

# Memorandum



CITY OF DALLAS

DATE January 22, 2021

TO Honorable Mayor and Council Members

SUBJECT **Fitch Ratings Assigns 'AA+' Rating, Negative Outlook for Tarrant Regional Water District Dallas Water Revenue Bonds**

Today, Fitch Ratings (Fitch) assigned their 'AA+' credit rating and negative outlook to the Tarrant Regional Water District (TRWD) Water Transmission Facilities Contract Revenue Bonds (City of Dallas Project), Series 2021A and Water Transmission Facilities Contract Revenue Refunding Bonds (City of Dallas Project), Taxable Series 2021B. The City of Dallas Project bonds rating is directly linked to the financial profile of Dallas Water Utilities (DWU) as the bonds are secured by an unconditional pledge of DWU gross revenues. The bonds are scheduled to be competitively sold on behalf of TRWD on February 2, 2021, with bond proceeds of the series 2021A to be used to pay for the Dallas component of the integrated pipeline (IPL) project and to fund associated reserves and costs of issuance, and the series 2021B bonds will be used to refund IPL project-associated bonds for debt service savings. Details of the IPL project were included in a briefing to the City Council on November 17, 2020.

According to the report, "the City and district entered into a water contract to build a pipeline that will serve both entities and achieve construction and operational cost savings. The project, known as the IPL, will provide both with ample transmission and supply capacity for future years." As such, the 'AA+' rating on the City of Dallas Project bonds reflects the credit quality of the Dallas, Texas (the City) waterworks and sewer system (DWU) whose revenue bonds are rated 'AA+/-Negative.'

In the report, Fitch detailed its key rating drivers including TRWD revenue defensibility, operating risks, and financial profile. According to Fitch, "revenue defensibility is very strong, driven by the purchaser credit quality of DWU and its unconditional repayment obligation under the contract to pay for the bonds." Fitch also assesses the operating risks favorably with "very low cost burden" and "manageable capital needs," stating "the contractual operating structure to pass-through project costs result in a low cost burden to DWU. Remaining capital needs for the project, while large, are manageable in the context of the size and the benefit to DWU." Fitch also rates the financial profile highly, explaining that TRWD "revenues and costs are largely balanced and passed through to DWU given the contractual obligation," therefore, "leverage and the financial profile of the district is less of a consideration in Fitch's determination of the final rating."

Fitch's rating of the TRWD IPL project bonds reflects the effective leadership and program management between the City of Dallas, Dallas Water Utilities System and regional partners to provide essential services to the greater region for the foreseeable future. Attached is the published Fitch Report for further details.

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Please let me know if you need additional information.



M. Elizabeth Reich  
Chief Financial Officer

#### Attachment

c: T.C. Broadnax, City Manager  
Chris Caso, City Attorney  
Mark Swann, City Auditor  
Biliera Johnson, City Secretary  
Preston Robinson, Administrative Judge  
Kimberly Bizer Tolbert, Chief of Staff to the City Manager

Majed A. Al-Ghafry, Assistant City Manager  
Jon Fortune, Assistant City Manager  
Joey Zapata, Assistant City Manager  
Dr. Eric A. Johnson, Chief of Economic Development and Neighborhood Services  
M. Elizabeth (Liz) Cedillo-Pereira, Chief of Equity and Inclusion  
Directors and Assistant Directors



## RATING ACTION COMMENTARY

# Fitch Rates TRWD City of Dallas Water Contract Revenue Bonds 'AA+'; Outlook Negative

Thu 21 Jan, 2021 - 4:46 PM ET

Fitch Ratings - Austin - 21 Jan 2021: Fitch Ratings has assigned an 'AA+' rating to the following bonds issued by the Tarrant Regional Water District, TX (TRWD):

--Approximately \$218.2 million Water Transmission Facilities Contract Revenue Bonds (City of Dallas Project), Series 2021A;

--Approximately \$298.6 million Water Transmission Facilities Contract Revenue Refunding Bonds (City of Dallas Project), Taxable Series 2021B.

The bonds will be sold via competitive bid on Feb. 2, 2021. Bond proceeds of the series 2021A bonds will be used to pay for design, acquisition, and construction of the Dallas component of the integrated pipeline (IPL) project and to fund associated reserves and costs of issuance. The series 2021B bonds will be used to refund IPL project-associated bonds for debt service savings.

The Rating Outlook is Negative.

