

CREDIT OPINION

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Arlington (City of) TX Water & Sewer Ent.

Update to credit analysis

Summary

[Arlington, TX's Water and Sewer Enterprise](#) (Aa1 stable) benefits from a large and diverse service area and a low debt profile due to a practice of cash funding much of the capital improvement plan. Debt service coverage improved in fiscal 2022 and it should remain strong despite continue debt and pay-go capital because of scheduled rate increases through fiscal 2028. The credit profile is constrained by its narrow unrestricted cash position relative to peers but the city has other reserves available that can support operations if needed, and there is also substantial liquidity held outside the enterprise that is available if needed.

Credit strengths

- » Large and diverse service area
- » Healthy debt service coverage

Credit challenges

- » Narrow unrestricted cash position relative to rated peers
- » Increasing but manageable debt to revenue ratio

Rating outlook

The stable outlook reflects the expectation that the system will continue satisfactory operations and cash will remain adequate. Further, continued annual rate increases will help to support future debt and pay-go capital plans.

Factors that could lead to an upgrade

- » Large and sustained increases to system liquidity
- » Material improvement in debt service coverage
- » Strengthening of the legal structure

Factors that could lead to a downgrade

- » Trend of narrowing debt service coverage
- » Decreased available liquidity
- » Material increase in the debt to revenue ratio

Key indicators

Exhibit 1

Arlington (City of) TX Water & Sewer Ent.					
System Characteristics					
Asset Condition (Net Fixed Assets / Annual Depreciation)	39 years				
System Size - O&M (in \$000s)	\$95,611				
Service Area Wealth: MFI % of US median	90.2%				
Legal Provisions					
Rate Covenant (x)	1.25				
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)	\$155,958	\$155,189	\$165,047	\$169,901	\$192,877
System Size - O&M (\$000)	\$85,201	\$87,752	\$89,878	\$98,379	\$95,611
Net Revenues (\$000)	\$72,357	\$71,510	\$76,973	\$72,413	\$91,512
Net Funded Debt (\$000)	\$210,181	\$296,001	\$272,314	\$296,171	\$292,690
Annual Debt Service (\$000)	\$21,776	\$24,889	\$30,972	\$26,169	\$30,500
Annual Debt Service Coverage (x)	3.3x	2.9x	2.5x	2.8x	3.0x
Rate Covenant	1.25	1.25	1.25	1.25	1.25
Cash on Hand	109 days	133 days	137 days	118 days	93 days
Debt to Operating Revenues (x)	1.3x	1.9x	1.6x	1.7x	1.5x

Sources: US Census Bureau, Arlington (City of) Water and Sewer Enterprise, 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 water and sewer enterprise provides treated water and wastewater collection for about 113,000 accounts within the city on a retail basis and a growing but small number of wholesale customers from the system's excess supply.

Detailed credit considerations

Service area and customer base: sufficient capacity to meet modestly growing customer base

Arlington's water and sewer enterprise benefits from a modestly growing customer base and excess water treatment capacity the city is leveraging to increase revenue. Residential water utility customers account for 96% of the customer base by count of units served and 69% of average daily water consumption. The system's historical number of customers has been modestly growing over the past five years, and at present is equal to just under 113,000 accounts. Given the largely residential customer base, the top 10 water customers account for less than 10% of revenue.

The city contracts for raw water and wastewater treatment from large and stable entities. The city obtains most of its untreated water from the Tarrant Regional Water District's (TRWD) surface reservoirs. TRWD estimates sufficient supply through 2040 to meet the needs of Arlington and other municipal participants, although is currently in a planning stage to extend that estimation through 2070. The treatment of raw water is provided by two city owned treatment facilities that have a combined capacity of 172.5 million gallons

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a day (MGD). The capacity well exceeds the maximum daily pumpage of 105.1 MGD in fiscal 2022, and the peak of 115 MGD in fiscal 2011. The projected peak demand at build-out is 133.4 MGD.

Wastewater is treated by the Trinity River Authority (TRA) at its central regional facility. City officials believe that TRA has enough treatment capacity to serve the city's present and foreseeable future needs.

Debt service coverage and net working capital: planned rate increases will keep coverage healthy

Debt service coverage will remain sound because of planned annual rate increases through fiscal 2028 (ranging from 1.9% to 6.7%). In fiscal 2022 (Sept. 30 year-end), coverage improved to 3.0 times, up from 2.8 times in fiscal 2021. The city adopted a 2% rate increase in fiscal 2023 and through the first quarter, revenue is over budget and expenses are under budget because of savings in treatment costs. Management will continue to transfer most of the surplus to various capital reserves.

The system's coverage calculation does not specifically segregate the city's share of debt issued by TRWD and TRA related to infrastructure improvements to access to raw water supply and wastewater treatment, respectively. While the debt is not a debt of the city, a portion of the debt service is passed to the city as an operating expense under the city's contract with the water district and the authority, and is combined with their respective bills for purchase of untreated water and wastewater treatment. Being an operating expense, which is paid before any direct revenue bonds debt service, any cost increases related to either the additional cost of raw water or further infrastructure spending, is passed on to customers and built into the rate setting models of the city.

