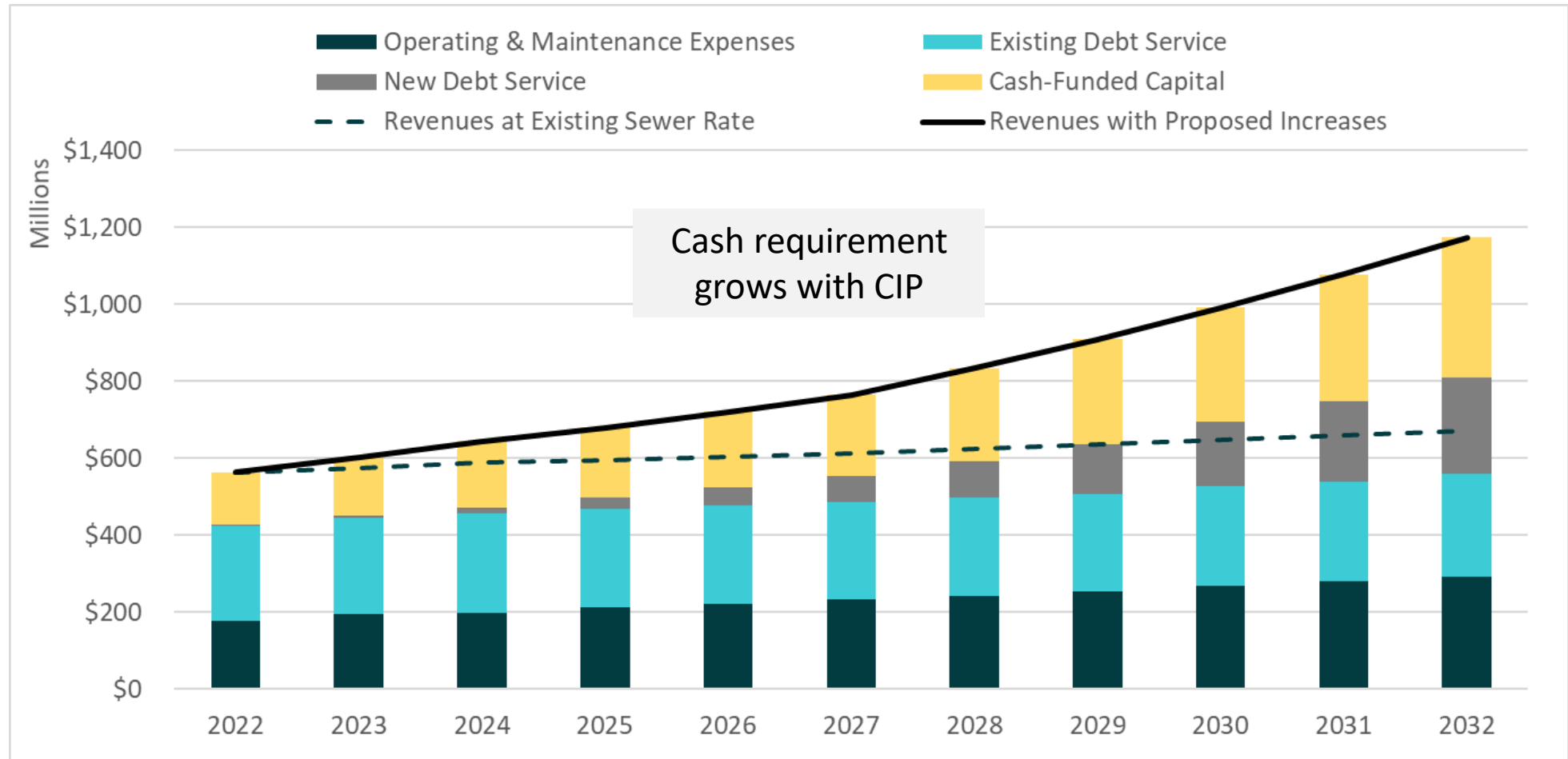
Capital Funding: 2023-2032 Adopted Rate Plan



