Tacoma, Washington

Electric System Revenue Bonds

Assessment

Standalone Credit Profile	aa–

New Issue

$145,000,000 Electric System Revenue Bonds, Series 2021 (Green Bonds)	AA–

Outstanding Debt

Electric System Revenue and Refunding Bonds	AA–

Rating Outlook

Stable

Applicable Criteria

U.S. Public Power Rating Criteria (April 2021)

Public Sector, Revenue-Supported Entities Rating Criteria (February 2021)

Related Research

Public Power - Fitch Analytical Comparative Tool (FACT) - 2021 (June 2021)

U.S. Public Power -- Peer Review (June 2021)

Fitch Ratings 2021 Outlook: U.S. Public Power and Electric Cooperatives -- Amended (December 2020)

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New Issue Summary

Sale Date: The week of Aug. 23, 2021

Series: Electric System Revenue Bonds, Series 2021 (Green Bonds)

Purpose: To refinance electric system debt and pay the cost of issuance.

Security: Electric system revenues.

The 'AA–' rating on the city of Tacoma, Washington's electric utility (Tacoma Power) bonds reflects the utility's very strong but variable financial performance. Financial performance fluctuates due to both variable costs and excess sales into wholesale markets, given the utility's reliance on its sizable hydroelectric power resources. Fitch's rating incorporates expectations that the electric system will experience periods of weaker margins and financial performance.

The rating also continues to reflect the utility's independent ability to adjust rates as necessary. Rates are affordable despite an ongoing commitment to annual increases, which should help to stabilize revenues and margins. Service-area characteristics are stable, with moderate customer growth and incomes partially offset by weaker unemployment levels. The operating cost burden of the utility's hydro resources is very low despite the consistent 7.5% transfer to the city's general fund, which was established by voter approval.

Key Rating Drivers

Revenue Defensibility: 'a'; Midrange Service Area and Variable Wholesale Sales: The utility derives a majority of revenues from retail electric service that Fitch Ratings believes is monopolistic in terms of demand characteristics, anchoring a strong revenue defensibility assessment. The electric system serves a gradually growing, nonconcentrated customer load located in and around the city of Tacoma. However, competitive revenue from market sales of wholesale electricity is expected to account for 10%–15% of total revenue for the 2020–2025 period and limits Fitch's revenue defensibility assessment at 'a'.

Operating Risk: 'aa'; Very Low-Cost Hydroelectric Power Supply: Power supply needs are met through very low-cost, primarily hydroelectric generation resources that are both owned and contracted. The contracted portion is largely supplied by Bonneville Power Administration, Oregon (AA–/Stable), which provides approximately half of Tacoma Power's needs under a long-term contract that expires in 2028.

The utility owns and operates seven hydro assets. Operating cost flexibility is weaker due to the concentration in a single fuel type — hydroelectric. However, this weakness does not outweigh the benefits of low-cost resources. Ongoing capital investment is needed but manageable, and management expects roughly half will be debt financed.

Financial Profile: 'aa'; Variable Financial Performance Offset by Very Low Leverage Profile: Tacoma Power's financial profile is very strong and reflects the expectation that financial performance will fluctuate based on hydrology. Despite the near-critical water year in 2019 followed by pandemic-related stresses in 2020, the utility's finances recovered to very strong levels. Leverage, measured as net adjusted debt/adjusted funds available for debt service (FADS), declined to 5.4x at YE 2020 from 9.7x at YE 2019 and days cash on hand (DCOH) improved to 242 days at YE 2020. In Fitch's stress scenario, leverage increases to just over 7.0x but remains adequate for the rating throughout Fitch's forward look.

Rating Sensitivities

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

- Stronger than expected growth in cash flow from operations that drives the financial leverage ratio below 5.0x on a sustained basis in Fitch's base and stress cases.

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

- Rate actions that do not support stability in the financial profile or the utility's own financial policies;
- Sustained leverage approximating 8.0x in Fitch's base and stress cases.

