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Summary:

Vallejo, California; Appropriations

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Summary:

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Credit Profile		
Vallejo (1999 Cap Imp Proj)		
Unenhanced Rating	CCC+(SPUR)/Stable	Upgraded
Many issues are enhanced by bond insurance.		

Rationale

Standard & Poor's Ratings Services raised its underlying rating (SPUR) to 'CCC+' from 'C' on Vallejo, Calif.'s series 1999 certificates of participation (COPs). The outlook is stable. The raised rating reflects our view of the expiration of the debt service restructuring under the settlement agreement with National Public Financing Guarantee Corp. (NPFG), which allowed the city to draw on its surety policy for 25% of debt service requirements; the city's appropriation of the full amount of the July 15, 2013 lease payment for the 1999 COPs; and the city's intent to continue to appropriate the full debt service payment in the future, according to management. The upgrade also reflects our opinion of the city's emergence from bankruptcy in 2011.

The rating reflects our opinion of the city's:

- General fund profile that currently exhibits strong reserves, although the city remains vulnerable to salary and benefit cost pressures despite a recently approved additional sales tax, as reflected in the city's five-year forecast, which requires significant employee compensation reductions to restore structural balance;
- Continued assessed value (AV) declines; and
- Debt service reserve, via a surety bond, which is currently below required levels.

In our opinion, the preceding weaknesses are partly tempered by the city's strong income levels and improving labor market.

The COPs represent an interest in lease payments from the city to Vallejo Public Financing Authority, subject to the city's covenant to annually budget and appropriate such lease payments from its general fund. Under the lease agreement, payments are required to be made annually at least 15 business days before the debt service dates of July 15 and Jan. 15 until the certificates mature on July 15, 2029.

At the time the COPs were issued, the city had elected to guarantee lease payments from motor vehicle license fees (MVLF) apportioned to the city from the state's license fee account. Pursuant to California Government Code Section 37351.5, upon notice from the trustee of insufficient funds on deposit from the city to make lease payments, the state controller is directed to make the city's MVLF apportionments from the state's license fee account to the trustee. According to the bond indenture, in the event the city fails to make required deposits of lease payments to the trustee for two consecutive months, the trustee will immediately communicate that information to the affected certificate owners and the state controller in writing by first class mail and it will request payment from the state controller in an

amount equal to the delinquent lease payments; this request will continue until the city is current in its payment of lease payments. However, we believe subsequent changes in state legislation have eliminated interceptable MVLF. Most recently, we understand that starting July 1, 2011, Senate Bill (SB) 89 redirects these MVLF allocations from general purpose revenue for cities to state law enforcement grants. In addition, with regard to the deficient payments that began in fiscal 2009, prior to the passing of SB 89, no such communication was made to the state controller by the trustee.

The COP documents include a debt service reserve requirement at the lowest of 10% of par, 125% of average annual debt service, and maximum annual debt service. According to the official statement, the reserve was originally funded at $322,210 via a surety bond issued by MBIA Insurance Corp., now National Public Financing Guarantee Corp. (NPFG). According to management, it was funded at $65,748 as of Feb. 1, 2013, down from $212,476.50 on Oct. 30, 2011, due to draws for debt service payments.

We understand that the city emerged from bankruptcy on Nov. 1, 2011. Included in the plan of adjustment was a settlement agreement (January 2011) between the city and NPFG. The agreement required the city to pay $248,462 to NPFG, which according to the settlement was about 75% of the amount drawn on the surety bond. In addition, the agreement structured 75% of the 1999 COP lease payments to be made by the city for fiscal 2011, fiscal 2012, and fiscal 2013, with the first full lease payment scheduled for July 15, 2013. We understand that the shortfall (25% of the debt service payments) would be funded from the surety during fiscal 2011, fiscal 2012, and fiscal 2013, for which NPFG will charge 5.25% interest annually on the shortfall in the surety balance. We understand that the city has appropriated the July 15, 2013 lease payment, which is due to the authority 15 business days preceding each bond interest payment date, according to the official statement. Management also informed us that the city intends to continue appropriating lease payments in the future.

Starting Jan. 15, 2014, the city is required to pay NPFG surplus MVLF for prior lease payment shortfalls. If the city fails to perform any of its obligations under the NPFG settlement agreement, the city will not oppose payment of MVLF by the controller to NPFG or the trustee under the MVLF intercept and the controller will comply with the statutory requirements of the intercept without further notice or order from the court. However, as noted above, we understand that the state eliminated all remaining interceptable MVLF revenue, effective July 1, 2011, by redirecting those funds to state law enforcement grants.

The city serves a population of 116,508 in Solano County and is located 32 miles northeast of San Francisco and 47 miles southwest of Sacramento. The city's population is down from a peak of about 121,435. Major employers include Kaiser Permanente Medical Center (3,906 employees in 2011), Six Flags Discovery Kingdom (1,600), Vallejo Unified School District (1,600), and Kaiser Permanente Call Center (950). Although unemployment remains elevated at 11.5% for December 2012 (preliminary, not seasonally adjusted), it is down 10% from the prior year, according to the Bureau of Labor Statistics. During the last decade, the annual unemployment rate reached a low of 6.1% for 2006 and peaked at 14.7% in 2010 due to a 150% increase in the number of unemployed workers. The city's monthly employment figures began stabilizing, on a year-over-year basis, in January 2011, and the pace of employment growth has picked up to between 1.7% and 3.7% since November 2011. Unemployment rates for the state and nation were 9.8% and 7.8%, respectively, for December 2012. Income levels in the city are strong, in our opinion, based on our general

obligation criteria ratios, with median household effective buying income (MH EBI) at 118% of the national level. However, the city's MH EBI is average when compared with the state level, at 103%, and below average when compared with the county's, at 91%.