- Utilities must determine how much cash to generate from annual revenue to fund capital expenditures – sometimes referred to as pay-as-you-go capital (yellow)
- Borrowing is required for CIP costs remaining after cash funding (blue)
- Issuing debt requires increased revenue to repay principal and interest over the term of the bonds (usually 30 years)

System Revenue for Cash-Funding

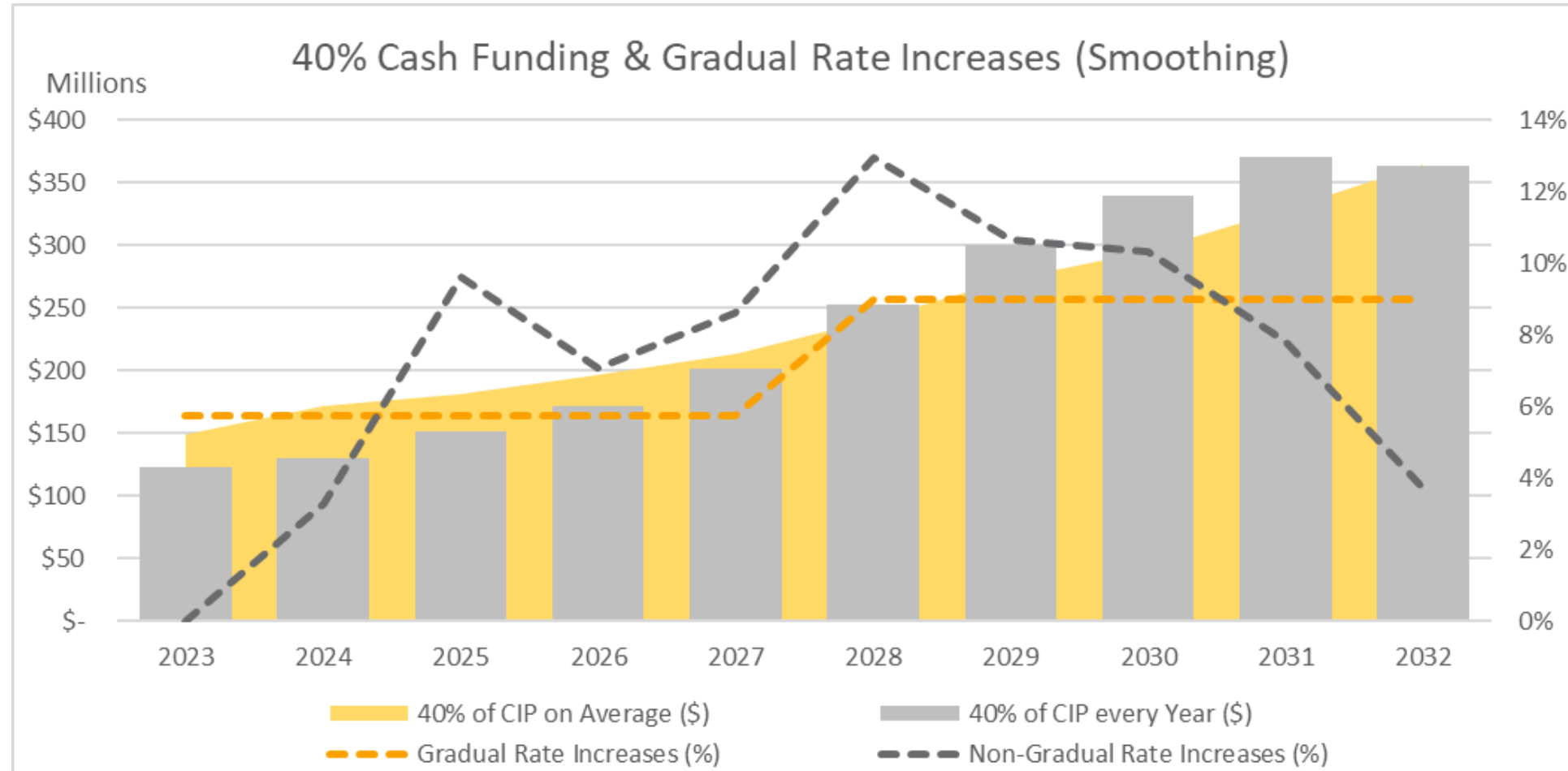
Revenue Requirement: 2023-2032 Adopted Rate Plan



