

AUSTIN, Texas--([BUSINESS WIRE](#))--Fitch Ratings takes the following rating action on Palo Pinto County Municipal Water District No. 1, Texas (the district):

--\$6.2 million revenue refunding bonds, series 2011 affirmed at 'AA-'.

Fitch has also affirmed its 'AA-' implied rating on the water and sewer system of the city of Mineral Wells, Texas.

The Rating Outlook is Stable.

SECURITY

The bonds are special obligations of the district and secured solely from a first lien on net revenues from the district's waterworks system. Pledged revenues specifically include payments received by the district from the city of Mineral Wells. The city's implied rating assumes a net revenue pledge of the city's water and sewer system

KEY RATING DRIVERS

Longstanding Relationship with City: The rating primarily reflects the credit quality of the Mineral Wells (the city) water and sewer system (the system) which provides nearly all district revenues. Long-term contracts between the district and the city provide strong legal protection. The water charge from the city which covers district debt service as well as operations is treated as an O&M expense, payable prior to any of the city's water and sewer debt.

Stable Financial Metrics: The district's financial performance has remained stable, reporting a solid coverage level of 1.8x for fiscal 2012. Forecasted coverage ranges from

1.7x-2.0x through 2016 due to the city's increasing payments to the district in support of a project to construct a new reservoir. The city's financial performance is also stable with system liquidity improved to over 200 days of cash on hand and healthy coverage of 1.7x all-in for fiscal 2012.

Growing Debt, Long-Term Supply: Water supply provided by the district to the city is sufficient to meet needs through 2050, with plans to build the new reservoir in the next five to 10 years. District debt is moderate and amortizes rapidly. However, the reservoir project will be partly debt financed and likely elevate the district's debt load in the next 5-10-year horizon.

Loss of Largest Customer: With the closing of a private jail facility, the city will see a loss of approximately 10% of system revenues, and may see a decline in residential demand as the facility was one of the top employers. To offset the loss, the city is increasing rates, reducing operations and seeking system efficiencies where possible.

Limited Rate Flexibility: Combined utility rates of the city are high relative to surrounding communities.

RATING SENSITIVITY

Management of District Debt: Maintenance of adequate coverage levels and a manageable debt load as the district enters construction for an additional water reservoir will be a key rating consideration. Additional leveraging by the district could pressure user rates which are already relatively high.

Deterioration of City's Financial Profile: Maintenance of adequate financial operations while balancing the loss of its largest customer and increasing contributions to the district in support of the reservoir project will be of paramount importance to maintaining the current rating.

CREDIT PROFILE

DISTRICT RELATIONSHIP WITH CITY

The district was created in 1961 to provide a source of water supply within Palo Pinto and Parker Counties. Currently, the district provides raw water to the city and two other entities as well as Lake Palo Pinto (the lake) residents. Revenues from the sale of water to the city are by far the largest source of income to the district, accounting for almost 80% of all district water revenues. The district is therefore highly reliant on the city's continued financial health to maintain its own solid credit quality.

Pursuant to a water purchase contract and an operation and maintenance (O&M) contract between the city and the district, the city operates and maintains all district facilities. In addition, the city makes equal monthly payments to the district as a water charge sufficient to pay any O&M costs of the district, the annual debt service requirements on all district revenue bonds, and the annual requirements of the district's debt service reserve and contingency funds.

DISTRICT AND CITY FACILITIES

The district owns the lake and a diversion reservoir with a combined capacity of approximately 27,500 acre-feet, sufficient to meet the district's needs, including the city's municipal and contracted needs, through 2050. The district also owns the Hilltop Water Treatment Plant, which treats all water provided to the city and has an operating capacity of 14 million gallons per day.

The city's water utility provides retail service to more than 6,300 city customer accounts and wholesale service to six rural water supply corporations. The sewer utility provides collection, treatment, and disposal services to approximately 5,600 customers within the city limits and certain areas outside the city. The combined service area is stable, experiencing only modest growth over the last several years.

