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Case Study: The Vallejo, Calif. Bankruptcy

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(Editor's Note: Please see "Municipal Bankruptcy: Standard & Poor's Approach And Viewpoint," published Oct. 4, 2012.)

Vallejo, Calif. succumbed to the Great Recession relatively early, in May 2008, and Standard & Poor's Ratings Services thinks it thus serves as a useful case to examine the short-term and long-term effects that a municipal bankruptcy can have on an obligor. Plummeting tax revenues, which contributed to an eventual \$15 million, or 17.8% drop in general fund revenue in the four-year span ending in 2011, along with stubborn expenses, were the ostensible causes of Vallejo's fiscal deterioration. In our view, the reality is much more complicated and incorporates other potentially controllable factors. We believe Vallejo's economic setting exaggerated its fiscal difficulties but was not unique. In fact, between 2008 and 2011, 20 cities in California with Standard & Poor's debt ratings endured revenue losses of 17% or more without filing a petition under Chapter 9. The difference, to us, was management. We believe that management in Vallejo contributed to the city's fiscal crisis through financially imprudent labor contracts. With salaries and benefits equal to about 80% of general fund expenditures, the contracts were a critical determinant of the city's financial condition.

In July 2006, when Vallejo agreed to contracts including multiple-year, formula-based pay escalators, we think the city wedged itself into a situation that it could only afford if bubble-like housing market conditions persisted so that tax revenue would continue to grow. Instead, we now know that as of April 2006 the housing market had actually already peaked, according to the S&P/Case-Shiller Home Price Index. Nevertheless, formulas dictating the city's salary increases were locked into place and not scheduled to expire until June 2010.

The Short-Term Effects

In bankruptcy, Vallejo realized the main benefits of a Chapter 9 filing by obtaining immediate temporary cash flow relief and eventually being able to reject its collective bargaining agreements. A portion of the city's immediate savings came from the discontinuation of the general fund's full payment, in July 2008, of debt service associated with approximately \$53 million of general fund-supported debt. Overall, the city reports that bankruptcy and claims costs saved it \$34 million over 18 months. This included the debt service avoided on its bonds (a portion of which was from paying less in interest than was due). However, the city paid bankruptcy-related legal fees totaling more than \$13 million, according to news accounts, through fiscal 2012, which offset a significant portion of these savings.

The remainder of the city's approximately \$123 million in debt obligations (backed by non-general fund pledged special revenues) and its \$128 million unfunded actuarial accrued pension liability were not renegotiated as part of the bankruptcy. In the three fiscal years ending in 2010, the city paid between \$9.9 and \$12.3 million annually in pension contributions. (The most recent year for which a comprehensive annual financial statement is available is fiscal 2010.) Bankruptcy, therefore, did not result in a renegotiation of contractual terms with the city's largest class of creditors, its pensioners.

Probably the most substantial adjustment Vallejo obtained in bankruptcy was the ability to reject its labor contracts. But even here, aside from some short-term savings, it's not clear to us that the bankruptcy will prove to have netted a

benefit to the city's fiscal position when considering the longer-term costs to the city and its economic effects. Furthermore, even after filing its bankruptcy petition, the city and its labor unions struggled to renegotiate contracts for 10 months before the bankruptcy judge, siding with the city, compelled a renegotiation.

Most significantly, the renegotiated contracts included cutting and capping retiree health care benefits, reducing this liability by approximately \$54 million to \$84.2 million (according to the city's most recent audited financial statements). On the other hand, bankruptcy-related litigation, professional services, and tangential administrative costs could wind up rivaling the estimated savings attributed to the bankruptcy. In addition, The Los Angeles Times reports that the city faces as much as \$479 million in claims filed by its various creditors. Even if final actual bankruptcy related costs and claims were to fall short of these estimates, based on our assessment, they could easily far surpass the short-term cash flow benefits gained in bankruptcy.