Liquidity

Unrestricted cash and investments totaled \$24.4 million in fiscal 2022 (93 days), down from \$31.4 million last year because some unrestricted funds were moved to capital reserves. The city has a policy of maintaining unrestricted reserves equal to 60 days of operating expenses and a target rate stabilization fund of approximately 18 days of expenses, for a combined targeted unrestricted reserve of 78 days of expenses.

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: increasing but manageable debt profile; adequate legal covenants

The debt profile will remain manageable despite future debt plans because of fast payout and planned rate increases. Because of strong revenue growth, the fiscal 2022 debt to operating revenue fell to 1.5x which is slightly below the national median of rated peers. The capital improvement plan from 2023 to 2027 includes \$251.3 million in planned capital expenditures, of which approximately 53% will be debt funded and the remaining portion will be funded with cash and bond proceeds from prior issuances. Historically, management has opted to forgo debt issuance when revenue significantly exceeds the budget, therefore the funding mechanism for the capital improvement plan could shift.

Legal provisions provide adequate bondholder security. The rate covenant requires net revenues to produce 1.25 times average annual debt service. The debt service reserve fund is equal to average annual debt service funded over 24 months and was fully funded with cash as of fiscal 2017. The additional bonds test requires 1.25 times average annual debt service. Finally, excess revenue may be used for any lawful purpose.

Legal security

The bonds are payable from a first lien on the net revenues of the combined water and wastewater utility system.

Debt structure

It is the city's practice to issue debt with level principal payments over twenty years. Principal retirement is relatively fast with 67% of repaid within 10 years.

Debt-related derivatives

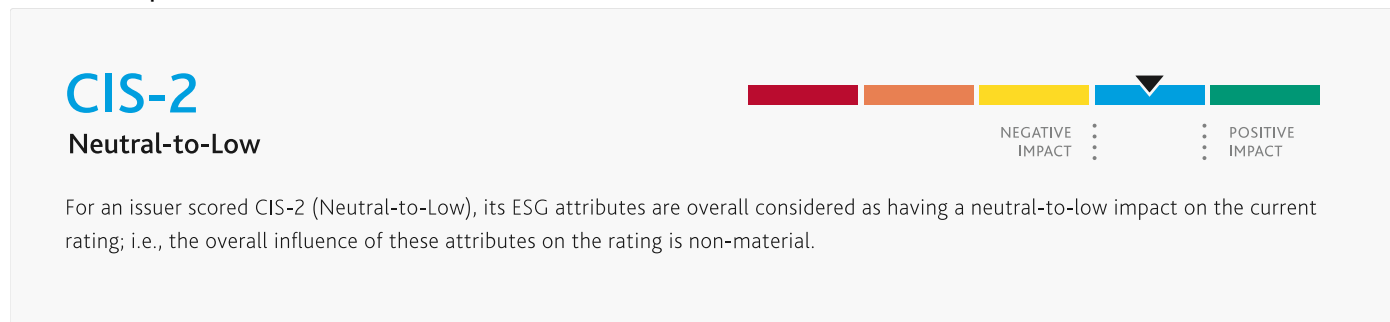
The utility system is not a party to any derivative agreements.

ESG considerations

Arlington (City of) TX Water & Sewer Ent.'s ESG Credit Impact Score is Neutral-to-Low CIS-2

Exhibit 2

ESG Credit Impact Score



Source: Moody's Investors Service

Arlington, TX water and sewer enterprise's ESG credit impact score of **CIS-2** indicates that ESG considerations have a neutral-to-low impact on its credit rating. This reflects moderately negative exposure to environmental and social risks and positive governance considerations.

Exhibit 3

ESG Issuer Profile Scores



Source: Moody's Investors Service

Environmental

The system's credit exposure to environmental risks is moderately negative (**E-3**), reflecting moderately negative exposure to water management risk. Wastewater and combined water and wastewater utilities have moderately negative exposure to water management considerations given the risk of potential regulatory violations associated with wastewater disposal. Wastewater operations face risks of increased operating costs or capital requirements in addressing any future violations. The system is not in violation of any regulations. The system has neutral-to-low exposure to other environmental considerations, including physical climate risks, carbon transition, natural capital, and waste and pollution.

Social

The system's credit exposure to social risks is moderately negative (**S-3**). Water utilities have moderately negative exposure to responsible production risk. Testing results reported to the Environmental Protection Agency indicate that most utilities provide clean and safe drinking water. Still, while the system does not currently have any violations, water utilities are at risk of health violations resulting from catastrophic events, changes in source water quality, failures in treatment or transmission processes or revised regulations. The system has neutral-to-low exposure to demographic and societal trends, customer relations, human capital, and health and safety considerations.

Governance

The system's governance considerations are positive (**G-1**). The system benefits from positive financial strategy and risk management considerations 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.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click [here](#) to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

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