FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Oakland, CA's IDR to 'A'; Outlook Revised to Negative

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Fitch Ratings - San Francisco - 27 Nov 2024: Fitch Ratings has downgraded Oakland, CA's (the city) Issuer Default Rating (IDR) to 'A' from 'AA-'. The Rating Outlook has been revised to Negative from Stable.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Oakland (CA) [General Government]	LT IDR	A Rating Outlook Negative	Downgrade	AA- Rating Outlook Stable
Oakland (CA) /Issuer Default Rating - General Government/1 LT	LT	A Rating Outlook Negative	Downgrade	AA- Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

The two-notch downgrade of the city's IDR to 'A' reflects the notable projected general fund budget gap for fiscal 2025 and future years. The projected deficit for fiscal 2024 (ended June 30) is $79 million (about 10% of adjusted budget expenditures), while the preliminary projected deficit for fiscal 2025 is $93 million (nearly 12% of adjusted budget expenditures). Fitch expects the significant expenditure reductions will be difficult to implement in the near term and will take time due to the city's changing elected leadership.

The Outlook revision to Negative reflects the uncertainty regarding the magnitude of the reductions in the city's unrestricted fund balances, which were $311 million or 33% of spending at fiscal end 2023. It also considers the timing needed for right-sizing of the operating budget to avoid significant reserve drawdowns and a weakening of financial resilience.

Fitch believes leadership turnover has heightened the city's financial vulnerability. Pending official election certifications, projections indicate city voters recalled the mayor due in part to public safety concerns. The eight-seat city council will have three new members and a fourth is possible as the current council president is projected to win a seat on Alameda County's Board of Supervisors. The current mayor is expected to step down once election results are certified in December, with a special election to follow within 120 days to replace the recalled mayor.

The churn in the city's elected government complicates its ability to address the current budget gaps, projected to widen unless decisive action is taken. A city report released on November 19th by the financial management team stated immediate action is necessary to avoid beginning the Chapter 9 process. This report has been replaced with another still calling for immediate action to maintain solvency in the general purpose fund but omitting any reference to bankruptcy or Chapter 9.

Oakland ended fiscal 2023 with an unrestricted general fund reserve of approximately $311 million (about 33% of total general fund spending and transfers out), more than double the pre-pandemic fiscal 2020 unrestricted reserve of $150 million (17%). The city used $188 million in American Rescue Plan Act (ARPA) funding for revenue recovery by temporarily shifting applicable general fund expenditures to its ARPA fund between fiscal 2021 and fiscal 2023, significantly boosting general fund reserves.

In fiscal 2024, ARPA funding expired, shifting those expenditures back into the general fund. This coincided with a sharp reduction in the city's real estate transfer tax (RETT), a key general fund revenue source. Fiscal 2024 projections indicate the RETT revenues at $58 million, well below its budgeted $110 million and the fiscal 2022 and fiscal 2023 amounts of $139 million and $78 million, respectively.

The city's three other large tax revenue sources showed mixed results in fiscal 2024. Property taxes, the city's largest tax revenue source, are projected to be $299 million, about 6% above fiscal 2023 levels. Business license taxes are also projected to increase by 6% in fiscal 2024 to $123 million. However, sales taxes are expected to decrease by 6%, ending fiscal 2024 at $62 million compared to $66 million in fiscal 2023. A fiscal 1Q25 report projects overall general purpose revenues increasing 3.3% above fiscal 4Q24 projections.

Expenditures are currently projected to exceed revenues by $79 million in fiscal 2024 and $93 million in fiscal 2025. The region's high cost of living continuously applies wage pressures for all departments. Furthermore, there is growing political pressure from residents and businesses to expand public safety efforts, which has led to increased public safety personnel and overtime pay. Current fiscal 2025 projections show police expenditures 16% ($52 million) above the adopted budget and fire 21% ($34 million) above budgeted levels.

Public safety is more than half of all general fund expenditures. The political pressure to enhance public safety is so great that it was one of the main contributors to the mayor's recall. Voters recently extended and increased parking and parcel taxes, providing an additional $20 million specifically for public safety. This additional revenue could temporarily relieve some political pressure for more public safety.

The original fiscal 2025 budget of $807 million included revenues of nearly $60 million from the potential sale of the Oakland Coliseum. Because the sale was not finalized at budget adoption, the city passed a contingency budget. This contingency budget would reduce budgeted expenditures equivalent to the Coliseum's sale proceeds if certain payments were not made on time from the African American Sports and Entertainment Group, the Coliseum's potential buyer.

Subsequent delays in payments have caused the contingency budget to be enacted, freezing positions across all departments, lowering spending, and halting new contract and grant agreements. Full enactment of the contingency plan is unlikely as many cuts target the police and fire departments, facing political headwinds due to public safety concerns. City management is expected to provide additional cuts in mid-December to help close the gap.

