Memorandum

CITY OF DALLAS

DATE May 29, 2020

TO Honorable Mayor and Council Members

SUBJECT **S&P Global Ratings Affirmed 'AAA' Rating and Stable Outlook for City of Dallas Waterworks and Sewer System Revenue Refunding Bonds, Series 2020C and 2020D**

Following recent General Obligation ratings, Standard and Poor's Global Ratings (S&P) affirmed their 'AAA' credit rating and stable outlook on the upcoming City of Dallas Waterworks and Sewer System Revenue Refunding Bonds, Series 2020C and Taxable Series 2020D, that are scheduled to be sold June 9, 2020. The S&P 'AAA' rating and stable outlook also applies to the Waterworks and Sewer System's ("System") $2.2 billion outstanding revenue bonds. There were several key rating factors for S&P in the report, including the System's "role as a regional provider not only for the more than 300,000 retail accounts in Dallas but on a wholesale basis for almost every suburb in Dallas County;" "long-term planning, locking in a 25-year water supply with planning ongoing for a 50-year supply;" "affordable rates, with a willingness to proactively and regularly adjust them;" "strong all-in coverage;" "very strong liquidity;" and "financial management practices that we consider strong, which indicate best practices across the utility and the city are well embedded, and financial and operational goals are highly aligned."

S&P also considered the potential risk profile of the System, including financials, customer base, and infrastructure, but notes that, "overall, city management has well-delineated financial management performance criteria for all its major operating funds, in our view, including for DWU, to which it holds itself strictly accountable and ensures overall financial integrity." In addition, the report continues that "the current governance and management structure has also allowed critical decision-making to be done with an eye toward financial integrity and maintaining operations at a high level."

In anticipation of the upcoming bond sale, the affirmed rating and detailed report are indicative of a robust and well-managed water and wastewater system with a stable outlook for the future, capable of maintaining continued services to all customers, even in challenging times.

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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S&P Global
Ratings

RatingsDirect®

Summary:
Dallas; Water/Sewer

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Summary:

Dallas; Water/Sewer

Credit Profile		
US$228.4 mil waterwks and swr sys rev rfdg bnds ser 2020C due 10/01/2040		
Long Term Rating	AAA/Stable	New
US$220.09 mil waterwks and swr sys rev rfdg bnds ser 2020D due 10/01/2035		
Long Term Rating	AAA/Stable	New
Dallas WS		
Long Term Rating	AAA/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AAA' rating to the city of Dallas' $228.4 million series 2020C waterworks and sewer system revenue refunding bonds and $220.09 million taxable series 2020D waterworks and sewer system revenue refunding bonds. At the same time, S&P Global Ratings affirmed its 'AAA' rating on the city's $2.2 billion of debt outstanding. The outlook is stable.

S&P Global Ratings also affirmed its 'AAA' rating on Tarrant Regional Water District (TRWD), Texas' contract revenue bonds, issued on behalf of the city of Dallas for the city's share of the joint integrated pipeline project; the city's system--doing business as Dallas Water Utilities (DWU)--currently supports about $507.9 million in contract revenue bonds outstanding.

The city intends to use the series 2020C bond proceeds to convert $260 million in commercial paper to long-term debt, as well as currently refund callable maturities of the system's series 2009B and 2010 revenue bonds. In addition, the city intends to use the proceeds of the series 2020D bonds to refund certain maturities of the system's series 2009C, 2011, 2012, and 2013 revenue bonds. All refunding transactions will be for savings purposes, with no adjustments to any final maturities. The bonds are secured by a first-lien pledge on the net revenues of the DWU system.

Credit overview

The rating reflects our view of the city's:

- Role as a regional provider not only for the more than 300,000 retail accounts in Dallas but on a wholesale basis for almost every suburb in Dallas County, and partial wholesale service for parts of cities in five surrounding counties;
- Long-term planning, locking in a 25-year water supply with planning ongoing for a 50-year supply;
- Affordable rates, with a willingness to proactively and regularly adjust them;
- Strong all-in coverage, boosted by the wholesale relationships that provide cash flow certainty to overall operating revenues even if weather patterns affect retail sales;
- Very strong liquidity; and

- Financial management practices that we consider strong, which indicate best practices across the utility and the city are well embedded, and financial and operational goals are highly aligned.

