US Public Finance
Weekly Credit Outlook

APRIL 17, 2014

FEATURE ARTICLES

RESEARCH HIGHLIGHTS

RATING CHANGE HIGHLIGHTS

Access our moodys.com public finance landing page at moodys.com/UsPublicFinance

Ted Hampton
Vice President – Senior Analyst
+1.212.553.2741
ted.hampton@moodys.com

Puerto Rican Court's Rejection of Teachers Pension Reforms Is Negative for Commonwealth

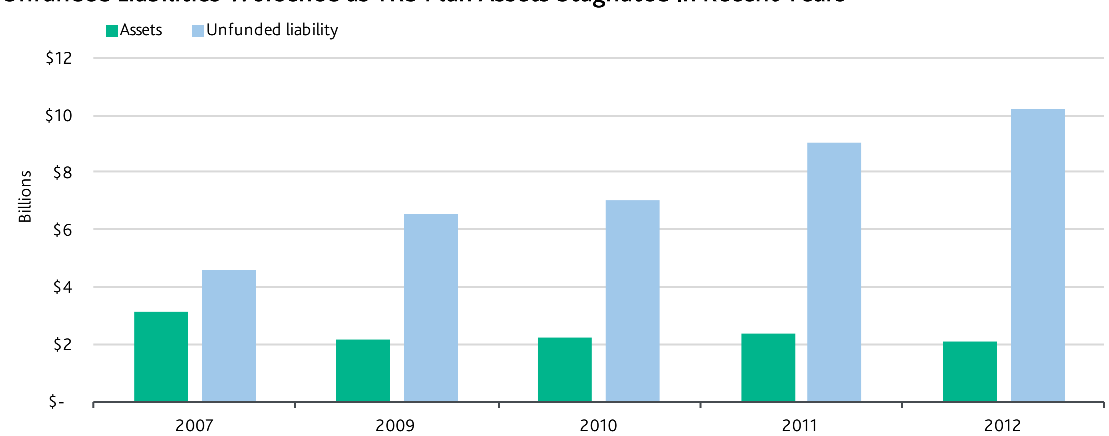
On April 11, Puerto Rico's (Ba2 negative) Supreme Court rejected reforms intended to keep the Teachers Retirement System (TRS) from running out of money. Since 2007, TRS has seen its unfunded liability more than double, exceeding $10 billion, and the plan is projected to become insolvent as soon as 2020. The court ruling is a negative development for Puerto Rico because it reverses steps to address the commonwealth's severe pension funding pressures.

Under Act 160, TRS's approximately 42,000 active members (as of June 30, 2013) would have faced increased minimum retirement age and contribution requirements, and a defined-contribution plan would have replaced the existing defined benefit system prospectively. Although the reforms would have preserved previously accrued defined benefits and provide enhancements such as higher minimum pensions, five of the court's nine members agreed that some of the law's changes would unfairly violate plan members' contractual rights. The court last year upheld similar reforms to the commonwealth's Employees Retirement System (ERS), which has a larger unfunded liability than the teachers' plan.

Act 160's goal was to maintain solvency of TRS, precluding the need for significant future pay-as-you-go contributions to fund retiree benefits. The plan's projected insolvency date has moved closer in recent years as plan assets stagnated and as unfunded liabilities soared, reaching $10.3 billion in fiscal 2012 on an as-reported basis (see Exhibit), up from $4.6 billion in fiscal 2007. TRS's reported liability equates to an Adjusted Net Pension Liability (ANPL) of $14.3 billion, up from $10.1 billion a year earlier. Our ANPL adjusts reported pension numbers by applying a market-derived discount rate, a common 20-year amortization period, and an assumed 13-year duration to value liabilities. The ANPL also uses market-value of assets rather than actuarial (or smoothed) asset values.

Meeting retiree benefit obligations after TRS's projected 2020 insolvency would require average annual appropriations estimated at $562 million, or about 5.8% of the current general fund budget. Savings attributable to Act 160 were estimated at $3.7 billion (on a present-value basis, assuming a 5.95% discount rate), primarily reflecting a lower amount of disbursements for benefit payments in the fiscal 2020-to-2050 period.

