

## **FITCH AFFIRMS OAKLAND, CA'S SEWER REVENUE BONDS AT 'AA'; OUTLOOK STABLE**

Fitch Ratings-San Francisco-19 January 2016: Fitch Ratings has affirmed the following Oakland, California (the city) bonds:

--\$36.6 million sewer revenue bonds at 'AA'.

The Rating Outlook is Stable.

### **SECURITY**

The bonds are backed by a first pledge on net revenues of the city's sewer system (the system) after payment of operations and maintenance expenses.

### **KEY RATING DRIVERS**

**STRONG FINANCIAL PERFORMANCE:** The sewer enterprise's debt service coverage (DSC) remains very strong, driven by a significant cash funded capital program. Liquidity is solid.

**LARGE, DIVERSE SERVICE AREA:** The enterprise provides an essential service to a large and diverse service area in the San Francisco Bay Area's third-largest city. Income and employment indicators are somewhat weak.

**LIMITED OPERATIONS:** The enterprise is a collection-only sewer system that owns no treatment plant, reducing the operational complexity of the system.

**SIGNIFICANT CAPITAL NEEDS:** The sewer system's infrastructure is quite old, and regulators have forced the city to undertake significant, but manageable, capital upgrades to reduce sewer discharges into the San Francisco Bay.

**DISCIPLINED RATE SETTING:** The Oakland City Council has consistently imposed rate increases to cover the increasing costs of upgrading the aging system, while preserving healthy financial performance.

**LOW DEBT BURDEN:** The debt burden is very low, and the system has no further debt issuance plans.

### **RATING SENSITIVITIES**

**RATE SETTING AND REGULATION:** A decrease in rate discipline or unexpectedly large regulatory capital requirements could put downward pressure on the rating, as would deterioration in the utility's liquidity. The Stable Outlook means that Fitch does not expect such pressures to emerge over the next two years.

### **CREDIT PROFILE**

The enterprise provides sanitary sewer services to a stable, established city of about 414,000 people and 102,000 accounts on the eastern edge of the San Francisco Bay. The payer mix is diverse with residential customers providing about 70% of revenues. The service area also includes a large downtown that's a regional employment hub with significant commercial, industrial and

governmental ratepayers. Customer concentration is low with the top 10 ratepayers providing less than 2% of revenues.

While the Oakland economy is large and diverse with strong ties to the broader Bay Area employment market, the city's economy is weaker than many of its wealthy San Francisco Bay area neighbors. The economy is currently growing at a healthy pace. The unemployment rate trends higher than the national average, but was quite healthy at 5.5% in November 2015. Median household income (MHI) is somewhat low for California at 86% of the state median and 99% of the national level. The individual poverty rate is high at 21%.

#### STRONG FINANCIAL PERFORMANCE

The city's sewer enterprise has performed well financially despite economic challenges and the burden of maintaining an aging infrastructure. The enterprise is a collection-only sewer system with no treatment plant, reducing the operational complexity, and its rate revenue comes primarily from fixed charges, providing a great deal of revenue stability. All-in debt service coverage averaged a very strong 5.4x over the three fiscal years ended June 30, 2014, exceeding medians for all rating categories. Coverage is expected to continue to remain quite strong, driven by strong cash flows generated to pay for capital investments.

Liquidity has improved markedly over the past five years, ending 2014 with a very strong 473 days cash on hand. The city historically kept very little cash on its balance sheet because it invested almost all of its free cash flow back into the aging system, but it has built up and maintained significant reserves in recent years as collections got ahead of capital spending.

While the funds are earmarked for capital, they are not legally restricted and provide a strong liquidity position that protects bondholders and system financial health. Fitch expects Oakland's cash balances to vary with its capital spending cycle, but a commitment to cash funding ongoing capital needs suggests the utility will have significant revolving capital reserves for the foreseeable future.

#### SIGNIFICANT CAPITAL NEEDS

The utility's financial profile is dominated by the need to revitalize an aging system and a practice of cash funding renewal and replacement projects. Oakland's sewer system includes pipes dating from the 1800s, and the average age of plant is elevated at 19 years. The aging infrastructure has contributed to significant sanitary sewer overflows, which have drawn heightened regulatory and public scrutiny amid efforts to protect the San Francisco Bay. Regulators continue to force the city to undertake significant renewal of the system. The city plans to spend about \$89.8 million on sewer capital spending over the next five years with significant portions of the capital program dedicated to preventing rainwater from flowing into the sanitary sewer system in order to comply with regulatory requirements.

#### SOLID RATE DISCIPLINE

The Oakland City Council has imposed significant rate increases to cover the increasing costs of upgrading the system, allowing the utility to meet most of these requirements on a pay-as-you-go basis. Rate increases averaged 7.5% in the five years through 2016. The rate hikes elicited few protests from ratepayers and no dissenting votes from elected policymakers, suggesting strong political support for the capital program. Still, the rate increases pushed Oakland residents' combined sewer collection bill (paid to the Oakland enterprise) and treatment bill (paid to East Bay Municipal Utility District) to slightly above Fitch's 1% affordability threshold for sewer bills, suggesting that rate flexibility may be diminishing in the face of continued significant increases. The decrease in rate flexibility does not appear likely to be a near-term credit concern as the city does not need significant rate increases. The city expects inflation-like rate increases over the next several years, and the Oakland City Council has already approved rate increases up to the rate of inflation over the period.

## LOW DEBT BURDEN

The consistent use of significant pay-go capital funding yields a very low debt burden for the enterprise. Debt is quite low at \$87 per capita or \$327 per customer. All of the city's outstanding sewer bonds amortize within 14 years. The city currently has no plans to issue additional debt over the near term, suggesting debt ratios will remain a positive credit factor.

Contact:

Primary Analyst

Andrew Ward

Director

+1-415-732-5617

Fitch Ratings, Inc.

650 California Street

San Francisco, CA 94103

Secondary Analyst

Alan Gibson

Director

+1-415-732-7577

Committee Chairperson

Douglas Scott

Managing Director

+1-512-215-3725

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: [elizabeth.fogerty@fitchratings.com](mailto:elizabeth.fogerty@fitchratings.com).

Additional information is available at '[www.fitchratings.com](http://www.fitchratings.com)'.

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

Applicable Criteria

Revenue-Supported Rating Criteria (pub. 16 Jun 2014)

[https://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=750012](https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=750012)

U.S. Water and Sewer Revenue Bond Rating Criteria (pub. 03 Sep 2015)

[https://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=869223](https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869223)

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