City of
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EVENT NOTICE PURSUANT TO S.E.C. RULE 15C2-12
RATING CHANGE

Dated: March 20, 2019

NOTICE IS HEREBY GIVEN that on March 19, 2019, Standard and Poor's Global Ratings ("S&P") upgraded the long-term rating to "AA" from "AA-" with a stable outlook for the City of Sacramento 2013 Wastewater Revenue Bonds. Additionally, with this report S&P has assigned a new rating to the upcoming issuance of the 2019 Wastewater Revenue Bonds.

The rating report from S&P is attached.

City of Sacramento

Brian Wong
Debt Manager

Attachment: S&P Press Release – City of Sacramento 2013 Wastewater Revenue Bonds and 2019 Wastewater Revenue Bonds.

S&P Global Ratings

RatingsDirect®

Summary:

Sacramento, California; Water/Sewer

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Summary:

Sacramento, California; Water/Sewer

Credit Profile		
US$27.075 mil wastewater rev bnds ser 2019 due 09/01/2039		
Long Term Rating	AA/Stable	New
Sacramento WTRSWR		
Long Term Rating	AA/Stable	Upgraded

Rationale

S&P Global Ratings raised its long-term rating to 'AA' from 'AA-' on Sacramento, Calif.'s outstanding series 2013 wastewater revenue bonds and at the same time assigned its 'AA' long-term rating to the city's series 2019 wastewater revenue bonds. The rating reflects our view of the wastewater system's very strong enterprise profile and extremely strong financial risk profile. The outlook is stable.

The raised rating reflects the city's consistent extremely strong all-in coverage and cash during the past three fiscal years, which we expect to continue given the sophisticated management team and strong rate-setting practices. In addition, the raised rating is supported by overall good operational management focused on long-term capital needs to maintain the integrity of the wastewater system and to comply with environmental regulations.

The series 2019 bonds are being issued to finance about $32 million in capital improvements to the city's wastewater system. The projects are largely rehabilitation and replacement in nature. The city's wastewater system supports about $6.2 million of outstanding state revolving fund loans and about $28.5 million of its 2013 wastewater revenue bonds. The state loans are also payable from the city's stormwater system, a separate enterprise. The city has historically paid about 75% of state loans debt service with stormwater fund revenue, with the remainder funded by the wastewater system. The last payment on the state loans is in 2021.

The enterprise risk profile reflects our view of the wastewater system's:

- Service area participation in the Sacramento-Roseville-Arden metropolitan statistical area, anchored by the state capital;
- Affordable service rates in the context of the service area's good income metrics, offset by exposure to planned Sacramento Regional County Sanitation District (SRCSD) regional treatment rate increases that are set separately by the regional treatment plant provider and work to increase customers' overall wastewater bill;
- Very low industry risk as a monopolistic service provider of an essential public utility; and
- Good operational management assessment represented by management's focus on maintaining the integrity of the wastewater and stormwater system, in addition to a continued focus on complying with environmental regulations.

The financial risk profile reflects our view of the wastewater system's:

- Extremely strong historical and projected all-in coverage metrics at above 2.0x, which we expect to stay extremely strong given the lack of debt plans during the next four years;
- Extremely strong liquidity position, which we expect will stay extremely strong, at $39 million, or 532 days of operating expenses;
- Low pro forma debt to capitalization ratio of nearly 27%, which, given management's lack of immediate debt plans, we expect to stay low; and
- Strong financial management assessment represented by formalized financial practices and policies and by long-term financial and capital planning.

We view the bond provisions as credit neutral. The bonds are secured by net revenue of the wastewater system. A rate covenant requires the city to generate net wastewater system revenue that provides at least 1.20x annual debt service coverage on parity obligations, 1.10x coverage on parity and subordinate obligations, and 1.0x coverage on all obligations, with any withdrawals from a rate stabilization fund included as revenue. To issue additional parity debt, the city must certify that projected net revenue will provide at least 1.20x debt service coverage on existing and proposed debt. The series 2019 bonds will not have a debt service reserve. We view this as credit neutral given the wastewater system's extremely strong cash position.

