Memorandum

CITY OF DALLAS

DATE July 23, 2021

TO Honorable Mayor and Members of the City Council

SUBJECT **Fitch Ratings Affirms 'AA+' Rating and Negative Outlook for Waterworks and Sewer System Revenue Refunding Bonds – INFORMATION**

Today, Fitch Ratings (Fitch) has affirmed its 'AA+' rating and Negative outlook on upcoming Waterworks and Sewer System Revenue Refunding Bonds, Series 2021C and outstanding City of Dallas Waterworks and Sewer System ("System") bonds. Fitch last affirmed the rating on May 6 as part of an annual review of the System. According to the current report, the rating reflects "the system'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 risk features high economies of scale and a capital planning and management assessment that is expected to remain favorable."

Fitch provides an analysis of the System's credit profile key rating drivers, including the System's revenue defensibility, operating risks, and financial profile. Once again, Fitch scores the System's revenue defensibility highly, noting the "strong rate flexibility" and "expansive service area." Regarding operating risks, Fitch's assessment of the System "reflects its very low operating cost burden and favorable life cycle ratio," adding that "DWU continues to invest in system maintenance to address aged facilities while also investing in additional water resources in partnership with TRWD." The financial profile of the System is scored according to Fitch's context of the System's weakening leverage position due to "declines in [funds available for debt service] FADS which were pressured by wet weather and recent rate declines." Although, the System's "liquidity cushion and coverage of full obligations (COFO) are sound and considered neutral to the assessment."

Fitch explains that the System's Negative outlook is, "driven by weaker fiscal 2019 results along with planned debt issuances over the next few years that could outpace revenue growth and lead to sustained elevated leverage." According to the report, a "trend of declining leverage is a positive development," but "further declines through the scenario horizon closer to 8.0x or below will be necessary to move the Outlook back to Stable."

As the coronavirus continues to present challenges worldwide and locally, Fitch notes Dallas Water Utilities' performance and ability to offset "modest revenue declines" due to the pandemic and heavy rains with reduced expenditures, highlighting the System's flexibility and prudent fiscal management. This is yet another key factor that maintains the Systems strong credit profile among investors and as a trusted provider of essential services to the City.

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Please find attached the report provided by Fitch. If you have any questions or need further information, please do not hesitate to contact me.

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
Directors and Assistant Directors

FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Dallas, TX's Water & Sewer Revs 'AA+'; Outlook Negative

Fri 23 Jul, 2021 - 1:45 PM ET

Fitch Ratings - Austin - 23 Jul 2021: Fitch Ratings has assigned a 'AA+' rating to the following city of Dallas (the city) bonds:

--Approximately $135.87 million waterworks and sewer systems revenue refunding bonds, series 2021C.

The bonds are scheduled to sell via competitive bid Aug. 24. Proceeds will be used to refund outstanding commercial paper notes of the city's water and sewer system (DWU or the system).

Fitch also affirms the 'AA+' rating on approximately $2 billion of outstanding system revenues bonds.

Fitch has assessed the city's system standalone credit profile (SCP) at 'aa+'. The SCP represents the credit profile of the system on a stand-alone basis irrespective of its relationship with and the credit quality of the city of Dallas, TX (Issuer Default Rating 'AA'/Stable).

The Rating Outlook is Negative.

ANALYTICAL CONCLUSION

The system's 'aa+' SCP and 'AA+' issue rating reflect the system'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 risk features high economies of scale and a capital planning and management assessment that is expected to remain favorable.

Fitch revised DWU's Outlook to Negative in May 2020 following weaker fiscal 2019 results. Additionally, planned debt issuances over the near horizon increased the possibility that costs would outpace revenue growth and lead to sustained elevated leverage. While fiscal 2020 leverage did increase incrementally, prospects for stronger revenue growth in Fitch's scenario analysis has improved the likelihood for a declining leverage trend to develop. System management currently anticipates additional rate increases for both wholesale and retail customers over the coming years with planned fiscal 2022 retail rates expected to grow by up to 1.5% and wholesale rates seeing larger increases. Even with the planned rate adjustments, system rates are expected to remain very affordable.

The system's leverage, expressed as net adjusted debt to adjusted funds available for debt service (FADS), rose to 9.3x in fiscals 2019 due a rate decrease coupled with reduced water demand from wet weather. Leverage increased in fiscal 2020 to 9.6x, impacted by increases in purchased water costs and growing debt. However, as a result of the impact of planned rate action, leverage now falls to 9.2x in fiscal 2021 Fitch's scenario analysis and then gradually decreases to the 8.0x range by fiscal 2025. This trend of declining leverage is a positive development, but realization of a drop in leverage along with continued expectation of further declines through the scenario horizon closer to 8.0x or below will be necessary to move the Outlook back to Stable.

