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CREDIT OPINION
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Arlington (City of) TX Muni.Drainage Util.

Update to credit analysis

Summary

Arlington TX's Municipal Drainage Utility (Aa1 stable) benefits from a large and diverse service area despite its limited operations that are characteristic of a stormwater system. The credit profile is further bolstered by strong debt service coverage. Unrestricted liquidity (used for the days cash on hand ratio) is very weak for the rating category, but the system has access to restricted liquidity for operations if needed. The debt profile is growing but has been affordable because of rate increases, which continued in fiscal 2023, and legal provisions protecting bondholders are adequate.

Credit strengths

- Gross revenue pledge
- Strong debt service coverage

Credit challenges

- Weak unrestricted liquidity and days cash on hand ratio
- Capital improvement plan will require additional debt
- Springing debt service reserve fund

Rating outlook

The stable outlook reflects the expectation that the system will continue to be conservatively managed and debt service coverage will remain strong, supported by rate increases to support the 10 year capital plan.

Factors that could lead to an upgrade

- Significant improvement in days cash on hand
- Reduction in the debt to operating revenue ratio
- Strengthening of the legal structure

Factors that could lead to a downgrade

- Further decline in days cash on hand
- Trend of narrowing debt service coverage
- Material increase in debt to operating revenue

Key indicators

Exhibit 1

Arlington (City of) TX Muni.Drainage Util.					
System Characteristics					
Asset Condition (Net Fixed Assets / Annual Depreciation)	53 years				
System Size - O&M (in $000s)	$4,593				
Service Area Wealth: MFI % of US median	90.2%				
Legal Provisions					
Rate Covenant (x)	1.10				
Debt Service Reserve Requirement	DSRF funded at less than 3-prong test OR springing DSRF (A)				
Management					
Rate Management	Aa				
Regulatory Compliance and Capital Planning	Aa				
Financial Strength					
	2018	2019	2020	2021	2022
Operating Revenue ($000)	$16,384	$18,014	$19,650	$20,526	$22,072
System Size - O&M ($000)	$3,903	$3,597	$4,290	$4,273	$4,593
Net Revenues ($000)	$12,731	$15,020	$15,428	$16,339	$22,406
Net Funded Debt ($000)	$29,647	$34,236	$42,672	$47,412	$53,147
Annual Debt Service ($000)	$2,748	$3,188	$3,711	$4,065	$4,566
Annual Debt Service Coverage (x)	4.6x	4.7x	4.2x	4.0x	4.9x
Rate Covenant	1.10	1.10	1.10	1.10	1.10
Cash on Hand	125 days	217 days	230 days	1049 days	65 days
Debt to Operating Revenues (x)	1.8x	1.9x	2.2x	2.3x	2.4x

Sources: Arlington (City of) TX's financial statements and Moody's Investors Service

Profile

Arlington is in the center of the Dallas (A1 stable)/Fort Worth (Aa3 stable) metroplex. The city encompasses 99.5 square miles and has a current population of approximately 397,000. The city operates its municipal drainage system as a self-supporting enterprise fund. The drainage utility was established in August of 1990 to protect the public health and safety from loss of life and property caused by surface water overflows and surface water stagnation.

Detailed credit considerations

Service area and system characteristics

The drainage system benefits from a modestly growing customer base and revenue that is derived from a diverse base of accounts. Residential and commercial rates are billed monthly through the city's utility billing system. Collection of fees is strong because of strong enforcement mechanisms; failure to pay may result in discontinuance of any utility service provided by the city. Residential properties are charged a flat monthly fee while commercial properties are charged based on the amount of impervious area square footage. Residential drainage utility customers account for about 95% of the customer base based on number of accounts, though total revenue is split more evenly between residential and commercial customers. The system's historical number of accounts has been growing modestly over the past five years (averaging less than 1% annually), and as of fiscal 2022 totaled 104,591 accounts. The top 10 drainage utility customers usually account for about 5% of annual operating revenue.