Enterprise risk

The city is located in Sacramento County in the northern section of California's Central Valley at the confluence of the Sacramento and American rivers. The city is the state's capital, and the employment base consists of government- and health care-related employment. Although Sacramento's recovery from the Great Recession has lagged more than that of other parts of California, the city and county's recent economic trends have been positive as a result of increased housing demand stemming from residents' fleeing more expensive coastal urban areas in the state. The city's current population is about 498,000 (2017), up from about 478,500 (2013). We view the service area's income levels to be good, based on the city's median household effective buying income (MHHEBI), which was 96% of the national median for 2017. For December 2018, the city's unemployment rate was about 3.7%, which was in line with the county's 3.7% and the state's 3.7% rates but lower than the 4.1% national rate. Unemployment has declined to 3.7% for December 2018 from about 6.3% in 2015.

The wastewater system's customer base is primary residential and very diverse, with projected customer growth of about .1% annually. The wastewater system provides sewer collection service to about 60% of the city, covering 77,500 accounts. The remaining 40%, largely in the northwest and southeast sections of the city, are served by the Sacramento Area Sewer District. About 94% of total customers served are residential. We consider the customer base to be very diverse based on the leading 10 customers contributing less than 7% of total operating revenue for fiscal year 2018. The largest customers are the State of California, the city of Sacramento, and Sacramento Unified School District. The leading customer, the state of California, represented about 1.6% of total operating revenue for 2018.

We view the wastewater system's market position as good, represented by affordable service rates in the context of the service area's good income metrics, although rates may be less affordable to a portion of the customer base given the high county poverty rate. Billing for wastewater service (including SRCSD charges) is included on a monthly bill that may include other utility services provided by the city. The city sets rates to cover costs of its local system only.

SRCSD sets a separate rate paid by customers to cover regional treatment plant expenses. The city is responsible for payment to SRCSD for any charges not paid on time by city customers. If there are delinquencies, the city pursues collections through liens or special assessments, or both, for any uncollectable fees. The city and other SRCSD contributing agencies collect the regional treatment fee on behalf of SRCSD and must cover any delinquencies.

The city charges a fixed monthly charge for wastewater rates. The city's wastewater bill is about $23.70 for a typical customer using our benchmark of about 6,000 gallons of water per month, and SRCSD's current wastewater treatment cost is $37 a month. For a typical residential customer using our benchmark of 6,000 gallons of water usage per month and including SRCSD's rates, the monthly-equivalent bill is affordable, at about 1.59% of the county's MHHEBI. The county's poverty rate as reported by the U.S. Department of Agriculture is 18.1%, which we view as higher than average. Furthermore, the city performs frequent internal rate studies and has pre-approved 9% rate increases through 2020. We understand the city plans to perform another analysis and evaluate the need for future rates increases after 2020. SRCSD's monthly rate for single-family residential customers is about $37 a month, and SRCSD plans to increase the rate to $39 per month on July 1, 2021.

Based on our operational management assessment, we score the wastewater system a '3' on a six-point scale on which '1' is the strongest. The assessment of good reflects the city's efforts to maintain the integrity of its aging wastewater collection system and management's focus to comply with environmental regulations. A significant portion of the city's collection system is a combined sewer system (CSS), which receives both wastewater and stormwater in the same pipe network. The CSS system covers the older areas of the city. The remaining network is a separated sewer system (SSS). The majority of the system's wastewater is conveyed to the SRCSD's 181 million gallon per day (mgd) treatment plant. Under an operating agreement, SRCSD is contracted to accept 60 mgd of wastewater and stormwater from the CSS and all flows from the SSS. During storm events, CSS flows in excess of 60 mgd are stored at the city's two wet weather storage and treatment facilities, where they are eventually discharged to the SRCSD treatment plant. During large storm events when the system's storage capacity is exhausted, excess flows are treated to a primary level at the city's facilities and discharged to the Sacramento River under a state discharge permit. The city is currently in compliance with all environmental regulations. Flows from the separated sewer system increased to about 10,600 million gallons in 2018 from roughly 8,800 million gallons in 2016.

Consistent with "Methodology: Industry Risk," published Nov. 19, 2013 on RatingsDirect, we consider industry risk for the system very low, the most favorable assessment possible on a six-point scale on which '1' is the best.

Financial risk

The wastewater system's historical all-in coverage has been extremely strong, and we expect this to continue during the next five years. The system's all-in coverage during the past three fiscal years was above 2.0x, which that we consider to be extremely strong. Our all-in coverage metric includes the city's annual payment to the general fund of 11%. The voter-approved general fund tax is equal to 11% and has been the same since 1998. We are not including a fixed-charge cost related to SRCSD because the city collects SRCSD rates for SRCSD but the actual revenues never flow through the city's financial statements. Payments are made to SRCSD every two weeks.

