

# RatingsDirect®

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## Summary:

# Tacoma, Washington; Water/Sewer

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## Summary:

# Tacoma, Washington; Water/Sewer

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Tacoma wtr		
<i>Long Term Rating</i>	AA+/Stable	Upgraded
Tacoma wtr		
<i>Long Term Rating</i>	AA+/Stable	Upgraded

## Rating Action

S&P Global Ratings raised its long-term rating to 'AA+' from 'AA' on Tacoma, Wash.'s existing water bonds. At the same time, we raised the long-term rating to 'AA+' from 'AA' on the city's outstanding Regional Water Supply System (RWSS) revenue bonds. The outlook is stable.

The raised rating reflects our opinion of the water system's consistently healthy financial performance, which continues to meet or exceed financial targets, including sound all-in debt service coverage (DSC) and robust cash balances that we believe can be sustained. During the past five years, the utility has implemented the necessary rate increases to maintain a robust financial profile, and we expect that all-in DSC will be at the same level going forward.

The utility has \$242.3 million in water revenue bond debt outstanding and is responsible for a share of the debt service associated with \$99.3 million in RWSS revenue bonds outstanding; this debt is a contract resource obligation (CRO) operating expense for Tacoma Water. The utility has \$64.8 million in outstanding super-subordinate lien debt.

## Credit overview

The raised rating further reflects the system's robust management and operational practices, and we believe the utility will continue to make rate and other budgetary adjustments to support its future capital needs without diluting the system's unrestricted liquidity or all-in DSC to levels we consider inconsistent with the rating level. Further support for the rating is provided by the system's stable customer base and robust long-range planning.

The city owns, operates, and maintains a separate water utility, the RWSS, which is accounted for in the same fund as the city's primary retail water system. The 2002 Second Supply Partnership Agreement delineates the rights and obligations of each participant with respect to system utilization and financial responsibilities. Each participant share represents a proportional right to receive, and obligation to pay for, water delivered by the Second Supply Project to the city's retail water utility and three nearby utilities. Tacoma's retail water system pays a portion of the costs of the RWSS. Those payments are treated as operating expenses and are senior to the retail system's debt service, which is a credit strength. In the agreement for the Second Supply Project, Tacoma has pledged to increase its participant share

to cover the deficit if any of the participants default on their share of debt service payments for more than 60 days.

The participants are:

- Tacoma (15/36th share right to receive and obligation to pay for water);
- City of Kent (7/36th);
- Covington Water District (7/36th); and
- Lakehaven Water and Sewer Utility District (7/36th) (AAA/Stable).

All participants have other sources of water supply in addition to deliveries from the RWSS. Under the project agreement, the participants pay the operating expenses of the system based on their proportionate share of rights to water, regardless of the amount of water delivered. Under a repayment agreement, participants pay their proportionate share of debt service unless a participant chooses to fund capital expenses with its own cash rather than participate in a RWSS debt issue. Lakehaven has not participated in any of the system's bond issues, opting instead to pay for capital projects with cash. The other participants' debt service obligations are as follows:

- Tacoma (69% of the series 2010 bonds and 55% of the series 2013 bonds);
- City of Kent (24% and 23%); and
- Covington Water District (7% and 22%).

The debt service payments of Tacoma, Covington, and Kent constitute operating expenses payable before debt service. For financial reporting purposes, Tacoma treats the RWSS debt obligations as debt rather than as operating expenses. Tacoma currently has \$99.3 million in RWSS debt outstanding. We understand that the other utilities have historically made payments on time. In our view, Tacoma water's robust financial liquidity somewhat mitigates the potential for Tacoma being required to cover a missed payment by another utility.

While the RWSS' revenues generally cover its costs, including debt service, with little additional margin, the participants all currently generate strong DSC in their respective utility systems, providing credit support for the RWSS bonds. Each also had a strong liquidity position as of the most recent audited fiscal year. In addition, Tacoma is required to step up and cover a default by any other participant after 60 days and, if necessary, take over the participant's obligations to make debt service payments. Historically, Tacoma's retail water system has generated surplus revenue after debt service that could have covered the other members' regional water supply obligations if needed. Tacoma has also maintained an extremely strong liquidity position in its retail water fund.

