Memorandum

CITY OF DALLAS

DATE July 6, 2018

TO Honorable Mayor and Councilmembers

SUBJECT **Fitch Ratings Affirmed 'AA' Rating and Stable Outlook for City of Dallas Outstanding General Obligation - INFORMATION**

On Tuesday, Fitch Ratings (Fitch) affirmed the City's 'AA' credit rating and stable outlook for General Obligation debt. This is a positive reinforcement to Standard & Poor's Global Ratings' actions Monday that further demonstrates the financial strength of the City of Dallas and bolsters investor confidence.

Fitch states the affirmed rating and outlook for the General Obligation debt reflects the City's "positive operating performance enabled by strong economic and revenue growth prospects, conservative budgeting, solid reserve levels, and long-term liabilities that Fitch expects to remain a moderate burden on resources given recent pension reforms." According to Fitch, the City has "demonstrated positive budget management practices historically, including programmed expenditure reductions that have enabled the city to maintain a strong financial cushion," and further expects "Dallas to demonstrate strong financial resilience during economic downturns, as demonstrated by a history of strong gap-closing capacity enabled by solid expenditure management and sizable reserves."

As we prepare for future bond issues, I look forward to the opportunity to continue to promote the City of Dallas, with its strong and diverse economy, prudent financial policies and practices, and commitment to Service First excellence.

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
Larry Casto, City Attorney
Craig D. Kinton, City Auditor
Bilierae Johnson, City Secretary
Daniel F. Solis, 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
Nadia Chandler Hardy, Chief of Community Services
Raquel Favela, Chief of Economic Development & Neighborhood Services
Theresa O'Donnell, Chief of Resilience
Directors and Assistant Directors

FitchRatings

Fitch Rates Dallas, TX $55MM GO Ref Bds 'AA'; Outlook Stable

Fitch Ratings-Austin-03 July 2018: Fitch Ratings has assigned an 'AA' rating to the following City of Dallas, TX obligations:

--$55.3 Million General Obligation (GO) Refunding Bonds, Series 2018.

The bonds are scheduled for a competitive sale on July 17. Proceeds will pay a legal settlement.

Fitch also has affirmed the following ratings:

--Issuer Default Rating (IDR) at 'AA';
--$1.76 billion of outstanding limited tax debt at 'AA'.

The Rating Outlook is Stable.

SECURITY
GO bonds are payable from the city's ad valorem tax levy, limited to $2.50 per $100 of taxable assessed valuation (TAV).

ANALYTICAL CONCLUSION

The city's 'AA' rating and Stable Rating Outlook reflect positive operating performance enabled by strong economic and revenue growth prospects, conservative budgeting, solid reserve levels and long-term liabilities that Fitch expects to remain a moderate burden on resources given recent pension reforms. These reforms, in the form of voter-approved changes to the Dallas Employees Retirement Fund (ERF) and legislative changes to the Dallas Police and Fire Pension System (DPFP) are projected to stabilize the city's obligation to both plans and support long-term plan viability. Recent settlement of several public safety back-pay disputes and expected resolution of other outstanding disputes appears to bring these long running issues to a close with substantially lower financial impacts to the city than previously feared.

Economic Resource Base
Dallas is the anchor of the large and diverse Dallas-Fort Worth regional economy. The

city is a center for technology, trade, finance and healthcare; it also ranks among the top visitor and leisure destinations in the state.

KEY RATING DRIVERS

Revenue Framework: 'aaa'
Strong revenue growth prospects are based on expectations for continued gains in taxable value and sales tax revenues due to ongoing economic expansion. The assessment also reflects the city's ample independent revenue-raising capacity.

Expenditure Framework: 'a'
The city's pace of spending is expected to be generally in line with revenue growth given its mature residential base. The assessment considers the city's expenditure flexibility that derives from workforce cost controls and conservative budgeting practices. However, increasing pension contributions-primarily to the DPFP-will put additional upward pressure on what are already elevated carrying costs. The city's debt amortization rate is rapid.

Long-Term Liability Burden: 'aa'
Long-term liabilities are comprised of unfunded pension obligations (about 60% of the fiscal 2017 total, based on Fitch-adjusted data) and debt (about 40%). The long-term liability burden currently represents a moderate 19% of personal income. The assessment assumes that recently approved pension reforms to both the civilian and uniform plans, in conjunction with continued economic growth, will keep the long-term liability burden within the current range.

Operating Performance: 'aaa'
The city of Dallas' gap-closing capabilities and healthy reserves position it to maintain financial resilience through a typical economic downturn, although increasing pension outlays will challenge the city's budget management practices.

RATING SENSITIVITIES
Maintenance of Operating Flexibility: Materially larger pension contributions beginning in fiscal 2018, combined with gradual increases in public safety personnel costs, will challenge management's operating and budget flexibility for the near to medium term. Any prolonged weakening of economic activity that cools recent solid gains in taxable values and sales tax receipts would exacerbate this pressure. The city's budgeting practices, including a new biennial budget adoption process, should assist management's efforts to incorporate these additional expenses and maintain the current level of overall budgetary flexibility; inability to do so likely would place

downward pressure on the rating.