- Sewer rate must be set to generate revenue to cover operating expenses, existing debt service and to meet a cash funding target (yellow)
- Reducing cash funding (yellow) results in higher borrowing and resulting debt service (grey)

Cash-Funding & Rate Smoothing

Annual Cash-Funding Requirements: 2023-2032 Adopted Rate Plan

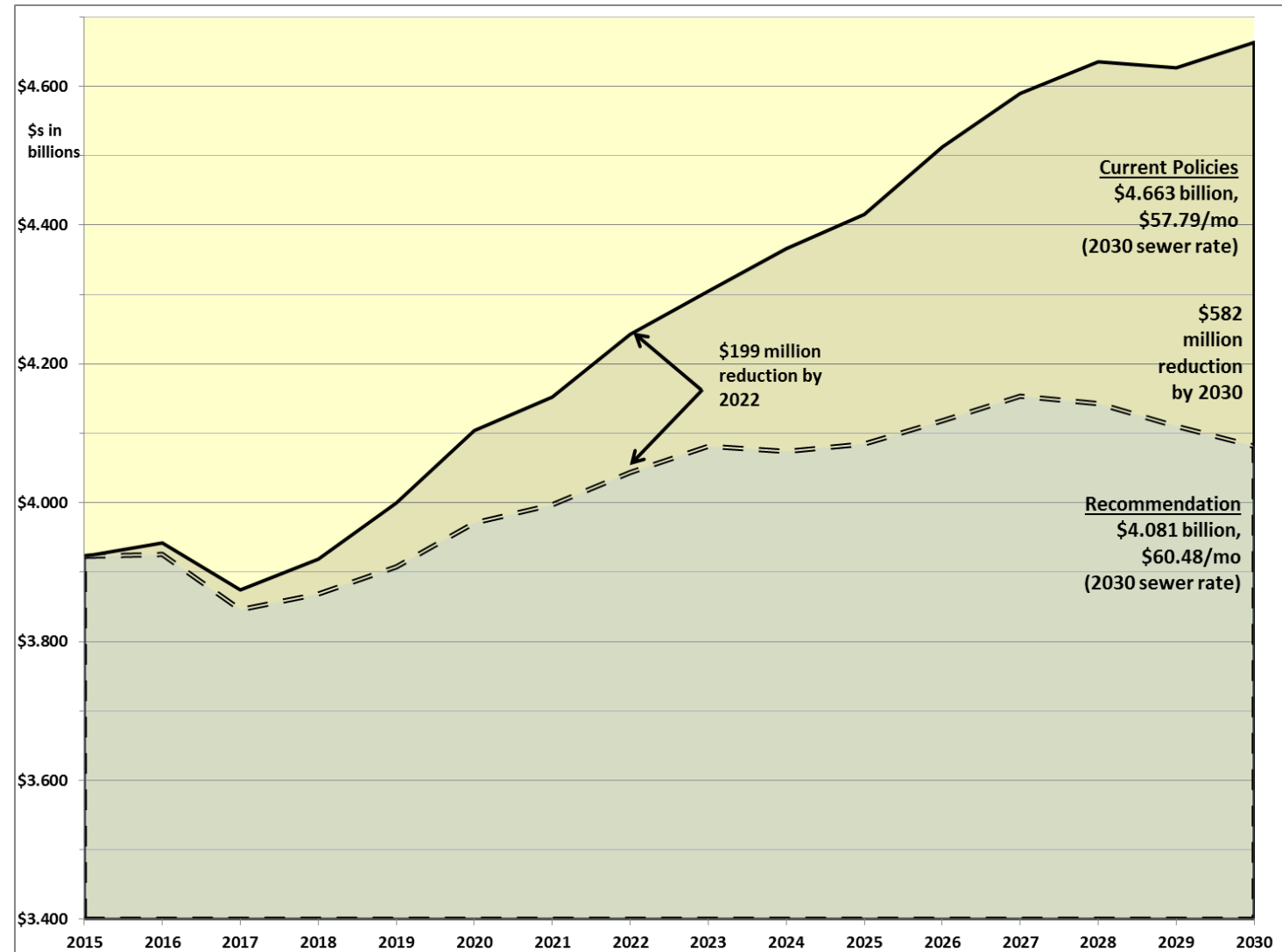


- Cash-funding requirements tied to a rapidly growing CIP result in steep, irregular rate increases (dark grey dotted line)
- WTD “smooths” the rates by averaging the 40% cash-funding requirement over 10 years (orange dotted line)
- Near-term rates become more sensitive to changes in CIP forecasts (more “volatility”)