We think that evaluating the city's bankruptcy solely on its fiscal merits, therefore, renders an equivocal verdict. When indirect and long-term costs are added to the equation, based on our estimate, it becomes even less likely that the benefits of bankruptcy will come near the costs.

The Long-Term Effects

Vallejo was in bankruptcy for three and one-half years and has not issued debt -- due to a lack of market access -- since prior to its filing. In addition, throughout the bankruptcy process and since it formally ended, the city -- according to several of its own measures -- inadequately maintained its infrastructure. The city reports that the quality of its infrastructure significantly lags its peers. For example, its pavement condition index has fallen 14% since 2002, is 23% below the Bay Area average, and would require an estimated \$135 million of investment to achieve a score considered "good." Similarly, the city's vehicle fleet assets are 87% depreciated. In its fiscal 2012 budget, the city funded just 23 of the 127 vehicles that need replacement. Other operating indicators are weak as well. For example, more than 13 months since bankruptcy ended, the city has yet to publish its fiscal year 2011 audited financial statements.

Since 2004, Vallejo reduced its sworn police officer staff by 42% (to 90) and its fire protection personnel by 47% (to 70). As one consequence, the city's incidence of violent crime per sworn officer is well above, and the number of fire fighters per 1,000 residents is well below, the Bay Area average (which the city uses as its benchmark).

The cuts and underinvestment have not helped solidify the city's finances. On the contrary, in our view, the city's fiscal situation continues to languish, partly as a result of its bankruptcy filing.

A key driver of the city's fiscal imbalance was its salary and benefit costs, which equaled 78% of its budget in 2008. However, in fiscal year 2012, the city's first budget year after emerging from bankruptcy, salaries and benefits had actually increased to 82% of the city's budget. Furthermore, the city still faces a structural deficit of \$3.8 million, equal to 4.3% of expected fiscal year 2013 expenditures. If one assumes there is a floor on service levels, the remaining deficit may prove especially stubborn given the depth of cutbacks the city has already implemented. In fact, the city's five-year general fund forecast anticipates another deficit in fiscal year 2014. These deficits are a bit smaller than in 2008 when the city filed for bankruptcy, but they are no better than performance in the years leading up to 2008. The city cites its annual deficits ranging from \$3 million to \$5 million as precipitating its financial downfall. An additional

sign of risk, in our view, is that the currently projected deficits have arisen after the city emerged from bankruptcy. In 2011, when it formally exited bankruptcy, the city projected a balanced budget for that year and thereafter. Yet, one year later, operating deficits returned.