The DWU system supplies retail water and wastewater service to Dallas, which has a population of about 1.3 million, as well as treated and raw water services to almost all the cities in Dallas County on a wholesale basis, and to the Dallas-Fort Worth International Airport. Because the customer base is sufficiently large and diverse, in our view, DWU has no dependence on any of its principal retail customers for its operating revenues. Although we rate DWU's debt above that of the U.S., DWU has a predominantly locally derived revenue base. Local service charges, derived through an autonomous rate-setting process, represent virtually all of the entity's revenues. This, coupled with operating expense flexibility, precludes exposure to federal revenues.

In addition, DWU has virtually no responsibility for or exposure to the city's most underfunded fiduciary obligations for its uniformed civil service. These pension and postemployment benefit liabilities have been among the factors most pressuring our general obligation rating on the city. Although the city did not pay 100% of its actuarially defined contribution in the most recent fiscal year, the plan in which DWU participates--the Employees Retirement System--is adequately funded at 83%. We also understand that despite recessionary pressures on the general fund tax revenues and recently announced general government employee furloughs through at least July 2020, the city has no intention of filling the budget gap with the use of surplus net revenues or available cash reserves of DWU.

Environmental, social, and governance factors

In addition to enhancing the long-term water supply with the joint project with TRWD, Dallas has proactively engaged in preserving its existing supplies by way of aggressive water conservation measures--most recently revised in 2019--including public education and a number of supporting ordinances and practices aimed primarily at curbing outdoor watering. Based on consumption use patterns in 2001 across all customer classes, DWU management estimates that the water conservation measures have extended the life of existing reservoirs by two-three years, as well as reducing per capita per day consumption by 30% even as the population has increased by 10%. Because of the complexity--and massive capital investments--required for bringing a new reservoir into commercial operations, we view this as especially favorable environmental stewardship relative to that of peers.

The city also is sensitive to affordability concerns, even as city council has a long history of as-necessary rate adjustments, even during the last recession. DWU does not have a formal bill pay customer assistance program, but does have payment plans and other ancillary services such as in-home leak detection and free repairs of certain fixtures to qualified customers to help them reduce water use and, therefore, lower their monthly bill.

It is our view that the good overall governance, in which immediate- and long-term operational needs are aligned with intended financial resources, also lend to credit stability. The city has for years used its financial management performance criteria (FMPC) to establish required financial metrics for all of its major operating funds, including DWU. The FMPC speaks to desired debt service coverage (DSC), minimum required reserves, and other guidelines that we typically associate with a financial management assessment we would characterize as strong.

Stable Outlook

Downside scenario

Should there be sustained deterioration in the credit fundamentals, primarily measured by total financial capacity, we could revise the outlook to negative or lower the rating. If, as S&P Global Economics projects, the recovery does not begin until late in the third quarter of 2020, we believe that credit conditions for all governments and their related utilities will face headwinds even into 2021. We believe this increases the possibility that unfavorable variances to budget could extend beyond fiscal 2020. For more information, see "COVID-19's Potential Effects In U.S. Public Finance Vary By Sector" (published March 5, 2020, on RatingsDirect), "All U.S. Public Finance Sector Outlooks Are Now Negative" (published April 1, 2020), and "An Already Historic U.S. Downturn Now Looks Even Worse" (published April 16, 2020). The stable outlook is also predicated on the city's representation that any near-term weakness in DSC is attributable to the purposeful drawdown of designated cash reserves, and that beyond that revenues will generally be supportive of financial performance more in line with historical levels.