2017 Implementation – Debt Reduction Initiative

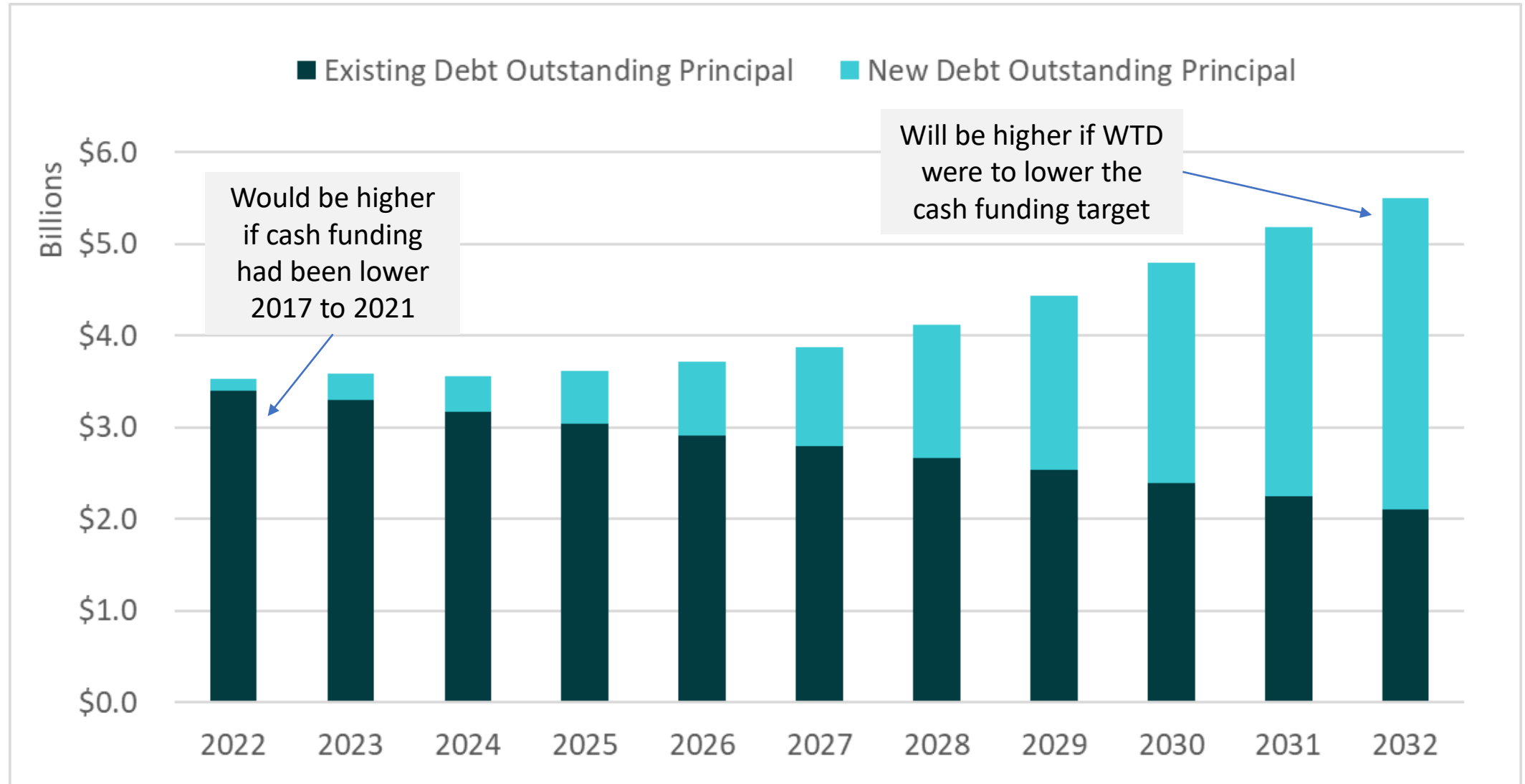
- Historically, any cash-funded capital was a result of the sewer rate revenue generated to meet debt service coverage (DSC) requirements.
- In 2013, MWPAAC formed Debt Review Committee in response to concerns about the amount of debt issued to fund Brightwater and expected new debt for future capital.
- In 2015, MWPAAC recommended increasing the DSC target from 1.15x to 1.40x to reduce growth in its debt balance.
- In response to MWPAAC's recommendations, the 2017 Adopted Rate Plan set the sewer rate at a level sufficient to generate cash to fund 40% of planned capital expenditures.

