

**New Issue: Moody's assigns Aa2 to Tacoma, WA's \$23M Water System Revenue Refunding Bonds, Series 2015A&B**

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Global Credit Research - 09 Apr 2015

**Affirms Aa2 ratings on \$283M of parity revenue bonds; stable outlook**

TACOMA (CITY OF) WA WATER ENTERPRISE  
Water Enterprise  
WA

**Moody's Rating**

<b>ISSUE</b>	<b>RATING</b>
Water System Revenue Refunding Bonds, Series 2015A	Aa2
<b>Sale Amount</b>	\$16,620,000
<b>Expected Sale Date</b>	04/15/15
<b>Rating Description</b>	Revenue: Government Enterprise

Water System Revenue Refunding Bonds, Series 2015B (Taxable)	Aa2
<b>Sale Amount</b>	\$6,425,000
<b>Expected Sale Date</b>	04/15/15
<b>Rating Description</b>	Revenue: Government Enterprise

**Moody's Outlook** STA

NEW YORK, April 09, 2015 --Moody's Investors Service has assigned Aa2 to Tacoma, Washington's \$23.1 million Water System Revenue Refunding Bonds, Series 2015A and Series 2015B (Taxable). Moody's has affirmed the Aa2 ratings on \$283 million of parity revenue bonds, pre-sale. The outlook is stable.

**SUMMARY RATING RATIONALE**

The Aa2 rating reflects the system's broad and diverse customer base; stable and satisfactory debt service coverage ratios; strong standing with respect to supply and system infrastructure, with major capital projects completed and ample, high-quality, long-lived supply expected to comfortably exceed demand for years to come; and manageable debt levels that will moderate considerably as capital spending is funded from cash and revenues through FY 2024.

**OUTLOOK**

The stable outlook reflects our expectation that the water system will continue to generate debt service coverage comfortably in excess of its policy target of 1.5 times; operations will remain manageable given the favorable condition of system infrastructure and the limited near-term capital program; and the service area economy will remain diverse and stable, and benefit from continued modest population growth.

**WHAT COULD MAKE THE RATING GO UP**

- Broadened service area with expanded economic diversity
- Multi-year trend of higher debt service coverage

**WHAT COULD MAKE THE RATING GO DOWN**

- Deterioration of financial position reflected in lower debt service coverage, weakened liquidity and elevated debt

## STRENGTHS

- Robust liquidity and healthy debt service coverage
- Ample water supply
- Sound financial policies and planning

## CHALLENGES

- Soft demand

## RECENT DEVELOPMENTS

Incorporated in Detailed Rating Rationale.

## DETAILED RATING RATIONALE

### SERVICE AREA AND SYSTEM CHARACTERISTICS: ECONOMICALLY DIVERSE SERVICE AREA IN THE PUGET SOUND REGION

With 98,600 metered customers in FY 2014, Tacoma Water is the second largest publicly-owned water utility in the Pacific Northwest. The utility effectively consists of two systems; a retail/wholesale water system and the Regional Water Supply System (RWSS), which is a multi-party supply agreement among the participants of Tacoma Water, Covington Water District (Aa3), Lakehaven Utility District (Aa2) and the City of Kent. Tacoma Water is the owner-operator of the Second Supply Project, the basis of RWSS.

The utility provides retail service to a population of over 318,000 in a service area that extends well beyond the City of Tacoma (Aa3 stable) into the urbanized areas of Pierce County (Aa1 stable) and southern King County (Aaa stable) and includes the cities of Puyallup (A2 stable), Federal Way (Aa2), Lakewood, Fircrest and University Place (A3). The service area is economically diverse and contains a major deepwater port, health care and higher education institutions, local government, manufacturing, military and professional services.