LARGE FUTURE CAPITAL INVESTMENT

The district will need to construct a new reservoir to meet long-term planning needs beyond 2050. The district issued subordinate lien bonds and received a grant from the Texas Water Development Board for planning and design costs associated with the project. Estimates on reservoir construction costs have jumped to \$80 million from approximately \$40 million in the last year. The increase results from geology in the area, which dictates that a different type of dam needs to be engineered than originally thought. The district is looking to purchase additional land in the 2015-2016 timeframe and construction should commence in the 2016-2017 timeframe, although there are still some permits outstanding that need to be finalized. The district expects to finance the project with loans from the state's revolving fund and revenues bonds.

District debt ratios have been trending down in the last five years. Debt on a per capita basis of \$664 is just slightly higher than the 'AA' median of \$492. It amortizes rapidly in an effort to free up debt capacity to finance the reservoir project. Balancing the future debt needed to fund the reservoir, maintaining sufficient financial results, and keeping rates affordable to city customers will be of paramount importance to the rating.

SOLID CITY PERFORMANCE DESPITE LOSS OF LARGE CUSTOMER

The city continues to support the district and the new reservoir by increasing the water charge paid to the district from fiscal 2012-2014. The payment from the city to the district grew almost 8% in fiscal 2012 and another 15% in fiscal 2013. Another increase of 9% is anticipated in fiscal 2014 as the construction timeline for the reservoir gets closer.

The city's fiscal 2012 financial performance was sound with all-in debt service coverage levels of 1.7x and liquidity of 253 days cash on hand. This followed a very strong fiscal 2011 when coverage was over 2.0x, bolstered by strong sales due to the drought. System liquidity has seen improvement after dipping to just 89 days of cash in fiscal 2010.

In July of 2013 the city was notified that the Texas Department of Criminal Justice would not be renewing the contract with the privately run jail in the city. The jail facility was one of the largest water customers and the largest sewer customer. The city estimates the loss will mean a direct reduction in revenues of approximately \$800,000. To offset the

loss in revenues, the city plans to adjust both water and sewer rates by 6% in fiscal 2014, on top of the 4% increase adopted in fiscal 2013.

Indirect impact of the closure is still unknown since the jail was the third largest employer, employing over 300 local residents. The city expects to see operational saving by the reduced wastewater flows from the jail. The additional rate hikes are necessary to support the district's planned debt issuance. Fitch believes the rate hikes, while necessary to keep coverage levels at the 'AA-' rating level, could continue to pressure the system's already high user rates.

LIMITED BUT STABLE ECONOMY

Mineral Wells is the largest city and principal commercial center in Palo Pinto County and located in the Barnett Shale, the second largest producing on-shore natural gas field in the U.S. The economic base is limited but relatively stable. Throughout the last decade, growth in oil and gas services and mineral extraction added concentration to the city's tax base which had historically included more diverse manufacturing. Population growth over the last decade has been flat and was estimated at about 16,900 in 2010. The city is the largest in Palo Pinto County and serves as the county's principal commercial center.

Palo Pinto County unemployment rates for July 2013 totaled 6.0%, below the state average of 6.7% and national average of 7.7%. Area wealth levels as measured by median household income are approximately 30% below the state and national levels.

Additional information is available at 'www.fitchratings.com'

In addition to the sources of information identified in Fitch's U.S. Municipal Revenue-Supported Rating Criteria, this action was additionally informed by information from Creditscope.

Applicable Criteria and Related Research:

--'Revenue-Supported Rating Criteria' (June, 2013);

--'U.S. Water and Sewer Revenue Bond Rating Criteria' (July 2013);

--'2013 Water and Sewer Medians' (Dec. 2012);

--'2013 Sector Outlook: Water and Sewer' (Dec. 2012).

Applicable Criteria and Related Research:

Revenue-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=709499

U.S. Water and Sewer Revenue Bond Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=715275

2013 Water and Sewer Medians

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=695756

2013 Outlook: Water and Sewer Sector

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=695755

Additional Disclosure

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http://www.fitchratings.com/gws/en/disclosure/solicitation?pr_id=803206

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