## **ANALYTICAL CONCLUSION**

The 'AA+' rating on the City of Dallas Project bonds reflects the credit quality of the Dallas, Texas (the city) waterworks and sewer system (DWU) whose revenue bonds are rated 'AA+' / Negative with a corresponding standalone credit profile of DWU assessed at 'aa+'. The water transmission facilities contract (water contract) between the TRWD and the city obligate the city to make payments from DWU revenues sufficient to pay 100% of the costs of the city's proportionate share of the project, including debt service on all of the bonds issued for its IPL project share. Dallas' obligation to make the payments is absolute and unconditional and extends until all debt associated with its IPL project share are repaid.

The rating incorporates the operational importance of the associated IPL project to DWU's supply portfolio and the district's financial profile that generates slim margins based on its contractual break-even structure. However, these attributes are less of a consideration in the rating than the credit quality of DWU.

## **CREDIT PROFILE**

TRWD is a water control and improvement district charged with the responsibilities for water supply and flood control, as well as management of recreational facilities related to the two functions. Excluding the Dallas contract, the district provides raw water supply to about 50 municipal and non-municipal entities located both within and outside of Tarrant County. Overall, the district provides water either directly or indirectly to about 95% of Tarrant County's estimated 2 million population. The district also operates and maintains a floodway system consisting of levees and river channel improvements and recreational assets related to its other functions.

The city and district entered into a water contract to build a pipeline that will serve both entities and achieve construction and operational cost savings. The project, known as the IPL, will provide both with ample transmission and supply capacity for future years. Under the water contract, the city will own reserved water capacity rights to 150 million gallons per day (mgd) and will pay for its share of design and construction (which is currently estimated at \$936 million). It is anticipated that the district will issue additional IPL Dallas Project bonds (approximately \$320 million) in the next five years to pay the remaining capital costs. The series 2021A bonds are the fourth series of City of Dallas Project bonds. The series 2021B refunding bonds will refund a portion of the \$415.7 million outstanding City of Dallas Project bonds for debt service savings.

## Coronavirus Considerations

The recent outbreak of coronavirus has not shown significant impairment in the district's or DWU's revenue and cost profiles. However, Fitch's ratings remain forward-looking in nature, and we will continue to monitor developments related to the severity and duration of the virus outbreak, as well as revise expectations for future performance as appropriate.

## KEY RATING DRIVERS

### Revenue Defensibility 'aa'

Unconditional Water Transmission Facilities Contract; Very Strong Purchaser Credit Quality

Revenue defensibility is very strong, driven by the purchaser credit quality of DWU and its unconditional repayment obligation under the contract to pay for the bonds and associated operating costs.

### Operating Risks 'aa'

Very Low Cost Burden, Manageable Capital Needs

The contractual operating structure to pass-through project costs result in a low cost burden to DWU. Remaining capital needs for the project, while large, are manageable in the context of the size and the benefit to DWU.

### Financial Profile 'aa'

High Leverage

The district's revenues and costs are largely balanced and passed through to DWU given the contractual obligation under the water transmission agreement. As a result, leverage and the financial profile of the district is less of a consideration in Fitch's determination of the final rating.

## **ASYMMETRIC ADDITIVE RISK CONSIDERATIONS**

No asymmetric risk considerations affected this rating determination.

## **RATING SENSITIVITIES**

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Improved credit quality of DWU.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Weaker credit quality of DWU.

## **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 special obligations of the district, payable from and secured by a first lien on DWU's gross revenues pursuant to the contract between the district and city.

## REVENUE DEFENSIBILITY

The revenue source characteristics of the IPL project are supported by the contractual terms between the district and Dallas. The two parties entered into a water contract dated Jan. 12, 2011 that remains in place through the later date of final bond maturity or the useful life of the asset (i.e. the IPL project). Unlike most of the district's projects and operations that have multiple members, the 150 mgd reserved water capacity for which the City of Dallas Project bonds are being issued have a sole obligor, DWU. Under the contractual terms, the city agrees to set rates and charges sufficient to make all debt service payments, as well as pro-rata share of operating expenses.

The city's contractual obligation to pay for the bonds is absolute, unconditional, and irrevocable until all of the bonds are paid regardless of whether or not the district actually provides any facilities or the city actually receives or uses any water pursuant to the agreement.

### Rate Flexibility

Rate flexibility is very strong as the district has full authority to set rates for the project that recover all costs. Rates charged by DWU are similarly determined independently by Dallas' city council.

### Purchaser Credit Quality

Fitch has assessed the purchaser credit quality at 'aa', based on the credit characteristics of DWU, the sole obligor to the bonds. Fitch's purchaser credit quality assessment, and ultimately the rating, is driven by the rating of DWU since bondholders have direct exposure to DWU default under the water contract.

