

# RatingsDirect®

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## Summary:

# Garland, Texas; Water/Sewer

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### Credit Profile

US\$48.735 mil wtr & swr rev rfdg bnd ser 2019A dtd 12/01/2019 due 03/01/2040

<i>Long Term Rating</i>	AA-/Stable	New
Garland CP		
<i>Short Term Rating</i>	A-1+	Affirmed
Garland WS		
<i>Long Term Rating</i>	AA-/Stable	Downgraded
Garland WS		
<i>Long Term Rating</i>	AA-/Stable	Affirmed

## Rationale

S&P Global Ratings lowered its long-term rating on Garland, Texas' senior-lien water and sewer system revenue debt to 'AA-' from 'AA'. At the same time, we assigned our 'AA-' long-term rating to the city's new series 2019A water and sewer system revenue refunding bonds. We also affirmed our 'AA-' long-term rating on the city's subordinate-lien debt outstanding. In addition, we affirmed our 'A-1+' rating on the system's series 2015 commercial paper (CP) program. The outlook is stable.

Because the system's senior lien is legally closed and represents a small portion of the system's total debt outstanding, we no longer make a rating distinction between the two liens based on the application of our criteria, "Assigning Issue Credit Ratings of Operating Entities" (published May 20, 2015, on RatingsDirect). The downgrade of the system's senior-lien debt also reflects our view of its thin historical and projected all-in debt service coverage (DSC) metrics of about 1.1x, which is not supportive of the prior rating. The 'AA-' senior-lien rating reflects our opinion of the system's general creditworthiness (issuer credit rating [ICR]) based on the application of our criteria, "Rating Methodology And Assumptions For U.S. Municipal Waterworks And Sanitary Sewer Utility Revenue Bonds" (published Jan. 19, 2016). In 2014, the city closed its senior lien, of which about \$44 million will be outstanding after this refunding.

All-in DSC is S&P Global Ratings' adjusted DSC metric that takes into account all long-term financial obligations of the utility system regardless of lien or accounting treatment, such as general obligation (GO) debt supported by the system or take-or-pay minimum payments. We also treat transfer payments as if they were operating expenses.

The rating also reflects our view of the city's extremely strong enterprise risk profile and strong financial risk profile.

The 2019A bonds proceeds will refund the series 2010 and 2011A bonds for interest cost savings, and convert a portion of the water and sewer system's CP notes outstanding to long-term debt. The system had \$201.3 million in total debt as of Sept. 30, 2018, including \$7.2 million in GO debt. Garland established the \$90 million CP program in 2015 as an interim funding mechanism for its capital improvement plan (CIP). The CP rating is based on the general

creditworthiness of the city's utility system. The 'AA-' rating correlates to an 'A-1+' CP rating based on our criteria. We understand that CP payments will be junior to the subordinate lien.

The enterprise risk profile reflects our view of the following credit factors utility system's:

- Service area participation in the broad and diverse Dallas-Fort Worth-Arlington metropolitan statistical area (MSA) economy, one that we believe remains strong;
- Operational management assessment (OMA) of strong, which, in our view, reflects its role as a distributor of North Texas Municipal Water District (NTMWD) treated water, greatly reducing operational and financial risk to the city, its strong rate-setting practices including projected annual retail rate increases, and the system's strategic planning practices;
- Very strong market position with combined water and sewer rates that are 2.25% of the city's median household effective buying income (MHHEBI) when annualized and reflect the recent 5% reduction in wholesale water costs for fiscal 2019 (Garland is one of four NTMWD member cities that, in late 2016, petitioned the state public utility commission [PUC] to review the district's wholesale water rates, but the PUC has not ruled on the petition); and
- Very low industry risk as a monopolistic service provider of an essential public utility.

The financial risk profile reflects our view of the Garland utility system's:

- All-in DSC that we believe remains thin for the rating at about 1.1x, as the city must cover recurring, fixed take-or-pay annual water purchases in addition to annual debt service requirements;
- Very strong liquidity and reserves, as evidenced by maintaining at least four months of liquidity on hand over the past three years and supported by Garland's willingness to adjust not only base rates but pass through wholesale increases from its treated water provider;
- Strong financial management practices and policies, indicating that internal financial controls and best practices are well embedded across the city, including in the water and wastewater funds; and
- Strong debt profile, with a debt-to-capitalization ratio at 46% in fiscal 2018, which we believe will increase steadily as the system debt-finances the majority of its CIP.

