

RatingsDirect®

Summary:

Palo Alto, California; Combined Utility

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Credit Profile

Palo Alto util sys (AMBAC)

Unenhanced Rating

AAA(SPUR)/Stable

Affirmed

Many issues are enhanced by bond insurance.

Rationale

Standard & Poor's Ratings Services affirmed its 'AAA' long-term rating and underlying rating (SPUR) on Palo Alto, Calif.'s series 1999A bonds, issued on behalf of the city's sewer collection, sewer treatment, and storm drainage utilities.

The 'AAA' rating reflects our view of the city's:

- Extremely strong financial metrics, including very high reserves and low debt levels, which enable the city to achieve high levels of debt service coverage (DSC) and fund ongoing capital improvements from annual surplus revenue;
- Very strong financial management; and
- Vibrant economic base (AAA/Stable general obligation rating) with well above-average wealth and income levels.

The bonds are secured by a subordinate lien on net revenue of the city's wastewater treatment, wastewater collection, and storm drainage systems, with the city's sewer system responsible for 71% of debt service requirements and the storm drainage system responsible for the remainder. Senior-lien 1995A bonds, issued for the city's six utilities (electric, gas, water, sewer treatment, sewer collection, and storm), are paid prior to the lien on the 1999A bonds. Although there is no cross-collateralization between the two funds (sewer and storm), a common debt service reserve fund is in place, and each fund maintains an extremely strong liquidity position.

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 average, 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.

Management of Palo Alto Utilities, which also includes water, electric, gas, and refuse systems, is strong, in our view, as demonstrated by formal financial policies, regular rate adjustments, and risk management practices. For the sewer system, average daily flow in fiscal 2012 was 22 million gallons per day (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 technology firms.

Financial performance for the combined sewer treatment and collection systems has been very strong during the past few years, with DSC of 4.5x in audited fiscal 2011 after accounting for transfers and senior-lien obligations, estimated at 5.0x in unaudited 2012 and budgeted at 4.6x in 2013. Even when including debt service costs related to two state loans, all-in DSC is estimated at 4.1x in 2012 and 3.8x for 2013. Likewise for the storm drainage system, DSC was a very strong 4.0x in 2011, estimated at 4.2x in 2012, and budgeted at 3.4x in 2013. The combined sewer system cash estimated as of fiscal 2012 was an extremely strong \$32 million, or 387 days' of operations, with storm system cash of \$6.8 million, or almost four years' cash. Direct debt of the three combined systems is \$31.2 million, which compares favorably with estimated cash reserves of \$39 million held as of June 30, 2012.

Capital needs are manageable for each system, with five-year capital improvement plans 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.

Outlook

The stable outlook reflects our anticipation that the city's ability to generate strong surplus revenue during the next two years will provide sufficient funding for capital improvements, allowing the city to maintain its extremely low debt burden, robust DSC, and strong reserve levels. We don't anticipate changing the rating during the next two years given the systems' extremely strong financial metrics.

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

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