Memorandum

CITY OF DALLAS

DATE July 30, 2021

TO Honorable Mayor and Members of the City Council

SUBJECT **Moody's Investors Service Releases Update to Credit Analysis of City's 'A1' (Stable) Rating - INFORMATION**

On July 29, Moody's Investors Service (Moody's) released an update to the credit analysis of the City's 'A1' rating. Moody's last affirmed the rating and stable outlook on June 5, 2020 as part of an annual review of the City. According to Moody's report, the credit profile of the City "benefits from a very strong and diverse economy that has led to job and population growth, as well as strong tax base expansion. Management's conservative budgeting and revenue growth have contributed to healthy operating reserves that have increased annually for the past several years. The growing tax base has allowed the debt burden to remain stable as the city continues to invest in infrastructure." A new feature in the report rates the City's ESG Credit Impact Score as "neutral-to-low (CIS-2), reflecting low exposure to environmental risks, low exposure to social risks, and good governance."

Moody's report also identifies two credit challenges of the City, including "longer term budgetary pressures deriving from rising pension costs, coupled with maintenance of city services and continued infrastructure investment," and "elevated pension burden expected to increase due to weak annual contributions and investment returns." However, the report explains that the stable outlook, "reflects the expectation that conservative financial management and growing operating revenue will lead to stable reserves, and that the tax base will continue to expand because of the strong economy."

While Moody's update is not a rating action on the City, their report is a testament to the stewardship and leadership of the City and a positive reflection of the credit ahead of budget adoption and debt issuance. Attached is the published report for your review. Please let me know if you need additional information.

M. Elizabeth Reich

M. Elizabeth Reich
Chief Financial Officer

Attachment

c: T.C. Broadnax, City Manager
Chris Caso, City Attorney
Mark Swann, City Auditor
Bilierae Johnson, City Secretary
Preston Robinson, Administrative Judge
Kimberly Bizor 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 & Neighborhood Services
M. Elizabeth (Liz) Cedillo-Pereira, Chief of Equity and Inclusion
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MOODY'S
INVESTORS SERVICE

CREDIT OPINION
29 July 2021

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Dallas (City of) TX

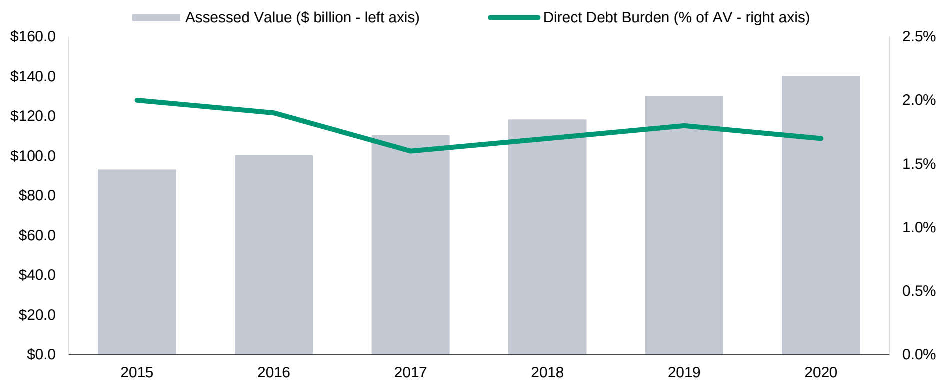
Update to credit analysis

Summary

The City of Dallas, TX's (A1 stable) credit profile benefits from a very strong and diverse economy that has led to job and population growth, as well as strong tax base expansion. Management's conservative budgeting and revenue growth have contributed to healthy operating reserves that have increased annually for the past several years. The growing tax base has allowed the debt burden to remain stable as the city continues to invest in infrastructure. The primary and continuing challenge to the credit profile is the unfunded pension liability that will continue to grow because caps to contributions remain below a "tread water" level that would prevent the liability from growing, while investment returns lag plan targets.

Exhibit 1

Strong AV growth keeps debt burden manageable despite annual new issuances



Source: Dallas (City of) TX's financial statements and Moody's Investors Service

Credit strengths

» Large, rapidly growing and diverse tax base that anchors the Dallas / Fort Worth (Aa3 stable) metroplex

» Continued annual surpluses have increased operating reserves to healthy levels

» Legal flexibility to further adjust pension benefits for current employees on a prospective basis

Credit challenges

» Longer term budgetary pressures deriving from rising pension costs, coupled with maintenance of city services and continued infrastructure investment

» Elevated pension burden expected to increase due to weak annual contributions and investment returns

Rating outlook

The stable outlook reflects the expectation that conservative financial management and growing operating revenue will lead to stable reserves, and that the tax base will continue to expand because of the strong economy. The outlook also considers pension contributions that should remain manageable in the near-term, but over the longer term the liability and annual costs are projected to grow.

