FitchRatings

RATING ACTION COMMENTARY

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

Fri 12 May, 2023 - 5:33 PM ET

Fitch Ratings - Austin - 12 May 2023: Fitch Ratings has assigned a 'AAA' rating to the following city of Arlington, TX (the city) revenue bonds:

--Approximately $ 6,920,000 water and wastewater system revenue bonds, series 2023A;

--Approximately $10,825,000 water and wastewater system revenue refunding bonds, series 2023B.

The bonds will be sold on June 7 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':

--$223,610,000 (prefunded) 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 [IDR] AAA/Stable).

The Rating Outlook is Stable.

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

ANALYTICAL CONCLUSION

The system's AAA bond rating reflects exceptionally low leverage, measured as net adjusted debt to adjusted funds available for debt service (FADS), 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.

Leverage was 4.2x in fiscal 2022 (FYE September 30), supported by strong FADS production and a modest decline in net adjusted debt for the year. Absent the most recent fiscal year, leverage from 2018 to 2021 has remained above 5x and is slightly elevated for the rating, but does not consider significant restricted reserves available for capital construction; inclusive of those funds leverage is materially lower. The city's practice is to transfer surplus funds each year into the restricted construction fund to address pay-go capital needs.

Fitch expects leverage to remain generally stable as the system continues to execute its capital improvement plan (CIP). The majority of bonds being used to fund upgrades at its water treatment facilities have been issued and work on the projects continues to be completed. Additionally, stable leverage is supported by planned rate adjustments from fiscal 2023 to 2026 that 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 104,000 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; IDR AA+/Stable) through a long-term contract. Sewer system treatment service is provided through a long-term contract with the Trinity River Authority (TRA; wastewater rev. bonds AAA/Stable).

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 rating could become constrained by a material decline in the city's general credit quality.

KEY RATING DRIVERS

Revenue Defensibility 'aa'

Very Strong Revenue Defensibility

System 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. Future rate adjustments are expected to keep pace with wholesaler rate increases yet system user charges should remain affordable for the vast majority of the population.

Operating Risks 'aa'

Very Low Operating Cost Burden

The system's operating risk is very strong support by a very low operating cost burden, lowlife cycle ratio and moderate investment needs. The system's $251 million CIP is up from the prior year with inflationary cost increases and as it remains in a capital-intensive period, yet remains manageable. It is expected to be about 50% debt funded.

Financial Profile 'aaa'

Leverage Expected to Gradually Decline

System leverage improved in fiscal 2022 to 4.2x reflecting of strong demand. Leverage will likely approach 5.0x in next one to two years as the system executes its CIP, but then begin a gradual decline thereafter. The liquidity profile is neutral to the assessment with 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:

--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 above 5.0x, 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 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 (around 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 produces stable financial margins. Despite above average rate increases adopted from 2018 to 2019, rates are still considered among the lowest in the Dallas Metroplex. Rates were held flat for fiscal years 2020 and 2021, and annual rate adjustments resumed in fiscal 2022 at 4.5% and a 2% rate increase was adopted in 2023. Rates are anticipated to continue to see modest annual adjustments ranging from about 2% to 6.7% through fiscal 2027. 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 with favorable demographic trends. The service area exhibits stable customer growth of 0.7% five-year total compound average growth rate and area income levels and unemployment are on par with the national averages. 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 very strong reflecting a very low operating cost burden with modest 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%. Capex routinely outpaces depreciation which also supports the assessment and 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 billion. Arlington's share of TRA's debt registers about 25% while the system's share of TRWD's debt is about 15%. 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 $4,045 per million gallons in fiscal 2022 and allows for capacity to absorb continued moderate increases in expenses paid for wholesale services.

CIP spending for fiscal years 2023 to 2027 totals about $250 million and will be about 50% 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 exceptionally strong. System leverage declined in fiscal 2022 to 4.2x, bolstered by a strong financial margin due to high demand during a hot dry summer. This level of leverage reversed a trend of moderately increasing leverage over the last several fiscal years that reached 6.1x in fiscal 2021.

Cash balances are influenced by a city practice in which excess surplus revenues are transferred to the restricted capital construction fund to assist with pay-go funding of capital and reduce debt financing. This results in strong restricted reserves for capital construction of about $232 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 2022 current days cash on hand of 95, down from the year prior, and COFO of 1.9x. Fitch calculated all-in debt service coverage is much higher at 3.2x, as it excludes the fixed services expense and net transfers.

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 expected annual rate adjustments, the adopted CIP, increasing wholesale provider costs that result in total operating expenses increasing around 6% annually, and expected debt issuance. Further, the FAST also assumes that funds restricted for capital construction will fund a portion of capital spending.

Factoring in these assumptions, leverage initially increases to 4.9x and 5.1x in the second year of the base and stress cases, respectively, but then gradually decreases thereafter reaching 3.8x by fiscal 2027 of the base case and 4.0x in the stress case. In both cases, the leverage metric is supportive of the current assessment. Given the city's practice of transferring surplus revenues at YE to restricted accounts to support pay-go spending, leverage that takes into consideration construction funds is consistently under 3.0x. The liquidity profile is expected to remain neutral to the assessment with COFO of at least 1.5x and sound liquidity 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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