# Memorandum

CITY OF DALLAS

DATE October 22, 2021

TO Honorable Mayor and Members of the City Council

SUBJECT **S&P Global Ratings Affirmed ‘AA-’ Rating and Stable Outlook for City of Dallas General Obligation Bonds – RATING ACTION**

On October 21, 2021, S&P Global Ratings (S&P) assigned its ‘AA-’ credit rating and stable outlook to the anticipated General Obligation Refunding and Improvement Bonds, Series 2021; Combination Tax and Revenue Certificates of Obligation, Series 2021; and Equipment Acquisition Contractual Obligation Notes, Series 2021, and affirmed the City's ‘AA-’ credit rating and stable outlook on outstanding general obligation bonds. S&P previously affirmed the City’s rating on September 25, 2020.

S&P continues to affirm the rating reflective of “the strength of Dallas' local economy and tax base, which are bolstered by solid population and market value growth,” as well as “very strong management, with strong financial policies and practices,” “very strong budgetary flexibility,” “very strong liquidity,” and a “strong institutional framework.” S&P also notes their assessment of the City’s credit weaknesses, including debt and contingent liability and budgetary performance, “with a slight operating deficit in the general fund but a slight operating surplus at the total governmental fund level in fiscal 2020.”

With an increasing focus on environmental, social, and governance factors (ESG), S&P’s report also details current strategic actions the City has implemented to address potential risks associated with ESG factors, such as the appointment of a Chief of Equity and Inclusion and the City Council’s approval of the City's first racial equity resolution in March 2021 to begin preparations of a comprehensive racial equity plan “which could alleviate community tension and support access to vulnerable populations.” The report also includes the security measures implemented to protect against potential cyber-attacks, such as the City leading the regional effort on the “construction of a Cyber Fusion Center, which unifies security functions such as threat intelligence, security automation, threat response, security orchestration, and incident response.” Definitively, S&P states, “we view the steps that Dallas is taking to mitigate ESG-related risks as a particular credit positive and believe that the city is favorably positioned from an ESG risk perspective to make needed policy changes to address issues as they arise.”

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The rating decision by S&P is a positive indicator ahead of the competitive sale scheduled for November 4 and a testament to the City's efforts supporting a robust and stable credit profile. Attached is the rating action report provided by S&P.

Please let me know if you need additional information.

for 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 and Neighborhood Services
M. Elizabeth (Liz) Cedillo-Pereira, Chief of Equity and Inclusion
Directors and Assistant Directors

S&P Global Ratings

# RatingsDirect®

## Summary:
# Dallas; General Obligation

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**Summary:**

# Dallas; General Obligation

| Credit Profile | | |
|---|---|---|
| US$220.685 mil GO rfdg and imp bnds ser 2021 dtd 11/19/2021 due 02/15/2042 | | |
| *Long Term Rating* | AA-/Stable | New |
| US$45.6 mil combination tax rev certs of oblig ser 2021 dtd 11/19/2021 due 02/15/2032 | | |
| *Long Term Rating* | AA-/Stable | New |
| US$27.025 mil equip acquisition contractual oblig ser 2021 due 02/15/2027 | | |
| *Long Term Rating* | AA-/Stable | New |
| Dallas GO | | |
| *Long Term Rating* | AA-/Stable | Affirmed |

## Rating Action

S&P Global Ratings assigned its 'AA-' rating to the City of Dallas' anticipated $220 million series 2021 general obligation (GO) refunding and improvement bonds, $45 million series 2021 combination tax and revenue certificates of obligation, and $27 million series 2021 equipment acquisition contractual obligations. At the same time, S&P Global Ratings affirmed its 'AA-' long-term and underlying ratings on Dallas' GO bonds outstanding. The outlook is stable.