DWU is in the midst of a large-scale capital project to build out the Integrated Pipeline project (IPL) in cooperation the Tarrant Regional Water District (TRWD) to access the city's next major water supply. As of January 2021, TRWD had issued $714 million in contract revenue bonds on behalf of DWU with $668.1 million currently outstanding. DWU's remaining capital costs associated with the IPL will be funded through two additional installments of approximately $335 million, slated for fiscal 2024 ($225 million) and fiscal 2026 ($110 million).

CREDIT PROFILE

The system serves an expansive territory, providing retail water and sewer service to over 1.3 million city residents. The system also provides wholesale treated water to 23 municipalities and wholesale sewer service to 11 customer cities in and around Dallas County (the county) 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 2.6 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 (SRA), Upper Neches River Municipal Water Authority and the U.S. Army Corps of Engineers. Water is supplied to DWU from six surface water impoundments in the Elm Fort of the Trinity River including Lake Ray Hubbard owned by the City of Dallas and Lake Palestine, which is being connected to the DWU system through a contract with the TRWD. Water supply from these seven reservoirs is expected to provide dependable yield through at least 2050 once Lake Palestine is connected to the system around 2027. Water is treated at three water treatments plants and wastewater flows are treated at two wastewater treatment plants. A small portion of the system's wastewater treatment is provided by the City of Garland, TX and the Trinity River Authority.

Fitch considers the system to be a related entity to the city for rating purposes given the city's oversight of the system, including the authority to establish rates and operations. The credit quality of the city does not currently constrain the bond rating. However, as a result of being a related entity, the issue ratings could become constrained by a decline in the general credit quality of the city.

Coronavirus Considerations

DWU's performance data through most recently available data has indicated modest revenue declines for fiscal 2020 as a result of the pandemic which were generally offset by reduced expenditures.

KEY RATING DRIVERS

Revenue Defensibility 'aa'

Strong Rate Flexibility; Expansive Service Area

The system's revenue defensibility is supported by DWU's extensive service area that includes the city and much of the neighboring suburban communities on a wholesale basis. The city anchors the large and diverse Dallas-Fort Worth regional economy. Rate increases have been regular and measured yet remain low relative to other large utilities both within and outside of the state. The assessment is further supported by the monopolistic nature of DWU's revenues and its legal independent authority to raise rates.

Operating Risks 'aa'

Very Low Operating Cost Burden

DWU's operating risk assessment reflects its very low operating cost burden and favorable life cycle ratio. DWU continues to invest in system maintenance to address aged facilities while also investing in additional water resources in partnership with TRWD.

Financial Profile 'aa'

Pressured Leverage Position

The system's leverage ratio has started to weaken due to declines in FADS, which were pressured by wet weather and recent rate declines. Based on planned debt issuances over the next few years, which include obligations associated with the final phase of the IPL, leverage may remain elevated for the current rating level. The liquidity cushion and coverage of full obligations (COFO) are sound and considered neutral to the assessment.

ASYMMETRIC ADDITIVE RISK CONSIDERATIONS

No asymmetric additive risk considerations affected this rating determination.

RATING SENSITIVITIES

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

--Sustained trend of leverage that approximates 5x through Fitch's base and stress case.

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

--Failure for the leverage trend to decline over the next few years, ultimately trending closer to 8.0x.

--Change in capital planning that results in elevated life cycle investment needs and an increase in life cycle ratio.

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

Bonds are secured by a first lien on the net revenues of the combined water and sewer system after payment of operating and maintenance expenses (including debt service on TRWD debt issued for DWU's portion of the IPL).

REVENUE DEFENSIBILITY

Revenue defensibility is very strong, assessed at 'aa' with all of DWU's revenues derived from services or business lines exhibiting monopolistic characteristics in a service area with favorable demographic trends. DWU revenues are comprised of retail customers (about 85%) and wholesale customers (about 15%). The city is among the three largest cities in Texas and among the 10 largest in the U.S. The city is a center for technology, trade, finance and healthcare; it also ranks among the top visitor and leisure destinations in the state. The system has independent legal ability to increase service rates without external approval.

Adopted fiscal 2021 water and sewer rates for residential retail customers produce a monthly bill of $64.37 (assuming Fitch's standard usage of 7,500 gallons per month for water and 6,000 gallons per month for sewer). Rate increases have been regular and measured yet remain low relative to other large utilities both within and outside of the state. Continued moderate planned adjustments should preserve a favorable degree of flexibility going forward.

