

## CREDIT OPINION

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# McKenzie (County of) ND

Credit analysis following initial Aa3 issuer rating

## Summary

[McKenzie County's](#) (Aa3) location within the Bakken Shale Play has driven rapid economic and revenue growth due to gains in the oil and gas industry. Its population, tax base, and income levels have grown considerably since 2011. The tax base is concentrated among its largest taxpayers and within the oil and gas industries. Despite rapid growth, the county maintains a low debt burden and has used excess oil and gas revenue to finance capital improvements. Its strong revenue growth and prudent financial management have resulted in maintenance of strong reserves and liquidity.

## Credit strengths

- » Above average wealth and income metrics
- » Strong reserves and liquidity
- » Low debt burden with rapid debt amortization

## Credit challenges

- » Economic and operating revenue concentration in the oil and gas industry
- » Substantial top taxpayer concentration

## Rating outlook

Outlooks are not usually assigned to local governments with this amount of debt.

## Factors that could lead to an upgrade

- » Economic and revenue diversification
- » Moderation of property taxpayer concentration

## Factors that could lead to a downgrade

- » Reduction in reserves and liquidity
- » Increased debt or pension burden
- » Weakening of oil and gas industry impacting top taxpayers

## Key indicators

Exhibit 1

McKenzie (County of) ND	2012	2013	2014	2015	2016
<b>Economy/Tax Base</b>					
Total Full Value (\$000)	\$505,112	\$808,305	\$1,097,466	\$1,472,199	\$1,488,920
Population	6,692	7,377	8,333	9,615	10,718
Full Value Per Capita	\$75,480	\$109,571	\$131,701	\$153,115	\$138,918
Median Family Income (% of US Median)	107.1%	119.5%	132.5%	138.3%	144.3%
<b>Finances</b>					
Operating Revenue (\$000)	\$27,762	\$42,485	\$83,258	\$62,769	\$53,255
Fund Balance (\$000)	\$23,068	\$40,249	\$50,598	\$36,502	\$33,811
Cash Balance (\$000)	\$23,503	\$40,249	\$50,598	\$36,502	\$33,811
Fund Balance as a % of Revenues	83.1%	94.7%	60.8%	58.2%	63.5%
Cash Balance as a % of Revenues	84.7%	94.7%	60.8%	58.2%	63.5%
<b>Debt/Pensions</b>					
Net Direct Debt (\$000)	\$0	\$0	\$0	\$11,393	\$40,689
3-Year Average of Moody's ANPL (\$000)	\$12,353	\$14,835	\$15,676	\$15,853	\$18,869
Net Direct Debt / Full Value (%)	0.0%	0.0%	0.0%	0.6%	0.9%
Net Direct Debt / Operating Revenues (x)	0.0x	0.0x	0.0x	0.2x	0.8x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	2.4%	1.8%	1.4%	1.1%	1.3%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	0.4x	0.3x	0.2x	0.3x	0.4x

Source: McKenzie County audited financial statements, US Census Bureau, Moody's Investors Service

## Profile

McKenzie County is located in northwestern North Dakota (Aa1 negative) along the Montana (Aa1 stable) border. It is in the heart of the Bakken Shale Play, and its population was estimated at 10,718 in 2016.

## Detailed credit considerations

### Economy and tax base: growing tax base and local economy with concentration in the oil and gas sector

We expect the county's location in the center of the Bakken Shale Play to result in continued economic development of the county, but volatility in operating revenue and tax base valuations will remain given the heavy concentration in the oil and gas sectors. Due to technological advancements in hydraulic fracturing ("fracking") and horizontal drilling, the local economy began growing significantly in 2011. Its population grew to an estimated 10,718 in 2016 from 6,262 in 2011. Median family income rose considerably over this time frame, to 144.3% of the US from 97.8%. The county reports that technological advancements continue to drive gains in oil and gas production.

Taxpayers in the oil and gas industries make up a substantial share of the county's tax base. The top ten taxpayers accounted for 45.2% of fiscal 2018 taxable valuation. The tax base has grown considerably over the last several years, growing 193%, to \$5 billion, in fiscal 2018 due largely to the April 2017 installation of the Dakota Access Pipeline. Prior to the increase in 2018, the tax base grew by an average annual rate of 31% over the last five years.

### Financial operations and reserves: robust but volatile revenue growth; strong reserves

Despite fluctuations in receipts, we expect the county's prudent use of oil and gas production tax (OGGPT) revenue for capital expenditures and otherwise balanced operating budgets to continue supporting its maintenance of strong reserve levels. In lieu of property taxes, the county receives state allocations of OGGPT revenue through a state formula based on oil and gas production in the county. The county receives about 30% of the total tax levied in the county itself. While operating performance has fluctuated in