The bonds and contractual obligations constitute direct obligations of the city, payable from and secured by a pledge of a direct and continuing ad valorem tax, within the limits prescribed by the law, on all taxable property within the city in an amount sufficient to provide for payment of principal of and interest on the bonds. The certificates are payable from and secured by a pledge of a combination of the levy and collection of a direct and continuing ad valorem tax, levied within the limits prescribed by law, on all taxable property within the city, as well as a limited pledge of the surplus revenues of the city's municipal drainage utility system in an amount not to exceed $1,000. The maximum allowable ad valorem tax rate in Texas is $2.50 per $100 of assessed value (AV) with the portion dedicated to debt service limited to $1.50. We view the limited-tax GO debt pledge on par with the city's general creditworthiness. The ad valorem taxes are not levied on a narrower or distinctly different tax base, and there are no limitations on the fungibility of resources available for the payment of debt service. Proceeds from the sales will refund existing debt for net present value savings as well as fund the construction of various projects and improvements throughout the city.

### Credit overview

Despite the influence of the COVID-19 pandemic in 2020 and 2021, the ratings and outlook reflect the strength of Dallas' local economy and tax base, which are bolstered by solid population and market value growth, as well as ongoing activity in various sectors. Although the hospitality and travel sectors have been slower to recover, steady sales tax and property tax revenue growth supported stable fiscal performance in 2021 and an anticipated modest improvement in available general fund reserves. However, the city continues to face high fixed costs and weak funded status of its pension plans. If pension liabilities rise, the plans' funded status remains low, and costs continue to escalate that cause near-term budgetary challenges, we could lower the rating.

The rating reflects our assessment of the city's:

- Strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Very strong management, with strong financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Weak budgetary performance, with a slight operating deficit in the general fund but a slight operating surplus at the total governmental fund level in fiscal 2020;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2020 of 23% of operating expenditures;
- Very strong liquidity, with total government available cash at 65.4% of total governmental fund expenditures and 4.4x governmental debt service, and access to external liquidity we consider exceptional;
- Very weak debt and contingent liability profile, with debt service carrying charges at 15.0% of expenditures and net direct debt that is 121.4% of total governmental fund revenue, as well as a large pension and other postemployment benefit (OPEB) obligation and the lack of a plan to sufficiently address the obligation; and
- Strong institutional framework score.

### Environmental, social, and governance factors

Our analysis encompasses our review of environmental, social, and governance (ESG) risks that the city faces and, in our view, Dallas does not face elevated ESG risk. Despite the city's susceptibility to some significant weather events, such as heavy storms, tornados, high winds, and drought, we do not view these risks as outsize for the region. Dallas serves a significant population, as it is the ninth largest city in the U.S. However, we also do not view this as a particular or outsize risk when compared with other issuers in the sector.

Dallas has implemented strategic actions to address potential risks associated with ESG factors. The city manager appointed a chief of equity and inclusion to the executive leadership team in July 2019. The city council approved the city's first racial equity resolution in March 2021. It directed the city manager to begin working with external stakeholders to prepare a comprehensive racial equity plan, which could alleviate community tension and support access to vulnerable populations.

The city has also implemented a host of security measures to protect against future cyber attacks, including working with the G20 Global Smart Cities Alliance to develop and implement a G20 Policy for Technology and Cybersecurity, which will be brought to the city council for review and adoption. The city is participating in development and construction of a Cyber Fusion Center, which unifies security functions such as threat intelligence, security automation, threat response, security orchestration, and incident response. The Cyber Fusion Center serves as a regional threat center for the greater Dallas-Fort Worth area in coordination with other municipalities and the Dallas Police Department. The city is also moving its web sites from the .com domain to the .gov domain, and will look to improve its data center operations.

Although previous governance risks related to the city's retirement fund weighed on the credit profile, modifications have tempered them and in time should have a positive influence on the city's overall pension outlook if assumptions are met.

We view the steps that Dallas is taking to mitigate ESG-related risks as a particular credit positive and believe that the city is favorably positioned from an ESG risk perspective to make needed policy changes to address issues as they arise.

## Stable Outlook

### Downside scenario

If debt service, pension, and OPEB carrying charges increase to a level we view as unsustainable and negatively affect the city's financial metrics or performance, we could lower the rating. In addition, if weakness or deterioration in budgetary flexibility, performance, or liquidity is realized due to Dallas' high fixed costs (pension and debt), we could lower the rating.