Rating History (IDR)

Rating	Action	Outlook/ Watch	Date
AA–	Affirmed	Stable	8/12/21
AA–	Upgraded	Stable	6/17/10
A+	Affirmed	Stable	5/6/04
A+	Assigned	—	5/24/94

Credit Profile

Tacoma Power is a division of the city of Tacoma's Department of Public Utilities. The division includes vertically integrated electric services to roughly 183,000 customers. The electric utility serves approximately 180 square miles in the city and surrounding area of Pierce County, with electricity primarily supplied from a long-term contract with Bonneville and seven owned hydro resources across four rivers in the region.

Fitch considers Tacoma Power to be a related entity to the city of Tacoma for rating purposes, given the city's oversight of the system, including the authority to establish rates and operations. The credit quality of the city of Tacoma does not currently constrain the bond rating. However, as a result of being a related entity, the issue ratings could become constrained by a material decline in the general credit quality of the city.

Coronavirus Considerations

Credit impacts related to the pandemic have been limited given a rebound in wholesale revenue in 2020 relative to 2019, retail rate increases, and the utility's ability to reduce spending. Retail electric load declined by roughly 1.3% in 2020, which compares to weather variability expectations in any given year.

Accounts greater than 120 days past due grew from $1.5 million in 2019 to $8.0 million at YE 2020, roughly 1.9% of revenue, which is larger than pre-pandemic levels but not a material credit concern. The state's utility cut-off moratorium is expected to remain in place through September 2021, when the utility will likely address past due bills with customers. To date, the utility's customer assistance spending has totaled $2.4 million, in addition to receiving significant federal funds, and other state and local support.

Revenue Defensibility

The majority of Tacoma Power's revenues are provided by energy sales to retail customers. However, Fitch's assessment of the utility's revenue source characteristics also reflects the utility's exposure to more competitive revenue from excess energy sales into the wholesale power market. These nonfirm sales are subject to variability in hydrological conditions and market prices. Wholesale revenues have typically accounted for between 12% and 13% of total operating revenues, but declined to 8% at YE 2019 due to unusually low water conditions that contribute to the variable but manageable revenue sources.

Fitch views the long-term lease of the telecommunications business as positive to revenue defensibility. The telecommunications business is a more moderate source of revenue — $6.2 million or 6% of total revenues in 2020 — but beginning in 2021 the utility's operating revenues no longer included retail telecommunication revenues. Fitch views the reduction of competitive revenues as a positive for revenue defensibility. Instead, Tacoma Power will receive a fixed lease payment from a third-party company for the life of the 20-year contract, and eliminate the associated operating expenses. The fixed lease payment will range from $2.5 million to $3.0 million in the first five years of the contract, and increase thereafter to reflect the consumer price index.

The utility's service area exhibits stable demographic trends with population and customer growth that benefits from access to the solid economy of the greater Puget Sound region. Customer growth is modest, with average annual growth at just over 1% in the past 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 offset efficiency gains. The utility's retail customer base is diverse and exhibits no concentration among the largest customers. Residential customers account for approximately 50% of revenues.

Economic conditions are hindered by above average unemployment and below average income levels in the city, but service-area demand characteristics remain midrange, given roughly half the customers reside outside of the city in Pierce County, where unemployment rates and incomes are more in line with the state averages.

Rate flexibility is very strong, as changes in rates and charges are not subject to external regulatory approval outside of the city. Recent rate increases of 2% per year in 2019–2020 were lower than the 3.0%–5.9% rate increases enacted in all but one year during 2011–2018. The utility delayed implementation of the 2% rate increase in 2020 from the scheduled implementation date of April 1, 2020 to July 1, 2020, due to pandemic-related economic disruptions. Tacoma Power updates its long-range financial plan each August, which includes projected rate increases for planning purposes. The 2019 financial plan indicates continued base rate increases of 2% annually.

Retail electric rates are competitive at 95% the state average as of the most recent U.S. Energy Information Administration data, and electric service is highly affordable at 1.9% of the city's median household income. The declining trend of both retail loads and wholesale electric revenue has necessitated the current environment of rising retail electric rates, but rate competitiveness and affordability remain very strong.

