STANDARD & POOR'S RATINGS SERVICES

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Palo Alto, California; Combined Utility

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Credit Profile		
Palo Alto util sys		
Long Term Rating	AAA/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services affirmed its 'AAA' long-term rating on Palo Alto, Calif.'s series 1995A bonds, issued for the city's electric, gas, water, sewer treatment, sewer collection, and storm drainage utilities.

The 'AAA' rating reflects our view of the following credit strengths:

- A closed senior lien;
- The continued ability of the combined six systems, as well as each individual system, to generate strong surpluses, achieve high levels of debt service coverage (DSC), and maintain strong liquidity while funding ongoing capital improvements mostly from annual surplus revenue;
- Strong operations, including a low-cost power supply, as well as ample water supply and sewer treatment capacity;
- Very high reserves and low debt levels, along with limited capital needs;
- Very strong financial management practices and policies;
- A vibrant economic base with above-average wealth and income levels; and
- A diverse mix of revenue supporting debt service payments on the bonds, with six different utilities all providing strong individual characteristics.

The bonds are secured by a senior lien on net revenue of the city's combined water, sewer collection, sewer treatment, electric, gas, and drainage funds. The lien is closed.

The largest system in terms of revenue is the electric system, followed by the gas system. The electric system accounts for 51% of unaudited fiscal 2012 operating revenue, in line with historical proportions, with the gas system accounting for 18%. The electric system is very strong financially, and has always had a distinct cost advantage over the investor-owned utilities (IOUs) and local municipalities, providing the electric fund with significant financial flexibility. According to U.S. Department of Energy figures for 2010, Palo Alto's average total electricity retail rate is 9% below the state average and 15% below the rate for Pacific Gas & Electric Co. (PG&E), the investor-owned utility in the area.

The combined systems' finances are extremely strong. With only $84 million in direct debt and $84 million in off-balance-sheet debt associated with electric generation from Northern California Power Agency (NCPA), the systems had a low combined leverage as of audited fiscal 2011, especially versus audited cash balances of $223 million for the same period. Consequently, annual debt service costs are very low compared with those of most integrated utilities in California Senior DSC estimated for fiscal 2012 was 109x, or 82x after general fund transfers. Combined DSC when including all senior- and subordinate-lien debt from all six utilities was 14.0x, or 10.5x after transfers. Fixed-charge coverage, which takes into account off-balance-sheet debt and transfers to the city's general fund, was likewise very strong at 4.6x in fiscal 2012, and supports the very high rating on the combined systems. Estimated cash reserves as of fiscal 2012 were $235 million, equal to about 500 days of operating costs.

Management is well above average, as demonstrated by financial policies, timely rate adjustments to reflect projected costs, and risk management practices. Palo Alto has also demonstrated the willingness to pass along rate increases as its costs rise, with substantial adjustments enacted during the past several years.

Outlook

The stable outlook reflects our anticipation that coverage and cash reserve levels will remain extremely strong given limited debt and capital needs, ongoing rate increases, large operating surpluses, and generally competitive rates. We don't anticipate changing the rating during the next two years given the utilities' extremely strong financial metrics.

Operations

Palo Alto Utilities provides water, sewer, drainage, gas, electric, and refuse services. Based on revenue, the largest are the electric ($119 million in operating revenue in fiscal 2011), gas ($42 million), and water ($31 million) systems.

Palo Alto's power supply comes from a diverse group of resources, with relatively inexpensive hydro power resources from Western Area Power Administration serving 42% of its load. Long-term purchased power contracts for wind and landfill gas contribute to Palo Alto's renewable resource needs, which totaled 21% as of fiscal 2011. California law requires 33% by 2020. Gas-fired generation from NCPA accounts for 11% of resources. The city served 29,527 customers as of 2012, with 90% of accounts residential. Consistent with management policies, bilateral contracts reduce the city's exposure to electricity market volatility. The electric system exhibits modest concentration among the leading customers, with the top 10 providing about 33% of annual electric system revenue. The single largest customer, however, accounts for only 7.4% of revenue. Because Palo Alto typically has a long position, off-system sales are made when power is available, providing additional revenue, but accounted for less than 3% of total operating revenue in 2012. No rate increases are needed or planned until 2015, with rate increases of 4%, 6%, and 5% planned for fiscal years 2015, 2016, and 2017, respectively. Financial margins are strong, and cash reserves in the electric system were estimated in 2012 at $135 million, the equivalent of 581 days' expenditures.