Factors that could lead to an upgrade

» Material reduction in the Moody's Adjusted Net Pension Liability (ANPL) relative to operating revenue

» Demonstrated balanced operations inclusive of pension funding at actuarially determined levels

Factors that could lead to a downgrade

» Trend of declining operating reserves

» Trend of pension asset accumulation that lags targets; increases to the ANPL and weakened annual contributions

» Significant increase to the debt burden

Key indicators

Exhibit 2

Dallas (City of) TX

	2016	2017	2018	2019	2020
Economy/Tax Base					
Total Full Value ($000)	$100,318,937	$110,387,629	$118,314,678	$130,080,986	$140,237,632
Population	1,278,433	1,300,122	1,318,806	1,330,612	1,330,612
Full Value Per Capita	$78,470	$84,906	$89,713	$97,760	$105,393
Median Family Income (% of US Median)	71.6%	72.3%	73.7%	74.9%	74.9%
Finances					
Operating Revenue ($000)	$1,355,442	$1,441,984	$1,506,713	$1,583,747	$1,606,195
Fund Balance ($000)	$178,987	$224,582	$263,690	$285,100	$367,076
Cash Balance ($000)	$187,938	$215,589	$245,393	$311,602	$373,966
Fund Balance as a % of Revenues	13.2%	15.6%	17.5%	18.0%	22.9%
Cash Balance as a % of Revenues	13.9%	15.0%	16.3%	19.7%	23.3%
Debt/Pensions					
Net Direct Debt ($000)	$1,933,095	$1,804,061	$2,057,083	$2,306,237	$2,403,401
3-Year Average of Moody's ANPL ($000)	$7,117,560	$8,047,975	$7,752,987	$7,191,402	$7,064,657
Net Direct Debt / Full Value (%)	1.9%	1.6%	1.7%	1.8%	1.7%
Net Direct Debt / Operating Revenues (x)	1.4x	1.3x	1.4x	1.5x	1.5x
Moody's - ANPL (3-yr average) to Full Value (%)	7.1%	7.3%	6.6%	5.5%	5.0%
Moody's - ANPL (3-yr average) to Revenues (x)	5.3x	5.6x	5.1x	4.5x	4.4x

Cash and fund balances include the general fund and debt service funds

Sources: US Census Bureau, Dallas (City of) TX's financial statements and Moody's Investors Service

Profile

Dallas is the ninth largest city in the US and the third largest in Texas (Aaa stable) behind Houston (Aa3 stable) and San Antonio (Aaa negative). The city serves as the anchor to the Dallas-Fort Worth metroplex. The current population is approximately 1.3 million.

Detailed credit considerations

Economy and tax base

Dallas' economy remains strong and the diverse tax base will continue to expand as new jobs come online leading to population growth and housing demand. Fiscal 2022 assessed value increased 4% to $155.9 billion. Approximately 45% of AV is comprised of commercial properties and while some commercial properties' values depreciated last year because of the pandemic, the overall growth in AV was due to new construction and appreciation of existing properties.

Dallas continues to have the largest job base in the metro area and employment gains since the middle part of last year have outperformed most other Texas cities, as well as the nation. The unemployment rate has declined considerably since last year and was 6.4% in April, which is on par with the state's 6.3% and slightly above the national rate of 5.7%. Out of the nation's twelve largest metropolitan statistical areas, Dallas experienced the second smallest job loss last year. Like most cities/metros, most of the job losses in Dallas were in the leisure and hospitality industry.

Financial operations and reserves

The city budgets and manages its finances conservatively, posting general fund surpluses for the past several years that have driven healthy reserves. While expect this trend will continue over the near term, the positive financial results are somewhat muted by persistent annual underfunding of pension plans, which is due to statutory and local ordinance caps on contributions, as well as investment returns which lag plan targets. Longer term, the financial position will be challenged by balancing increasing pension and public safety expenses, as well as general costs of services.