Water consumption, although having declined moderately over the last 10 years, has been relatively stable since FY 2010. The utility's top 20 customers represented 19.4% of water revenues in FY 2014. The largest customer, Rock-Tenn Company (Baa3 stable), represented 8.5% of water revenues, although this concentration is not a material concern given the multi-year take-or-pay contract established between the utility and the user, provisions for liquidated damages payable from Rock-Tenn upon breach of contract, and the strategic nature of, and recent capital investment in, the plant on the part of Rock-Tenn. The contract is in the process of being renegotiated, and will likely entail terms that strengthen protections for the utility.

65% of FY 2014 water revenues were derived from residential service, and approximately 36% of residential service is provided outside of the City of Tacoma. Currently, wholesale service is a small part of the system's operations, representing approximately 5% of water revenues. While existing wholesale deliveries under standard cost of service pricing are expected to remain stable, the utility is beginning to offer market-priced wholesale offerings that have the potential to result in near-term demand and service revenue growth, which is not currently reflected in financial plans and projections. The utility has a significant amount of supply (discussed below), and pipelines nearby and interties already connected to prospective customers, allowing it to offer competitive pricing as an alternative to these systems developing their own supply capabilities. Additionally, Tacoma Water currently receives fixed revenues from Cascade Water Alliance (CWA) as part of a renegotiated agreement in 2012 that restructured the take-or-pay obligations of a prior agreement and enabled CWA to transition 10 MGD of previously purchased capacity in exchange for partial recovery of its System Development Charges. CWA can transition this capacity to the cities of Auburn, Bonney Lake, Buckley and Sumner, at which point Tacoma Water can negotiate new wholesale contracts directly with the cities. The first such transfer occurred in FY 2014 with the execution of an agreement with the City of Auburn, which augmented the wholesale supply capacity of a prior agreement from 1 MGD to 3.5 MGD. Any water sales revenue resulting from these wholesale agreements will be in addition to the fixed revenues from CWA.

The utility is well positioned to monetize its excess water capacity given the increasing difficulty for water systems in obtaining new water rights. These difficulties have resulted from legal challenges to the State Department of Ecology's authority to administer water rights and concern that the additional appropriation of water in many areas may deplete limited resources. Several water systems in King and Pierce counties have had a water moratorium in recent years, restricting development. These circumstances make the utility's second diversion water right on

the Green River, for 65 MGD, particularly valuable and attractive to the participants in RWSS and potentially to other systems in the vicinity of Tacoma Water's existing transmission pipelines. These other systems have occasionally experienced water shortages due to increased demands resulting from customer growth.

#### HIGH-QUALITY, LONG-LIVED SUPPLY; SYSTEM FACILITIES ARE IN SOUND CONDITION AND MAJOR CAPITAL PROJECTS HAVE BEEN COMPLETED

The utility is in an excellent position with respect to supply, infrastructure and asset condition. The utility has high-quality, long-lived surface water supply. The utility has a first diversion water right, established in 1912, to 73 MGD of water from the Green River, and a second diversion water right, established in 1986, to 65 MGD (peak of 95 MGD) on the Green River, with the opportunity to store capacity for peak summer usage. The utility has 55 MGD of capacity from 25 groundwater wells, which it generally uses in limited quantities for blending and peaking, with natural recharge from river flows. In addition to the groundwater, which typically provides only 4% of water supply, the utility has 141 MG of reservoir storage.

This supply profile contrasts with FY 2014 average use of 47 MGD and peak use of 84 MGD. The system foresees sufficient supply for more than 50 years.

Redundancy is healthy given that the groundwater wells provide less than 4% of the utility's water needs, the utility maintains 22 interties with 11 different systems, and 22 reservoirs provide more than 140 MG of storage. The utility's system flows primarily by gravity, and recent completion of a major filtration facility has addressed regulatory requirements for the removal of cryptosporidium, reduced sediment concerns and has resulted in notably improved water quality and supply reliability. Water loss is low at less than 4% and the near-term capital plan is focused on main replacement. Well water quality has been addressed by a 40 MGD groundwater treatment facility at the utility's Hood Street reservoir.