Operating Risk

The utility's portfolio of largely hydroelectric resources, both owned and contracted, produces a very low operating cost burden that averaged approximately 6.5 cents/kWh over the past five years, including the near critical water conditions in 2019, when the cost burden increased moderately to 8.1 cents/kWh. Operating costs benefited from better water conditions and also the removal of operating expenses associated with the now-leased telecom system in 2020.

Tacoma Power pays a 7.5% gross earnings tax to the city's general fund, which Fitch includes in the electric cost burden metric. The gross earnings tax formula is fixed through 2025 by voter approval, but the total transfer is also limited to 8% by state law.

As with most Fitch-rated Pacific Northwest public power providers, the operating cost flexibility is assessed as weaker due to the concentration of the utility's generating mix in a single fuel type — hydroelectric. The reliance on hydroelectric power for the significant majority of power supply creates the potential for future operating challenges or cost impacts, but does not currently constrain operating risk.

Fitch projects that the utility's power supply will be sufficient to meet retail needs through at least 2039 under near-critical water conditions — critical water means the worst water year since records began over 80 years ago. Owned resources include seven hydroelectric projects that annually supply just under half of the system's power supply needs.

Positively, these owned resources are flexible in their operation as dams with significant reservoirs that 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.

Bonneville Contract

Just over half of Tacoma Power's energy needs are purchased pursuant to a long-term contract with Bonneville 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 Bonneville's actual output, causing Tacoma Power to bear hydro-volatility risk depending on water conditions. The slice portion annually accounts for the larger percentage of the power that is purchased from Bonneville.

Environmental Considerations

Under the state's renewable portfolio standards (RPS), utilities serving 25,000 customers or more, such as Tacoma Power, are required to obtain 15% of their load from renewable resources, including incremental hydro, wind, solar or renewable energy credits (RECs). Large hydro, the majority of the utility'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 2024 when an approximately $700,000 in additional REC purchases are estimated to be required to meet the RPS.

Washington passed the Clean Energy Transformation Act in 2019, which requires the state to achieve a power supply free of carbon emissions by 2045. The utility is similarly well-positioned to meet this mandate given its carbon-free power supply.

Tacoma Power's capital planning and management assessment reflects the utility's high lifecycle investment needs and increasing age of plant, calculated by Fitch at 24 years. Management notes the flexibility in capital spending including the ability to push out capex during the recent stresses of the poor hydro conditions in 2019 and the pandemic in 2020.

The five-year capital improvement plan (CIP) for fiscals 2021–2025 is modestly larger than in recent years at approximately $380 million. The age of plant is slowly decreasing, but capex has averaged 115% of depreciation since 2016, signaling a healthy amount of investment. Management expects roughly half of the CIP to be debt-funded.

Financial Profile

The utility's financial profile is very strong based on historical performance that generally produces very low leverage and healthy liquidity ratios, but is periodically weaker during years when hydrological conditions are adverse. Tacoma Power's key ratios all weakened in 2019, a near-critical water year that was one of the lowest water years on record. Tacoma used $10 million in reserves from its rate stabilization fund (the balance in the reserve decreased to $38 million from $48 million) to offset both higher purchased power costs and declines in wholesale revenue associated with the poor water supply at the hydro assets, but leverage still rose to nearly 10x and coverage of full obligations fell below 1.0x.

The utility saw a return to healthy performance in 2020 aided by substantial cash reserves, annual rate increases and the return to average water conditions. After a 0% operating margin at YE 2019, margins improved to 12% at YE 2020 on much improved water conditions.

Leverage also moderated back to 5.4x at YE 2020 despite the pandemic-driven reduction in retail energy sales that was partially offset by retail rate increases and rebounding wholesale revenue. Water conditions YTD in 2021 are trending toward adverse in the Northwest, but not comparable to current drought conditions in much of the Southwest. The utility plans for adverse water condition scenarios in its budget and long-range financial plan, which Fitch believes is prudent.

Neutral Liquidity

Fitch assesses the liquidity profile of the utility as neutral given the cash reserves on hand that account for 242 days. The utility's reserves, including the rate stabilization fund (RSF), are set aside to be used during years producing unfavorable power costs and wholesale revenues such as in 2019. The $10 million spend of the RSF in 2019 was the first such transfer since the fund's inception in fiscal 2012. The RSF was established to offset or minimize the need for large rate increases in any given year and is designed to provide liquidity and flexibility to manage revenue and expenditure volatility inherent in the utility's hydroelectric power supply.

