

Pension and OPEB Study Commission
March 31, 2014
Minutes of the Meeting

A Study Commission meeting was held in the Senate Lounge of the State House, 82 Smith Street, Providence, Rhode Island on Monday, March 31, 2014.

Rosemary Booth Gallogly, Director of Revenue and Chairperson of the Pension and OPEB Study Commission called the meeting to order at 10:25 AM.

Commission members present: Rosemary Booth Gallogly, Jean Bouchard, Paul Doughty, Allan Fung, Dennis Hoyle, Mark Dingley representing Gina Raimondo, John Simmons and Steven St. Pierre. Richard Licht joined the meeting.

Members absent: J. Michael Lenihan, Antonio Pires, Joseph Polisena, Angel Taveras, and there is a vacancy due to the retirement of the Jamestown Town Administrator.

Others present: Susanne Greschner, Chief of the Division of Municipal Finance, Daniel Sherman, Actuary for the Pension and OPEB Study Commission and members of the public

At this point, Chairperson Booth Gallogly noted that the Commission did not have a quorum and Agenda Item #1 was postponed.

Agenda Item #2 – Rating agencies – Evaluating pension and OPEB obligations, Attachment B

Chairperson Booth Gallogly referred to Attachment B, which included excerpts from a presentation to the Rhode Island Finance Officers Association meeting conducted by Moody's. The Chair noted the importance that the rating agencies are placing on the legacy cost for pension and other post employment benefits (OPEB). Moody's report stated that Rhode Island cities continue to deal with weak revenue and economic growth and large pension liabilities. Moody's debt and pensions weightings were increased from 10% to 20%, economy/tax base 30%, finance 30%, and management 20%. Moody's report titled *US Local Government General Obligations Debt* includes the different metrics that are being used to measure net pension liability. Moody's report also indicates that the metric seeks to measure pension obligations relative to the size of the local government's budget. The analysis considers the funded status, future contributions, and overall liability in the context of the local government's long term resources. The Commission members were also provided with a handout from Standard & Poor's titled *Evaluating Pension/OPEB Obligations under Standard & Poor's U.S. Local Government GO Criteria*.

Mayor Fung, from the City of Cranston, informed the Commission that Moody's had lifted a negative watch over the City of Cranston, particularly concerning their locally-administered underfunded pension. He said that Moody's had applied their new weighted factors relating to the structure of the settlement agreed on by the city's retirees and union members when analyzing how it fits within their budget in both the short term and long term. The city's long term structural health of their pension and OPEB obligations were viewed by Moody's, and how it would be addressed in their current budget, as well as in the coming years. The Mayor pointed out that all of the plans in the city had been reviewed by Moody's.

Agenda Item #1 – Approval of Minutes from February 24, 2014

With additional Commission members present at this time, the Commission had a quorum. Chairperson Booth Gallogly asked if the Commission members had any corrections, adjustments or additions to the draft minutes provided from the Study Commission meetings held on February 24, 2014. There were none. Paul Doughty, President of the Providence Firefighters Union Local 799, made a motion to accept the minutes as written. The motion was seconded by Richard Licht, Director of the Department of Administration. The motion passed all in favor.

Agenda Item #3 – Pension & OPEB Study Commission discussion of next steps, Attachment C

Next on the agenda, the Chair said that some of the major issues have been identified to discuss by the Commission for recommendations to the General Assembly, and she referred to Attachment C. She said that the pension study commission meetings to be held on April 28th, May 19th and June 30, 2014 would allow for continued discussions on the proposed recommendations. The Commission's goal would be to act on those recommendations, and then legislation would be crafted by her staff and made available to the Commission members when they resume in the fall. She informed the Commission that the Division of Municipal Finance is working on a report similar to the State of Michigan that will include data collected on pensions and OPEB.

Mark Dingley, representing Gina Raimondo, said that if he were considering legislation to support, he would want to know how effective the Commission has been. He asked if there had been follow-up with the communities regarding the funding improvement plans (FIPs), and he would be interested to know how the communities have measured up against their plans. He believes that a reality check would provide a better barometer of what is reasonable pertaining to the municipal incentive aid. Susanne Greschner, Chief of the Division of Municipal Finance said that there had been follow-up with the communities, and that continued follow-up would be needed to determine if the plans are being followed. In some instances, she said that a new FIP would be needed when negotiations had been settled. The FIPs can be found on the website at www.municipalfinance.ri.gov. With the exception of Cumberland and Providence, all the communities had responded with an update in August 2013. The Chair said that the "effectiveness" of the Commission depends on the actual implementation of the FIPs. She indicated that a more detailed survey would be conducted to determine the progress of the communities on their FIPs. She pointed out that in some communities, negotiations are still in progress. Mr. Doughty inquired as to how many communities had completed their bullet points on the FIPs, and which communities are still in negotiations. Ms. Greschner indicated that information has to be updated based on recent developments.

The Chair indicated that confirmation of a community's annual required contribution (ARC) payment would be made when their audit is received by the State. She thought a tracking system could be put into place to determine when a community has actually funded their ARC. When the MERS contribution is not funded, the State could withhold aid. She asked if this needs to be put into place at the local level as well, and if so, how would it then be monitored. Steven St. Pierre, sergeant of the Bristol Police Department, suggested adding a mechanism for continued oversight, and also believes that there is no barometer for the success of all of the work of the Commission if it is not monitored. The Chair agreed that there needs to be ongoing oversight, and that the FIPs need to be renewed on a regular basis, and need to be compared to their original plan. Mr. Licht echoed the other commission members, and suggested that experience studies be performed on a periodic basis. To determine a community's eligibility for the municipal incentive aid, the Department of Revenue would have to see the community's budget, and then confirm that their contribution had in fact been made. The Chair

indicated that it creates a challenge when the State has not received a community's budget. She said that the municipal incentive aid legislation may have to be tweaked to ensure actual funding of the plans, as opposed to the ARC just being budgeted. She welcomed any suggestions from the Commission members relating to the municipal incentive aid legislation.

The Chair referred to question #4 - provide a mechanism for continued oversight. She said that unless the guidelines are either in statute or are formally adopted by a regulation, they may only be viewed as guidelines, and she thought that they should be more formalized. Legislation would be needed to have a formalized entity that would be responsible for monitoring the communities and formalized actions that could be taken when a community does not comply. Dennis Hoyle, State Auditor General, said that the cost of the oversight body needs to be considered and that there needs to be the right composition of people with the right skill set to perform the oversight.

Mr. Licht suggested formalizing some "best practices" as to the reporting. The Chair thought the oversight body provisions could include some penalties. Mr. Dingley said that the new GASB rules will give them a good scorecard when looking at the municipalities as it relates to their OPEB and pension liabilities. He suggested that the composition of the stakeholder group to include a health insurance expertise. Mr. Licht said that the Department of Administration would be happy to be part of the stakeholder group. He pointed out that the state's OPEB trustees are: Mr. Dingley, a budget officer, Deborah Blair of Human Resources, and Marc Leonetti, State Controller. Mr. Doughty encouraged the Commission to provide a seat for a labor representative and a city/town representative to be included in the stakeholders group. All commission members agreed that both the under 60% and over 60% funded pensions need to be monitored.

Mr. Dingley views the MERS system as a model when dealing with the OPEB liabilities, and suggested that the commission adopt a vehicle that demonstrates best practices; however it would not have to be for everybody. The Chair asked if he thought there was a possibility that there could be an OPEB plan providing choice where people could inquire what health care benefits they prefer, or possibly available to a city or town for investment purposes only. Mr. Dingley believes that it has to be a benefit structure, and best practices could be put into place for employees who have not retired yet. He does not believe that a statewide trust could administer efficiently all the different benefit structures; therefore he suggested that those be left behind. He suggested a trust that is not just for investment purposes, but that has efficient benefit structures.

As of September 1st, Mr. Licht indicated that all the state's post 65 retirees will be moved into a defined contribution plan, a substantial savings for the State. Mr. St. Pierre said he didn't know if he could buy into another state vehicle for OPEB when the commission could easily recommend legislation that the municipalities could follow. The Chair thought that if they could establish an attractive "low hassle" structure at the state level, she believes that several communities would be interested since most do not have the resources to understand the intricacies of the health care plans, and what best practices are available. However, Mr. Doughty cannot imagine any set of circumstances where labor would voluntarily agree to create a MERS type OPEB. Mr. Dingley would be concerned about the state taking control of assets when it has no ability to control liabilities. Mr. Hoyle suggested that when they look at the OPEB local plans that they look for any efficiencies that could be built in. Jean Bouchard, municipal vice president, AFSCME, Council 94, believes that the communities are doing their due diligence with regards to the collective bargaining agreements and labor to curb many areas. Her thought is that the commission should take it slow in deciding on statutes and so forth and weight it very carefully with all the feedback provided to them.

John Simmons, executive director from the Rhode Island Public Expenditure Council said there are varying levels of sophistication and knowledge within the municipalities. He pointed out that there is a difference between what the state has in its capacity of moving people and setting up benefits, and that fundamentally the cities and towns do not have that same right. There is a different standard altogether he said, and a different level of sophistication. Mr. Simmons believes that if 4-5 health care plans were made available to the communities that were rational and that had enough of a broad base associated to it, then he believes that they might join. However, he indicated with the exception if payments were required or if the plans were changed without the municipality's involvement.

The Chair referred to question 5 and explained that if a community determines that they no longer want the responsibility for investing their local plan that the investment commission could have a program where they would enter into just for investment purposes, and not to bring the whole plan into MERS under the MERS structure. Mr. Dingley explained that when benefits paid out every year far exceed the amount of contributions coming in, it is just an investment that is going to require a large cash investment. He said "cash drags down the overall investment performance." Therefore, he cautioned the commission when looking at plans from a cash flow perspective.

Daniel Sherman, Actuary for the Pension and OPEB Study Commission said that in Massachusetts several municipalities are continuing to make their benefit payments on a paygo basis, and the extra money is deposited in an investment trust or sent directly to the state. The Chair asked if the only cash that is sent over in the State of Massachusetts is the excess cash. Mr. Sherman responded yes. Both Mr. Doughty and Mr. St. Pierre would support this. Mr. Dingley said that it could be easily done, provided that the plans brought in were similarly structured.

Question 6 relates to the Fiscal Stability Act which includes certain criteria before the Department of Revenue can take over. The Chair suggested that current criteria could be expanded to include the critical status of a plan. Currently it includes items like a rating agency credit rating decline, a deficit in the audits and/or the lack of timely audits being provided to the state. It would not be based on sole criteria. Mr. Doughty's only caveat is whether there is a FIP in place and if the community had reached the criteria required.

Question #7 – require that plans comply with GASB standards for actuarial methodology, such as entry age normal, smoothing, and actuarial assumptions. Mr. Sherman said that the Commission may want to consider setting up rules for methodology for funding purposes due to GASB's departure from the typical funding approach. Mr. Sherman would strongly suggest setting up some type of standards regarding assumptions. Mr. Doughty's only concern is if compliance is used, then GASB could change their standards. Mr. Sherman said that the assumptions should be counted consistent with the experience studies and the actuary's best practices.

Question #8 – establish penalties if a municipality does not fund its locally-administered pension plan's required funding contribution. This question was discussed earlier by the commission. Mr. Dingley suggested giving the communities the incentives as opposed to accessing penalties. Mr. Simmons agreed, and he pointed out that penalties will force the municipalities to be at a disadvantage in terms of their bargaining position with its labor unions. A notice requirement was suggested by Mr. Doughty, when a community does not comply it would require that labor representatives and their elected officials would be notified. Mr. Simmons suggested that the communities report on a quarterly basis the funding of their ARC. Mr. Hoyle believes that if a permanent oversight structure was to be created it should include "some teeth" to be effective. Mr. Licht believes that penalties are in order once a community is given the appropriate transition period.

Question #9 pertains to the submission of OPEB valuations. The Chair indicated that the OPEB valuations had been received since there is a Commission in place; however they were not in the past. Mr. Licht said that if an oversight commission is created, then the communities would then be required to submit them. Also, he believes that experience studies should be required.

Question #10 – establish a state-wide OPEB trust. The Chair said that the Commission could work on that concept.

Question #11 – required a FIP similar to the FIP for pensions. This is for future discussion by the commission members. Mr. St. Pierre pointed out the fact that all the additional reporting requires a tremendous amount of work from the communities.

