

RatingsDirect®

Summary:

Mesquite, Texas; Water/Sewer

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Summary:

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Credit Profile

US\$10.24 mil wtrwks and swr sys rev rfdg and imp bnds ser 2018 dtd 05/01/2018 due 02/15/2038

Long Term Rating AA/Stable New

Mesquite wtrwks

Unenhanced Rating AA(SPUR)/Stable Affirmed

Rationale

S&P Global Ratings assigned its 'AA' rating to Mesquite, Texas' series 2018 waterworks and sewer system revenue refunding and improvement bonds. At the same time, we affirmed our 'AA' rating on the city's existing waterworks and sewer system revenue debt. The outlook is stable.

The ratings reflect our opinion of the system's very strong enterprise risk profile, including its:

- Stable, primarily residential, customer base that benefits from its participation in the strong, broad and diverse Dallas metropolitan statistical area (MSA);
- Role as a distribution and collection-only system; treatment is provided by the North Texas Municipal Water District (NTMWD), which greatly reduces operational risk to the city--although Mesquite is one of four NTMWD member cities that in late 2016 petitioned the state public utility commission to review the district's wholesale water rates, we can predict neither the timing nor outcome but do not currently view the dispute as likely to affect the rating; and
- Management's willingness to adjust rates as necessary, including passing through in full any wholesale increases received from NTMWD. We believe an adjustment to rates implemented in November 2014 should improve all-in debt service coverage (DSC).

The ratings also reflect Mesquite's very strong financial risk profile, characterized by:

- Coverage metrics that are now more in line with its similarly rated peers and are likely to remain around 1.2x in the upcoming three years by our calculation;
- Extremely strong liquidity and reserves; and
- Strong financial management, as the city has a number of policies and best practices that should support a consistent financial performance in the future. It is also a key in maintaining the current rating, as there is a better-than-average likelihood that the system's finances will rebound within the next two years.

The system's first-lien pledge of net revenues secures the bonds. Bond proceeds will be used primarily to fund the city's 2018 capital improvement plan (CIP), as well to refund for savings the series 2008 revenue bonds. A debt service reserve fund in the amount of average annual debt service provides additional liquidity.

Enterprise risk profile

The system provides retail water and sewer service to over 40,000 mainly residential customers in Mesquite, a mature Dallas suburb of roughly 143,000 residents. The system is a distribution and collection system, with all water supply, water treatment, and sewer treatment services provided by the NTMWD. Growth in the number of metered accounts and water sales has been flat for the past five years, with the only fluctuations in sales attributable to weather. The customer base is diverse, with the 10 leading customers accounting for about 10% of operating revenues. Mesquite's median household effective buying income (MHHEBI) is in line with the nation. The city's system is not reliant on any of its principal customers for operating revenues.

The city council consistently passes through wholesale rate increases from NTMWD, most recently in for fiscal 2018, with additional adjustments likely given the district's ongoing major water supply and treatment plant projects. Base-rate increases, exclusive of NTMWD pass-through costs, have been less frequent but have still been implemented as necessary based on an annual review of rates. As such, a residential water and sewer bill, based on an average residential bill provided by the city, is still moderately affordable at about \$113.7 million or 3.0% of MHHEBI.

Consistent with "Methodology: Industry Risk," published Nov. 19, 2013, we consider industry risk for the water system to be very low or '1', the most favorable assessment possible on a six-point scale, with '1' being the best.

