City of
SACRAMENTO
Office of the City Treasurer

915 I Street, HCH 3rd Floor
Sacramento CA 95814

Russell Fehr ~ City Treasurer

Phone 916-808-5168
Fax 916-808-5171

ADDITIONAL (VOLUNTARY) DISCLOSURE
RATING AFFIRMED

Dated: December 3, 2014

NOTICE IS HEREBY GIVEN that on December 1, 2014, Fitch Ratings ("Fitch") affirmed the long-term and underlying rating of "AA-" with a stable outlook for the City of Sacramento Water Revenue Bonds, Series 2013 debt issue.

The rating report from Fitch is attached.

City of Sacramento

Janelle Gray
Debt Manager

Attachment – Fitch Rating Report (City of Sacramento Water Revenue Bonds, Series 2013)

FITCH AFFIRMS SACRAMENTO'S WATER REVS AT 'AA-'; OUTLOOK STABLE

Fitch Ratings-San Francisco-01 December 2014: Fitch Ratings affirms the following city of Sacramento, California rating:

--$215.2 million water revenue bonds outstanding at 'AA-'.

The Rating Outlook is Stable.

SECURITY
The bonds are secured by a senior lien on net water revenues after payment of maintenance and operations expenses.

KEY RATING DRIVERS

SOLID FINANCIAL PERFORMANCE: Financial performance is above average for the rating category with very stable revenues, strong debt service coverage (DSC) and healthy liquidity. Coverage is expected to decline to levels more typical for the rating category with additional leveraging. Near-term drought performance is likely to be solid due to flat-rate billing.

SIGNIFICANT DROUGHT CONSERVATION: The utility benefits from an ample, local surface water supply under high-priority water rights, but is currently experiencing an exceptional drought that has required significant water conservation measures. As a result, historically high consumption levels have been declining.

DECREASING RATE FLEXIBILITY: Rates are quite low compared to other local water providers, but likely to rise significantly over the next five years. Rates are likely to surpass Fitch's 1% of median household income affordability metric, suggesting that rate flexibility could diminish.

LARGE, DIVERSE SERVICE AREA: The utility provides water to a large urban service area that is recovering from a deep economic downturn due primarily to the housing market collapse and budget cutbacks at the largest local employer, the State of California. The customer base is diverse and largely residential.

HIGH DEBT, CAPITAL NEEDS: Debt ratios are expected to rise to well above average within the next five years as the utility works to address a long backlog of deferred maintenance needs.

GOOD MANAGEMENT, GOVERNANCE PRACTICES: The utility's governance is sound, with solid political and public support to date for the rate hikes necessary to fund the utility's increased infrastructure investments. The utility engages in thorough financial and capital planning processes within a reasonable policy framework.

RATING SENSITIVITIES

OVERLEVERAGING RISK: The rating incorporates significant additional borrowing plans, which will require further significant rate increases. This additional debt could put downward pressure on the rating if rate discipline slips or borrowing plans increase beyond the current forecast. The Stable Outlook suggests Fitch believes this is unlikely.

PRESSURE FROM STATEWIDE DROUGHT: The rating could come under downward pressure if the current, severe drought forces multiyear water rationing that reduces financial margins and reserve levels more than expected.

CREDIT PROFILE

The utility provides essential retail water services to the 480,000 residents of the city of Sacramento, California's state capital and the nation's 35th-largest city. The utility also serves several small wholesale accounts. The customer base of 137,300 accounts is largely residential (80% of revenues), and the utility's largest customers are governmental entities. The 10 largest retail accounts provide just 6.7% of revenues.

The service area has experienced a deep economic downturn in recent years, but it is growing again and appears to have positive long-term prospects. The city was hard hit by the recession due to budget cuts at its largest employer, the State of California, and a deeper than average housing downturn. However, incomes remain solid, and the unemployment rate has fallen over the past two years. The city of Sacramento jobless rate declined to a still-elevated 8.1% in September 2014 from 15.1% at its recessionary high.