Going back to Question #2, relating to an amendment to the legislation. The Chair said that at the state level, legislation cannot be passed which impacts pension liabilities unless there has been an actuarial study performed, and that isn't necessarily required at the local level. She pointed out that it might help to raise the awareness what the collective bargaining changes might mean. Mr. Doughty thought that this could be clearly enacted at the local level, if the local government wants it, and wouldn't require state legislation.

Questions #3 – relates to the municipal incentive aid. The Chair mentioned that there may be clarification needed relating to the timeline in meeting the guidelines and if there are legal challenges. In addition, what are the consequences if it is in the enacted budget, and the community does not make the payment? Another challenge would be if a community's pension plan was 100% funded and had to make their ARC in order to be eligible for the incentive aid. The Chair said these were some of the challenges with the currently drafted Article 2 in the budget and they are working to resolve them.

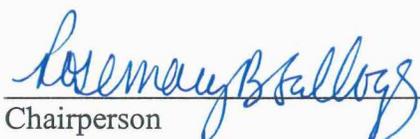
Mr. Hoyle commented that if a permanent oversight body were put into place, they may want to consider monitoring investment performance similar to the State of Massachusetts. He said that Massachusetts monitors their local plans, and if the plans significantly underperform, then it invokes some additional state oversight that require them to move their assets into the state plan. He thinks it is worth considering; however the Chair pointed out that it would be very crucial to have the State of Massachusetts' calculation requirements. The Chair welcomes any suggested recommendations from the commission members.

Agenda Item #4 – Public comments

A public comment was received from Michael Riley.

Agenda Item #5 - Adjourn

Richard Licht made a motion to adjourn which was seconded by Mr. Doughty. The meeting adjourned at 12:00 PM.


Chairperson

April 28, 2014
Date

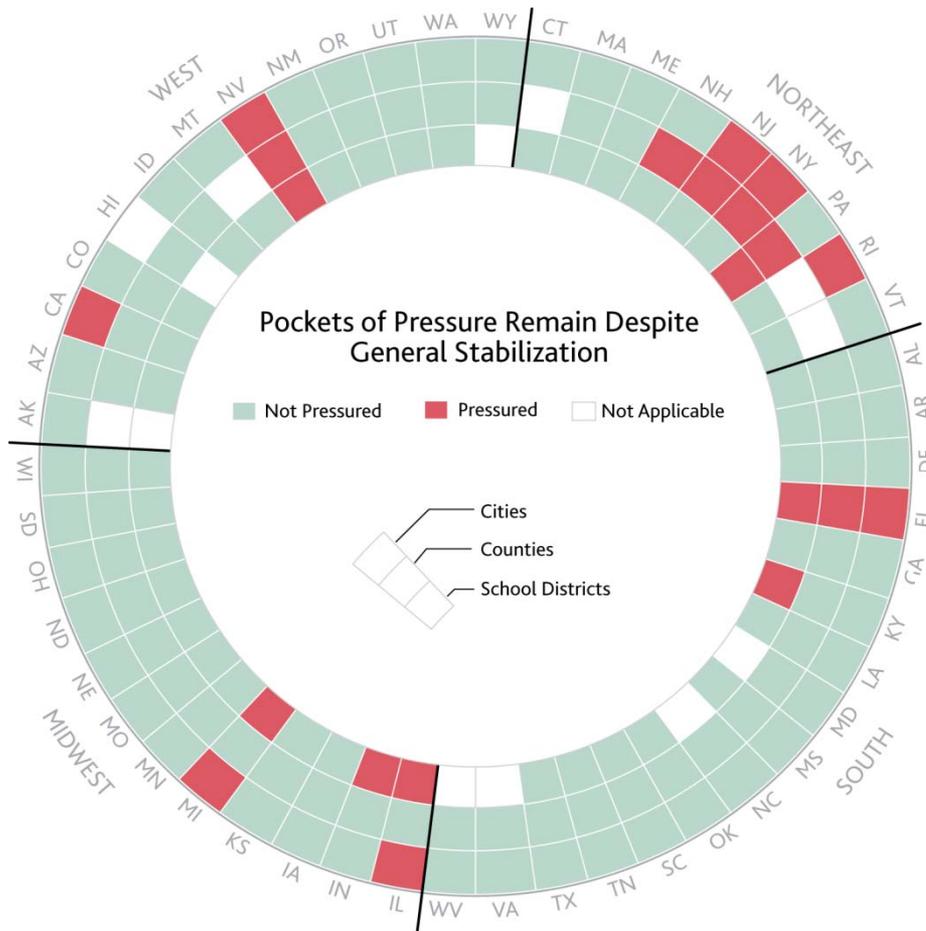
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Addendum to the
March 31, 2014
OPEB and Pension Study
Commission
Meeting Minutes



Excerpts from presentation to Rhode Island GFOA
Local Government Credit Update

Pockets of Pressure Remain



Source: Moody's Investors Service

Stressed Sectors

New Hampshire	Subsidies for nursing homes will pressure financial performance of counties.
New Jersey	Along with a lagging economic recovery, declining fund balances and limited revenue increase will weigh on cities and counties.
New York	Both cities and counties are facing rising pension and healthcare costs.
Pennsylvania	While coping with declining state aid, many issuers are also coping with strained tax bases and rising costs.
Rhode Island	Cities continue to deal with weak revenue and economic growth and large pension liabilities.
Florida	Still recovering from the downturn, tax levels are still suppressed and many issuers still need to achieve structural balance.
Kentucky	Schools are strained by lease issues.
Illinois	Pension pressures weigh on cities, while delayed state aid is worrisome for school districts.
Indiana	State aid is being held flat and raising property taxes has become more difficult.
Michigan	Cities are coping with shrinking tax base and revenues. Schools face lower enrollment and lower state aid.
California	Significant revenue raising constraints and pension liabilities are above average due to generous benefits.
Nevada	Not yet recovered from the downturn, tax levels have not rebounded and budgets are still cut.

New GO Scorecard

Change in Weightings:

Factor 1 Economy/Tax Base	Factor 2 Finances	Factor 3 Management	Factor 4 Debt/Pensions
30%	30%	20%	20%
Was 40%	Unchanged	Unchanged	Was 10%

- Factor 1 weighting lowered to reduce the influence of tax base size
- Factor 4 weighting increased to include a specific quantitative measure for pensions

New GO Scorecard - Factors, Subfactors and Weights

Factors & Sub-Factors	Weights
Factor 1: Economy/Tax Base	30%
Full Value (market value of taxable property)	10%
Full Value per Capita	10%
Median Family Income	10%
Factor 2: Finances	30%
Fund Balance as % of Operating Revenue	10%
5-Year Dollar Change in Fund Balance as % of Revenues	5%
Cash Balance as % of Revenues	10%
5-Year Dollar Change in Cash Balance as % of Revenues	5%
Factor 3: Management	20%
Institutional Framework	10%
Operating History: 5-Year Average of Operating Revenues / Operating Expenditures	10%
Factor 4: Debt/Pensions	20%
Net Direct Debt / Full Value	5%
Net Direct Debt / Operating Revenue	5%
3-Year Average of Moody's Adjusted Net Pension Liability / Full Value	5%
3-Year Average of Moody's Adjusted Net Pension Liability / Operating Revenues	5%

Controlling Costs Associated with Healthcare and OPEB

- Municipal employee and retiree healthcare costs account for 6% to 14% of total operating budgets
- Increasing faster than the rate of inflation because of an aging workforce, increasing life expectancy, and growth in per capita use of healthcare services.
- Rhode Island municipalities have sought several strategies to control these expenditures:
 - Reducing Benefits and Raising Employee Co-Pays
 - Transferring Eligible Retirees onto Medicare
 - Joining Municipal Consortiums
 - Funding OPEB Trusts
 - Researching ACA Healthcare Exchanges

Ongoing Monitoring of Pressured Credits

Our Focus Going Forward

- Consecutive deficits in operating funds
- Accumulated deficit positions in the General or School Funds
- Full payment of local pension ARCs
- Adequate liquidity net of TANs or state aid advances
- Effectiveness of appointed overseers and budget commissions

SPECIAL COMMENT

Rate this Research



Rhode Island Municipalities Look to ACA Exchanges and Other Strategies to Reduce Growing Healthcare Expenses

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Introduction

Rhode Island local governments' employee and retiree healthcare costs, which account for 6% to 14% of their operating expenses, are increasing faster than the rate of inflation because of the state's aging workforce, increasing life expectancy of retirees, and growth in per capita use of healthcare services. To combat these high costs, the state of Rhode Island (rated Aa2/negative) is seeking to harness the new Affordable Care Act (ACA) healthcare benefit exchange to reduce local governments' retiree healthcare costs. This effort is one of several strategies that local governments have been pursuing to control healthcare expenditures:

- » **Shifting Retirees to ACA Healthcare Exchanges:** Retirees under the age of 65 meeting certain income thresholds are eligible to transition their healthcare from the municipality to the Federal Government's budget.
- » **Reducing Benefits and Raising Employee Co-Pays:** Some of Rhode Island's financially-stressed communities have eliminated budget deficits by reducing the cost of health care for active employees and retirees, often facing challenges from bargaining units and retirees.
- » **Transferring Eligible Retirees onto Medicare:** The state enacted legislation as part of its 2012 budget process that gave municipalities the power to transfer their retirees to Medicare as soon as they are eligible.
- » **Joining Municipal Consortiums:** The goal of these arrangements is to increase negotiating power and limit premium growth.
- » **Funding OPEB Trusts:** Since most OPEB plans are currently underfunded, many municipalities are planning to create trust funds that will accumulate interest and investment income to offset future healthcare expenses

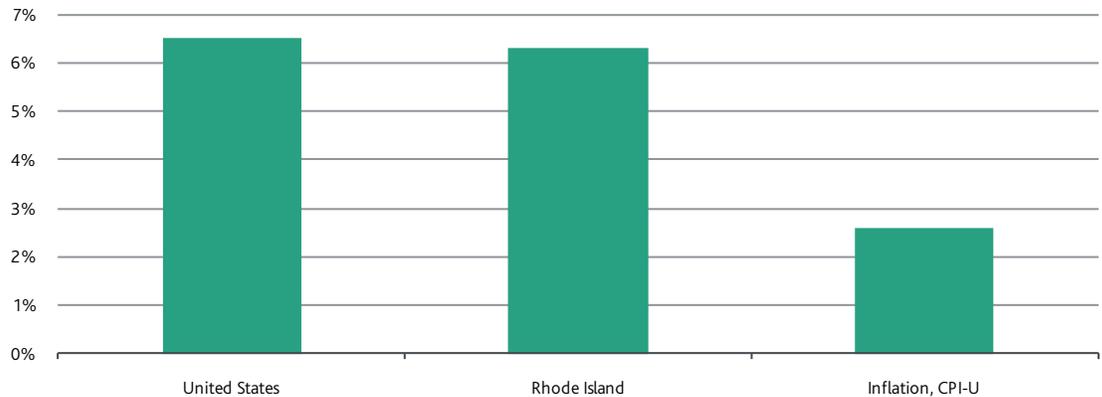
Several stressed local governments in the state, including Central Falls (rated B1/positive), Providence (rated Baa1/stable), and Woonsocket (rated B3/negative), have employed these strategies to manage and control their healthcare costs.

Rapid Growth in Healthcare Costs for Rhode Island Municipalities

According to data from the Kaiser Foundation, health insurance costs in Rhode Island increased by an average of 6.3% annually from 1991 through 2009 while general inflation averaged 2.6% annually over the same period. This trend is consistent with the national healthcare expenditure growth trend which was 6.5% over the same time period (Exhibit 1).

EXHIBIT 1

Cost of Healthcare Insurance Outpacing Inflation, Average Annual Growth Rate, 1991-2009



Source: Henry J. Kaiser Family Foundation, Bureau of Labor Statistics CPI-U

High healthcare costs have strained Rhode Island local governments' budgets and increased their other post-retirement healthcare benefit (OPEB) liabilities. These liabilities represent the projected long-term cost to the municipality of meeting the contractual obligations to provide these benefits. The total unfunded OPEB liability for Rhode Island municipalities was \$3.5 billion according to a 2011 report published by the Rhode Island Auditor General. This represents a \$4,752 liability for each of the state's 1.05 million residents and is sizable relative to the estimated \$4.9 billion reported unfunded liability for Rhode Island's local government pension plans. The relative size of pension liabilities is deflated, however, by the use of higher discount rates used for reported pension liability calculations than the rates used in OPEB calculations when a community utilizes pay-go funding.

