

RatingsDirect®

Summary:

Tacoma, Washington; Water/Sewer

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Credit Profile

US\$66.82 mil wtr sys rev rfdg bnds (Green Bnds) ser 2024 due 12/01/2043		
<i>Long Term Rating</i>	AA+/Stable	New
US\$32.04 mil regl wtr supp sys rev rfdg bnds (Green Bnds) ser 2024 due 12/01/2032		
<i>Long Term Rating</i>	AA+/Stable	New
Tacoma wtr		
<i>Long Term Rating</i>	AA+/Stable	Current
Tacoma wtr (MBIA) (National)		
<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Current

Credit Highlights

- S&P Global Ratings assigned its 'AA+' long-term rating to Tacoma, Wash.'s (Tacoma Water) anticipated series 2024 water revenue refunding bonds.
- At the same time, S&P Global Ratings assigned its 'AA+' long-term rating to the city's anticipated series 2024 Regional Water Supply System (RWSS) revenue refunding bonds.
- The outlook is stable.

Security

The Tacoma Water 2024 refunding bonds are being issued to current-refund the outstanding Tacoma Water 2013 revenue and refunding bonds for debt service savings. Likewise, the RWSS 2024 refunding bonds are being issued to current-refund the outstanding RWSS 2013 refunding bonds for debt service savings. The city has a separate water utility, known as the RWSS, which is accounted for in the same fund as the city's primary retail water system. The RWSS operates the Second Supply Project, which provides wholesale water to the city's retail water utility and three nearby utilities. The 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. The city currently has approximately \$95 million in RWSS debt outstanding. Tacoma's retail water system is responsible for a majority of the RWSS' debt service expenses as defined by repayment agreements. The RWSS also provides water to the city of Kent, Covington Water District, and Lakehaven Utility District. If a member were to default on its payment obligation to the RWSS, Tacoma is required to cover the utility's debt service payment. We understand that the other utilities have historically made payments on time. In our view, Tacoma Water's healthy all-in debt service coverage (DSC) and liquidity somewhat mitigate the potential for Tacoma being required to cover a missed payment by another utility.

We view the bond provisions as credit neutral. The bonds are secured by a pledge of net revenues of the city's water system. A rate covenant requires the system to generate DSC of at least 1.25x. The additional bonds test requires historical or projected revenues to provide 1.25x coverage. The utility has \$230 million in water revenue bond debt

outstanding and is responsible for a share of the debt service associated with the RWSS revenue bonds outstanding; this debt is a contract resource obligation (CRO) operating expense for Tacoma Water, as noted previously. The utility also has \$53 million in outstanding super-subordinate lien debt.

Credit overview

The rating reflects our opinion of the water system's sound and conservative management, with strong operational and financial policies that support Tacoma Water's long-term financial planning efforts and mitigation strategies. Despite the loss of its largest customer (WestRock Company announced that it would begin shutting down its Tacoma paper mill effective Sept. 30, 2023), the utility has implemented necessary rate increases to maintain a healthy financial profile, and we expect that all-in DSC will be closer to historical levels going forward. The rating also reflects Tacoma Water's consistently healthy financial performance, which continues to meet or exceed financial targets, including sound all-in DSC and robust cash balances that we believe can be sustained. We believe the utility will continue to make rate and other budgetary adjustments to support its future capital needs without diluting the system's available liquidity or 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.

WestRock's recent closure is expected to decrease overall revenues of Tacoma Water. WestRock provided approximately 7.3% of Tacoma Water's total water sales revenues and 31.9% of water volume usage in 2022. With the closure of the mill, we view the utility's customer base as further diversified, with an opportunity to market excess capacity to new wholesale members or new businesses. To help mitigate the financial impact of this loss, Tacoma's city council adopted an additional rate increase of 5% on Nov. 28, 2023, for a total average annual rate increase of 9% beginning on Jan. 1, 2024. We understand that management will conduct an updated financial plan and cost-of-service analysis and is forecasting phased-in annual 5% rate adjustments in the next biennial cycle of 2025-26 to mitigate any remaining revenue losses from the WestRock closure. We view these adjustments as supporting the future financial performance of the utility in the near term.

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 those of its higher-rated peers in the area;
- Sound all-in DSC levels at the retail utility level during the past three years that we expect will be sustained going forward. 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 about \$155 million in available cash balance at the end of 2022. This figure includes the operating unrestricted cash fund, system development charge (SDC) fund, and the capital reserve fund. Combined, this is equal to more than 700 days of adjusted operating expenses.