STRONG WATER RIGHTS

The utility's most valuable asset is a large supply of low cost, local surface water that is limited in only the most severe California droughts. Sacramento draws about 85% of its water supplies from the American and Sacramento Rivers. Another 15% of supplies are provided by municipal groundwater wells. The city estimates that its reliable surface water supplies currently equal about 225 million gallons per day (MGD) compared to recent production of less than 100 MGD.

The city has a mixture of pre-1914 water rights (the oldest and most reliable California water rights) and post-1914 water rights (backed by a contract with the U.S. Bureau of Reclamation) that provide reliable supplies well in excess of current demand. The city's contract with the bureau requires the federal agency to provide sufficient flows to meet city needs before serving the bureau's own Central Valley Project customers from its Folsom Lake reservoir.

Despite its ample supply and high priority rights, Sacramento uses shared river water resources and is not completely immune to the stresses on the state's water system in the third year of one of the most extreme droughts in state history. While it is likely that the city could legally withdraw its full typical water demand from its rivers this year, the city is participating aggressively in statewide efforts to reduce water usage. For example, water use this year in peak summer watering periods was reduced by more than 20%.

Sacramento's strong water rights led to tardiness in adopting water conservation, creating some political risk for the city. Per capita water use of about 204 gallons per day in fiscal 2014 was significantly above state wide averages even with aggressive conservation. Sacramento did not install water meters until required to by state law and is not expected to complete the metering of its service area until 2025. The city is considering accelerating the program. The lack of meters is positive for credit quality in the near-term; revenues are likely to be quite resilient in the face of this year's significant conservation efforts.

The city appears to be sensitive to the political risks associated with its above-average water use. The city's water rights are a creation of state law and potentially subject to both changes in state legislation and changing interpretations of state water law. The city also relies on actions of state and federal water managers to maintain river levels sufficient for its withdrawals. Fitch believes the city's aggressive conservation efforts in the current drought are useful insurance against charges of water wasting and will help protect the city's water supplies in the long term at a relatively low cost in terms of lost revenues.

Sacramento is likely to continue reducing water usage as its service area adapts to metering in the years ahead, and it will gradually lose the revenue stability benefits of its fixed per household rate structure. However, it remains well positioned for the current drought. The eventual reduction in water use should create greater drought resiliency, provide capacity for growth and reduce political risks. The shift will, however, require careful rate setting to assure continued revenue sufficiency amid declining sales volumes.

SOLID FINANCES

The majority of the utility's revenue currently comes from fixed meter fees and from flat fees on unmetered residential accounts, providing a much higher degree of revenue stability and predictability than the typical water agency. While the city is gradually metering accounts, it maintains fixed charges on metered accounts, reducing the impact of variability in water sales due to weather and economic conditions. Current projections assume a 20% decline in water use in 2014 and 2015 with minimal financial deterioration.

Fitch calculated DSC on the rated senior lien debt (net of transfers out) was 4.1x for the year ended June 30, 2014, according to unaudited results for the year. Fiscal 2014 was both the first year of full debt service payments on the rated bonds and the first year of significant drought rationing. All-in DSC (including debt service on obligations subordinate to the rated debt) was very solid at 1.9x.

All-in coverage is forecast to fall a more moderate 1.6x on average over the 2015 to 2018 time period, as the utility's debt obligations increase. Senior coverage is expected to remain very strong for the rating category at better than 2.0x. The forecast appears reasonably conservative with significant cost increases but no connection fee revenues in a city with significant amounts of developable land and a long history of solid population growth. The forecast also assumes continued 20% water conservation through fiscal 2015. The forecast assumes sizeable rate increases to fund debt service on new bonds to support continuation of the long-term water capital improvement program. Fitch believes the city has flexibility to calibrate issuance if it cannot secure the expected level of rate increases, but a failure to adjust debt offerings to reflect actual rate increases and to maintain compliance with the utility's strong financial policies could put downward pressure on the rating.