Fiscal 2020 (September 30 year-end) audited results came in better than projected because of stronger sales tax revenue and tight expenditure controls. The city posted another surplus of $47.5 million which increased available general fund balance to $320.5 million or 23.5% of revenue. The city receives most of its general fund revenue from property taxes (54% of total revenue in fiscal 2020) and collections have been stable, and sales taxes account for about 25% of total revenue every year.

The rebound in sales tax revenue is continuing six months into fiscal 2021; year-end sales tax revenue is projected to be up almost 12% over the budget. Property tax revenue is also outperforming the budget, and this is helping to offset underperformance in charges for services and interest earnings revenue as well as an overage in expenses for public safety overtime and facility repairs caused by Winter Storm Uri. At this point, the city is projecting another surplus at fiscal year-end.

Liquidity

Cash will remain healthy and in line with fund balance. The fiscal 2020 general fund cash position was $328.3 million or 24.1% of general fund revenue. When also including the debt service fund, the combined the operating funds cash position was $374 million or 23.3% of operating revenue.

Debt and pensions

Balance sheet leverage is high because of the pension burden; the debt burden remains stable and moderately-low and the unfunded OPEB liability is modest. The outstanding debt and unfunded retirement benefit liabilities (using our adjustments to pension and OPEB) total a significant 676% of operating revenue and 7.7% of full value as of fiscal 2020.

The debt burden has been stable despite annual bond issuances due to strong tax base growth and it is expected to remain around 2%. In November 2017, voters approved a $1.05 billion bond package to invest in city roads and other public infrastructure, which the city has been issuing in phases. Of this, $710.5 million remains unissued.

Fixed costs, which include debt service, pension and OPEB contributions, totaled a high 32% of fiscal 2020 operating revenue. If the city were to increase its pension contributions to prevent the unfunded liability from growing, fixed costs would increase to 38.7% of operating revenue.

Legal security

The general obligation limited tax bonds constitute direct and general obligations of the city, payable from the levy and collection of a direct and continuing annual ad valorem tax, within the limits prescribed by law, on all taxable property located within the city.

Debt structure

All general obligation bonds are fixed rate and about 73% of the outstanding principal matures within 10 years.

Debt-related derivatives

The city is not a party to any derivative agreements.

Pensions and OPEB

The unfunded pension liability remains high and is a key constraining factor to the credit profile. Further, additional contributions and/or benefit reforms will likely be needed to the Dallas Police and Fire Plan (DPFP) and the Employees' Retirement Fund (ERF) plan to maintain their solvency. The ERF plan is projecting depletion in 2058. For the plan to remain solvent and amortize the unfunded liability, asset returns would need to exceed targets, absent increases to contributions or further benefit changes. The plan is governed by local ordinance and increases to contributions would need to be approved by voters.

The DPFP plan remains poorly funded and is not projected to reach full funding for several decades. The plan has negative non-investment cash flow, which heightens the importance of the plan achieving its return targets in the near-term. But achieving targeted returns are challenged because the plan remains heavily invested in illiquid assets. The accumulation of assets is also dependent on higher near-term contributions tied to payroll targets. Deviation from these key targets will likely require further benefit changes and/or higher contributions. Favorably, police officer counts have increased and salaries have been raised to better compete with suburban police departments. Both factors increase total public safety payroll, which bodes well for annual contributions because they are based on a percentage of payroll after 2024, though it increases the long-term liability.

The city's adjusted net pension liability (ANPL), reflective of all three of the city's single-employer plans[1] increased to $7.9 billion in fiscal 2020, which is equal to a high 5x operating revenue. The ANPL was based on a discount rate of 3.22%. The plans assume discount rates of 7.00% and 7.25%, which were reduced last year but are still elevated compared to other large pension systems nationally. The ANPL is expected to continue to increase because contributions are not sufficient to prevent the unfunded liability from growing, even if all reported assumptions are met, including the assumed rates of return for both plans.

Texas House Bill 3898, effective September 1, 2021, was passed by the 87th Texas Legislature in May 2021. The legislation calls for local retirement systems, such as those of the City of Dallas, to develop funding policies that align with certain state guidelines. The city's two retirement systems, the DPFP and the ERF, will review contribution policies in light of the new state legislation, although the precise timing and effect on the city's annual contributions is currently uncertain.

