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Summary:

# Stockton Public Financing Authority, California Stockton; Appropriations

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**Summary:**

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| Stockton, California | | |
| **Stockton Pub Fincg Auth ser 2006A lease** | | |
| *Unenhanced Rating* | BB(SPUR)/Positive | Upgraded |

Many issues are enhanced by bond insurance.

## Rationale

S&P Global Ratings has raised its long-term rating and underlying rating (SPUR) four notches to 'BB' from 'B-' on Stockton Public Financing Authority, Calif.'s $9.4 million series 2006A lease revenue refunding bonds, which is an appropriation obligation of the City of Stockton. The outlook is positive.

The rating action reflects our view of the city's sustained strong-to-very strong financial performance, sustained very strong budgetary flexibility, and institutionalized integration of a revised reserve policy into its last three budget cycles. We view it as significant that both the reserve policy and its formal budget documents directly link the now higher reserve threshold to the city's intention to avoid circumstances comparable with those present when the city filed for bankruptcy in 2012. Coupled with a long-term forecast that puts current decisions into a 20-year forward looking context, we are optimistic Stockton will be ready to discuss the tradeoffs necessary to maintain financial sustainability the next time its core operating revenues decline.

The positive outlook reflects our expectation the city will continue to make full and timely payments on its debt obligations while balancing the opportunities and challenges associated with a growing economic base and recent voter-approved tax increases, which came with political mandates to deliver quality municipal services. Although our credit conditions forecast doesn't anticipate a recession during our two-year outlook horizon, should one occur, we expect to be particularly interested in how quickly and effectively the city responds to negative revenue effects.

### Security and use of proceeds

Lease payments made by the city for the use and occupancy of certain other leased premises secure the bonds. The city has agreed to budget and appropriate rental payments to meet its obligations under the lease agreement during the bonds' life. We have set the rating one notch below our view of the city's general creditworthiness to reflect appropriation risk. The city used the bonds to realize interest expense savings by refunding its series 1999 lease revenue bonds, which were originally used to provide a portion of the financing for a police administration building and parking structure.

## Credit overview

The rating reflects our view of the city's:

- Weak economy, with market value per capita of $71,093 and projected per capita effective buying income (EBI) at 66.4%, but that is benefitting from access to a broad and diverse metropolitan statistical area (MSA);
- Weak management, despite good financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Strong budgetary performance, with an operating surplus in the general fund and break-even operating results at the total governmental fund level in fiscal 2017;
- Strong budgetary flexibility, with an available fund balance in fiscal 2017 of 46% of operating expenditures, but limited capacity to reduce expenditures;
- Very strong liquidity, with total government available cash at 144.4% of total governmental fund expenditures and 25.9x governmental debt service;
- Very weak debt and contingent liability profile, with debt service carrying charges at 5.6% of expenditures and net direct debt that is 71.6% of total governmental fund revenue, as well as a large pension obligation and the lack of a plan to sufficiently address the obligation; and
- Strong institutional framework score.

## Weak economy

We consider Stockton's economy weak. The city, with an estimated population of 315,103, is located in San Joaquin County in the Stockton-Lodi MSA, which we consider to be broad and diverse. The city has a projected per capita EBI of 66.4% of the national level and per capita market value of $71,093. Overall, the city's market value grew by 3.2% over the past year to a preliminary $22.4 billion in 2019. The county unemployment rate was 7.0% in 2017.

After a sustained period of economic weakness at the end of the Great Recession, Stockton and its surrounding area have experienced improvements in several economic indicators. Most notable, in our view, was the 7% average annual assessed value (AV) growth during the five fiscal years ending in fiscal 2017 and, using slightly different measurements, another 8% for fiscal 2018, and 5% for fiscal 2019 (preliminary). Included within the five-year growth average was a 14% increase in fiscal 2015 that, we understand, reflected resets in values to stronger market conditions after the county lowered values at the end of the Great Recession. (Under the state constitution, AV by property can grow by only 2% per year without a property sale, which makes further AV growth likely to be more moderate in the absence of new construction or significant turnover.) Management reports that the city has about 4,700 housing units in its development pipeline, with about 200-300 likely to be built this year. Although available land and rising prices have attracted developer interest, we understand from management that home prices may still be about a quarter below their peak a decade ago on average.

The overlapping county's unemployment rate tends to track above the national average, but has been on a downward trajectory since its monthly peak of 18% in 2010; and reached a monthly low of 5.8% in April 2018. Management reports the city continues to attract investment in logistics operations, including investments by Amazon underway in the online retailer's road and air distribution capabilities.

We anticipate that local economic trends will continue to improve in some form during the next two years, consistent with our forecast that the Pacific U.S. states will experience 2%-3% real GDP growth through 2020.

