Memorandum

CITY OF DALLAS

DATE May 29, 2020

TO Honorable Mayor and Council Members

SUBJECT **Fitch Ratings Affirmed 'AA+' Rating, Revises Outlook to Negative for City of Dallas Waterworks and Sewer System Revenue Refunding Bonds, Series 2020C and 2020D**

Yesterday, Fitch Ratings (Fitch) assigned their 'AA+' credit rating and revised the outlook to negative from stable 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 Fitch 'AA+' rating and negative outlook also applies to the Waterworks and Sewer System's ("System") $2.2 billion outstanding revenue bonds. According to the report, "the 'AA+' issue rating reflect the system's strong revenue defensibility, which is supported by its fundamental role as the regional water provider to a broad service area with favorable demographic trends." Fitch's scenario analysis reflects the negative outlook "driven by weaker fiscal 2019 results along with planned debt issuances over the next few years," adding that "the system experienced revenue decline in fiscal 2019 due to a rate decrease coupled with declines in water demand from wet weather."

The key rating drivers Fitch detailed in the report include the System's revenue defensibility, operating risks, and financial profile. According to Fitch, the System's "revenue defensibility is very strong" and "continued moderate planned adjustments should preserve a favorable degree of flexibility going forward." In terms of operating risks, Fitch's assessment of the System "reflects its very low operating cost burden and favorable life cycle ratio," adding that "favorably, capital spending has exceeded depreciation annually over the last five years and is expected to continue as the utility has a robust capital plan to address long range water supply and continuing system maintenance." Regarding the financial profile of the System, Fitch notes that the "system's leverage ratio has started to weaken," although, "the liquidity cushion and coverage of full obligations (COFO) are sound and considered neutral to the assessment."

While the City faces several unforeseen challenges, the Dallas Water Utilities System continues to provide service excellence to customers following the City's Financial Management Performance Criteria with long-range planning, prudent management, and sound leadership.

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
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
Nadia Chandler Hardy, Assistant City Manager
Dr. Eric A. Johnson, Chief of Economic Development and Neighborhood Services
Laila Alequresh, Chief Innovation Officer
M. Elizabeth (Liz) Cedillo-Pereira, Chief of Equity and Inclusion
Directors and Assistant Directors

FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Dallas, TX's Water & Sewer Revs 'AA+'; Outlook to Negative

Thu 28 May, 2020 - 4:24 PM ET

Fitch Ratings - Austin - 28 May 2020: Fitch Ratings has assigned a 'AA+' rating to the following bonds issued by the city of Dallas, TX (the city):

--Approximately $228.4 million waterworks and sewer system revenue refunding bonds, series 2020C and

--Approximately $364.6 million waterworks and sewer system revenue refunding bonds, taxable series 2020D.

Bond proceeds will be used to refund certain outstanding bonds of the city and refund commercial paper notes of the city's water and sewer system (DWU or the system). The bonds are expected to sell July 7, 2020 via negotiated sale.

In addition, Fitch has affirmed the 'AA+' rating on the system's $2 billion in outstanding parity debt.

Fitch has assessed the system's Standalone Credit Profile (SCP) to be 'aa+'.

The Rating Outlook is revised to Negative from Stable.

ANALYTICAL CONCLUSION

The system 'aa+' SCP and 'AA+' issue rating reflect the system's strong revenue defensibility, which is supported by its fundamental role as the regional water provider to a broad service area with favorable demographic trends. DWU's very low operating risks feature high economies of scale and a capital planning and management assessment that is expected to remain favorable. The Negative Outlook is driven by weaker fiscal 2019 results along with planned debt issuances over the next few years that could outpace revenue growth and lead to sustained higher leverage than experienced in recent years. The utility's net leverage, as expressed in adjusted debt to adjusted funds available for debt service (FADS), rose in fiscal 2019 to 9.3x from 7.7x the year prior. The system experienced revenue decline in fiscal 2019 due to a rate decrease coupled with declines in water demand from wet weather. Expectations for 2020 are for some improvement in net leverage despite additional forecasted revenue contractions from fiscal 2019 levels due to lower demand related to the coronavirus. Negative rating action would be expected to occur if net leverage failed to point towards stabilization around or below 8x.

Coronavirus Considerations

DWU management is forecasting revenue declines in fiscal 2020 related to the current outbreak of coronavirus government containment measures taken by the city of Dallas and the impact to many of its retail commercial accounts. Management expects to control expenses and reduce cash transfers for capital construction to offset the revenue declines in 2020. To date, system wide consumption demand, which includes wholesale customers, is tracking on budget. The city has received over $230 million in Coronarvirus Relief Fund (CARES Act) funds to assist with conoravirus related expenses. DWU management is currently gathering data related to funds spent to date that could qualify for CARES Act support.

The recent outbreak of coronavirus and related government containment measures worldwide creates an uncertain global environment for the Water and Sewer sector. While the utility's performance data through most recently available data has not indicated impairment, material changes in revenue and cost profile are occurring across the sector and likely to worsen in the coming weeks and months as economic activity suffers and government restrictions are maintained or expanded. Fitch's ratings are forward-looking in nature, and Fitch will monitor developments in the sector as a result of the virus outbreak as it relates to severity and duration, and incorporate revised expectations for future performance and assessment of key risks.

