S&P Global Ratings

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Summary:

Canyon, Texas; General Obligation

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Rationale

S&P Global Ratings lowered its long-term rating to 'A+' from 'AA-' on Canyon, Texas' general obligation (GO) debt outstanding. The outlook is stable.

The one-notch downgrade reflects the city's recent budgetary imbalance that materially weakened general fund balance to levels no longer comparable with those of higher-rated peers. The city's net deficit spending in four of the past five fiscal years is largely the result of increased cash contributions, in lieu of debt issuances, for unbudgeted capital outlay; this led the available fund balance to decline to 4.8% of operating expenditures in fiscal 2018, from 31.1% in fiscal 2014, and limits the city's ability to respond to financial stress. However, we recognize the city enacted revenue enhancements that increased its utility rates for 2019 and tax rates for fiscal 2020, bringing its spending in line with recurring revenues.

Security

The bonds and certificates are the city's direct obligations, payable from a combination of the levy and collection of a continuing annual ad valorem tax, within the limits prescribed by law, on all taxable property in the city. The certificates outstanding are additionally secured by net revenues of the city's waterworks and sewer system. We rate to the strength of the GO pledge on these certificates, due to the lack of legal covenants in place to assess the strength of the utility pledge.

Texas statutes limit the ad valorem tax rate for home rule cities to $2.50 per $100 of taxable assessed valuation (AV) for all city purposes. The Texas attorney general permits the allocation of $1.50 of the $2.50 maximum tax rate for ad valorem tax debt service. In fiscal 2019, Canyon's total levy is well below the maximum at 44.76 cents per $100 of AV, 05.68 cents of which is dedicated to debt service. Despite state statutory tax-rate limitations, we do not differentiate between the city's limited-tax debt and its general creditworthiness, since the ad valorem tax is not derived from a measurably narrower tax base and there are no limitations on the fungibility of resources, which supports our view of the city's overall ability and willingness to pay debt service.

The rating reflects our assessment of the following credit characteristics:

- Weak economy, with market value per capita of $55,685 and projected per capita effective buying income at 87.3% of the national level;
- Adequate management, with standard financial policies and practices under our Financial Management Assessment methodology;
- Weak budgetary performance, with operating deficits in the general fund and at the total governmental fund level in fiscal 2018;
- Adequate budgetary flexibility, with an available fund balance in fiscal 2018 of 4.8% of operating expenditures;
- Very strong liquidity, with total government available cash at 64% of total governmental fund expenditures and 17.3x governmental debt service, and access to external liquidity we consider strong;
- Very strong debt and contingent liability position, with debt service carrying charges at 3.7% of expenditures and net direct debt that is 56.8% of total governmental fund revenue, as well as rapid amortization, with 67.9% of debt scheduled to be retired in 10 years; and
- Strong institutional framework score.

Weak economy

We consider Canyon's economy weak. The city, with an estimated population of 14,672, is located in Randall County. The city has a projected per capita effective buying income of 87.3% of the national level and per capita market value of $55,685. Overall, the city's market value grew by 11.4% over the past year to $817 million in 2019. The county unemployment rate was 2.6% in 2018.

Canyon is in the Texas Panhandle, about 16 miles south of Amarillo. The economy centers on education, agriculture, and tourism at Palo Duro Canyon State Park. West Texas A&M University (WTAMU), with a student enrollment of roughly 9,961, is in the city. While Canyon's economy lacks significant depth and diversity beyond the university, residents can commute into Amarillo's broader economy for employment opportunities.

Canyon's AV has experienced steady growth in recent years in line with continued residential and retail development, and city officials anticipate this positive trend to persist, with an assortment of projects currently in varying stages of development. Over the past five years, annual AV growth has averaged 7.4%, and in total, the city's tax base increased by approximately $243.3 million, or 42%. Some of the notable developments underway is the Spring Canyon subdivision that is expected to add roughly 500 homes and the construction of various facilities on WTAMU main campus.

We assess the local economy will continue to experience sustained growth, but do not anticipate any material changes to the city's key economic credit fundamentals over the next two years.

Adequate management

We view the city's management as adequate, with standard financial policies and practices under our Financial Management Assessment methodology, indicating the finance department maintains adequate policies in some but not all key areas.

Our assessment of the city's financial management accounts for the recent fund balance drawdowns for capital outlay, coupled with the inability to amend the budget to achieve balanced operations, which led to a disparity between revenues and expenditures at year-end. However, based on recent revenue enhancements, management expects to produce structurally balanced operations and year-to-date results show revenues are either on target or above projections.

