

# RatingsDirect®

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## Summary:

# Tacoma, Washington; Water/Sewer

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## Summary:

# Tacoma, Washington; Water/Sewer

### Credit Profile

US\$68.0 mil wtr supp sys rev bnds (Regl Wtr Supp Sys) ser 2013 dtd 04/18/2013 due 12/01/2032

*Long Term Rating* AA/Stable New

Tacoma regl wtr supp sys rev bnds (Tax-Exempt) (Regl Wtr Supp Sys) ser 2010A due 12/01/2022

*Long Term Rating* AA/Stable Affirmed

**Tacoma Regl Wtr Supp Sys rev bnds ser 2002 dtd 12/15/2002 due 12/01/2005-2015 2017 2024 2028 2032**

*Unenhanced Rating* AA(SPUR)/Stable Affirmed

Many issues are enhanced by bond insurance.

## Rationale

Standard & Poor's Ratings Services assigned its 'AA' rating to Tacoma, Wash.'s regional water supply system revenue bonds, series 2013. At the same time, we affirmed our 'AA' rating on the city's outstanding regional water supply system revenue bonds. The outlook is stable.

The rating reflects our view of the following credit strengths:

- Generally strong credit quality of the four participants in the system;
- Participants' covenants to collect water rates and charges sufficient to cover system obligations under a take-or-pay agreement;
- An agreement by Tacoma, the largest participant and operator of the system, to cover payment defaults by other system participants if the payments are needed for system debt service; and
- Liquidity available to the system in a two-month operating reserve, plus a debt service reserve fund backing the bonds.

Partly offsetting these strengths, in our view, is the relatively slim debt service coverage at the system level when excluding participants' capital contributions due to the cost-recovery nature of the project agreements. However, in our view this is mitigated by stable financial performance and strong liquidity at the participant level, as well as Tacoma's obligation to cover defaulted payments if necessary to make debt service payments.

For more information on Tacoma's retail water system, please see our report published March 26, 2013 on RatingsDirect.

The series 2013 bonds are being issued to refund the system's series 2002 bonds for debt service savings. The bonds are secured by the net revenues of Tacoma's regional water supply system (RWSS), including payments made by participating utilities under a project agreement and debt repayment agreement. The RWSS is separate from the city's retail water system. The bonds are also backed by a reserve, funded at average annual debt service (about \$6.9 million after the refunding). A rate covenant requires the city to set regional water supply system rates to generate sufficient revenues to cover system costs, including debt service. Each participant has covenanted to set rates sufficient to cover

RWSS costs. Tacoma can issue additional RWSS bonds if each participant certifies that its historic net revenues, plus adjustments based on system expansion and adopted rate increases, are sufficient to cover the participant's operating expenses, RWSS payments, and its own debt service.

The RWSS, also known as the second supply project, is an enterprise of Tacoma that supplies water to Tacoma's retail water system and three nearby water systems. The system consists primarily of certain surface water rights owned by Tacoma on the Green River, water storage rights, a pipeline, improvements made at a diversion dam, and treatment facilities. Tacoma owns and operates the system and accounts for it separately from its retail water system although the funds are combined in its audited financial statements. The system delivers Green River surface water supply to four participants on a take-or-pay basis under the second supply project agreement. The participants are:

- Tacoma (15/36th share right to receive and obligation to pay for water),
- Kent (7/36th),
- Covington Water District (7/36th), and
- Lakehaven 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. The other participants' debt service obligations are as follows:

- Tacoma (52% of the series 2010 bonds and 55% of the series 2013 bonds),
- Kent (24% and 23%), and
- Covington Water District (24% and 22%).

The debt service payments of Tacoma and Kent constitute operating expenses payable before debt service while payments from Covington represent operating expenses as long as the RWSS is operating. For financial reporting purposes, each participant treats the RWSS debt obligations as debt rather than operating expenses.

Under the project agreement, if a participant other than Tacoma is in default for more than 60 days and the payments due are necessary to pay debt service, Tacoma is required to cover the defaulted payments and take over the defaulting participant's share of the project. This occurs after the defaulting participant's share is first offered to all other participants. We view this requirement of Tacoma as a key credit strength.

The system typically generates debt service coverage of near 1.0x when excluding participant capital contributions due to the cost-recovery nature of the project agreement and repayment agreement. In 2012, operating revenue totaled \$14.4 million, up substantially (74%) from the prior year, due largely to increased capital contributions from participants. Operating expenses were up 1.0% in 2012, totaling \$2.5 million. The system also received Build America Bond subsidy payments of \$868,000 and interest income of \$408,000. Net revenues totaled \$13.2 million, providing debt service coverage of 1.82x. Excluding \$5.7 million in capital contributions in 2012, most of which were from Lakehaven in lieu of participating in the system's bond issues, debt service coverage was 1.04x. Debt service coverage was 0.98x in 2011. Tacoma has a policy of maintaining a two-month operating reserve. Additional liquidity is provided

by a fully funded debt service reserve fund.

While the system's revenues generally cover its costs, including debt service, with little additional margin, the participants all currently generate strong debt service coverage 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 takeover the participant's obligations if necessary to make debt service payments. In 2011 (audited) and 2012 (unaudited) Tacoma's water system generated surplus revenue after debt service that could have covered the other members' regional water supply obligations if needed. Tacoma has also maintained a strong liquidity position in its water fund.

Tacoma's capital improvement program for the RWSS for 2013 through 2016 totals \$81.5 million. The largest component is a new treatment plant near the Green River intake, which is being constructed to meet increasingly stringent water quality regulations. Tacoma expects to have the plant fully operational by late 2014. According to management, the sources of funding for the capital plan include prior bond proceeds, contributions from participants, and state loans. No additional parity debt is planned.

## **Outlook**

The stable outlook reflects our anticipation that Tacoma's water system will continue to have stable financial performance and will maintain the financial capacity to cover a participant default should one occur. The outlook also reflects our anticipation that the credit quality of the other participants will remain good, keeping the likelihood of a participant default under the project agreement low. If the credit quality of Tacoma's retail water system were to decline, in our view, we could lower the rating on the RWSS bonds. Conversely, if the retail system's credit quality were to improve, we could raise the rating.

## **Related Criteria And Research**

- USPF Criteria: Key Water And Sewer Utility Credit Ratio Ranges, Sept. 15, 2008
- USPF Criteria: Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008

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