MOODY'S
INVESTORS SERVICE

New Issue: MOODY'S ASSIGNS Aa2 RATING TO SAN FRANCISCO'S REFUNDING COP, SERIES 2010A; OUTLOOK NEGATIVE

Global Credit Research - 13 Sep 2010

Aa1 G.O. RATING AND OTHER LONG-TERM RATINGS AFFIRMED

Municipality
CA

Moody's Rating

ISSUE	RATING
Refunding Certificates of Participation, Series 2010A	Aa2

Sale Amount	$137,325,000
Expected Sale Date	09/16/10
Rating Description	Certificates of Participation

Opinion

NEW YORK, Sep 13, 2010 -- Moody's Investors Service has assigned an Aa2 rating to the City and County of San Francisco's Refunding Certificates of Participation, Series 2010A. We have also affirmed the Aa1 rating on the city's general obligation bonds as well as the ratings on the city's various general fund related debts. The outlook on the city's ratings is negative.

RATINGS RATIONALE

The city's ratings reflect its position as a large, world renowned city with a diverse economy and strong resident wealth levels. The city's conservatively structured debt and moderate debt burden are also incorporated into the ratings. Our negative outlook on the city's ratings is based on the city's likely weakening financial position. The city's large, persistent structural imbalance is a credit negative in itself. In addition, this imbalance has resulted in draws on the city's already very thin budgetary reserves. The city's demonstrated strong budgetary control is a critical, positive factor but is not in itself sufficient to preserve the city's high rating in the face of narrowing balances. The negative outlook reflects the likelihood that reserves could decrease to levels inconsistent with the city's current rating even with the city's other credit strengths.

The current financing is secured by a fairly typical, abatable municipal lease which is in turn secured by the city's pledge to budget and appropriate lease payments so long as it has use and occupancy of the leased asset. The leased asset is the city's San Bruno jail. Proceeds will be used to refund four outstanding lease financings for debt service savings, by far the largest of which is the city's Certificates of Participation, Series 2000 (San Bruno Jail No. 3 Replacement Project). The one notch rating distinction between the Aa2 on the current offering and the city's Aa1-rated general obligation bonds is consistent with the one-notch distinction on the rating of the Series 2000 issue. The rating on the Series 2000 issue reflected demonstrated voter support for the project in excess of the 50% threshold for the city's usual lease financings, although the proposed authorization did not pass by the required two-thirds margin. The essentiality and high seismic standard of the San Bruno jail, the leased asset, are also key contributors to the one-notch distinction between the city's general obligation bond rating and the rating on the current issue.

ASSESSED VALUATION GROWTH PARTIALLY REFLECTS EARLIER YEARS' ACTIVITY

San Francisco is both a city and a county. Its sizable assessed value (AV) approximates the median for large, highly rated cities nationwide, and is well above the median for California counties. The city's AV has grown steadily each year for the past ten years, notably including the current year. For fiscal 2011 AV reached a total $163.4 billion after 3.7% growth over the fiscal 2010 figure. Based on state Board of Equalization data (which is formatted slightly differently than that presented by the city) San Francisco was one of only a handful of counties to show any AV growth at all this year, compared to a statewide county median decrease of 2.1%. The city's fiscal 2011 AV growth resulted not just from fiscal 2010 real estate transactions, but also from prior years' transactions newly reflected on the tax rolls. AV is a lagging indicator, particularly in the city as the assessor works through backlogged transactions. Once the impacts of the residential real estate downturn and the recession are more completely reflected in the tax rolls, weaker AV growth is likely and even a modest decline is possible. Large decreases, however, are not anticipated. Median home prices in the city were well above AV levels and price declines were smaller than they were elsewhere, so downward pressure on AV is likely to be limited. Pressure on AV growth may be driven by commercial property, particularly downtown office buildings. However office buildings represent only about 15% of the city's total assessed valuation, so even dramatic declines for individual commercial office properties would not likely have significant overall AV implications. San Francisco's tax base is diverse and tourist oriented: the top ten assessed parcels account for just 3.6% of assessed value, and represent primarily office, retail and hotel properties.