CREDIT PROFILE

Dallas is located in northcentral Texas and, with a population of 1.3 million, ranks among the top 10 U.S. cities by population. The city serves as corporate headquarters for AT&T, Southwest Airlines, Texas Instruments, 7-Eleven, Inc., HollyFrontier Corp., Pizza Hut, Inc. and other large corporate concerns. Large employers in the education, government and health services sectors lend stability to the city's employment base.

The city's role as a wholesale and retail trade center is enabled by a strong transportation network of airports, rail and interstate highways. Dallas Area Rapid Transit (DART) provides major employers easy access to a highly skilled work force to support growing technology, finance, business and medical service sectors. Driven by professional service, construction, mining and trade sector growth, the city's employment base continues its post-recession expansion. Top taxpayers represent utility, air transportation, developers, real estate, manufacturing and retail industries, and the tax base has no significant concentration.

Revenue Framework

General fund operations are supported by a diverse mix of revenues led by ad valorem tax revenues (48% of the fiscal 2017 total), sales tax revenues (25%) and franchise fees (12%). General fund revenue growth has exceeded inflation but has been somewhat below GDP growth over the past decade.

Medium-term revenue growth prospects are strong based on the overall strength of the local and regional economies, including expansion in the trade/transportation, professional business services and leisure/hospitality sectors. New development continues as indicated by ongoing growth in the city's residential and commercial building permit activity, including $4.26 billion in permits issued in fiscal 2017. This activity is also reflected in recent tax base gains. Taxable assessed valuation (TAV) climbed by 10% in fiscal 2017 and 7% in fiscal 2018 to $118 billion. Another 9% gain in TAV is expected for fiscal 2019.

The city's fiscal 2018 total tax rate of $0.7804 per $100 of TAV provides ample legal revenue-raising capacity below the constitutional and city charter caps of $2.50. If a proposed tax rate results in an 8% year-over-year levy increase (based on the prior year's values), the rate increase may be subject to election if petitioned by voters.

Expenditure Framework

As is typical with U.S. cities, public safety is Dallas' largest operating spending category (61% of fiscal 2017 general fund outlays), followed by culture and recreation (12%), and general government (10%). General fund spending growth has generally kept pace with revenue gains in recent years.

Fitch expects the pace of spending growth to generally track what is projected to be a positive trajectory in revenues, as future service demands from a relatively mature residential base and increasing public safety and pension outlays should align with increasing operating receipts over the near to medium term.

The 'a' assessment is informed by the city's elevated carrying costs that exceeded 30% of fiscal 2017 governmental spending. Actuarially required pension contributions comprised 52% of carrying costs, while debt service comprised 46%; retiree health insurance outlays made up the remainder. Fitch expects actual carrying costs to remain high, the result primarily of increasing pension contributions to the police and fire plan mandated by reforms approved by the Texas Legislature and signed into law in 2017. Fitch's supplemental pension metric, which estimates the annual pension cost based on a level dollar payment for 20 years with a 5% interest rate, indicates that carrying costs are vulnerable to future increases (although the magnitude will be revised when the DPFP reforms are included in the calculation). For more information, see Fitch's "Revised Pension Risk Measurements (Enhancing Pension Analysis in U.S. Public Finance Tax-Supported Rating Criteria)," dated May 31, 2017.

A $1.05 billion GO bond authorization approved by voters in November 2017 will contribute to elevated carrying costs for some time; the new bond program is heavily weighted toward streets (53%) and parks and recreation (26%). The current carrying costs do reflect a rapid 68% amortization rate over the next 10 years, which will lessen somewhat the burden associated with new debt. The city's ability to control headcount and salary costs is strong, providing a measure of operational flexibility.

Long-Term Liability Burden

Dallas' long-term liability burden is moderate at 19% of personal income, with roughly 60% of the Dec. 31, 2016 total attributable to unfunded pension liabilities. The $1.05 billion GO bond authorization discussed above likely will not materially change the liability burden calculation given the current rapid rate of debt repayment and expected additional growth in personal income over the life of a new bond authorization program; the city currently has roughly $1.8 billion in GO debt outstanding, about 13% of the total long-term liability burden.

Dallas participates in three single-employer defined benefit pension plans. The ERF covers non-uniformed employees. The DPFP (combined plan) and Supplemental Police and Fire Pension Plan of the city of Dallas (supplemental plan) cover police and firefighters.

Under GASB Statement 68, the ERF plan at Dec. 31, 2016 reported a NPL of nearly $940 million, with fiduciary assets covering 78% of total pension liabilities at the plan's 7.75% investment return assumption. The Dallas ERF board approved changes to the benefit plan in May 2016, which were subsequently approved by the city council and by nearly 70% of voters. The changes apply to employees hired on or after Jan. 1, 2017 and include an increase in the normal retirement age from 60 to 65, an increase in service retirement from 30 years to 40 years, elimination of the health benefit supplement and a reduction in the benefit multiplier from 2.75% to 2.5%. The city estimates these changes will reduce normal costs by 36% and boost to the long-term viability of the plan.

