

RatingsDirect®

Summary:

Midland, Texas; General Obligation

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Credit Profile

US\$28.92 mil GO imp and rfdg bnds ser 2019 dtd 02/15/2019 due 03/01/2044		
<i>Long Term Rating</i>	AA+/Stable	New
US\$23.32 mil tax and ltd pledge rev certs of oblig ser 2019 dtd 02/15/2019 due 03/01/2040		
<i>Long Term Rating</i>	AA+/Stable	New

Rationale

S&P Global Ratings assigned its 'AA+' long-term rating to Midland, Texas' series 2019 general obligation (GO) improvement and refunding bonds and certificates of obligation (COs). At the same time, S&P Global Ratings affirmed its 'AA+' long-term rating on the city's GO bonds and COs outstanding. The outlook is stable.

The city's GO bonds and COs constitute direct obligations of the city payable from revenue from a direct and continuing ad valorem tax levied on all taxable property within its borders. The maximum ad valorem rate allowed by the state is \$2.50 per \$100 of taxable assessed value (AV), no more than two-thirds of which can be allocated for debt service; the city by charter has further limited its tax rate to \$2.00 per \$100 of AV for all city purposes. The city is well below both the state and self-imposed maximum levies at 39.22 cents per \$100 of AV, 4.48 cents of which is dedicated to debt service. Additional security for the COs is provided by surplus net revenue of the city's water and sewer system, not to exceed \$2,500. Given the de minimis pledge, we rate the certificates based on the city's GO pledge. We do not differentiate between the city's limited-tax GO debt and its general creditworthiness given that the ad valorem tax is not derived from a measurably narrower tax base and that there are no limitations on the fungibility of the city's general resources.

The 2019 GO bond proceeds will be used to finance road improvements and refund the outstanding portion of the city's 2009 COs for debt service savings. The 2019 CO proceeds will finance fire protection service infrastructure improvements, road improvements, and water/sewer system improvements. As with the city's other COs, a portion of debt service will be supported by water/sewer enterprise revenue, which we take into account when calculating the city's net direct debt liability.

The 'AA+' long-term rating reflects our view of the city's:

- Strong economy, with projected per capita effective buying income at 147% of the national level and market value per capita of \$107,836;
- Strong management, with good financial policies and practices under our financial management assessment methodology;
- Strong budgetary performance, with operating surpluses in the general fund and at the total governmental fund level in fiscal 2017;

- Very strong budgetary flexibility, with an available fund balance in fiscal 2017 of 54% of operating expenditures;
- Very strong liquidity, with total government available cash at 1.6x total governmental fund expenditures and 35.0x governmental debt service, and access to external liquidity we consider strong;
- Weak debt and contingent liability position, with debt service carrying charges at 4.5% of expenditures and net direct debt that is 88.1% of total governmental fund revenue, and significant medium-term debt plans and a growing pension obligation, but low overall net debt at less than 3.0% of market value; and
- Strong institutional framework score.

Strong economy

We consider Midland's economy strong. The city, with an estimated population of 134,121, is located in Midland County. The city has a projected per capita effective buying income of 147% of the national level and per capita market value of \$107,836. Overall, the city's market value grew by 10.7% over the past year to \$14.5 billion in 2019. The county unemployment rate was 3% in 2017.

Midland is located in West Texas, midway between Dallas-Fort Worth and El Paso. The city lies on Interstate 20 approximately 20 miles east of Odessa. Midland is located in the Permian Basin, an area containing a significant proportion of the U.S.' known accessible oil and natural gas reserves. Given the location, the city is dependent on the oil and gas industry. Although the industry acts as a foundational employment base, the volatility of price movements inherent to the sector affects the local area's labor market and the city's sales tax revenue. A softening of oil and gas prices in late 2015 and 2016 leading to lower regional output contributed to an uptick in unemployment and lower sales tax revenue for the city. However, stabilizing prices over the past two years have contributed to substantial growth in rig counts and output, benefiting the city economically. We note that oil output in the county is up 358% over the past five years (3.7% year over year), reaching a record 112.4 million barrels in 2018, while casinghead gas (natural gas obtained from oil wells) output has experienced similar growth.

The activity has fueled labor demand, often supplied by temporary workers, and growth of taxable sales within the city. The maintenance of output at these levels depends partly on the transportation and storage infrastructure, which lags the region's ability to generate output. Among the key challenges facing the region is the ability to economically store and transport commodities. It is our understanding that a number of pipeline projects are underway to alleviate these pressures, though these pressures will remain a challenge if output continues to increase.

With the astronomical growth in output and drilling activity, the city faces an extremely tight labor market, which has partly contributed to substantial wage premiums, construction contract premiums, and rapid appreciation in property values. However, this has also induced demand in hotels and new real estate development, expanding the city's revenue base.