Management does not forecast another draw on the RSF given the adopted and planned rate increases, and will instead contribute funds given YTD 2021 performance. Nevertheless, the $38 million remaining in the RSF at fiscal YE 2020 meets the utility's liquidity and reserve policies. Short-term liquidity facilities are generally used to fund working capital and provide additional liquidity.

Fitch Analytical Stress Test (FAST) — Base and Stress Cases

Fitch's base case uses 2020 audited results as the starting point and considers the utility's pro forma financials throughout the forward look. The utility's long-range financial plan assumptions consist of retail energy sales that decline moderately due to gains in efficiency, annual retail base rate increases of 1.5%–3.5%, planned capex of approximately $70 million–$80 million per year financed roughly half from debt, and relatively conservative adverse water conditions.

Fitch expects leverage to remain adequate for the rating in the base case. Leverage increases given the debt-funded capex plans and the declining trend in wholesale revenues, while noting the sensibly conservative water conditions and wholesale price assumptions in the long-range financial plans. Adverse water years can occur frequently, such as one in four years, but it is unlikely the utility would experience five such years in a row. Fitch therefore considers the FAST base case as more relevant hydro stress in its analysis than the standard stress case.

The utility's long-range financial plan stress scenarios highlight its ability to absorb a financial impact through the short-term use of RSF reserves, implementation of rate increases in biennial budgets, and management of expenses and capex. In Fitch's stress scenario, a moderate combination of use of reserves, expense and capex management are adequate to maintain leverage below 8.0x that supports the rating without further rate increases.

The utility's debt profile is neutral to the rating. Outstanding revenue bonds are entirely fixed-rate, with a final maturity in 2047. Tacoma Power also uses short-term variable-rate debt in the form of its line of credit that is used on an interim basis to fund capex, which the series 2021 bonds will fix out as long-term fixed rate debt. Debt service is not level but includes spikes in the structure in years just outside Fitch's scenarios, including roughly $40 million in 2026 and $40 million each year in 2030–2034. The utility plans to address the spike through a combination of funds set aside for such use in the RSF.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

