

MOODY'S

INVESTORS SERVICE

New Issue: Moody's assigns Aa2 rating to the City of Tacoma, Washington, Regional Water Supply System Revenue Refunding Bonds, 2013

Global Credit Research - 27 Mar 2013

Approximately \$116 million in Regional Water Supply debt affected

TACOMA (CITY OF) WA
Water Enterprise
WA

Moody's Rating

ISSUE	RATING
Regional Water Supply System Revenue Refunding Bonds, 2013	Aa2
Sale Amount	\$68,325,000
Expected Sale Date	04/01/13
Rating Description	Revenue: Government Enterprise

Moody's Outlook STA

Opinion

NEW YORK, March 27, 2013 --Moody's Investors Service has assigned a Aa2 rating to the City of Tacoma Regional Water Supply System Revenue Refunding Bonds, 2013. In addition, Moody's affirms the Aa2 rating on the regional water system's outstanding \$47.8 million in water revenue bonds. The bonds are secured by the water utility operating revenues of three of the four regional system participants, which include Tacoma, the City of Kent, and the Covington Water District. Debt service on the current offering is senior to the existing water revenue bonds for Tacoma, Kent and Covington. The fourth participant in the regional system, Lakehaven Utility District, has elected to separately pay its share of capital costs for the project with existing resources and is only liable for operating expenses of the regional system. Additionally, the City of Tacoma has pledged the gross revenues of its water system (also known as "Tacoma Water") to the payment of the bonds in the event of non-payment by the other participants.

SUMMARY RATING RATIONALE

The Aa2 rating reflects the nature of the project and repayment agreements which essentially make debt service on the current offering an operating expense of the participating systems, the growing service area and stable operations of the participants and the overall credit strength of Tacoma Water.

STRENGTHS

- Step up provision by Tacoma water and its ability to absorb all debt with only minimal impact on its credit quality
- Payment of current offering is senior to existing obligations of participants
- No additional debt plans

CHALLENGES

- Slow payout of debt
- Somewhat uneven financial operations of smaller participants

DETAILED CREDIT DISCUSSION

BONDS WERE ISSUED TO FUND PORTION OF COST FOR REGIONAL SUPPLY SYSTEM

The Second Supply Project consists of (i) water from the exercise of Tacoma Water's Second Diversion Water Right (up to 100 cubic feet per second); (ii) the Second Supply Pipeline; (iii) improvements made at the headworks diversion dam and intake; (iv) Second Supply Project fisheries and environmental enhancements; (v) the right to store water as a result of the Howard Hanson Dam Additional Storage Project; and (vi) treatment facilities. Tacoma Water (water revenue bonds rated Aa2) has been developing the Second Supply Project since 1968 and is the holder of the Second Diversion Water Right of up to 65 million gallons per day (MGD) from the Green River in the Cascade Mountains. This right is in addition to Tacoma's existing 72 MGD right to surface water from the Green River. The Second Supply Pipeline is approximately 34 miles long and varies from 48 to 90 inches in diameter. All components of the Second Supply Project are complete, with the exception of the Howard Hanson Dam additional water storage project, which is expected to be completed in 2017. Tacoma Water owns and operates the Second Supply Project and has transferred facilities of the Second Supply Project from the existing Water System to the Regional System.

As mentioned above, in addition to Tacoma Water, the City of Kent, Covington Water District (water revenue bonds rated Aa3/Negative outlook) and Lakehaven Utility District (water & sewer revenue bonds rated Aa2) participate in the Second Supply Project. Tacoma has a 15/36 participant share and each of Kent, Covington Water District and Lakehaven Utility District has a 7/36 participant share in the project. Each share represents a participant's proportional right to receive, and obligation to pay for, operating costs and water delivered by the project.

Lakehaven Utility District has contributed cash from its utility revenues and proceeds of its own bond issues in aid of construction to the Second Supply Project and is therefore not liable for debt service. In addition to the current offering and the outstanding Series 2010 bonds, Tacoma, Kent and Covington have financed portions of the project with a combination of utility revenues, bonds, and state loans.

DEBT SERVICE ON THE BONDS ARE OPERATING EXPENSES OF PARTICIPATING UTILITIES

Tacoma Water, the City of Kent's water utility and the Covington Water District are obligated to pay amounts sufficient to provide for the payment of the principal of and interest on the current offering. Tacoma Water is responsible for payment of approximately 55% of the debt service with the City of Kent and Covington Water District each responsible for approximately 23% and 22%, respectively. Kent and Covington will pay their shares to Tacoma. The percentage shares of debt service are subject to change with the addition of a new participant, the payment default of a participant, the issuance of additional bonds or the optional prepayment by a participant.