Unfunded Liabilities Worsened as TRS Plan Assets Stagnated In Recent Years



Source: Puerto Rico Official Statement

The commonwealth itself, rather than local entities, is responsible for all employer contributions to TRS and for covering any funding deficiency. Even so, the priority of payment for pension contributions ranks below both debt service and any other obligations on "legally binding contracts." The commonwealth's annual contributions to TRS – based on statutory percentage-of-payroll calculations – typically falls far short of the actuarially determined annual required contribution (ARC). For example, fiscal 2013 employer contributions to TRS were only 25% of the ARC.

The commonwealth anticipated only minimal near-term budgetary effects from Act 160. Required commonwealth contributions to TRS were scheduled to increase in fiscal year 2015 in any case, because of prior legislation. Rejection of the law therefore has no significant impact on the commonwealth's ability to balance its budget in the year starting July 1. We expect Governor Alejandro Garcia Padilla to release a budget proposal near the end of this month.

Puerto Rican officials will "analyze alternative courses of action" to prevent TRS's insolvency, according to a statement last week from the Puerto Rico Treasury Department and the Government Development Bank, Puerto Rico's fiscal agent. The statement questioned the court's ruling, arguing that Act 160 is legally "consistent" with the ERS reforms approved by the Supreme Court almost a year ago. So far, the commonwealth has not identified any alternative measures that would extend TRS's solvency while remaining consistent with the Supreme Court's decision.

Marcia Van Wagner
Vice President – Senior Analyst
+1.212.553.2952
marcia.vanwagner@moodys.com

Vito Galluccio
Analyst
+1.212.553.2738
vito.gallucio@moodys.com

Rhode Island Pension Impasse Compounds Uncertainty

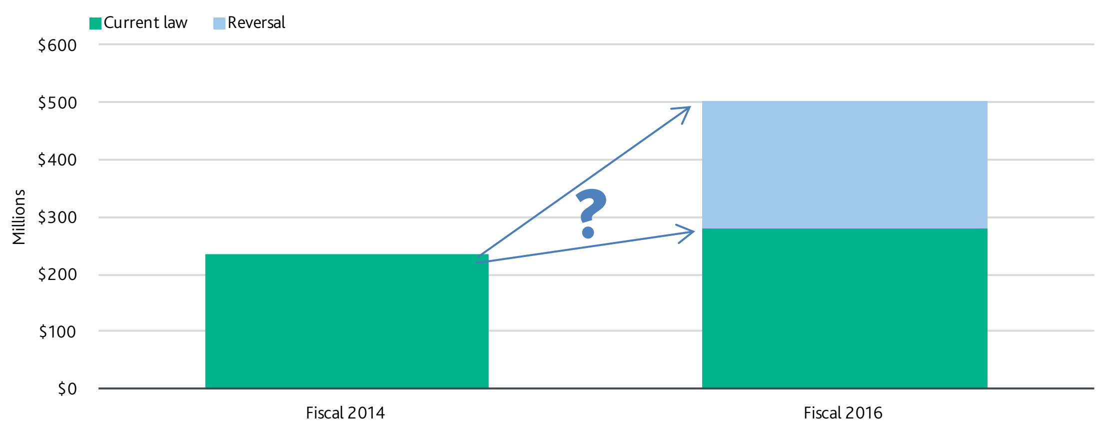
Last Friday, state officials and representatives of employee unions and retirees in Rhode Island (Aa2 negative) announced that efforts to settle litigation over the state's 2011 pension reforms failed. The lawsuit will move to court on September 15. The development is a credit negative for the state and local governments because it prolongs uncertainty over the timing and cost of resolution of this bellwether pension reform and risks an estimated $400 million in annual pension savings. The state's $222 million share of those savings amounts to 6% of its projected fiscal 2016 revenues. Local governments' $178 million portion of those savings is significant because it would reduce their projected 2016 pension annual required contribution (ARC) by 46%.

This failed settlement is the latest twist in the legal fall-out from the state's efforts to contain its retiree pension costs. A court-ordered mediation to litigation that followed the sweeping pension reforms (the Rhode Island Retirement Security Act, or RIRSA) produced a proposal earlier this year that would have scaled back some of the initial reforms but preserved most of the savings.

To adopt the proposal, eligible state and local employees and retirees were designated a "class" for purposes of a class action settlement. Rejection of this designation by any of the participating groups would scuttle the proposal and return the matter to litigation. Police union members rejected the designation in an April 3 vote, even though a majority of all votes (including non-returned ballots) were in favor of the class action designation. A subsequent effort to reach a mediated solution failed.