The gas utility is the sole provider of gas service within the city, with gas delivered to the city through PG&E Corp.'s transmission system to four receiving stations. Gas accounts total 23,902, up slightly from 23,353 in 2006, and almost one-half of consumption is residential. The leading 10 customers represent 23% of total gas usage and 18% of total revenue. The most recent rate change was a decrease of 10% in July 2012 as wholesale gas prices declined, and future rate increases are projected at 4% annually. The city has historically hedged a portion of gas needs out three years, but given very low gas prices the hedging program is not active. No automatic gas cost pass-through exists, but management reviews rates annually. Gas rates are slightly above average when compared with those of PG&E, the only other natural gas provider in the county. The gas system's unrestricted cash and investments as of unaudited fiscal 2012 totaled $36 million, equal to 512 days of operations. The gas system's five-year capital improvement plan (CIP) totals $30.4 million in projects.

The water system is the sole provider of water within Palo Alto, which covers an area of approximately 26 square miles. The customer base is stable, having grown only slightly to 20,323 accounts as of 2012 from 19,645 in 2006. Residential customers account for about two-thirds of all water usage. The 10 largest customers account for just 17% of revenue. City officials anticipate that water consumption will remain stable, with average daily usage of 10.4 million gallons per day (mgd) in 2012, up from 10.1 mgd in 2010, versus total supply of 17 mgd. Peak demand is estimated at around 12 mgd.

The water system purchases all of its water from the San Francisco Public Utilities Commission (SFPUC) through a contract that runs through June 30, 2034. The contract was renewed in 2009 without significant changes to the cost allocation methodology. Palo Alto anticipates that the volume provided under the contract will be more than adequate to handle the system's demand, and may even consider selling its surplus. We understand that the city has additional water capacity from its own well production capabilities for emergency service, and for interconnections to other providers or cities.

Following what we consider sizable rate increases from 1999 through 2009, water rates, at about $74 per month for 7,500 gallons of usage, are competitive for the area, and high income indicators mitigate any concern with regard to ability to pay. Following wholesale rate increases from the SFPUC, Palo Alto increased rates 20.9% in October 2011 and an additional 15% on July 1, 2012. Management also projects rate increases of 15% in fiscal 2014 and 9% in fiscal 2015.

Rate increases are largely in response to SFPUC rate increases stemming from its $4.6 billion water system improvement project, and management (based on input from the SFPUC) anticipates that rates will almost double by 2018. These rate increases will also replenish the water fund's rate stabilization fund to targeted levels; the city anticipates drawing down the RSF in 2013 and 2014 to less than its minimum target level of 15% of budgeted sales revenue. (The maximum target is 30% of budget sales.) Palo Alto has been planning for these increases for the past several years, and will continue to address rising wholesale water supply costs through rate increases.

In our opinion, the financial health of the water system and management's demonstrated willingness to adjust rates when it deems doing so necessary mitigate our concerns regarding increasing wholesale costs for the water system. The water system's estimated unrestricted cash and investments as of fiscal 2012 was $23.7 million, which was equal to 328 days of operations. The water system's five-year CIP totals $29.2 million in projects.

For the sewer system, average daily flow in fiscal 2012 was 22 mgd, with peak flow of 50 mgd, versus dry and wet weather capacity of 39 and 80 mgd, respectively. Sewer and storm accounts in 2012 totaled 22,411, of which 21,015 or 94% were residential. Leading customers include Stanford Hospital, the city, the school district, and various high-tech firms. Capital needs are manageable for each system, with five-year CIPs of $23 million for sewer collection, $13 million for sewer treatment, and $14 million for storm utilities. Capital projects consist largely of rehabilitation and replacement projects. According to the city, no additional bond issuance is planned for any of the three systems, as funding will come from operations and cash on hand, or grants, if received.

As of fiscal 2012, the combined sewer system cash was estimated at an extremely strong $32 million, or 387 days' of operations, with storm system cash estimated at $6.8 million, or almost four years' cash.

Direct debt of the six combined systems was approximately $84 million as of June 30, 2011, which compares favorably with cash reserves of $223 million held as of June 30, 2011.

Economy

Palo Alto, with a population of 64,403 as of 2011, is 35 miles south of San Francisco in Santa Clara County, the heart of Silicon Valley. The city, home of Stanford University, is built out, which reduces growth and capacity pressures for its utilities. The Palo Alto economy is, in our view, strong, but we believe it exhibits some concentration in the high-tech sector, which has created much of the city's wealth. Median household and per capita effective buying income are 199% and 251% of the national averages, respectively, and unemployment, at 4.5% as of August 2012, is significantly below the state's 10.4% rate. Residents participate in the greater San Francisco and Silicon Valley economies. Overall customer concentration is manageable, in our opinion, and there is much overlap among the top customers of each utility system. Leading utility customers include a mix of local governments, hospitals, residential real estate complexes, and high-tech firms.

Related Criteria And Research

- USPF Criteria: Key Water And Sewer Utility Credit Ratio Ranges, Sept.15, 2008
- USPF Criteria: Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008
- USPF Criteria: Electric Utility Ratings, June 15, 2007