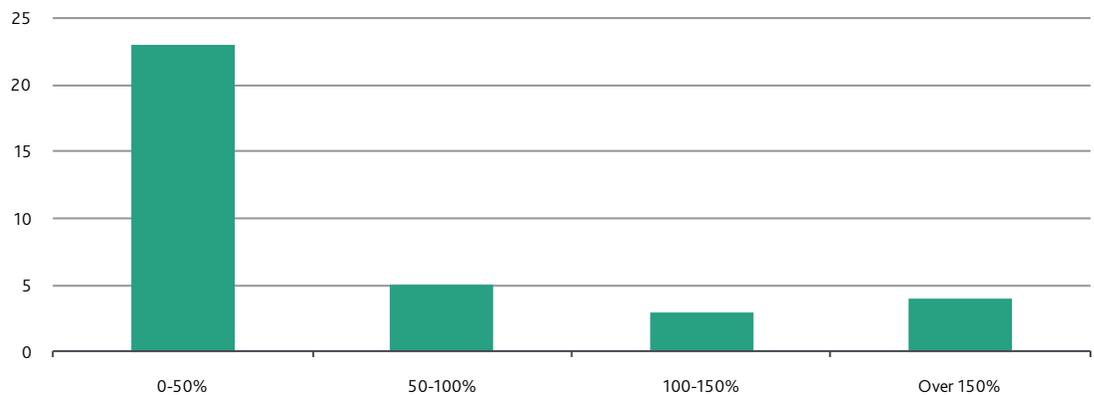
Local governments are responsible for the administration of retiree healthcare benefits and funding of their own liability, including determining plan provisions, obtaining actuarial valuations, making required contributions, investing assets, and paying benefits to their retirees. Teachers, however, may opt to purchase retiree healthcare coverage through the state-administered plan, although the state assumes no funding obligation for premiums or benefits.

The magnitude of the liability varies across municipalities but most Rhode Island local governments have manageable OPEB liabilities (Exhibit 2). Several Rhode Island local governments, such as Hopkinton (Aa3), and Richmond (Aa3), do not offer retiree benefits and have no unfunded liability, but they are exceptions. Other local governments, such as Woonsocket, Johnston (A3/stable), Pawtucket (Baa2/negative) and Providence, have significant liabilities. (See appendix for full list)

EXHIBIT 2

Most Rated RI Cities Have Manageable OPEB Liabilities

Number of Local Governments Categorized by OPEB Liability as a Percent of Revenues



Source: audited financial statements and OPEB valuation reports

Strategy #1: Shifting Retirees to ACA Healthcare Exchanges

Currently, most local governments in Rhode Island provide health insurance benefits to retirees. Although no local government has publicly stated its intention to shift qualified retirees to individual plans purchased on the new ACA exchange, the state is exploring ways municipalities could potentially participate in the future. The exchange opened in October 2013 and offers plans that take effect in January of 2014. Only qualifying retirees that are ineligible to receive Medicare could purchase insurance from the exchange. These include retirees under the age of 65 with incomes at or below 400% of the federal poverty level. Retirees who use the exchange would receive a federal subsidy based on their income level to help pay the insurance premiums. Additionally, local governments might cover some of the premium costs given that the strategy may be politically difficult, likely requiring significant negotiations with public employee bargaining groups. There is not adequate detail currently on how much savings use of the exchange could generate, although as of June 2013 roughly 30% of Rhode Island's local government retirees participating in the ERS and MERS pension were under the age of 65.

Rhode Island is not the only government seeking to use healthcare exchanges to reduce costs. Chicago (rated A3/negative) plans to move eligible retirees to the exchanges to help alleviate its severe budgetary challenges, and the emergency manager of Detroit (rated Caa3/rating under review for downgrade) has proposed moving retirees to the exchanges as part of its bankruptcy plan.

Affordable Care Act Is Credit Negative for Hospitals

Local governments may benefit from lower healthcare costs by shifting employees to ACA health insurance exchange plans, but there are several exchange-related risks that create modest negative credit implications for hospitals. These risks include the anticipated lower reimbursement rates from exchange plans and the expected growth in bad debt with higher out-of-pocket costs associated with exchange plans.

A shift from the current employer-provided plans, which have high reimbursement rates, to the expected lower-reimbursing exchange plans will place pressure on hospitals' revenue growth. Hospitals are reporting that insurers offering exchange plans are negotiating reimbursement rates that range from Medicaid rates, usually the lowest reimbursement rate and the exclusion of costs of care, to a discount based off commercial rates, usually the highest reimbursement rate among all payers. Beyond 2014, as the number of exchange plan enrollees expands, we expect negotiations to become more aggressive and commercial rates and exchange rates to blend. Ultimately this blending will reduce revenues from current levels and pressure profitability for hospitals.

Additionally, bad debt growth increasingly pressures hospitals' revenue, especially in Rhode Island where bad debt for the largest health system grew over 20% from fiscal year 2009 to 2012. We expect exchange plans to exacerbate this growth. Nationally, providers report that co-pays, co-insurance and high deductibles (also known as out-of-pocket costs) are a fast growing part of bad debt. Exchange plans as well as other commercial plans require out-of-pocket costs and likely lower premium exchange plans will have higher out-of-pocket costs. Enrollees in exchange plans may be more judicious with their healthcare choices and become price-sensitive consumers. The lack of understanding about premiums and out-of-pocket costs may result in higher bad debts.

Strategy #2: Reducing Healthcare Benefits and Raising Employee Co-Pays

Under Rhode Island law, health insurance is a protected benefit, requiring union negotiations to make cuts, with exceptions for local governments under receivership. However, some Rhode Island local governments have been able to successfully reduce benefits to reduce costs related to both active and retired workers. Strategies that local governments have employed to reduce benefits include limiting employee coverage to specific networks, eliminating duplicate coverage, or not providing insurance for certain healthcare services. The City of Providence now requires OPEB beneficiaries who are retired, but employed by another entity, to use healthcare coverage provided by that employer.

Local governments can also lower costs by shifting more costs onto employees. This includes raising employee's portion of insurance premiums, the total annual costs required to hold the policy. It also includes raising employee deductibles and co-pays, which is the amount of the employee's health expense not covered by insurance. Notably, Central Falls and Woonsocket have both employed these strategies.

Some municipalities have implemented employee wellness programs where early screenings and preventative measures are implemented as a holistic approach to lowering healthcare costs. Blue Cross Blue Shield of Rhode Island, for example, offers a program to government employees called Wellness Works, which for a nominal increase in premium includes annual screenings, weight management programs and incentives to maintain gym memberships or to quit smoking. These programs aim to generate savings over the long-term by encouraging employees to remain healthy.

There has been strong resistance from employee bargaining and retiree groups to restructuring healthcare benefits. For example, some local governments have attempted to lower premiums by negotiating with competitor healthcare insurers and soliciting cost proposals from multiple insurers

through a competitive bidding process. However, pressures from unions or politicians to use particular insurers may make switching providers difficult.

City of Central Falls (rated B1/positive)

Central Falls has a small tax base and weak socioeconomic indicators that include the highest poverty rates in the state and a high debt burden. Financial pressures stemming from the loss of a large tax payer and rapidly increasing pension costs resulted in a federal bankruptcy filing in August of 2011. The city emerged from bankruptcy in fiscal 2013 with significantly reduced expenditures related to employee salaries, pensions and healthcare as well as a recent trend of surplus operations through fiscal 2013.

In August 2011, the city's state appointed receiver unilaterally reduced active and retiree healthcare benefits several weeks before the city filed for federal bankruptcy protection under Chapter 9. Changes included the conversion of the city's eight health insurance plans into one standardized plan, a significant increase in the deductible, a 20% co-pay for premiums, and the transfer of eligible retirees to Medicare. The city also eliminated healthcare for part-time employees. As a result, the city's annual health insurance premium was reduced by \$1.3 million, or 49%, to \$1.3 million, which accounted for 9% of budget in 2012. The city also reduced its unfunded OPEB liability by 55%, to \$14.1 million at June 30 2012 from \$32 million in June 30 2011.

City of Woonsocket (rated B3/negative)

Woonsocket has struggled with weak market access and a high debt burden, largely due to \$90 million pension obligation bonds issued in 2002 and \$11 million deficit funding bonds issued in 2011. Pension liabilities are sizable and a large accumulated deficit caused by overspending in the school fund has resulted in severe cash shortages throughout the year.

Woonsocket had the second highest unfunded OPEB liability in the state at \$203 million as of June 30 2011. The liability is expected to be lower in 2014 as a result of recent healthcare reductions. Approximately 72% of this liability is for city employees and the remainder covers school employees.

The city reduced healthcare benefits in order to close a \$6.4 million General Fund budget gap in fiscal 2013. These reductions were part of a five-year deficit reduction plan, developed in conjunction with a state-appointed budget commission, and included cost savings associated with pension COLA freezes. The majority of savings resulted from the institution of a Unified Health Care Plan which required a 20% co-pay and higher deductibles for active and retired city and school employees, saving \$3.5 million per year starting in fiscal 2014. The plan also included the transition of 81 eligible retirees, mostly police and their beneficiaries, to Medicare parts A and B. As of July 2012, 51% of the 430 Woonsocket retirees and spouses were over the age of 65. The transition to Medicare is projected to yield an additional \$800,000 of annual savings.

Negotiations with bargaining groups and retirees slowed the original implementation of the cost reductions in fiscal 2013. Implementation was ultimately accomplished through the budget commission and made effective July 1, 2013 when the police union contract expired. Although negotiations between the budget commission and Woonsocket's seven bargaining groups were more onerous than the negotiations Central Falls faced, only 48 out of 800 total retirees and beneficiaries challenged the Woonsocket's health and pension cuts. A union representing active police officers also filed suit. These pending legal challenges could threaten this significant component of the five-year deficit reduction plan.

Strategy #3: Transferring Retirees to Medicare

Public sector employees hired after 1986 are eligible to receive Medicare benefits once they turn 65 or meet other requirements. Even so, most eligible Rhode Island retirees do not utilize Medicare given that their existing plans have better coverage and local governments are often constrained by collective bargaining agreements from transferring employees to Medicare. However, Rhode Island enacted legislation in 2012 authorizing municipalities to transfer retirees to Medicare when they turn 65, superseding existing collective bargaining agreements. The legislation provides a powerful tool for curtailing benefit costs because a large portion of state and local retirees are over 65. For example, as of a 2012 valuation, the average age of retirees participating in the state-administered MERS pension plan was 71.3 year old. When Providence attempted to transition retirees to Medicare in fiscal 2012, the city's police and fire retirees filed suit, alleging that the state legislation authorizing the action taken by the city was unconstitutional. A superior court judge originally blocked the transition and ordered the city and retirees to return to mediation. The retirees ultimately dropped the lawsuit under a combined settlement agreement that included, in addition to pension changes, the successful transfer of retirees to Medicare in fiscal 2013.

So far, only a few municipalities, including Providence, Central Falls and Woonsocket, have transferred retirees to Medicare. Some local governments make Medicare more appealing to retirees by offering supplements that expand coverage. As such, the Medicare premiums that municipalities are paying vary depending on the terms that each city has negotiated with its retirees.

City of Providence (rated Baa1/stable)

In February 2012, a Rhode Island Superior Court judge denied Providence the authority to transfer eligible city retirees to Medicare, a strategy intended to help close a \$30 million budget gap. Further negotiations with retirees eventually resulted in the successful transfer of retirees to Medicare in April 2013, with the city agreeing to cover C and D supplements for retirees.

The city did not make changes to healthcare benefits for retirees under the age of 65. However, the city did require spouses of active employees to utilize insurance coverage from their primary employers. The combined healthcare reductions helped the city to close its 2013 structural budget gap, lowering annual fixed expenditures by \$4 million a year to \$32 million, or 7.3% of expenditures in 2013. Providence's unfunded OPEB liability declined by 27%, to \$1.1 billion.

