

# RatingsDirect®

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## Summary:

# Mesquite, Texas; Water/Sewer

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Rationale

## Summary:

# Mesquite, Texas; Water/Sewer

### Credit Profile

US\$14.695 mil waterworks and swr sys rev rfdg and imp bnds ser 2017 dtd 05/01/2017 due 03/01/2037

<i>Long Term Rating</i>	AA/Stable	New
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### Mesquite wtrwks

<i>Unenhanced Rating</i>	AA(SPUR)/Stable	Outlook Revised
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## Rationale

S&P Global Ratings revised its outlook to stable from negative and affirmed its 'AA' rating on Mesquite, Texas' waterworks and sewer system revenue debt. We also assigned our 'AA' rating and stable outlook to the city's series 2017 waterworks and sewer system revenue refunding and improvement bonds.

The outlook revision reflects our view that the system's all-in coverage metric has recovered from recent performance that we believed was thin for the rating level, and is likely sustainable at the improved levels given management's commitment to maintaining improved margins despite increasing fixed costs. We recognize the inherent difficulties in implementing aggressive mandatory water conservation measures such as the city did for several years even as its operating costs were rising. Since water restrictions were lifted in 2015, the system's financial risk profile has continued to rebound without deferring any capital investments in the system.

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

- A stable, primarily residential, customer base that benefits from participation in the strong, broad and diverse Dallas metropolitan statistical area (MSA);
- The city's 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 strong financial risk profile, characterized by:

- Coverage metrics that are now more in line with similarly rated peers and likely to continue to improve from an average of 1.1x the past three years to over 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 refund for savings eligible maturities of the series 2009 revenue bonds, as well as to fund new projects. 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's. The city's system is not reliant on any of its principal customers for operating revenues.

Based on our operational management assessment (OMA), we view Mesquite to be a '3' on a scale of 1-6, with '1' being 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 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 council consistently passes through wholesale rate increases from NTMWD, most recently in for fiscal 2017, 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, assuming 6,000 gallons of service, is still very affordable at about \$83, or 2.3% of MHHEBI.

### **Financial risk profile**

The system's financial performance is, on balance, strong, and continues to rebound from a period of weakness. Working capital at fiscal 2016 year-end totaled \$20.9 million, which was equivalent to a solid four months of 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 1.17x. We have reviewed the forecast management supplied, and agree that the projections of consistently 1.2x or better all-in coverage are realistically attainable.

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 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 scale of 1-6, 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 web site, 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 'AA+' rated peers, all other things being equal.

**Downside scenario**

While we would view it as unlikely, the rating could be pressured most likely by a precipitous collapse in the financial risk profile, such as what might come from a rapid increase in debt due to an environmental regulatory enforcement action or an unaddressed structural imbalance between revenues and fixed costs.

Ratings Detail (As Of April 17, 2017)		
North Texas Mun Wtr Dist (Lower East Fork) wastewtr		
<i>Long Term Rating</i>	AA/Stable	Outlook Revised
<b>Mesquite wtrwks</b>		
<i>Long Term Rating</i>	AA/Stable	Outlook Revised

Many issues are enhanced by bond insurance.

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.globalcreditportal.com](http://www.globalcreditportal.com). All ratings affected by this rating action can be found on the 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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