### Upside scenario

Should the city's large and rising pension liabilities, as well as annual pension costs, moderate, and should the funded status of the plans significantly improve to what we consider adequate, we could raise the rating.

## Credit Opinion

### Strong economy

We consider Dallas' economy strong. The city, with an estimated population of 1.4 million, is in Collin, Dallas, and Denton counties in the Dallas-Fort Worth-Arlington, TX MSA, which we consider broad and diverse. It has projected per capita effective buying income of 95.8% of the national level and per capita market value of $114,234. Overall, market value grew by 5.8% over the past year to $155.9 billion in 2022. The counties' weighted-average unemployment rate was 7.6% in 2020.

Dallas and the greater Dallas-Fort Worth MSA continue to draw population and businesses to the region. For fiscal 2022, the city's tax base increased to $155.9 billion. Taxable values represent the 10th consecutive year of tax base growth. The value of new construction has increased by an average of 5.8% in the past five years. For fiscal 2022, approximately $3.2 billion of value was attributable to new construction. Despite a modest year-over-year decline in sales tax collections in 2020 from 2019, current forecasts for 2021 indicate collections are exceeding fiscal 2019's. Although the pandemic is still an influencing factor, economic activity in the region is stable. Steady population (1.32 million) and job growth is also fueling stable economic indicators, which contributes to the rating outlook.

City officials report continued economic development throughout the city. Construction is nearing completion on a new $100 million grocery fulfillment center in the Inland Port of southern Dallas. Kroger and Ocado Solutions are partnering on the project, which will employ 400 when operations begin in 2022. The Stack, a $106 million mixed-use building, opened in 2021 in the Deep Ellum neighborhood. The 16-story building features retail space and 200,000 square feet of state-of-the-art class AA office space. Redevelopment of Red Bird Mall continues, and Chime Solutions has opened a new office in the mall. Other companies such as CBRE Group and AECOM have announced recent or upcoming relocations of global or corporate headquarters from California to Dallas. We expect the breadth and depth of the Dallas economy will remain a positive credit factor.

### Very strong management

We view the city's management as very strong, with strong financial policies and practices under our FMA methodology, indicating financial practices are strong, well embedded, and likely sustainable.

Dallas uses multiyear trends of certified property tax values, historical sales tax revenue trends, and other economic and revenue data, as well as outside sources to formulate the budget. Management provides monthly reports to city council and produces a year-end report that reflects expenditures, concurrent with publishing a comprehensive annual financial report. City staff prepares and presents long-range financial forecasts for the general and debt service funds, which are presented to council during the budget development process or during bond program development. The city maintains an inventory of capital needs that is updated annually. It has historically used a multiyear capital bond program to fund infrastructure improvements. Management also reports investment results quarterly to council, and it reviews the investment policy annually. The city's financial management performance criteria (FMPC) establish guidelines and targets for operating programs and cash-and-debt management, including minimum reserves, debt ratios, and restrictions on debt use and issuance. The FMPC is part of the budget development process, at year-end, and is part of GO bond program development. The city adheres to a reserve policy of not less than 50 days of expenditures. It has also developed Dallas 365, which comprises 35 performance measures organized by six key strategic priorities that it tracks and reports on to better inform decision-making throughout the year.

### Weak budgetary performance

Dallas' budgetary performance is weak in our opinion. When factoring in 2020 pension contributions that fell $62 million short of actuarial determined amounts, the city had a slight deficit operating result in the general fund of 1.1% of expenditures, but a slight surplus result across all governmental funds 0.9% in fiscal 2020. Weakening our view of budgetary performance is the city's deferral of significant pension expenditures. When not incorporating the shortfall of pension annual required contributions, the city would have realized a positive operating surplus in the general fund.

Dallas' stable fiscal performance in the past several years is a result of increasing revenues, prudent fiscal management and assumptions, and the city's adoption of the upcoming and subsequent fiscal year's budget. However, incorporated in the fiscal performance is the contribution deficiency in the city's employees retirement fund and police and fire pension fund. The combined contribution deficiency for 2020 was $62.5 million, which materially affects the city's budgetary performance.