San Francisco residents' socioeconomic profile is quite strong for a large U.S. city with per capita income at 152.2% of the state average and median family income at 119.8% of the state average. San Francisco's median family income also appears to have improved in recent years: as of the U.S. Census Bureau's 2006-2008 American Community Survey 3-Year Estimates, San Francisco's median family income rose somewhat to between 122% and 130% of the state average (the range reflects the survey's statistical margin of error). Unemployment in the city stood at 9.6% as of June 2010, in line with the national rate and well below the state's 12.2%. Moody's continues to believe that the city's economy is fundamentally sound, with its diversity and its highly skilled labor force supporting long-term growth.

FISCAL 2011 BUDGET BALANCED WITH SUBSTANTIAL ONE-TIME MEASURES, PERPETUATING STRUCTURAL IMBALANCE

The negative outlook on the city's long-term rating results from the city's persistent structural imbalance, as the fiscal 2011 budget gap was addressed in large part with one-time measures. Given that these measures deplete the city's already very thin reserves, this imbalance is a critical credit negative. In the past the city has exhibited an established trend of rapidly increasing GAAP-basis reserves during growth years. To the extent that the city's structural balance will defer or delay such increases, this too would put downward pressure on the city's ratings. In April the Board of Supervisors adopted an ordinance creating two new reserves, a General Reserve and Budget Stabilization Reserve, including funding requirements and drawdown restrictions. While this ordinance is a modest positive, its regular, sustained implementation is needed in order to materially improve the city's credit prospects.

The city's audited reserve position is extraordinarily thin, with fiscal 2009 unreserved fund balance of $28.2 million representing just 1% of general fund revenues. This is low even for the city, whose narrowest unreserved fund balance in the previous ten years had represented 2.0% of revenues. The city's strong budget controls are an important credit positive, mitigating to a certain extent the city's historically thin and somewhat more volatile reserves than those of other large, highly rated cities.

Recent pre-audit estimates show a higher budgetary fund balance in fiscal 2010 than assumed in the Mayor's proposed 2011 budget. Various taxes outperformed conservative projections in fiscal 2010, yielding budget-based discretionary revenues that were stronger than previous projections by approximately $35 million. The Mayor's proposed fiscal 2011 budget assumed the drawdown of $19.6 million in budgetary reserves and $64 million in budgetary fund balances. The stronger performance in fiscal 2010 allowed the fiscal 2011 budget to rely upon a higher $79.9 million in prior year fund balance. Before approving the budget, the Board of Supervisors restored various programs totaling $43.8 million (1.5% of the total General Fund budget). These restorations were funded in part through the outperforming fiscal 2010 revenues and in part with additional expenditure reductions imposed by the Mayor. On a positive note, the outperforming taxes in fiscal 2010 together with higher than budgeted fiscal 2011 assessed value established a stronger base for fiscal 2011 revenues than had previously been assumed, increasing the likelihood that revenues will meet or exceed budgeted figures.

The city's fiscal 2011 general fund budget totals $3.0 billion. It addressed a $482.7 million deficit using approximately $257 million of one-time measures, the largest component of which was $173 million of one-time revenues. As of this month, $123 million of budgeted revenues require federal government approval and $11 million require local action. In addition to the federal and local revenues, critical uncertainty remains pertaining to the state budget. It is now known that there will be a shortfall in at least two programs, Federal Medical Assistance Percentage (FMAP) funds and state Hospital Fee revenues. Further state cuts are to be expected, though the amount and type are impossible to predict with any accuracy. San Francisco incorporated a $30 million decrease in state revenues into its budget assumptions. Given the city's weak fund balances, materially higher state cuts could have a severe impact on the city's financial strength and credit standing.

The city addressed its fiscal 2011 budget gap in part with cost cuts. Notably, wage concessions totaling approximately $62 million are expected to more than offset pension and healthcare cost increases, resulting in a $17.8 million savings in fiscal 2011. The concessions, which have been agreed to by the affected labor groups, largely are taking the form of furlough days, 12 in each of the next two years, for almost all groups. Moody's observes that once the two-year contracts have expired, the city will likely have to address demands for revocation of the furlough days, if not for compensatory salary increases, which will add to the challenges associated with achieving and maintaining structural balance. Other key expenditure cuts are a decrease in social service spending and cuts in the general fund subsidy to the hospital, though this relies upon receipt of federal and state revenue which is already known to be overstated.

