Memorandum

CITY OF DALLAS

DATE June 5, 2020

TO Honorable Mayor and Council Members

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

Today, Moody's Investors Service (Moody's) released a credit opinion article regarding recent updates to the credit analysis of the City. According to Moody's report, the 'A1' (stable outlook) rating of the City "has benefited greatly from strong job growth fueling population growth, tax base expansion, revenue growth and increasing operating reserves. The city's credit profile also benefits from ongoing infrastructure investment while the debt burden remains stable relative to its expanding tax base." Regarding the coronavirus outbreak, Moody's states, "we do not see any material immediate credit risks for Dallas because the majority of the city's operating revenues are derived from property taxes, which tend to be more stable, and because the city is actively implementing expenditure cuts to make up the projected revenue shortfall in fiscal 2020."

The report identifies certain credit challenges, such as the "legislative reform that reduces the flexibility to increase property tax revenues," starting in fiscal 2021 and "budgetary pressures over the next few fiscal years stemming from economic contraction resulting from the coronavirus pandemic," and notes the pension plans' contribution caps and investment returns as weaknesses in the City's credit profile. However, the report continues, "The stable outlook reflects the city's strong fiscal management, ample budgetary flexibility and high nominal amount of governmental liquidity that will enable the city to weather the current economic downturn."

This article is not a rating action from Moody's but reflects the City's resiliency and the positive impact of strong leadership, prudent management, and careful consideration in budgeting and fiscal forecasting. Please let me know if you need additional information.

M. Elizabeth Reich

M. Elizabeth Reich
Chief Financial Officer

[Attachment]

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MOODY'S
INVESTORS SERVICE

CREDIT OPINION
5 June 2020

Update

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Dallas (City of) TX

Update to credit analysis

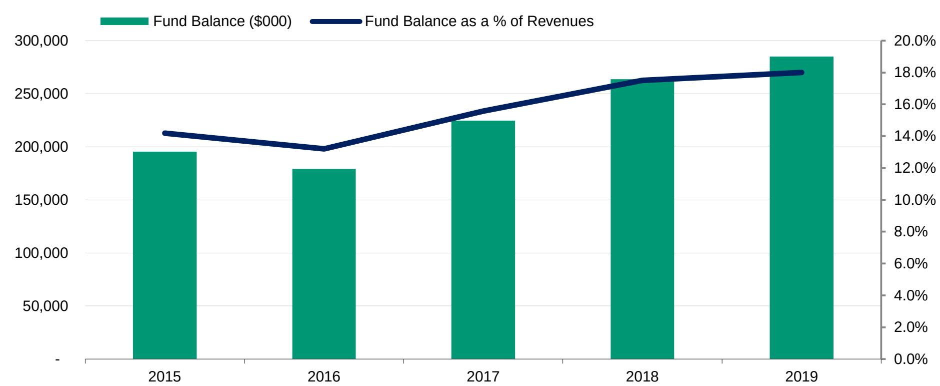
Summary

The city of Dallas (A1 stable) has benefited greatly from strong job growth fueling population growth, tax base expansion, revenue growth and increasing operating reserves. The city's credit profile also benefits from ongoing infrastructure investment while the debt burden remains stable relative to its expanding tax base. The city's primary credit weakness remains its poorly funded pension plans despite pension reform. The city's pension burden has decreased post-reform, but will grow again because caps to contributions remain below a "tread water" level that would prevent the liability from growing, while investment returns lag plan targets.

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 Dallas because the majority of the city's operating revenues are derived from property taxes, which tend to be more stable, and because the city 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 Dallas changes, we will update our opinion at that time.

