Memorandum

CITY OF DALLAS

DATE July 7, 2022

TO Honorable Mayor and Members of the City Council

SUBJECT **Fitch Ratings Downgrades Dallas Water Utilities Following Annual Review – RATING ACTION**

Today, following an annual review, Fitch Ratings (Fitch) lowered its long-term rating to ‘AA’ (stable outlook) from ‘AA+’ (negative outlook) on the outstanding water and sewer system revenue bonds issued for Dallas Water Utilities (DWU or the “System”). Fitch has assessed the DWU rating as a standalone credit profile irrespective of its relationship with and the credit quality of the City of Dallas general obligation credit (current rating 'AA'/stable outlook). The ‘AA’ designation is two notches below the highest Fitch rating and remains a high-grade, low-risk, investment-grade rating.

According to the Fitch report, the downgrade reflects the System's elevated leverage of net adjusted debt to adjusted funds available for debt service (FADS), “which has steadily increased during the past three years,” with fiscal year 2021 “impacted by increased costs related to the write off of bad debt, increased chemical and power costs related to Texas' winter storm Uri, increased pension costs and additional infrequent and one-time expenses.” Additionally, Fitch’s formulation of the leverage calculation is determined by the Fitch Analytical Stress Test (FAST), which assumes capital costs 10% above expected levels; “an increase in IPL costs of about $250 million beyond what has previously been anticipated,” “driven by environmental studies and increased construction pricing;” and “additional assumptions surrounding revenue and expense growth in the fiscal 2022 to account for potential higher inflation.” Fitch notes that leverage rose in 2019, “pressured by a rate decreases coupled with reduced demand from wet weather resulted in a sharp decline in revenues,” adding that “revenues saw a rebound in fiscal 2021 but were outpaced by expense growth.”

Fitch states that the rating also considers, “DWU's very strong business risk profile that is characterized by very strong revenue defensibility, 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 also asserts that, “rate increases have been regular and measured, yet rates remain low relative to other large utilities both within and outside of the state.”

While maintaining service to residents and operations during the COVID-19 pandemic and various serious weather events, the City has made no fundamental changes to the Dallas Waterworks and Sewer System during the period of review. DWU provides retail water and sewer service to over 1.3 million city residents, wholesale treated water to 23 municipalities, and wholesale sewer service to 11 customer cities in and around Dallas County.

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

Jack Ireland
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, Deputy City Manager
Jon Fortune, Deputy City Manager
Majed A. Al-Ghafry, Assistant City Manager
M. Elizabeth (Liz) Cedillo-Pereira, Assistant City Manager
Robert Perez, Assistant City Manager
Carl Simpson, Assistant City Manager
Genesis D. Gavino, Chief of Staff to the City Manager
Directors and Assistant Directors

FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Dallas, TX Water and Sewer Revs to 'AA'; Outlook Stable

Thu 07 Jul, 2022 - 4:50 PM ET

Fitch Ratings - Austin - 07 Jul 2022: Fitch Ratings has downgraded the following water and sewer system revenue bonds issued by the City of Dallas (the city), TX to 'AA' from 'AA+':

--Approximately $2 billion of outstanding system revenues bonds.

Fitch has assessed the city's water and sewer system (the system or DWU) 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 Stable.

ANALYTICAL CONCLUSION

The downgrade to 'AA' reflects the system's elevated leverage, which has steadily increased during the past three years. Moreover, Fitch's prior expectation of declining leverage has not materialized, with fiscal 2021 leverage increasing to 9.8x, up from 9.6x the year prior. DWU's leverage, expressed as net adjusted debt to adjusted funds available for debt service (FADS), in fiscal 2021 was impacted by increased cost related to the write off of bad debt, increased chemical and power costs related to Texas' winter storm Uri, increased pension costs and additional infrequent and one-time expenses.

Fitch's forward scenario, which was informed by management provided forecasts, points to an initial decline in leverage in 2022, supported by continued rate adjustments and an expectation that operating costs will decline. However, thereafter leverage migrates toward 9.0x a level that is inconsistent with the 'AA+' rating and leaves limited headroom to absorb any additional inflationary stress that is present in the current economic environment.