Strategy #4: Municipal Insurance Consortiums

Rhode Island local governments have the authority to join consortiums to purchase or self-fund health insurance using an intergovernmental risk pooling structure. These consortiums strengthen purchasing power, diversify risks and drive down premiums. Consortiums also lower costs by pooling expertise and administrative resources.

There are currently three municipal insurance consortiums in the state, the largest being the Rhode Island Interlocal Risk Management Trust, "The Trust", which consists of 45 public entities. The second largest is WB Community Health which consists of 22 entities and the third is Rhode Island Municipal Insurance Corporation which has 10. There is some evidence that these consortiums have been successful at limiting premium growth. Premiums paid by The Trust increased by 4.4% in 2013, comparing favorably to the 6% growth reflected in the Milliman national healthcare cost index during 2013, and The Trust experienced only a 2.1% overall increase in fiscal 2014. In addition to achieving a lower premium increase than the national average, The Trust also distributed a \$5.8 million

dividend to its participating local governments in fiscal 2014, a common practice for consortiums when accumulated surpluses exceed predetermined thresholds.

Consortiums may lower healthcare insurance costs for the consortium as a whole, but the expenditure growth for individual participating municipalities may vary depending on their healthcare claims experience. For example, of the 4.4% overall premium increase for the Rhode Island Interlocal Risk Management Trust in 2013, the annual premium increased by 12.7% for one local government and decreased by 2% for another, with the remaining participants experiencing cost growth within that range.

Strategy #5: Funding OPEB Trusts

Retiree healthcare costs are generally funded annually on a pay-go basis, resulting in significant OPEB liabilities for most local governments. The accumulation of financial assets in OPEB trusts allows municipalities to offset future funding growth over time. In this way, trusts can save costs over the medium to long term and smooth year-to-year expenditure spikes. However, funding an OPEB trust increases annual expenditures, which can be challenging given Rhode Island municipalities' generally constrained operating budgets.

Many Rhode Island local governments are pursuing this strategy to manage growing OPEB liabilities. According to a recent state survey, over half of Rhode Island's municipalities either have established, or are planning to establish, OPEB trusts. Although 15 municipalities have set up OPEB trusts, many of them remain unfunded. Of the estimated \$3.5 billion of statewide local government OPEB liabilities, only \$27.5 million of actuarial value of assets was estimated to have been collectively held by these plans, representing a less than 1% overall funding ratio. However, a few have been funded to a significant level. The Town of Bristol (GO rated Aa2) created an OPEB trust in 2006 and as of June 30, 2013 reported \$3.4 million of assets to help offset a \$13.8 million actuarially accrued liability. Similarly, the Town of Westerly (GO rated Aa2) has also funded an OPEB trust fund to the amount of \$3.5 million as of July 2012, which offsets \$14.4 million of actuarial accrued liabilities for town employees. The extent to which Rhode Island municipalities will fund the newly established trusts remains unclear.

Rate this Research



Addendum

	Rating	Outlook	OPEB Valuation Date	OPEB Funding Method	Assets (\$000)	Unfunded Liability (\$000)	Total Operating Revenue (\$000)	Total Full Value (\$000)	Unfunded Liability as % of Operating Revenue	Unfunded Liability as % of Full Value
Richmond Town, RI	Aa3	NOO		No OPEB	0	0	22,018	978,026	0.0%	0.0%
Hopkinton Town, RI	Aa3	NOO		No OPEB	0	0	24,270	1,096,393	0.0%	0.0%
Burrillville Town, RI	Aa2	NOO	01/07/2010	Pay-Go	0	2,191	44,465	1,337,402	4.9%	0.2%
Glocester Town, RI	NR		01/07/2011	Pay-Go	0	2,315	25,923	1,109,017	8.9%	0.2%
Scituate Town, RI	Aa2	Negative	01/04/2012	Pay-Go	0	3,977	29,942	1,860,413	13.3%	0.2%
Coventry Town, RI	A1	Negative	01/07/2011	Pay-Go	0	12,523	89,658	4,101,115	14.0%	0.3%
Westerly Town, RI	Aa2	NOO	01/07/2012	Pay-Go	3,474	10,909	77,660	6,145,010	14.0%	0.2%
Charlestown Town, RI	Aa2	NOO	01/07/2012	Pay-Go	1,794	3,567	24,020	2,718,712	14.9%	0.1%
Warren Town, RI	Aa3	NOO	30/06/2009	Pay-Go	740	3,592	23,162	1,287,314	15.5%	0.3%
N. Smithfield Town, RI	Aa2	NOO	01/07/2011	Pay-Go	0	6,292	34,331	1,574,572	18.3%	0.4%
S. Kingstown Town, RI	Aa1	NOO	01/07/2011	Pay-Go	1,650	17,610	83,012	4,546,821	21.2%	0.4%
Little Compton Town, RI	Aa2	NOO	01/07/2010	Pay-Go	0	2,630	11,915	2,003,780	22.1%	0.1%
Central Falls City, RI	B1	Positive	31/12/2011	Pay-Go	0	14,113	60,555	439,019	23.3%	3.2%
Bristol Town, RI	Aa2	NOO	01/07/2012	Funded	3,428	13,284	39,190	3,264,576	33.9%	0.4%
Jamestown Town, RI	Aa2	NOO	01/07/2011	Pay-Go	0	9,979	31,933	2,138,498	31.2%	0.5%
East Greenwich Town, RI	Aa1	NOO	01/07/2010	Pay-Go	0	15,656	49,305	2,612,045	31.8%	0.6%
Lincoln Town, RI	Aa2	NOO	30/06/2011	Pay-Go	280	15,498	74,932	2,864,633	20.7%	0.5%
Portsmouth Town, RI	Aa2	NOO	6/30/2013 6/30/2012	Funded (Town) Pay-Go (School)	203	19,532	55,052	3,829,726	35.5%	0.5%
Barrington Town, RI	Aa1	NOO	30/06/2011	Pay-Go	3,743	25,492	61,270	3,175,576	41.6%	0.8%
Cranston City, RI	A2	Negative	7/1/2012 7/1/2011	Funded (Pub Safety) Pay-Go (School)	255	89,386	240,627	7,841,653	37.1%	1.1%
N. Kingstown Town, RI	Aa2	NOO	01/07/2010	Pay-Go	0	34,511	89,967	4,817,882	38.4%	0.7%
Middletown Town, RI	Aa1	NOO	30/06/2012	Funded	3,338	26,125	60,693	2,764,583	43.0%	0.9%
Cumberland Town, RI	A1	Stable	01/07/2011	Pay-Go	0	39,364	80,318	4,005,116	49.0%	1.0%
Tiverton, RI	NR		01/07/2011	Pay-Go	0	24,272	45,083	2,245,484	53.8%	1.1%
Smithfield Town, RI	Aa2	NOO	01/07/2011	Pay-Go	0	35,142	57,876	3,114,752	60.7%	1.1%
N. Providence Town, RI	Baa1	Pos	01/07/2012	Pay-Go	0	66,227	84,839	3,005,983	78.1%	2.2%
East Providence City, RI	Ba1	Stable	31/10/2011	Pay-Go	0	104,550	130,441	4,536,169	80.2%	2.3%
Warwick City, RI	Aa3	Negative	01/07/2011	Pay-Go	0	261,426	270,387	9,846,428	96.7%	2.7%
Narragansett Town, RI	Aa2	NOO	01/07/2011	Pay-Go	0	64,319	54,491	4,954,199	118.0%	1.3%
West Warwick Town, RI	Baa2	Negative	01/07/2012	Pay-Go	0	107,330	81,106	2,236,995	132.3%	4.8%
Newport City, RI	NR		01/07/2012	Pay-Go	23,113	96,229	91,804	5,117,478	104.8%	1.9%
Woonsocket City, RI	B3	Negative	01/07/2011	Pay-Go	0	210,945	128,508	1,769,992	164.1%	11.9%
Pawtucket City, RI	Baa2	Negative	01/07/2011	Pay-Go	0	311,500	174,832	4,130,567	178.2%	7.5%
Providence City, RI	Baa1	Stable	01/07/2011	Pay-Go	1,238	1,149,115	595,431	10,232,000	193.0%	11.2%
Johnston Town, RI	A3	Stable	01/07/2012	Pay-Go	0	186,960	91,628	2,648,829	204.0%	7.1%

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RATING METHODOLOGY

US Local Government General Obligation Debt

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This methodology explains how Moody's evaluates the credit quality of US local government General Obligation (GO) debt. This document is intended to provide general guidance that helps local governments, investors, and other interested market participants understand how key quantitative and qualitative risk factors are likely to affect rating outcomes for local governments that issue GO bonds. This document does not include an exhaustive treatment of all factors that are reflected in our ratings but should enable the reader to understand the qualitative considerations, financial information, and ratios that are usually most important for ratings in this sector.

This rating methodology replaces the Rating Methodology for General Obligation Bonds Issued by US Local Governments published in April 2013. While reflecting many of the same core principles that we have used in assigning ratings to this sector for many years, this updated methodology introduces a scorecard that quantifies several factors that we previously evaluated in qualitative ways. A modest number of ratings are expected to change as a result of the publication of this methodology.

The purpose of the scorecard is to provide a reference tool that market participants can use to approximate most credit profiles within the local government sector. The scorecard provides summarized guidance for the factors that we generally consider most important in assigning ratings to these issuers. However, the scorecard is a summary that does not include every rating consideration. The weights the scorecard shows for each factor represent an approximation of their importance for rating decisions. In addition, the scorecard was built based on historical results while our ratings are based on our forward-looking expectations. As a result, we would not expect the scorecard-indicated rating to match the actual rating in every case.

The refinements to our analytical approach were outlined in a Request for Comment which we published in August 2013. We received market commentary which we have sought to address where appropriate.

Introduction

The methodology covers debt backed by the GO pledge of a local government¹ to pay its debt service. The unlimited tax GO pledge most often provided by US local governments is a contractual “full-faith-and-credit pledge,” including, either explicitly or implicitly, the local government’s obligation to levy an unlimited ad valorem (based on the value of property) property tax to pay debt service. In some instances, a local government’s GO bonds are secured solely by an unlimited ad valorem tax without the broader “full faith and credit pledge.” In other situations, the GO pledge is subject to limits on tax rate or amount of pledge.

Despite its fundamental strength, the GO pledge has practical and legal limits. From a practical perspective, there is an economic limit on the level of taxation that a municipality's tax base can bear. From a legal perspective, the local government’s mandate to provide essential public services and pay retiree pensions may also have strong claims on a government’s revenue and taxing power, depending on the particular state’s laws. While a default on GO debt can occur with or without a Chapter 9 bankruptcy filing, bankruptcy laws may further circumscribe the power of the GO pledge (see “General Obligation Bonds in Bankruptcy” later in this report).

While property taxes are typically the security underpinning the GO pledge, we do not restrict our analysis to the capacity of a property tax levy to cover debt service. The unconditional and open-ended nature of the GO pledge typically means a local government legally commits all its revenue-producing powers to meet debt service. Even in instances where the legal commitment is not that broad, our evaluation of credit quality includes more than just an evaluation of the local government’s legally pledged resources. Rather, our analysis seeks to measure a local government’s overall means and wherewithal to meet financial obligations from all of the resources at its disposal.

This methodology identifies and describes the various measures of our broad rating factors: economy/tax base, finances, management, and debt/pensions. Additionally, we describe the reasons we rate most local governments’ General Obligation debt higher than many other governmental and corporate borrowers, and the types of developments that can cause a local government rating to fall outside of the normal rating distribution.

The Scorecard

The local government scorecard (see Exhibit 1 and Appendix A) is a tool providing a composite score of a local government’s credit profile based on the weighted factors we consider most important, universal and measurable, as well as possible notching factors dependent on individual credit strengths and weaknesses. The scorecard is designed to enhance the transparency of our approach by identifying critical factors as a starting point for analysis, along with additional considerations that may affect the final rating assignment.

The scorecard is not a calculator. Its purpose is not to determine the final rating, but rather to provide a standard platform from which to begin viewing and comparing local government credits. It therefore acts as a starting point for a more thorough and individualistic analysis.

¹ Other types of local government bonds such as pool financings, government-owned utility revenue bonds, lease financings, and special tax bonds are covered under different methodologies. See [Moody's Index of Rating Methodologies](#). Some of these security types, such as lease financings, are often notched off or otherwise related to the GO rating.