### Weak management

We view the city's management as weak, despite good financial policies and practices under our FMA methodology, indicating financial practices exist in most areas, but that governance officials might not formalize or monitor all of them on a regular basis.

We no longer view the city as exhibiting an unwillingness to meet its appropriation obligations due to it making full and timely payments on its remaining--and in some cases--restructured debt obligations after exiting bankruptcy protection in February 2015. In addition, the city's improved budgetary performance and flexibility lessens the probability that the city would withdraw its support for its obligations in the future.

We changed our FMA to good from standard due to our view that the city's budget amendments and updates practices and reserve and liquidity policy are more strongly embedded in its operations. The assessment reflects our view of the city's:

- Robust analytical underpinnings for revenue and expenditure assumptions for building budgets, although what in retrospect were aggressive assumptions on employee concessions played a role in the city's budgetary stress at the end of the Great Recession and have not been tested in an adverse economic environment since then;
- Practice of providing the council with quarterly budget-to-actual updates with an analytical discussion of influences on recent performance that we see as institutionalized since a suspension in fiscal 2015;
- Financial forecast that extends for two decades and is integrated into the city's budget document with a clear link to structural balance goals and is now updated annually, but is presented in chart form without detail that we think would be necessary to support a full debate regarding long-term assumptions;
- Annually updated five-year capital plan that identifies project costs and funding sources;
- Quarterly reporting to the council on investments holdings and performance and compliance with an internal policy;
- Debt policy that covers qualitative aspects of debt management and was updated in 2017 to better define special purpose district debt issuance and disclosure, but doesn't directly address the city's bankruptcy and lacks significant quantitative constraints on debt issuance; and
- Well-defined reserve policy that consists of two months' (about 17%) operating expenses. It also transfers out working capital for "known contingencies, unforeseen revenue changes, infrastructure failures, and catastrophic events" and separately defined risk-based reserves that are tailored annually to match 19% of projected taxes, 2% of deferred maintenance, 2% of physical asset values for extreme events, and an "other" designation that can be used for such items as known legal liability risks.

### Strong budgetary performance

Stockton's budgetary performance is strong in our opinion. The city had surplus operating results in the general fund of 4.1% of expenditures, and balanced results across all governmental funds of negative 0.5% in fiscal 2017. Based on revenue growth and what we observe to be strides in achieving long-term budgetary sustainability, we no longer view the city as deferring spending to achieve short-term financial needs.

The city's surpluses moderated substantially in fiscal 2017 after two years of 11%-12%-of-expenditures positive general fund net results and we think may have slowed further in fiscal 2018. We think this shift reflects the conclusion of temporary circumstances, such as major expenditure controls imposed to conserve cash during bankruptcy. Now in its fourth fiscal year since exiting bankruptcy, the city is focused on long-term sustainability. Helping in this effort has been tax revenue growth--fueled by a stronger economy--and the addition of voter-approved sales tax for public safety that took effect at the end of fiscal 2014. Stockton's main employment contracts, which run for three-years through fiscal 2019, include substantial cost-of-living adjustments to bring the city's salary schedule in line with its peers and in the process contribute to expenditure growth, but we understand the challenge of filling open public safety positions has slowed such growth relative to budget. On a budgetary basis of accounting, which can differ from generally accepted accounting principles (GAAP), the city's latest fiscal 2018 figures point to nominally negative general fund net results, although management anticipates positive operations approximating 1% of expenditures based on current data. We calculate based on the city's adopted budget that fiscal 2019 general fund operations could strengthen to 5% of expenditures.

We think the city's structural performance benefits from a legacy of voter support. We view Measure A (approved in 2013), which took effect at the end of fiscal 2014 as the most significant. Voters directed the city, on a non-binding basis, to use the proceeds of this 0.75% sales tax for law enforcement and crime prevention by a concurrent ballot measure. These revenues equal what we consider a substantial 15% of expenditures but law enforcement is also the general fund's largest line item. Management indicates that revenues under this measure have helped the city indirectly and directly to start to pre-fund its pension liability, rebuild reserves and purchase property for a city hall replacement. This measure is set to expire in 2024 unless extended by city council and could be eliminated earlier should the city meet certain revenue targets. Voters in November 2016 approved Measure M, which added another 0.25% sales tax increase (equivalent to 5% of general fund expenditures) for 16 years for library and recreation services. Finally, Measure W, which took effect in fiscal 2005 and funds police and fire protection services, generates 5% of expenditures under a 0.25% sales tax. The council can renew this tax every five years.