### DWU Credit Quality Assessment

DWU serves an expansive territory with favorable demographic trends, providing retail water and sewer service to over 1.3 million city residents. DWU also provides wholesale treated water to 23 municipalities and wholesale sewer service to 11 customer cities in Dallas County and the contiguous counties with a population of over 1.2 million. Dallas

county, which approximates the service area for both retail and treated wholesale water customers, has a population of over 2.5 million and five-year average annual growth is just under 1%.

DWU water is supplied through contractual agreements with surface reservoir operating entities that include Sabine River Authority, Upper Neches River Municipal Water Authority and the United States. Water is supplied to DWU from six surface water impoundments including the Elm Fork of the Trinity River and Lake Palestine, which is being connected to DWU through the water transmission facilities contract with the district.

DWU's 'aa+' SCP and 'AA+' waterworks and sewer system revenue bonds ratings reflect DWU's strong revenue defensibility, which is supported by its fundamental role as the regional water provider to a broad service area with favorable demographic trends. DWU's very low operating risks feature economies of scale and a favorable capital planning and management assessment. Fitch's revision to DWU's Outlook to Negative from Stable in May 2020 was driven by weaker fiscal 2019 results along with the planned debt issuance over the next few years that could outpace revenue growth and lead to sustained higher leverage than experienced in recent years. DWU's net leverage, as expressed in adjusted debt to adjusted funds available for debt service (FADS), rose in fiscal 2019 to 9.3x from 7.7x the year prior. DWU's experienced revenue decline in fiscal 2019 due to a rate decrease coupled with declines in water demand from wet weather. Expectations for fiscal 2020 are for some improvement in net leverage despite additional forecast revenue contractions from fiscal 2019 levels due to lower demand related to the coronavirus. Negative action would be expected to occur if net leverage failed to point towards stabilization around or below 8x.

For more information on DWU, see 'Fitch Rates Dallas, TX's Water & Sewer Revs 'AA+'; Outlook to Negative' dated May 28 2020.

## **OPERATING RISKS**

The district's operating risk is assessed at 'aa' which takes into consideration a very low operating cost burden. The district's life cycle ratio indicates low capital needs. Capital spending as a percent of depreciation has been high over the last five fiscal years.

The shared pipeline and pass through nature of the water transmission facilities contract is expected to yield significant savings to DWU to continue to support DWU's own 'aa' operating risks assessment.



## FINANCIAL PROFILE

The district's own financial profile is very strong. However, the City of Dallas Project bonds rating is directly linked to the financial profile of DWU as the bonds are secured by an unconditional pledge of DWU gross revenues. Fitch assessed the DWU's financial profile at 'aa'.

Fitch's calculated net leverage ratio for DWU was 9.3x at the end of fiscal 2019, which is at the higher end of the assessment range. The liquidity profile is neutral to the rating with coverage of full obligations (COFO) at 1.06x and liquidity cushion of 221 days at the close of fiscal 2019. DWU's liquidity cushion remained strong at about 200 days or more since fiscal 2017. COFO dipped to 0.84x in fiscal 2017 due to one-time large pension expenses related to adopted pension reforms, but has remained over 1x since then.

Net leverage has trended downward in recent years from 9.8x in fiscal 2015 to 7.7x in fiscal 2018, which was supported by an uptick in water demand during more normal hydrological conditions. However, rate decreases in fiscal 2019, coupled with reduced demand from wet weather resulted in sharp decline in revenues, pushing leverage up past 9x for the year. Reduced water demand has postponed the need for additional water supplies and generally lowered capital and operating costs over the long term. Consumption has leveled off and the city feels they have reached their base line consumption of about 136 billion gallons annually. From year to year, demand is still very weather dependent and rate revenues fluctuate based on weather-driven water use.

No scenario analysis was completed, or necessary, in the determination of the rating.

## ASYMMETRIC ADDITIVE RISK CONSIDERATIONS

No asymmetric additive risk considerations affected this rating determination.

## DATE OF RELEVANT COMMITTEE

20 January 2021

## SOURCES OF INFORMATION

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.

## **PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS**

The rating is linked to the rating of the Dallas, TX waterworks and sewer system.

## **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](http://www.fitchratings.com/esg)

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Additional information is available on [www.fitchratings.com](http://www.fitchratings.com)**APPLICABLE CRITERIA**[Public Sector, Revenue-Supported Entities Rating Criteria \(pub. 27 Mar 2020\) \(including rating assumption sensitivity\)](#)[U.S. Water and Sewer Rating Criteria \(pub. 03 Apr 2020\) \(including rating assumption sensitivity\)](#)**ADDITIONAL DISCLOSURES**[Dodd-Frank Rating Information Disclosure Form](#)[Solicitation Status](#)[Endorsement Policy](#)**ENDORSEMENT STATUS**

Tarrant Regional Water District (TX)

EU Endorsed, UK Endorsed

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