Exhibit 3

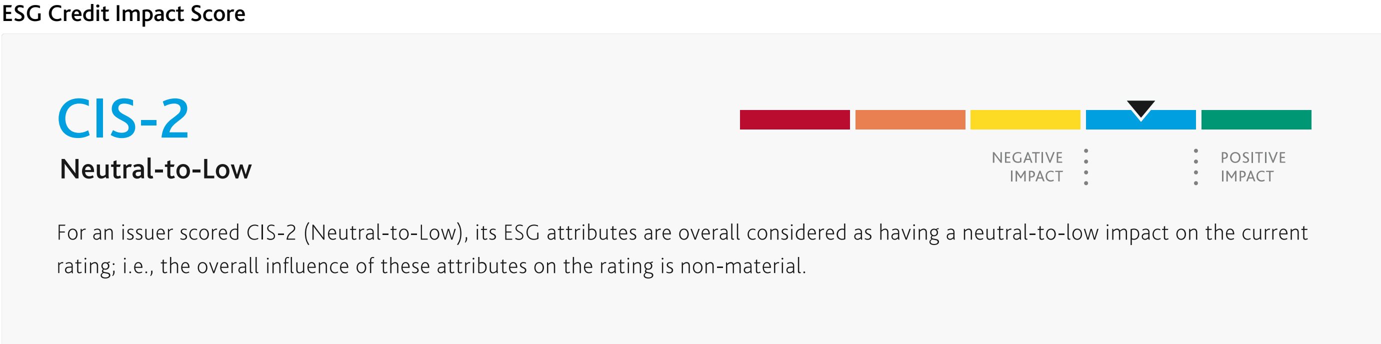
2020	$$$(000)	% of Operating Revenues	Discount Rate
Operating Revenue	1,606,195	n/a	n/a
Reported Unfunded Pension Liability	4,017,001	250%	6.53%
Moody's Adjusted Net Pension Liability	7,945,879	495%	3.22%
Reported Net OPEB Liability	530,989	33%	2.41%
Moody's Adjusted Net OPEB Liability	510,315	32%	2.65%
Net Direct Debt	2,403,401	150%	n/a
Debt & unfunded retirement benefits (Moody's adjusted)	10,859,595	676.11%	
Pension Contribution	201,542	12.55%	n/a
OPEB Contribution	18,572	1.16%	n/a
Debt Service	293,549	18.28%	n/a
Total Fixed Costs	513,663	31.98%	n/a
Tread Water Gap	108,120	6.73%	n/a
Moody's Adjusted Fixed Costs	621,783	38.71%	n/a

The ANPL is an aggregate of DPFP and ERF; ERF is net of enterprise support. The discount rate for the reported unfunded liabilities is blended for the plans. DPFP assumes 7% and ERF assumes 7.25%. Given the ERF depletion projection, the single-equivalent discount rate as reported in the 2020 audit was 5.93%.
Source: Dallas (City of) TX's financial statements and Moody's Investors Service

ESG considerations

Dallas (City of) TX's ESG Credit Impact Score is neutral-to-low CIS-2.

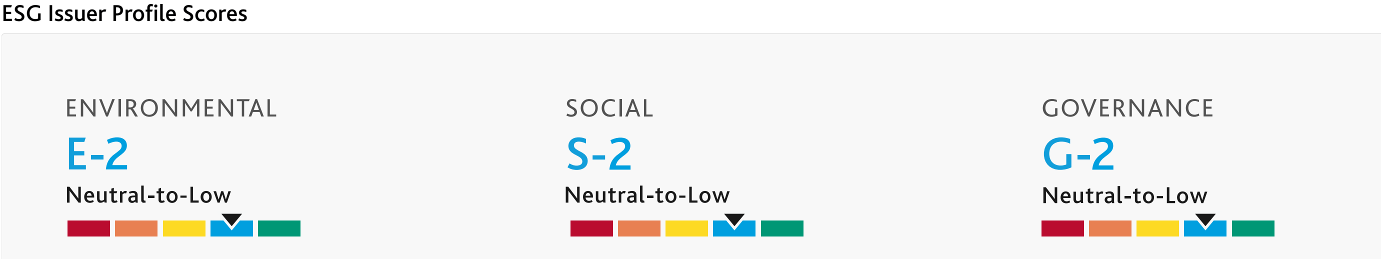
Exhibit 4
ESG Credit Impact Score



Source: Moody's Investors Service

The City of Dallas' ESG Credit Impact Score is neutral-to-low (**CIS-2**), reflecting low exposure to environmental risks, low exposure to social risks, and good governance.