#### DEBT SERVICE COVERAGE AND LIQUIDITY: HEALTHY DEBT SERVICE COVERAGE EXPECTED TO IMPROVE INCREMENTALLY GOING FORWARD; ROBUST LIQUIDITY WILL BE USED TO SUPPORT CAPITAL PLAN AND RATE RELIEF

We expect the system's financial profile will remain favorable over the intermediate term due to planned rate increases, stability in the customer base and water demand, and a near-term capital plan focused primarily on asset upkeep with no major projects anticipated. Since FY 2010, senior debt service coverage has been consistently healthy, averaging greater than 1.9 times annual debt service. Coverage of senior and subordinate debt service has also been sound, averaging more than 1.4 times for the same period. Management budgets to maintain a minimum of 1.5 times senior and 1.25 times total debt service coverage (inclusive of the 8% gross earnings tax it pays to Tacoma), and all-in debt service coverage is expected to remain above 1.15 times for the forecast period (reaching 1.36 times by FY 2024). The multi-year projections reflect periodic transfers from the system's \$35.6 million rate stabilization account, which serves to mitigate rate increases. The utility has adopted rate increases of 4% in FY 2015 and FY 2016, and anticipates additional rate increases annually through the forecast period. Projections assume no account growth, and given the low marginal cost of incremental deliveries, any account/volume growth, particularly through expanded wholesale service, would likely enhance coverage. The system has healthy flexibility as existing rates are low.

Given the long-term trend of flat to declining consumption, the existing rate structure is positive. More than 50% of revenues are derived from fixed meter charges, and the water system has adopted a policy that allows it to increase the fixed charge revenues to 65% of total revenues. The volume component is based upon a marginally inclining block structure to promote consumption. Other revenues are stable and the Cascade Water Alliance agreement was recently renegotiated to provide a fixed revenue stream. Annual charge-offs are minimal at less than 0.4% of billed sales.

#### Liquidity

Liquidity is exceptionally healthy. The utility ended FY 2014 with \$45.7 million of operating cash and equity in pooled investments, \$53.3 million of cash in a system development charge (SDC) fund, and \$27.8 million of cash in a capital reserve fund. In the aggregate, these balances summed to more than 1,100 days of cash. The utility has elected to contribute cash reserves toward its capital plan and transfer cash from the rate stabilization fund (contained within the SDC fund) to mitigate rate increases in the coming years. The current cash balances are projected to be drawn down through FY 2024, at which point the utility would have \$45 million of available cash, or more than 60% of anticipated operating expenses at that time. We note that this use of cash obviates the issuance of new debt over the same period, so is on balance credit neutral.

## DEBT AND LEGAL COVENANTS: MANAGEABLE DEBT LEVELS WILL MODERATE GOING FORWARD; STANDARD LEGAL COVENANTS

The system has a manageable debt burden, consisting of \$283 million of senior bonds and \$86 million of junior state and federal loans. The RWSS has \$110.1 million of bonds outstanding, of which \$69 million has been allocated to Tacoma Water for repayment.

The major capital needs of the utility, most notably the filtration plant and covering of reservoirs, have been completed. The capital program through FY 2023 is funded internally from cash balances and annual revenues. During this time, the system will pay down \$127.6 million of principal, which includes \$77.4 million on water system senior bonds and RWSS bonds and \$50.2 million on junior loans. The next bond issue is slated for FY 2024.

Pursuant to the RWSS governing agreements, Tacoma Water is responsible for payment of approximately 70% of the costs of the regional system, which includes debt service, O&M and additional costs. The participating municipalities purchase water from the regional system based on the proportionate share of supply allocated to them. Tacoma Water must ultimately step up upon an uncured participant default, but it would take and remarket the water share of the defaulted participant in doing so, and the gross debt service assumed would remain affordable.

### Debt Structure

The bonds are secured by the net revenues of the water system and by monies held in the bond fund (where the BAB subsidy is deposited and the debt service reserve fund is held) and the rate stabilization account. There is currently \$35.6 million in the rate stabilization account, although the bond ordinance does not require the utility to maintain a balance in the rate stabilization account. The bonds are additionally secured by a rate covenant that requires net revenues to equal 1.25 times annual debt service, although the utility has adopted, and adhered to, a policy prescribing a minimum coverage ratio of 1.5 times. The senior bonds are secured by a common debt service reserve fund, currently funded with cash and a surety that has been reinsured by National Public Finance Guarantee (A3 negative).