Exhibit 1

Operating fund balances increased annually through fiscal 2019



Operating fund balance includes the general and debt service funds, net of restricted amounts in the general fund reporting.
Source: Moody's Investors Service, city audited financial reports

Credit strengths

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

» Continued annual surpluses have increased operating reserves

» Ample flexibility to adjust expenditures to maintain healthy reserves

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

Credit challenges

» Legislative reform that reduces the flexibility to increase property tax revenues starts in fiscal 2021

» Budgetary pressures over the next few fiscal years stemming from economic contraction resulting from the coronavirus pandemic

» 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 city's strong fiscal management, ample budgetary flexibility and high nominal amount of governmental liquidity that will enable the city to weather the current economic downturn. The outlook also considers the reduced pension liabilities, now a few years into reform, though considers that weak annual contributions and investment returns will lead to future increases in the liability and rising pension costs.

Factors that could lead to an upgrade

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

» 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	2015	2016	2017	2018	2019
Economy/Tax Base					
Total Full Value ($000)	$93,138,211	$100,318,937	$110,387,629	$118,314,678	$130,080,986
Population	1,260,688	1,278,433	1,300,122	1,318,806	1,318,806
Full Value Per Capita	$73,879	$78,470	$84,906	$89,713	$98,635
Median Family Income (% of US Median)	71.1%	71.6%	72.3%	73.7%	73.7%
Finances					
Operating Revenue ($000)	$1,377,442	$1,355,442	$1,441,984	$1,506,713	$1,583,747
Fund Balance ($000)	$195,532	$178,987	$224,582	$263,690	$285,100
Cash Balance ($000)	$198,819	$187,938	$215,589	$245,393	$311,602
Fund Balance as a % of Revenues	14.2%	13.2%	15.6%	17.5%	18.0%
Cash Balance as a % of Revenues	14.4%	13.9%	15.0%	16.3%	19.7%
Debt/Pensions					
Net Direct Debt ($000)	$1,854,845	$1,933,095	$1,804,061	$2,057,083	$2,306,237
3-Year Average of Moody's ANPL ($000)	$6,476,453	$7,117,560	$7,974,113	$7,599,576	$6,929,342
Net Direct Debt / Full Value (%)	2.0%	1.9%	1.6%	1.7%	1.8%
Net Direct Debt / Operating Revenues (x)	1.3x	1.4x	1.3x	1.4x	1.5x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	7.0%	7.1%	7.2%	6.4%	5.3%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	4.7x	5.3x	5.5x	5.0x	4.4x

Cash and fund balances include the general fund and debt service funds
Source: Moody's Investors Service

Profile

The city of Dallas is the ninth largest city in the US and the third largest in Texas behind Houston (Aa3 stable) and San Antonio (Aaa stable). 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: large and diverse economy anchors Dallas/Fort Worth metro area

The coronavirus is driving an unprecedented economic slowdown which is impacting the city of Dallas. We currently forecast US GDP to decline significantly during 2020 with a gradual recovery commencing toward the end of the year. Local governments with the highest exposure to tourism, hospitality, healthcare, retail, and oil and gas could suffer particularly severe impacts. Given that Dallas is a large and diverse economy, these are industries, among many, that operate within the city and are being negatively impacted. Dallas continues to have the largest job base in the metro area, serving as a home to many fortune 500 companies and a daytime population that increases by an estimated 20% relative to resident population. Unemployment in the city had been incredibly low over the past several years, tracking around 3.4% for the past few years, though increased to 4.4% as of March 2020 and will reflect a greater increase as April and May data is released.

Prior to the coronavirus pandemic, the city continued to grow rapidly with job creation that surpassed state and national rates, driving strong population growth, high demand for commercial and residential property and robust tax base growth. As of fiscal 2020, the city's tax base grew to $140.2 billion, up nearly 8% year over year. Over the past five years the city's tax base has grown an average of 8.5%. While the economic impacts of the pandemic will likely negatively impact the pace of new construction as well as property values, this will not hit the tax base until fiscal 2022 given the lag in property valuation. Fiscal 2021 (January 1, 2020 assessment date) preliminary assessed values increased 14.3% although certified values are likely to be lower.

