Memorandum

CITY OF DALLAS

DATE August 6, 2021

TO Honorable Mayor and Members of the City Council

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

On July 28, Moody's Investors Service (Moody's) released an update to the credit analysis of Dallas Water Utilities' (DWU) 'Aa2' rating. Moody's last affirmed the rating and stable outlook on June 22, 2020 as part of an annual review of the System. In the report, Moody's again highlights DWU's "healthy credit fundamentals," noting "the system is a very large, regional water and wastewater service provider with a healthy asset condition, ample water supply and system capacity." Additionally, the large service area, strong regional economic indicators and strong bond holder legal protections are also reflected in the report as credit strengths.

Moody's report identifies two credit challenges of the DWU system, including "exposure to ERF unfunded pension liability" and the "elevated ratio of debt to operating revenues," further explaining that this "is in line with similarly sized systems with substantial capital needs to serve a regional population." The report also states 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."

While Moody's update is not a rating action on the DWU system, their report is a testament to the stewardship and leadership of Dallas Water Utilities and further confirmation of their continued efforts toward fiscal sustainability, resiliency, and equity in challenging times. 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
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MOODY'S
INVESTORS SERVICE

CREDIT OPINION
28 July 2021

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Dallas (City of) TX Waterworks & Sewer Ent.

Update to credit analysis

Summary

The credit profile of the Dallas (City of) TX Waterworks and Sewer Enterprise (the system) (Aa2 stable) 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 for both general city operations and the system.

The 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 a 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. Financial performance remains healthy, but debt service coverage has declined for the past few years because of rising operating costs and debt service. 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 an 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.

Credit strengths

» Large service area that is nearly double the size of the city of Dallas

» DFW region exhibits strong economic indicators

» Strong bond holder legal protections

Credit challenges

» Elevated ratio of debt to operating revenue

» Trend of declining debt service coverage

» 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. 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 manageable percentage of operating expenses.

Factors that could lead to an upgrade

» Reduced ratio of debt to operating revenues

» Significant improvement in debt service coverage

» Upgrade of the city's issuer rating

Factors that could lead to a downgrade

» Further declines in debt service coverage and/or liquidity

» Increase in debt to operating revenue ratio

» Downgrade of the city's issuer rating

» Material increases to the unfunded pension liability associated with ERF

Key indicators

Exhibit 1

Dallas (City of) TX Water & Sewer Ent.					
System Characteristics					
Asset Condition (Net Fixed Assets / Annual Depreciation)	41 years				
System Size - O&M (in $000s)	$319,348				
Service Area Wealth: MFI % of US median	97.%				
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					
	2016	2017	2018	2019	2020
Operating Revenue ($000)	$611,430	$658,969	$676,398	$635,285	$647,914
System Size - O&M ($000)	$313,288	$284,684	$300,230	$295,389	$319,348
Net Revenues ($000)	$298,142	$374,285	$376,168	$339,896	$328,566
Net Funded Debt ($000)	$2,443,753	$2,510,782	$2,617,816	$2,568,229	$2,720,947
Annual Debt Service ($000)	$182,900	$182,000	$202,597	$212,157	$215,254
Annual Debt Service Coverage (x)	1.6x	2.1x	1.9x	1.6x	1.5x
Cash on Hand	202 days	225 days	269 days	274 days	243 days
Debt to Operating Revenues (x)	4.0x	3.8x	3.9x	4.0x	4.2x

MFI based on broader service area; annual debt service includes principal on bonds and pension obligation bonds from the statement of cash flows plus interest on bonds and notes from the statement of revenues, expenses and changes in fund net position.
Source: US Census Bureau, Dallas (City of) financial statements and Moody's Investors Service

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 system serves a large area of residential, commercial and retail development which will continue to grow. The system has approximately 303,000 water accounts and provides water on a wholesale basis to 26 local governments in the metro area (23 treated and three untreated water). Water supply is available from six surface water impoundments, from water in the Elm Fork of the Trinity River, and from recycled water. All the sources are in north central and east Texas. The 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 2020, the average demand on the system was 380 MGD and the peak was 588 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 its long-range water supply plan in 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 4,040 miles of pipe and two treatment plants.

The plants are permitted to treat 280 MGD on an average daily basis. As of 2020, the average daily usage was 198 MGD and the peak usage of 428 MGD.

Debt service coverage and net working capital: debt service coverage remains adequate but has declined for the past few years

Debt service coverage will remain adequate because the city council, who approves water and sewer rates, has demonstrated willingness to increase rates as needed. However, coverage has declined over the past three years because of rising operating expenditures and debt service, and continued declines could lead to negative credit pressure.

Both water and sewer rates for retail and wholesale service (which represents the most of system revenues) have reflected manageable annual increases historically. Rates remained flat in fiscal 2019 (September 30 year-end) and 2020 because of a settlement with the Sabine River Authority (SRA). Rates increased in fiscal 2021 and are projected to modestly increase annually through fiscal 2025 to accommodate planned capital improvements.

In fiscal 2020, net revenue available for debt service declined to $328.6 million, which covered annual debt service an adequate 1.5 times. This is down from a high of 2.1x in fiscal 2017. When excluding interest paid on commercial paper, fiscal 2020 coverage is 1.6x. 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 2020 was anticipated because wholesale customers received a credit for the second straight year as a result of the SRA settlement; this will continue into fiscal 2021. System operating expenditures reflect a Moody's adjustment of -$30 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.

Six months into fiscal 2021, revenue is forecasted to be about 2% below budget primarily because of the third and final credit for the SRA settlement, as well as an increase in delinquent bills and the elimination of late fees because of the pandemic. Expenses are under budget as well to balance the budget. Any additional reductions in revenue will be balanced with a matching reduction in expenses.

Liquidity

Unrestricted liquidity declined slightly in fiscal 2020 to $212.8 million (from $221.8 million last year), which represents a sound 243 days, though it is well below the Aa2 median. The city has 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 debt to revenue ratio will remain elevated because of additional borrowing plans, and further increases in leverage metrics could lead to negative credit pressure. The fiscal 2020 debt to revenue ratio increased to 4.2 times, which is over twice the Aa2 median but is in line with similarly sized systems with substantial capital needs to serve a regional population. The system has undertaken a robust capital improvement plan to replace and expand aging infrastructure to accommodate growth. The city uses a combination of commercial paper, revenue bonds and cash contributions from current revenues to fund annual capital needs.

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 the debt service reserves have been cash funded. Outstanding commercial paper notes 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 structure

The revenue bond debt service schedule is descending and approximately 40% of principal will amortize within 10 years.

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 2020, the system was allocated 19.5% of the reported ERF net pension liability of $2 billion, based on a 5.9% discount rate. The Moody's Adjusted Net Pension Liability (ANPL) of the ERF as of fiscal 2020 was $4.3 billion, based on a 3.2% discount rate. Based on an assumed 19.5% share, the ANPL attributable to the system is $838.7 million or 1.3 times revenue.

ESG considerations

Environmental

The system is within the Great Plains region, which is forecasted 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 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

Service area demographic trends have been strong, exhibiting a growing population. Though the city's income levels are below average, the larger service area wealth and income levels are generally above average relative to the nation.

Governance

Management of the system provides departmental administration within the framework of the city's council-manager form of government. Subject to the direction and supervision 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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