FITCH AFFIRMS TACOMA, WA'S ELECTRIC SYSTEM REV BONDS AT 'AA-'; OUTLOOK STABLE

Fitch Ratings-New York-23 September 2019: Fitch Ratings has affirmed the following ratings of the city of Tacoma, WA's electric system, dba Tacoma Power at 'AA-':

--Long-Term Issuer Default Rating (IDR);
--$392.9 million electric system revenue bonds, series 2010B, 2010C, 2013A, 2013B, and 2017.

The Rating Outlook is Stable.

ANALYTICAL CONCLUSION

Fitch's 'AA-'/Outlook Stable ratings on Tacoma Power is based on the utility's revenue source characteristics, which include a component of competitive revenue, as well as the utility's fully independent ability to adjust rates as necessary and generally strong financial performance. The electric system's energy mix includes owned and contracted resources that produce a very low operating cost burden and overall strong operating risk profile despite the concentration in hydro-resources. The system's leverage is very low and expected to remain so despite fiscal 2019's YTD weaker fiscal performance due to critically low regional water flows.

CREDIT PROFILE

Tacoma Power is a unit of Tacoma's Department of Public Utilities that includes vertically integrated electric generation and transmission and telecommunications service to roughly 178,000 customers. The system serves roughly 180 square miles in the city and surrounding area of Pierce County. In addition to the rating of the electric revenue bonds, Fitch rates the city's tax-supported IDR and general obligations (GOs) 'AA'/Outlook Stable.

Additionally, Tacoma Power owns and operates Click! Networks (or Click), a telecommunications business line providing residents with internet and cable services. Financial statements are presented on a consolidated basis.

KEY RATING DRIVERS

Revenue Defensibility: 'a'; Midrange Service Area and Rates; Variable Wholesale Sales

The utility derives a large majority of revenues from retail electric service that Fitch believes is monopolistic in terms of demand characteristics. Additionally, revenue from competitive sources, including market sales of wholesale electricity, accounts for just over 10% of revenue and can be variable, which informs Fitch's view of the revenue defensibility assessment. The electric system serves a gradually growing, non-concentrated, customer load located in and around the city of Tacoma.

Operating Risk: 'aa'; Very Low Cost Hydro Power Supply

Power supply needs are met through very low cost and carbon-free hydroelectric generation resources that are both owned and contracted. The contracted portion is largely associated with Bonneville Power Administration (BPA), which provides approximately half of Tacoma Power's needs under a long-term contract that expires in 2028.

Financial Profile: 'aa'; Solid Financial Profile; Managing Volatility

Leverage declined to 5.0x in fiscal 2018 with coverage and liquidity improving as well. Wholesale revenues continue to fluctuate widely depending on several factors including the hydro conditions in the Northwest, but a continued environment of retail rate increases have produced stable and strong net margins. Days cash on hand (DCOH) remains very sound at 222, and have remained above 200 days since at least 2014 when wholesale revenue peaked and DCOH increased to above 300 days. Lower wholesales sales in fiscal 2019 stemming from the year's critical water conditions will result in lower cash and higher leverage, but not to a level that is expected to pressure the rating.

Asymmetric Additional Risk Considerations

There are no asymmetric additional risk considerations that affected this rating.

RATING SENSITIVITIES

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

SECURITY

The bonds are payable from the net revenues of the electric system.

Revenue Defensibility
The majority of Tacoma's revenues are provided by energy sales to retail customers. However, Fitch's assessment of the utility's revenue source characteristics also incorporates Tacoma's exposure to competitive revenue business lines that annually make up over 10% of total revenues. The majority of this revenue is from excess energy sales into the wholesale power market under most water conditions. These non-firm, short-term sales are subject to variability in hydrological conditions and market prices. Wholesale power prices have declined significantly in the Pacific Northwest over the past several years, reducing revenues earned by the utility on wholesale sales. In response, Tacoma has implemented retail rate increases to supplement lower wholesale revenues in order to support financial performance. Retail electric sales have increased from 71% to 78% of total revenue from fiscal 2014 to fiscal 2018.

