



RATING ACTION COMMENTARY

Fitch Affirms Tacoma, WA's Electric System Rev Bonds at 'AA-'; Outlook Stable

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Fitch Ratings - Austin - 08 Aug 2022: Fitch Ratings has affirmed Tacoma, WA's electric system (Tacoma Power) bonds at 'AA-' rating to the following bonds:

--Approximately \$487.9 million electric system revenue bonds and rev refunding bonds.

The Rating Outlook is Stable

In addition, Fitch assesses Tacoma Power's standalone credit profile (SCP) at 'aa-'. The SCP represents the credit profile of the utility on a stand-alone basis irrespective of its relationship with and the credit quality of the city of Tacoma (Issuer Default Rating [IDR], AA/Stable).

ANALYTICAL CONCLUSION

The 'AA-' rating reflects Tacoma Power's very strong but historically variable financial performance. Given the system's reliance on hydroelectric power resources for nearly all of its power supply, financial performance fluctuates depending on hydrology conditions due to both variable costs and excess energy sales into the wholesale market. Fitch's rating incorporates our expectation that the electric system will experience temporary periods of weaker and stronger financial margins periodically.

CREDIT PROFILE

Tacoma Power is a division of the city of Tacoma's Department of Public Utilities. The division provides vertically integrated electric services to roughly 184,000 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 Power Administration (Bonneville; AA-/Stable) and seven owned hydro resources across four rivers in the region.

Tacoma Power is governed by a Public Utility Board appointed by the mayor and confirmed by the city council. The board has approval authority for most department business, although the biennial budget, rates, and bond issues must also be approved by city council. Fitch considers Tacoma Power to be a related entity to the city of Tacoma (general government IDR, AA/Stable) 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.

KEY RATING DRIVERS

Revenue Defensibility: 'a'

Variable Wholesale Sales and Midrange Service Area

The utility derives a majority of revenues from retail electric sales within the city of Tacoma, which Fitch considers monopolistic. However, revenues derived from competitive market sales of wholesale electricity limits Fitch's revenue defensibility assessment to 'a'.

The assessment also incorporates mixed service area characteristics, including modest customer growth below 1.0%, income levels in line with the national average and unemployment levels notably above the national average. The assessment additionally reflects the utility's independent ability to adjust rates as necessary and very affordable rates, despite an ongoing commitment to annual rate increases.

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, which provides approximately half of Tacoma Power's needs under a long-term contract that expires in 2028. Additionally, the utility owns and operates seven hydro assets.

Operating cost flexibility is weaker due to the concentration in a single fuel type, hydroelectric generation. However, this weakness does not outweigh the benefits of the 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 incorporates the expectation that financial performance will fluctuate based on hydrology. Despite weaker financial margins in 2019 due to the near-critical water year, financial performance recovered beginning in 2020, even with pandemic related stresses. Leverage, measured as net adjusted debt-to-adjusted funds available for debt service, declined to 5.4x in 2020 and remained at 5.3x in 2021, down from 9.7x in 2019. Liquidity is robust, with \$248.4 million in unrestricted cash, or 246 days cash on hand at the end of 2021, which included \$63 million held in the rate stabilization fund (RSF).

Financial performance YTD in 2022 is very strong with above average water conditions and higher than budgeted market prices in the wholesale power market. Leverage is expected to temporarily decline further in 2022, but then return to between 5.5x and 7.0x in future years, which remains supportive of the rating.

Asymmetric Additional Risk Considerations

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

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:

--Sustained increase in the utility's reliance on wholesale revenue as a percentage of total revenues;

--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 or stress cases.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

SECURITY

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

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 incorporates the utility's exposure to more competitive revenue from excess energy sales into the wholesale power market. These non-firm sales are subject to variability in hydrological conditions and market prices. Wholesale revenue as a percentage of total revenue increased to a five-year high of 18% in 2021. Increased wholesale revenue was due to an above average water year and higher market wholesale energy prices.

Fitch considers the long-term lease of the telecommunications business positive to revenue defensibility. Beginning in 2021, the utility's operating revenues no longer include retail telecommunication revenues, which accounted for a modest 6% of total revenues in 2020. Fitch views the reduction of competitive revenues 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.

Service Area Characteristics

The utility's service area exhibits stable midrange 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 under 1% over the last five years. The utility's retail customer base is diverse and exhibits no concentration among the largest customers. Residential customers account for approximately 50% of revenues.

About half of Tacoma's customers reside within the city, which had strong median household income metrics that were 99% of the national average in 2020. The remaining customers residing in the surrounding Pierce County had higher income levels at 118% of the national average, but remains within the midrange category. The service area is hindered by persistently above average unemployment, which was 4.9% as of May 2022, or 144% of the national average.

Rate Flexibility

Rate flexibility is very strong as changes in rates and charges are not subject to external regulatory approval outside of the city. Tacoma raised rates by 1.5% on April 1, 2021, and by 2% on April 1, 2022. The utility applies for rate adjustments in two-year periods and will apply to city council in fall 2022 for proposed rate increases in 2023 and 2024.

Retail electric rates are competitive at 95% of the state average as of the most recent EIA data, and electric service is highly affordable at 1.8% of the city's median household income.

