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## ADDITIONAL (VOLUNTARY) DISCLOSURE
## RATING AFFIRMED

Dated: May 31, 2017

NOTICE IS HEREBY GIVEN that on May 26, 2017, Fitch Ratings ("Fitch") affirmed the long term 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

Brian Wong
Debt Manager

Attachment: Fitch Press Release – Water Revenue Bonds, Series 2013

FitchRatings

# Fitch Rates Sacramento, CA's Water Revenue Bonds 'AA-'; Outlook Stable

Fitch Ratings-San Francisco-26 May 2017: Fitch Ratings has assigned a 'AA-' rating to the following City of Sacramento, California (the city) bonds:

--Approximately $56 million water revenue bonds, series 2017.

The bonds are scheduled to sell via negotiation on or about June 8, 2017. Bond proceeds will fund the city water enterprise's ongoing capital improvement plan (primarily its water metering project) and pay costs of issuance.

In addition, Fitch has affirmed the following outstanding debt:

--$204.2 million water revenue bonds, series 2013 at 'AA-'.

The Rating Outlook is Stable.

SECURITY

The bonds are secured by a senior lien on the city's net water system revenues after payment of maintenance and operations expenses.

KEY RATING DRIVERS

SOLID FINANCIAL PERFORMANCE: Financial performance is solid with very stable revenues, strong debt service coverage (DSC) and healthy liquidity. Coverage is expected to decline with additional leveraging but remain adequate for the rating category.

HIGH DEBT, CAPITAL NEEDS: The debt burden is above average and expected to continue to grow over the next five years as the utility finishes a major water metering project.

DISCIPLINED RATE POLICY: The city council has approved significant rate increases to support planned capital investments and rising debt service. Rates are currently low but likely to surpass Fitch's 1% of median household income affordability metric over the next few years, suggesting that rate flexibility is decreasing.

STRONG SUPPLY POSITION: The city has rights to an ample supply of local surface water under high-priority water rights. It conserved heavily in the recent drought and aims to maintain a lower level of usage going forward.

LARGE, DIVERSE SERVICE AREA: The utility is the monopoly provider of essential retail water services to a large urban service area. The customer base is diverse and largely residential.

RATING SENSITIVITIES

LEVERAGE TO DRIVE RATING: The rating incorporates significant additional borrowing plans. 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.

CREDIT PROFILE

The utility provides essential water services to about 490,000 residents of the city, California's state capital and the nation's 35th-largest city. The utility also serves several small wholesale accounts. The customer base of 136,130 accounts is largely residential, and the utility's three largest customers are governmental entities. The 10 largest retail accounts provide just 6.8% of operating revenues.

The Sacramento economy is growing at a healthy pace with payroll employment growth outpacing the nation over the past two years and unemployment continuing to decline. The unemployment rate trends somewhat higher than the national average and was 5.4% in March 2017 compared to 4.6% for the nation. The State of California is the dominant local economic force and employer. While the state provides as solid fundamental base for local economic activity, the concentration of state employment in the city leaves Sacramento heavily exposed to changes in the state's budget position and employment levels.

SOLID FINANCIAL PERFORMANCE

Financial performance remained solid through a period of intense drought due to ongoing adjustments in water rates and substantial amount of revenues provided by fixed meter fees and by unmetered accounts (46%) billed at flat rates. Fitch-calculated senior DSC net of transfers out was 3.1x fiscal year (FY) 2016 and 3.3x in FY 2015, providing solid coverage for the rated bonds. All-in DSC was solid at 1.7x in both years. Free cash to depreciation averaged a healthy 109% across the two years, providing solid excess revenues for investment in the system after payment of debt service and operating expenses.
Liquidity is strong. Days cash averaged 696 days over the past three fiscal years. Unrestricted cash and investments equaled $101.8 million, or 779 days cash, as of June 30, 2016. Cash has been increasing rapidly in recent years as the city ramped up rates to support its capital investment program. Cash balances more than doubled over the past five years.

Financial performance is expected to moderate somewhat over the next five years as the utility's debt obligations increase. The city forecasts that all-in DSC will fall to a more moderate 1.5x over the 2017 to 2022 time period and average 1.8x across the period. Senior coverage is expected to remain strong for the rating category, declining to 2.2x in FY 2022 and averaging 2.9x across the period. The forecast appears conservative with water use projected to remain near drought levels and no operating revenues from new connections assumed. Projected revenue growth relies on increases in rates, which have already been approved. Fitch expects the city to outperform the forecast somewhat.

STRONG RATE DISCIPLINE

The Sacramento City Council has shown strong rate discipline in recent years, increasing rates by an average of 8% annually over the past five years (FY 2013-2017) to support a significant increase in capital spending. Water rates remain affordable with 10 hundred cubic feet of water costing $37.80 a month, or 0.9% of median household income, in FY 2017.

While rates 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, suggesting that rate flexibility, while adequate, is decreasing. 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.

HIGH DEBT, CAPITAL NEEDS

The utility's main credit weaknesses are a large backlog of deferred maintenance projects on its aging infrastructure and the debt burden that it plans to take on to address these needs. The utility's $276.5 million 2017 - 2021 capital improvement plan (CIP) relies heavily on debt at 85% funding. The current CIP is driven by the statutorily mandated plan to meter its large customer base (a $230 million project that is about half completed and required to be finished by 2025). The city also continues to work on main replacements and other asset renewal.

Debt per customer is expected to climb to about $2,900 after the current bond issue, well above the median for 'AA' rated water and sewer utilities of $1,823. The utility plans to borrow an additional $173.2 million through FY 2021, pushing debt per customer to a very high $3,871. While Fitch expects the utility to engage in greater pay-as-you-go funding over time, the high reliance on debt and the high debt burden are the main factors precluding a higher rating in the near term.

STRONG WATER RIGHTS

The utility maintains 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 local ground water wells. The city estimates that its reliable supplies equal about 280 million gallons per day (MGD) compared to recent demand of less than 100 MGD. The city has contracts with the U.S. Bureau of Reclamation that require the 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 high priority rights, Sacramento cut use quite aggressively in the recent drought, even before state-mandated conservation measures were put in place. Once state regulation was imposed, the city maintained compliance with a very high conservation requirement of 28%. Policymakers expect conservation to continue with its metering program and public outreach aimed at hardening demand at lower levels.

Reducing water usage allows the city to create greater drought resiliency and to accommodate new growth without investing in expensive new supply projects. The reductions would also reduce political and regulatory risk that could stem from above average water use in a state where water policymakers are pushing to reduce usage. Reductions in the volume of water sold are not a credit concern so long as the city continues to take offsetting rate action to recover the full cost of providing service.

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In addition to the sources of information identified in Fitch's Revenue-Supported Rating Criteria, this action was additionally informed by information from Lumesis.

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Additional information is available on www.fitchratings.com

**Applicable Criteria**
Revenue-Supported Rating Criteria (pub. 16 Jun 2014) (https://www.fitchratings.com/site/re/750012)
U.S. Water and Sewer Revenue Bond Rating Criteria (pub. 30 Nov 2016) (https://www.fitchratings.com/site/re/890402)

**Additional Disclosures**
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/site/dodd-frank-disclosure/1024329)
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