The city has worked to diversify the employment base during the past several years, and the leading employers are found in the education, oil and gas, and medical fields. In addition, the city serves as a regional trade, service, and medical center for West Texas. Service sector growth, particularly in retail and distribution-related positions, has further diversified the economy. Leading employers in the city include Pioneer Natural Resources, Midland Independent School District, Midland Memorial Hospital, and Endeavor Energy Resources. According to a variety of

sources, including the U.S. Energy Information Administration, drilling output from the Permian Basin will remain central to the nation's energy infrastructure. Although volatility is inherent to the city's economy, we anticipate that the economy will remain strong given its central and established position within the U.S.' oil and gas industry.

Strong management

We view the city's management as strong, with good financial policies and practices under our financial management assessment methodology, indicating our view that financial practices exist in most areas, but that governance officials might not formalize or monitor all of them on a regular basis.

Among the highlights of the city's management techniques is the city finance department's monthly monitoring and reporting of the current fund budget to ensure compliance and to allow corrective actions to be taken to ensure a balanced budget. The city's finance department also forecasts revenue and expenditures by looking at historical trends and revenue growth projections. In addition, the city provides quarterly updates on the budget and quarterly reports on investment holdings to the city council. Midland has a five-year rolling capital plan, which identifies anticipated funding sources. The city maintains a formally adopted investment management policy. Additionally, the city has a formal fund balance policy of maintaining a 25% general fund reserve, with a target of 35%, to which it has historically adhered. The city lacks a formal debt policy but informally seeks to keep tax-supported debt below 8% of total AV.

Strong budgetary performance

Midland's budgetary performance is strong, in our opinion. The city had operating surpluses of 8.1% of expenditures in the general fund and of 3.2% across all governmental funds in fiscal 2017. While we anticipate that budgetary performance will remain balanced-to-positive, our assessment accounts for our expectation that operating performance will moderate relative to the very strong results exhibited in fiscal years 2017 and 2018.

The city's financial results are adjusted to account for regularly occurring transfers and capital expenditures funded through one-time resources, including debt proceeds. In 2017, a voter initiative led to the closure of the Sports Complex Development Corp., which funded capital projects for the Sports Complex enterprise fund primarily through a dedicated 0.25% local sales tax. With the termination of the corporation, \$31.2 million in reserves and dedicated sales tax revenue were transferred to the general fund, which was then transferred to the Sports Complex fund at the start of fiscal 2018. The 2017 audited results and 2018 unaudited results net out this interim transfer. The sports complex fund will be operated as an enterprise fund, with the accumulated sales tax proceeds partly financing operations.

Operating results in 2017 were partly attributable to positive revenue variances relative to the budget, particularly sales tax revenue, while expenditures came in under budget. Operating results in 2018 were positive, as general fund revenue was over budget by \$24 million, according to officials. After transferring out the sports complex funds, unaudited results indicate an approximately \$15 million increase to the fund balance. This addition is after general fund resources financed approximately \$14.8 million in one-time capital projects, according to officials.

The 2019 operating budget is balanced and represents a 14% increase over the 2018 budget, primarily reflecting a 7% increase to employee wages, 20 new positions, and increased capital spending from general fund resources. As a result of strong AV growth, property tax revenue is budgeted to increase 3% over the revenue-neutral level, despite the operating millage rate declining two cents. Because of strong results thus far in 2019, officials revised the budget to

increase estimate sales tax collections by \$10 million, nearly 20% of originally budgeted amounts. Officials report that the city will look for opportunities to utilize fund balance to finance capital projects should the revenue outlook remain positive. We anticipate that the city's operating performance will remain strong given recent positive revenue trends, continued real estate appreciation and new development, and capital expenditure flexibility.

Very strong budgetary flexibility

Midland's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2017 of 54% of operating expenditures, or \$62.9 million. We expect the available fund balance to remain above 30% of expenditures for the current and next fiscal years, which we view as a positive credit factor.

Over the past five years, Midland's available fund balance has exceeded 30% of expenditures, and has exceeded the city's policy-mandated minimum. With the operating surplus in 2017 and 2018, the city's available reserves will likely remain above 30% even if some reserves were used for one-time capital projects as previously indicated. We anticipate that the city will maintain its reserves above its policy minimum of 25%. Officials intend to maintain reserves at least above 35%. Additionally, the city maintains substantial flexibility under its tax rate limitation (levying 39.22 cents under a \$2.00 per \$100 of AV limit under the city's charter). The budgeted millage rate decrease in 2019 following increases in 2017 and 2018 demonstrates the city's flexibility under this limitation and its willingness to increase property taxes as a means to offset revenue volatility. We anticipate that budgetary flexibility will remain very strong.

