FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Arlington, TX Drainage Rev Bonds 'AAA'; Outlook Stable

Mon 15 May, 2023 - 9:36 AM ET

Fitch Ratings - Austin - 15 May 2023: Fitch Ratings has assigned a 'AAA' rating to the following city of Arlington, Texas (the city) bonds:

--Approximately $4.5 million municipal drainage utility system revenue bonds series 2023.

The bonds will be sold on June 6 via competitive bid. Bond proceeds will be used to pay for improvements to the city's municipal drainage system (the system) and issuance costs.

In addition, Fitch has affirmed the 'AAA' rating on the following bonds:

--$55.1 million in outstanding municipal drainage utility 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 standalone basis irrespective of its relationship with, and the credit quality of, the city of Arlington, TX (Issuer Default Rating AAA/Stable).

The Rating Outlook is Stable.

RATING ACTIONS

ENTITY / DEBT	RATING		PRIOR
Arlington (TX) [Stormwater]			
Arlington (TX) /Stormwater Revenues/1 LT	LT	AAA Rating Outlook Stable Affirmed	AAA Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

ANALYTICAL CONCLUSION

The 'AAA' bond rating and 'aaa' SCP reflect the system's exceptionally low leverage, as measured by net adjusted debt to adjusted funds available for debt service (FADS), within the framework of very strong revenue defensibility and very strong operating risk assessments, both assessed at 'aa'. The low cost of system maintenance provides it with a high degree of operating and financial flexibility. The revenue defensibility is supported by very stable revenue in the form of a fixed rate charge. The system has a long history of gradual rate adjustments that Fitch expects will continue to support capital needs.

The most recent city Comprehensive Stormwater Plan (CSP) was completed in April 2021, and spending over the coming five-year period will be higher than the past five years. Fiscal 2022 (FYE Sept. 30) leverage was 2.7x, and Fitch expects system leverage to remain stable, between 2.0x and 3.0x, over the coming five years as the system progresses through the CSP to increase resilience to flooding.

CREDIT PROFILE

The city established the system in 1990 to address damage to property caused by surface water overflows and surface water stagnation. The system serves over 104,000 accounts, which include residential, commercial and non-residential property within the city.

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 direct 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 rating could become constrained by a material decline in the general credit quality of the city.

KEY RATING DRIVERS

Revenue Defensibility 'aa'

Very Strong Revenue Defensibility Supported by Fixed Rate Structure

Revenue defensibility is very strong, supported by the city's favorable service area characteristics, very affordable rates and 100% monopolistic business service. The drainage fee, which in nominal dollars is very low, is a fixed charge and provides a very stable revenue stream.

Operating Risks 'aa'

Low Operating Risk

The system generally has limited operations and lacks measured flows. Consequently, Fitch has assessed operating risk at 'aa'. Annual capital spending on stormwater projects has gradually increased as the city has been addressing priority projects outlined in the system's CSP.

Financial Profile 'aaa'

Exceptionally Strong Financial Profile; Very Low Leverage

Despite recent debt issuances, system leverage is very favorable and is expected to remain stable. The liquidity profile is considered neutral to the assessment with coverage of full obligations (COFO) of 4.5x in fiscal 2022.

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:

--The rating is at the highest level on Fitch's scale and cannot be upgraded.

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

--Sustained leverage that exceeds 5.0x in Fitch's base and stress cases, assuming no change in revenue defensibility and operating risk assessments;

--Further escalation in capital spending without offsetting increases in revenues that weakens FADS.

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 secured by a first lien on the gross revenues of the system.

Revenue Defensibility

The system has a very stable and predictable revenue stream, with the system fee determined by the amount of impervious cover, in turn equating to an equivalent residential unit (ERU), and charged on the monthly combined utility bill. Nonpayment of any portion of the utility fees results in termination of water service. The assessment is also supported by a favorable service area that displays modest customer growth and income and unemployment levels largely in line with the nation. All revenue is derived from a monopolistic business line.

Starting in fiscal 2014, rates have been adjusted annually to support planned capital spending. The monthly fee for one ERU, which is low in nominal terms and considered affordable for the vast majority of the population (around 90%), registered $8.00 in fiscal 2022. The city expects to continue to gradually step up rates by $0.50 annually. Revenues from fees are collected almost equally between residential and commercial customers and revenue concentration among customers is limited at just 6%.

Operating Risks

Operating risk is assessed at 'aa' and reflects the system's moderate investment needs, limited operations and lack of measured flows. The system's life cycle ratio is favorable at 25% with five-year average capex to depreciation of 516%. The system's CSP was most recently updated in April 2021 and projects focus on making the city more resilient to flooding.

Since fiscal 2016, capital spending has seen steady increases to address flood and erosion mitigation but needs are considered manageable. The CSP points to annual capital spending of between $15 million and $26 million. The fiscal 2023-2026 capital improvement plan (CIP) totals about $98 million. The current offering provides about a quarter of the funding for planned fiscal 2023 capital spending of $19 million.

Financial Profile

The financial profile is assessed at 'aaa'. The system's historically exceptionally low leverage ratio has grown over the last several years as investment in capital funded by debt continues. The leverage ratio also increased by the reclassification of cash balances into restricted funds in fiscal 2018 to align accounting methodologies with the water and sewer utility system.

Fiscal 2022 leverage increased slightly to 2.7x from 2.2x the year prior as the city did not complete its typical practice of transferring surplus funds to restricted accounts in fiscal 2021. Based on expected capital spending, combined with planned debt, Fitch expects leverage will be maintained at 2.0x to 3.0x over the next several years, consistent with the current assessment.

Liquidity is neutral to the assessment. Nevertheless, financial metrics are strong with COFO typically between 3.5x and 4.5x since fiscal 2018. Fitch calculated all-in debt service coverage is stronger at 5.1x, as it excludes net transfers. Fiscal 2022 current days cash on hand fell to 65 days from 1,050 days the year prior as the system continued its typical practice of transferring surplus funds to restricted accounts. Management expects this transfer to continue to occur, keeping cash low. Nevertheless, financial ratios and margins are very healthy as the fixed revenue stream and low maintenance cost of this type of utility provide the system with high degree of operational and financial flexibility.

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 and CIP and included the current and planned debt issuances in formulating the FAST base case scenario. Fitch made additional reasonable assumptions surrounding expenditure growth at about 5.9% annually.

Factoring in these assumptions, leverage is expected to hover between 2.2x to 2.4x in the base case and 2.4x to 3.0x in the stress case, which is supportive of the assessment. The liquidity profile is expected to remain neutral to the assessment with COFO of at least 3.0x and sound cash levels.

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.

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APPLICABLE CRITERIA

U.S. Water and Sewer Rating Criteria (pub. 03 Mar 2023) (including rating assumption sensitivity)

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 27 Apr 2023) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Arlington (TX)	EU Endorsed, UK Endorsed

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