

Memorandum



CITY OF DALLAS

DATE June 26, 2020

TO Honorable Mayor and Council Members

SUBJECT **Moody's Investors Service Releases Credit Opinion in Update to Credit Analysis of Dallas Water Utilities' 'Aa2' (Stable) Rating - INFORMATION**

On June 22, Moody's Investors Service (Moody's) released a credit opinion article regarding recent updates to the credit analysis of Dallas Water Utilities' (DWU) 'Aa2' (stable outlook) rating. According to Moody's report, the DWU system "exhibits healthy credit fundamentals. The system is a very large, regional water and wastewater service provider with a healthy asset condition, ample water supply and system capacity and strong financial performance." Regarding the coronavirus outbreak, Moody's states, "we regard the coronavirus outbreak as a social risk under our environmental, social and governance framework, given the substantial implications for public health and safety and the economy," and explains, "we do not see any material immediate credit risks for the Dallas Waterworks and Sewer Enterprise because of the essential service provided and because the system management is actively implementing expenditure cuts to make up the projected revenue shortfall in fiscal 2020."

The report identifies certain credit challenges, such as the "slightly elevated ratio of debt to operating revenues," due in part to "robust and long-range capital planning to access additional water supply and replace aging infrastructure," and "exposure to ERF unfunded pension liability." However, the report continues that, "the stable outlook reflects the expectation that favorable demographic trends, strong financial management and strategic planning, and ongoing city council support of rate increases as needed will lead to maintenance of solid liquidity and adequate debt service coverage levels for the system."

This article is not a rating action from Moody's but is a positive reflection of DWU's fiscal strength and sound fundamentals, especially during unprecedented times. Attached is the published report for your review. Please let me know if you need additional information.


M. Elizabeth Reich
Chief Financial Officer

[Attachment]

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CREDIT OPINION

22 June 2020

Update

✓ Rate this Research

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Dallas (City of) TX Waterworks & Sewer Ent.

Update to credit analysis

Summary

The Dallas Waterwork and Sewer Enterprise ("the system" or "the enterprise") (Aa2 stable) credit profile considers the close credit relationship between the city of Dallas (A1 stable) and the system, as well as the strong credit fundamentals of the system. The linkage between the two entities is driven by its shared governance, as the City Council is the responsible body over general city operations as well as the enterprise system.

The enterprise system exhibits credit strengths that bolster the profile, including both legal protections and system fundamentals. Specifically, the legal framework protecting bondholders is strong, both in state legislation and the bond legal documents, including secured pledge of net revenue and the closed loop of funds as required in the city's voter-approved charter. Additionally, the system exhibits healthy credit fundamentals. The system is a very large, regional water and wastewater service provider with a healthy asset condition, ample water supply and system capacity and strong financial performance. Being a large provider, system management exhibits robust and long-range capital planning to access additional water supply and replace aging infrastructure, though this has resulted in a slightly elevated debt level relative to revenue. The profile is also constrained by its exposure to the Dallas Employees' Retirement Fund, though allocated pension leverage and annual pension costs to the system are manageable.

We regard the coronavirus outbreak as a social risk under our environmental, social and governance framework, given the substantial implications for public health and safety and the economy. We do not see any material immediate credit risks for the Dallas Waterworks and Sewer Enterprise because of the essential service provided and because the system management is actively implementing expenditure cuts to make up the projected revenue shortfall in fiscal 2020. However, the situation surrounding coronavirus is rapidly evolving and the longer term impact will depend on both the severity and duration of the crisis. If our view of the credit quality of the enterprise system changes, we will update our opinion at that time.

Credit strengths

- » Large service area that is nearly double the size of the city of Dallas
- » DFW region exhibits strong economic indicators
- » Long history of rate increases to support capital needs

- » Strong bond holder legal protections

Credit challenges

- » Slightly elevated ratio of debt to operating revenues
- » Exposure to ERF unfunded pension liability

Rating outlook

The stable outlook reflects the expectation that favorable demographic trends, strong financial management and strategic planning, and ongoing city council support of rate increases as needed will lead to maintenance of solid liquidity and adequate debt service coverage levels for the system. The stable outlook also incorporates the expectation that rising pension costs associated with the Dallas Employees' Retirement Fund, and allocated to the system, will remain a small percentage of operating expenses.