Finances and liquidity: ample budgetary flexibility and healthy reserves help city weather downturn

Strong revenue growth and increasing reserves serve the city well in managing the expected revenue loss through fiscal 2020 and 2021. Coupled with the city's strong financial trends, ample budgetary flexibility is enabling the city to enact expenditure controls in the current fiscal year in order to maintain relatively stable reserves. Longer term, the city's financial position will be challenged by balancing increasing pension and public safety expenses, as well as general costs of services, with reduced revenue-raising flexibility under Senate Bill 2 (SB2).

Over the past five years, the city has increased general fund reserves. In fiscal 2019 (ending September 30), the city reported a general fund surplus of $44.8 million, bringing available reserves to $272.6 million, or 20.3% of revenues, up from 14.3% of general fund revenues in 2014. These financial results are somewhat muted by persistent annual underfunding of pension plans post pension reform. The underfunding is due to statutory and local ordinance caps on contributions, as well as investment returns which lag plan targets.

While the economic situation is evolving, as of May 2020 the city projects general fund revenues will be $44.7 million below budget, largely due to a projected decline in sales tax revenues, charges for services, and franchise fees. Management is working through expenditure cuts to minimize the impact to reserves. The city has implemented staff furloughs, as well as other departmental cuts, and to date has identified $19.6 million in savings, leaving another $25 million to either cut, or dip into reserves. Prior to the pandemic, the city projected expenditures would exceed the budget because of police staffing levels that exceeded expectations, which is positive in that it has been a goal to bring levels up, though does leave less room to cut. The police department is projected to end the year with 97 officers above budgeted counts, driving department expenditures to $5.1 million above the original 2020 budget. Even if no additional budgetary cuts were implemented, the reserve draw would be relatively modest compared to the total amount the city holds in the general fund, and available general fund reserves would decline to about 18% of revenues. Looking to fiscal 2021, the city is projecting to reduce budgeted general fund expenditures by 5-9%, or $73-$134 million, based on its projected continuation of weak revenues.

Starting in fiscal 2021, the city's property tax revenue-raising flexibility will decrease to 3.5% from 8% of revenues on existing property; new values are excluded from the annual revenue cap calculation. The city has historically not captured the previously allowable 8% property tax increase, and has been decreasing the tax rate since 2016 amid strong property value appreciation. In 2020, the tax rate was again be decreased slightly, to $7.766 per $1000 of AV, from $7.767. SB2 does allow for the cities to increase revenues on existing property by up to 8% if there was a disaster declaration, which the state's governor did declare in March. However, the city council voted in May that they will not exceed the new 3.5% cap in the coming fiscal year.

LIQUIDITY

The city's general fund cash position as of fiscal 2019 was $278 million, a healthy 20.7% of general fund revenues. Inclusive of the debt service fund, the combined the operating funds cash position was $312 million, or 19.7% of operating revenues.

Debt and pensions: manageable debt burden; improved but high ANPL and fixed costs

The city's balance sheet leverage is high, though this is largely driven by the pension burden, as the debt burden remain stable and moderately-low. The city's debt burden has been stable despite annual bond issuances due to strong tax base growth, and will remain under 2% of the tax base over the next few years due to additional growth expected for fiscal 2021. As of fiscal 2019, the net direct debt of $2.3 billion, inclusive of accrued interest, represented a moderately-low 1.8% of the 2020 tax base. 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, $888.5 million in authorization remains outstanding, a portion of which is expected to be issued in 2020.

The city's fixed costs, which include debt service, pension contributions and OPEB, are high at 31.9% as of 2019. While the city is exercising its ample legal flexibility to adjust the budget during the coronavirus pandemic, high fixed costs are a constraining factor to flexibility. If the city were to increase its pension contributions to prevent the unfunded liability from growing, fixed costs would increase to 33.9% of operating revenues.

DEBT STRUCTURE

All of the city's general obligation bonds are fixed rate. About 70% of the outstanding principal matures within ten years. Principal repayment is slower than the median for Texas cities (80.7% over ten years), though relatively rapid considering the current practice of annual issuance to continue to invest in the city's infrastructure.