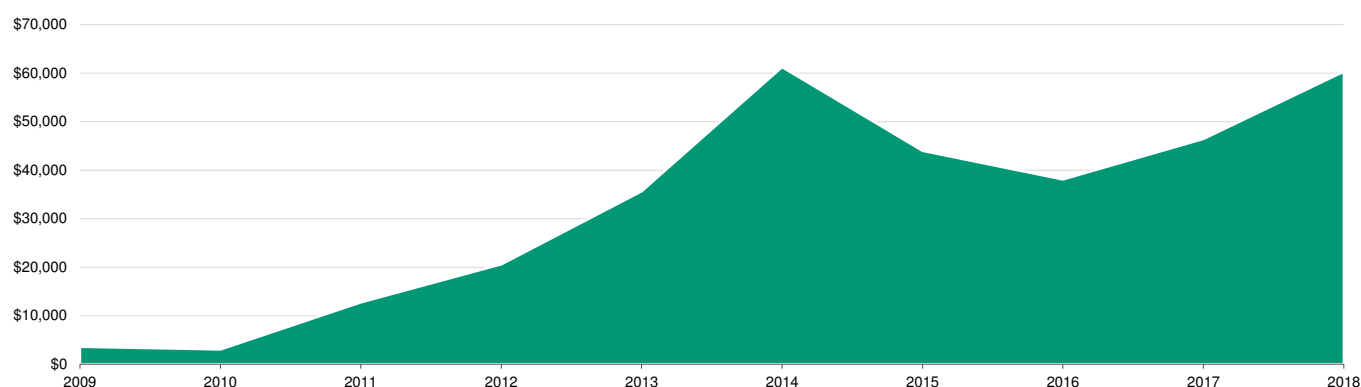
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recent years due to volatility in OGGPT receipts and capital transfers to its road and bridge fund in fiscal 2015 and 2016, the county has maintained strong reserve levels. After transfers, general fund reserves totaled \$33.8 million, or 63.5% of revenue in fiscal 2016. Based on unaudited results for fiscal 2017, the county estimates a \$12.8 million general fund surplus after transfers. For fiscal 2018, revenue receipts through October are exceeding expenditures by \$53 million, although the county traditionally transfers a large portion of its general fund surplus to its road and bridge fund for capital improvements. These yearly transfers have averaged about \$32 million, or approximately 50% of general fund revenue in the last four audited years.

The largest portion of the county's general fund revenue comes from its allocation of OGGPT revenue, which combined with other intergovernmental revenue, comprised 74% of revenue in fiscal 2016. Due to its robust OGGPT revenue allocations, the county levies property taxes significantly below its statutory property tax limit. In fiscal 2018, the county had about \$10.3 million in unused general fund levy authority. This excess property tax levy authority provides the county greater financial flexibility should OGGPT revenue significantly decline in the future. However, there could be practical limitations of how fast the county could raise taxes in a downturn.

Exhibit 2

### County OGGPT Revenue Allocations (\$000s)



Source: McKenzie County, ND offering documents and audited financial statements, Moody's Investors Service

## LIQUIDITY

The county maintains very strong liquidity in its general fund, which in fiscal 2016 totaled \$33.8 million or 63.5% of revenue. It maintains additional liquidity in its road and bridge fund, which in fiscal 2016 totaled \$46.5 million. Road and bridge fund liquidity has been historically strong, but fluctuates with capital spending.

### Debt and pensions: low debt burden expected to continue; moderate pension burden

The county's low debt and fixed cost burden is expected to remain a key credit strength given an absence of future borrowing plans and rapid amortization. The debt burden was moderate at 0.9% of full value and 0.78x operating revenue in fiscal 2016. Debt service was low at 0.4% of operating revenue in fiscal 2016, although it was for interest only on the 2015 certificates. Based on debt service requirements under the 2018 certificates, debt service would have comprised 9% of 2016 operating revenue. Total fixed costs, inclusive of debt service and pension contributions, totaled 1.9% of operating revenue.

## DEBT STRUCTURE

The 2018 certificates, when issued, will be the county's only debt obligation. They are fixed-rate and long-term bonds with level annual debt service requirements. With the issuance of the 2018 certificates, 100% of principal will be scheduled for repayment within 10 years. The 2018 certificates will refund the county's 2015 certificates, which were privately placed with the Bank of North Dakota. The certificates are subject to variable interest rate terms, although they do not pose a significant contingent liability risk to the county given its plans to refund the certificates and the county's limited debt service requirements relative to operating revenue. There are no swaps or demand features on the 2015 certificates.

## DEBT-RELATED DERIVATIVES

The county is not party to any derivative agreements.

## PENSIONS AND OPEB

The county participates in the North Dakota Public Employees Retirement System (NDPERS), which is a cost-sharing multiple employer pension plan. The Moody's adjusted net pension liability (ANPL) for the county totaled \$28.8 million in fiscal 2016, equal to 2% of full value and 0.54x operating revenue. Annual pension costs will likely grow because statutory contribution levels have not kept pace with growing unfunded liabilities. Pension contributions in 2016 were only 82% of our "tread water indicator."<sup>1</sup> A full tread water payment in fiscal 2016 would have totaled a higher but still low 1.8% of operating revenue. The county does not have any OPEB liabilities.

## Management and governance: moderate institutional framework

North Dakota counties have an Institutional Framework score of Aa, which is high. Institutional Framework scores measure a sector's legal ability to increase revenues and decrease expenditures. The sector's major revenue source, property taxes, are subject to a cap of 60 mills, which can be overridden at the local level with voter approval. Revenues and expenditures tend to be predictable. North Dakota is a Right to Work state, providing expenditure-cutting ability. Across the sector, fixed and mandated costs are modest. The county has benefited from strong OGGPT revenue allocations, which have provided ample funding for its capital needs. It maintains a 5-year capital improvement plan for its road and bridge improvements. Management has an informal general fund reserve target of \$20 million.

## Endnotes

- <sup>1</sup> Employer contributions that tread water equal the sum of current year service cost and interest on reported net pension liabilities at the start of the year, using reported assumptions. If plan assumptions are met exactly, contributions equal to the tread water indicator will prevent the reported net pension liabilities from growing.

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