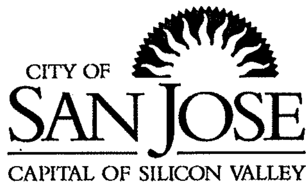

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Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Julia H. Cooper

SUBJECT: **2012 RATING AGENCY ACTION MOODY'S INVESTORS SERVICES**

DATE: March 28, 2012

Approved [signature] Date 3/28/12

INFORMATION

The City has recently received inquiries from all three rating agencies, Moody's Investors Services ("Moody's"), Standard & Poor's ("S&P"), and Fitch Ratings ("Fitch") for credit updates on a variety of the City's credits including the Airport (Fitch), Successor Agency to the Redevelopment Agency (Fitch) and City's general credit (Moody's and S&P). These inquires are part of the rating agencies ongoing credit surveillance work. Their surveillance work is undertaken by reviewing publically available documents and engaging in dialogue with City staff.

On Monday, March 26, 2012, Moody's took a rating action and downgraded City of San José general obligation bonds from "Aaa" to "Aa1" and lease revenue bonds from "Aa2" to "Aa3" and assigned a stable outlook. Moody's two notch rating distinction between current lease revenue ratings and general obligation ratings represents its standard rating difference for essential-purpose lease revenue ratings. The general obligation rating action by Moody's follows the similar rating action taken a year ago by Fitch when the City's general obligation ratings were downgraded one notch from "AAA" to "AA+", along with a corresponding downgrade of the City's lease revenue bonds from "AA+" to "AA".

The rationale for Moody's rating action is best characterized by the following comment in their rating report, *"The rating reflects the multi-year erosion of the city's general fund reserves. This decline is indicative of the difficulty the city has faced to manage costs versus weakened revenues resulting from the economic downturn and a very slow and tenuous recovery. ... The city's management is also being significantly challenged to manage retirement costs and faces arduous barriers to reduce the impact of those obligations."*

Moody's also acknowledges in its rating report credit strengths for San José includes:

- *"Exceptionally large Silicon valley economy with solid resident wealth levels for a large City of San Jose*
- *Aggressive pursuit of opportunities to effectively manage retirement costs*
- *Satisfactory fiscal position for the rating level"*

A copy of the full rating report is attached to this memorandum.

Moody's provided the Finance Department a draft of its research report on the morning of March 26, 2012. Pursuant to Moody's policy, the City was allowed a very brief period of time (one hour) to review for any factual errors and/or inadvertent disclosure of confidential information. For Moody's to maintain complete independence in its rating opinions, Moody's strictly retains editorial control over the form and content of all of its publications. City staff made several recommended edits to the chronology of the Fiscal Reform Plan and City Council actions which were not accepted by Moody's. Additionally, the corrections of the Election Day from July 2012 to June 2012 and change in the unemployment rate from 9.7% to 9.1% were not made in the final report. As required by the City's continuing disclosure agreements that were entered into pursuant to the Securities & Exchange Commission's Rule 15c2-12, the Finance Department will be notifying the financial markets of the rating downgrade within the deadlines specified in the continuing disclosure agreements.

Impact of Rating Downgrade

The City has eight separate series of variable rate lease revenue bonds outstanding for five separate projects (Civic Center, City Hall Garage, Hayes Mansion (taxable and tax-exempt), Ice Centre, and Land Acquisition/Airport West). The total amount of this debt outstanding is $237.89 million. These variable rate bonds are supported by letters of credit which are provided by three different banks (Bank of America, Union Bank, and U.S. Bank). Each of the agreements with the banks includes provisions for changes in the letter of credit fees paid by the City in the event of a rating downgrade. The increased fees are triggered when two of the three rating agencies rate the City's lease revenue debt at levels lower than the initial benchmark underlying rating on the bonds (Aa2/AA/AA). The single rating downgrade last year by Fitch did not result in an increase in the fees; however the additional action by Moody's will increase the City's letter of credit fees. Increased fees are triggered by subsequent downgrades as well.

The annualized fee increase is approximately $350,000. The Finance Department will work with the Budget Office to determine the impact (if any) on the current year budget and will work with the Budget Office on the appropriate budget adjustments for the FY 2012-13 Proposed Operating Budget.