Chart 1

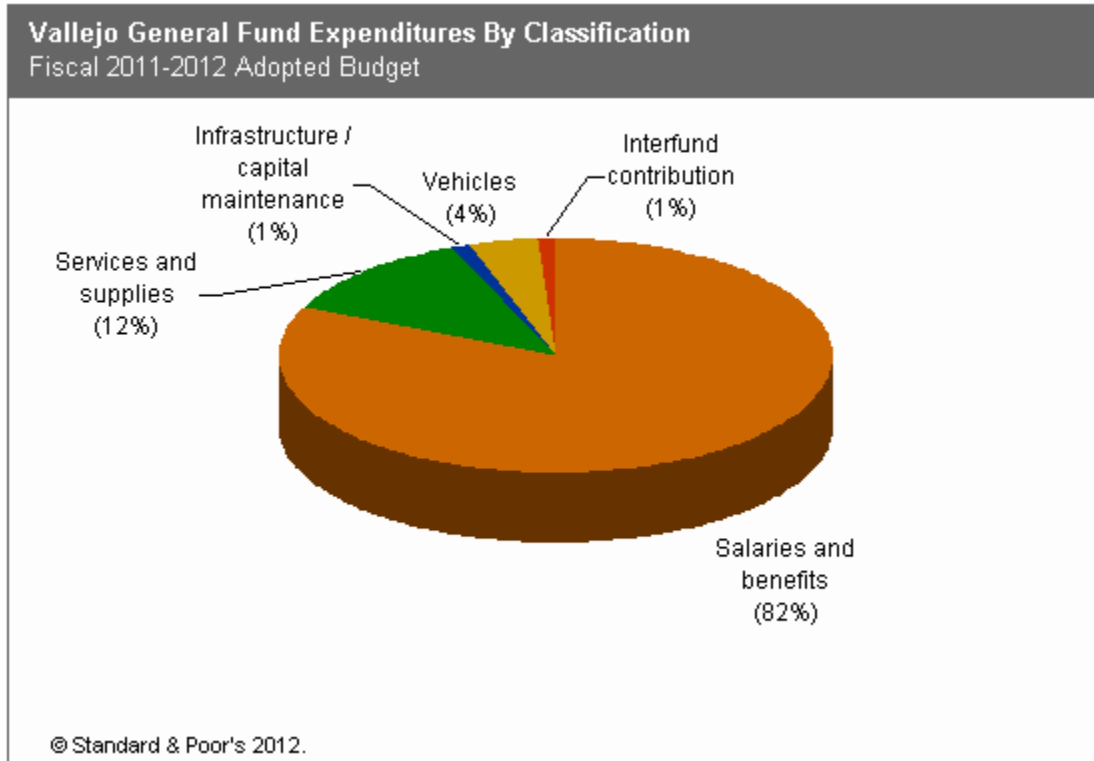


Chart 2

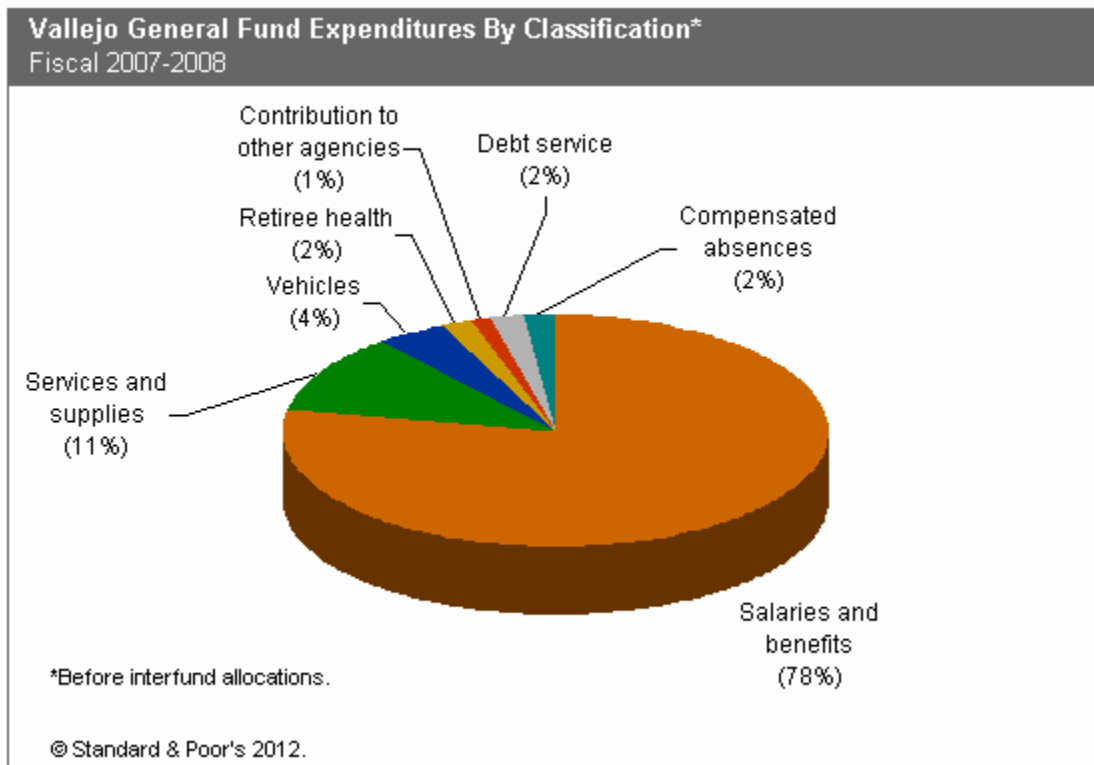