However, we see three main challenges for the city in sustaining at least balanced operations in the coming decade. First, a recovery in the real estate market has brought AV for many properties up against the maximum allowed under state constitutional limitations on AV growth of 2% per year before a property sale. This suggests to us that future property tax revenue increases will slow, which played a role in the city recently revising its policy for assessments associated with new special-purpose districts that support infrastructure financing in new housing developments. Property taxes make up 25% of estimated general fund revenues for fiscal 2018 compared with sales taxes, at 35%. Second, we see the potential for salary and benefit costs to rise as the city seeks to restore service quality, compete in the labor market, and meet political promises associated with voter-approved sales tax measures. At the same time, we think Stockton's now institutionalized two-months'-of-expenditures reserve goal will help the city to balance its priorities during budget decisions and employee contract negotiations. Third, despite the creation of a new pension benefits tier after the period of layoffs earlier in the decade and the elimination of postemployment health care benefits as part of the city's bankruptcy exit plan, we anticipate pension costs will increase relative to total governmental fund expenditures into the next decade. In fiscal 2018, the city began addressing this challenge by depositing $21 million in an irrevocable pension trust, although management indicates that under the city's current approach, future deposits are likely to be contingent on general fund performance proving conservative relative to budget.

Deferred maintenance is also a long-term challenge in our view, albeit one in which the city has more flexibility. Stockton curbed its spending on road and other projects to close to zero for a sustained period, but after its bankruptcy exit was able to resume such spending, largely with restricted revenues. For now, the city is deploying restricted revenues and the $5 million (which is equal to about 3% of general fund expenditures) in grants it receives under a statewide tax increase on gasoline sales and electric vehicles known as Senate Bill 1, which took effect January 2018. Should the statewide tax be repealed by Prop. 6--a ballot measure state voters will consider in November 2018--management indicates the city would likely cut back on projects proportionate to the grants rescinded. The latest estimate put the bill for catching up on deferred maintenance at approximately $970 million, or nearly 5x annual general fund expenditures, which we believe will be an important cost and potentially a spur to debt issuance in the coming years.

### Strong budgetary flexibility

Stockton's budgetary flexibility is strong, in our view, with an available fund balance in fiscal 2017 of 46% of operating expenditures, or $96.5 million, inclusive of our adjustment to include the city's committed balance, which we consider to be available. Negatively affecting budgetary flexibility, in our view, is Stockton's limited capacity to reduce expenditures.

Due to a combination of substantial expenditure curbs during the period of financial stress at the end of the Great Recession and a subsequent sustained economic recovery that has boosted operating tax revenues, the city has substantially improved and maintained its very strong available general fund position from less than 2% of expenditures during fiscal years 2011-2013. We calculate that the city's available general fund position relative to expenditures dropped 1% in fiscal 2017 from the previous year due to increased expenditures, but we anticipate that the city's available general fund balance will show a slight increase for fiscal 2018 (reflecting our discussion with management and the city's latest estimates for fiscal 2018 on a budgetary basis). Stockton's available general fund balance could grow further for fiscal 2019, in our view, but we think that the renewal of the city's main employment contracts could affect reserves in fiscal 2020, even if Western U.S. real GDP growth proceeds as per our forecast, and the city's tax revenues continue to grow.

Our view of the city's budgetary flexibility reflects our view that the city has limited capacity to cut spending after multiple years of maintenance and service reductions before and during bankruptcy. We think that two voter-approved tax increases implemented since bankruptcy have provided more flexibility to the city overall, but also would likely make it more difficult for Stockton to implement service cuts to balance its budget due to raised community service quality expectations.

### Very strong liquidity

In our opinion, Stockton's liquidity is very strong, with total government available cash at 144.4% of total governmental fund expenditures and 25.9x governmental debt service in 2017. Based on the city's sustained very strong budgetary flexibility and external borrowing, we no longer view its access to external liquidity to be limited.

The city's improved general fund position and continuing strength in its water and wastewater enterprise funds' balance sheets support the city's liquidity position. We think the city's well-publicized defaults on certain general fund obligations and period of bankruptcy protection limit the city's access to external liquidity for general government

debt, but we note that the city's wastewater utility and redevelopment successor agency have successfully issued debt for refunding purposes in the past four years. Management has confirmed that the city has no alternative financing, which we find can represent a source of contingent liquidity risk, outstanding or under consideration.

We do not consider the city's investments portfolio aggressive. The city's largest investment categories as of the end of fiscal 2018 were U.S. agencies and treasuries (36% of government investments by fair market value), followed by corporate notes (18%), most of which were rated investment grade by S&P Global Ratings, and investments managed by the state's Local Agency Investment Fund (12%).

### Very weak debt and contingent liability profile

In our view, Stockton's debt and contingent liability profile is very weak. Total governmental fund debt service is 5.6% of total governmental fund expenditures, and net direct debt is 71.6% of total governmental fund revenue.