While there is a debt service reserve fund for the senior-lien bonds, there is no such fund for the subordinate lien. Given the utility's consistently solid liquidity and reserves, however, we do not view this as a credit weakness. The 2014 master resolution covenants that management set rates to achieve budgeted DSC of at least 1.25x average annual debt service, at which point it can issue additional junior-lien bonds.

### **Enterprise risk**

The city, with an estimated population of 246,200, provides retail water and sewer service to almost 69,500 metered accounts in the largest suburb in Dallas County. It also provides wholesale sewer service to all of nearby Rowlett and Sachse and portions of Sunnyvale, Richardson, and Dallas. Besides its participation in the Dallas MSA, Garland has its own deep and mature employment base, with income indicators at 96% of the national level and a low 3.6% unemployment rate for 2018. Leading employment sectors in the city include a deep and diverse manufacturing component, warehousing and distribution, and retail, including a destination retail center anchored by Bass Pro Shops.

Given Garland's largely built-out status of development and its treated water counterpart, the system's CIP has been generally limited to infrastructure rehabilitation and replacement, areas in which it has historically been proactive. This has allowed rates to remain relatively affordable. Based on S&P Global Ratings' universal assumption of 6,000 gallons of residential service, a monthly water and sewer bill is about \$91.49, or 2.25% of its 2018 MHHEBI. Aside from fully recouping any cost increases in wholesale water, the city reviews and adjusts rates regularly, generally implementing base-rate adjustments at least in line with inflation. In fiscal 2019, NTMWD approved a new budgeting methodology based on budgeting 90% of contractual minimum water purchases, which has resulted in net savings for members. For example, the wholesale rate decreased 5% in fiscal 2019 to \$2.92 per 1,000 gallons. However, wholesale rates are projected to rise annually, along with Garland's retail water and sewer rate increases ranging between 2% and 5% annually through fiscal 2024.

Garland is a full-requirements water customer, and member city of NTMWD. It owns and operates two wastewater treatment plants that serve not only the city, but also neighboring Rowlett and Sachse and small portions of Dallas, Richardson, and Sunnyvale. Because the city receives all its treated water from the district, its operational requirements are limited mainly to its underground infrastructure and storage. The treated water contract includes a take-or-pay minimum to the district, determined mainly by Garland's historical peak demand. NTMWD has recently faced interrelated challenges primarily reflecting growth. This has had significant effects on wholesale rates, but more recently, NTMWD slightly revised their budget methodology providing a small wholesale rate decrease, which benefits all member cities. In 2013, the district constructed a \$300 million, 46-mile pipeline to deliver water from Lake Texoma, which provides 28% of the district's total raw water supply directly to its main water treatment plant in Collin County, rather than transferring the Lake Texoma water to the district's main reservoir, Lake Lavon. The pipeline became necessary to prevent a nonnative, invasive species of zebra mussel already in Lake Texoma from spreading to Lake Lavon.

Increasing wholesale costs led four of the district's most built-out members--Garland, Richardson, Plano, and Mesquite--to ultimately ask the Texas PUC in late 2016 to review the district's rates. We understand that NTMWD and cities are engaging in discussions outside the PUC case to resolve the dispute. Although the city cannot predict neither the timing nor the outcome, we don't believe this affects the city's or district's credit quality. As of Oct. 17, 2019, NTMWD's key reservoir, Lake Lavon, is 78% full, and Lake Texoma is 98% full. Garland has the authority to implement voluntary or mandatory water conservation measures at any time, even if the district doesn't ask it to.