The rating reflects our view of the retail water system's:

- Substantial and diverse economic base in the Seattle-Tacoma-Bellevue metropolitan statistical area (MSA);
- Median household effective buying income (MHHEBI) that we consider good, which enhances rate affordability and flexibility; however, we view Tacoma's incomes as lower than that of its higher-rated peers in the area;
- Retail water rates that remain affordable and competitive, even as management has implemented annual rate increases in recent years;

- Good all-DSC levels at the retail utility level during the past three years that we expect will be sustained going forward. Per S&P Global Ratings' calculation, all-in DSC is 1.8x as of FYE 2021 (unaudited), a level we view as extremely strong. All-in DSC is our internally adjusted DSC that tracks the use of total utility operating revenue. It also incorporates our recognition of fixed costs associated with Tacoma's required debt payment to the RWSS, which we define as a long-term recurring item that is debt-like, even if legally treated as an operating expense (this methodology is different from the indenture-based calculations); and
- Robust liquidity at the retail utility level, with an estimated \$174.4-million unrestricted cash balance for fiscal 2021 (unaudited). This figure includes the operating unrestricted cash fund, \$78.8 million in a system development charge (SDC) fund, and \$33.1 million in the capital reserve fund. Combined, this is equal to more than 1,000 days of operating expenses.

### Environmental, social, and governance

Overall, we believe management mitigates most environmental, social, and governance (ESG) factors by adopting, adhering to, and adjusting its operating and financial policies and procedures. In our view, environmental risks facing the utility, such as drought, wildfires, earthquakes, and per- and polyfluoroalkyl substances (PFAS), are in line with those of other similarly rated utilities in the region. Although system demand is projected to remain flat or decline slightly in the next ten years, supply is expected to remain relatively constant, providing an opportunity for market development. Modeling of the water supply portfolio indicates that climate change will produce warmer temperatures that may alter runoff timing and amounts as early as the mid-2030s and may impact water supply by the 2050s. Planned upgrades to the source portfolio are included in the capital improvement plan (CIP) to ensure that the system will have adequate supply in the long-term. In 2016, a full vulnerability assessment was performed that included malevolent risks as well as natural hazards such as wildfire, drought, and flood, with a major focus on seismic threats. Several recommended projects have been completed or included in the CIP. The analysis, as a result of the vulnerability assessment, will be updated in 2024. In response to Federal Health Advisory Limits and in anticipation of future regulatory requirements for PFAS, the utility has tested all of its water sources that are planned for usage in meeting current and future demands. The primary water supply source at the Green River showed no PFAS detections and levels detected in groundwater sources were low and not anticipated to require treatment facilities to be constructed. In our view, the utility is well-positioned to address potential future regulatory mandates. Elevated health and safety risks, which we view as a social risk factor, are abating and are currently considered credit neutral in our analysis. The utility's governance factors are highlighted by its credit-supportive financial and management policies. The utility maintains a formal cyber security policy and cyber insurance, which we view as a credit positive.

The stable outlook reflects our view that the utility will continue to manage operations in a way that will allow it to meet current projections of all-in DSC and liquidity. The stable outlook also reflects our view of the system's stable customer base and our expectation that the city will implement rate adjustments or cost-cutting measures such that net revenue beats projections.

## Stable Outlook

### Downside scenario

If the utility were to significantly draw down its unrestricted cash and investments or were unable to meet its all-in DSC projections, we would likely lower the rating. If coverage were to drop well below current projections or if liquidity were reduced substantially during the next two years, we could lower the rating. Furthermore, any further increases in debt beyond those projected without offsetting increases in supportive credit factors would likely have rating implications.

### Upside scenario

We do not anticipate raising the rating within the two-year outlook period given Tacoma's less robust economic fundamentals compared to those of other higher-rated peers in the area. Furthermore, we do not view Tacoma's incomes as indicative of a higher rating.

## Credit Opinion

The economic base diverse and conveniently located near other local employment centers. The water system service area covers all of Tacoma (population 221,000) in addition to other areas of Pierce County and portions of South King County. The regional economic base continues to diversify and has a strong aerospace, military, and high-tech presence, with many large, stable employers, including Boeing, several Army and Air Force bases, the port, and the city itself. Unemployment as of Feb. 2021 was 4%. MHHEBI in the city is good at 102% of the U.S. average in 2021. Wholesale customers currently provide about 3% of annual water sales; this includes the city of Fife, Firgrove Mutual, the city of Black Diamond, and the city of Bonney Lake. WestRock Company paper mill is the utility's largest customer and accounted for approximately 8% of water sales revenue and 32% of water billed in 2021. Current economic development within the service territory is active and the utility continues to add new services at a pace that has not been seen since 2005. However, the system's retail demand per account has been trending downward, with projections for total demand remaining flat or diminishing slightly during the next 10 years.