The City Controller has established reserves against the uncertain revenues built into the budget in accordance with the city's charter. By doing so, the Controller effectively prohibits appropriation of these funds until their receipt is assured: appropriations are 'haircut' across all departments to prevent over-spending. When and if it becomes clear that anticipated revenues are not forthcoming this fiscal year, we expect the city will make appropriate budget adjustments. We consider the city's budget monitoring a credit strength, as it has swiftly and consistently implemented mid-year expenditure adjustments to offset any weakness in revenue growth. While this strength is necessary, Moody's notes that it is not sufficient in order for the city to retain its current rating.

MODERATE DEBT LEVELS CONSERVATIVELY STRUCTURED; MINIMAL VARIABLE RATE DEBT

The city's direct and overall debt burdens stood at 1.4% and 2.0% as of fiscal year end 2009, and are expected to increase to still moderate rates as of the end of the current fiscal year. In total the city now has $1.2 billion of authorized unissued G.O. debt. The city has stated its intention to maintain its existing G.O. bond property tax rate, and it has planned to issue new debt in line with assessed valuation growth. Given the sound rise in AV this year, debt burden should remain moderate. Should AV growth slow and the city's funding needs outweigh the need to maintain the current tax rate, debt burden could rise.

The structure of San Francisco's outstanding GO debt is conservative. The city typically uses a level debt service structure and twenty to twenty-five year final maturities, rather than thirty years. Its resulting ten-year rate of direct, tax-supported debt retirement is a favorable 64.8%, and total debt service declines annually. A relative weakness in the city's debt profile is indicated by its high direct and overall debt per capita figures of $2,411 and $3,434. Given the wealth of city residents, however, this is not a material credit concern.

The city's exposure to the variable rate market is quite modest. None of the city's general obligation debt and only one of its outstanding lease-backed obligations is variable rate. The city just initiated a commercial paper program which Moody's believes is also manageable and conservatively designed. The city's general fund cash and investments as reported in its fiscal 2009 audit is more than twice the city's variable rate exposure, suggesting that the general fund could absorb the impact of any failed remarketing. This is important given that the City Treasurer has expressed a reluctance to purchase the city's variable rate or commercial paper obligations as investments for its pool, citing the appearance of a conflict of interest.

The variable rate lease is a $141.6 million convention center lease representing about 14.3% of the city's $992.8 million of outstanding lease-backed debt and just 6.7% of its $2.16 billion of total direct debt as of fiscal year end 2009; by the end of the current fiscal year the long-term variable rate debt is expected to decrease as a percentage of the total given that the amount of the city's outstanding lease obligations has risen. Lease payments for the variable rate financing are made from a dedicated hotel tax established by city voters for the express purpose of funding the related capital improvements. The hotel tax provides ample debt service coverage and excess revenues are deposited in a special revenue fund rather than the city's general fund.

The commercial paper program was authorized at $150 million in March, 2010. The city has only obtained letters of credit to support $100 million, suggesting that is the maximum amount expected to be issued in the near term. The program is intended to provide interim funding during project acquisition or construction, with long-term take-out financing once the project is completed and costs are known. According to the staff memo provided to the Board when it authorized the program, projects can only be funded with the commercial paper program if the long-term permanent financing has been approved as well, a positive credit factor.

OPEB LIABILITY IS WELL ABOVE AVERAGE AND WILL LIKELY BE A SIGNIFICANT, ADDITIONAL LONG-TERM CHALLENGE

San Francisco's other post-employment benefit (OPEB) liability is extremely large and will be a significant long-term challenge, barring a major change in the country's health care delivery system. The most recent actuarial valuation puts the city's unfunded liability at $2.6-to-$4.0 billion (depending on funding assumptions). Even at the lower estimate, the liability is more than the city's currently outstanding debt. Funding the city's retiree health care benefit at a full, actuarially required amount would require the dedication of an additional 5%-to-10% of the city's general fund revenues. City voters approved a charter amendment that reduces the post-retirement eligibility and benefits available to new hires starting in January 2009. But virtually no progress has been made in addressing the already outstanding liability, despite the city having established in 2006 a "Health Benefits Committee" with its labor groups to develop a recommendation. While this is a long-term challenge, rather than one that is pressing, many municipalities, particularly those that are highly rated, have made substantive progress in addressing their OPEB liabilities. Our Aa1 rating on the city's G.O. bonds assumes that the city will prepare a long-term solution to this funding challenge which it will implement when economic conditions improve.