Based on our operational management assessment (OMA), we view Mesquite to be a '3' on a six-point scale, where '1' is the strongest. This indicates, in our view, that operational and organizational goals are generally well aligned, even if some challenges exist. The OMA of good reflects our view of the system's role as a distribution- and collection-only system, which greatly reduces operational risk to the city. While wholesale rate increases continue to pressure Mesquite's all-in coverage metric, they provide the city a secure, long-term water supply as well as wastewater treatment capacity at least through the life of the bonds, or likely beyond. The city also has a sanitary sewer overflow initiative in place with the Texas Commission on Environmental Quality, essentially a proactive measure for preventive collection system maintenance. The city has recently completed asset management plans for both the water and sanitary sewer systems that provides a risk based replacement strategy for capital replacement of water and sanitary sewer systems infrastructure. To preserve the water supply as much as possible during the drought and the period Lake Texoma was unavailable, district management asked member cities to implement progressively stricter water conservation measures, eventually including limited outdoor watering, to reduce demand by at least 10%. Mesquite and other district cities complied. All of this was coming even as the NTMWD began a series of double-digit rate increases for the Texoma project and its newest reservoir, the Lower Bois D'Arc Creek (LBC) project north of the Dallas area in Fannin County. Increasing costs, coming especially at a time when conservation limited retail revenues of the cities, led four of the most built-out members--Plano, Richardson, Garland, and Mesquite--to ultimately ask the Texas Public Utility Commission (PUC) in late 2016 to review the district's rates. To date, the case has completed the discovery stage and set for court in the fall of 2018. We understand that the NTMWD and cities are engaging in discussions outside the PUC case to resolve the dispute. While we can predict neither the timing nor the outcome, we don't believe this affects the city's or district's credit quality.

Financial risk profile

The system's financial performance is, on balance, strong, and continues to rebound from a period of weakness. The city not only continues to pass along any wholesale rate increases from NTMWD, but also recently adjusted its retail

rate schedule, a move that it believes will bolster its finances over time. All-in coverage is S&P Global Ratings' adjusted DSC metric that treats certain costs as if they were debt-like--such as take-or-pay minimums--even if they are legally treated as operating expenses. The difficulty for the city, however, was that as the drought worsened from 2011 through 2015, it led to below-budgeted sales in both 2013 and 2014 and barely sufficient all-in coverage in each year. All-in coverage bounced back in fiscal 2015 to fiscal 2017 growing from 1.17x to 1.20x, respectively. We have reviewed the forecast management supplied, and agree that the projections of consistently around 1.2x or better all-in coverage are realistically attainable when excluding the rate stabilization fund.

Similar to the all-in DSC, the unrestricted liquidity has grown in unison as coverage levels have stabilized from 2013. Working capital at fiscal 2013 year-end totaled \$10.6, which was equivalent to a solid three months of operating expenses, to \$22.6 million in fiscal 2017, which was an equivalent to just over five months of operating expenses. Based on management's plan to debt fund the capital improvement plan for the distribution system, we believe the unrestricted cash will remain as levels we view as very strong.

The utility has outlined \$57 million in CIP over the next five years. The city indicated that it will be all-debt funded over the next five years. The system's leverage level is, in our opinion, average, based on a debt-to-capitalization ratio of 43.7%. The city has net pension liability is funded at roughly 67% and funding ARC is done at 100% on the outstanding pension. We view the pension and OPEB risk as credit neutral.

The system annually makes significant transfers to the city's general fund. Transfers are limited by policy to 20% of customer charges and have historically been \$4.5 million per year. Based on our financial management assessment (FMA), we view Mesquite to be a '1' on a six-point scale, with '1' being the strongest. An FMA of strong indicates that practices are strong, well embedded, and likely sustainable. The city maintains most of the best practices we believe are critical to supporting credit quality and these are well embedded in the government's daily operations and practices. Formal policies support many of these activities, adding to the likelihood that these practices will continue and transcend changes in the operating environment or personnel. These include regularly updated long-term financial and capital plans, monthly budget-to-actual reports available on the city's website, and robust policies on debt management and permitted investments.

Outlook

The stable outlook is reflects S&P Global Ratings' expectation that management's focus on funding all of the system's revenue requirements--including fixed costs over which it has little control--while improving net revenues and not deferring any capital needs will support financial performance in line with projections over our two-year outlook horizon and likely beyond.

Upside scenario

Given the inherent economic stability of the city's mature service territory, the key to a higher rating, in our view, would be based primarily on sustained all-in coverage of 1.4x or better, which would be more in line with its 'AA+' rated peers, all other things being equal.

Downside scenario

The rating could be pressured if the financial metrics do not meet management projections as we calculate all-in service coverage, or liquidity is measurably weaker as it was in periods five years ago.

Ratings Detail (As Of April 26, 2018)		
North Texas Mun Wtr Dist (Lower East Fork) wastewtr		
<i>Long Term Rating</i>	AA/Stable	Affirmed
Mesquite wtrwks		
<i>Long Term Rating</i>	AA/Stable	Affirmed
Many issues are enhanced by bond insurance.		

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