The range of possible financial outcomes of a litigated resolution are quite broad (see Exhibit). For example, a complete reversal of the reforms would result in state annual required contributions of $500 million for the fiscal year ending June 30, 2016, or about 14% of projected state revenues of $3.55 billion in that year, according to estimates by the actuary for the state-run Employee Retirement System of Rhode Island (ERSRI). This does not include additional amortization payments that would be created from the lower post-RIRSA contribution levels. At the other extreme, if the current post-reform structure is upheld, the state's projected fiscal 2016 required contributions (including contributions to the defined contribution plan) are $280 million, a savings of about 45%. In either case, annual costs would continue to rise after 2016. It is also possible that any changes resulting from a court decision would first take place in a later year.

Potential State Costs of Court Decision Cover Broad Range



Source: State of Rhode Island; Gabriel Roeder & Smith

The $270 million range in projected annual state costs between the most favorable legal outcomes to the most unfavorable poses a considerable risk. Rhode Island is challenged by narrow liquidity and sluggish economic growth, and faces increasing competition from Massachusetts for critical gaming revenues. An unfavorable court decision will result in extremely difficult budgetary choices and considerable credit pressure.

For local governments, $178 million in savings on pension contributions would evaporate in the worst-case scenario. This amount represents 46% savings from pre-RIRSA required contributions. Rhode Island cities that already are financially stressed by high pension costs such as Woonsocket (B3 negative) and Providence (Baa1 stable), would be further challenged to absorb additional expenses.

Genevieve Nolan
Assistant Vice President - Analyst
+1.312.706.9957
genevieve.nolan@moodys.com

James Eck
Vice President – Senior Credit Officer
+1.212.553.4438
james.eck@moodys.com

Detroit's Proposed Settlement of General Obligation Unlimited Tax Debt Is Credit Positive

On April 9, the City of Detroit (Caa3 negative) announced that it had reached a settlement with three insurers of its general obligation unlimited tax (GOULT) debt. The settlement must still be approved by the bankruptcy court, but it is significant because the city agreed to provide these creditors with 74% recovery on a claim of $388 million, essentially elevating their claim to a secured status and reversing the city's earlier proposal to treat GOULT bondholders as unsecured creditors with a 15% recovery. The agreement is credit positive for GOULT bondholders, primarily bond insurers National Public Finance Guarantee Corp. (Baa1 positive), Assured Guaranty (lead company Assured Guaranty Municipal Corp., A2 stable) and Ambac (unrated).

Notably, the settlement covers 2.7% of the city's approximately $14.3 billion of reported outstanding claims. The city faces significant negotiations with other creditors before it can exit Chapter 9, although there are signs of progress. On April 11, for example, the bankruptcy court approved Detroit's third attempt to settle the swap agreements associated with the city's outstanding certificates of participation (COPs). This will result in an $85 million payment by the city to the swap counterparties, producing a recovery of 30% based on the city's most recently reported mark-to-market swap value.

Detroit's settlement with the insurers for 74 cents on the dollar is consistent with our recovery expectations for the city's GOULT bonds as indicated by our Caa3 rating. (Our expected recovery range for Caa3-rated bonds in default is 65%-80%.) Less clear is what this settlement means for other liabilities, including holders of general obligation limited tax (GOLT) bonds, COPs and unfunded pension liabilities. The settlement reportedly requires that the unlimited tax bonds receive a greater rate of recovery than other general fund claims, including GOLT bonds and COPs. This treatment is in line with our one-notch rating distinction for GOLT and COPs liabilities, which are rated Ca and reflect a recovery range of 35%-65%. Pension claimants may benefit from the settlement because it diverts property tax revenue to an income stabilization fund for pensioners. However, the court must approve the proposed diversion of dedicated property tax revenues as part of confirming the city's overall plan.

If approved by the bankruptcy court, the better settlement would reflect bond insurers' effective negotiations with issuers and other creditors to mitigate losses. Importantly, the city reversed its earlier position and now acknowledges that the GOULT bonds are secured claims. As such, the revenues securing the GOULT bonds are "special revenue" pledges under Section 902 of the bankruptcy code, although questions as to the sufficiency of Detroit's levy remain. The financial guarantors were also able to obtain additional security on the reinstated bonds through a deeply subordinated lien on distributable state aid payments. The significant increase in recovery for the financial guarantors relative to earlier offers from the city and the recovery of claims payments made on omitted interest payments on the reinstated bonds are positive credit developments.