When developing its budget, management evaluates five years of historical data and uses conservative assumptions for revenue and expenditure projections. The city uses a consultant that assists with sales tax trends and projections. The budget can be amended as needed throughout the fiscal year, and management provides monthly budget-to-actual reports to council. The city has a formal investment policy that follows state investment requirements, and it provides quarterly reports to the governing body on holdings and returns. The city also has a minimum fund balance target of 25% of current budget for all funds combined to allow for the city to respond to emergencies or any unanticipated expenditures. The city does not have a long-term financial plan that includes multiyear revenue and expenditure projections. The city does not maintain a formalized long-term capital improvement plan; however, it is currently in the process of developing one. Lastly, the city does not have a formalized debt management policy but is currently developing one.

Weak budgetary performance

Canyon's budgetary performance is weak in our opinion. The city had operating deficits of negative 3.3% of expenditures in the general fund and of negative 2.9% across all governmental funds in fiscal 2018. We have adjusted our calculations to account for routine transfers into the general fund from the city's water and sewer fund. Historically, the city had budgeted for break-even operations when incorporating transfers in from its water and sewer fund and has historically relied on the water and sewer utility system to subsidize general fund operations and assist in managing the tax rate.

Although the city's deficits largely resulted from management choosing to use reserves to fund capital equipment purchases, surplus operational results were largely the result of transfers from the utility system, which somewhat insulated Canyon from posting larger operating deficits. The weak performance in fiscal 2018 is largely attributed to a negative variance of ($423,824) in total expenditures stemming from capital outlay expenses that were not budgeted for when comparing final budget-to-actual figures, as management chose to cash-fund these purchases after the budget was settled. While modest economic growth has translated to an increase in operating revenues, expenditures have outpaced revenues with utility transfers providing support for operations, although not sufficient to cover capital spending, resulting in weakening general fund reserves. While the city's water and sewer fund consistently produces positive operating margins leading to its healthy financial position, the general fund's reliance on transfers and recent practice of funding unbudgeted capital outlay indicates difficulties in raising sufficient governmental fund revenue to support operations absent of an increase in its M&O tax rate.

Major general fund revenue sources in fiscal 2018 consisted of property taxes (26.3%), charges for services (22.9%), sales taxes (22.2%), and utility transfers (10.8%). The adopted fiscal 2019 budget reflects balanced operations in the general fund due to another large utility fund transfer. Year-to-date results indicate that revenues are outpacing expenditures, and management does not foresee any unplanned capital projects that would cause current operating trends to deteriorate. The room for negative variances is limited given the city's close to low-nominal reserve position. We recognize that the city has implemented revenue enhancements in an effort to achieve structural balance by increasing its M&O rate 3% above its effective rate, as well as by raising water and sewer rates by 2% and 5%.

If the city is unsuccessful in stabilizing its budgetary performance through revenue enhancements, adequate utility transfers, expenditure reductions, and continues to produce a trend of negative operating performance, the rating could be pressured. However, if we observe a sustained trend of stabilized stronger budgetary results over the long term in the general fund and across all governmental funds, we could revise our view of the city's budgetary performance to a more positive outlook.

Adequate budgetary flexibility

The city maintains a formal fund balance policy that requires a minimum unassigned fund balance in the general fund of 25% of budgeted expenditures for the fiscal year. However, Canyon's commission interpretation of the policy combines the available fund balance across all funds, including its enterprise funds, in the overall budget. This practice reduces the clarity of legally available funds in its operating fund, which our criteria assesses to measure the degree a local government can look to additional financial flexibility in times of stress.

Net operating deficits in four of the past five fiscal years, has eroded the city's available fund balance to levels we consider adequate, at 4.8% of operating expenditures or $512,000 in fiscal 2018 from 31.1% or $2.5 million in fiscal 2014. The drawdown in fund balance over the past five years is attributed to unplanned capital outlay without corresponding revenue sources causing a structural gap.

Management has confirmed that there are no plans to reduce its current reserve levels and expects to rebuild its reserves in the outlook horizon. While year-to-date results show that revenues are outpacing expenditures, continued weak budgetary performance or one-time spending that results in additional declines in available fund balance to levels we consider low nominal could place downward pressure on the rating.

Very strong liquidity

In our opinion, Canyon's liquidity is very strong, with total government available cash at 64.0% of total governmental fund expenditures and 17.3x governmental debt service in 2018. In our view, the city has strong access to external liquidity if necessary.

