Summary:

Frederick City, Maryland; General Obligation

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Rationale

Standard & Poor's Ratings Services raised its rating to 'AA+' from 'AA' on Frederick City, Md.'s general obligation (GO) bonds outstanding.

At the same time, Standard & Poor's assigned its 'AA+' rating to Frederick's series 2016A, B, and C GO bonds. The outlook is stable.

We based the upgrade on Frederick City's improved debt and liabilities position and budgetary performance.

A pledge of the city's full faith credit and resources and an agreement to levy ad valorem property taxes without limitation as to rate or amount secure these bonds. Bond proceeds will refund various prior bond issues and finance certain capital improvements. The city is taking annual savings with the refunding.

The rating reflects our assessment of the following factors for the city:

- Very strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Very strong management, with strong financial policies and practices under our Financial Management Assessment methodology;
- Adequate budgetary performance, with an operating surplus in the general fund but an operating deficit at the total governmental fund level in fiscal 2015;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2015 of 20% of operating expenditures;
- Very strong liquidity, with total government available cash at 86.6% of total governmental fund expenditures and 19.6x governmental debt service, and access to external liquidity we consider strong;
- Weak debt and contingent liability position, with debt service carrying charges at 8.8% of expenditures and net direct debt that is 126.4% of total governmental fund revenue, and a large pension and other postemployment benefit (OPEB) obligation, but rapid amortization, with 66% of debt scheduled to be retired in 10 years; and
Very strong institutional framework score.

Very strong economy
We consider Frederick City's economy very strong. The city, with an estimated population of 68,576, is located in Frederick County in the Washington-Arlington-Alexandria, D.C.-Va.-Md.-W.V. MSA, which we consider to be broad and diverse. The city has a projected per capita effective buying income of 113% of the national level and per capita market value of $102,818. Overall, the city's market value grew by 3.3% over the past year to $7.1 billion in 2015. The county unemployment rate was 5.1% in 2014.

Frederick is about 50 miles from Baltimore and Washington, D.C. Interstates 270 and 70, which serve as connectors to the regional economy, facilitate regionwide access. While the city has easy access to the vibrant regional economy, it maintains a strong and growing local economy. Fort Detrick, the city and county's leading employer with 9,100 military and civilian personnel, anchors the economy and houses the National Cancer Research Institute, a national policy and research center. Fort Detrick's presence and the institute continue to attract telecommunications- and biotechnology-related companies. Residential construction continues to increase, because building permits have increased annually since fiscal 2010.

Very strong management
We view the city's management as very strong, with strong financial policies and practices under our Financial Management Assessment methodology, indicating financial practices are strong, well embedded, and likely sustainable.

Highlights include:
- Looking back between two and three years at revenues and expenditures, while taking certain future trends into consideration, when budgeting;
- Quarterly budget-to-actual reports;
- Informal long-term financial planning;
- A rolling five-year capital improvement plan;
- A formal investment management policy;
- A formal debt management policy; and
- A formal reserve policy that requires the city's unreserved/undesignated general fund balance to be maintained at a minimum 12% of expenditures.

Adequate budgetary performance
Frederick City's budgetary performance is adequate in our opinion. The city had surplus operating results in the general fund of 1.9% of expenditures, but a deficit result across all governmental funds of 8.5% in fiscal 2015.

The two general fund drawdowns in fiscals 2013 and 2014 were planned drawdowns, as a result of the city wanting to use some fund balance toward capital projects. Officials attribute the positive financial performance to budgeting very conservatively, as well as income taxes coming in higher than expected. The fiscal 2016 budget totals $77.1 million, using $2.5 million of fund balance appropriation, which the city has done historically as part of its conservative budgeting practices. As of now, officials report that most line items are coming in on track, and that income taxes are once again coming in higher than anticipated. We currently expect the city to have a very slight use of general fund
reserves at year-end, which is why we expect budgetary performance to remain adequate. Roughly 72% of revenues come from property taxes, which we view as the most stable revenue source.

**Very strong budgetary flexibility**
Frederick City's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2015 of 20% of operating expenditures, or $14.4 million.

With a slight use of reserves expected in fiscal 2016, we do not anticipate a significant change to the city's budgetary flexibility. Also, the city's adopted reserve policy requires the city's unreserved/undesignated general fund balance to be maintained at a minimum 12% of expenditures, which is also known as the "rainy day" fund. The policy also requires that if the rainy day fund is used it must be approved by a super-majority of the board and be followed up with a plan to restore those reserves within the next two fiscal years. Therefore, we expect budgetary flexibility to remain very strong.

**Very strong liquidity**
In our opinion, Frederick City's liquidity is very strong, with total government available cash at 86.6% total governmental fund expenditures and 9.8x governmental debt service in 2015. In our view, the city has strong access to external liquidity if necessary.

The city has historically issued GO debt, which we believe gives it access to strong liquidity, if need be. We do not view any of the city's investments as aggressive, as they are mostly in the Maryland Local Government Investment Pool. The city currently does not have any direct purchase debt outstanding.

**Weak debt and contingent liability profile**
In our view, Frederick City's debt and contingent liability profile is weak. Total governmental fund debt service is 8.8% of total governmental fund expenditures, and net direct debt is 126.4% of total governmental fund revenue. Approximately 66% of the direct debt is scheduled to be repaid within 10 years, which is in our view a positive credit factor.

According to the city's capital improvement plan, the city will be issuing roughly $37.6 million of new debt for various capital projects over the next two years.

In our opinion, a credit weakness is Frederick City's large pension and OPEB obligation. Frederick City's combined required pension and actual OPEB contributions totaled 20.1% of total governmental fund expenditures in 2015. Of that amount, 12.3% represented required contributions to pension obligations, and 7.8% represented OPEB payments. The city made its full annual required pension contribution in 2015. The funded ratio of the largest pension plan is 66.4%.

Frederick provides pension and retirement benefits to city employees. Three pension plans currently exist. The city has historically contributed 100% of the actuarially determined contribution. In addition, Frederick provides OPEBs and the city has set up an OPEB trust. As of July 1, 2014, the total unfunded actuarial liability (UAAL) was $98.9 million. According to management, in trying to address ongoing contribution costs, the city has closed its OPEB trust to new employees hired July 1, 2013, and after, making defined contributions to a separate account from now on instead. As of July 1, 2014, the OPEB was 16.99% funded. The UAAL will be amortized as a level dollar amount over a
closed 27-year period beginning with the July 1, 2014, valuation, which we view as a positive credit factor regarding the city addressing its large pension and OPEB cost.

**Very strong institutional framework**
The institutional framework score for Maryland municipalities is very strong.

**Outlook**
The stable outlook reflects the very strong economy, coupled with very strong budget flexibility and liquidity. Very strong management aids the city in maintaining consistent financial operations. Therefore, we do not expect the rating to change over the outlook's two-year horizon.

**Upside scenario**
If economic indicators were to improve to levels commensurate with a higher rating, and pension contributions were to decrease--with all other factors remaining stable--we could raise the rating.

**Downside scenario**
Though unlikely, if budgetary performance were to deteriorate, causing liquidity or budgetary flexibility to deteriorate, we could lower the rating.

**Related Criteria And Research**

**Related Criteria**
- USPF Criteria: Local Government GO Ratings Methodology And Assumptions, Sept. 12, 2013
- USPF Criteria: Financial Management Assessment, June 27, 2006
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

**Related Research**
- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Institutional Framework Overview: Maryland Local Governments

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.
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