Whether the GOULT settlement comes to fruition is less than certain. This settlement is one small piece of a much larger overall plan of adjustment that must be approved by the bankruptcy court. Should the court decline approval, then the agreement will be moot and litigation on the issue of GOULT's secured status may resume. The settlement also paves the way for a cram down on other creditors if they do not accept the plan. Under the bankruptcy rules, only one class of impaired creditors is needed to confirm a plan. Reportedly, Detroit has also reached agreements with its two largest pension funds, which would be another important step in moving the city closer to exiting bankruptcy. Any settlement agreed upon by the boards of each pension will still be subject to a vote by the pensioners themselves.

Sarah Vennekotter
Assistant Vice President - Analyst
+1.212.553.3881
sarah.vennekotter@moodys.com

Court Ruling Is Credit Negative for Not-for-Profit Hospitals with Church Pension Plans

On March 31, a US federal district judge ruled that Saint Peter's University Hospital's (Ba1 stable) defined benefit pension plan is not a "church plan" as defined by the Employee Retirement Income Security Act (ERISA). The ruling is credit negative for Saint Peter's and could have negative consequences for other Moody's-rated hospitals and health systems with church plans. A church plan exemption allows religiously affiliated organizations to operate pensions without federal oversight, affording the organizations more flexibility in funding their pension plans. Without a church plan exemption, organizations with defined benefit pension plans are subject to federal pension funding requirements, which compel hospitals to keep their plans funded at certain minimum levels. The funding requirements are often substantial and can have the effect of reducing cash balances.

After operating its pension fund as an undesignated plan following ERISA guidelines for more than 30 years, Saint Peter's filed for a private letter ruling from the IRS in 2006 confirming that the pension plan was a church plan. The hospital received a private letter ruling from the IRS in August 2013 approving church plan status. The recent court ruling overturns the IRS's decision. As of fiscal year-end 2013, the New Jersey-based Catholic hospital's pension liability was $56 million with a 75% funded ratio (on a GAAP basis). On an ERISA basis, St. Peter's funded status at December 31, 2013 was greater than 80%, meaning it is reasonably funded and not "at risk" under IRS guidelines.

This is the second ruling in recent months where a court rejected the IRS's interpretation of a pension plan's status; in December 2013 a court ruled that Dignity Health's (A3 stable) pension plan was not a church plan. Other health systems in the midst of similar lawsuits regarding their pension plans' status include: Advocate Health Care Network (Aa2 stable), Ascension Health (Aa2 stable), Catholic Health East (part of CHE Trinity, rated Aa2 negative) and Catholic Health Initiatives (A1 negative).

Dignity Health and Saint Peter's are appealing the rulings on their respective cases. If the appellate courts ultimately determine that these plans are not church plans, affected hospitals' would be subject to ERISA funding requirements and may have to make sizeable contributions to reduce their pension liabilities, as well as possibly pay damages. However, it is also possible that, depending on the current level of funding at the time of judgment, the additional contribution may not be significant. Three of the six plans affected by current lawsuits have greater than 80% funding ratios (on a GAAP basis, based on most recent audited financial statements available), which indicates that these organizations have well-funded plans (see Exhibit 1).