DEBT-RELATED DERIVATIVES

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

PENSIONS AND OPEB

Now in year three of major reform to the city's public safety pension plan, the pension burden has declined but remains elevated and a key constraining factor to the credit profile. Given the investment losses in the first quarter of 2020, and expected poor investment returns through the rest of the year, combined with weak contributions relative to benefit outflows, pension assets will be set back further while liabilities increase.

While focus has been on the Dallas Police and Fire Plan (DPFP) for several years, the city's Employees' Retirement Fund (ERF) is projecting depletion in 2049. In order for ERF 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.

For the DPFP reform plan to amortize the liability by 2057 as projected, accumulation of assets is highly dependent on investment returns and higher near-term contributions tied to payroll targets. Deviation from these key targets over the medium term could require further benefit changes or higher contributions. Favorably for DPFP, police officer counts have increased and salaries have been raised to better compete with suburban police departments. Both of these factors increase total public safety payroll, which bodes well for annual contributions, which are based on a percentage of payroll after 2024, though does increase the long term liability.

The city's fiscal 2019 adjusted net pension liability (ANPL), reflective of all three of the city's single-employer plans [1] has declined to $6.2 billion, down from $8.1 billion in 2017. While improved, the ANPL still represents an elevated 4 times fiscal 2019 operating revenues. The ANPL was calculated based on a discount rate of 4.22%, while the plans assume 7.25-7.75%, which is high compared to other large pension systems nationally.

Exhibit 3

Overall balance sheet leverage is improved but remains high driven by ANPL

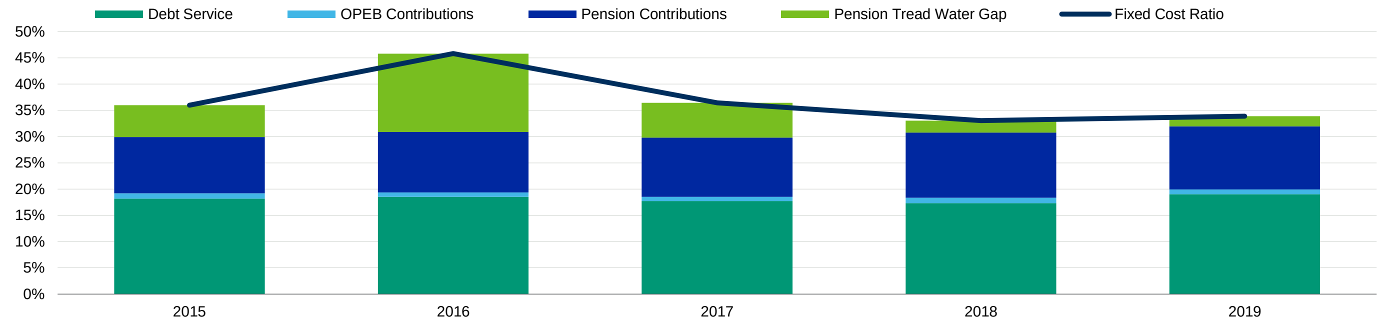
2019	(000)	% of Operating Revenues	Discount Rate
Operating Revenue	1,583,747	n/a	n/a
Reported Unfunded Pension Liability	3,771,525	238.1%	6.73%
Moody's Adjusted Net Pension Liability	6,243,059	394.2%	4.22%
Reported Net OPEB Liability	423,887	26.8%	2.75%
Moody's Adjusted Net OPEB Liability	397,144	25.1%	3.13%
Net Direct Debt	2,306,237	145.6%	n/a
Debt & unfunded retirement benefits (Moody's adjusted)	8,946,440	564.9%	
Pension Contribution	190,027	12.0%	n/a
OPEB Contribution	14,648	0.9%	n/a
Debt Service	301,276	19.0%	n/a
Total Fixed Costs	505,951	31.9%	n/a
Tread Water Gap	30,381	1.9%	n/a
Moody's Adjusted Fixed Costs	536,332	33.9%	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 7.25%, while ERF assumes 7.75%. Given the ERF depletion projection, the single-equivalent discount rate as reported in the audit was 5.98% in 2019.
Source: Moody's Investors Service, city audited financial reports