OPERATING RISK

The utility's portfolio of largely hydroelectric resources (both owned and contracted) produces a very low operating cost burden that totaled 7.13 cent/KWh in 2021, and averaged about 6.71 cents/KWh over the last five years. This period includes the near critical water conditions in 2019 when the cost burden increased moderately to 8.1 cents/KWh. Operating costs in 2021 benefitted from improved water conditions and the removal of operating expenses associated with the now leased telecom system.

Tacoma Power pays a 7.5% gross earnings tax to the city's general fund, which Fitch includes in the operating 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.

Operating Cost Flexibility

As with most Pacific Northwest public power providers that Fitch rates, 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 the significant majority of power supply creates the potential for future operating challenges or cost impacts, but does not currently constrain operating risk.

Fitch expects that the utility's power supply will be sufficient to meet retail needs through at least 2039 under "near-critical" water conditions (critical water is the worst water year since records began over 80 years ago). Owned resources include seven hydroelectric projects that supply just under half of the system's annual power supply needs. 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 also geographically distributed allowing for some diversification benefits in terms of watershed and water conditions. Tacoma Power 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 met with the low-cost hydroelectric power purchased as a statutory preference customer of Bonneville. The current long-term contract with Bonneville expires on Sept. 30, 2028, and includes energy provided under slice and block arrangements. 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. Bonneville and its preference customers have begun discussions about replacement contracts for the period following 2028.

Environmental Considerations and Clean Energy Transition

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 is finalizing a new long-

term contract for solar RECs, adding approximately 189,000 KWh annually in RECs from 2023 to 2030. With this new deal, Tacoma projects to remain in compliance through 2026.

Washington also 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.

Capital Planning and Management

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. In recent years capex has varied, but averaged an adequate 124% of depreciation since 2017. 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 pandemic in 2020.

The five-year capital improvement plan (CIP) for fiscals 2022-2026 is larger than in recent years at approximately \$403.9 million. 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, one of the lowest water years on record. Tacoma used \$10 million in reserves from its RSF to offset both higher purchased power costs and declines in wholesale revenue associated with the low 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 annual rate increases and the return to average water conditions. After a 0% operating margin in 2019, margins improved to 12% in 2020 on much improved water conditions. Leverage also moderated back to 5.4x in 2020 despite the pandemic-driven reduction in retail energy sales that was partially offset by retail rate increases as well as rebounding wholesale revenue.

The utility enjoyed another strong fiscal year in 2021 with an operating margin of 9% and leverage further declining to 5.3x. Operating revenues increased by \$9.3 million in 2021 after transferring \$25 million of wholesale revenues to the RSF. While 2022 water conditions are well above average in the 83rd percentile, 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 246 days. The utility's reserves, including the RSF, are set aside to be used during years producing unfavorable power costs and wholesale revenues such as in 2019. Management does not forecast another draw on the RSF given the adopted and planned rate increases, and instead contributed \$25 million of wholesale revenues to the fund in fiscal year 2021. The balance of \$63 million in the RSF at FYE 2021 meets the utility's liquidity and reserve policies.

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

Fitch's base case uses 2021 audited results as the starting point and considers the utility's pro forma financials over the next five years. The utility's long-range financial plan assumptions consist of retail energy sales that remain flat due to gains in efficiency, annual retail base rate increases of 1.5%-3.5%, planned capex of approximately \$80 million per year financed roughly half from debt, and relatively conservative adverse water conditions in 2023 and 2024.

Overall, Fitch expects leverage to remain adequate for the rating. After a likely decline in leverage to below 4.0x in 2022 due to higher than budgeted wholesale revenues, leverage is expected to return to between 5.5x and 7.0x over the following four years. Given the conservative water assumptions in 2023 and 2024 in Fitch's base case, Fitch considers the FAST base case as a more relevant hydro stress in its analysis than Fitch's standard stress case in those years.

Debt Profile

The utility's debt profile is neutral to the rating. Outstanding revenue bonds are entirely fixed rate, with final maturity in 2047. Debt service is not level but includes spikes in the payment structure in the years just outside Fitch's scenarios including roughly \$40 million in 2027 and \$40 each year 2031-2035. The utility plans to address the higher year payments by setting funds aside for such use in the RSF.

Tacoma uses short-term variable-rate debt in the form of its \$150 million line of credit that is used on an interim basis to fund capex and periodically refunded into long-term, fixed-rate debt.

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

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

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.

RATING ACTIONS

ENTITY / DEBT ⇅	RATING ⇅			PRIOR ⇅
Tacoma (WA) [Electric]				
Tacoma (WA) /Electric System Revenues/1 LT	LT	AA- Rating Outlook Stable	Affirmed	AA- Rating Outlook Stable

[VIEW ADDITIONAL RATING DETAILS](#)

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APPLICABLE CRITERIA

[U.S. Public Power Rating Criteria \(pub. 09 Apr 2021\) \(including rating assumption sensitivity\)](#)

[Public Sector, Revenue-Supported Entities Rating Criteria \(pub. 01 Sep 2021\) \(including rating assumption sensitivity\)](#)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

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Tacoma (WA)

EU Endorsed, UK Endorsed

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Utilities and Power US Public Finance North America United States