Very strong liquidity

In our opinion, Midland's liquidity is very strong, with total government available cash at 1.6x total governmental fund expenditures and 35.0x governmental debt service in 2017. In our view, the city has strong access to external liquidity if necessary.

Overall, we expect the city's liquidity position to remain very strong. Its investments consist of high-quality, liquid assets, including funds held in state investment pools and federal securities, which we do not consider aggressive. As of the latest report, all of Midland's investments comply with Texas statutes and the city's internal investment policy. Additionally, it is our understanding that Midland is not exposed to any contingent liabilities that could lead to an unexpected deterioration in its liquidity position. We anticipate that the city's liquidity will remain very strong.

Weak debt and contingent liability profile

In our view, Midland's debt and contingent liability profile is weak. Total governmental fund debt service is 4.5% of total governmental fund expenditures, and net direct debt is 88.1% of total governmental fund revenue. Negatively affecting our view of the city's debt profile are its significant medium-term debt plans. Overall net debt is low at 2.5% of market value, which is, in our view, a positive credit factor.

The city plans to issue the additional \$50 million authorized under its 2017 GO referendum over the next two years. Additionally, officials report \$50.0 million in other debt plans over the next two years, though water/sewer revenue will support approximately \$33.5 million.

Midland's required pension and actual OPEB contributions totaled 7.9% of total governmental fund expenditures in 2017, with 7.4% representing required contributions to pension obligations and 0.5% representing OPEB payments.

The city made its full annual required pension contribution. The funded ratio of the plan with the largest net pension liability is 58.9%. In our opinion, a credit weakness is Midland's growing pension obligation.

The city participates in the Texas Municipal Retirement System (TMRS) to provide pension benefits for eligible employees. It also provides a single-employer retirement plan for firefighters under the Midland Firefighters' Relief and Retirement Fund (MFRRF). While pension carrying charges have historically remained manageable relative to the budget, our view of permissive assumptions, particularly in the fire plan, will contribute to a growing net pension liability. As of the Dec. 31, 2016 valuation date, the MFRRF funded ratio was 58.9%, having deteriorated in recent years. The plan's net pension liability grew 38% over the past two measurement dates to \$57.8 million. Based on current assumptions, which the pension board may change, the plan maintains an open amortization schedule reset to 44.7 years, with contributions based on a level percent of pay. It is our understanding that these conditions will result in negative amortization in perpetuity, whereby annual plan contributions will remain insufficient to cover interest costs on the total pension liability. Furthermore, it is our opinion that the asset position may be subject to volatility with a plan discount rate of 8%, which we view as high relative to plans nationally. Additionally, plan contributions are not actuarially determined, though the city does contribute a level percent of pay substantially higher than the statutory requirements.

The city's share of the TMRS net pension liability was \$45.2 million as of December 2016, with a funded ratio of 85.3%. The plan's assumed discount rate of 6.75% is not considered aggressive, in our opinion, though we do consider the closed amortization period of 29 years as extended, leaving greater potential for costs to grow depending on actual performance. Midland's combined net pension liability is \$102.9 million, or 77% of 2017 governmental revenue. We will continue to monitor the health of the city's pension plans, including changes to assumptions and contributions.

The city provides eligible retired employees health insurance benefits through a single-employer OPEB plan. The city allows retirees to enroll in its health care plan, acting as an implicit subsidy, and the city contributes a fixed amount toward monthly premiums, with the beneficiary to pay the balance. These benefits are discretionary and provided on a pay-as-you-go basis. We consider the unfunded OPEB liability manageable at \$25 million, particularly given its discretionary nature.

Strong institutional framework

The institutional framework score for Texas municipalities is strong.

Outlook

The stable outlook reflects our view of Midland's very strong reserve and liquidity positions, supported by its strong management practices. It also reflects our view of the city's recent economic gains and property taxing flexibility. We do not anticipate changing the rating over the two-year outlook horizon.

Downside scenario

If the city realizes multiple years of operating deficits, leading to weakened reserve and liquidity positions, we could consider lowering the rating.

Upside scenario

All else equal, we could raise the rating in the event of improvements and diversification in the local economy and a stronger debt and liability profile.

Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Incorporating GASB 67 And 68: Evaluating Pension/OPEB Obligations Under Standard & Poor's U.S. Local Government GO Criteria, Sept. 2, 2015
- 2018 Update Of Institutional Framework For U.S. Local Governments

Ratings Detail (As Of January 30, 2019)		
Midland GO		
<i>Long Term Rating</i>	AA+/Stable	Affirmed
Midland tax and ltd pledge rev certs of oblig		
<i>Long Term Rating</i>	AA+/Stable	Affirmed
Midland GO		
<i>Long Term Rating</i>	AA+/Stable	Affirmed
Midland GO		
<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

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