We note that, under certain conditions, the utility can enter into additional contract resource obligations (CROs), which are structurally senior to the bonds and therefore subordinate existing bondholders, and that the conditions permitting the incurrence of CROs are not especially restrictive. CROs can be related to water supply, transmission, treatment, or other commodity or service contracts relating to the water system, and only require a five-year net revenue test to ensure coverage will still be met. However, while the system has a CRO related to the RWSS, it treats the CRO as parity with its senior and junior bonds in its total coverage calculation and planning.

### Debt-Related Derivatives

All debt is fixed rate and the system has no debt-related derivatives.

## OPERATING ENVIRONMENT AND GOVERNANCE

Management is strong and experienced. Operating and capital budgets are planned over a multi-year horizon, and internal coverage, liquidity and reserve policies guide planning decisions. The utility has a degree of operating autonomy given its structural separation from the city, although its budgets, rates and borrowings must be approved by the city council.

## KEY STATISTICS

- Asset Condition (Remaining Useful Life): 53 years
- System Size (O&M in \$000s): \$41,800
- Annual Debt Service Coverage: 2.23X
- Cash on Hand: 1,107 days
- Debt to Operating Revenues: 4.74X
- Rate Covenant: 1.25X
- Debt Service Reserve: Lesser of MADS or 1.25X AADS

## OBLIGOR PROFILE

Tacoma Water is the second largest publicly-owned water utility in the Pacific Northwest. The utility provides retail service to a population of over 318,000 in a service area that extends well beyond the City of Tacoma (Aa3 stable) into the urbanized areas of Pierce County (Aa1 stable) and southern King County (Aaa stable) and includes the cities of Puyallup (A2 stable), Federal Way (Aa2), Lakewood, Fircrest and University Place (A3). The service area is economically diverse and contains a major deepwater port, health care and higher education institutions, local government, manufacturing, military and professional services.

## LEGAL SECURITY

The bonds are secured by the net revenues of the water system and by monies held in the bond fund (where the BAB subsidy is deposited and the debt service reserve fund is held) and the rate stabilization account. There is currently \$35.6 million in the rate stabilization account, although the bond ordinance does not require the utility to maintain a balance in the rate stabilization account. The bonds are additionally secured by a rate covenant that requires net revenues to equal 1.25 times annual debt service, although the utility has adopted, and adhered to, a policy prescribing a minimum coverage ratio of 1.5 times. The senior bonds are secured by a common debt service reserve fund, currently funded with cash and a surety that has been reinsured by National Public Finance Guarantee Corp. (A3 negative). The reserve requirement is equal to the lesser of maximum annual debt service (MADS) or 1.25x average annual debt service. As long as the 2005 bonds remain outstanding, the current bonds will be secured by the reserve account. If the 2005 bonds are redeemed or defeased, the current bonds will no longer be secured by the reserve account, nor will the utility be required to establish a new debt service reserve account for the current bonds. The current sale will refund all of the 2005 maturities except for the final one, \$5,000 maturing in 2025, which has the effect of maintaining the 2005 bonds as outstanding and the surety in force. The 2025 maturity matches the term of the final maturity of the current bonds. We note that the reserve account is held by the City Treasurer and not by a third-party trustee, which is a modest weakness by comparison with more traditional arrangements.

## USE OF PROCEEDS

Bond proceeds will refund substantially all of the maturities of the utility's 2005 bonds for savings.

## PRINCIPAL METHODOLOGY

## RATING METHODOLOGY

The principal methodology used in this rating was US Municipal Utility Revenue Debt published in December 2014. Please see the Credit Policy page on [www.moodys.com](http://www.moodys.com) for a copy of this methodology.

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