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INVESTORS SERVICE

Rating Update: MOODY'S DOWNGRADES CALIFORNIA TAX ALLOCATION BONDS DUE TO NEAR-TERM CASH FLOW RISKS ARISING FROM REDEVELOPMENT AGENCIES' IMPENDING DISSOLUTION; ALL TAX ALLOCATION RATINGS REMAIN ON REVIEW FOR POSSIBLE FURTHER DOWNGRADE

Global Credit Research - 17 Jan 2012

Approximately $11.6 Billion in Debt Affected

ALAMEDA COUNTY REDEVELOPMENT AGENCY, CA
Tax Increment/Tax Allocation
CA

Opinion

NEW YORK, January 17, 2012 --

Moody's Investors Service has downgraded by one notch all California tax allocation bonds rated Baa2 and above. All California tax allocation bond ratings remain on review for possible downgrade.

SUMMARY RATING RATIONALE

The downgrade primarily reflects near-term cash flow risks arising from legislation recently upheld by the state supreme court that dissolves all redevelopment agencies. Effective February 1, 2012, every redevelopment agency statewide will be replaced by a "successor agency" charged with winding down the redevelopment agency's affairs. This wind-down includes the payment of existing debts according to their terms. However, the implementation and potential for varying interpretations of the new legislation incrementally raises the risk that some debt service payments will not be made on a timely basis.

Compliance with the requirements of the new legislative framework may prove challenging, particularly in the near term as affected agencies attempt to interpret the law and comply with its specified timelines. Most significantly, in the new law County Auditor-Controllers are given new auditing requirements to be met by July 1, 2012, and on-going administrative responsibilities that may initially conflict with existing bond indentures. The resolution of any such conflicts according to the new law's property tax reallocation process could take a substantial amount of time, and it is entirely untested. The limited, one-notch downgrade across the Baa2-and-above rating spectrum reflects the broad-based but modest nature of this new risk. While Baa3-and-lower rated tax allocation bonds also face this new risk, their overall risk profile remains consistent with their current ratings.

While we believe that existing legal protections for contracts, as well as the legislature's clearly stated intent in the new law, almost certainly preserves tax allocation bonds' fundamental security, our tax allocation bond ratings remain on review for possible further downgrade. This continued review reflects the near-term practical and potential legal challenges to implementing the new dissolution legislation while maintaining tax allocation bonds' credit quality above a minimum level. We expect that the promulgation of implementation guidelines in the near future and the resolution of any conflicting interpretations of the law should permit a reevaluation of these ratings within our standard 90-day timeframe.

STRENGTHS

- Successor agencies, which replace the dissolved redevelopment agencies, remain explicitly obligated to honor existing bond contracts, with recognition of legally pledged revenue streams, debt service reserve funding requirements, and other performance requirements in existing bond documents.

- While the mechanics of the new law may be problematic, the legislature's intent to honor existing obligations is clearly stated in the law.

- County Auditor-Controllers have generally indicated a very strong willingness and abiity to comply with the new revenue allocation requirements on a sufficiently timely basis to allow successor agencies to meet existing debt service payment obligations.

CHALLENGES

- The law establishs an initial allocation of property tax revenues that conflicts with existing bond documents, and the effectiveness of the resolution process on a timely basis is uncertain.

- The timeframe for property tax disbursements is more restricted than it had been previously, potentially resulting in mismatched receipt and disbursement schedules over the course of a year.

- The new law's audit requirements and sheer complexity may result in unexpected payment delays as legal and administrative clarification is pursued.

DETAILED CREDIT DISCUSSION

POTENTIAL FOR CASH SHORTFALLS DURING SECOND SEMI-ANNUAL PROPERTY TAX DISTRIBUTION PERIOD

Timely debt service payment may be at risk if the legislation is implemented strictly as written, since it creates a new pattern of revenue distribution that would not have been contemplated when the bonds were initially structured and sold. Beginning February 1st, property taxes will be distributed just twice a year. Property tax distributions were previously as frequent as monthly and allowed pledged revenues to be set aside for debt service payments beyond a six-month horizon. Now, the semi-annual distributions are expected to be sufficient to cover debt service and other specified obligations coming due in the following six months, with any excess property taxes distributed to local government agencies. However, distribution of the excess property tax in the first semi-annual period could give rise to cash shortfalls in the second period, resulting in insufficient liquidity for debt service payments.

