STANDARD & POOR'S RATINGS SERVICES

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Summary:

Surprise, Arizona; General Obligation

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Rationale

Standard & Poor's Ratings Services revised its outlook on Surprise, Ariz. to stable from negative. At the same time, Standard & Poor's affirmed its 'A' issuer credit rating (ICR) on the city.

We base the outlook revision on Surprise's fiscal 2012 audit, which contains an unqualified auditor opinion reflecting a good available general fund balance and minimal restatements compared with the city's fiscal 2011 audit that had a qualified opinion.

The 'A' ICR reflects what we consider the city's:

- Diversifying and strong local economy, with convenient employment access to the greater Phoenix economy and strong-to-extremely strong wealth and income indicators;
- Sufficient liquidity in the general fund as well as in nongeneral fund accounts to support general fund expenditures;
- Good financial practices and policies, including a recent proactive management plan that has helped control general fund costs; and
- Low overall debt burden, with no immediate plans to issue general additional debt.

These strengths are somewhat mitigated we believe by Surprise's:

- Spend-down of general fund balances and cash in previous years to support capital needs; and
- Significant prior-year audit adjustments and qualified audit opinion in fiscal 2011, which highlighted previous erroneous accounting practices, although we expect the city's recent efforts to complete a historical review of accounting practices should result in minimal future audit adjustments.

The city released its fiscal 2012 audit, which included an auditor opinion that the financial statements present fairly, in all material respects, the financial position of the city funds. While there were additional restatements to Surprise's governmental funds and proprietary funds in fiscal 2012, these were relatively minor overall compared with prior-period adjustments made in fiscal 2011 and they did not affect the city's general fund. In fiscal 2011, the qualified audit and prior-period adjustments were related primarily to the city's previous incorrect accounting of development impact fees. We understand Surprise was able to produce an unqualified fiscal 2012 audit after it hired consultants to review more than 185,000 impact fee transactions since fiscal 2000 to address these accounting inconsistencies and properly book all liabilities related to the development fees.

After several years of general fund balance and cash declines, primarily due to transfers out to other funds and for capital, the city's available reserves had fallen to what we consider an only adequate 2.3% of expenditures in fiscal

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2011. However, Surprise posted a $3.4 million general fund operating surplus after transfers in fiscal 2012 to increase the available assigned and unassigned general fund balance to $5 million, or what we consider a good 7% of expenditures. The improved financial result was driven primarily by higher revenue related to some economic recovery as well as lower transfers out compared with the previous two fiscal years. The majority of the city's general fund revenue comes from excise taxes and state-shared sales and income taxes, which had grown since fiscal 2011.

In fiscal 2013, as part of its policy to increase its operating reserves to a minimum level equal to two months of expenditures within two years, the city made budget adjustments by eliminating some positions as well as overall departmental cuts to save about $5 million. In addition, Surprise estimates stronger sales tax and building related revenues in fiscal 2013 will contribute to a general fund operating surplus of $9.8 million and an ending available general fund balance of $14 million, or about 19% of expenditures, which we consider very strong and which exceeds the city's policy. In fiscal 2014, the city's budget projects about 4% revenue growth related primarily to continued excise tax growth. Officials report home prices and residential building permits are increasing, a new auto mall has opened in Surprise, and the scheduled completion of the Loop 303 highway expansion between the cities of Goodyear and Surprise by late 2014 could attract more retail development to drive future sales tax revenue. Management reports that it has budgeted for a $7.5 million general fund surplus for fiscal 2014, including a 2.2% salary increase for employees, which could increase the unassigned general fund balance to $22 million, or what we view as a very strong 27% of expenditures. The city has a policy to retain the first $1.25 million of annual one-time transaction privilege tax revenue from construction in the general fund and transfer any excess into the general fund capital projects fund; as a result of this policy, officials expect to contribute about $1 million to the unrestricted general capital projects fund balance in fiscal 2014.

