Rating Update: Moody's confirms City of Oakland's Pension Obligation Bond Rating; G.O. and lease rating affirmed ratings

Global Credit Research - 30 Jan 2013

Approximately $1.1 billion in debt affected

OAKLAND (CITY OF) CA
Cities (including Towns, Villages and Townships)
CA

Opinion

NEW YORK, January 30, 2013 --Moody's Investors Service has confirmed the long-term ratings for the City of Oakland's Aa3 senior lien pension obligation bonds and the A1 rating on the city's subordinate lien pension obligation bonds. We have also affirmed the city's Aa2 general obligation bond rating and A1 lease revenue bond ratings. The outlook is stable for all ratings.

RATINGS RATIONALE

The rating actions reflect Oakland's large and improving local economy, stable finances that must be closely monitored amid potential challenges to reserves, and manageable debt levels.

In October we downgraded the city's senior lien POBs from Aa2 to Aa3. The Aa3 rating on the subordinate lien POBs and the leases were placed at A1. The downgrades created a more appropriate distinction between the city's general obligation bond rating and its pension and lease ratings. This distinction was made to reflect our changed view of the pledge supporting leases and pensions versus general obligation bonds. We believe the aforementioned is relatively less secure than our prior estimates, both in terms of probability of default and likely losses in the event of default. Security for the underlying non-GO payments is a contractual pledge of the city backed by all of its available financial resources. This promise is notably in contrast to the stronger, voter approved general obligation pledge that provides a baseline for our estimate of the city's credit quality. Under California law, a city's GO pledge is an unlimited ad valorem property tax pledge. The city must raise property taxes by whatever amount necessary to repay the obligation, irrespective of the city's general financial position. The relative performance of California cities' property tax bases and their financial profiles through the recent economic cycle, and likely continued divergence going forward, has resulted in our creating a greater distinction between these different types of pledges than we had previously.

STRENGTHS

-Modest economic growth

-Improving fiscal position

-Short term to maturity for several components of debt portfolio

CHALLENGES

-Economic recovery still gradual

-Assessed value growth needed to generate projected tax override revenues

DETAILED CREDIT DISCUSSION

VERY LARGE CORE BAY AREA ECONOMY CONTINUES MODEST BUT STEADY GROWTH

Oakland's very large tax base is gradually improving and appears likely to continue to move along a slow growth trajectory. The 2013 assessed value of $42 billion exceptionally large for the rating level. After two years of modest decline in 2009 and 2010, the tax base has grown two consecutive years by 1.7% and 1.6% through 2013. General economic activity continues to strengthen as the city's property , sales and hotel tax revenues all improved in 2012 and are projected to continue to increases in 2013. The city's median family income as a percentage of the US median appears to have improved over the last decade and according to the 2010 census has reached 92.9%, a solid level for a large city with Aa2-rated general obligation bonds. Unemployment is 13.1% still elevated above the state and national marks as it has been every year since at least 2002. However it has fallen three consecutive years after peaking at 17%. As it typical of an inner Bay Area city, home prices are well above national median at 253% and showing increasing signs of price increases.

FISCAL 2012 FINANCIAL IMROVEMENT CONSISTENT WITH EXPECTATIONS; CONTINUED IMPROVEMENT LIEKLY FOR FISCAL 2013

As expected, the city's fiscal 2012 audited results reflected very small operating surplus. However, the surplus is nonetheless meaningful as it was the city's first surplus after six years of very small deficits that peaked at 6% in 2008. Oakland's management has effectively lowered costs during the recent years of strained revenues. Though certain elements of the budget such as public safety costs continue to present a challenge, the city's overall costs fell each year from fiscal 2008 through 2011.

The fiscal 2013 budget is the first since 2006 to forecast a surplus and does not include any service reductions. The city's revenues are currently tracking ahead of budgeted expectations making it likely that the city will improve its already solid total general fund reserve level that is 44.8% of total general fund revenues. Over the longer term, the city will benefit from updates to its pension policies approved in 2012. This includes establishing a two-tier benefit schedule, increasing employee contributions, and basing pensions on an employee's highest three year average salary rather than the highest single year.

In December the city settled an agreement to avoid having its police department placed into "receivership." Instead, the city must fund a court appointed Director of Compliance who will have discretion over $250,000 of the police department budget, the power to fire the chief of police and will oversee the department's compliance with a range of recommendations stemming from a lawsuit. Costs attendant to getting into compliance with the recommendations are currently unknown but do not currently appear likely to materially impact the city's fiscal position.

SOLID SECURITY FOR POBS FROM PLEDGED REVENUE STREAM

The city's 2001 pension obligation bonds are secured on a senior basis to the remaining POBs which include the 2008 and 2012 issues. All legally available monies of the city as well as a property tax override are pledged to each series. Debt service also benefits from a dedicated but non-pledged annuity. Maximum annual debt service coverage on the senior lien POBs by 2013 tax override revenues is sufficient to provide a solid 1.26 times debt service coverage. This level of coverage and senior claim on the property tax override revenues is the basis for the higher Aa3 rating on the 2001 POBs relative to the A1 rated subordinate lien POBs. Total maximum annual debt service coverage by 2013 override revenues is considerably more narrow at 0.95 times. Current revenues provide just 1.06 times coverage of fiscal 2013 debt service though it rises to a more comfortable 1.10 times inclusive of the non-pledged annuity. The city projects 2% property tax override growth to provide 1.13 times total MADs debt service coverage in 2023.

SIZEABLE BUT MANAGEABLE DEBT LEVELS

Oakland's direct debt level of 2% is high compared to other Moody's-rated cities but is still manageable for the city. The overall debt level of 5% is similarly above average. While these debt levels are substantial in comparison to the universe of Moody's-rated U.S cities, Oakland is not an outlier when compared to cities of similar size and service provision. The city's general fund debt obligation is 14% including its leases and POBs, a level that is more typical at 4% if the POB is netted out .

SMALL VARIABLE RATE DEBT EXPOSURE

The city has modest variable rate debt exposure ($47.5 million in Coliseum/Arena revenue bonds). This obligation represents only 5% of the city total debt outstanding. The bonds are currently supported for three years by a Bank of New York letter of credit. Since the city's exposure to variable rate debt is fairly low, and the city has the resources to handle any likely portion of debt service, Moody's does not consider the debt to pose a significant credit risk.

OUTLOOK

The stable outlook is derived from our expectation that the city will continue to experience gradual economic improvement and produce stable financial results.

WHAT COULD MAKE THE RATING GO UP

-Material and sustained improvement to the city's assessed valuation and socio-economic indicators

-Significant improvement to the city's financial position

WHAT COULD MAKE THE RATING GO DOWN

-Erosion of the city's financial position

-Prolonged economic decline

KEY STATISTICS

2012 assessed valuation: $42.6 billion

2012 unrestricted general fund reserve: 25.4%

Direct debt: 2%

Overall debt: 5%

RATING METHODOLOGIES

The principal methodology used in rating the general obligation bonds was General Obligation Bonds Issued by U.S. Local Governments published in October 2009. The principal methodology used in rating the lease revenue bonds was The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in December 2011. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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Analysts

Michael Wertz
Lead Analyst
Public Finance Group
Moody's Investors Service

Kristin Button
Additional Contact
Public Finance Group
Moody's Investors Service

Kenneth Kurtz

Additional Contact
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653

Moody's Investors Service, Inc.
250 Greenwich Street
New York, NY 10007
USA