CREDIT PROFILE

The system serves an expansive territory, providing retail water and sewer service to over 1.2 million city residents. The system also provides wholesale treated water to 23 municipalities and wholesale sewer service to 11 customer cities in Dallas County (the county) and the contiguous counties with a population of over 2.6 million. 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 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 United States. Water is supplied to DWU from six surface water impoundments in the Elm Fort of the Trinity River and Lake Palestine, which is being connected to the DWU system through a contract with the Tarrant Regional Water District (TRWD). Water supply from these seven reservoirs is expected to provide dependable yield through at least 2050 once Lake Palestine is connected to the system around 2027. Water is treated at three water treatments plants and wastewater flows are treated at two wastewater treatment plants. A small portion of the system's wastewater treatment is provided by the City of Garland, TX and the Trinity River Authority.

KEY RATING DRIVERS

Revenue Defensibility 'aa'

Strong Rate Flexibility; Expansive Service Area

The system's revenue defensibility is supported by DWU's extensive 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 remain low relative to other large utilities both within and outside of the state. The 'aa' assessment is further supported by the monopolistic nature of DWU's revenues and it legal independent authority to raise rates.

Operating Risks 'aa'

Very Low Operating Cost Burden

DWU's 'aa' operating risks 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 its TRWD.

Financial Profile 'aa'

Weakening Leverage Position

The system's leverage ratio has started to weaken due to declines in FADS which were pressured by wet weather and recent rate declines. Based on planned debt issuances over the next few years, which include obligations associated with the final phase of the Integrated Pipeline project (the IPL), net leverage may remain elevated for the current rating level. 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/rating stabilization:

--Expectations of net leverage returning to under 8x on a sustained basis.

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

-- Continuing trend of net leverage above 8x.

-- Change in capital planning that result in elevated lifecycle investment needs and an increase in life cycle ratio.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Public Finance 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 (O&M) 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 of Dallas, (general obligation Issuer Default Rating AA/Stable Outlook) is among the three largest cities in Texas and among the ten largest in the US. 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.

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. Recent 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 customer 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 and DWU management is planning for continued rate increase of 2% to 5% for retail customers and approximately 3% for wholesale customers over the next five years.

OPERATING RISKS

The utility's operating risks are assessed at 'aa' which take 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 continue as the utility has a robust capital plan to address long range water supply and continuing system maintenance. 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 2020-2024 total $1.6 billion excluding costs related to the IPL, with annual spending between $300 million and $350 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. The next portion of DWU's debt for the IPL is expected in fiscal 2021 for about $300 million with completion expected around 2027.

FINANCIAL PROFILE

The financial profile is assessed at 'aa'. Fitch's calculated net leverage ratio was 9.3x at the end of fiscal 2019, which is at the higher end of the assessment range. The liquidity profile is neutral to the rating with coverage of full obligations (COFO) at 1.06x and liquidity cushion of 221 days at the close of fiscal 2019. DWU's liquidity cushion remains 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 then.

Net leverage has trended downward in recent years from 9.8x in fiscal 2015 to 7.7x is fiscal 2018, which was supported by an uptick in water demand during more normal hydrological conditions. However, rate decreases in fiscal 2019, coupled with reduced demand from wet weather resulted in sharp decline in revenues, pushing leverage up past 9x for the year. Reduced water demand 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 136 billion gallons annually. From year to year, demand is still very weather dependent and rate revenues fluctuate based on weather-driven water use.

Fitch Analytical Stress Tool (FAST)

The FAST considers the potential trend of key ratios in a base case and a stress case, with the stress case imposing capital costs 10% above base case levels. Under the FAST base case, net leverage is expected to decline in fiscal 2020 from fiscal 2019 levels but then jump to 9.3x in fiscal 2021 and then remain in the 9x range through fiscal 2024. Under the stress case net leverage is slightly higher and peaks at 9.6x in fiscal 2021. Fitch used the city's forecast in formulating the FAST base case scenario, which includes revenue and expense reductions in fiscal 2020 related to the coronavirus government imposed shutdowns, modest annual rate adjustments and more normalized usage resuming in fiscal 2021, as well as planned capital spending and debt financing (including a near-term increase in capex of around $300 million related to the IPL). Fitch notes that while other sensitized downside scenarios were evaluated to layer in additional stresses related to coronavirus impacts, these did not form the basis of the rating.

ASYMMETRIC ADDITIVE RISK CONSIDERATIONS

No asymmetric additive risk considerations affected this rating determination.

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.

ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Teri Wenck, CPA
Director
Primary Rating Analyst
+1 512 215 3742
Fitch Ratings, Inc. 111 Congress Avenue Suite 2010 Austin 78701

Gabriela Payne, CPA
Director
Secondary Rating Analyst
+1 512 215 3731

Douglas Scott
Managing Director
Committee Chairperson
+1 512 215 3725

MEDIA CONTACTS

Sandro Scenga
New York
+1 212 908 0278
sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

U.S. Water and Sewer Rating Criteria (pub. 03 Apr 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Dallas (TX)	EU Endorsed

DISCLAIMER

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS. IN ADDITION, THE FOLLOWING HTTPS://WWW.FITCHRATINGS.COM/RATING-DEFINITIONS-DOCUMENT DETAILS FITCH'S RATING DEFINITIONS FOR EACH RATING SCALE AND RATING CATEGORIES, INCLUDING DEFINITIONS RELATING TO DEFAULT. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. DIRECTORS AND SHAREHOLDERS RELEVANT INTERESTS ARE AVAILABLE AT HTTPS://WWW.FITCHRATINGS.COM/SITE/REGULATORY. FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

READ LESS

COPYRIGHT

facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001

Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see https://www.fitchratings.com/site/regulatory), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

READ LESS

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's approach to ratings endorsement so that ratings produced outside the EU may be used by regulated entities within the EU for regulatory purposes, pursuant to the terms of the EU Regulation with respect to credit rating agencies, can be found on the EU Regulatory Disclosures page. The endorsement status of all International ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for all structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

US Public Finance Infrastructure and Project Finance North America United States