For financial reporting purposes, Tacoma treats the RWSS debt obligations as debt rather than as operating expenses. While the RWSS' revenues generally cover its costs, including debt service, with little additional margin, the

participants all currently generate healthy 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 participants of the RWSS 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).

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, while Covington is cash-funding its share through this 2024 transaction. The debt service payments of Tacoma and Kent constitute operating expenses payable before debt service, which we view as credit positive.

Environmental, social, and governance

Overall, we believe the city's water system's environmental, social, and governance (ESG) risks are credit-neutral in our analysis. In our view, Tacoma Water has been mitigating environmental risks facing the utility, such as drought, wildfires, earthquakes, and contaminants such as per- and polyfluoroalkyl substances (PFAS). 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. The primary water supply source at the Green River showed no PFAS detections; however, levels were detected in groundwater sources. While Tacoma Water's groundwater has historically only been used to meet summer peaks and is now largely redundant, preliminary planning is under way for treatment or operational changes to ensure the groundwater supply will be in compliance with new regulatory requirements. In our view, the utility is well positioned to address potential future regulatory mandates. The utility's governance is highlighted by its credit-supportive financial and management policies. The utility maintains a formal cyber security policy and cyber insurance, which we view favorably.

Outlook

The stable outlook reflects our view that Tacoma Water will continue to manage operations in a manner 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 utility system will implement rate adjustments or cost-cutting measures such that net revenues overperform projections in the current financial plan.

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. 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 income indicators compared to those of other higher-rated peers in the area. To consider a higher rating, we would primarily assess if the utility achieves strengthening of its financial metrics with sustainable financial performance through this economic cycle, while enhancing its economic and profile.

Credit Opinion

The economic base is diverse and conveniently located near other local employment centers. The water system service area covers all of Tacoma (population 222,000) 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. MHHEBI in the city is good at 107% of the U.S. average. 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. Despite economic development within its service territory, 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. Water charges appear on a combined 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. In our view, the water rates are competitive with those of neighboring cities.

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 million gallons per day [mgd]) and groundwater (47 mgd). The RWSS completed the Green River Filtration Facility (partly financed with RWSS bonds) and began operating it in 2015. 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.

Financial operations have been consistent for the retail utility, with all-in DSC (including subordinate debt payments) averaging about 1.6x during the past three years. We do note that in the event Kent were to 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

sufficient coverage without having to raise its retail rates. This, in our view, remains a credit strength.

Tacoma, Washington--Economic and financial data

	Most recent	Fiscal year-end			Median (AA+)
		2022	2021	2020	
Economic data					
Water customers	107,872				34,150
MHHEBI of the service area as % of the U.S.	107.0				110.0
Unemployment rate (%)	5.2				3.4
Poverty rate (%)	8.2				9.9
Water rate (6,000 gallons or actual) (\$)	47.83				36.0
Annual utility bill as % of MHHEBI	0.8				1.0
Operational Management Assessment	Strong				Good
Financial data					
Gross revenues (\$000s)		115,218	111,366	104,468	41,079
Net revenues available for debt service (\$000s)		44,836	42,611	47,221	--
Debt service (\$000s)		25,620	25,621	26,566	--
Total operating expenses less depreciation (\$000s)		71,316	72,006	66,787	29,720
S&P Global Ratings-adjusted all-in DSC (x)		1.7	1.6	1.7	2.4
Unrestricted cash (\$000s)		141,042	179,867	185,823	47,258
Days' cash of operating expenses		722	912	1,016	588
Total on-balance-sheet debt (\$000s)		397,346	413,134	429,601	73,325
Debt-to-capitalization ratio (%)		37.0	38.8	40.3	24.5
Financial Management Assessment	Strong	--	--	--	Good

Note: Most recent economic data available from our vendors. MHHEBI--Median household effective buying income. DSC--Debt service coverage.

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 December 22, 2023)

Tacoma wtr		
Long Term Rating	AA+/Stable	Current
Tacoma wtr		
Long Term Rating	AA+/Stable	Current
Tacoma wtr		
Long Term Rating	AA+/Stable	Current
Tacoma wtr (MBIA)(National)		
Unenhanced Rating	AA+(SPUR)/Stable	Current

Many issues are enhanced by bond insurance.

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