Debt service coverage and liquidity

Debt service coverage will remain healthy because we expect rate increases to be approved to finance the growing debt profile. The city has increased rates annually since 2014 (including in fiscal 2023) and will continue to do so, as needed, in accordance with the 10 year capital improvement plan. The fee is $8.50 as of fiscal 2023. The city plans to propose a $0.50 fee increase for fiscal 2024, and will continue the $0.50 incremental increases to reach a targeted fee of $10.

In fiscal 2022 (Sept. 30 year-end), debt service coverage based on the legal security of gross revenues produced strong coverage of 5.9x debt service. Despite the gross revenue pledge, Moody's also assesses debt service coverage based on net revenues given the operating costs of the system will continue. Fiscal 2022 net revenue produced coverage that was still strong at 4.9x debt service. Through the first quarter of fiscal 2023, revenue is about $82,000 under budget and expenses are tracking close to budget.

Liquidity

The days cash on hand ratio declined materially in fiscal 2022 from the prior year because of the transfer of excess unrestricted cash to restricted cash for construction; this is a normal annual practice, but the transfer was not made in 2021. Unrestricted cash was just $822,000 (65 days) in fiscal 2022. Unrestricted cash will likely remain narrow, but the city also has additional cash and investments that are restricted for construction but are available for operations if needed.

Further, the city continues to maintain significant additional resources outside of the system but available for any city need, most notably through the Arlington Tomorrow Foundation Fund, which had net position of $75.1 million in fiscal 2022. This is down from last year because some money was spent for capital projects and there was also a $12 million unrealized loss in securities due to declines in the stock market. Derived from natural gas bonus payments and royalties received by the city, the foundation is controlled by a board, made up of the city council and an executive director that is an employee of the city. This fund provides substantial operating flexibility given a super-majority vote of city council could enable it to be used for any lawful purpose of the city.

Debt and legal covenants

The drainage utility's debt burden has been increasing over the past several years but remains on par with the national Aa1 median. Debt to operating revenue was 2.4x in fiscal 2022, up from 1.8x in fiscal 2018. The city will continue to fund projects in its 10 year capital plan pay-go and with debt, so we expect this metric will continue to grow. However, the city will evaluate the plan annually and will propose more rate increases, as discussed above.

The bonds are secured by first lien on gross revenues of the system; therefore, debt service payments are the highest priority in the flow of funds. Under the bond indenture, the city covenants to set rates sufficient to yield net revenues that provide 1.1x maximum annual debt service (MADS) coverage. To issue additional parity debt, gross revenues must provide 1.25x MADS coverage of current and proposed debt. The bond ordinance further requires the maintenance of a debt service reserve fund equal to maximum annual debt service should debt service coverage fall below 2.0x. The reserve fund may be funded over a period of 60 months, with plans to use cash.

Legal security

The bonds are payable from a first lien on the gross revenues of the drainage system.

Debt structure

It is the city's practice to issue debt with level principal payments over twenty years. Principal amortization is relatively fast with 66% retired within 10 years.

Debt-related derivatives

The drainage system is not a party to any derivative agreements.

ESG considerations

Arlington, TX municipal drainage utility's ESG credit impact score of CIS-2 indicates that ESG considerations have a neutral-to-low impact on its credit rating. This reflects neutral-to-low exposure to environmental and social risks and positive governance considerations.

Environmental

The utility's credit exposure to environmental risks is neutral-to-low (E-2), reflecting neutral-to-low exposure to physical climate risks, carbon transition, water management, natural capital, and waste and pollution considerations.

Social

The utility's credit exposure to social risks is neutral-to-low (S-2), reflecting neutral-to-low exposure to demographic and societal trends, customer relations, human capital, health and safety, and responsible production considerations. Population and the labor force have been growing, though the city's median family income as a percentage of the state and national medians has been modestly declining for the past few decades. Housing costs remain affordable compared with the US median.

Governance

The utility's governance considerations are positive (G-1). The system benefits from positive financial strategy and risk management practices and positive management credibility and track record considerations. The system has neutral-to-low exposure to organizational structure and compliance and reporting considerations. Utilities overseen by a municipal government have moderately negative exposure to board structure, policies and procedures risk resulting from concentrated control by a city or county government.

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