Exhibit 5
ESG Issuer Profile Scores



Source: Moody's Investors Service

Environmental

Dallas' E issuer profile score is neutral-to-low (**E-2**), reflecting relatively low exposure to environmental risks across all categories, including physical climate risk, carbon transition, natural resources management, and waste and pollution. Of the physical climate risks Moody's affiliate Four Twenty Seven evaluates, Dallas has medium exposure to heat stress, water stress and extreme rainfall. The city maintains 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

We assess the S issuer profile score as neutral-to-low (**S-2**), reflecting relatively low exposure to social risks across all categories, including demographics, labor and income, education, housing, health and safety, and access to basic services. Demographic trends have been strong, though income levels are below the US median, similar to other large urban centers. Health and safety and access to basic services are positive in the area, and exposure to labor and income, education and housing risks are neutral to low.

Governance

Dallas' G issuer profile score is neutral-to-low (**G-2**), reflecting solid institutional structure and the city's strong commitment to transparency and disclosure reflected in monthly financial reporting and timely filing of audited financial statements and other disclosures. Budget management is sound as evidenced in outcomes that are favorable compared to expectations. The city also maintains long-term financial forecasting and capital planning, and has demonstrated policy credibility and effectiveness. Although management of the city's two defined benefit pension plans has led to very high unfunded liabilities, the city has the legal ability to enact additional reform to prevent further leveraging and rising fixed costs.

Rating methodology and scorecard factors

The US Local Government General Obligation Debt methodology includes a scorecard, a tool providing a composite score of a local government's credit profile based on the weighted factors we consider most important, universal and measurable, as well as possible notching factors dependent on individual credit strengths and weaknesses. Its purpose is not to determine the final rating, but rather to provide a standard platform from which to analyze and compare local government credits.

Exhibit 6

Scorecard Factors and Subfactors	Measure	Score
Economy/Tax Base (30%) [1]		
Tax Base Size: Full Value (in 000s)	$147,443,518	Aaa
Full Value Per Capita	$110,809	Aa
Median Family Income (% of US Median)	74.9%	Baa
Notching Factors:[2]		
Regional Economic Center		Up
Finances (30%)		
Fund Balance as a % of Revenues	22.9%	Aa
5-Year Dollar Change in Fund Balance as % of Revenues	10.7%	Aa
Cash Balance as a % of Revenues	23.3%	Aa
5-Year Dollar Change in Cash Balance as % of Revenues	10.9%	Aa
Notching Factors:[2]		
Other Scorecard Adjustment Related to Finances: treadwater gap		Down
Management (20%)		
Institutional Framework	Aa	Aa
Operating History: 5-Year Average of Operating Revenues / Operating Expenditures	1.0x	Aa
Debt and Pensions (20%)		
Net Direct Debt / Full Value (%)	1.6%	Aa
Net Direct Debt / Operating Revenues (x)	1.5x	A
3-Year Average of Moody's Adjusted Net Pension Liability / Full Value (%)	4.8%	A
3-Year Average of Moody's Adjusted Net Pension Liability / Operating Revenues (x)	4.4x	Baa
Notching Factors:[2]		
Unusually Strong or Weak Security Features		Up
Other Scorecard Adjustment Related to Debt/Pensions		Down
	Scorecard-Indicated Outcome	Aa3
	Assigned Rating	A1

[1] Economy measures are based on data from the most recent year available.
[2] Notching Factors are specifically defined in the US Local Government General Obligation Debt methodology.
[3] Standardized adjustments are outlined in the GO Methodology Scorecard Inputs publication.
Source: US Census Bureau, Dallas (City of) TX's financial statements and Moody's Investors Service

Endnotes

1 The city participates in three single-employer systems: the Employees' Retirement Fund (ERF), Dallas Police and Fire Plan (DPFP), and the Supplemental Police and Fire Plan. Contribution rates for the systems are set by ordinance or statutes, and the ERF and DPFP are each managed by separate boards. In 2017, the city, DPFP and the state, were able to come to an agreement around pension reform: HB 3158 implemented sweeping changes to the DPFP plan, including reduced prospective pension benefits for current and future employees, significant reductions to DROP, including time limits to participation, ceased lump-sum withdrawals and elimination of guaranteed interest, increased statutorily required contributions from the city and the membership, and governance, changes. ERF also implemented changes in 2017, with the approval by the city council and voters in November 2016 to create a new tier of reduced pension benefits for new employees hired on or after January 1, 2017. The new tier reduces the normal cost and the pace at which pension liabilities are accrued.

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