CURRENT REFUNDING IS A TYPICAL LEASE BUT RESERVE HALF STANDARD SIZE; SAVINGS TAKEN LARGELY IN THE COMING AND FINAL YEAR

The city's lease burden is manageable, with its peak lease payment obligation representing about 4% of fiscal 2009 revenues and expected to remain level as a percentage of this year's revenues. The current issue is expected to refund four outstanding financings, by far the largest of which is Series 2000 (San Bruno Jail Project) outstanding at $121.38 million. The current issue will also refund Series 1997 (2789 25th Street Property) outstanding at $4.84 million, Series 1999 (555 7th Street Property) outstanding at $5.93 million, and Series 2001-1 (25 Van Ness Avenue Project) outstanding at $6.955 million. The rating on the current issue preserves the one-notch distinction between the Series 2000 rating and the city's general obligation bond rating. This reflects the fact that the current series primarily reflects refunding of Series 2000 and the San Bruno Jail is the asset being leased in the current financing. The essentiality and high seismic standard for the jail are key components of the rating. In addition, the rating on the Series 2000 issue reflected demonstrated voter support for the project in excess of the 50% threshold for the city's usual lease financings, although the proposed authorization did not pass by the required two-thirds margin. In addition the city validated the Series 2000 financing in the local superior court.

The savings from the refunding are taken almost entirely upfront: the city expects to reduce its fiscal 2011 payment by $4.7 million and its subsequent payments by amounts ranging from $212,000 to $946,000 annually. Significant savings also will be realized in the maturity year, 2034, as the reserve fund is released. While not a material amount in the context of the city's overall budget, this structure is another one-time solution being applied to address the city's fiscal 2011 deficit, and as such is a credit negative.

The lease itself is structured as a standard California abatement lease wherein the city covenants to annually budget and appropriate, from any legally available funds, lease payments for use and occupancy of the leased asset. The asset is the city's San Bruno Jail property, which the city's real estate division has valued at $160 million. The financing includes a cash-funded reserve sized at half the standard three-part test, two years of rental interruption insurance, and title insurance.

Outlook

Our outlook for the city's long-term ratings is negative. As discussed in more depth above, the negative outlook reflects the one-time nature of a significant portion of the measures adopted in order to address the large fiscal 2011 budget gap. These include draws on the city's already very thin reserves, which could very well erode to levels inconsistent with the current rating even given the city's mitigating strengths.

KEY INDICATORS

Fiscal 2009:

Net General Fund cash, % of revenue: 9.3%

Total General Fund balance, % of revenue: 10.6%

Unreserved General Fund balance, % of revenue: 1.0%

Net direct debt, % of AV: 1.4%

Overall net debt, % of AV: 2.0%

Peak lease payment, % of General Fund revenues: 4.0%

2000 Census:

Median Family Income: $63,545 (120% of the state average)

Per Capita Income: $34,556 (152% of the state average)

Persons below poverty: 11.3%

The last rating action with respect to the City and County of San Francisco was on July 9, 2010 when a rating was upgraded to Aa2 from Aa3 for the city's Lease Revenue Refunding Bonds, Series 2010-R1 (911 Information and Communications System)

The principal methodology used in rating San Francisco (City & County of) was The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations rating methodology published in October 2004. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found on Moody's website.

REGULATORY DISCLOSURES

Information sources used to prepare the credit rating are the following: parties involved in the ratings, public information and confidential and proprietary Moody's Analytics' information.

Moody's Investors Service considers the quality of information available on the credit satisfactory for the purposes of assigning a credit rating.

MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

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Please see the Credit Policy page on Moodys.com for the methodologies used in determining ratings, further information on the meaning of each rating category and the definition of default and recovery.

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