

Tacoma Power, Washington

Electric System Revenue Bonds

New Issue Report

Ratings

New Issue

\$69,905,000 Electric System Revenue Bonds, Series 2017 AA-

Outstanding Debt

\$358,335,000 Tacoma Power Electric System Revenue Bonds, Series 2010 A, B and C and 2013 A and B AA-

Rating Outlook

Stable

Key Utility Statistics

(As of Fiscal Year End 2016)

System Type	Retail Electric
NERC Region	WECC
Number of Customers	176,784
Annual Revenues (\$ Mil.)	418.6
Primary Fuel Source	Hydro
Peak Demand (MW)	906
Retail Energy Growth (%)	0.9
Debt Service Coverage (x)	2.84
Days Operating Cash	240
Equity/Capitalization (%)	63.6

NERC – North American Electric Reliability Corporation. WECC – Western Electric Coordinating Council.

Related Criteria

[Rating Criteria for Public Sector Revenue-Supported Debt \(June 2017\)](#)

[U.S. Public Power Rating Criteria \(May 2015\)](#)

Related Research

[Fitch Rates Tacoma, WA's Electric System Rev Bonds 'AA-'; Outlook Stable \(August 2017\)](#)

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New Issue Details

Sale Information: \$69,905,000 Electric System Revenue Bonds, Series 2017.

Security: Bonds are payable from net revenue of the electric system.

Purpose: Bond proceeds will reimburse and pay for capital improvements to the electric system and pay the costs of issuance. The bonds will be sold via a negotiated sale the week of Aug.14, 2017.

Final Maturity: January 2046.

Key Rating Drivers

Retail Provider: Tacoma Power operates a vertically integrated retail electric system and a relatively smaller telecommunications business called Click! Network. The electric system serves a gradually growing, nonconcentrated customer base located in and around the city of Tacoma, WA.

Low Cost Power Supply: Power supply needs are met through low-cost, carbon-free and flexible hydroelectric generation resources that are both owned and contracted. The Bonneville Power Administration (BPA) provides approximately half of Tacoma Power's needs under a long-term contract expiring in 2028.

Solid Financial Profile: Financial metrics remain consistent with the rating. Debt service coverage (DSC) improved in 2016 due to lower debt service, increased wholesale revenue and recent retail rate increases. Liquidity levels are sound with 240 days cash on hand at YE16.

Wholesale Sales: Tacoma Power is a net seller into the wholesale power market in most years. These nonfirm, short-term sales are subject to variability in hydrological conditions and market prices, leading to volatility in wholesale revenue. Favorably, the utility implemented retail rate increases to reduce reliance on wholesale revenue to support financial performance.

Telecommunications Business: Click! is not self-supporting and is expected to require approximately \$6 million in financial support in 2017 from the electric system. The competitive nature of the telecommunications industry could continue to erode the Click! customer base and provide an additional level of risk. Continued financial support by the electric system, to the detriment of financial metrics, could pressure the rating.

Rating Sensitivities

Management of Revenue Streams: Rating stability for Tacoma Power is dependent upon the utility's ability to manage volatile wholesale sales, uncertain telecommunication revenue and retail electric revenue in a manner that maintains stable financial performance.

Issuer Rating History

Rating	Action	Outlook/ Watch	Date
AA-	Affirmed	Stable	8/7/17
AA-	Affirmed	Stable	4/28/15
AA-	Affirmed	Stable	4/30/13
AA-	Affirmed	Stable	6/4/12
AA-	Upgrade	Stable	6/17/10
A+	Affirmed	Stable	9/25/09
A+	Affirmed	Stable	2/14/07
A+	Affirmed	Stable	9/7/05
A+	Affirmed	Stable	5/6/04
A+	Assigned	Stable	5/6/04

Credit Profile

Tacoma Power is a division of the city of Tacoma's Department of Public Utilities (the department). The utility operates the city's vertically integrated electrical generation and distribution facilities along with Click!, its telecommunications division. Click! accounted for approximately 6.4% of operating revenue in 2016.

Tacoma Power is one of the largest publicly owned utilities in the Pacific Northwest, serving approximately 176,784 customers in a modestly growing service area approximately 180 square miles, including the greater Tacoma area.