While improved, the ANPL is expected to increase again because contributions are not sufficient to prevent the unfunded liability from growing, even if all reported assumptions are hit, including the assumed rates of return for both plans. As shown in the exhibit below, annual contributions relative to the unfunded liability have improved significantly, though remain about $30.4 million below a “tread water” level, or about 1.9% of 2019 operating revenues.

Exhibit 4

Dallas' fixed costs remain high but reduced following pension reform in 2017



Pension tread water gap indicates a contribution that is below an amount needed to prevent the unfunded liability from growing, under reported plan assumptions.
Source: Moody's Investors Service, city audited financial reports

Environmental, social, and governance considerations

ENVIRONMENTAL

The city 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 city 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 city's demographic trends have been strong though its socioeconomic profile is weak, similar to other large urban centers. The city's population is estimated at over 1.3 million as of 2019, and has increased by over 9% since the 2010 census. The median age in the city has increased slightly, but is still relatively young at 32.7 years as of the 2018 American Communities Survey, compared to 37.9 years for the nation. However, resident income levels are below average. As of 2018, median family income was 73.7% of the US median, though has been increasing very gradually since 2013.

MANAGEMENT

The city operates under a council-manager form of government. Over the past few years, Dallas' city manager and CFO have worked to implement enhanced forward-thinking and strategic planning to bolster the already sophisticated financial management of the city.

Texas Cities have an institutional framework score of "Aa", which is strong. The sector's major revenue sources (property taxes and sales taxes) account for about a third of revenues each and are subject to a cap; the remaining third is derived from other fees and is not subject to a cap. Property taxes, are subject to a statutory cap of $25 per $1,000 of assessed values, with no more than $15 allocated for debt. Most cities are well under the cap, and on an annual basis can increase their property tax revenues by 8% on existing property without voter approval. Most cities are at the sales tax cap for operating purposes. Unpredictable revenue fluctuations tend to be minor, or under 5% annually. Across the sector, fixed and mandated costs are generally less than 25% of expenditures and are primarily debt service expenditures. Unpredictable expenditure fluctuations tend to be minor, under 5% annually.

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.

Dallas (City of), TX

Scorecard Factors	Measure	Score
Economy/Tax Base (30%) [1]		
Tax Base Size: Full Value (in 000s)	$140,237,632	Aaa
Full Value Per Capita	$106,337	Aa
Median Family Income (% of US Median)	73.7%	Baa
Notching Factors:[2]		
Regional Economic Center		Up
Finances (30%)		
Fund Balance as a % of Revenues	18.0%	Aa
5-Year Dollar Change in Fund Balance as % of Revenues	7.7%	A
Cash Balance as a % of Revenues	19.7%	Aa
5-Year Dollar Change in Cash Balance as % of Revenues	9.8%	A
Notching Factors:[2]		
Other Analyst Adjustment to Finances Factor:		Down
Management (20%)		
Institutional Framework	Aa	Aa
Operating History: 5-Year Average of Operating Revenues / Operating Expenditures (x)	1.0x	A
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 (%)	4.9%	Baa
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: GO secured by statute		Up
Other Analyst Adjustment to Debt and Pensions Factor (specify):		Down
	Scorecard-Indicated Outcome	A1
	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 dated December 16, 2016.
[3] Standardized adjustments are outlined in the latest GO Methodology Scorecard Inputs publication.
Source: Issuer's audited financial statements; US Census Bureau

Endnotes

1 The city participates in three single-employer systems: the Employees' Retirement Fund (ERF), 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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