The scorecard-indicated rating will not match the actual rating in every case, for a number of reasons including the following:

- » Our methodology considers forward-looking elements that may not be captured in historical data
- » The scorecard is a summary that does not include every rating consideration
- » In some circumstances, the importance of one factor may escalate and transcend its prescribed weight in this methodology

EXHIBIT 1

Scorecard Factors and Weights

Local Governments

Broad Rating Factors	Factor Weighting	Rating Subfactors	Subfactor Weighting
Economy/Tax Base	30%	Tax Base Size (full value)	10%
		Full Value Per Capita	10%
		Wealth (median family income)	10%
Finances	30%	Fund Balance (% of revenues)	10%
		Fund Balance Trend (5-year change)	5%
		Cash Balance (% of revenues)	10%
		Cash Balance Trend (5-year change)	5%
Management	20%	Institutional Framework	10%
		Operating History	10%
Debt/Pensions	20%	Debt to Full Value	5%
		Debt to Revenue	5%
		Moody's-adjusted Net Pension Liability (3-year average) to Full Value	5%
		Moody's-adjusted Net Pension Liability (3-year average) to Revenue	5%

Our scorecard metrics were intentionally limited to major rating drivers that are common to most issuers. Outside of these drivers, we may adjust the grid score for a variety of “below-the-line” adjustments, which are more idiosyncratic factors that are likely not to apply to all issuers, but that can impact credit strength. The scorecard score is the result of the “above-the-line” score based quantitatively on the above-the-line ratings factors, combined with any “below-the-line” notching adjustments. The scorecard score is a guideline for discussion, but does not determine the final rating. The rating is determined by a committee, which considers, but is not bound by, the scorecard score.

What is a local government?

A local government is a subdivision of a state, most commonly a city², county, or school district. The provisions establishing local governments are typically enumerated in each state’s constitution. Most states have local government laws governing the authorities and responsibilities of the political subdivisions within each state.

Local governments provide public services such as police and fire protection, courts, property records, public works maintenance, and water and sewer services. Cities or counties can also be responsible for

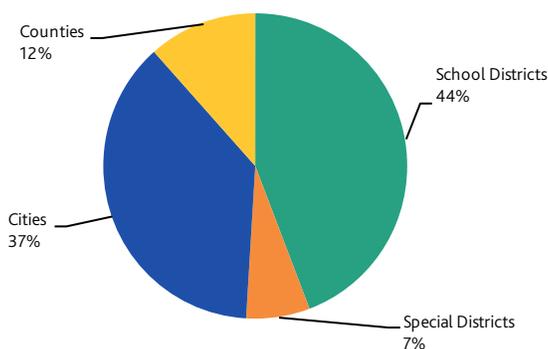
² We use the term “city” interchangeably with terms such as Town, Township, Village, and Borough.

public education, but this varies by states, and in most cases is provided by a separate school district dedicated to that sole function. Local governments fund these services with an array of revenues including property taxes, sales taxes, income taxes, state and federal aid, departmental income such as fines and fees, or direct charges for service.

States or subdivisions frequently create additional local governments such as authorities or special districts. These could include separate government-owned water, sewer, sanitation, or electric utilities, or public library, park, community college, or community development districts.

EXHIBIT 2

Moody's Rated Local Governments by Sector



Source: Moody's

What is a GO bond?

An unlimited tax GO (GOULT) bond is typically a security backed by the full-faith-and-credit pledge and total taxing power of the local government. The GOULT pledge means the local government promises to do everything it can to meet debt service. The specific definition of the pledge is laid out in state laws governing local government debt issuance; the precise legal characteristics of a GO bond can vary by state and sector (school district, county, etc.) depending on the structure of the local government and other technical issues.

Most often, the GO security offers the local government's full faith and credit pledge, including the levying of ad valorem taxes without limit as to rate or amount, for the timely payment of debt service (an unlimited tax, or GOULT pledge).

An illustration of the variety in the meaning of "General Obligation" arises in California, where a local government "General Obligation" bond is not secured by the full faith and credit of the local government, but solely by an unlimited ad valorem tax. We rate California local government GO bonds under this methodology, and even though they do not benefit from the broader pledge that secures GO bonds in many other states³, this is not necessarily a weakness.

In some instances, GO bonds are secured by a limited rather than unlimited property tax pledge. The limits may be on the specific debt service levy or tax rate, or on the taxing jurisdiction's overall

³ The primary rationale for this inclusion is threefold: First, our GO ratings reflect a comprehensive evaluation of a municipality's overall credit quality, which includes more than just an evaluation of pledged, legal security. Most significantly, we believe a California local government's overall financial profile and general management wherewithal can provide meaningful additional indicators of GO bond default probability. Second, the stronger a local government's overall, general credit quality, the less likely the local government will ever seek bankruptcy court protection. Third, our GO methodology is sufficiently flexible to recognize the unique strengths and weaknesses of each state's particular version of GO bonds, including California's, with "below-the-line" adjustments. Such adjustments are discussed later in this report.

property tax levy or total tax rate. We use our GO methodology for evaluating such limited tax General Obligation (GOLT) bonds in the same manner as unlimited tax GO bonds, but we may notch downward from the GOULT rating (whether an implied or public rating) to reflect the narrower, limited security provided by the GOLT pledge.

Moody's assesses the relative strength of unlimited versus limited tax securities on a case-by-case basis, considering, among other things, the legal provisions that protect bondholders' potential claims on tax revenue in the event of a default. We also consider the degree to which a currently levied, limited property tax rate is below the legally allowed maximum rate, and the amount of any additional available or pledged revenues beyond property taxes to pay debt service.

Some types of revenue bonds or other structures can receive a GO rating based on either a "double-barrel" pledge (meaning the GO as well as a second security are both explicitly pledged) or a municipality's legal guarantee to cover a separate entity's debt, provided we determine the legal enforceability of the guarantee and the structural mechanics assure the issue is sufficiently insulated from the risk of payment default by the underlying obligor.⁴

Note that state-level GO bonds do not typically involve ad valorem taxes and are rated under our separate state methodology⁵.

General Obligation Bonds in Bankruptcy

The enforceability of the GO pledge can change once a municipality enters a Chapter 9 bankruptcy. Treatment of GO bonds can vary by state, with some states designating GO debt service as a protected payment stream, others prohibiting bankruptcy altogether, and some leaving the question of how GO bonds should fare in a bankruptcy unanswered.

When a local government petitions for Chapter 9 bankruptcy protection, the debtor is subject to an "automatic stay" that halts all outflows, freezes all creditor recovery actions against the debtor, and prevents the borrower from liquidating assets to pay claims.

Bankruptcy courts have generally interpreted "special revenues" as exempt from the automatic stay, and therefore of stronger credit strength than other debts in a bankruptcy situation. Unless otherwise specified by state law or a jurisdiction's bankruptcy court, we believe GO bonds would generally not be treated as special revenues. In addition, certain states provide a statutory lien for GO bonds that makes it likely that courts would treat them as secured debt. In other states it is unclear whether GO claims could be considered unsecured and therefore enjoy less protection than secured debt.

Many Chapter 9 bankruptcy provisions remain untested, so it is difficult to make generalizations about how GO bonds will fare in bankruptcy. We expect the treatment of GO bonds in bankruptcy to evolve as precedents are set. It is also important to note that default and bankruptcy are separate events. A default can occur without a jurisdiction ever entering Chapter 9 proceedings, and conversely, a local government can enter bankruptcy without defaulting on its GO debt.

For more information, please refer to our Special Comment, [Key Credit Considerations for Municipal Governments in Bankruptcy](#).

⁴ See "[Rating Transactions Based on the Credit Substitution Approach](#)" (March 2013)

⁵ See [US States Rating Methodology](#) (April 2013)

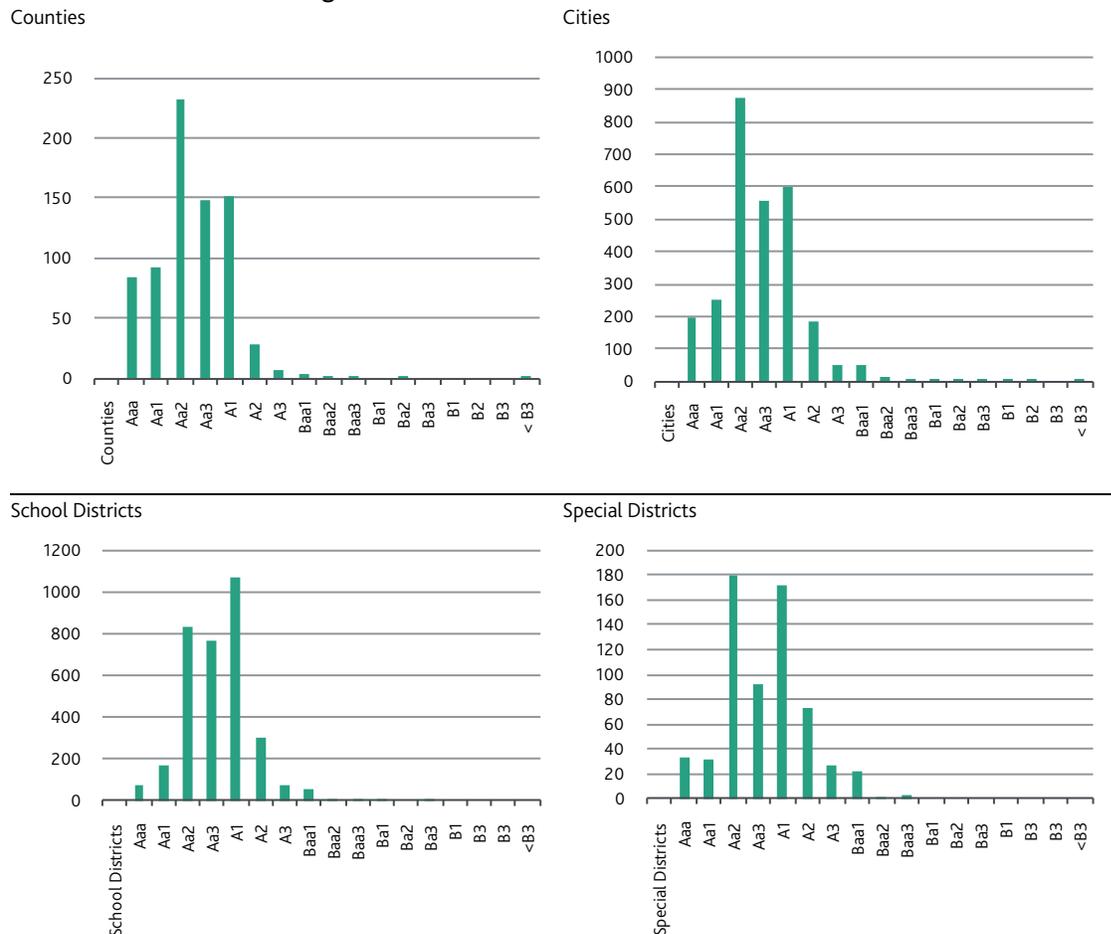
Fundamental Strengths of the Local Government Sector

US local governments are generally highly-rated compared to other types of government entities and corporations. As of this report publication date, only about 35 local government GO bonds are rated below investment-grade, out of a rated universe of approximately 8,000.

The high average rating assigned to local government general obligation bonds reflects credit strengths which typically include the strong institutional framework, predictability of property tax revenues, characteristic use of amortizing debt structures and the strengths resulting from municipal governments' perpetual status, and is consistent with historical and expected rating performance. Default experience for General Obligation bonds is exceedingly limited. We believe the occurrence of defaults will remain rare and the great majority of local governments will continue to warrant investment grade ratings.

This performance record and a number of fundamental strengths anchor the majority of ratings in the A and Aa range.