Governance and Management Strategy

The department, governed by a five-member board, is composed of the light division (dba Tacoma Power), the water division and the belt line railroad division. Each division is accounted for separately. Board members serve five-year rotating terms, and are appointed by the mayor and confirmed by the city council. In turn, the board appoints the department director, who acts as CEO. In 2014, a change to the city charter was implemented and passed city vote. While the department director is still appointed by the utility board, the director also needs a confirmation vote by city council to be appointed. The city council will also review the director's performance annually and vote to reconfirm appointment every two years.

The board has approval authority for most department business. However, budgets, rates and bond issues must also be approved by city council. Approved rates and charges are not subject to approval from other governmental agencies, but are subject to citizen comments at a public meeting. Recent rate increases were approved unanimously, demonstrating political support for the utility.

Financial Targets

Fitch Ratings views Tacoma Power's budgeting and financial planning practices positively. Tacoma Power sets rates at a level providing a cash balance equivalent to at least 90 days of operating expenses in adverse situations such as a poor water condition occurring only 25% of the time in 80 years. For the purposes of calculating financial metrics, operating expenses include debt service of principal and interest, and gross earnings tax and capex, which Fitch considers a conservative methodology. DSC is targeted at 1.5x under adverse water conditions and 1.8x under average water conditions.

Customer Profile and Service Area

The city is located on the Puget Sound in Pierce County, WA. The area has a diverse economy, with industry sectors including the military, healthcare, manufacturing and wholesale distribution. The city is home to the Port of Tacoma, the seventh-largest North American seaport. The port has 2,400 acres used for shipping, warehouse storage, distribution and manufacturing, and is considered an economic engine for the region.

Tacoma Power is one of the largest publicly owned utilities in the Pacific Northwest in terms of customers served and energy sold. Customer growth for the electric business is positive and manageable, with a total increase of approximately 4.6% from 2012 to 2016. Even with the growth in customers, retail energy sales are projected to decline over the medium to long term due to increased efficiency and conservation.

Recent sales trended modestly negative, with much of the annual variation attributable to weather. Tacoma Power's customer base is relatively nonconcentrated. The single largest, and top 10 customers, accounted for about 5% and 17%, respectively, of 2016 retail electric revenue. Retail sales by customer class are stable, with residential customers composing

approximately 39% of retail sales; commercial and industrial customers account for the remainder.

Sales Information

	2012	2013	2014	2015	2016
Peak Demand (MW)	922.9	980.0	1,011.8	872.0	881.1
Total Electric Sales (MWh)	7,885,215	7,051,724	7,572,632	6,505,033	7,358,604
Total Electric Sales Growth (%)	—	(10.57)	7.39	(14.10)	13.12
Retail Sales (MWh)	4,748,288	4,806,761	4,729,938	4,587,348	4,627,528
Retail Sales Growth (%)	—	1.23	(1.60)	(3.01)	0.88
Residential Sales (% of Retail)	39.83	39.66	39.05	38.31	39.13
Commercial and Industrial Sales (% of Retail)	48.74	48.24	49.23	49.81	49.04
Wholesales Sales (% of Total)	39.78	31.84	37.54	29.48	37.11
Average Load Factor (%)	0.59	0.56	0.53	0.60	0.60
Total Customers	169,016	171,506	172,531	174,558	176,784

Source: Tacoma Power, Washington, audited financial statements.

Assets and Operations

Fitch views Tacoma Power's resource mix as a significant credit strength. Consisting largely of owned and contracted hydroelectric resources, Tacoma's power supply is relatively low-cost, carbon free and flexible in operation. Current resources are projected to be sufficient to meet power supply needs through 2037 under critical water conditions. Tacoma Power serves as its own balancing authority and owns and operates 351 miles of transmission facilities to serve retail load and provides wholesale transmission to 10 smaller utilities.

Owned resources include five hydroelectric projects accounting for 42% of Tacoma Power's 2016 power supply needs. The most significant resources and average cost of generation in 2016 are summarized below. The total average cost of owned resources was very competitive in 2016 at \$10.14/MWh. These resources are flexible in operation, with owned-resources largely consisting of reservoirs allowing the utility to manage flow releases to maximize value. Positively, owned and contracted resources are somewhat geographically distributed, allowing for some diversification benefits in terms of watersheds and water conditions.

Large Power Resources Summary

Generating Unit	License Expiration	Generating Units (No.)	Aggregate Name Plate Rating (kW)	2016 Power Supply (%)	Operating Cost (\$/MWh)
Nisqually River Project	2037	7	114,000	8.4	9.06
Cushman Hydro Project	2048	5	124,200	6.7	12.78
Cowlitz River Project	2038	6	462,000	26.5	9.90
Wynochee River Project	N.A.	1	12,800	0.5	2.47

N.A. – Not applicable.