Credit Opinion

Enterprise risk profile

The city is the economic engine in its namesake Dallas-Fort-Worth-Arlington metropolitan statistical area (MSA), with business and professional services, health care, and finance among a deep employment base that remains one of the most vibrant in the state. Dallas' exposure to the cyclicality of the commodity and energy sector is limited, although the city and the MSA are home to the corporate headquarters of some the largest firms in the U.S., including AT&T Inc., ExxonMobil, and Southwest Airlines. Given the sheer size of the customer base, the city is not dependent on any of its retail customers for operating revenues. In a typical fiscal year, wholesale sales for water and wastewater services account for about 15%-20% of total operating revenues. The recessionary pressures across the globe have not spared the Dallas MSA; the estimated unemployment rate for April 2020 was 13%. The city continues to comply with a March 2020 state public utility commission directive to suspend disconnections and shut-offs for customers unable to pay their bill. The city does expect and has budgeted for a downturn in revenues for the remainder of fiscal 2020, primarily from small commercial customers, but has not reported any interruptions or under-collections from any wholesale customer, and through mid-May year-over-year consumption patterns versus 2019 were unchanged.

DWU's raw water sources are favorably situated for the summer months; the entire reservoir system remains, in aggregate, 100% full as of May 26, 2020. In 2012, city leaders implemented permanent, year-round mandatory maximum twice-weekly outdoor water conservation measures beyond the seasonal outdoor watering time-of-day measures that have been in place for years. City management also frequently updates its drought-management plan, along with its long-range water supply plan, as part of the regularly revised regional water supply planning process in which it participates. In addition to the joint venture with TRWD, the city also has other regional partnerships for conservation, supply, and environmental stewardship.

Management reviews utility rates annually, both for retail and wholesale customers. The most recent retail rate increase went into effect on Oct. 1, 2017. The 1.6% increase brought the average utility bill to about $67. In our opinion, when considering service area income and poverty rate levels, utility rates remain affordable and provide for additional rate-raising flexibility. The recommendations from and implementation of a 2018 rate study were largely revenue neutral, save mainly for the creation of an additional tier for very high-use residential customers. Rates will be further adjusted after a designated reserve related to a legal settlement has been fully utilized; Dallas challenged a 2015 rate increase in purchased raw water from the Sabine River Authority's (SRA) Lake Fork reservoir in east Texas. While the dispute was ongoing, Dallas still made the full payment, but the portion reflecting the rate increase was put in escrow until the dispute was resolved. In fiscal 2018 when the dispute was finally resolved, the escrow had a balance of about $68.7 million, which has been serving as a rate-stabilization fund, smoothing the effect of SRA's rate increase until the city extinguishes the balance in 2022. Management projects the net effect thereafter will increase operating expenses by approximately $8 million per year, against typical annual operating revenues of more than $600 million.

Reflecting our operational management assessment (OMA), we view DWU to be a '1' on a scale of 1 to 6, with '1' being the strongest. This indicates, in our view, that operational and organizational goals are highly aligned, even if some challenges exist. The primary challenge will be continuing the focus on renewal and replacement of aging underground infrastructure, as well as constructing the new assets necessary for the city to begin receiving water from the integrated pipeline project. The OMA of strong also includes the city's efforts toward maintaining its distribution and collection systems; ongoing meter replacements have helped to keep nonrevenue water low. The city has also extended a sanitary sewer overflow initiative with the state environmental body. Both wastewater treatment plants have recently renewed their respective discharge permits, and the city is fully compliant with all prevailing environmental requirements. The current governance and management structure has also allowed critical decision-making to be done with an eye toward financial integrity and maintaining operations at a high level.