EXHIBIT 3
Local Government GO Rating Distribution



Source: Moody's

The potency of ad valorem taxing power

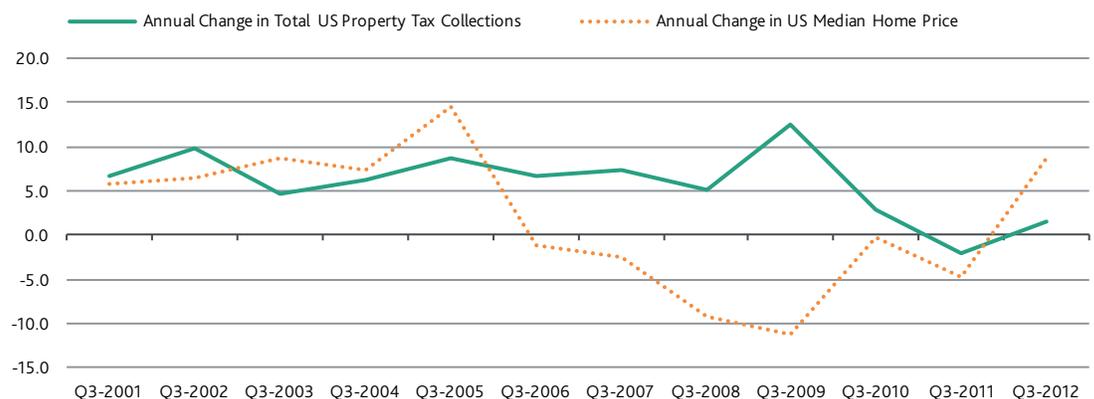
The pledge to levy ad valorem property taxes to repay bondholders has proven its durability over many decades.

Ad valorem taxes -- the bedrock of US local government finance -- are by nature predictable. Property taxes are historically more stable through economic cycles than sales taxes, income taxes, or other local government revenues.

Even during depressed real estate cycles such as the US housing downturn over the last several years, property taxes have remained generally stable. One reason for this is that a local government first determines the amount that it wants to raise (the levy) and then sets the tax rate (millage) on the taxable properties in its jurisdiction. If taxable property values decline, municipalities usually have the legal ability to increase the millage to achieve an unchanged or increased levy. Further, changes in the market value of taxable properties usually translate to the assessed value on municipalities' tax rolls on a lag, and to the property tax bills on a further lag, helping to smooth economic cycles (see Exhibit 4). Though some local governments were hit with double-digit declines in tax base in the years following 2008, the ability to adjust millage, in combination with the time-lag buffer, enabled most to adjust and re-balance operations.

EXHIBIT 4

Property Tax Receipts Lag Valuations



Source: Census Bureau, National Association of Realtors, Moody's Analytics

Amortizing debt structures

Most local government debt service structures are level or declining. Local governments typically pay down some principal with each year of debt service. Spikes in debt principal are rare.

This type of debt structure mitigates or eliminates several risks prevalent in other sectors, including rollover risk, balloon repayment risk and interest rate risk (if the coupon is fixed, which is the typical municipal structure). Local governments generally pay debt service according to a predictable schedule and, unlike many sovereign and corporate bond borrowers, generally do not rely on market access (i.e., new borrowing) to meet debt service payments.

Several of the local government sector's largest General Obligation defaults arose because of municipalities that exposed themselves to unstable debt structures (Jefferson County, AL) or carried an unmanageable debt burden because of a guarantee issued on another entity's debt (City of Harrisburg, PA).

Stable institutional framework

The local government General Obligation pledge has proven extremely strong in part because local governments' legal, institutional, and practical environment is stable and protective.

- » Most local governments are perpetual entities and monopoly providers of essential, legally mandated services such as police and fire protection, jails, and education.
- » Local governments in nearly all states operate under balanced budget requirements. Strictly speaking it is illegal for most entities to operate with imbalanced budgets.
- » Most entities are required to submit to annual audits, and budgets are subject to public scrutiny.
- » Many states limit local government debt burdens.
- » Many states operate fiscal oversight programs that monitor local government behavior and in some cases take over financially struggling entities. School districts in particular are typically closely linked to their states through oversight and operational mandates.

The local government sector's elemental strengths lead to high ratings on average.

Discussion of Key Scorecard Factors

A primary purpose of the methodology and scorecard is to enhance the transparency of our rating process by identifying and discussing the key factors and subfactors that explain our local government ratings and how these factors and subfactors are used. The scorecard is not intended to be an exhaustive list of factors that we consider in every local government rating, but should enable the reader to understand the key considerations and financial metrics that correspond to particular rating categories. We reiterate that our rating process involves a degree of judgment, or consideration of analytical issues not specifically addressed in the scorecard, that from time to time will cause a rating outcome to fall outside the expected range of outcomes based on a strict application of the factors presented herein.

To arrive at a scorecard-indicated rating, we begin by assigning a score for each subfactor. We've chosen quantitative measures that act as proxies for a variety of different tax base characteristics, financial conditions, and governance behaviors that can otherwise be difficult to measure objectively and consistently. Based on the scores and weights for each subfactor, a preliminary score is produced that translates to a given rating level.

We may then move the score up or down a certain number of rating notches based on additional "below-the-line" factors that we believe impact a particular local government's credit quality in ways not captured by the statistical portion of the scorecard. This is where analytical judgment comes into play. We may also choose to make adjustments to the historical subfactor inputs to reflect our forward-looking views of how these statistics may change.

The scorecard score, combined with below-the-line notching, then provides an adjusted score. This adjusted score is not necessarily the final rating. Because some local governments' credit profiles are idiosyncratic, one factor, regardless of its scorecard weight, can overwhelm other factors, and other considerations may prompt us to consider ratings that differ from the scorecard-indicated rating.

Below we discuss each factor and subfactor, as well as the below-the-line adjustments and other considerations we analyze within each category of the methodology. From time to time, we may amplify or further clarify the various subfactor considerations and below-the-line adjustments within this methodology.

Factor 1: Economy/Tax Base (30%)

	Aaa	Aa	A	Baa	Ba	B & Below	Weight
Tax Base Size: Full Value	> \$12B	\$12B ≥ n > \$1.4B	\$1.4B ≥ n > \$240M	\$240M ≥ n > \$120M	\$120M ≥ n > \$60M	≤ \$60M	10%
Full Value Per Capita	> \$150,000	\$150,000 ≥ n > \$65,000	\$65,000 ≥ n > \$35,000	\$35,000 ≥ n > \$20,000	\$20,000 ≥ n > \$10,000	≤ \$10,000	10%
Socioeconomic Indices: MFI	> 150% of US median	150% to 90% of US median	90% to 75% of US median	75% to 50% of US median	50% to 40% of US median	≤ 40% of US median	10%

Why It Matters

The ultimate basis for repaying debt is the strength and resilience of the local economy. The size, diversity, and strength of a local government's tax base and economy drive its ability to generate financial resources. The taxable properties within a tax base generate the property tax levy. The retail sales activity dictates sales tax receipts. The income earners living or working in the jurisdiction shape income tax receipts. The size, composition, and value of the tax base, the magnitude of its economic activity, and the income levels of its residents are therefore all crucial indicators of the entity's capacity to generate revenues.

Also crucial in this area of our analysis is the type of tax base and economy (residential bedroom community or an industrial, retail, or services center). Based on the type of local economy, Moody's will focus its questions and comparisons to include topics like commuting patterns, office or retail vacancy rates, or residential building permit activity, among other things.

While economic factors are important in our analysis, as demonstrated by the factor's 30% weight, the depth and breadth of a tax base is not the sole determinant of a credit rating. We have seen some local governments either unwilling or unable to convert the strength of their local economies into revenues. Tax caps, anti-tax sentiment, the natural lag between economic activity and its conversion into government revenues, and a variety of other factors have the potential to place obstacles between municipal governments and the wealth generated by their local economies. For these reasons, we consider other factors as well. Our scorecard inputs into Finances and Management capture the strengths of those governments that are able to translate economic weight into credit strength, while not assuming all do.

Subfactor 1.a: Tax Base Size (10%)

Input: Full value, i.e. the market value of taxable property accessible to the municipality. Often calculated as a multiple of assessed value, or the book value of properties on the tax rolls. Methods for calculating vary by state.

The tax base represents the well from which a local government draws its revenues. A larger tax base (measured by full value, or the total taxable value of property) in general offers a local government a broader, more flexible, and more diverse pool from which it can draw revenues. Smaller tax bases are more susceptible to shocks such as natural disasters or the closure of a major employer that destroy a great portion of taxable property values. Larger tax bases are better able to absorb these kinds of shocks. Smaller tax bases also tend to be less diverse and more dependent on a small number of properties.

Because an ad valorem pledge often underpins the GO security, the tax base is in a sense the ultimate repayment source for GO bondholders.

Subfactor 1.b: Full Value Per Capita (10%)

Input: Full value divided by population

Full value per capita scales the taxable property available to generate resources to a per resident metric. The per resident property wealth of the tax base depicts the availability of tax-generating resources relative to the users of the services those resources fund.

We believe looking at the magnitude of taxable property in tandem with taxable property per capita gives a clearer picture of tax base strength than looking at the magnitude of taxable property alone. Some entities, such as the City of Detroit, MI, have large tax bases on an absolute basis but low full value per capita, illustrating the difficulties in funding services for the city's population using the resources of the base. Alternatively, the City of Industry, CA has a very high full value per capita despite moderate income levels, due to a substantial commercial presence that is a robust component of the tax base.

Subfactor 1.c: Median Family Income (10%)

Input: Median family income as a percentage of the US median (source: American Community Survey⁶)

An important measure of the strength and resilience of a tax base is the income level of its residents. A community with higher wealth levels may have relative flexibility to increase property tax rates in order to meet financial needs. A wealthier community has greater spending power to sustain sales tax revenue and provide the demand necessary to support growth in the commercial and service sectors.

We emphasize median family income over per capita income because per capita income is more easily skewed by low-income populations that are not necessarily reflective of the strength of the tax base, such as the student residents at a university or inmates at a prison. To illustrate, the per capita income of the City of Charlottesville, VA was equal to 90% of the US median as of 2010, a figure we believe understates the city's wealth because of the presence of the 21,000-student University of Virginia. Both median family income and full value per capita portray a stronger tax base than the PCI indicates for Charlottesville.

Median family income also recognizes the economies of scale achieved when people share a household.

Below-the-line adjustments

Institutional presence (positive): Some types of properties such as universities or military bases can offer stability and tax base strength. Because these properties are often tax-exempt, they may not be captured in full value or full value per capita; in fact, they often depress full value per capita. We may notch a score up if tax base measures fail to capture the anchoring influence of an institution. Institutional presence is exhibited when the local government is the state capital or a long-term, stable entity such as a university or military base that contributes 10% or more of a local government's population.

Regional economic center (positive): Economic and employment centers may generate revenues from daytime visitors such as employees or shoppers. Traditional tax base measures don't necessarily reflect the characteristics of these revenue-generating people if they are not permanent residents. We may notch a score up if a local government has a substantially greater daytime population than nighttime or weekend population.

⁶ The American Community Survey has replaced the Census as surveyor of incomes in the US.

Economic concentration (negative): Local governments that generate a significant portion of their revenues from a single taxpayer or industry are particularly vulnerable to a loss of those revenues, especially if that industry is weak or volatile. Sizable economic concentrations could cause us to notch a score down.

Outsized unemployment or poverty levels (negative): This factor is designed to adjust the final score if a local government's socioeconomic characteristics are unusually weak in ways not already reflected in the scorecard. High unemployment or poverty levels may strain a local government's ability to tap its tax base for new revenues, or in extreme cases sustain existing tax collections. High levels may also pose additional demands for services.

Other considerations not on the scorecard that may lead to scorecard adjustments

A number of other factors do not appear on the scorecard or as a below-the-line adjustment, but are considered in our ratings and are frequent topics of discussion in our analysis.