Source: Tacoma Power, Washington.

BPA Contract

Tacoma Power entered into a power purchase agreement with BPA on Oct. 1, 2011, expiring on Sept. 30, 2028. BPA supplies more than half of Tacoma Power's energy needs through a block/slice contract.

The block product provides a guaranteed energy amount over all hours of the month, with blocks varying from month to month to correspond with seasonal variations in Tacoma Power's load. In 2016, the monthly energy amount ranged from 142 aggregate megawatts (aMW) to 228 aMW.

The Slice product represents a specific percentage of the federal system. Tacoma Power's percentage is 2.97%. The actual amount of energy received under the slice product is based

on the system's performance, causing the utility to bear the hydro-volatility risk. Under critical water conditions, Tacoma Power's slice allocation is projected to provide 210 aMW.

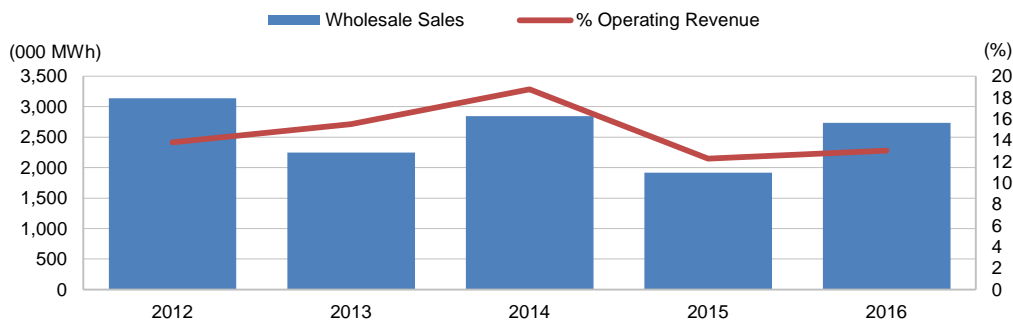
Stream flows related to BPA's production were approximately 99% of normal in 2016, resulting in a competitively priced cost of power at an average of \$28.62. Water flows pertaining to BPA production are expected to be higher in 2017, at an estimated 137% of normal.

Wholesale Sales

Tacoma Power is a net seller into wholesale markets under most water conditions given its resource base, load shape and seasonality of hydroelectric generation. Wholesale power prices declined significantly in the Pacific Northwest over the past several years, reducing revenue earned by the utility on wholesale sales.

Positively, Tacoma Power took steps to reduce reliance on wholesale revenue by increasing retail rates and reducing debt service costs. In addition, the utility is increasingly looking to sell non-energy products and services to derive additional value from flexible resources to offset revenue declines from low power prices.

Tacoma Power Wholesale Energy Sales



Source: Tacoma Power.

Renewable Portfolio Standards

The state's renewable portfolio standards (RPS) require utilities serving greater than 25,000 customers to obtain 3% of load from renewable resources by 2012, 9% by 2016 and 15% by 2020. Eligible resources include incremental hydro, wind, solar or renewable energy credits (RECs). Large hydro, which is the majority of Tacoma Power's generation resources, is not eligible to meet the state's RPS requirements.

Tacoma Power met the requirements through a combination of incremental hydro projects and the purchase of RECs. Management estimates the utility will remain in compliance through 2025 with already secured resources, including banked RECs.

Click! Network

Tacoma Power's telecommunications division, Click!, was launched in 1998. Click! provides Tacoma Power with two-way signals for advanced metering, while providing customers with retail cable television, wholesale broadband and wholesale high-speed internet over a cable modem.

Click! provides retail cable TV services to 17,468 customers and 23,344 wholesale Internet customers. Click! currently maintains an approximate 15% penetration in a very competitive local cable television market, down from 20% in 2012. Click! provides internet service to the

city of Tacoma keeping the city’s cost of telecommunications low. Additionally, cable modem systems support Tacoma Power’s SMART electric meters throughout its service area.

Click! has been operating at a loss for a number of years and the electric system helped to support the business financially. A lawsuit was recently filed against Tacoma Power seeking \$21 million, claiming the electric system subsidy to Click! is illegal. The timeline and outcome from the lawsuit are uncertain at this time.