Additionally, costs related to the Integrated Pipeline project (IPL) have increased by about $250 million driven by environmental studies and increased construction pricing, which will result in additional debt issuance by DWU to complete the project by 2027. DWU is in the midst of a large-scale capital project to build out the IPL in cooperation the Tarrant Regional Water District (TRWD) to access the city's next major water supply. Fitch had expected additional debt issuance through 2026 of about $335 million, but that has now increased to $585 million. DWU's remaining capital costs associated with the IPL will be funded through two additional debt issues, slated for fiscal 2023 ($255 million) and fiscal 2025 ($250 million). An additional $80 million of spending is expected after 2026, but will likely be paid from cash balances.

The rating also considers DWU's very strong business risk profile that is characterized by very strong revenue defensibility, and 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.

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). 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 customer 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 Trinity River and Sabine River Basins, including Lake Ray Hubbard owned by the City of Dallas. Lake Palestine, located in the Neches River Basin, is being connected to the DWU System through a contract with TRWD. Water supply from these seven reservoirs is expected to provide dependable yield through at least 2055 once Lake Palestine is connected to the system around 2030. Water is treated at three water treatments plants and wastewater flows are treated at two wastewater treatment plants, with ample treatment capacity of over 900 million gallons daily (mgd) to meet the system's 380 mgd average daily demand. 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.

KEY RATING DRIVERS

Revenue Defensibility 'aa'

Very 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 rates 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 continued to weaken due to growing debt. Based on planned debt issuances over the next few years, which include obligations associated with the final phase of the IPL. 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 7.0x through Fitch's base and stress case.

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

--Sustained trend of leverage above 10x following issuance of all IPL related debt.

--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.

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%. 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 remain strong 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 $2,606 per million gallons (mg) of water produced for fiscal 2021, well below Fitch's $6,500 per mg threshold for the 'aa' assessment. The city's conservation measures over the past two decades have 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 2022-2026 total about $1.7 billion on par with the prior year's plan 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 expected to issue $255 million of contract revenues bonds for DWU's next installment for the IPL in fiscal 2023 through the Texas Water Development Board's State Water Implementation Funds of Texas with the remaining additional debt related to the IPL expected in fiscal 2025 ($250 million) and about $80 million to likely be paid from cash resources in fiscal 2027.

Financial Profile

DWU's financial profile continued to weaken in fiscal 2021 as the system's expenses outpaced revenues. In fiscal 2021, debt grew by 10%, while FADS only saw a 7% increase, pushing leverage higher. DWU's increasing leverage trend has not reversed as had been expected. Instead leverage had trended higher for the past three years, after registering a more favorable 8.0x in fiscal 2017 and 7.7x in fiscal 2018.

Leverage rose above 9.0x in fiscal 2019, pressured by a rate decreases coupled with reduced demand from wet weather resulted in a sharp decline in revenues. Ratios have remained elevated for the rating, growing incrementally yoy due to higher purchased water costs, additional debt, increased write off of bad debt expense and higher power and chemical costs during Winter storm Uri in February of 2021. Revenues saw a rebound in fiscal 2021, but were outpaced by expense growth.

The liquidity profile is neutral to the rating with COFO at 1.0x and a liquidity cushion of 226 days at the close of fiscal 2021. DWU's liquidity cushion has remained 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 1.1x in fiscal 2021.

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 fiscal 2022 to account for potential higher inflation and also in the final three years to reflect revenues that matched expenses. Fitch's assumptions also included a CIP execution rate of 80% and an increase in IPL costs of about $250 million beyond what has previously been anticipated.

Based on these reasonable assumptions, leverage is expected to decline in 2022, but range between 8.4x to 8.9x in Fitch's bases case and 8.5x to 9.3x in the stress case. In both cases, ratios remain in line with the 'AA' rating.

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.

RATING ACTIONS

ENTITY / DEBT	RATING		PRIOR
Dallas (TX) [Water, Sewer]			
Dallas (TX) /Water & Sewer Revenues/1 LT	LT	AA Rating Outlook Stable Downgrade	AA+ Rating Outlook Negative

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

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

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 01 Sep 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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