Legal resolution involving rate disputes with SRA resulted in DWU providing rate relief to retail and wholesale customers in the form of a 6% rate reduction in fiscal 2019. Retail customers saw a 1% rate increase in fiscal 2021 after rates remained flat for fiscal 2020, with wholesale customers seeing about a 2% increase. City Council has a very long history of adopting recommended rate adjustments. DWU management is planning for continued retail rate increases of 1.5% - 4% over the next few years. Wholesale treated and untreated water rates for fiscal 2022 will see large increases of about 9% and 16%, respectively, with wastewater rates growing by a more modest 2.5%. Increases in wholesale water rates take into consideration additional costs associated with accessing new water sources.

OPERATING RISKS

The system's operating risk profile is assessed at 'aa', which takes into consideration a very low operating cost burden with moderate life cycle investment needs. Favorably, capital spending has exceeded depreciation annually over the last five years and is expected to continue as DWU has a robust capital plan to address long range water supply and continuing system maintenance.

The system's operating cost burden is a very favorable $2,428 per million gallons (mg) of water produced for fiscal 2020, well below Fitch's $6,500 per mg threshold for the 'aa' assessment. The city's conservation measures over the past two decades has resulted in reduced water demand. This decline in turn 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 135 billion to 139 billion gallons annually. From year to year, demand is still very weather dependent and rate revenues fluctuate based on weather-driven water use.

Most near-term capital needs are geared towards renewal and replacement of existing infrastructure and maintaining regulatory compliance, with a significant portion of costs devoted to replacing aging water and wastewater mains. Total capital costs for fiscal years 2021-2025 total about $1.7 billion excluding costs related to the IPL, with annual spending between $323 million and $345 million.

DWU is partnering with TRWD for the completion of the IPL to access DWU contractual water rights in Lake Palestine. The project allows DWU to share the costs of water transmission from the lake and TRWD is issuing all the bonds for the project, including DWU's share. TRWD issued $240 million of contract revenues bonds for DWU's next installment for the IPL in fiscal 2021 with the remaining additional debt related to the IPL expected in fiscal 2024 ($225 million) and fiscal 2026 ($110 million).

FINANCIAL PROFILE

The financial profile is assessed at 'aa'. Fitch's calculated leverage ratio was 9.6x at the end of fiscal 2020, which is at the higher end of the assessment range. The liquidity profile is neutral to the rating with COFO at 1.1x and a liquidity cushion of 222 days at the close of fiscal 2020. DWU's liquidity cushion remains 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. Fitch-calculated total debt service coverage was 1.3x in fiscal 2020.

Leverage had trended downward in recent years from 9.8x in fiscal 2015 to 7.8x is 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 a sharp decline in revenues, pushing leverage up past 9x. Leverage remained above 9x for fiscal 2020 due to higher purchased water costs and additional debt, despite a modest rebound in revenues.

Fitch Analytical Stress Test (FAST)

The FAST considers the potential trend of key ratios in a base case and a stress case, with the stress case designed to impose capital costs 10% above expected levels and evaluate potential variability in projected key ratios. Fitch used management's provided forecast, CIP and expected debt issuance (including IPL related debt) in formulating the FAST base case scenario. Fitch made additional reasonable assumptions surrounding revenue and expense growth in the final three years of the FAST based on discussions with management. Overall Fitch expects that planned rate adjustments will increase revenues to between 3.7% - 6%, which leads to improvement in FADS.

Factoring in these assumptions, fiscal 2021 leverage in the FAST base and stress cases is expected to see modest declines to 9.2x and 9.3x, respectively, driven by the IPL issuance. Thereafter, leverage is expected to gradually decline by fiscal 2025 to around 8.0x and 8.4x in the FAST base and stress cases, respectively.

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 Tarrant Regional Water District, TX (City of Dallas water contract revenue bonds).

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

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Teri Wenck, CPA
Director
Primary Rating Analyst
+1 512 215 3742
teri.wenck@fitchratings.com
Fitch Ratings, Inc.
2600 Via Fortuna, Suite 330 Austin, TX 78746

Gabriela Payne, CPA
Director
Secondary Rating Analyst
+1 512 215 3731
gabriela.gutierrezpayne@fitchratings.com

Douglas Scott
Managing Director
Committee Chairperson
+1 512 215 3725
douglas.scott@fitchratings.com

MEDIA CONTACTS

Elizabeth Fogerty
New York
+1 212 908 0526
elizabeth.fogerty@thefitchgroup.com

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 23 Feb 2021) (including rating assumption sensitivity)

U.S. Water and Sewer Rating Criteria (pub. 18 Mar 2021) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Dallas (TX)	EU Endorsed, UK Endorsed

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