History of General Obligation Ratings

The City received general obligation bond ratings in February 2001 in advance of the issuance of the first series of general obligation bonds in nearly 40 years. The ratings at that time were Aa1/AA+/AA+ from Moody's, S&P, and Fitch, respectively. The City held these ratings until S&P upgraded the ratings to AAA in May 2008. In May 2010, as part of a comprehensive review of municipal credits, Moody's and Fitch recalibrated the City's general obligation ratings to Aaa/AAA, respectively. In March 2011, Moody's and S&P confirmed the City's Aaa/AAA ratings with stable outlooks, and Fitch downgraded the general obligation rating to AA+ with a stable outlook.

The current general obligation ratings of Aa1/AAA/AA+ from Moody's, S&P, and Fitch, respectively, as reflected in this memorandum still place the City in an admirable position as a highly-rated, large California city.

JULIA H. COOPER
Acting Director of Finance

For questions, please contact Julia H. Cooper, Acting Director of Finance at (408) 535-7011.

Attachment

Rating Update: MOODY'S DOWNGRADES SAN JOSE G.O. AND LEASE REVENUE BONDS TO Aa1 and Aa3 RESPECTIVELY; OUTLOOK REMAINS STABLE

Global Credit Research - 26 Mar 2012

APPROXIMATELY $1.1 BILLION IN DEBT AFFECTED

SAN JOSE (CITY OF) CA
Cities (including Towns, Villages and Townships)
CA

Opinion

NEW YORK, March 26, 2012 --Moody's Investors Service has downgraded the City of San Jose's general obligation bond ratings to Aa1 from Aaa. The city's various lease revenue bond ratings have been downgraded to Aa3 from Aa2. The outlook for the ratings is stable.

RATING RATIONALE

The rating reflects the multi-year erosion of the city's general fund reserves. This decline is indicative of the difficulty the city has faced to manage costs versus weakened revenues resulting from the economic downturn and a very slow and tenuous recovery. The rating and outlook incorporate our expectation that the city's fiscal position will remain stable albeit at a lower level than in recent years. The city's management is also being significantly challenged to manage retirement costs and faces arduous barriers to reduce the impact of those obligations.

The general fund bonds are secured by the city's unlimited property tax pledge. The various leases are backed by a pledge to budget and appropriate lease payments in exchange for numerous leased assets.

The two notch rating distinction between the current lease ratings and the city's general obligation rating represents Moody's standard notching for essential purpose, fixed asset leases relative to a California issuer's general obligation rating. Broadly speaking the two notches reflect the risk of abatement (and the related lack of seismic insurance coverage) and the narrower, general fund security pledge for leases compared to the unlimited property tax pledge securing general obligation bonds.

STRENGTHS

-Exceptionally large Silicon Valley economy with solid resident wealth levels for a large city

-Aggressive pursuit of opportunities to effectively manage retirement costs

-Satisfactory fiscal position for the rating level

CHALLENGES

-Four consecutive years of audited deficits

-Increasing retirement cost burden

-Difficult barriers to reducing retirement costs

DETAILED CREDIT DISCUSSION

MULTI-YEAR DEFICITS HAVE WEAKENED THE CITY'S FISCAL POSITION

In fiscal 2011, the city recorded its fourth consecutive year of general fund deficit. Though the deficit was minor relative to total general fund revenues, it continued a trend of general fund reserve erosion that has seen the fund balance fall from 39.4% in fiscal 2007 to 23.4% in fiscal 2011. The decline has resulted from significant drops in revenue during the recession, which prompted material deficits as the city attempted to adjust its expenditures. As a result, the city's available cash and reserves, while still satisfactory, are appreciably weaker than in the years prior to the downturn. The city currently anticipates balanced general fund operations for fiscal 2012 and a small surplus in fiscal 2013. The expectations are hopeful indicators that the city is entering a new period of positive operating results. We expect that the city will be able to at least preserve its fund balances and cash at levels comparable to the current position. We also recognize that slow improvement to the economy and the

difficulty of managing costs will likely keep the city's fiscal position at its currently stable but diminished position for an extended period.

DIFFICULT BARRIERS TO CONTROLING RISING RETIRMENT COSTS

The city's retirement costs include both pension and other post employment benefits (OPEB) that are expected to rise as a percentage of the city's budget. The city's management is facing several difficult hurdles in its effort to manage and ultimately lower the impact of these obligations.