The electric system is expected to provide around \$6 million in financial support to Click! in 2017. The reduced subsidy amount in 2017 is largely driven by the utility’s decision to stop building out the Click! network while the lawsuit is pending.

Click!’s operating performance weakened in recent years as revenue failed to keep pace with expenditure. A 12.9% rate increase was implemented in 2017 and another is planned for 2018, although the declining customer base for cable services adds significant uncertainty to how much additional revenue will be generated by raising rates.

Previous proposals to spin off Click! or enter into a public-private partnership have not moved forward. Management started developing a business plan to improve Click!’s financial performance, which was temporarily suspended pending the outcome of the lawsuit referred to above and further policy direction.

Cost and Rate Structure

Electric rates are established by the utility board and require city council approval. Retail rates are competitive, remaining below most other utilities in the region. Tacoma Power began increasing retail rates in April 2011 to offset declining wholesale revenue and shift the revenue structure to more reliable retail sales. Fitch views this transition positively. A chart showing the recent annual rate increases is provided to the left.

Financial Performance

Financial metrics have been generally strong and stable over the past five years with the exception of 2015, when coverage levels declined as a result of higher debt service costs and lower wholesale revenue. In 2016, Fitch-calculated DSC and coverage of full obligations improved to 2.84x and 1.46x, respectively, generally consistent with preceding years except 2015. The return to more baseline financial performance was due to a combination of lower debt service, improved wholesale revenue and the implementation of retail rate increases.

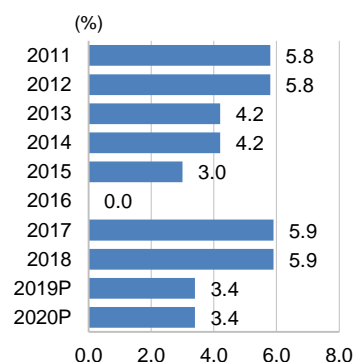
Management’s implementation of a series of rate increases helped to insulate metrics from wholesale sale fluctuations. Wholesale revenue demonstrated significant variability over the past several years, hitting a high of \$82.8 million in 2014 and a recent low of \$53.5 million in 2012. Wholesale revenue was approximately \$54.5 million in 2016.

Financial projections reflect the increased reliance on retail rather than wholesale revenue to support financial performance. Approved retail rate increases of 5.9% in 2017 and for 2018 and projected annual increases of 3.4% through 2022 are projected to continue increasing retail revenue as a percentage of total operating revenue. Financial metrics are expected to remain in line with similarly rated peers with DSC under adverse water conditions staying at or above 1.85x through the forecast time frame. Liquidity levels are likewise projected to remain satisfactory, falling to a still adequate level of 193 days in 2022.

Liquidity

Liquidity levels are sound with unrestricted funds equal to 240 days cash on hand. The utility’s rate stabilization fund, which is included in this total, remained at \$48 million since 2012. The funds are available to offset or minimize the need for large rate increases in any given year.

Percent Average Retail Rate Increase^a



^aRate increases effective April 1.
P – Proposed.
Source: Tacoma Power.

The utility used significant cash balances to pay down debt in recent years and plans to do so again following this transaction. Management plans to use up to \$28 million in unrestricted cash to defease a portion of outstanding debt and level debt service through 2020. Cash balances are expected to remain at levels commensurate with the rating following the transaction.

Tacoma Power retains two bank facilities to provide for additional liquidity and financing options. A \$100 million facility with Wells Fargo & Company (AA-/Negative) provides the utility with short-term financing for capital investments. The utility finances construction and related activities with the facility and then fixes out the debt into long-term bonds once borrowings under the agreement reach a certain size.

Tacoma Power retains a \$25 million facility with KeyBanc N.A. to provide liquidity for general business needs. The facility can be increased to \$50 million at the utility's option with 90 days' notice to the bank.

General Fund Transfers

The city charter prohibits the use of Tacoma Power revenue to make loans or purchase the bonds of any other utility, agency or department of the city. While it does not transfer funds to the general fund, Tacoma Power is required to pay a gross earnings tax to the fund and a public utility tax to the state of Washington. The city tax is subordinate to debt service and paid after, while the state tax is part of the utility's operating expenses and paid prior to debt service.

An increase in the gross earnings tax on electric revenue was recently approved by the city's voters. The tax was increased through 2025 to 7.5% from the previous 6.0%. Cable television revenue continues to be taxed at the maximum allowable rate of 8.0%. Cable revenue is also subject to a 5.0% city franchise fee. Combined, the taxes and fees paid by Tacoma Power amounted to 12.0% of operating revenue in 2016.

