FitchRatings

Fitch Affirms Houston, TX's IDR & LT Bond Ratings at 'AA'; Outlook to Negative

Fitch Ratings-Austin-15 November 2018: Fitch Ratings has affirmed the following City of Houston, Texas' (the city) ratings:

--$2.3 billion limited tax public improvement bonds (PIBs), certificates of obligation (COs), and pension obligation bonds (POBs) at 'AA';
--$200 million GO commercial paper series G-1 and G-2 bank notes at 'AA';
--$225 million TRANs, series 2018 at 'F1+';
--Issuer Default Rating (IDR) at 'AA'.

The Rating Outlook is revised to Negative from Stable.

(Fitch does not rate the following city outstanding PIB series: 2008A, 2009A, taxable 2009B, 2011A, taxable 2011B, 2014A and 2016A. Fitch also does not rate the city's taxable POBs, series 2008A and 2008B.)

SECURITY
Public improvement bonds, COs and pension obligation bonds are payable from an ad valorem tax limited by state constitution to $2.50 per $100 TAV. COs are also payable from a subordinate lien on certain city revenues.

TRANs are payable from ad valorem taxes, sales and use taxes, franchise charges and fees, and certain other general fund revenues (remaining after legally required deductions of amounts for payments of bonded indebtedness and other obligations of the city, or payment to any special fund or special trust fund).

ANALYTICAL CONCLUSION

The Outlook revision to Negative from Stable is due to anticipated erosion of expenditure flexibility due to a charter amendment (Proposition B) approved by voters on Nov. 6 that requires the city to increase firefighter pay to levels comparable to police pay. Assuming implementation of the amendment, this additional spending will exacerbate an already challenged budgetary profile. The city reports it is exploring the question of whether state law, which prescribes the process for establishing firefighter pay, supercedes a city charter amendment.

The 'AA' IDR reflects the city's strong revenue growth prospects and a moderate debt burden. Management has previously demonstrated an ability and willingness to adjust spending levels to counter revenue limitations and periods of revenue weakness and to maintain sound reserves. This expenditure flexibility will be tested over the near term given the combination of the new charter amendment, increased pension-related spending, and existing budgetary pressures. Houston's overall long-term economic outlook continues to be positive.

Economic Resource Base
Houston, with a population of 2.3 million, features a large, diverse economy that has inherent exposure to the energy sector. However, expansion of healthcare, port, and petrochemical industries over the past several decades has reduced the historically strong reliance on the oil and gas industry. Population and tax base growth continue as the local and regional economies expand.

KEY RATING DRIVERS

Revenue Framework: 'aa'
Houston is reliant predominantly on ad valorem property taxes. The energy sector contributes to some sales tax volatility, but overall revenue performance is generally stable. Although the ability to increase ad valorem revenues is constrained by a 2004 voter approved charter amendment, revenue-raising ability is satisfactory relative to modest expected revenue volatility. Revenue growth prospects are strong.

Expenditure Framework: 'a'
The pace of spending is expected to be marginally above revenue growth, primarily due to increasing public safety and pension-related debt service costs. The increased public safety spending may result in meaningful service reductions, and carrying costs are high.

Long-Term Liability Burden: 'aa'
Debt levels are manageable, and the combined debt and pension burden is moderate as a percentage of personal income. A $1 billion pension obligation borrowing in December 2017 shifted a portion of the overall burden from the net pension liability to the city's direct debt total, but should not affect the overall long-term liability burden assessment.

Operating Performance: 'aa'
Fitch expects currently sound reserve funding and a demonstrated ability to make budgetary adjustments will allow the city to maintain a high level of financial flexibility through a down business cycle. Recent pension reforms approved by the Texas Legislature and signed into law will require the city to close a chronic gap between annual actuarially determined and actual pension contributions; however, specific reform components also makes the pensions more sustainable.

RATING SENSITIVITIES
STRUCTURAL BUDGETARY IMBALANCE: The increased spending pressure imposed by Proposition B brings into sharper focus the structural budgetary gap that has plagued Houston in recent years. If management is unable to absorb increasing expenditures and to adjust outlays to match ongoing revenues, negative rating action is likely.

CREDIT PROFILE

Ongoing gains in taxable values illustrate the increased diversity of Houston's economy, while declines in fiscal 2016 and fiscal 2017 sales tax receipts suggest the city remains vulnerable to the shifting fortunes of the energy sector. Longer-term, continued expansion of the healthcare, shipping and petrochemical industries is expected to be the principal growth driver of the regional economy and help the city's ongoing recovery efforts from Hurricane Harvey in 2017.

Revenue Framework
Houston's revenue framework is dominated by property (50%) and sales taxes (30%). Performance through the last recession was better than many cities, as Texas' economy rebounded well from the 2008 recession.

Houston's general fund revenue growth of 3.6% annually over the past 10 years has exceeded both U.S. GDP and CPI for the same period; the gains were driven by increasing sales tax receipts and more recently climbing property tax revenues. Longer-term growth prospects are strong, given the breadth and increased diversity in the local and regional economies.

