FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Arlington, TX Water and Sewer Revs 'AAA'; Outlook Stable

Wed 27 Apr, 2022 - 10:55 AM ET

Fitch Ratings - Austin - 27 Apr 2022: Fitch Ratings has assigned a 'AAA' rating to the following City of Arlington, TX (the city) revenue bonds:

--Approximately $18.94 million water and wastewater system revenue bonds, series 2022A;

--Approximately $7.31 million water and wastewater system revenue refunding bonds, series 2022B.

The bonds will be sold on May 18 via competitive bid. Bond proceeds will be used to make improvements and extensions to the city's water and sewer system (the system), refund portions of outstanding bonds and pay issuance costs.

Additionally, Fitch has also affirmed the following parity system revenues bonds at 'AAA':

--$225.72 million outstanding water and wastewater system revenue bonds.

Fitch has assessed the system's standalone credit profile (SCP) at 'aaa'. 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 (Issuer Default Rating AAA/Stable).

The Rating Outlook is Stable.

ANALYTICAL CONCLUSION

The system's 'AAA' bond issue rating and 'aaa' SCP reflect the very low leverage, measured as net adjusted debt to adjusted funds available for debt service, within the framework of very strong revenue defensibility and very low operating risk. The system has a high degree of rate affordability and the city retains legal autonomy to raise rates. The operating cost burden is very low but influenced by its dependence on wholesale service providers.

The city's practice is to transfer surplus funds each year into the restricted construction fund. Taking these restricted funds into consideration, leverage registers 2.6x in fiscal 2021, and is considered exceptionally low. Absent these funds, leverage was 6.0x in fiscal 2021, impacted by additional debt and a slight drop in unrestricted cash balances. Leverage since 2017 has remained above 5x and is elevated for the rating, but does not consider significant restricted reserves available for capital construction. Fitch expects leverage to begin gradually declining over the near term as the system has issued the largest amount of bonds to address its capital needs.

The system's declining leverage ratio is further supported by planned rate adjustments from fiscal 2023 to 2026, which provide an offset to increasing costs paid to wholesale providers and annual debt service requirements.

CREDIT PROFILE

The system provides retail water and sewer service to over 105,000 residential and commercial customers within the city. The city has water rights in Lake Arlington and its own water treatment facilities, but purchases raw water supplies on a wholesale basis from Tarrant Regional Water District (TRWD) through a long-term contract. Sewer system treatment service is provided through a long-term contract with the Trinity River Authority (TRA).

Fitch considers the system a related entity to the city for rating purposes, given the city's oversight of the system, including the authority to establish rates and direct operations. The city's credit quality does not currently constrain the bond rating. However, as a related entity, the issue ratings could become constrained by a material decline in the city's general credit quality.

KEY RATING DRIVERS

Revenue Defensibility 'aa'

Very Strong Revenue Defensibility

Utility rates are some of the lowest in the Dallas Metroplex and are affordable for the vast majority of the city population. The assessment is further supported by the monopolistic utility services and the city's legal independent ability to increase rates without external approval.

Operating Risks 'aa'

Very Low Operating Cost Burden

The system's operating cost burden is very low with moderate life cycle investment needs. The system's $179 million capital improvement plan (CIP) is modestly up from the prior year and expected to be about 40% debt funded.

Financial Profile 'aaa'

Leverage Expected to Gradually Decline

Leverage has seen moderate increases as the system has been accelerating capital investment, but is expected to gradually decline as projects related to system upgrades are completed over the near term. The liquidity profile is neutral to the assessment with current days cash on hand seeing moderate growth over last three years and coverage of full obligations (COFO) consistently above 1.3x.

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:

--Positive rating action is not applicable due to the 'AAA' rating.

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

--Sustained leverage above 5x, taking into consideration reserves for capital construction, particularly if near-term results do not point to declining leverage;

--A liquidity cushion that falls below 90 days could lead to an asymmetric risk and produce rating pressure.

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

The bonds are special obligations of the system, payable from and secured by a pledge of and first lien on net revenues of the system.

Revenue Defensibility

Revenue defensibility is very strong and assessed at 'aa' with all system revenue derived from services or business lines exhibiting monopolistic characteristics in a service area with favorable demographic trends. The city maintains independent rate setting authority without external approval, and the monthly combined water and sewer bill is considered affordable for the vast majority of the city population (about 85%) and revenue concentration among customers is limited at just 5%.