Surprise (serving a population of about 119,000) is approximately 20 miles northwest of downtown Phoenix and is generally considered a bedroom community to the greater Phoenix area. The city had expanded rapidly early in the decade given its abundant vacant and affordable land and convenient location within an easy commute of Phoenix and other major county employment centers, although the economic downturn has significantly slowed development in the city since 2008. Surprise remains a desirable community to which retirees relocate; 20% of the population is over the age of 65 (156% of the national average). Within Surprise is the retirement community of Sun City Grand, where about 15% of city residents live. Median household effective buying income is 115% of the national level, which we consider strong. Market value per capita is also very strong, in our view, at $87,000. As of March 2013, unemployment was 8.1%, slightly above both the state's and nation's rates of 7.9% and 7.6%, respectively.

The city's management practices are considered "good" under Standard & Poor's Financial Management Assessment (FMA) methodology. An FMA of good indicates that, in our view, practices exist in most areas although not all might be formalized or regularly monitored by governance officials. We note Surprise is close to meeting its adopted minimum reserve policy that requires it to build general fund balances to at least two months of expenditures in a two year period. The city reports budget-to-actual results to council on a monthly basis and reports on investment holdings and earnings quarterly. Surprise also maintains a long-term capital plan it updates every year, although all funding sources for projects are not identified. It forecasts revenue over a five-year horizon and expenditure forecasting is done more informally over a two-to-three year horizon, although Surprise officials expect to formalize a long-term expenditure plan in the future.

Total direct and overlapping debt is low, in our view, at about $1,700 per capita and 2% of total market value. The city does not have any direct general obligation debt outstanding and its municipal property corporation (MPC) had about $32 million of series 2003 excise tax bonds outstanding at fiscal year-end 2012. Surprise also has community facilities district GO bonds and series 2007 MPC wastewater development fee and subordinate wastewater utility revenue bonds outstanding that Standard & Poor's does not rate. We consider amortization of all debt below average, with 67% of principal retired in 10 years and 72% retired in 20 years. The city is fully funding its pension and other postemployment benefit annual required contributions of $1.26 million, $963,000, and $51,000 for the police, fire, and other employee plans, respectively, at 1.7% of governmental expenditures.

Outlook

The stable outlook reflects our view of the city's fiscal 2012 audit, which contains an unqualified auditor opinion reflecting a good available general fund balance and minimal restatements compared with the fiscal 2011 qualified audit. The outlook also reflects our expectation that future significant audit restatements affecting the general fund are unlikely given the extensive review of previous accounting practices and the fiscal 2012 unqualified auditor opinion. Should Surprise release future audits on time and with unqualified auditor opinions, while continuing to increase its general fund balance to meet its reserve policy and remain in line with projections, we could raise the rating. Given the improved liquidity and balances in the general fund, we don't expect to lower the rating in the next two years.

Interfund Loans

The fiscal 2012 general fund balance still includes a $3.4 million liability related to a cash advance from the general capital fund in fiscal 2011 to cover operations. City management reports that there are no plans at this time to repay this internal loan, which could otherwise decrease general fund cash. General fund cash of $4.7 million at the end of fiscal 2012 represented about 6% of expenditures and transfers, or about 22 days of operations. While the general fund position is positive, the city's unassigned governmental fund balances reflect a significant negative $46 million, or negative 34% of the governmental expenditures due to interfund loans in the development fee funds. We understand the general capital projects fund and sewer fund primarily advanced cash to cover pay-as-you-go capital projects that Surprise expects would be reimbursed primarily by future general government development fees, although we understand the city's ability to continue to charge these impact fees are under legal dispute. Should the city become unable to impose this fee, it is possible it would have to write-off the interfund loan. Should this occur, we believe the general capital project fund balances would decline, but we don't expect there would be a significant impact on Surprise's general fund.

Related Criteria And Research

- USPF Criteria: Key General Obligation Ratio Credit Ranges – Analysis Vs. Reality, April 2, 2008
- USPF Criteria: GO Debt, Oct. 12, 2006
- USPF Criteria: Financial Management Assessment, June 27, 2006

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