Under GASB Statement 68, the DPFP plan reported a net pension liability (NPL) for the combined and supplemental plans of $6.3 billion and $23 million, respectively, as of Dec. 31, 2016. Fiduciary assets of the combined plan covered a low 26% of liabilities based on a blended discount rate of 4.12% (the 7.25% actuarial rate of return during the period through 2028 that the plan was projected to have a fiduciary net position, and a 3.78% municipal bond rate thereafter). Fiduciary assets covered 44% of the liabilities of the supplemental plan using a blended rate of 7.10%.

In response to a steady weakening of the DPFP plan--attributable primarily to issues associated with the deferred retirement option program (DROP) feature--the Texas Legislature in its 2017 regular session approved legislation (HB 3158) that made a number of noteworthy changes to the DPFP plan. The modifications included increases in retirement ages for the various tiers of employees, a reduction in the benefit multiplier for most employees and elimination of the current COLA benefit. The legislation also made changes to the troubled DROP, including a 10-year limitation on participation, elimination of interest on DROP accounts after Sept. 1, 2017 and modifications to DROP account distribution options. The legislation also called for increased plan contributions from both the city and employees.

The city received an actuarial analysis of the DPFP plan performed by Deloitte Consulting LLP. The analysis incorporated the changes included in HB 3158 and also relied upon certain actuarial assumptions and methods employed to make projections regarding plan liability, contributions and amortization period. The analysis also relied on plan participant and asset information provided by DPFP and projected salary and hiring information from the city. Deloitte's analysis showed a nearly 25% reduction in the plan liability and an improved ratio of assets to liabilities to 50%, up from the plan's 38% level before reforms. This calculation also used the plan's 7.25% investment return assumption. These reforms should stabilize the city's obligations to the plan and reduce the risks presented by the DROP feature of the retirement plan, and should enhance the plan's long-term viability.

The city has made notable progress recently on another potential financial liability, namely several back pay disputes with city public safety employees. The Dallas city council in November 2017 approved a settlement of four suits (the Collin County lawsuits) for $61.7 million, and the court approved a final judgement on June 8, 2018. Negotiations continue with the remaining two class-action back-pay lawsuits (the Rockwall County suits), and the city council authorized a settlement on June 27th. The reported settlement amount in the Rockwall suits is $173.3 million, bringing the total amount to be paid by the city to $235 million. This figure, while not immaterial, is substantially less than potential figures previously mentioned. These series 2018 refunding bonds will finance the Collin County suits' payment. A future tax-supported borrowing likely will be the vehicle for financing the Rockwall County suits' liability, assuming all parties agree to a settlement.

Operating Performance
Fitch expects Dallas to demonstrate strong financial resilience during economic downturns, as demonstrated by a history of strong gap-closing capacity enabled by solid expenditure management and sizable reserves. The city completed fiscal 2017 with a net surplus after transfers of $44 million and unrestricted general fund reserves of $212 million (18% of spending), as both revenues and expenditures outperformed budget.

The city has demonstrated positive budget management practices historically, including programmed expenditure reductions that have enabled the city to maintain a strong financial cushion. However, the increasing annual pension contributions that are mandated by the reforms to the DPFP plan will challenge the city's budget management practices for the foreseeable future. Any slowdown in TAV and economically sensitive revenue trends, combined with expected increases in public safety personnel costs, will add to this challenge.

The fiscal 2018 budget-year one of a biennial budget adopted by the city for the first time-is operationally balanced despite materially larger DPFP pension contributions. Fiscal 2018 DPFP contributions from the city are scheduled at roughly $152 million, which is approximately $41 million more than if the reforms had not been approved.

The projected contribution includes a $13 million supplemental contribution that is scheduled to occur annually until 2024.

This additional expense is offset to a large extent by reduced public safety personnel costs. The fiscal 2018 budget included funding for 3,094 police officers, down from 3,613 budgeted positions in fiscal 2017; police staffing is currently projected to end fiscal 2018 at about 3,044, as attrition losses will more than offset the number of new hires. Management plans to address this attrition, which likely reflects both rank and file departures during the pension crisis and police recruiting challenges nationwide, through continued enhanced recruitment efforts. The current projection for fiscal 2018 general fund results suggest another operating surplus of roughly $11 million, indicating sufficient budgetary adjustments to initially absorb the additional pension expenditures (and also a boost from revenues again outperforming budget).

Contact:

Primary Analyst
Steve Murray
Senior Director
+1-512-215-3729
Fitch Ratings, Inc.
111 Congress Avenue
Austin, TX 78701

Secondary Analyst
Jose Acosta
Senior Director
+1-512-215-3726

Committee Chairperson
Laura Porter
Managing Director
+1-212-908-0575

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis and InvestorTools.

Media Relations: Sandro Scenga, New York, Tel: +1 212-908-0278, Email:

sandro.scenga@fitchratings.com

Additional information is available on www.fitchratings.com

Applicable Criteria

U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018) (https://www.fitchratings.com/site/re/10024656)

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