Based on our OMA, we view Garland to be a '1' on a six-point scale on which '1' is the strongest. In our opinion, this indicates the strongest alignment of operations and organizational goals. The strong OMA includes our view of the city's role as a distributor of NTMWD treated water, which greatly reduces operating and financial risk to Garland. In addition, the city has established a robust demand-side management program--including for times of drought--and has very low nonrevenue water. Also, we understand that Garland completed a 10-year, proactive voluntary program in 2017 to reduce sanitary sewer overflows; the collection and wastewater treatment system fully complies with all applicable environmental requirements and continues to have sufficient treatment capacity.

Consistent with our criteria "Methodology: Industry Risk" (published Nov. 19, 2013), we consider industry risk for the system very low, the most favorable assessment possible on a six-point scale on which '1' is the best.

## Financial risk

In our view, all-in DSC remained at a thin 1.1x for fiscal 2018, a level we consider low for the rating. The all-in coverage ratio is S&P Global Ratings' internally adjusted DSC calculation that treats certain recurring debt-like obligations, such as take-or-pay minimum or capacity payments, as if they were actually debt, because NTMWD essentially has issued debt on Garland's behalf to build the regional infrastructure. Although the city also has historically limited transfer payments from the water and sewer funds to formulaic payment in lieu of taxes, we also consider net transfers part of this adjusted coverage metric because they are a recurring use of utility operating revenue. Actual annual DSC is stronger, generally 1.4x or better over the past four audited fiscal years, and our review of the city's financial forecast indicates maintaining all-in DSC at around 1.1x through fiscal 2024. Even with the pressure on net margins, however, system liquidity of almost \$30 million or equal to a very strong 122 days' cash on hand for fiscal 2018 is well above management's policy-mandated level of available reserves equivalent to at least 45 days of operating expenses.

We consider the system's debt burden to be moderate with a 46% debt-to-capitalization ratio in fiscal 2018. Although the five-year CIP for both the water and sewer systems of about \$258 million through fiscal 2024 will be mostly debt-financed, we believe the city's willingness to adjust rates will allow the system to sustain its financial metrics. However, we also believe the additional debt will likely limit any material improvement in all-in DSC.

We do not view the CP program as introducing a contingent liquidity risk for the utility system because we view the city as having market access commensurate with its high rating. If it is unable to issue debt--likely due to market dislocation or other events or circumstances but through no fault of the city that would be considered an automatic termination event--it has an agreement with Sumitomo Mitsui Banking Corp. (A-1), acting through its New York Branch, to provide additional liquidity to match the \$90 million authorization of the CP program. Since this letter of credit (LOC) is effectively acting as a standby note purchase agreement rather than a direct-pay LOC, and because the CP is payable first from funds supplied by the city, we view the Sumitomo agreement as supplementing the city's water and sewer funds' on-balance-sheet liquidity but not ultimately the driver for the CP rating. Our rating approach instead treats the CP as backstopped by self-liquidity, giving credit to the city's liquidity from the committed Sumitomo line. The aggregate amount of the CP notes cannot exceed the stated amount of the Sumitomo line. The Sumitomo agreement is in place through Sept. 30, 2023, matching the authorizing resolution of the CP program.

Based on our FMA, we view Garland to be a '1' on a six-point scale on which '1' is the strongest. An FMA of strong indicates our view that practices are strong, well embedded, and likely sustainable. The city maintains most of the best practices we consider critical to supporting credit quality and these are well embedded in the utility's daily operations and practices. Formal policies support many of these activities, increasing the likelihood that these practices will continue and transcend changes in the operating environment or personnel. This includes a well-defined long-term CIP, supported by a financial forecast that estimates the effect on rates and the likelihood of additional debt. The city's finance team also regularly monitors and reports on budget-to-actual performance and bases all budgets and forecasts on what we view as reasonably conservative assumptions.

## **Outlook**

The stable outlook reflects the system's plans to raise water and sewer rates annually to support its CIP and allow the system to maintain its historical financial margins.

### **Downside scenario**

We could lower the rating over the next two years if all-in DSC weakens and becomes more of an outlier at the current rating level, or if our assessment of the system's market position weakens as retail water and sewer rates increase while city income levels remain flat.

### **Upside scenario**

We do not anticipate raising the rating because of the system's historically thin all-in DSC for the rating and its capital needs which will likely limit material improvement in its financial metrics.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column.

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