Dallas' fiscal 2021 forecast revenues for the year exceed budgeted expectations. While forecast expenditures also exceeded the budget, revenues modestly outpaced expenditures and the city anticipates adding about $36 million to total fund balance at the end of the year, or an increase to $272 million from $235.9 million (total general fund balance including committed and restricted balance). An expanding property tax base, as well as strong sales tax growth, supported balanced operations for the year.

The city is receiving $355.4 million in local recovery money. The city council discussed an allocation plan for American Rescue Plan Act funding during the 2022 budget process focused almost entirely on one-time expenditures. Dallas has appropriated $282.5 million thus far.

Officials do not anticipate a significant drawdown in reserves for 2022; however, they do have priorities for the year that include improvements to public safety responsiveness by hiring 250 police officers in each of the next two years. Over the next two years, the city plans to invest $300 million in street improvements, and increase the minimum wage for most city employees to $15.50 per hour in 2022 and $16.00 in 2023. For the fiscal 2022 budget, officials anticipate sales tax revenues to increase 2.5% to $344.3 million, from the amended budget of $336.0 million in fiscal 2021. They also anticipate solid gains in property tax collections based on market value growth. We expect stable future financial performance.

### Very strong budgetary flexibility

Dallas' budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2020 of 23% of operating expenditures, or $318.5 million.

The city continues its trend of adding to year-end available reserve balance, which remains what we consider very strong. Based on expectations for fiscal 2021 performance, officials anticipate general fund balance will increase.

### Very strong liquidity

In our opinion, Dallas' liquidity is very strong, with total government available cash at 65.4% of total governmental fund expenditures and 4.4x governmental debt service in 2020. In our view, the city has exceptional access to external liquidity if necessary.

Supporting our view is the city's exceptional access to external liquidity based on frequent bond issuances, secured by various revenue streams, over the past 15 years. Given year-to-date budget performance trends, we do not anticipate deterioration in liquidity in the near term.

### Very weak debt and contingent liability profile

In our view, Dallas' debt and contingent liability profile, including pension and OPEB obligations, is very weak. Total governmental fund debt service is 15.0% of total governmental fund expenditures, and net direct debt is 121.4% of total governmental fund revenue.

Dallas' fixed costs, including debt and pension costs, amounted to a high, in our opinion, 28.9% of expenditures for fiscal 2020, which influences our overall view of the debt and liability profile. We expect the city will continue to issue bonds for general infrastructure improvements should AV growth support such issuances. Incorporated into the debt profile are the city's contingent liabilities to make up any shortfalls in debt service coverage for both the Dallas Convention Center Hotel revenue bonds and the Downtown Dallas Development Authority tax increment revenue bonds. The city also has a commercial paper program through JPMorgan Chase Bank N.A. The notes have a total program authorization of $350 million. Liquidity support is provided by JPMorgan Chase Bank through a revolving credit agreement.

Pension and OPEB liabilities:

In our opinion, a credit weakness is Dallas' large pension and OPEB obligation, without a plan in place that we think will sufficiently address the obligation. Combined required pension and actual OPEB contributions were 14.6% of total governmental fund expenditures in 2020. Of that amount, 13.9% represented required contributions to pension obligations, and 0.7% represented OPEB payments. The city made 78% of its required pension contribution in 2020.

The funded ratio of the largest pension plan is 43.5%.

We consider the high contributions, as well as continued contribution shortfalls compared with the actuarially determined contribution (ADC), a credit weakness. Dallas' combined total pension and OPEB contributions for fiscal 2020 were 14.6% of governmental expenditures (13.9% for pension alone). Despite significant structural changes to the pension plans, we anticipate pension obligations will remain a source of pressure for Dallas. Pension contribution rates fixed by statute are high and still insufficient based on ADC rates. OPEB closed to new participants, and thus, represents a comparatively smaller liability for the city. Dallas provides benefits to its employees primarily via the following defined-benefit retirement plans, as of fiscal 2020:

- Employees' Retirement Fund (ERF): 64.7% funded (Dec. 31, 2019) using a 5.9% discount rate, with a net pension liability of $2.0 billion down from $2.26 billion in 2019.
- Dallas Police and Fire Pension System (Combined Plan): 43.5% funded using a 7.25% discount rate, with a net pension liability of $2.67 billion up from $2.5 billion in 2019; and
- OPEB: 0% funded, with a net OPEB liability of $531 million.