Factors that could lead to an upgrade

- » Reduced ratio of debt to operating revenues
- » Significant improvement to debt service coverage
- » Upgrade of the city's GOLT rating

Factors that could lead to a downgrade

- » Trend of declining system liquidity
- » Downgrade of the city's GOLT; material increases to the unfunded pension liability associated with ERF

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Key indicators

Exhibit 1

Dallas Waterworks and Sewer Enterprise, TX

System Characteristics					
Asset Condition (Net Fixed Assets / Annual Depreciation)	42 years				
System Size - O&M (in \$000s)	\$295,389				
Service Area Wealth: MFI % of US median	100.0%				
Legal Provisions					
Rate Covenant (x)	1.25				
Debt Service Reserve Requirement	DSRF funded at less than 3-prong test OR springing DSRF (A)				
Management					
Rate Management	Aa				
Regulatory Compliance and Capital Planning	Aaa				
Financial Strength					
	2015	2016	2017	2018	2019
Operating Revenue (\$000)	\$577,362	\$611,430	\$658,969	\$676,398	\$635,285
System Size - O&M (\$000)	\$295,619	\$313,288	\$284,684	\$300,230	\$295,389
Net Revenues (\$000)	\$281,743	\$298,142	\$374,285	\$376,168	\$339,896
Net Funded Debt (\$000)	\$2,371,905	\$2,443,753	\$2,510,782	\$2,617,816	\$2,568,229
Annual Debt Service (\$000)	\$178,354	\$182,900	\$182,000	\$202,597	\$212,157
Annual Debt Service Coverage (x)	1.6x	1.6x	2.1x	1.9x	1.6x
Cash on Hand	207 days	202 days	225 days	269 days	274 days
Debt to Operating Revenues (x)	4.1x	4.0x	3.8x	3.9x	4.0x

MFI based on broader service area

Source: Moody's Investors Service, city audited financial reports, revenue bond documents

Profile

The City of Dallas Waterworks and Sewer Enterprise is a large water and sewer utility serving 300,000 retail accounts within the city of Dallas. The system also provides wholesale water and wastewater treatment to numerous local governments in the Dallas - Fort Worth metroplex.

Detailed credit considerations

Service area and customer base: large wholesale and retail service base; strong planning for long-term water resources

The response to the coronavirus pandemic has resulted in an unprecedented slowdown in economic activity across the US. The effect on local governments will vary based on the extent and duration of local disruption and could be more or less severe than the nation overall. The evolution of the crisis remains highly uncertain and the full extent of the economic costs will be unclear for some time.

The Dallas waterworks and sewer system serves a growing area of residential, commercial and retail development. The system has approximately 300,000 water accounts and provides water on a wholesale basis to 27 local governments in the metro area (23 treated, and 4 untreated water). Water supply is available from six surface water impoundments and from water in the Elm Fork of the Trinity River. All of the sources are located in north central and east Texas. The city's dependable connected water supply yield is 431 million gallons per day (MGD) from current connections, and increases to 604 MGD including available but not yet connected supply. As of 2019, the average demand on the system was 369 MGD and the peak was 606 MGD. Future surface water impoundments are anticipated, including an important connection to Lake Palestine which is about two-thirds complete and expected to be available by the time it is needed in 2027. The city's water supply is projected to be adequate to 2050 upon completion of the connection to Lake Palestine. Long-term affordable water supply options continue to be identified – the city updated their long range water supply plan in fiscal 2014 in order to secure water through 2070.

The system also includes wastewater collection and treatment, and serves the City of Dallas on a retail basis, and provides treatment services to 11 local governments in the area. Wastewater infrastructure includes over 4,020 miles of pipe and two treatment plants. The plants are permitted to treat 280 MGD on an average daily basis. As of 2019, the average daily usage was 231 MGD and the peak usage of 552 MGD.

Debt service coverage and net working capital: healthy debt service coverage supported by regular rate increases

Debt service coverage will remain adequate over the next few fiscal years despite the economic slowdown associated with the coronavirus pandemic due to the essentiality of the service, limited retail delinquencies and no expected wholesale delinquencies, and otherwise a strong fiscal management team.

The city's exhibits a strong and stable trend rate management to maintain adequate debt service coverage, which is a favorable credit factor given the utility's increasing expenditure requirements. The City Council, who approves water and sewer rates, has demonstrated willingness to increase rates as needed. Both water and sewer rates for retail and wholesale service (which represents the majority of system revenues) have reflected manageable annual increases historically. Rates remained flat in fiscal 2019 and 2020, as a result of the settlement with the Sabine River Authority, though are projected to modestly increase again annually through 2024 to accommodate planned capital improvements.

In fiscal 2019, net revenues available for debt service declined to \$339.9 million, which covered annual debt service requirements of \$212.2 million by an adequate 1.6 times. City officials have a goal to maintain fiscal year-end maximum debt service coverage of 1.5 times. Prudently, the target is used for budgeting purposes in order to account for any reductions in water revenues and still sufficiently meet the rate covenant and additional bonds test. The drop in net revenues in fiscal 2019 was anticipated, as wholesale customers received a credit as a result of the Sabine River Authority (SRA) settlement, which will be offset by fund balance, and decreased water consumption. Additionally, system operating expenditures reflect a Moody's adjustment of -\$71 million, which converts the GASB accrual expense for pension and OPEBs into cash contributions. More information about this adjustment can be found in our [pension and OPEB adjustments methodology](#).