Subsidization of Telecommunications Business Potentially Eliminated

In addition to competitive wholesale revenues, Tacoma's telecommunications business accounted for 6% of revenues in fiscal 2018, although net margin from the business has been negative. Click does not generate sufficient revenues to cover its full operating and capital expenses and required approximately $7 million in financial support in fiscal 2018 from the electric system. Notably, management reports the utility is in negotiations with third party partners to run the system that would eliminate the need for the electric system's annual subsidy and has begun eliminating telecommunications positions. An ongoing court case asserting the utility is unlawfully subsidizing the telecommunications business received a partial decision against Tacoma, and Tacoma is continuing its efforts to seek a new business model.

Service Area Characteristics

Tacoma's service area exhibits stable demographic and economic conditions. The number of customers continues to grow modestly with average annual growth at 0.7% over the last five years, although the utility projects a continued decline in overall energy sales as the growth driven from economic development in the service area is not expected to outperform efficiency gains. The service area benefits from proximity to the solid economy in the greater Seattle-Tacoma metro area (Tacoma is about 34 miles south of Seattle). The median household income for the city of Tacoma is in line with national averages. However, unemployment rates in the city and county continue to trend above the national level and limit the service area assessment.

Rate Flexibility

Tacoma has competitive retail electric rates at 89% of the state average as of the most recent EIA data, and electric service is highly affordable at 1.9% of the city's median household income. While the declining trend of both retail loads and wholesale electric revenue has necessitated the current environment of rising retail electric rates (including 2% base rate adjustments in fiscals 2019 and 2020), rate competitiveness and affordability remain very strong.

Operating Risk

Tacoma's portfolio of largely hydroelectric resources (both owned and contracted) produces very low operating cost burden at about 5.9 cents per KWh in fiscal 2018 not including the telecommunications operating expense. The largest expense is the purchased power from BPA at about 39% of expenses. Fitch's cost burden metric includes transfers to host municipalities, which for Tacoma Power comes to $34.4 million or about 7.6% of revenues annually, paid as a gross earnings tax to the city. The tax is largely fixed through 2025 as approved by voters.

The utility's power supply is projected to be sufficient to meet retail needs through 2037 under "near-critical" water conditions (where critical water is 5th percentile, or the worst water year on record over the last 80 years). Owned and contracted resources largely consist of low-cost, well-established, Pacific Northwest hydropower resources. Owned resources include five hydroelectric projects that account annually for just under half of the system's power supply needs. Positively, these owned resources are flexible in their operation as dams with significant reservoirs allow the utility to manage flow releases and maximize their value. The resources are geographically distributed allowing for some diversification benefits in terms of watershed and water conditions. The system serves as its own balancing authority and owns and operates 351 miles of transmission facilities to serve its retail loads.

Resource Diversity Weaker

As with most Pacific Northwest public power providers that Fitch rates, the operating cost flexibility is assessed as weaker due to the concentration of the utility's generating mix in a single fuel type - hydroelectric generation. The reliance on hydroelectric power for roughly three-quarters of power supply creates the potential for future operating challenges or cost impacts. However, Tacoma's power supply portfolio is predominately carbon free, which positions the utility well in regard to efforts aimed at reducing greenhouse gas emissions. The state of Washington has had various carbon tax initiatives proposed but they have all been unsuccessful to date.

Environmental costs are the subject of ongoing litigation and have generally increased over time. These costs are included in BPA's power rates for its preference customers, which includes Tacoma Power. Furthermore, the power sales contracts have a cost recovery adjustment mechanism that allows for additional rate recovery for fish-related cost increases in between rate cases. Fitch will continue to monitor the potential for cost flexibility issues, though none are deemed a limiting factor on the rating at this time.

BPA Contract

Just over half of Tacoma Power's energy needs are purchased pursuant to a long-term contract with BPA that expires on Sept. 30, 2028. The contract was amended in 2011 to include a slice program in addition to the block program. The block product provides a guaranteed energy amount with blocks varying month-to-month based on the seasonal variations existing in Tacoma Power's load. The slice product provides for Tacoma Power to receive a specific percentage (2.97%) of BPA's actual output, causing Tacoma Power to bear additional hydro-volatility risk depending on BPA's performance, but also benefits Tacoma Power directly when water conditions are favorable. The slice portion annually accounts for the larger percentage of the power that Tacoma purchases from BPA.