Despite its weak general fund budgetary performance, Canyon still demonstrates proportionately very strong liquidity when considering all available governmental funds, including its utility funds. In our view, the city has strong access to external liquidity if necessary, based on its history of issuing GO debt over the past 20 years. Canyon has historically had what we consider very strong cash balances, and we do not believe its liquidity position will weaken over the next two years. Currently, all of its investments comply with state guidelines and its formal investment policy and we do not consider them aggressive. At Sept. 30, 2018, the city's investments were primarily in certificates of deposit which we view to be highly liquid.

Very strong debt and contingent liability profile

In our view, Canyon's debt and contingent liability profile is very strong. Total governmental fund debt service is 3.7% of total governmental fund expenditures, and net direct debt is 56.8% of total governmental fund revenue. Approximately 67.9% of the direct debt is scheduled to be repaid within 10 years, which is in our view a positive credit factor.

According to management, there are no plans to issue additional debt in the next 12 to 24 months. Additionally, we note that our view of the city's debt profile could further weaken should future debt issuances cause the city's 10-year amortization schedule to fall below 65%.

Pension and OPEB

Canyon's combined required pension and actual other postemployment benefits (OPEB) contributions totaled 8.5% of total governmental fund expenditures in 2018. Of that amount, 8% represented required contributions to pension obligations, and 0.5% represented OPEB payments. The city made its full annual required pension contribution in 2018.

The city contributes to a nontraditional, joint contributory, hybrid defined-benefit pension plan administered by the Texas Municipal Retirement System (TMRS). The city's required pension contribution is its actuarially determined contribution (ADC), which is calculated using the entry age actuarial cost method. The city has historically paid at least 100% of the ADC. In fiscal 2018, it contributed 16.4% of covered payroll, which amounted to $857,048 in contributions to the pension system. In addition to the TMRS pension plan, Canyon also participates in the cost-sharing, multiple-employer, defined-benefit, group-term life insurance plan operated by TMRS known as the Supplemental Death Benefits Fund. The city may terminate coverage and discontinue participation by adopting an ordinance before Nov. 1 of any year to be effective the following Jan. 1. The city has historically contributed 100% of the contractually required rate as determined by an annual actuarial valuation and its net liability under the plan was $222,438 as of Dec. 31, 2017.

Actuarial assumptions include a discount rate of 6.75% and a 28-year closed amortization period. The plan's assumed discount rate is not considered aggressive, in our opinion, though we do consider the closed amortization period of 28 years as extended, leaving greater potential for costs to grow depending on actual performance. Using updated reporting standards in accordance with Governmental Accounting Standards Board Statement No. 68, the city's net pension liability, measured as of Dec. 31, 2017, was $2.2 million. The plan's fiduciary net position as a percent of the total pension liability is 92.5%.

In addition to TMRS, the city participates in the Texas Emergency Services Retirement System (TERS) to provide pension benefits for certain volunteer emergency services personnel who serve without significant monetary compensation. The plan is funded through a combination of local contributions and state appropriations. The minimum local contribution established by the TERS Board is $36 per month for each participating member. The local contribution is not actuarially determined. However, the state is required to contribute an amount necessary to make the total system contributions actuarially sound. The actual costs to Canyon remain relatively modest and for the August 2017 measurement date, the city paid $50,395 to the plan. Per the fiscal 2018 audit, the city's net pension liability was 81.4% and the city's proportionate share of the liability was $216,975.

The city provides health care benefits for retired employees through an agent multiple-employer plan administered by Texas Municipal League Intergovernmental Employee Benefits Pool; these costs, however, are minimal compared to overall expenditures and are covered on a pay-as-you-go basis. At fiscal year-end, the total OPEB liability was $1.8 million.

Strong institutional framework

The institutional framework score for Texas municipalities is strong.

Outlook

The stable outlook reflects our view that despite recent reserve deterioration due to cash-funded capital outlays, we expect the city to continue making the necessary budgetary adjustments to maintain, what we consider, stable operating results, adequate reserves, and very strong liquidity, as evidenced by recent revenue enhancements to the city's maintenance and operations (M&O) tax rate and utility rate increases. Furthermore, the city does not expect a further draw down to its available reserves to finance capital projects in the near term. For these reasons, we do not expect to change the rating during the two-year outlook period.

Downside scenario

If the city is unsuccessful at sustainably aligning revenue and expenditures, pressuring reserves further, we could lower the rating.

Upside scenario

We could raise the rating if Canyon demonstrates a track record of positive budgetary performance causing its available fund balance to materially improve, coupled with strengthened financial policies.

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