We consider the funded levels of both pension plans to be poor. The assumed return rate was lowered to 7.25% for ERF and to 7.0% for the Combined Plan, which is comparatively less risk than previous assumptions; however, the change led to lower funded levels for fiscal 2020. The ERF discount rate is lower than the assumed return due to a projected asset depletion date under Governmental Accounting Standards Board calculations.

The previous changes to Dallas' pension plans are an improvement to funding discipline, but we expect it will be several years until funding progress materially improves. For fiscal 2019, the city paid 73% and 97% of the ADC for ERF and the Combined Plan, respectively. The 2020 ADC for the ERF plan is calculated using an open period and a 30-year length that we view negatively, and a level percent of payroll basis (2.5% for ERF and 2.5% for the Combined Plan) that defers contributions to the future. Dallas Police and Fire changed its contribution policy to a closed 25-year funding of the unfunded accrued liability for 2020, and in future years, there is a 20-year amortization of gains and losses. These contributions were not only well below our minimum funding progress metric guideline, but also below static funding, which indicates increasing unfunded liabilities if all assumptions are met. Furthermore, the Combined Plan is expected to have supplemental contributions expire by fiscal 2025, though an actuarial review is scheduled. This funding discipline is weak and is likely to be insufficient, leading to weakening funded levels for the foreseeable future unless additional funding requirements are implemented in the future.

The OPEB plan is funded on a pay-as-you-go basis and discontinued offering subsidized retiree health care for employees hired after Jan. 1, 2010. The city moved the post-65 retirees to fully insured plans, which has been cost effective. The change allowed for a lowering of the claims cost assumption and reduced the overall liability of the plan. Dallas also updated its governing documents to ensure clarity of eligibilities as well as to increase efficiencies. Based on plan assumptions, as well as some recent changes to the plan, we believe the overall liability will continue to slowly decrease over time.

### Strong institutional framework

The institutional framework score for Texas municipalities is strong.

## Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

| Ratings Detail (As Of October 21, 2021) | | |
|---|---|---|
| Dallas comb tax and rev certs of oblig ser 2020 due 02/15/2030 | | |
| *Long Term Rating* | AA-/Stable | Affirmed |
| Dallas taxable GO (AGM) (SEC MKT) | | |
| *Unenhanced Rating* | AA-(SPUR)/Stable | Affirmed |
| Dallas GO (AGM) | | |
| *Unenhanced Rating* | AA-(SPUR)/Stable | Affirmed |
| Dallas GO (AGM) | | |
| *Unenhanced Rating* | AA-(SPUR)/Stable | Affirmed |
| Dallas GO (BAM) (SECMKT) | | |
| *Unenhanced Rating* | AA-(SPUR)/Stable | Affirmed |
| Dallas GO (BAM) (SECMKT) | | |
| *Unenhanced Rating* | AA-(SPUR)/Stable | Affirmed |
| Dallas GO (BAM) (SECMKT) | | |
| *Unenhanced Rating* | AA-(SPUR)/Stable | Affirmed |
| Dallas GO (BAM) (SECMKT) | | |
| *Unenhanced Rating* | AA-(SPUR)/Stable | Affirmed |
| Dallas GO (BAM) (SECMKT) | | |
| *Unenhanced Rating* | AA-(SPUR)/Stable | Affirmed |
| Dallas GO (BAM) (SECMKT) | | |
| *Unenhanced Rating* | AA-(SPUR)/Stable | Affirmed |
| Dallas GO (BAM) (SECMKT) | | |
| *Unenhanced Rating* | AA-(SPUR)/Stable | Affirmed |
| Dallas GO (BAM) (SEC MKT) | | |
| *Unenhanced Rating* | AA-(SPUR)/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.