The utility has a very robust water supply that will address demands for more than 50 years. Tacoma's water supply includes a mix of Green River surface water (first- and second-diversion rights totaling 138 mgd) and groundwater (55 mgd). The groundwater has historically been used to meet summer peaks but is now a largely redundant supply. In 2021, average daily delivery was 55.7 mgd and peak delivery was 97.1 mgd. In a typical year, about 96% of Tacoma's supply is derived from the Green River. Until December 2014, the Green River supply was unfiltered. In December, the RWSS completed and began operating a new, \$187-million treatment plant (partly financed with RWSS bonds). According to management, the system's water supply is well in excess of the system's demands, which we view a credit positive, especially given current drought conditions in the west.

Current retail rates are competitive for the region even with proposed rate increases and provide management with good revenue-raising flexibility. Rates are adopted every two years with the budget cycle but are reviewed each year, and mid-budget rate adjustments can be made. Water charges appear on a combined bimonthly bill with electric, sewer, and solid waste services, and the utility is able to shut off power and water in the event of non-payment. Underpayments are allocated across all funds, and failure to pay may result in a lien on property. In our view, the water rates are competitive with those of neighboring cities. Residential customers are charged a monthly fixed fee and

a variable rate based on consumption, currently \$41 per month for water services (compared to Seattle's \$58), assuming 6,000 gallons in water consumption. When annualized, this represents about 0.9% of the city's MHHEBI, a level that we view as affordable.

Financial operations have been consistent for the retail utility, with direct DSC (including subordinate debt payments) averaging above 2x between 2017 and 2021. We calculate an extremely strong all-in DSC metric of 1.8x for fiscal 2021 (unaudited), reflecting S&P Global Rating's internal adjustments. We anticipate that the city will sustain good all-in DSC (relative to its peers in the 'AA+' rating category) averaging about 1.8x through 2026. We do note that in the event Covington and Kent default on its debt service requirements for the RWSS, Tacoma would be able to step up and cover all of the debt for the project and maintain coverage at 1.6x without having to raise their retail rates. This remains a credit strength.

S&P Global Ratings' calculated all-in DSC as of fiscal-year end 2021 (unaudited) for the RWSS was 1.0x, with the previous year's coverage at 1.06x. While we view this level as thin, these figures are on par with historical coverage for the project. While the RWSS' revenues generally cover its costs, including debt service, with little additional margin, the participants all currently generate strong all-in DSC in their respective utility systems, providing credit support for the RWSS bonds. Each also had a strong liquidity position as of the most recent audited fiscal year. We also expect the RWSS to maintain the same level of all-in DSC going forward. In addition, the retail system is required to step up and cover a default by any other participant after 60 days and if necessary take over the participant's obligations to make debt service payments.

As of Dec. 31, 2021 (unaudited), the retail system held cash of \$62.5 million, \$78.8 million in its SDC fund, and \$33.2 million in a capital reserve fund, all of which is considered unrestricted available reserves for the combined three funds (total \$174.5 million) and is equivalent to 1,000 days' operations, which we consider robust. The utility's financial plan includes intentional spend-down of reserves through 2034 to about \$60 million total in reserves while maintaining coverage and liquidity well in excess of policy minimums.

The CIP through 2026 totals a manageable \$144 million. No additional debt is planned in the near term. Each biennium, the utility prepares a ten-year CIP that includes improvements necessary to maintain the quality, supply, and stability of the water system. The financing approach supports using a blend of cash reserves and debt to pay for capital costs, with reserves funding a significant portion of the CIP during the planning period. Significant projects planned in the 2021-2022 biennium include the installation of automated meters and several seismic upgrades that will continue into the next biennium. The CIP through 2026 for the RWSS totals about \$8 million and there are no additional debt plans at this time.

## Related Research

Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022

### Ratings Detail (As Of March 31, 2022)

**Ratings Detail (As Of March 31, 2022) (cont.)**

Tacoma wtr (AGM)		
<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Upgraded
Tacoma wtr (MBIA) (National)		
<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Upgraded
Tacoma wtr (MBIA)(National)		
<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Upgraded

Many issues are enhanced by bond insurance.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column.

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