Projected Outstanding Debt: 2017 Sewer Rate Issue Paper



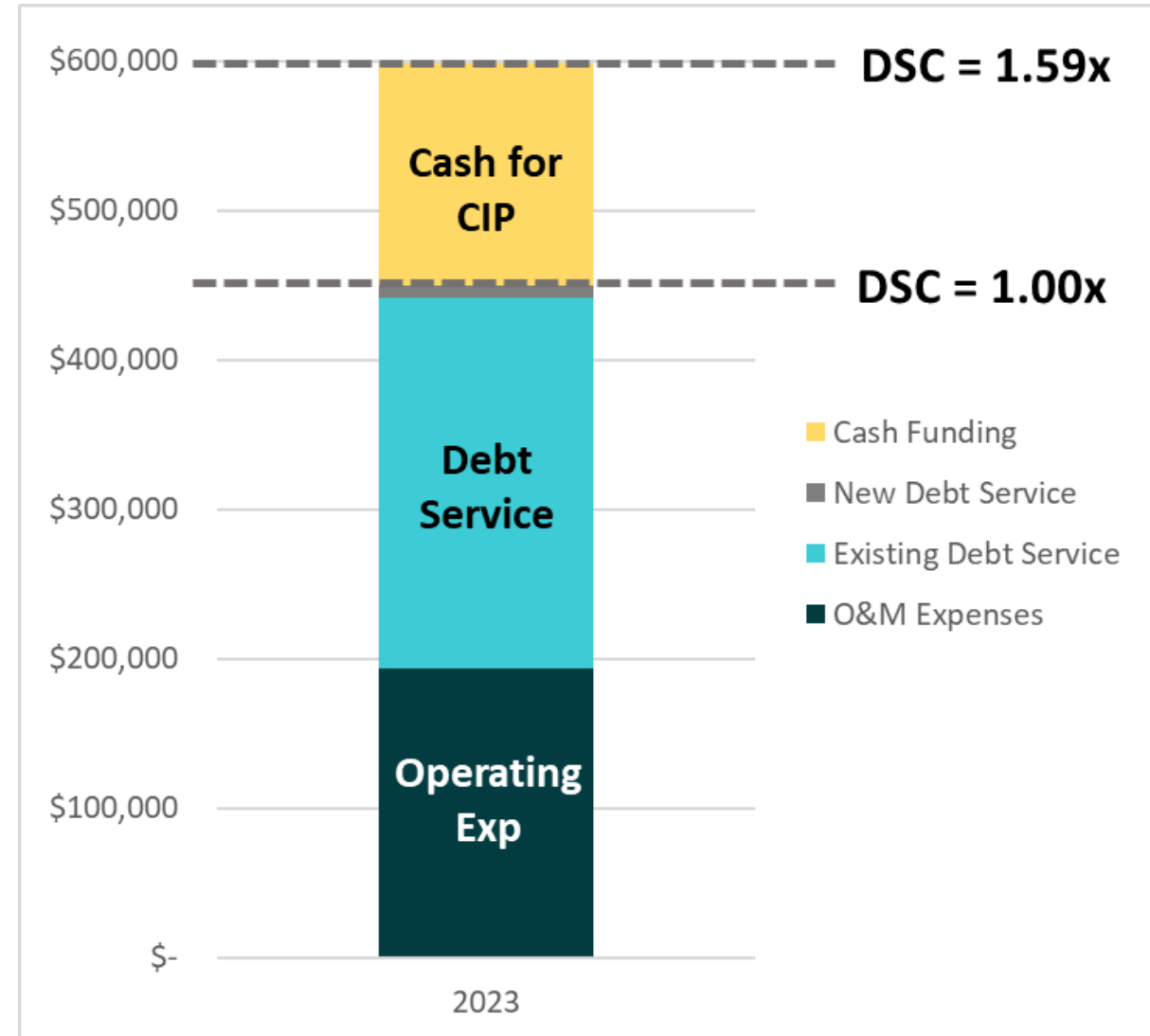
Debt Balances – 2023 -2032 Adopted Rate Plan