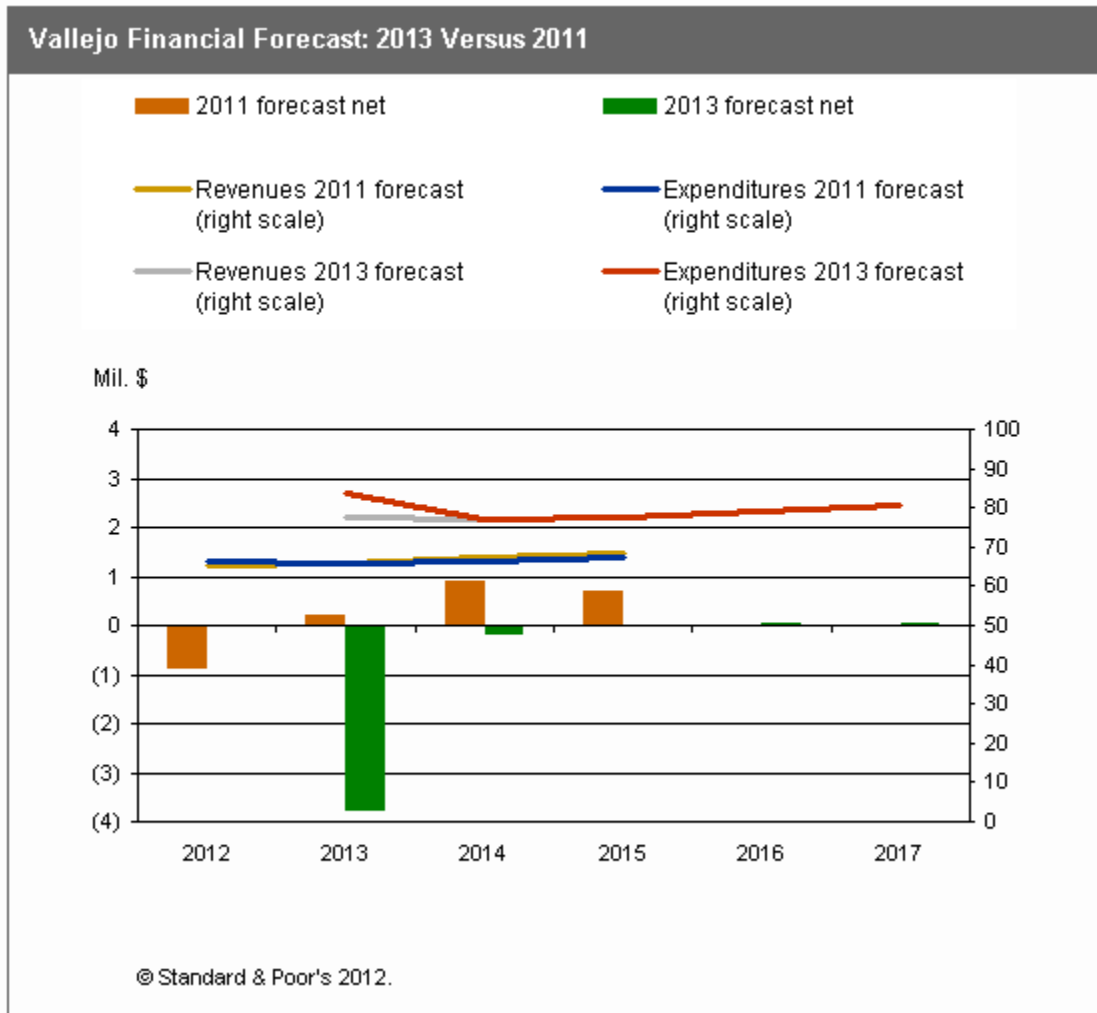


Chart 3



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