

RATING ACTION COMMENTARY

Fitch Upgrades Oakland, CA's Sewer Revs to 'AAA'; Outlook Stable

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Fitch Ratings - Austin - 23 Apr 2024: Fitch Ratings has upgraded the following Oakland, CA (the city) obligations to 'AAA' from 'AA+':

--\$18.5 million sewer revenue refunding bonds, 2014 series A.

Fitch has also assessed the standalone credit profile (SCP) of the city's sewer system (the system) at 'aaa'. The SCP represents the credit profile of the system on a standalone basis irrespective of its relationship with and the credit quality of the city (Issuer Default Rating AA-/Stable).

The Rating Outlook is Stable

RATING ACTIONS

ENTITY / DEBT ⚡	RATING ⚡	PRIOR ⚡
Oakland (CA) [Sewer]		
Oakland (CA) /Sewer Revenues/1 LT	LT AAA Rating Outlook Stable	Upgrade AA+ Rating Outlook Positive

VIEW ADDITIONAL RATING DETAILS

The upgrade to 'AAA' reflects Fitch's expectation that the system's leverage will remain exceptionally low and well below 5.0x despite meaningful capital spending related to the

system's consent decree and a sizable capital improvement plan (CIP). The finances of the city and the system were not materially affected by a cyber incident in February 2023. As part of its remediation effort, the city has significantly improved its security operations and begun development of formal incident response plans to guide response activities should such an event happen again.

The 'AAA' sewer revenue bond rating along with the 'aaa' SCP further reflect the system's 'Exceptionally Strong' financial profile within the framework of 'Very Strong' revenue defensibility and a 'Very Strong' operating risk profile, both assessed at 'aa'. The system's leverage of -0.1x in fiscal 2023, measured as net adjusted debt to adjusted funds available for debt service (FADS), indicates cash and investments available for debt service that are greater than net adjusted debt. Leverage is projected to increase to 1.9x over the next five years in Fitch's Analytical Stress Test (FAST) rating case, but the metric should retain ample headroom within the rating category.

SECURITY

The bonds are secured by the system's net revenues after payment of operations and maintenance expenses.

KEY RATING DRIVERS

Revenue Defensibility - 'aa'

Favorable Service Area, Affordable Rates for a Significant Majority of the Population: The city retains the legal authority to adjust rates as needed without external oversight. Fitch considers the monthly residential sewer bill affordable for around 79% of the service area population based on standard monthly usage of 6,000 gallons. The favorable service area is characterized by stronger income levels, a volatile unemployment rate relative to the nation and midrange customer growth. Customer growth registered a five-year compound annual growth rate of 0.7% as of fiscal 2023. Income levels are about 26% higher than the national median as of 2022. The unemployment rate has decreased to 3.9% since 2020 and was 8% more than the national average in 2022.

Operating Risk - 'aa'

Very Low Operating Cost Burden, Moderate Investment Needs: In fiscal 2023, the system's operating cost burden was very low at \$2,825 per million gallons (mg), consistent with the operating risk assessment. The life cycle ratio was low at 39% in fiscal 2023. Annual capital spending relative to depreciation has been strong, averaging 150% over the

last five fiscal years from 2019 to 2023. Planned capital spending for the next five years should generally outpace historical depreciation, supporting a continued low life cycle ratio.

The CIP for fiscals 2024-2028 totals \$169 million and continues to be entirely pay-go funded. No additional debt is expected since the current plan continues to focus on rehabilitating about 13 miles of sewer mains per year as part of the system's consent decree. In FY23, the system rehabilitated a total of 15.1 miles.

Financial Profile - 'aaa'

Leverage to Increase: The system had leverage of -0.1x as of fiscal 2023 since available cash exceeds adjusted debt. The liquidity profile is neutral to the overall assessment with current days cash on hand of 562 and coverage of full obligations (COFO) of 4.5x. Fitch-calculated total debt service coverage for fiscal 2023 was 5x.

The FAST considers the potential trend of key ratios in a base case and stress scenario over a five-year period. The stress scenario is designed to impose capital costs 10% above expected base-case levels and evaluate potential variability in projected key ratios. The FAST reflects Fitch's view of a reasonable scenario, which is generally informed by publicly available and/or management provided information with respect to capex, user charges and rate of revenue and expenditure growth.

In the base case scenario, the leverage ratio is expected to increase to 1.4x through fiscal 2028. In the stress scenario, which is considered the rating case, the leverage ratio is projected to increase to 1.9x over the five-year horizon. Both scenarios factor capital spending in line with CIP and sufficient to address the system's current consent decree. The liquidity profile is expected to remain neutral to the assessment over the five-year horizon.

Asymmetric Additional Risk Considerations

No asymmetric additive risk considerations affected the rating determination.

RATING SENSITIVITIES

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

--Deterioration in the city's credit quality, whether as a result of negative events related to the recent cyberattack or other factors, could lead to negative rating action;

--Adoption and execution of a long-term comprehensive CIP significantly in excess of the current CIP that results in prospective leverage greater than 5.0x.

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

--The rating is at the highest level on Fitch's scale and cannot be upgraded.

PROFILE

The enterprise provides collection-only sewer service with treatment provided by the East Bay Municipal Utility District (EBMUD; sewer revenue bonds AA+/Stable). EBMUD bills all of the system's customers directly so the city has no costs associated with EBMUD treatment reflected on the system's income statement. Oakland is the San Francisco Bay Area's third-largest city with a population of about 420,000 people and approaching 119,000 service accounts. The city's large downtown is a regional employment hub with significant commercial, industrial and governmental ratepayers.

The sewer system operates under a consent decree to undertake significant, but manageable, capital upgrades to reduce sewer discharges into the San Francisco Bay. The utility has committed to funding these needs with cash flow from operations, which, to date, had resulted in healthy financial margins and should allow for sustained exceptionally low leverage.

Fitch considers the system to be a related entity to the city for rating purposes given the city's oversight of the system, including the authority to establish rates and operations. The credit quality of the city does not currently constrain the bond rating. However, as a result of being a related entity, the issue rating could become constrained by a decline in the general credit quality of the city.

February 2023 Cyberattack

On Feb. 14, 2023 Oakland issued a local state of emergency in the wake of a cyberattack on the city's network. The attack disrupted the city's non-emergency systems as well as the ability to collect payments and issue permits and licenses. Although the city incurred costs and expenses immediately following the attack related to the considerable staff time involved, engaging outside consulting services to respond to and address the incident, and ongoing budget impacts for enhanced IT, the city's finances were not materially affected by the incident. However, the hackers released data on the dark web in two different instances, which could make the city vulnerable to litigation and additional costs that will not be known for some time.

Sources of Information

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

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

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 www.fitchratings.com/topics/esg/products#esg-relevance-scores.

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APPLICABLE CRITERIA

U.S. Public Sector, Revenue-Supported Entities Rating Criteria (pub. 12 Jan 2024) (including rating assumption sensitivity)

U.S. Water and Sewer Rating Criteria (pub. 29 Feb 2024) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

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Oakland (CA)

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