The city has a track record of projecting deficits by closing the gaps through vacancies and department cost savings. Current vacancies are near 22% while assumed cost savings come from 10% vacancies. The size of the current deficits are outliers from years past. However, Fitch notes that extraordinary levels of unrestricted reserves built up over the past few years will help absorb the recent projected deficits. There is an immediate need for the city to sharply reduce its deficit spending to more sustainable levels, while anticipating some fund balance use throughout the potential revenue recovery, with reserves likely stabilizing near pre-pandemic levels.

The elected leadership void casts some uncertainty regarding when the city will enact the necessary cuts and align expenditures with revenues. The current rating is dependent on the city restoring budget alignment measures. Delayed corrective budgetary action and projections showing unrestricted reserves falling outside the 10%-17.5% range for a financial resilience assessment of 'a' and below pre-pandemic levels , could put additional negative pressure on the rating.

The rating incorporates a -1.0 Additional Analytical Factor (AAF) for Management Practices given elected leaders' irresolute decision making in closing budget gaps, heightened solvency concerns by the financial management team, and the council enacting numerous cost saving measures that are likely unenforceable due to a highly charged political climate.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--Inability to significantly close the projected budget gap, causing unrestricted general fund reserves to fall and be sustained below 10% of spending and transfers out, the minimum reserve level for 'a' financial resilience when issuers have limited budgetary flexibility;

--Sustained weakening of the city's demographic and economic data;

--The combined liability burden nearly doubling when assuming current levels of personal income, governmental revenues and expenditures.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Sharp reductions in deficit spending that support maintenance of unrestricted reserves above at least 10% of spending which could support the removal of the negative AAF or Fitch expectations for sustainment of unrestricted general fund balances at least equal to or above 17.5% of spending.

SECURITY

Issuer Default Rating Only.

FITCH’S LOCAL GOVERNMENT RATING MODEL

The Local Government Rating Model generates Model Implied Ratings, which communicate the issuer's credit quality relative to Fitch's local government rating portfolio. (The Model Implied Rating will be the Issuer Default Rating except in certain circumstances explained in the applicable criteria.) The Model Implied Rating is expressed via a numerical value calibrated to Fitch's long-term rating scale that ranges from 10.0 or higher (AAA), 9.0 (AA+), 8.0 (AA), and so forth down to 1.0 (BBB- and below).

Model Implied Ratings reflect the combination of issuer-specific metrics and assessments to generate a Metric Profile and a structured framework to account for Additional Analytical Factors not captured in the Metric Profile that can either mitigate or exacerbate credit risks. Additional Analytical Factors are reflected in notching from the Metric Profile and are capped at +/-3 notches.

RATINGS HEADROOM & POSITIONING

Oakland Model Implied Rating: 'A' (Numerical Value: 5.85)

-- Metric Profile: 'A+' (Numerical Value: 6.85)

-- Net Additional Analytical Factor Notching: -1.0

Individual Additional Analytical Notching Factors:

-- Management Practices: -1.0

Oakland's Model Implied Rating is 'A'. The associated numerical value of 5.85 is at the upper end of the 5.0 to 6.0 range for its current 'A' rating.

KEY RATING DRIVERS

FINANCIAL PROFILE

Financial Resilience - 'a'

Oakland's financial resilience is driven by the combination of its 'Low' revenue control assessment and 'Midrange' expenditure control assessment, culminating in a 'Limited' budgetary flexibility assessment.

-- Revenue control assessment: Low

-- Expenditure control assessment: Midrange

-- Budgetary flexibility assessment: Limited

-- Minimum fund balance for current financial resilience assessment: >=10.0%

-- Current year fund balance to expenditure ratio: 33.4% (2023)

-- Five-year low fund balance to expenditure ratio: 17.3% (2023)

Revenue Volatility - 'Midrange'

Oakland's weakest historic three-year revenue performance has a modest negative impact on the Model Implied Rating.

The revenue volatility metric is an estimate of potential revenue volatility based on the issuer's historical experience relative to the median for the Fitch-rated local government portfolio. The metric helps to differentiate issuers by the scale of revenue loss that would have to be addressed through revenue raising, cost controls or utilization of reserves through economic cycles.

-- Lowest three-year revenue performance (based on revenues dating back to 2005): 3.2% decrease for the three-year period ending fiscal 2010

-- Median issuer decline: -4.7% (2023)

Financial Profile Additional Analytical Factors and Notching: -1.0 notch (for Management Practices)

Fitch has applied a -1.0 notch for Management Practices. The 2025 budget balancing steps show a level of irresolute decision making by elected officials to find long-term, sustainable solutions to close the projected budget gaps. When the contingency budget was enacted due to delayed payments for the sale of the Coliseum, many of the action items included public safety cuts, which are unlikely to be enforced due to the highly charged political climate demanding greater public safety services.