The payments by Tacoma Water, the City of Kent and Covington Water District constitute "Contract Resource Obligations" payable as operation and maintenance expenses from the gross revenues of their respective water utilities. Covington Water District has included a provision in its bond authorizing resolution enabling it to treat its share of all costs of the Second Supply Project as a Contract Resource Obligation if the following requirements have been met at the time such a Contract Resource Obligation has been entered into including no event of default has occurred under its own water system bond resolutions and certain coverage requirements have been met (1.0 times coverage of MADs on all utility local improvement bonds outstanding and 1.25 times coverage of MADs on all other water system parity bonds to be outstanding).

Each participant has entered into a separate repayment agreement which constitutes a take or pay obligation payable in monthly installments. The participants have covenanted to establish, maintain and collect rates or charges which shall be adequate to provide revenues sufficient to enable each participant to make the payments for Second Supply Project costs, including debt service and O&M, and to pay all other charges and obligations payable from each participant's water utility revenues. The participants are obligated to make the payments required under the Second Supply Project Agreement whether or not the project is completed, operable or operating except as noted above.

Additional bonds may be issued provided each participant's system generates gross revenues sufficient to pay the participant's operation and maintenance expenses of the participant's system and the participant's portion of the debt service on the additional bonds then proposed to be issued based on the highest debt service in the next three calendar years. In addition, net revenues of each participant's system must be sufficient to meet the rate covenant required by each participant's ordinance or resolution.

Additionally, a participant share that has been in default for a period of 60 days or more on a payment obligation will be offered for assignment to the non-defaulting participants. Any non-defaulting participant may accept all or any portion of the defaulting participant's share and, upon that acceptance, will be obligated to cure a proportionate share of any existing payment default and will be responsible for paying all obligations associated with the

increased participant share then assigned to it. In the event that other non-defaulting participants decline any or a defaulting participant's entire share, Tacoma Water will automatically increase its participant share in an amount equal to the defaulting participant's participant share then remaining unassigned.

The debt service reserve requirement is equal to average annual debt service, but cannot exceed 10% of par. The reserve requirements on the current offering and the outstanding parity bonds have been met with cash.

TACOMA WATER'S HISTORICAL AND PROJECTED COVERAGE RATIOS TO REMAIN SATISFACTORY DESPITE INCREASED COSTS ATTRIBUTABLE TO REGIONAL SYSTEM; OTHER PARTICIPANTS OPERATIONS HAVE BEEN UNEVEN

Since Tacoma Water is ultimately responsible for costs of the Regional System in the unlikely event of default of the system participants, Moody's has evaluated the effect on Tacoma Water in the event that it would assume all the costs of the system. Projected annual net revenues for Tacoma's senior lien bonds from 2013 to 2017 indicate coverage averaging 2.02 times, well in excess of both the rate covenant of 1.25 times and the system's policy of maintaining minimum coverage of 1.50 times. Under a scenario where Tacoma would need to support all of the regional supply debt service, projected net revenue coverage of total annual debt service (not including the effect of the BABs subsidy), adjusted to treat second supply debt as senior lien debt, would only moderately decrease to an average of about 1.52 times through 2017. For a more detailed discussion of Tacoma Water's credit quality, please refer to Moody's Municipal Research dated March 26, 2013. The Kent, Covington and Lakehaven systems serve growing areas north and east of Tacoma. Although operations at Covington have been strained, if the Contract Resource Obligation were treated as debt and added to outstanding revenue bonds coverage for its portion of RWSS debt is estimated to be low but sound averaging 1.8 between 2008 and 2011. Similarly, Kent's coverage has improved in recent years and averaged an estimated 1.3 times with Lakehaven covering its other revenue bonds by an average 3.3 times, although it is no longer required to provide payment of debt given its payment of its obligation in cash as explained above.

Outlook

Moody's has assigned a stable rating outlook based upon the expectation that the system will continue to be efficiently managed, with debt levels monitored and ongoing participant contributions.

WHAT COULD MAKE THE RATING GO - UP

-Significant and sustained improvement in Tacoma metrics

WHAT COULD MAKE THE RATING GO -DOWN

-Significant deterioration of Tacoma metrics as a result of water utility performance and/or a participant default

KEY STATISTICS

Pledge: City of Tacoma's pledge of gross water system revenues in the event of non-payment by the other participants

Participant shares:

Tacoma: 15/36

Kent, Covington Water District and Lakehaven Utility District: 7/36 each

Payout of principal (10 years): 14.7%

The principal methodologies used in this rating were Public Sector Pool Financings published in July 2012 and Analytical Framework For Water And Sewer System Ratings published in August 1999. Please see the Credit Policy page on www.moody.com for a copy of these methodologies.

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