- » Per capita income (source: American Community Survey)
- » Composition of workforce/employment opportunities
- » Proportion of tax base that is vacant or exempt from taxes
- » Median home value (source: American Community Survey)
- » Trend of real estate values
- » Population trends
- » Property tax appeals outstanding
- » Unusually significant tax base declines or growth

Factor 2: Finances (30%)

	Aaa	Aa	A	Baa	Ba	B & Below	Weight
	> 30%	30% ≥ n > 15%	15% ≥ n > 5%	5% ≥ n > 0%	0% ≥ n > -2.5%	≤ -2.5%	
Fund Balance as % of Revenues	> 25% for School Districts	25% ≥ n > 10% for SD	10% ≥ n > 2.5% for SD	2.5% ≥ n > 0% for SD	0% ≥ n > -2.5% for SD	≤ -2.5% for SD	10%
5-Year Dollar Change in Fund Balance as % of Revenues	> 25%	25% ≥ n > 10%	10% ≥ n > 0%	0% ≥ n > -10%	-10% ≥ n > -18%	≤ -18%	5%
	> 25%	25% ≥ n > 10%	10% ≥ n > 5%	5% ≥ n > 0%	0% ≥ n > -2.5%	≤ -2.5%	
Cash Balance as % of Revenues	> 10% for School Districts	10% ≥ n > 5% for SD	5% ≥ n > 2.5% for SD	2.5% ≥ n > 0% for SD	0% ≥ n > -2.5% for SD	≤ -2.5% for SD	10%
5-Year Dollar Change in Cash Balance as % of Revenues	> 25%	25% ≥ n > 10%	10% ≥ n > 0%	0% ≥ n > -10%	-10% ≥ n > -18%	≤ -18%	5%

Why It Matters

A local government's fiscal position determines its cushion against the unexpected, its ability to meet existing financial obligations, and its flexibility to adjust to new ones. Financial structure reflects how well a local government's ability to extract predictable revenues adequate for its operational needs are matched to its economic base.

The Finances category comprises two major components:

- » cash reserves and other liquid resources
- » the financial trend, which reflects on the quality of financial operations, the local government's ability to adjust to changing circumstances, and the potential for future stability or instability

Moody's financial analysis includes a review of historical financial performance as an indication of a local government's ability to weather budgetary pressures stemming from economic downturns or other factors. Our analysis focuses on multiyear financial trends, rather than performance in any given year, to indicate financial health over the medium term. Financial flexibility is a key area of analysis, as it provides insight into a local government's ability to maintain or augment its financial position going forward, ensuring a sufficient buffer to address any unexpected contingencies.

Moody's assessment of management includes a comparison of budget versus actual performance trends, focusing on the accuracy of both revenue and expenditure forecasts. Revenue forecasting is a key consideration, as overly optimistic revenue budgeting can lead to shortfalls within a fiscal year. The strongest financial managers work with information that is updated on a regular basis. For instance, property tax revenue projections will be more reliable if they are based on historic trends and also include reasonable assumptions about the future of the local real estate market, the direction of national interest rates, and the local government's likely tax collection rate. Similarly, strong sales tax revenue projections incorporate recent actual trends and indicators of likely future purchasing demand – such as population trend numbers, expected unemployment rates and the impact of current and expected nearby retail competition. The strongest management teams have a solid track record of meeting projections in key budget line items over several years.

Finally, school districts, as noted earlier, are local governments dedicated to a single purpose, often operating under extensive state supervision and with correspondingly limited revenue-raising abilities derived from a mix of property taxes and state aid—also state-controlled. School districts tend to have more predictable revenue composition and cost structures than most other types of local governments. Moody's has accordingly developed two separate sets of financial scores, discussed below, to reflect the often less flexible but more stable financial position particular to school districts.

Subfactor 2.a: Fund Balance (10%)

Input: *Available fund balance (Operating funds assets minus operating funds liabilities, adjusted for other resources or obligations that are available for operating purposes) as a percentage of operating revenues*

Fund balance describes the net financial resources available to an entity in the short term. The input for this factor isn't simply General Fund balance; we include all reserves that our analysis finds is available for operating purposes. The specific funds that will be included will vary by credit, although almost all will include at least the General Fund unassigned plus assigned fund balance.

The fund balance communicates valuable information about both the past and the future. The existing balance depicts the cumulative effects of the local government's financial history. It also identifies the liquid resources available to fund unforeseen contingencies as well as likely future liabilities.

The strength of a given level of fund balance varies depending on the particular local government and its respective operating environment. Larger balances may be warranted if budgeted revenues are economically sensitive and therefore not easily forecasted, or to offset risk associated with tax base concentration, unsettled labor contracts, atypical natural disaster risk, and pending litigation. Alternately, municipalities with substantial revenue-raising flexibility may carry smaller balances without detracting from their credit strength; this weakness is offset by their ability to generate additional resources when necessary.

We include both restricted and unrestricted fund balance unless there is reason to believe the restricted portions are not usable for operating purposes. For groups of local governments that do not follow Generally Accepted Accounting Principles accounting standards, we adjust the fund balance to improve comparability. For example, with New Jersey credits, we include in fund balance receivables that under state statutory accounting are stripped out of fund balance, but would be considered part of fund balance under GAAP accounting.

Our scorecard allows for school districts to carry lower fund balances than cities and counties at the same rating level. This is consistent both with existing medians and with our belief that school districts by nature need less fund balance to operate consistently. School districts generally have a more predictable funding composition and more transparent schedule of cash outflows than cities or counties. Cities and counties often provide social services whose costs can spike unexpectedly, and are also typically more reliant on less-predictable revenue sources such as sales taxes, fines, and fees.

Subfactor 2.b: 5-Year Dollar Change in Fund Balance as % of Revenues (5%)

Input: *Available fund balance in the most recent year minus available fund balance five years earlier, as a percentage of operating revenues in the most recent year*

The strength of local government financial operations encompasses many elements, some of which interact: whether (and how much of) reserves are appropriated into the budget, how conservative the budget projections are, and how management reacts midcourse to variances from the original assumptions.

The most important aspect of financial operations is the local government's ability to achieve structural balance: long-term revenues matching long-term spending. The focus here is on whether financial reserves are increasing in step with budgetary growth.

We measure results as the dollar change in fund balance over the past five years, expressed as a percentage of the most recent year's revenues. We believe that a five-year window is generally representative of a full economic cycle.

For issuers that have maintained a stable fund balance throughout the five-year period, the metric is likely to come out at the "A" level, in the 0% to 10% range. If rating committee feels that the "A" score does not adequately reflect the credit strength of the issuer's five-year fund balance history, the committee can add a half-notch or full notch up in "Other analyst adjustment to Finance factor."

Another adjustment to the scorecard may be made if the change in fund balance was due to planned capital spending. Local governments frequently build capital reserves to pay for projects instead of, or in addition to, borrowing. In this case, the analyst may adjust the calculation to reflect ongoing operating reserves, rather than capital reserves that are likely to be spent on long-term projects.

Subfactor 2.c: Cash Balance (10%)

Input: *Operating funds net cash (cash minus cash-flow notes) as a percentage of operating revenues*

Fund balance is an accounting measure subject to the modified accrual accounting prescribed by the Governmental Accounting Standards Board. While fund balance and cash are usually correlated, accruals can often lead to divergence between the two. A large receivable for delinquent taxes, for instance, can lead to an ostensibly high fund balance position and a weaker cash position; yet in this case, the fund balance position is less indicative of credit quality than the cash position.

Cash (net of notes payable within one year) represents the paramount liquid resource without regard to accruals.

For the same reasons we believe school districts can carry less fund balance than cities and counties at the same rating level, we believe school districts can carry less cash too.

We believe evaluating cash and fund balance in tandem is more informative than evaluating either in isolation. Our approach mutes some of the effects of modified accrual accounting while still recognizing the non-cash resources that are nonetheless likely accessible in the near-term.

Subfactor 2.d: 5-Year Dollar Change in Cash Balance as % of Revenues (5%)

Input: *Operating funds net cash in the most recent year minus Operating funds net cash five years earlier, as a percentage of operating revenues in the most recent year*

This factor seeks to reflect changes to a local government's cash position distinct from its fund balance. Accrual accounting can sometimes depict a story that obscures some details of financial operations. The trend in the local government's cash balance gives us additional information about financial operations that may be veiled by accrual-driven changes in fund balance.

Below-the-line adjustments

Outsized enterprise or contingent liability risk (negative): We may notch a score down by one or several notches if a local government operates, has guaranteed the debt of, or is otherwise exposed to an enterprise or operation that poses outsize risk relative to the local government's own operations. This risk could reflect a General Obligation guarantee of an independent entity's debt (such as the City of Harrisburg, PA's guarantee of an incinerator authority's debt) or the local government's operation of an enterprise, even if currently self-supporting. The adjustment strives to reflect the potential impact of an enterprise's debt, debt structure, or legal issues that could limit the flexibility of the general government in the event it had to cover the enterprise's debt or operations.

Unusually volatile revenue structure (negative): Volatile or unpredictable revenue sources can present challenges to budgetary balance and stable fund balance and cash reserves. We may notch a score down if volatile, unpredictable, or economically sensitive revenue sources comprise 50% or more of operating funds revenues, or if any major revenue sources has changed by 10% or more in any one year of the past five.

Other considerations not on the scorecard that may lead to scorecard adjustments

- » Questionable balance sheet items that may distort fund balance
- » Large portion of fund balance that is restricted or unusable
- » Labor contracts that materially affect credit strength

- » Limited revenue raising ability: restrictive property tax cap, constraints on capturing tax base growth, or other levy-raising limitation
- » Limited ability to cut or control expenditures: limitation constrains budgetary flexibility to a degree not already captured in the scorecard
- » Heavy fixed costs, including contractually fixed costs such as pension payments

Factor 3: Management (20%)

	Aaa	Aa	A	Baa	Ba	B & Below	Weight
Institutional Framework	Very strong legal ability to match resources with spending	Strong legal ability to match resources with spending	Moderate legal ability to match resources with spending	Limited legal ability to match resources with spending	Poor legal ability to match resources with spending	Very poor or no legal ability to match resources with spending	10%
Operating History: 5-Year Average of Operating Revenues / Operating Expenditures	> 1.05x	1.05x ≥ n > 1.02x	1.02x ≥ n > 0.98x	0.98x ≥ n > 0.95x	0.95x ≥ n > 0.92x	≤ 0.92x	10%

Why It Matters

Both the legal structure of a local government and the practical environment in which it operates influence the government's ability to maintain a balanced budget, fund services, and continue tapping resources from the local economy. The legal and practical framework surrounding a local government shapes its ability and flexibility to meet its responsibilities.

The laws of each state establish a framework for its political subdivisions that determines what revenues they are empowered to raise and how much flexibility they have in increasing them, as well as what services they are required to provide and how much flexibility they have in cutting them.

Subfactor 3.a: Institutional Framework (10%)

Input: An input of Aaa through B and below determined for each sector/state combination annually

This score measures the municipality's legal ability to match revenues with expenditures based on its institutional apparatus: the constitutionally and legislatively conferred powers and responsibilities of the local government entity.

We determine one score for every state and sector combination. [See link here for the scores.](#) For example, all school districts in Ohio will have the same institutional framework score. Each year, we determine the institutional framework score to apply to all local governments in that state and sector based on the state/sector's legal edifice and any potential changes to it.

The following rubric acts as a launching point for these discussions:

Operating Revenue Flexibility		Revenue Raising Ability				
		Strong ability to raise revenues	Moderate ability to raise revenues	Weak ability to raise revenues		
Revenue Predictability	Major revenue sources tend to be highly stable and predictable	Aaa	Aa	A	Major expenditures tend to be highly stable and predictable	Expenditure Predictability
	Major revenue sources tend to be moderately stable and predictable	Aa	A	Baa	Major expenditures tend to be moderately stable and predictable	
	Major revenue sources tend to be somewhat unstable and unpredictable	A	Baa	Ba or B and Below	Major expenditures tend to be somewhat unstable and unpredictable	
		Strong ability to reduce expenditures	Moderate ability to reduce expenditures	Weak ability to reduce expenditures	Operating Expenditure Flexibility	
		Expenditure Reduction Ability				

The interplay between legally dictated resources and responsibilities contributes to the stability of a local government’s credit profile and its capacity to match revenues to expenditures over time. A local government with a stable institutional framework is less likely to face an abrupt change in its obligations without the corresponding ability to meet those obligations.

Factors that drive the institutional framework score:

- » Tax caps⁷
- » Organized labor
- » Difficulty of increasing revenues (i.e., subject to public approval)
- » Predictability of costs (such as charter school tuition)
- » State-imposed limitations on fund balance or reserves

We know that applying a single institutional framework score to all local governments in a state and sector will inevitably lead to exceptions. For instance, a struggling school district in a state that may ordinarily provide a weak institutional framework could gain a stronger framework if placed under state supervision or receivership. We will appropriately score these exceptions through adjustments below the line.

⁷ Tax caps matter even if they don’t limit increases in property taxes to pay for debt service. A limitation on revenue raising can restrict financial flexibility and make it difficult to grow reserves, hampering credit even for an unlimited tax General Obligation pledge.