Renewable Portfolio Standard (RPS)

Washington's RPS requires utilities serving greater than 25,000 customers to obtain 15% of their load from renewable resources by 2020. Eligible resources include incremental hydro, wind, solar or renewable energy credits (RECs). Large hydro - the majority of Tacoma Power's generation portfolio - is not eligible to meet the state's RPS requirements. Instead, the system meets the requirements through a combination of incremental hydro projects and the purchase of RECs. Management estimates that the utility will remain in compliance through 2025 with already secured resources, including banked RECs.

Capital Planning and Management

Planned capital investment appears adequate. The five year capital improvement plan (CIP) totals $453 million (2019-2023), with the majority of the capital investment dedicated to generation and transmission and distribution. While the utility generally funds over half of its capital investment from debt, the long-range plan calls for less debt funding and instead uses additional cash from operations. The CIP is not final, and capital improvements for the Click network that were previously funded by the electric system are now on hold pending the above referenced lawsuit. The capital plan does include a potential $150 million debt issuance in 2021 to fund ongoing replacement and modernization needs. Tacoma's age of plant at 20 years indicates a higher need for lifecycle investment; however, Fitch notes that over the previous five years capex has averaged above the level of depreciation signaling a healthy amount of investment is being made.

Financial Profile
Generally strong financial results over the past five years - with the exception of 2015 when coverage levels declined as a result of lower wholesale revenues but also higher debt service costs - have allowed the utility to continue to maintain healthy cash balances while paying down debt and decrease leverage to 5.0x in fiscal 2018. The utility implemented a series of retail rate increases over this time and has reduced its exposure to variable wholesale revenues while maintaining financial balance. Liquidity levels are sound with unrestricted funds equal to 240 DCOH including the utility's Rate Stabilization Fund (RSF) that has remained at $48 million since 2012. The RSF was established in 2001 to offset or minimize the need for large rate increases in any given year, but has not been drawn upon, which Fitch believes provides significant flexibility to manage future volatility.

2019 Critical Water Conditions

YTD fiscal 2019 water conditions are one of the two worst years on record and considered near-critically low. Despite the very poor water inflows into the city's reservoirs and regional snowpack relied upon for electricity generation, the system does not estimate a need to draw on the RSF even in an additional five years of "adverse" (25th percentile) water conditions. Declines in wholesale revenue (as of June 2019) were down $14 million or 25% yoy. on operating revenues of $455 million in fiscal 2018. Notably, the decline in revenue is expected to be more than offset by the increase in retail revenue from 2% base rate increases implemented in fiscals 2019 and 2020.

Fitch Forward Look

Fitch considers the utility's forecast in its stress case and believes leverage will increase, but should remain acceptable for the rating category. Fitch's base case assumptions include 2% rate increases going forward for the medium term, the separation of the telecom unit, adverse water conditions, capex from the CIP, and poor operating results in fiscal 2019.

Leverage is expected to increase to 7x largely due the poor performance in fiscal 2019 and also increased capital spending. Over the period through 2023, however, Fitch expects leverage will settle below 8x as the utility continues to adjust rates as necessary, funds a majority of capital from healthy margins, experiences savings from the new business model for the telecom unit, and maintains significant reserve levels. The board has approved 2% retail rate increases through 2020.

The utility's internal long-term financial plan includes various stress scenarios including budgeting for adverse water conditions in each of the five years of the projections, which would be an unprecedented event following upon the critical water year in 2019. This financial planning assumption is significantly harsher than the Fitch Analytical Stress Test (FAST). In a stress scenario where Fitch applies a moderate demand stress to retail (but not further stressing already critically water conditions in the wholesale market), leverage increases further to roughly 9x before settling back below 8x subsequent various adjustments that management could make including a potential 4% rate increase that management has discussed to offset various scenarios of revenue stress. Tacoma in the past has shown willingness to quickly adjust retail electric rates to match market conditions.

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In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

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Additional information is available on www.fitchratings.com

Applicable Criteria

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 28 May 2019)

https://www.fitchratings.com/site/re/10064680

U.S. Public Power Rating Criteria (pub. 03 Apr 2019)

https://www.fitchratings.com/site/re/10066654