The city's most recent actuarial study anticipates that total retirement costs will increase from 21.8% of total general funds in fiscal 2012 to 26.2% of total general funds by fiscal 2016. This cost burden is at the higher end for large Moody's-rated cities. If the city's revenue growth remains slow, the cost of funding these obligations could become particularly burdensome, a possibility that in not unrealistic given the weak nature of the economic recovery.

The city has commendably opted to aggressively seek ways to manage and reduce the impact of retirement benefits. This is particularly noteworthy given that so few cities have taken such a direct approach in addressing the challenge of retirement costs. Nonetheless, the city's efforts to address this issue have applied stress to management. In May 2011, the Mayor proposed a "fiscal reform plan" that would have declared fiscal emergency, impaired the contracts of bargaining units , and placed a retirement benefit reform measure on the ballot. The city delayed taking any action on the proposal to declare fiscal emergency for the remainder of the year while it continued to negotiate with its labor groups. In February 2012, a city employee union filed an ethics complaint against the Mayor and others alleging that the city's projected retirement costs and fiscal position had been overstated. On March 6, the city council voted to place a retirement costs reform measure on the July 2012 ballot. However, in light of the projected operating surplus for 2013, the city is not currently pursuing a declaration of fiscal emergency. The unions have responded by filing a lawsuit to force the city back to the bargaining table and prohibit the measure from being placed on the ballot. Another lawsuit has been filed challenging the legality of the phrasing of the measure. Additionally, the city council has directed the city staff to file a declaratory relief action in the event the ballot measure passes.

The contentiousness around this issue raises the possibility that even if the ballot measure were approved by voters, it may face additional legal challenges, which could adversely affect any cost benefit that may otherwise be implemented. In absence of modification to the city's retirement benefit structure, costs are likely to become an increasingly burdensome share of the city's general fund.

ECONOMY EXHIBITNG MODEST SIGNS OF IMPROVEMENT AMID VERY SLOW GROWTH

The city's tax base is the largest in the Silicon Valley and has undergone only very minor declines resulting from the economic downturn. This pressure appears to be slowly relenting as the 2012 assessed value by grew 0.8% for the first time in two years. Unemployment remains elevated at 9.7% but has still improved two percentage points on a year over year basis. The city's economic strengths include a very highly educated workforce, culture of business creation and entrepreneurship, significant presence of several high-tech enterprises, and location within the San Francisco Bay Area regional economy. All of these factors support the likelihood of long-term vitality despite the current weakness relative to the boom years when the unemployment routinely approximated 5% and annual tax base growth was just under 10%.

MODEST VARIABLE RATE DEBT AND LEASE BURDEN WITHIN SIZEABLE DEBT PORTFOLIO

The city's variable rated debt obligations include the 2008ABCDEF revenue bonds , which represent 21% of the city total debt. The city does not have any swap agreements but does have letters of credit that expire in October 2013 and 2014. We do not expect that the city will be unable to renew these facilities as needed. The lease burden for the bonds is low at just 4% of the city's total general fund revenues with direct and overall debt levels of 1.2% and 3.5%, typical for a Moody's-rated city.

WHAT COULD CHANGE THE RATING UP

-Significant and sustained improvement to the city's fiscal position

-Implementation of a strategy to address long-term retirement cost impacts

-Strengthening of the local economy

WHAT COULD CHANGE THE RATING DOWN

-Additional diminution of the city's fiscal position

-Inability to effectively manage retirement costs

KEY STATISTICS

Fiscal 2011 general fund balance as a percentage of revenues: 23.4%

Direct debt as a percentage of full value:1.2%

Overall debt as a percentage of full value: 3.5%

Assessed value per capita: $104,993

The principal methodology used in this rating was General Obligation Bonds Issued by U.S. Local Governments published in October 2009. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

Although this credit rating has been issued in a non-EU country which has not been recognized as endorsable at this date, this credit rating is deemed "EU qualified by extension" and may still be used by financial institutions for regulatory purposes until 30 April 2012. Further information on the EU endorsement status and on the Moody's office that has issued a particular Credit Rating is available on www.moodys.com.

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Analysts

Michael Wertz
Lead Analyst
Public Finance Group
Moody's Investors Service

Eric Hoffmann
Backup Analyst
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653

Moody's Investors Service, Inc.
250 Greenwich Street
New York, NY 10007
USA

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