REQUIREMENT THAT COUNTY AUDITOR-CONTROLLERS AUDIT ALL OBLIGATIONS COULD DELAY REVENUE ALLOCATION

Another potential cash flow risk lies with the county Auditor-Controllers' new responsibilities. Auditor-Controllers are tasked with auditing all the contracts and obligations of the former redevelopment agencies. They also control the distribution of property tax revenues to holders of approved obligations, including bondholders. Auditing all contracts and obligations and verifying all payments due to various parties may take more time than contemplated by the legislation. Previously, most such non-debt-service-obligation payments were made by the redevelopment agency after payment of debt service. To the extent that an Auditor -Controller feels that audits of all contracts must be completed before any distribution can be made, there could be an interruption in cash flow and thus in debt service payments. Based upon our conversations with various Auditors, the need to delay payments until audited certainty is reached is not a commonly held position, but it remains a possibility.

FLOW OF FUNDS REQUIRED BY LEGISLATION COULD CONFLICT WITH REVENUE PLEDGES OF EXISTING INDENTURES; TRACKING OF PLEDGED REVENUES REMAINS UNCERTAIN

Additional risks remain, including those which we highlighted when we initially placed these bonds under review for possible downgrade on August 31, 2011: the segregation and tracking of revenues pledged to individual tax allocation bonds, and changes to the flow of funds that are allocated to bond debt service.

The change in the flow of funds also poses a potential near-term cash flow risk.

The legislation directs the Auditor Controllers to "allocate" funds according to a priority of payments schedule that may conflict with the revenue pledges of existing bond indentures. New administration costs for the Auditor Controllers are taken off the top of the property tax revenue stream. While potentially the new administration costs may be a modest reduction in revenues flowing to bondholders, this provision nevertheless introduces a new and unanticipated senior payment. Currently only the county's small administration fee to collect the property taxes is skimmed off the top before pledged revenues are distributed to redevelopment agencies. Additional payment priority conflicts may arise with respect to existing "pass-throughs" to other taxing entities. All pass-through payments are to be allocated prior to debt service, while in bond indentures many pass-through payments were subordinate to debt service. The legislation includes a reallocation process if the initial allocation results in insufficient funds to pay bondholders, but it is unclear whether this process will be sufficiently timely to prevent interruption in debt service payments.

The legislation also does not explicitly require segregation and tracking of revenues pledged to individual tax allocation bonds. In fact it seems to suggest the opposite - a pooling approach - which could raise potentially serious contract impairment issues. The pledge of project area-specific revenue streams is typically the fundamental security for a tax allocation bond. If left uncorrected, the absence of clarity on this issue could severely diminish the bonds' credit quality.

County Auditors, who are responsible for allocating the revenues in accordance with the legislation, are working on implementation guidelines which will address the flow of funds issues, among others. The guidelines will almost certainly call for the collection of information allowing for the continued segregation and tracking of pledged revenues. As a practical matter, the determination of pass-through payments would require such detailed revenue tracking. The way that individual county Auditors ultimately choose to implement the legislation could significantly affect credit risk. We believe that substantially more clarity will be achieved within the next two to three months, at which time would reconsider the current, continued review for downgrade.

WHAT COULD MAKE THE RATINGS GO UP

- Implementation of the legislation in a manner that clearly preserves timely debt service payment and enables compliance with bond documents

- Legislative or judicial clarification that compliance with bond documents takes precedence over other, apparently conflicting aspects of the legislation

- In the long-run, assuming resolution of the legal and practical cash flow uncertainties, a sustained resumption of property tax growth

WHAT COULD MAKE THE RATINGS GO DOWN

- Implementation of the legislation in a way that does not preserve timely debt service payment

- Continued legal uncertainty and conflict between the law's requirements and compliance with existing bond documents

- Judicial clarification that compliance with bond documents is subordinate or to be balanced against other objectives of the legislation

The principal methodology used in this rating was Moody's Analytic Approach To Rating California Tax Allocation Bonds published in December 2003. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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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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