EXHIBIT 1

Pension funding levels vary among issuers with church plans

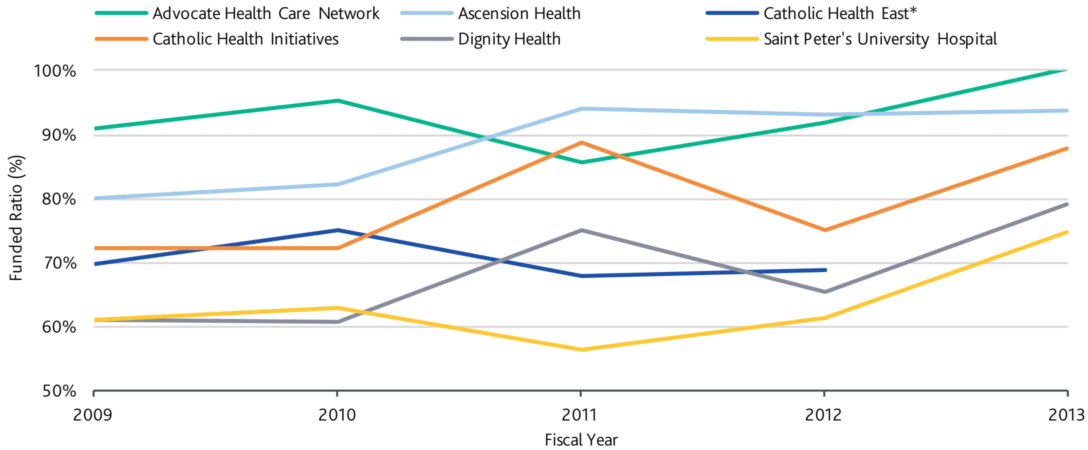
Obligor	Senior Lien Rating	Outlook	Projected Benefit Obligation ($'000)	Fair Value of Plan Assets ($'000)	Unfunded Pension Liability ($'000)	Funded Ratio (%) Per GAAP	Employer Contribution ($'000)	Most Recent Data Available
Advocate Health Care Network	Aa2	Stable	838,093	840,137	2,044	100%	31,950	31-Dec-13
Ascension Health	Aa2	Stable	7,201,780	6,742,384	(459,396)	94%	54,541	30-Jun-13
Catholic Health East	Aa2	Negative	1,335,065	917,584	(417,481)	69%	60,476	31-Dec-12
Catholic Health Initiatives	A1	Negative	3,877,485	3,404,633	(472,852)	88%	203,564	30-Jun-13
Dignity Health	A3	Stable	3,742,989	2,956,840	(786,149)	79%	325,602	30-Jun-13
Saint Peter's University Hospital	Ba1	Stable	222,843	166,876	(55,967)	75%	3,000	31-Dec-13

Source: Moody's Investors Service

More broadly speaking, the courts' rulings could open the floodgates for more legal challenges against organizations with church plans. Organizations with lower funding levels could be subject to large contributions to their pension plans should they lose the flexibility offered to them by their church plan status (see Exhibit 2). Large pension funding contributions have the potential to significantly reduce hospitals' cash reserves.

EXHIBIT 2

Pension Funding Status for Select Obligors with Church Plans 2009-2013



*FY 2013 information not available for CHE

Source: Moody's Investors Service

Peter Liberatore
Analyst
+1.415.274.1709
patrick.liberatore@moodys.com

North Las Vegas Anticipates a Balanced Budget for 2015, a Credit Positive

On April 15, the City of North Las Vegas (Ba3 negative) submitted its tentative budget for fiscal 2015 to the state for review. The budget development is credit positive because management expects that the city will adopt a balanced budget. Officials previously forecast a large $24 million budget shortfall (representing nearly 15% of budgeted operating revenues), and recent court judgments totaling $29 million added to fiscal pressures. The budget assumes that the largest judgment will be settled at significant discounts following tentative settlements with labor groups. The city's budget must be finalized by June 1 before fiscal year 2015 begins July 1.

The city's financial position is expected to remain narrow with reserves of 11% of operating revenues, or $19.7 million, on a budgetary basis for fiscal 2015. The budget anticipates a modest draw from estimated operating reserves for fiscal 2014 of approximately $21.2 million.

Politically difficult spending cuts and labor concessions were necessary to address the budget shortfall. Compensation under labor contracts drives the structural deficit. Management presented an alternative plan to close the budget gap with broad spending cuts of up to 20% if unions do not accept discounted settlements.

Management secured tentative agreements with labor groups for settlements of approximately $7.7 million last week to resolve a larger judgment estimated at $25 million. The discounted settlements are positive for the city's finances, but are subject to ratification by union members in the near term. A Nevada District Court recently ruled that the city breached labor agreements by suspending scheduled wage increases and benefits since fiscal 2013. The Nevada Supreme Court ruled that the city owes over $4 million in damages to land developers from wrongful pre-condemnation; the timing and structure of payment for this judgment is unknown and the city could still pursue further litigation appeal.

State intervention is less likely in the near term if the city adopts a balanced budget as required by state law. However, union members need to ratify discounted settlements assumed in the city's tentative budget to alleviate fiscal pressures.