Liquidity is strong and expected to remain high for the rating category over the next five fiscal years. Cash averaged 446 days of operating expenses from fiscal 2009-2013. Unrestricted cash and investments ended fiscal 2013 at $52.2 million, or 442 days cash.

GOOD RATE DISCIPLINE

The Sacramento City Council has shown strong rate discipline in recent years, increasing rates by an average of 9% annually over the past five years (2011-2015) to support a significant increase in capital spending. Water bills are quite low compared to other local water providers at about $38 a month, or 0.9% of median household income.

While rates currently are low by California standards, they are likely to surpass Fitch's 1% of median household income affordability metric over the next two to three years and reduce rate flexibility. The utility has faced some rate controversy in the past, but has received strong political and electoral support for its need to raise rates to update its aging infrastructure. The city's population has also conserved aggressively in the current drought, despite the lack of traditional price signals provided by water meters and drought rates.

HIGH DEBT, CAPITAL NEEDS

The utility's main credit weaknesses are a large backlog of deferred maintenance projects and the debt burden that it plans to take on to address the problem. The utility's 2014-2018 capital improvement plan (CIP) is large at $296 million or $431 per customer annually. The plan is expected to be about 73% debt funded.

The current CIP is driven by the statutorily driven plan to fully meter its large customer base by 2025(a $450 million project). About 54% of accounts currently have water meters. The city also continues with treatment plant projects financed by the rated bonds and has set a goal of cutting its water main replacement cycle to 100 years from as long as 400 years over the next five to 10 years.

While the proposed infrastructure investments would position the utility well for the longer term and greatly enhance reliability, the investments will require sustained rate increases and significant borrowing for a number of years. Fitch notes that the exact timing of projects is reasonably flexible, giving management the ability to adjust the pace of the capital plan to match ratepayers' willingness to pay.

The utility plans to borrow an additional $227 million in 2017, pushing debt per customer to a very high $4,156 from $2,989 at the end of fiscal 2013. While Fitch expects the utility to engage in greater pay-as-you-go funding over time, the heavy reliance on debt and resulting large debt burden are the main factors precluding a higher rating in the near term.

GOOD MANAGEMENT PRACTICES
The utility's management is professional and experienced, and utility governance by the city council is not overly politicized; long-term capital needs appear to drive rate policy more than concerns about the political impact of rate increases. The utility's policy framework is solid, as evidenced by its shift to a 100-year replacement cycle for its pipe network and reserve policies that require operating reserves of 120 days cash and a rate stabilization fund equal to 25% of total debt service.

TYPICAL LEGAL COVENANTS
The rate covenant and additional bonds test are typical at 1.2x. Rate stabilization fund transfers may be used to meet the rate covenant, which is permissive but not atypical. The additional bonds test applies to average annual debt service over the first five years of debt service (after project completion or the exhaustion of any capitalized interest). This somewhat weakens the rate covenant compared to a rate covenant based on maximum annual debt service (MADS) or average annual debt service, but it is not atypical and provides adequate, albeit imperfect, protection against overleveraging. The utility has cash funded a debt service reserve fund at 50% of MADS from bond proceeds.

Contact:

Primary Analyst
Andrew Ward
Director
+1-415-732-5617
Fitch Ratings, Inc.
650 California Street, 4th Floor
San Francisco, CA 94108

Secondary Analyst
Karen Ribble
Senior Director
+1-415-732-5611

Committee Chairperson
Steve Murray
Senior Director
+1-512-215-3729

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: elizabeth.fogerty@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.

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', dated June 12, 2012;
'U.S. Water and Sewer Revenue Bond Rating Criteria', dated Aug. 3, 2012;
'2012 Water and Sewer Medians', dated Dec. 8, 2011;
'2012 Outlook: Water and Sewer Sector', dated Dec. 8, 2011.

Applicable Criteria and Related Research:
2012 Outlook: Water and Sewer Sector
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=657110
2012 Water and Sewer Medians
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=657111
Revenue-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=750012