Fiscal 2020 revenues are forecast to be about 10% below budget, and slightly below fiscal 2019, though coverage should remain stable through reduced expenditures. Wetter weather earlier in the fiscal year, coupled with decreased commercial demand resulting from the pandemic are the primary reasons for the forecast decline. However, the city has been able to source cost savings to make up for the loss. In addition to cost savings from reduced water treatment expenses, it has also implemented hiring freezes, restricted non-essential spending, and deferred certain capital projects.

LIQUIDITY

The system's unrestricted liquidity has continued to improve, with cash increasing from \$147.4 million in 2014 to \$221.8 million in fiscal 2019, representing a healthy 274 days of operating expenditures. The city has also adopted a financial policy to maintain an unreserved cash balance that provides a minimum quick ratio of 1.50 times and 30 days of budgeted expenditures.

Debt and legal covenants: substantial capital plan to replace aging infrastructure and source additional water supply; strong legal structure

The systems' debt to revenues ratio will likely remain elevated though manageable in the near term given additional borrowing plans through 2024 in line with past issuance trends. The fiscal 2019 ratio of debt to revenues has come down slightly over the past few years, though remains moderately elevated at 4 times revenues, which is in line with similarly sized enterprises with substantial capital needs to serve a regional population. The system has undertaken a robust capital improvement plan for the system to replace aging infrastructure and expand to accommodate growth. The city uses a combination of commercial paper, revenue bonds and cash contributions from current revenues to fund annual capital needs. The current city council authorization for the CP program is \$600 million. As of 2019, the system's total debt includes approximately \$2.2 billion in revenue bonds and \$425.4 million in contract revenue bonds associated with the integrated pipeline project, as well as \$75.5 million in pension obligation bonds allocated to the system (including accretion).

DEBT STRUCTURE

The system issues 30 year, fixed rate, revenue bonds to take out the outstanding CP. Overall revenue bond debt structure descends over time. Approximately 39% of principal will amortize within 10 years.

LEGAL STRUCTURE

The bonds are secured by a first lien on the net revenues of the system. The contract revenue bonds are secured by a pledge of gross operating revenues and are considered an O&M expense.

Legal provisions associated with the revenue bonds provide strong bondholder security. Texas government code 1208 perfects the lien on pledged revenues, which can point to increased bondholder recovery in the event of severe fiscal distress of the city. Additionally, per the current city charter and management practices, there exists a strict separation of accounts and assets between general city operations and the system, except for payments in lieu of taxes, street rental fees, and charges for services rendered. While the charter may be amended by a vote of the residents, an amendment impacting the system is not currently contemplated.

The bond documents include a rate covenant that requires net revenues to produce 1.25 times peak debt service, and the additional bonds test is 1.25 times average annual debt service. A reserve fund is required to be maintained at 100% average annual debt service funded over 60 months. All of the debt service reserves have been cash funded. As of September 2019 the balance in the DSRF was \$105.4 million. Outstanding CP notes (rated P-1) have a subordinate lien on system net revenues. Finally, the Bond Ordinance requires equal monthly installments for the next payment of principal and interest due.

DEBT-RELATED DERIVATIVES

The system is not a party to any debt-related derivative agreements.

PENSIONS AND OPEB

The system funds a portion of the city's single-employer Employees' Retirement Fund ("ERF"). As of fiscal 2019, the system was allocated 19.3% of the reported ERF net pension liability of \$2.3 billion, based on a 5.98% discount rate. The Moody's Adjusted Net Pension Liability ("ANPL") of the ERF as of fiscal 2019 was \$3.7 billion, based on an assumed rate of return of 4.2%. Based on an assumed 19.3% share, the ANPL attributable to the system is \$708.1 million, or 0.9 times revenues.

Environmental, social, and governance considerations**ENVIRONMENTAL**

The system is within the Great Plains region, which is forecast to be most affected by rising temperatures that put increasing strain on water supplies and energy. The region is also expected to see periods of extreme rainfall that can cause flooding. The system maintains a robust water, wastewater and stormwater capital improvement, water sourcing and conservation plans to manage these risks, which are expected to materialize over the long term.

SOCIAL

The system's service area demographic trends have been strong, exhibiting a growing population. Though the city's socioeconomic profile is weak overall, the larger service area wealth and income levels are generally above average relative to the nation.

GOVERNANCE

Management of the Dallas Waterworks and Sewer System provide departmental administration within the framework of the city's council-manager form of government. Subject to the direction and supervision of the Office of the City Manager, the Director of Water Utilities is charged with management of the system. The system demonstrates good governance through annual adoption of rate increases to support system needs, and maintenance of policies for debt service coverage and liquidity.

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