Tatiana Killen
Analyst
+1.312.706.9972
tatiana.killen@moodys.com

Kansas Education Funding Increase is Credit Positive for Local School Districts

On April 6, the Kansas (Aa1 negative) legislature narrowly passed a bill to allocate an additional $129 million of school aid to address the Kansas Supreme Court's recent ruling that the state's school finance formula was unconstitutional. The measure also allows school districts to raise property taxes both by increasing the cap based on a percentage of state funding and tweaking the funding formula based on a higher per-pupil funding base. An additional temporary measure for 2015 permits 14 school districts to raise the cap on the Local Option Budget (LOB) levy for property taxes without voter approval. The credit positive measures will increase school districts' revenues, though the added revenues will not fully make up for funding cuts schools endured as the state reduced aid over the past several years.

Districts are likely to use the added revenues both from the $129 million in aid and new funding formula to reinstate recently cut programs or undertake deferred capital projects, rather than bolster district fund balances or cash positions. Districts had made cuts over the last five years to manage their budgets as the state cut the state financial aid Base State Aid Per Pupil (BSAPP) figure to $3,838 in fiscal 2014 from a peak of $4,492 in fiscal 2010 (see Exhibit).

Annual State Aid to Districts Declines From 2009 Peak
Base State Aid Per Pupil (School Years 2003- 2013)

Source: Kansas State Department of Education (KSDOE) General Fund and Supplemental General Fund, September 2013

The $129 million in added funding will be distributed across all Kansas school districts. With voter approval, the additional flexibility to increase property tax revenues raises the LOB levy cap to 33% of state funding from the current 31%.

Under state law, all districts have a cap of 30% without voter approval. With voter support, they have been able to increase the levy cap to 31%. Now, with the new legislation, the cap moves to 33% if voters are on board. Districts that already have approval for a LOB levy in excess of 30% for fiscal 2015 will be able to increase their LOB levy amount up to 33% without voter approval for one year. Districts seeking the 33% level beyond fiscal 2015 will need to hold an election in order to maintain the levy increase for fiscal 2016 and beyond.

All districts will benefit from a change in the base state funding formula on which the LOB levy limit is derived. Though the state financial aid BSAPP was $3,838 in fiscal 2014, the LOB levy limit BSAPP is actually $4,433 per pupil. The new legislation increases that formula to $4,490 per pupil for all districts. The increase in BSAPP is effective for fiscal 2015 and 2016, reverting back to $4,433 in 2017.

For the State of Kansas, the legislation calling for additional funding is credit negative because it offers another challenge as the state copes with raising revenue to compensate for an income tax cut. The mandated educational funding increase, outlined in the new legislation, equals approximately 1.9% of the state's $6.2 billion proposed fiscal 2015 budget. While the current allocated amount is minimal when compared to the state's total fiscal 2015 budget, the additional appropriation does pressure state finances that are already stressed by revenue from losses from income tax cuts.

The legislation is awaiting Governor Sam Brownback's signature. The governor has yet to say whether he will sign the measure, but an April 6 statement noted the bill "fully complies with, and indeed exceeds, the requirements of the recent Kansas Supreme Court ruling for funding schools and providing equity."

RESEARCH HIGHLIGHTS

Shift From Property Tax to Alternative Revenues Reduces Florida Local Governments' Financial Flexibility

As prospects for growing property taxes remain limited, Florida local governments will continue to look to alternative sources of revenues to help support their basic operations. Demands on these alternative revenues, which often secure debt, are therefore likely to increase. Post-recession Florida is typified by a slowly recovering economy and housing market, and therefore limited property tax revenue growth. This new environment will leave local governments dependent to a greater extent on non-property tax funds to support daily operations, reducing the previously ample availability of these revenues for payment of debt. Strong financial management will be critical for Florida local governments to maintain financial health while comfortably meeting debt service obligations.

Colorado's Legalized Marijuana Tax Revenues Exceed Expectations

Tax revenues from recreational marijuana in Colorado are exceeding pre-legalization expectations and will continue to grow. The revenues, however, will remain a small fraction of overall state and local budgets. We anticipate growth in these revenues in the near term as the Colorado market matures and as legalization lessens the appeal of black market sales, which should redistribute revenue from illegal traffickers to state coffers. But even at their higher levels, these revenues will constitute only a small percentage of the state's general fund dollars, at 1.4%. School districts will benefit most from the marijuana tax revenues to be distributed to local governments.