The system has a history of annual rate adjustments to keep pace with necessary increases related to purchased water and sewer service from its wholesale providers (TRA and TWRD) and produce stable financial margins. Despite above average rate increases adopted from 2017 to 2019, rates are still considered among the lowest in the Dallas Metroplex. Expected rate increases for wholesale services over at least the next few years are expected to be moderate, averaging about 3% annually through fiscal 2026 and limiting the need for rapidly increasing rates.

Rates were held flat for fiscal year 2022, and additional annual rate adjustments are expected to resume in fiscals 2023 at a modest 2%. Rates are expected to see annual increases of between 2.3% and 4.8% through fiscal 2026. Historically, the city council has voted to pass through rate adjustments related to wholesale services.

The city is located in the center of the Dallas-Fort Worth Metroplex. The close proximity to the Dallas-Fort Worth International Airport and a well-developed highway transportation network make the city a logical center for manufacturing, distribution, and trade. Its central location in the Metroplex has also led to the development of sizeable retail trade activity.

Operating Risks

The system's operating risk is assessed at 'aa' which takes into consideration a very low operating cost burden with modest life cycle investment needs. The system has been moving through an accelerated capital plan to address necessary upgrade and modernization at the system's water treatment facilities. The system has a favorable life cycle ratio of 34%, which has remained stable for the last three years. Capex routinely outpace depreciation which also supports the 'aa' assessment; favorable capex levels are expected to continue.

The system depends on wholesale providers for raw water purchases and wastewater treatment, which also influences annual operating costs. Both TRA and TRWD have been in capital intensive phases and each agency has total debt outstanding of about $1.1 billion. Arlington's share of TRA's debt registers about 26% while the system's share of TRWD's debt is about 17%. Both TRA's and TRWD's capital costs are included within the system's purchased services, but these amounts have not resulted in elevated costs. In fact, the system's operating cost burden is very low at $4,523 per million gallons in fiscal 2021 and allows for capacity to absorb continued moderate increases in expenses paid for wholesale services.

CIP spending for fiscal 2022 to 2026 totals $179 million and will be 44% debt financed. The plan includes spending for upgrades to a city owned water treatment plant, continued replacement of water and sewer mains, and implementation of enhanced technology, which includes advanced metering system.

Financial Profile

The financial profile is assessed at 'aaa'. Fiscal 2021, financial results are unaudited due to delays related to implementation on a new software system, but management informed Fitch that results are largely final. Fitch's leverage calculation of net adjusted debt to adjusted funds available for debt service was 6.0x at the end of 2021, but approximately

2.6x when incorporating restricted funds for capital. This level of leverage continues an overall trend of moderately increasing leverage over the last five audited fiscal years.

Cash balances are influenced by a city practice in which excess surplus revenues are transferred to the restricted capital construction fund to assist with paygo funding of capital and reduce debt financing. This results in strong restricted reserves for capital construction of about $243 million. The restricted construction funds also include unspent bond proceeds that have been issued for appropriated capital projects. The liquidity profile is neutral to the assessment with fiscal 2021 days cash on hand of 117 days, down modestly from the year prior, and COFO of 1.3x.

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's inputs that inform the base case are based on near final results for fiscal 2021, expected annual rate adjustments, adopted CIP and expected debt issuance. Additionally, Fitch made reasonable assumptions for operating expenses of around 4.4% based on the five-year CAGR.

Further, the FAST also assumes that funds restricted for capital construction will be used toward capital spending. Factoring in these assumptions, leverage is expected to gradually decrease yoy, trending below 5x in both the base and stress cases by fiscal 2023. Given the city's practice of transferring surplus revenues at year end to restricted accounts to support paygo spending, leverage that takes into consideration construction funds is more representative of the system's true leverage profile. Leverage including restricted construction funds has consistently remained under 3.5x which is supportive of the current assessment.

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

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
Arlington (TX) [Water, Sewer]			
Arlington (TX) /Water & Sewer Revenues/1 LT	LT	AAA Rating Outlook Stable Affirmed	AAA Rating Outlook Stable

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

Arlington (TX)	EU Endorsed, UK Endorsed

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