The city does not plan to issue additional debt supported by the general fund, but is in the design phase of a remodel of its wastewater treatment plant, which is likely to cost about $150 million. Management indicates the project is too early in the development stage to determine the financing plan, but that the city intends to first explore lower cost federal and state sources before pursuing revenue bonds. The city may also refinance all or a portion of its callable utility revenue bonds, issued the previous decade, in the coming year to achieve interest cost savings.

In our opinion, a credit weakness is Stockton's large pension obligation, without a plan in place that we think will sufficiently address the obligation. Stockton's pension contributions totaled 11.3% of total governmental fund expenditures in 2017.

The city participates in cost-sharing, multiple-employer defined-benefit plans managed by the Public Employees' Retirement System (CalPERS) for public safety employees and employees in other positions, known as "miscellaneous." In addition, certain current and former employees who worked at the municipal utility under an external contract during 2003 and 2008 qualify for an enhancement plan administered by Public Agency Retirement Services (PARS). Under Governmental Accounting Standard Board (GASB) Statement Nos. 67 and 68, the city's net pension liability (NPL) measured as of June 30, 2016, was $20.3 million for the safety plan (the largest plan), $13.9 million for the miscellaneous plan and $0.5 million for the enhancement plan. As of the same date, the CalPERS safety plan maintained a funded level 68.6%, using its fiduciary net position as a percent of the total pension liability. The miscellaneous plan was funded at 75.6% and the enhancement plan by 62.4%.

For fiscal year 2017, the city's actuarially determined contribution (ADC) for all plans was $33.4 million, or 11.3% of total government funds expenditures. Management indicates the city deposited $21 million in an irrevocable trust under Section 115 of the U.S. Internal Revenue Code in the fall of 2017. The city intends to use the trust as an actuarial asset to moderate future contribution rate increases and already takes advantage of a CalPERS program in which a participating local government can receive favorable treatment if it makes its annual pension contribution at the beginning of the fiscal year. Management intends to recommend to the council that the city make an additional, likely much smaller contribution, this fall to the degree that fiscal 2018 year-end performance materializes ahead of budget.

The contribution amounts for the CalPERS plans are actuarially based using a 30-year fixed amortization approach. Mortality rates used to determine liabilities for the 2016 valuation reflect the 2010 CalPERS experience study covering

1997-2007 and the Society of Actuaries AA scale. The liabilities used to calculate the funded levels as of the most recent valuation were discounted at 7.5%, which is slightly above the national average--leading to an above-average likelihood of upward revisions to the NPL following years of poor investment performance. In general, these actuarial methodologies and assumptions are comparable with those of other pension plans nationally. The much smaller enhancement plan uses a similar methodology with a below-average 7.0% discount rate.

The city made its annual required pension contributions in 2017 and did so earlier in the decade while it operated under bankruptcy protection but as part of its bankruptcy exit plan eliminated its liability for retiree health benefits. The removal of non-pension postemployment benefits and the creation of a new, lower-cost tier for new employees after substantial workforce reductions lowered the city's pension costs over a 30-year horizon, but didn't prevent annual carrying charges from becoming what we consider to be large again as of fiscal 2017. Annual carrying charges fell to 9% of total governmental funds expenditures in fiscal 2015, from 13% in fiscal 2013, but rose to 11% for fiscal 2017. Based on CalPERS' advice to local agencies that discount rate reductions, management will boost nominal contribution rates to improve plan funded ratios. We anticipate the city's pension carrying charges will rise in some form during the next five years. At present, we do not consider the city's trust contributions to represent a plan that will substantially reduce annual costs during the next five years, although our view could change should the city make additional large contributions over time.

### Strong institutional framework

The institutional framework score for California municipalities required to submit a federal single audit is strong.

## Outlook

The positive outlook reflects our view of the likelihood that continued local economic growth, disciplined expenditure growth management, and implementation of recent policy enhancements will sustain a pattern of balanced operations through fiscal 2020, even if new employment contracts lead to higher salary and benefit costs. This could lead us to raise our rating during our two-year outlook horizon.

Because we view the city's willingness to meet its obligations as untested by adverse economic or financial conditions, we could revise the outlook to stable if we see signs that a more difficult budgetary environment--such as could occur if revenue growth reverses or if efforts to improve service quality cause cost growth to exceed revenue growth--leads to weakening performance and flexibility.

## Related Research

- U.S. State And Local Government Credit Conditions Forecast, July 26, 2018
- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Incorporating GASB 67 And 68: Evaluating Pension/OPEB Obligations Under Standard & Poor's U.S. Local Government GO Criteria, Sept. 2, 2015
- 2017 Update Of Institutional Framework For U.S. Local Governments

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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