Although the housing market peaked in April 2006, according to the S&P/Case-Shiller Home Price Index, the city's AV continued to expand through fiscal 2008, which we have observed is consistent with Bay Area trends. Total AV declined 28% between fiscal 2009 and fiscal 2013 to $8 billion (including exemptions and redevelopment tax increment value), or $68,547 per capita, which we consider strong. Median home values for 2011 were about 147% of the national level, but 94% of the county's and 74% of the state's medians.

In our view, the city's general fund performance has improved due to significant expenditure reductions, resulting in reserves that we consider strong, at 10.9% of expenditures for fiscal 2011. In addition, we understand that the city council's reserve policy is to maintain a minimum unrestricted general fund balance equal to 15% of expenditures, which it anticipates rebuilding with the proceeds of a 1% sales tax (Measure B) approved by voters in November 2011. However, in our view, budget pressures persist, including the city's forecast deficit spending starting in fiscal 2013, expiring labor agreements, and a five-year general fund forecast that includes anticipated compensation reductions to salaries and benefits. Fiscal 2011 (the most recent audited fiscal year) marked the city's third year of positive general fund results, at $7.9 million, equal to 11.8% of general fund revenue -- a significant reversal from consecutive general fund deficits that preceded the city's bankruptcy petition in May 2008. Deficit spending, driven by expenditure growth outpacing revenues, resulted in a drop in the unreserved undesignated general fund balance to less than $1 million for fiscal 2008 from $9.9 million in fiscal 2005. Although fiscal 2011 general fund revenue was still down compared to the prior year, the pace of decline slowed to 1.8% from 9.7% in fiscal 2010. Also, general fund revenues exceeded original estimates and tight cost controls that kept expenditures within budget, according to the audit, resulted in an increase in the general fund unassigned fund balance to 10.9% of expenditures, which we consider strong, from 6% in fiscal 2010, which we view as good, and 1.7% in fiscal 2008.

Labor costs comprised 73% of general fund expenditures, prior to inter-fund cost allocations, according to the audit. The city implemented significant staffing reductions between fiscal 2004 and fiscal 2011, including a 36% reduction in general fund full-time employees, and a 44% cut to public safety (full- and part-time employees citywide). The city was also able to reduce its compensation and benefit costs by reorganizing labor contracts; two labor units agreed to revisions and settled claims in bankruptcy and two labor units renegotiated contracts in the spring and fall of 2010. However, we understand one of four bargaining unit's contracts has expired and the remaining three are scheduled to expire June 30, 2013. All four units are currently engaged in contract negotiations that are currently confidential, according to management.

For fiscal 2012, general fund projected results include a $2.9 million positive result, which is better than the budgeted $110,717 deficit, according to projections reported in the fiscal 2013 budget in May 2012. Management attributes the better-than-budgeted results to strong sales tax revenue performance growth of 4%, compared to budgeted 2% growth, and unfilled budgeted staff positions. The fiscal 2013 adopted budget includes a deficit of $5.2 million, including a spend down of $3.4 million of Measure B sales tax revenue. However, management also anticipates better-than-budgeted results due to continued revenue gains and unfilled positions. The city's five-year forecast

includes positive general fund results of about $1.3 million to $1.5 million for fiscal 2014 through fiscal 2017. However, fiscal 2014 includes a $7.9 million reduction to salaries and benefits, $5.5 million of which reflects anticipated compensation reductions. Assumed compensation reductions grow to $7.7 million for fiscal 2015 to fiscal 2017. If excluding these assumed, but not yet ratified reductions, the ending results would be negative, starting at $4.2 million for fiscal 2014 (4.6% of expenditures) growing to about 6.5% of expenditures. The forecast also includes a 1% decline in general fund revenue, excluding the Measure B sales tax revenue, for fiscal 2013. General fund revenue (including Measure B sales tax revenue) is forecast to decline an additional 1% for fiscal 2014, before turning positive in fiscal 2015 by 1% and 2% in both fiscal 2016 and fiscal 2017.

Measure B sales tax was approved by voters in November 2011, and became effective April 1, 2012. Fiscal 2013 will be the first full year of collections. Measure B generated about $2.4 million for fiscal 2012 and is budgeted at $9.6 million for fiscal 2013, growing to $11.2 million by fiscal 2017 in the city's five-year general fund projections.

We consider the overall net debt burden to be moderate, at $2,211 per capita and 3% of market value. The city's direct debt includes $49.5 million of COP general fund obligations, $10.1 million of tax allocation bonds, and $1.1 million of capital lease obligations.

The city participates in the California Public Employees Retirement System for its pension other postemployment benefits (OPEB). The pension contribution for fiscal 2011 was $9.6 million. The city currently funds its OPEB on a pay-as-you-go basis, which was about 62% of the actuarial determined annual required contribution for fiscal 2011. The pension and OPEB contribution represented 9.8% of total governmental funds expenditures for fiscal 2011. For fiscal 2013, general fund pension contributions are budgeted to equal 15% of general fund expenditures.

Outlook

The stable outlook reflects our view that the city will continue to appropriate amounts sufficient to fully pay principal and interest on the COPs. The outlook also reflects our opinion of the city's currently strong general fund balance, which provides some cushion against delays in implementing structural budget corrections or deeper-than-budgeted revenue declines. Should the city deplete general fund reserves, we could lower the rating. In addition, we could lower the rating if the city does not make a bond payment, secured by pledged revenues or reserves, in full and on time. Over time, we could raise the rating if the city's ability to fully fund lease payments is supported by consistently stable financial performance, a structurally balanced budget, and the maintenance of good reserves.

Related Criteria And Research

USPF Criteria: Appropriation-Backed Obligations, June 13, 2007

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