Financial risk profile

Fiscal 2019 all-in DSC slipped to--by our calculation--1.2x from a historical trend of 1.6x-1.8x, reflecting the purposeful decision to draw on the SRA escrow. All-in DSC is S&P Global Ratings' adjusted DSC metric that takes into account all long-term financial obligations, regardless of lien or accounting treatment, and hypothetically treats recurring fixed costs as if they were debt service. Traditionally calculated DSC for fiscal 2019 was more than 1.7x maximum annual debt service (MADS) for senior-lien debt. Total DSC is consistently above management policy's set rates to achieve budgeted revenue bond DSC of at least 1.5x MADS, and well above the 1.25x average annual debt service rate covenant. We have reviewed the management team's financial forecast, which has been updated to reflect expected recessionary-related impacts to operating revenues. We view it as a reasonable assumption that recurring revenues should bounce back to historical norms once the planned use of the SRA escrow has been completed. The wholesale water purchase contracts--generally in place through the 2030s or longer--contain take-or-pay minimum amounts, paid monthly as an operating expense by each respective city, which lends further consistency to cash flow. Overall, city management has well-delineated financial management performance criteria for all its major operating funds, in our view, including for DWU, to which it holds itself strictly accountable and ensures overall financial integrity.

The 10-year capital improvement plan (CIP) through fiscal 2030 is $3.63 billion; the FMPC and other internal practices outline a goal of limiting debt financing to 50% of the CIP. None of the identified capital commitments is associated with an unfunded regulatory mandate such as the federal Clean Water Act violations. The city has, in fact, an extraordinarily low ratio of both overflows and line breaks per mile, indicating, in our view, a strong level of discretionary maintenance.

Reflecting our financial management assessment (FMA), we view the city to be a '1' on a scale of 1 to 6, with '1' being the strongest. An FMA of strong indicates policies are embedded and likely sustainable. Management produces and shares interim financial results throughout the year and updates its multiyear financial projections and CIP throughout the fiscal year. There are formal policies regarding liquidity and investments, and the city produces independently audited financial statements annually. The city has no direct-purchase debt or other less traditional financing obligations. We also view as supportive of consistent operational and financial performance management's long history of regular rate adjustments, which we are assuming are likely to continue after the designated reserves are exhausted. Officials review rates annually and adjust them as necessary--including during and immediately after the previous recession.

In our opinion, a credit weakness is Dallas' large pension and other postemployment benefits (OPEB) obligation. Despite significant structural changes to the pension plans, we anticipate the city's pension obligations will remain a source of pressure for Dallas, as funding has yet to meet minimum funding progress or 100% of our static funding calculation.

Dallas provides pension benefits to its employees through three separate retirement plans, although DWU only participates in the first one, with an allocable liability of $438 million as of fiscal 2019 below:

- Employees Retirement System, 83% funded for fiscal 2018 and the city contributed $60.5 million, or 65.8%, of its ADC;
- Dallas Police and Fire Pension System, 47% funded for fiscal 2018, which we consider weak, and the city contributed $151.8 million, or 96% of the statutorily required contribution amount; and
- Supplemental Police and Fire Pension Plan of the City of Dallas, 53% funded and the city contributed 100% of its ADC in 2018, $2.2 million, which we consider relatively low.

The relatively recent changes to the city's pension plans have stabilized them for the medium term, but we expect it will be several years until funding progress improves to a position we deem adequate. Uncertainty exists in the near term around plan investment return assumptions and the ability for market returns to match assumptions.

Aside from its pension benefits, Dallas provides certain OPEB for retired employees. As of Sept. 30, 2018, the plan was not funded. The city discontinued offering subsidized retiree health care for employees hired after Jan. 1, 2010. At Sept. 30, 2018, the city's OPEB liability was $511.1 million, down from $518.8 million the previous year. OPEB costs equaled 0.8% of the city's expenditures. Given the closed nature of the plan, we expect the city's OPEB liability will slowly decline on an annual basis.

Ratings Detail (As Of May 28, 2020)		
Dallas WS		
Long Term Rating	AAA/Stable	Affirmed
Dallas WS (AGM)		
Unenhanced Rating	AAA(SPUR)/Stable	Affirmed

Ratings Detail (As Of May 28, 2020) (cont.)		
Tarrant Regl Wtr Dist, Texas		
Dallas, Texas		
Tarrant Regl Wtr Dist (Dallas) wtr		
Long Term Rating	AAA/Stable	Affirmed
Tarrant Regl Wtr Dist (Dallas) wtr		
Long Term Rating	AAA/Stable	Affirmed

Many issues are enhanced by bond insurance.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.