FitchRatings

Fitch Upgrades Oakland Sewers to 'AA'; Outlook Revised to Stable

Ratings Endorsement Policy
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Fitch Ratings-San Francisco-22 January 2014: Fitch Ratings assigns an ‘AA’ rating to the following Oakland, California debt:

--$41.7 million sewer revenue refunding bonds 2014 series A.

The bonds are scheduled to sell via negotiation on or about Jan. 27, 2014. The proceeds will be used to refund the district’s outstanding sewer revenue bonds.

In addition, Fitch upgrades the following ratings:

--$48.7 million sewer revenue bonds series 2004A to ‘AA’ from ‘AA-’.

The Rating Outlook is revised to Stable from Positive.

SECURITY

The bonds are secured by net sewer revenues.

KEY RATING DRIVERS

UPGRADED ON FINANCES: The sewer enterprise’s debt service coverage remains very strong, and liquidity has improved markedly after a series of rate increases.

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.

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 overflows into the San Francisco Bay.

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

MIXED SERVICE AREA FUNDAMENTALS: The enterprise is the monopoly provider of an essential service to a large and diverse service area in the San Francisco Bay Area’s third-largest city. However, income and employment indicators are somewhat weak.

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 material deterioration in the utility’s cash position.

CREDIT PROFILE

The enterprise provides sanitary sewer services to a stable, mature city of about 400,000 people and 102,000 accounts on the eastern edge of the San Francisco Bay. The payer mix is diverse with residential accounts providing 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.

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 4.9x over the three fiscal years ended June 30, 2013, exceeding medians for all rating categories. Coverage is expected to continue to remain quite strong, improving over a conservative five-year forecast horizon that requires only minimal rate increases.

Liquidity has improved markedly over the past five years, ending 2013 with a very strong 517 days cash on hand. Improvements in liquidity are a key driver of the upgrade. 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 robust reserves in recent years as revenues got ahead of capital spending.

This is a typical pattern for water and sewer utilities with large capital programs. The need to build large balances for capital projects tends to create very strong liquidity in the sector. 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 sizeable revolving capital reserves for the foreseeable future. The city also maintains a small rate stabilization fund that is currently funded at about $1.2 million.

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 quite elevated at 18 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. The utility has made good progress in reducing overflows.

Regulators forced the city to undertake a 25-year, $260 million upgrade of system capacity that the city will complete in 2014. The utility's 2014 National Pollutant Discharge Elimination System permit is likely to require further significant, but manageable, investments in the city's pipe replacement and renewal program. The city plans to spend about $81.6 million on sewer capital spending over the next five years with much 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 substantial 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. Policymakers approved rate increases of 16% in 2011, 2012 and 2014 to fund the capital program. 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 rate increases. Indeed, the city council delayed the final increase from 2013 to 2014 to give rate payers some relief during difficult economic times. The final rate increase was implemented as scheduled on Jan. 1, 2014, and the delay did not cause any deterioration in the utility's financial position.

LOW DEBT
The consistent use of pay-go capital funding yields a very low debt burden for the enterprise. Debt is quite low on both a per capita ($127) and per customer ($499) basis and declining due to rapid amortization. All of the city's outstanding sewer bonds amortize within 16 years. The city currently has no plans to issue additional debt over the near term, suggesting debt ratios will remain a positive credit factor.

WEAK ECONOMY
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 San Francisco Bay area neighbors. The unemployment rate tends to run above regional, state and national averages, and it was quite elevated at 10.4% in November 2013. Median household income is low for California at 83% of the state median and 97% of the national level. The individual poverty rate is high at 20.3%.

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In addition to the sources of information identified in the Revenue-Supported Rating Criteria, this action was informed by information from CreditScope and IHS Global Insights.

Applicable Criteria and Related Research:
--'Revenue-Supported Rating Criteria' (June 3, 2013);
--'U.S. Water and Sewer Revenue Bond Rating Criteria' (July 31, 2013);
--'2014 Water and Sewer Medians', dated Dec. 12, 2013;
--'2014 Outlook: Water and Sewer Sector', dated Dec. 12, 2013.

Applicable Criteria and Related Research:
Revenue-Supported Rating Criteria
U.S. Water and Sewer Revenue Bond Rating Criteria
2014 Water and Sewer Medians
2014 Outlook: Water and Sewer Sector

Additional Disclosure
Solicitation Status