Capital Plan

The 2017 through 2021 capital improvement plan (CIP) totals \$444.8 million, with the majority of the capital investment dedicated to transmission and distribution system improvements. While the utility has a long-term goal of financing approximately 50.0% of capital investment from debt, approximately 58.7% of the CIP is expected to be debt financed. Fitch views the additional debt as manageable for the utility at the current rating level.

The CIP includes approximately \$13 million for additions to the Click! network. The investments are currently on hold pending a lawsuit against the use of electric funds to support the Click! system.

Legal Provisions

Rate Covenant

Establish, maintain and collect rates adequate to cover annual debt service of 1.25x. Transfers from the rate stabilization fund are included in the calculation.

Reserve Account

The series 2017 bonds will not have a debt service reserve fund.

Additional Bonds

Can be issued if 1.25x DSC of maximum annual debt service in the previous 12-month period if the bonds were outstanding.

Tacoma Power, Washington

(\$000, Audited Years Ended Dec. 31)	2012	2013	2014	2015	2016
DSC (x)					
DSC	2.22	2.28	2.40	1.67	2.84
Adjusted DSC (Including PP Adjustment as DS)	1.77	1.76	1.85	1.40	1.88
Adjusted DSC (Including Transfer/PILOT/Dividend as O&M Expense)	1.78	1.80	1.92	1.23	1.96
Coverage of Full Obligations (PP as DS and Transfer/PILOT/Dividend as O&M Expense)	1.49	1.48	1.56	1.14	1.46
Liquidity Metrics					
Days Cash and Investments on Hand	335	318	335	222	240
Days Liquidity on Hand	335	318	335	222	240
Leverage Metrics (x)					
Debt/FADS	4.4	4.8	4.2	4.7	4.8
Adjusted Debt (Including PP Adjustment)/Adjusted FADS (Including PP Adjustment)	5.2	5.5	5.0	5.6	5.7
Debt/Electric Customers	3,236.7	3,459.1	3,261.4	2,616.1	2,660.5
Net Debt/Net Capital Assets (%)	19.3	19.0	18.2	19.6	20.8
Equity/Capitalization (%)	58.8	57.4	59.4	64.4	63.6
Debt/Capitalization (%)	41.2	42.6	40.6	35.6	36.4
Adjusted Debt/Capitalization (%)	51.1	52.6	50.9	47.9	48.5
Other Financial and Operating Metrics (%)					
Operating Margin	11.6	14.9	15.4	8.3	7.3
Wholesale Electric Revenue/MWh (\$/MWh)	17.1	28.6	29.1	26.3	20.0
Retail Electric Revenue/kWh (Cents/kWh)	6.4	6.4	6.6	6.9	7.0
Transfer and PILOT and Tax/Total Operating Revenue	10.9	11.0	10.5	11.1	12.0
Capex/Depreciation and Amortization	107.8	105.4	128.6	134.8	147.4
DS/Cash Operating Expenses	16.5	15.5	15.1	15.4	9.6
Income Statement					
Total Operating Revenue	387,883	414,462	441,246	410,626	418,614
Total Operating Expense	342,794	352,519	373,173	376,576	388,220
Operating Income	45,088	61,943	68,073	34,050	30,394
Adjustment to Operating Income for Deferred Revenue	75,678	58,297	62,937	59,178	64,600
Funds Available for DS	124,721	123,881	134,678	96,904	98,678
Total Annual DS	56,115	54,442	56,054	58,181	34,749
Balance Sheet					
Unrestricted Funds (Cash and Liquid Investments)	261,385	257,668	287,950	193,804	214,474
Restricted Funds	120,627	172,585	116,119	73,481	43,108
Total Net Assets/Member's Equity	779,206	799,079	822,803	825,933	821,996
Total Debt	547,037	593,256	562,696	456,663	470,332
Cash Flow Statement					
FCF (FADS — Transfer and PILOT — Total Annual DS)	43,990	43,468	51,626	13,241	33,467
Capex	62,326	59,455	76,056	77,375	82,126
FCF Less Capex	(18,336)	(15,987)	(24,430)	(64,134)	(48,659)

DSC – Debt service coverage. PP – Purchased power. DS – Debt service. PILOT – Payment in lieu of taxes. FADS – Funds available for debt service.
Source: Tacoma, Washington; Fitch.

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