RATING CHANGE HIGHLIGHTS

Milwaukee, WI's GO Downgraded to Aa3; Outlook Stable

Apr. 9 – We downgraded the City of Milwaukee's general obligation rating to Aa3 from Aa2, affecting $811 million. The outlook is stable. The downgrade reflects the city's weakened socioeconomic indices, elevated unemployment rate and trend of tax base declines. Additionally, it reflects the interest rate risks and refinancing risks associated with some of the city's debt instruments. We also expect the city's use of these debt structures to increase.

University of North Texas System's Aa2 Outlook Revised to Negative

Apr. 9 – We revised the outlook to negative from stable for the Aa2 rating on the University of North Texas System's revenue bonds, affecting $468 million. The outlook change reflects the system's weakened operating performance resulting from state appropriation cuts; internal use of reserves for a large capital program; and a period of financial management transition stemming from an investigation by the state auditor's office for salary and benefit funding inconsistencies.

California HFA's Residential Mortgage Revenue Bonds, 2009 Series A-5, Upgraded to A2; Outlook Positive

Apr. 9 – We upgraded the rating to A2 from A3 on California Housing Finance Agency's Residential Mortgage Revenue Bonds, 2009 Series A-5, affecting $408 million. We also revised the outlook to positive from stable. The upgrade reflects the improved performance of single-family mortgage loans securing bond repayment, as well as cash flow projections that demonstrate an ability to repay debt under stress scenarios. The outlook change reflects a clear upward momentum in mortgage loan performance, improving California housing markets and our expectation for continued strong financial performance.

Orlando-Orange County Expressway Authority's (FL) Revenue Bonds Outlook Revised to Stable

Apr. 11 – We revised the outlook to stable from negative for the A2 rating on Orlando-Orange County Expressway Authority's outstanding revenue bonds, affecting $2.2 billion. The outlook change reflects the authority's successful implementation of its Consumer Price Index-linked toll increase without a significant negative effect on transaction volume; a dramatic improvement in debt service coverage ratios on a net revenue basis; and our expectation that traffic revenues will continue to provide strong financial margins and debt service coverage ratios and that the authority will retain adequate liquidity.

Simi Valley USD's (CA) GO Bonds Downgraded to A1; Outlook Negative

Apr. 11 – We downgraded to A1 from Aa3 Simi Valley Unified School District's GO rating, affecting $170.5 million. The outlook remains negative. The downgrade reflects the district's continued enrollment declines and narrow general fund reserves. The negative outlook reflects the expected narrowing of operating reserves in fiscal year 2014 and the district's limited ability to enact meaningful measures aimed at structural balance.

Eastern Maine Healthcare Systems' Baa1 Outlook Revised to Negative

Apr. 11 – We revised the outlook to negative from stable for the Baa1 rating on Eastern Maine Healthcare Systems, affecting $144 million. The outlook change reflects a decline in operating performance in fiscal year 2013 and a further decline in the first quarter of 2014. The outlook change also reflects risks related to implementing a number of major strategies within a short time period, including completing a large construction project and expanding the number of lives under the system's accountable care organization.

CREDIT RATINGS & ANALYSIS

Michel Madelain
President and Chief Operating Officer

Michael Rowan
Managing Director, Global Public, Project & Infrastructure Finance

Gail Sussman
Managing Director, US Public Finance

John Nelson
Director of Research, Global Public, Project, Infrastructure Finance

Christopher Holmes
Director of Research, US Public Finance

Local Government Ratings

Jack Dorer
Managing Director, US Public Finance

Naomi Richman
Managing Director, US Public Finance

State Government Ratings

Robert Kurtter
Managing Director, US Public Finance

Tim Blake
Managing Director, US Public Finance

Healthcare, Higher Education, Not-for-Profits

Kendra Smith
Managing Director, US Public Finance

Housing

Kendra Smith
Managing Director, US Public Finance

Public Infrastructure

Chee Mee Hu
Managing Director, Project Finance

EDITORIAL CONTENT

Crystal Carrafiello
Senior Vice President, Rating Communications

Robert Cox
Senior Editor, Rating Communications

MARKETING & PRODUCT STRATEGY

John Walter
Director, Senior Product Strategist

Sara Harris
Assistant Director, Product Strategist

PRODUCTION

Jason Lee
Vice President, Production

WEBSITE

www.moodys.com

CLIENT SERVICE DESKS

New York: 1.212.553.1653
San Francisco: 1.415.274.1700