Total Outstanding Debt: 2023-2032 Adopted Rate Plan



Cash-Funding and Debt Service Coverage

- Revenue generated for cash-funding CIP helps ensure DSC performance
- 1.00x (times) equals the debt service and factors above demonstrate a cushion.
(Operating Revenues – Operating Expenses) / (Debt Service)
- Bond covenants define a minimum coverage above 1.00x and rating agencies prefer DSC that is above minimums.



Rating Agency Perspectives (DSC)

Moody's assigned it's Aa1 Stable rating July 2021: DSC "satisfactory," below sector median

"...combined debt service coverage (including subordinate lien obligations) was stable at 1.5x, in line with its five-year average of 1.48x. While combined coverage compares below the Moody's rated wastewater sector median of 2.1x, we view it as satisfactory, given the substantial size of the system (\$177.7 million 2020 O&M) compared to the national median of \$11.6 million."

DSC is trending upward in the industry - growing attention to financial capacity to address aging infrastructure

- Moody's median DSC tracking shows a 30% increase between 2009 and 2019 (WTD increased slower at 19%)*
- The five years reported with cash-funding implementation, DSC has averaged 1.54x compared to 1.34x average in the five years preceding the 2017 implementation

History of WTD's DSC and Bond Ratings:

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
WTD All-in DSC Ratio	1.24x	1.33x	1.30x	1.32x	1.28x	1.33x	1.33x	1.36x	1.41x	1.51x	1.49x	1.58x	1.56x	1.57x
S&P Rating	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+
Moody's Rating	Aa3	Aa3	Aa2	Aa2	Aa2	Aa2	Aa2	Aa2	Aa2	Aa1	Aa1	Aa1	Aa1	Aa1

* Moody's May 2020 Sector Profile - Medians

Rating Agency Perspective (Debt & Assets)

Standard and Poor's assigned it's AA+ long term rating in December 2021, but expressed some concern regarding WTD's high leverage level

“Extremely high existing leverage (as measured by the system's 96% debt-to-capitalization ratio, as of Dec. 31, 2020) further tempered by the WTD's \$2.3 billion CIP, which we understand will require approximately \$1.5 billion of additional debt through 2027 (and does not include any potential costs related to the proposed nutrient removal permit);”

S&P August 2019 Ratings Median Data Report also discusses WTD highly leveraged Debt to Capitalization Ratio (how much is owed against assets – similar to home equity)

- King County WTD: 98%*
- Northwest Utilities: 30%
- National “Very Large” Utilities: 47%

Takeaways and Next Steps

A thoughtful cash-funding approach helps us to:

- Manage sewer rate increases
- Uphold WTD's bond ratings
- Ensure debt service coverage performance
- Moderate growth in debt balances

Next steps:

- **Mid-September** - Cash-funding Issue Paper drafted by WTD will be shared with MWPAAC
- **October 6 Rates & Finance Meeting** - Findings and recommendations from this analysis will be presented
- **November/December** - Feedback from MWPAAC and other interested parties, including at MWPAAC General Meeting
- **2023** – Implement cash-funding policy as modified to guide 2024 sewer rate process



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