Management projects fiscal 2018 sales tax revenues to increase by more than 6% to nearly $675 million, aided by Hurricane Harvey recovery purchasing activity and reversing a two-year slide. The fiscal 2019 budget includes a more conservative sales tax revenue forecast of $657.7 million, with management reasonably assuming some pullback from the pace of post-storm purchasing activity.

A charter amendment approved by voters in 2004 (Proposition 1) limits annual property tax revenue growth to the lesser of the amount collected in the previous year plus 4.5% or the amount of property tax revenue collected in fiscal 2005 adjusted for the cumulative combined rates of inflation and population growth. A subsequent measure (Proposition H) adds up to $90 million in ad valorem tax revenues to the annual budget for public safety and related spending, such amount to be added to the following year's ad valorem tax revenue base.

Expenditure Framework
As is the case with most cities, public safety is the largest spending component in Houston's general fund; it comprised two-thirds of fiscal 2017 operating outlays. Increased spending pressures in this area, as well as pension contributions, will continue to be the city's main budgetary concerns.

Proposition B, which was approved by a 60-40 margin, requires the city to pay firefighters the same as police employees of similar rank and seniority. Firefighters currently are paid on average 25% below police, the result of recent failed contract negotiations and prior decisions to beef up fire pension benefits at the expense of larger pay increases. This measure will primarily affect the salaries of more experienced firefighting staffers; more tenured firefighters currently earn significantly less than police staff of comparable rank and seniority.

City officials report the measure will cost the city $100 million the first year (roughly 5% of general fund spending), a number that will increase in subsequent years. Given the city's limited ability to increase property tax revenues (due to the 2004 revenue cap), officials say the only option is to reduce spending. They warn of up to 1,000 layoffs (starting in the fire department), and a possible reduction in other city services. The city also instituted a hiring freeze of new firefighters following the Nov. 6 election.

Given the nature of the issuer's revenue system and shifting spending landscape, Fitch believes that growth in major spending areas on average is likely to be marginally above expected strong revenue growth.

Ongoing expenditure pressures are also reflected in high carrying costs (debt, pension and OPEB) of 26% of governmental spending for fiscal 2017. The reforms to the city's three pension plans included a requirement to fund the actuarially determined contribution amount, suggesting a chronic pension contribution gap will close. The $1 billion pension obligation bond (POB) issued in December 2017 shifts a portion of carrying costs to debt service payments; however, the $2.9 billion in future benefit and contribution changes resulting from the pension reform measure are expected to limit increases to overall carrying costs and support sustainability.

Long-Term Liability Burden
Houston's debt burden is moderate. The pace of tax-supported debt retirement has slowed with the inclusion of the POB borrowing (roughly 48% retired in 10 years, down from 65% previously). The city

also issues short-term cash flow notes annually. The debt burden is likely to remain relatively steady over the near to medium term given limited borrowing plans.

Pensions are comprised of three single employer plans, and they have been a source of funding and budget pressure due largely to benefits adjustments made around 2000. The estimated combined ratio of assets to liabilities (adjusted for a 6% investment return) was 63% in fiscal 2017, reversing a recent downward trend. The reversal was due to a combination of positive asset performance and benefit and contribution changes included in the recent reform package. The Fitch-adjusted net pension liability is $6.5 billion, roughly one-third of the total liability burden. The combined liability (direct and overlapping debt plus adjusted pension liabilities) is moderate at 15% of total personal income.

The pension reform measure that was approved by the Texas Legislature and signed into law in 2017 contains some notable changes to all three plans, including:

--reduction of plan benefits;
--reduction in the discount rate and rate of anticipated asset return to 7%;
--amortization of the net pension liability over a 30-year closed period;
--increased employee contributions;
--suspension of cost of living adjustments for current retirees for up to three years;
--a limit to future maximum city pension contribution rates.

Operating Performance
An analysis of Houston's operating resilience supports Fitch's expectation that the city will maintain sound reserves during a downturn. Recent history indicates an ability and willingness by management to adjust spending levels to counter revenue shortfalls, and this will be tested again by the required increase in firefighter pay required under Proposition B.

Fitch believes further cost cutting will be necessary over the near term given the current imbalance between ongoing revenues and expenditures, the city's limited revenue-raising ability, and increased public safety and pension-related spending. The current administration has made structural budgetary balance a stated priority, and Fitch will closely monitor progress on this front as the city adjusts to increased firefighter salaries.

Fiscal 2017 general fund results included a more than $88 million surplus and addition to reserves, (about 4% of operational spending), the result of better than expected revenue performance and ongoing spending control efforts; the unrestricted fund balance increased to $330 million or nearly 14% of spending. Projected fiscal 2018 results include a nearly 7% increase in sales tax receipts to $674 million and an additional boost to general fund reserves. The fiscal 2019 budget includes full pension funding for the second consecutive year and a more conservative sales tax revenue projection from preliminary fiscal 2018 totals. An initial $114 million general fund budget gap was closed with transfers from other funds, proceeds from a lawsuit settlement, and the use of more than $80 million in fund balance.

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U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018) (https://www.fitchratings.com/site/re/10024656)

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