Financial Summary

($ 000)	2016	2017	2018	2019	2020
(Audited Fiscal Years Ended Dec. 31)					
Net Adjusted Debt/Adjusted FADS (x)	**5.87**	**5.03**	**5.01**	**9.68**	**5.37**
Net Adjusted Debt Calculation					
Total Short-Term Debt	0	250	0	0	0
Total Current Maturities of Long-Term Debt	12,730	11,575	10,095	9,365	138,720
Total Long-Term Debt	457,602	417,800	461,339	470,425	386,222
Total Debt	**470,332**	**429,625**	**471,434**	**479,790**	**524,942**
+ Capitalized Fixed Charge - Purchased Power and Gas	304,406	325,974	323,084	386,613	328,996
+ Total Pension Obligation (GASB Fitch-Adj. NPL + FASB PBO)	125,542	117,411	62,944	127,622	76,683
- Total Unrestricted Cash	214,474	195,176	198,827	177,471	232,706
- Restricted Funds for Debt Service	27,162	26,176	25,047	24,207	22,078
Net Adjusted Debt	**658,644**	**651,658**	**633,589**	**792,347**	**675,837**
Adjusted FADS for Leverage Calculation					
Total Operating Revenue	418,614	446,343	455,291	461,366	460,953
Total Operating Expenses	388,220	403,210	389,242	459,566	407,737
Operating Income	**30,394**	**43,133**	**66,050**	**1,801**	**53,216**
+ Adjustment for Deferred and Subsidy Revenue	3,684	3,688	3,824	(6,407)	3,725
+ Depreciation and Amortization	55,702	57,231	53,869	48,700	48,124
+ Interest Income	2,405	2,251	3,720	7,607	6,065
+ Other Noncash Charges	6,492	7,519	8,233	9,205	9,228
FADS	**98,678**	**113,823**	**135,696**	**60,906**	**120,358**
+ Adjustment for Purchased Power	38,051	40,747	40,386	48,327	41,124
- Total Transfers/Distributions	30,462	34,142	34,385	33,985	36,809
+ Pension Expense	5,860	9,170	(15,162)	6,602	1,273
Adjusted FADS for Leverage	**112,127**	**129,597**	**126,534**	**81,849**	**125,947**
Coverage of Full Obligations (x)	**1.46**	**1.65**	**1.97**	**0.94**	**1.76**
FADS	98,678	113,823	135,696	60,906	120,358
+ Adjustment for Purchased Power	38,051	40,747	40,386	48,327	41,124
- Total Transfers/Distributions	30,462	34,142	34,385	33,985	36,809
Adjusted FADS for Coverage	**106,266**	**120,428**	**141,696**	**75,247**	**124,673**
Full Obligations Calculation					
Cash Interest Paid	20,014	19,416	20,060	21,294	20,474
Prior-Year Current Maturities	14,735	12,730	11,575	10,095	9,365
Total Annual Debt Service	34,749	32,146	31,635	31,389	29,839
+ Adjustment for Purchased Power	38,051	40,747	40,386	48,327	41,124
Total Fixed Obligations	**72,799**	**72,893**	**72,021**	**79,716**	**70,963**
Liquidity Cushion (Days)	**262**	**318**	**272**	**229**	**366**
Unrestricted Cash (Days)	**240**	**210**	**222**	**161**	**242**
Liquidity Calculation					
+ Total Unrestricted Cash	214,474	195,176	198,827	177,471	232,706
+ Total Borrowing Capacity	100,000	100,000	100,000	150,000	250,000
- Amounts Unavailable	80,250	250	55,300	75,250	131,250
Total Liquidity	**234,224**	**294,926**	**243,527**	**252,221**	**351,456**
Cash Operating Expense Calculation					
Total Operating Expense	388,220	403,210	389,242	459,566	407,737
- Depreciation and Amortization	55,702	57,231	53,869	48,700	48,124
- Other Noncash Charges	6,492	7,519	8,233	9,205	9,228
Cash Operating Expenses	**332,518**	**345,979**	**335,373**	**410,865**	**359,613**

FADS – Funds available for debt service.
Source: Fitch Ratings; Fitch Solutions; Lumesis; EIA; Tacoma, Washington.

Key Definitions

Terms	Definition	Significance
Issuer Default Rating (IDR)	An expression of overall enterprise risk and relative vulnerability to default.	Provides an opinion of the relative ability of an entity to meet financial commitments, expressed as an ordinal measure of credit risk.
Standalone Credit Profile (SCP)	An expression of overall enterprise risk.	Provides an opinion of the credit quality of an entity on a standalone basis, irrespective of its relationship with, or the credit quality of, its related municipality.
Net Adjusted Debt	Adjusted debt – unrestricted cash – funds restricted for debt service	Provides an inclusive evaluation of long-term liabilities offset by funds available for debt service.
Adjusted FADS	EBITDA + interest income + 30% of purchase power expense + operating lease expense – transfers/distributions + pension expense	Provides an indication of cash flow available for the payment of debt service, adjusting for purchased power, operating lease and pension obligations.
Net Adjusted Debt to FADS	Net adjusted debt/adjusted FADS	Provides an indication of net total leverage position against available operating cash flow.
Full Obligations	Cash interest paid + scheduled long-term principal payments + 30% of purchase power expense	Provides an indication of inclusive fixed and debt service obligations.
Coverage of Full Obligations	(EBITDA + interest income + 30% of purchase power expense + operating lease expense – transfers/distributions)/full obligations	Provides an indication of the relative cushion of operating cash flow to fixed charges.
Base Case	The expected forward-looking case in the current macroeconomic environment.	Provides the analytical starting point in the forward-looking analysis, and also informs the stress case.
Stress Case	The potential performance under a common set of assumptions.	Illustrates how cycles affect individual issuers differently, and informs the level of rating stability and credit resiliency.

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.