Management expects to propose additional cost saving options in mid-December, but sizeable cuts outside of public safety could also be difficult. Additionally, the Fiscal 2025Q1 report's language discussing Chapter 9 indicates a heightened level of concern by the city's financial management team, which Fitch believes is exacerbated by the high turnover in the city council and mayor's office.

DEMOGRAPHIC AND ECONOMIC STRENGTH

Population Trend - 'Weak'

Based on the median of 10-year annual percentage change in population, Oakland's population trend is assessed as 'Weak'.

Population trend: 0.3% Analyst Input (21st percentile) (vs. 0.5% 2022 median of 10-year annual percentage change in population)

Unemployment, Educational Attainment and MHI Level - 'Midrange'

The overall strength of Oakland's demographic and economic level indicators (unemployment rate, educational attainment, median household income [MHI]) in 2023 are assessed as 'Midrange' on a composite basis, performing at the 55th percentile of Fitch's local government rating portfolio. This is due to very high education attainment levels and midrange median-issuer indexed adjusted MHI offsetting elevated unemployment rate.

-- Unemployment rate as a percentage of national rate: 127.8% 2023 (22nd percentile), relative to the national rate of 3.6%

-- Percent of population with a bachelor's degree or higher: 48.4% (2022) (86th percentile)

-- MHI as a percent of the portfolio median: 105.2% (2022) (56th percentile)

Economic Concentration and Population Size - 'Strongest'

Oakland's population in 2023 was of sufficient size and the economy was sufficiently diversified to qualify for Fitch's highest overall size/diversification category.

The composite metric acts asymmetrically, with most issuers (above the 15th percentile for each metric) sufficiently diversified to minimize risks associated with small population and economic concentration. Downward effects of the metric on the Metric Profile are most pronounced for the least economically diverse issuers (in the 5th percentile for the metric or lower). The economic concentration percentage shown below is defined as the sum of the absolute deviation of the percentage of personal income by major economic sectors relative to the U.S. distribution.

-- Population size: 436,504 (2023) (above the 15th percentile)

-- Economic concentration: 23.3% (2023) (above the 15th percentile)

Analyst used 2023 population, the most currently available data.

LONG-TERM LIABILITY BURDEN

Long-Term Liability Burden - 'Weakest'

Oakland's long-term liability metrics remain moderately weak across each of the three dimensions: liabilities to personal income, liabilities to governmental revenue, and carrying costs to governmental expenditures. The long-term liability composite metric in 2023 is at the 19th percentile, indicating an elevated liability burden relative to the Fitch's local government rating portfolio.

-- Liabilities to personal income: 8.3% Analyst Input (28th percentile) (vs. 8.2% 2023 Actual)

-- Liabilities to governmental revenue: 215.2% Analyst Input (34th percentile) (vs. 210.6% 2023 Actual)

-- Carrying costs to governmental expenditures: 28.6% Analyst Input (3rd percentile) (vs. 28.2% 2023 Actual)

Direct debt was adjusted to remove scheduled principal amortized in fiscal 2024 and to include new GO debt of $154 million issued in October 2023. Debt service was also adjusted to include the 2024 GO debt service. The input uses the Fiscal 2026 debt service due to the Fiscal 2025 principal payment being an outlier in size.

PROFILE

Oakland, the third-largest San Francisco Bay Area city, benefits from a large and diverse service-based economy that is growing rapidly amid a boom in the region's technology-driven economy. The city is the commercial, service, healthcare and governmental center of the East Bay region. The city is also a regional transportation hub with one of the largest ports in the nation and an international airport.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Oakland has an ESG Relevance Score of '5' for Rule of Law, Institutional & Regulatory Quality, Control of Corruption, which reflects certain governance factors that have a negative impact on the credit profile and highly relevant to the rating. Governance concerns center on the potential recall of the mayor (pending election certification) and turnover in other key management positions that will likely strain the city's ability to reach consensus on fiscally sustainable solutions to its existing budget gap in a timely manner.

Oakland maintains some margin to sustain the 'A' rating but additional negative rating action is foreseeable should the city prove unwilling or unable to control overspending reported across most city departments in order to stave off ongoing revenue pressures and continued draws on existing reserves.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

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APPLICABLE CRITERIA

U.S. Public Finance Local Government Rating Criteria (pub. 02 Apr 2024) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

U.S. Local Government Rating Model, v1.2.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Oakland (CA)	EU Endorsed, UK Endorsed

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