All-in coverage during the past three fiscal years was 4.98x (2018), 2.50x (2017), and 3.06x (2015), all figures we consider to be extremely strong. The decline in all-in coverage in fiscal 2017 was related to two new positions added to employee services and a spike in expenses related to pump replacements, computer software licenses, and new vehicle purchases. Following this, the services and supplies expense dropped back down to about $12 million (2018) from $14 million in (2017). In addition, the rising expenses assumed to increase in 2019 have been offset by the pre-approved 9% annual rate increases through 2020. Based on our analysis of management-provided projections, we expect all-in coverage to stay above 2.0x during the next five years. The city plans to pay interest only for fiscal 2020 and 2021, after which maximum annual debt service will be about $2.2 million. Given the lack of immediate debt plans, we expect coverage to stay consistent with historical metrics, although we understand the city's 25-year, $1.1 billion wastewater capital plan could put pressure on coverage metrics if management decides to issues additional debt.

The wastewater system's liquidity has been extremely strong during the past three fiscal years, and we expect it to remain extremely strong despite management's plans to spend down cash on capital projects. The wastewater system's unrestricted cash position for fiscal 2018 was about $39 million, equivalent to about 532 days of operating expenses. Based on our analysis of management-provided projections, cash is expected to stay above $38 million, or 445 days of operating expenses, figures we consider to be extremely strong. During the next five years, the city plans to spend between $2 million and $10 million on annual capital projects.

The wastewater system's pro forma debt-to-capitalization ratio is low, at about 26.8%, and the system's capital plan is sizable at about $59 million through 2023 and potentially $1.1 billion during the next 25 years. The city's capital plan focuses on renewal and replacements. The city is currently in compliance with all environmental regulations but will be spending about $22 million on maintaining compliance with the city's CSS permit and $37 million on renewal and replacement projects. It is our understanding that about 54% of the five-year capital plan will be funded from the series 2019 bond proceeds, with the remaining 46% funded from revenue. About 70% of the combined system and 23% of the separated system is 70 years or older. The city will continue to face challenges with aging infrastructure and compliance with future environmental regulations.

Based on our financial management assessment, we score the wastewater system as a '1' on a six-point scale on which '1' is the strongest. In our view, financial practices and policies exist and are transparent. The city reviews the budget semiannually. The city has a formalized investment, debt and liquidity policy. The liquidity policy is to maintain a minimum of 120 days of working capital for the wastewater fund. The city's capital improvement program includes a comprehensive five-year plan for identifying current fiscal requirements. Additionally, the program includes a long-term, 30-year capital plan. Furthermore, the city annually updates its long-term financial plan and complies with generally accepted accounting principles.

Outlook

The stable outlook reflects our anticipation that the city will continue setting wastewater rates to generate extremely strong all-in coverage metrics, maintain a stable, extremely strong liquidity position, and provide needed capital funding. The diversifying and strong economic base provide stability to the overall credit quality.

Upside scenario

We could raise the rating if the city can continue to manage through its large capital plan while maintaining extremely strong coverage and cash.

Downside scenario

While unexpected over the two-year outlook period, we could lower the rating if there is a material decline in the city's economic fundamentals, such as median income metrics, or a rise in unemployment or poverty rates. As our assessment of the city's market position reflects both the city's cost of service and SRCSD's treatment costs, a significant increase in SRCSD's planned capital needs could affect our view of the cost of wastewater collection and treatment service in the city over time.

Leased Wastewater Assets

The city has a master lease program under which it has issued bonds for financing various capital improvements unrelated to the wastewater system. The bonds are secured by lease payments from the city's general fund. Under the master lease program, the city has leased a pool of assets, including portion of the wastewater system's wet weather facilities related to the CSS. If the city were to fail to make any portion of its lease payments under the entire program, the trustee has the right to re-let a portion of the leased property, potentially including the wastewater system assets. Any disruption in the use of the system's wet weather facilities would affect operations, particularly during storm events. Therefore, in our view, under the lease revenue bond structure, the wastewater system has some exposure to the financial position of the general fund. However, given S&P Global Ratings' current rating on the city's general fund-backed debt, we do not view this exposure as a key credit weakness at this time.