Summary:
Tacoma, Washington; Water/Sewer

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Credit Profile

| US$17.0 mil wtr sys rev & rfdg bnds ser 2015A | AA/Stable | New |
| US$6.0 mil wtr sys rev & rfdg bnds ser 2015B | AA/Stable | New |

Rationale

Standard & Poor's Ratings Services assigned its 'AA' rating to the City of Tacoma, Wash.'s series 2015A and 2015B water system revenue refunding bonds. At the same time, Standard & Poor's affirmed its 'AA' long-term rating and underlying rating (SPUR) on the city's outstanding water system revenue bonds. The outlook is stable.

The ratings reflect our view of the water system's:

- Large service area anchored by the city of Tacoma and located within the larger Puget Sound regional economy,
- Strong debt service coverage (DSC), and
- Strong liquidity position.

These strengths are partly offset, in our view, by the city's projection of a decline in fixed-charge coverage (FCC) to near 1x in 2015. This coverage incorporates an 8% tax the water system pays to the general fund. The 8% tax is subordinate to debt service.

The bonds are being issued to refund a portion of the system's outstanding series 2005 bonds for debt service savings.

The bonds are secured by a pledge of net revenues of the city's water system. The bonds will also be backed by a reserve, though under an amendment to the bond ordinance, the reserve can be released when all series 2005 bonds are defeased. We understand that the city could defease these bonds at any time, thereby releasing the reserve. 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. Prior to this refunding, the system had $283.0 million in senior-lien bonds and $86.7 million in subordinate-lien loans outstanding.

The city has a separate water utility, known as the Regional Water Supply System (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 $110.1 million in RWSS debt outstanding. Tacoma's retail water system is responsible for about 70% of the RWSS' expenses, including debt service. 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 good DSC and strong liquidity somewhat mitigate the potential for Tacoma being required to cover a missed payment by another utility.

The water system service area covers all of Tacoma, in addition to other areas of Pierce County and portions of South King County. As of 2014, the system served 98,600 accounts. We view the system as diverse, with the top 10 representing 17% of operating revenues in 2014. Tacoma is a regional jobs center and participates in the larger Puget Sound economy. The city's median household income is good, in our view, at 98% of the national median.

Tacoma's water supply includes a mix of Green River surface water (first and second diversion rights total 138 million gallons per day, or mgd) and groundwater (55 mgd). In a typical year, about 96% of Tacoma's supply comes 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 the city, the system's water supply is well in excess of the system's demands.

The city has historically raised rates annually. Rates were raised 4.0% in 2015, and the city plans to increase rates another 4.0% in 2016. We view the rates as moderate. Currently, a residential customer using 1,000 cubic feet of water would pay about $38 per month during the summer. Under its financial projections, the city is assuming 4% annual rate increases through 2019.

The system's financial results have been stable in recent years, with rate increases leading to increasing operating revenue over time. The city combines the finances of its retail water system and the RWSS in the same fund in its financial statements. The figures below represent the local system only; the RWSS' revenues and expenses are excluded. In 2014 (unaudited), operating revenue totaled $79.2 million, up 7.9% over 2013. Operating expenses excluding depreciation were up 5.0% in 2014, totaling $43.7 million. Net revenues, including net operating income, connection fees, Build America Bonds subsidies, interest income, and other income totaled $41.3 million in 2014, providing senior-lien DSC of 2.26x and total DSC of 1.83x. This is up from senior-lien DSC of 1.86x and total DSC of 1.56x in 2013. The water system pays a tax to the general fund of about 8% of operating revenue ($6.3 million in 2014), which is not included in the expenses above. The system's FCC of total debt service (with the tax as a net revenue offset) was 1.55x in 2014, as calculated by Standard & Poor's.

Under the city's projections, senior-lien DSC remains strong and total DSC remains good through 2019. These projections factor in assumed 4% annual rate increases. Under the projections, FCC (including the 8% general fund tax as a fixed charge) is near 1x in 2015 before increasing thereafter. We view this coverage level as only adequate though it is partly mitigated by the system's strong liquidity position, in our view.

The water system has maintained a strong liquidity position in recent years. Unrestricted cash and investments totaled $45.8 million as of Dec. 31, 2014, representing 428 days of retail system operating expenses on hand. Including all operating expenses in the water fund (including RWSS expenses), liquidity was 400 days at year-end 2014. The water fund also has cash and investments that are classified as restricted in the financial statement but could be used to pay debt service or operating expenses if needed. Including these funds, we estimate 2014 year-end total liquidity to be $122 million, or 1,064 days of total operating expenses.

The water system's capital improvement program is manageable, in our view. The city is planning $95.6 million in
capital spending from 2015 through 2020. According to the city, the sources of funding are operating revenues, connection fees, other revenues, and cash on hand. No additional new-money debt is planned during this period.

**Outlook**

The stable outlook reflects our anticipation that the water system will generate at least good total DSC while maintaining a strong liquidity position. We understand that FCC may decline to near 1x in 2015. If FCC drops well below 1x or if liquidity is reduced substantially during the next two years, we could lower the ratings. If coverage increases during this period and liquidity remains strong, we could raise the ratings.

**Related Criteria And Research**

**Related Criteria**
- USPF Criteria: Key Water And Sewer Utility Credit Ratio Ranges, Sept. 15, 2008

**Related Research**
- U.S. State And Local Government Credit Conditions Forecast, April 2, 2015

**Ratings Detail (As Of April 9, 2015)**

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<td>Tacoma wtr sys rev &amp; rfdg bnds</td>
<td>AA/Stable</td>
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**Tacoma wtr**

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Many issues are enhanced by bond insurance.

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor’s public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.