Subfactor 3.b: Operating History (10%)

Input: *The average of operating revenues divided by operating expenditures in each of the past five years*

While institutional framework communicates the context of a municipality's legal ability to match revenues and spending, the operating history communicates the local government's demonstrated willingness to utilize that ability.

This factor measures the five-year average of the ratio of operating revenues to operating expenditures. A ratio of greater than 1.0 indicates a budget surplus on average, a ratio of 1.0 indicates balanced operations, and a ratio of less than 1.0 indicates a sustained deficit.

A local government's success in navigating the legal, political and practical environment in which it operates depends on a multitude of factors, including management's mastery in understanding its resources and managing its responsibilities, public and executive support for its plans, and its willingness to use the tools at its disposal.

We do not believe a single playbook prescribes how best to manage a budget. Rather, we assess management's success in planning and adjusting under a mosaic analysis based foremost on results: does the evidence show a trend of operating surpluses, operating deficits, or are the results mixed?

When evaluating a credit, we seek to understand the probable impact of fund balance policies, multi-year financial or capital planning, liquidity management, accuracy of budget forecasts, and willingness to make midyear adjustments. Reliance on non-recurring, or "one-shot" revenues, such as proceeds from the sale of assets, windfall delinquent tax collections, or the use of fund balance as a revenue source, leaves the municipality vulnerable should these one-time revenues fail to materialize in the future. Ultimately, we believe actual results are the best indicator of the effectiveness of all these factors. The five-year operating history shows whether the local government's financial position is strengthening or weakening, and whether management has been effective at planning for the future and adjusting when things haven't gone as planned.

Below-the-line adjustments

State oversight or support (positive or negative): Control boards, receivership, emergency management, or other forms of state oversight can alter a municipality's institutional framework and differentiate its resources and responsibilities from others in its state and sector. Oversight structures can make it easier or more difficult to issue debt, raise taxes, or restructure labor contracts. We may notch up, or in some cases down, when state intervention changes a local government's legal and practical landscape.

Unusually strong or weak budget management and planning (positive or negative): We recognize that a five-year operating history will not always tell the whole story of a local government's willingness to achieve balanced operations. We may notch a score up or down if we believe a local government's financial planning and budget management are unusually strong or weak, in ways not reflected in the recent financial trend or existing cash reserves and fund balance.

Factor 4: Debt/Pensions (20%)

	Aaa	Aa	A	Baa	Ba	B & Below	Weight
Net Direct Debt / Full Value	< 0.75%	0.75% ≤ n < 1.75%	1.75% ≤ n < 4%	4% ≤ n < 10%	10% ≤ n < 15%	> 15%	5%
Net Direct Debt / Operating Revenues	< 0.33x	0.33x ≤ n < 0.67x	0.67x ≤ n < 3x	3x ≤ n < 5x	5x ≤ n < 7x	> 7x	5%
3-Year Average of Moody's Adjusted Net Pension Liability / Full Value	< 0.9%	0.9% ≤ n < 2.1%	2.1% ≤ n < 4.8%	4.8% ≤ n < 12%	12% ≤ n < 18%	> 18%	5%
3-Year Average of Moody's Adjusted Net Pension Liability / Operating Revenues	< 0.4x	0.4x ≤ n < 0.8x	0.8x ≤ n < 3.6x	3.6x ≤ n < 6x	6x ≤ n < 8.4x	> 8.4x	5%

Why It Matters

Debt and pensions represent important components of the long-term financial obligations facing a local government.

Debt and pension burdens are measures of the financial leverage of a community. Ultimately, the more leveraged a tax base is, the more difficult it is to service existing debt and to afford additional debt, and the greater the likelihood that tax base or financial deterioration will result in difficulties funding fixed debt service expenditures.

Our treatment of debt seeks to scale the magnitude of a local government's debt obligations relative to: 1) its resources (using tax base as the proxy), and 2) its operations (using operating revenues as a proxy).

We see pension liabilities as characteristically similar, though not identical, to debt. Because of disparities in the way local governments measure and report pension liabilities, we use an internal standardization process to calculate the adjusted liability⁸.

Our methodology and scorecard are more restrictive with respect to debt burdens compared to pension burdens. This reflects the fact that measures of accrued pension liability are estimates that depend on numerous actuarial assumptions and are affected by external market factors that can be volatile from year to year. In addition, it may be possible for governments to amend or renegotiate pension plan provisions in a manner that reduces accrued liabilities. In contrast, debt principal obligations are fixed in nature.

Subfactor 4.a: Debt to Full Value (5%)

Input: *Gross debt minus self-supporting debt, as a percentage of full value*

Our first gauge of a local government's debt burden evaluates net direct debt relative to full value. This metric tells us how onerous future debt service payments could be to the tax base. We use full value as a proxy for the capacity of a local government to generate additional revenues to pay debt service.

To arrive at net direct debt, we calculate the local government's gross debt burden including all GO bonds, notes, loans, capital leases, and any third-party debt backed by the local government's GO

⁸ See [Adjustments to US State and Local Government Reported Pension Data](#) (April 2013)

guarantee. This calculation may include lease, other appropriation-backed debt, and special tax debt as well if our analysis concludes these securities represent future claims on operating resources. We then subtract debt for essential service utilities (such as water and sewer systems) that is self-supporting from user fees, based on a coverage calculation⁹. We do not subtract debt whose principal and interest is paid by taxes, even if those costs are external to the General Fund. The self-supporting calculation is designed to strip out debt that won't be supported by taxes or the General Fund because it is paid for with user fees such as water, sewer, or electric charges. We do not deduct GO debt for non-essential enterprises such as golf courses, even if it is self-supporting (see Appendix D).

Subfactor 4.b: Debt to Revenues (5%)

Input: *Gross debt minus self-supporting debt, as a percentage of operating revenues*

Next, we evaluate net direct debt relative to operating revenues. This metric expresses the potential budgetary impact of future debt service. A high debt burden relative to operating revenues implies a possibility that debt will consume a greater portion of the local government's budget in future years.

We believe evaluating net direct debt relative to both full value and operating revenues is superior to evaluating either one alone because in tandem they express the obligations' potential pressure on the budget as well as on the revenue-generating resources the local government utilizes to fund the budget.

Subfactor 4.c: 3-year Average of Moody's-Adjusted Net Pension Liability to Full Value (5%)

Input: *The average of Moody's-adjusted Net Pension Liability (as calculated in Appendix B) in each of the past three years, as a percentage of full value*

We seek to measure the magnitude of a local government's pension obligations (as adjusted by Moody's) relative to its tax base. Similar to the debt burden evaluation, we use the tax base as a proxy for future revenue-generating capacity to amortize accrued pension obligations for which trust assets are not currently set aside.

We use a three-year average of the net pension obligation to smooth the volatility inherent in a metric that changes with market interest rates and the value of pension plan assets.

Subfactor 4.d: 3-year Average of Moody's-Adjusted Net Pension Liability to Operating Revenues (5%)

Input: *The average of Moody's-adjusted Net Pension Liability (as calculated in Appendix B) in each of the past three years, as a percentage of operating revenues*

This metric seeks to measure pension obligations relative to the size of the local government's budget.

The metric attempts to reflect the prospect that amortization of accrued net pension obligations could sap revenues out of future-year budgets and lead to funding shortfalls. Because pension contributions are for many governments a significant fixed-cost share of what is already typically the largest component of general government operations – salaries and benefits – they directly affect annual budgets and the ability to sustain essential services.

Overall, the pension scores are used as a starting point for an analysis of the pension position and its impact on operations. The analysis considers the funded status, future contributions, and overall

⁹ Debt is considered self-supporting if operating revenues minus operating expenditures (excluding depreciation) have been sufficient to cover principal and interest for the previous three years. If essential-service debt fails this test (for instance, if it fails in one of the past three years), it will not be considered self-supporting and will be added to the debt burden.

liability in the context of the local government's long-term resources. The analysis is not driven solely by the ANPL number.

Also considered as part of this overall category are other post employment benefits (OPEB), which are primarily healthcare liabilities for retired workers. Municipalities typically do not fund their future healthcare liabilities, choosing instead to meet these payments on a pay-as-you-go basis. We do not add present-value measures of unfunded OPEB to the scorecard, as these obligations have proven in many jurisdictions to be subject to greater discretionary control by management. However, when OPEB obligations appear to be particularly large relative to budget and tax base and management has not demonstrated a willingness to address related costs, we will factor this into our rating analysis through a below-the-line adjustment.

Costs of Funding Retirement Benefits

To provide sufficient funds to meet pension benefit payments when they are due, governments and their actuaries identify annual contributions sufficient to meet a pension plan's accrued obligations over a reasonable time period. The annual amount – known as the actuarially required contribution or ARC – consists of the present value of the future benefits accrued by employees during the current year (referred to as “normal” or “service” cost), plus the amortization of unfunded benefit liabilities accrued in past years.

This ARC was initially adopted by GASB as the standard for creating a sound annual pension contribution amount. Although there has not been uniformity across governments in the calculation of pension valuations and ARCs because of leeway provided by GASB rules, we have considered consistent adherence to a prudent actuarially determined pension funding plan as an indicator of sound budget management practices. Conversely, failure to follow such a plan is an indicator of structural budget imbalance and cost deferral that we view as credit negative. Employers contributing less than an actuarially determined contribution run the risk of experiencing rapid cost increases as unfunded liabilities grow and benefit payments become due. Although GASB has dispensed with providing funding guidance in its new pension accounting standards to be implemented in 2014 and 2015, and therefore ARC as such will disappear, the concept and credit implications of adhering to sound pension funding practices remain unchanged.

While treated similarly to pensions in accounting standards, the costs of retiree health benefits have been approached differently by governments. Most governments meet the current expenses of the plans on a pay-as-you go basis. Since we do not view these liabilities as having the same contractual or constitutional protections as pension liabilities, we expect that governments will have some flexibility over time to manage these expenses. We view pre-funding of OPEB liabilities as moderately credit positive.

Below-the-line adjustments

Unusually weak or strong security features (negative or positive): General Obligation bonds sometimes have structural features that are fundamentally stronger than a local government simply paying debt service out of its operating revenues. For example, some structures employ a lock box, where funds from tax collections are transferred directly from a third-party tax collector to the trustee for the bonds and never flow into the issuer's own accounts. Conversely, if the courts were to interpret a state's GOULT security as weaker than the typical pledge, or if pensions were granted superior status to debt, we could notch down. Overall, this notching factor is designed to adjust the score when the security features enhance or weaken the factors on the scorecard.

Unusual risk posed by debt structure (negative): The structure of a local government's debt profile can pose additional risks not captured by the debt burden. A large amount of short-term notes without sufficient offsetting liquidity can expose the local government to market access risks. A large amount of variable-rate debt or swaps can expose a municipality to a variety of risks, including termination risk, counterparty risk, and interest rate risk. Non-amortizing debt structures with bullet maturities are unusual for General Obligation bonds, and may also result in downward notching.

History of missed debt service payments (negative): A historical default may reflect an elevated risk of failure to meet financial obligations going forward. Defaults frequently reflect poorly on management and the local government's willingness and/or ability to meet financial obligations. We include in this category not only defaults on other General Obligation bonds or guarantees with GO backing, but on non-parity obligations such as a lease revenue bond. The magnitude of notching, if any, depends on the timeframe for the cure if any, changes instituted since the default, and the reason for default or missed payment.¹⁰

Other considerations not on the scorecard that may lead to scorecard adjustments

- » Very high or low debt service relative to budget
- » Very high or low overall debt burden (including overlapping debt)
- » Heavy capital needs implying future debt increases
- » Unusually slow or rapid amortization of debt principal (gauged by the percentage of principal repaid within 10 years)
- » Other post-employment benefits (OPEB), the most significant of which is retiree healthcare liabilities, when they have the potential to significantly constrain operational flexibility

Determining the Scorecard-Indicated Rating

To determine the scorecard-indicated rating, each of the assigned scores for the subfactors is converted into a numerical value based on the following scale:

Rating Category	Aaa	Aa	A	Baa	Ba	B and below
	1	2	3	4	5	6

Each subfactor's value is multiplied by its assigned weight and then summed to produce a weighted average score. This score is then mapped to the ranges specified in the table below, and a corresponding alpha-numeric rating is determined based on where the total score falls within the ranges. This produces the grid-indicated rating. This grid-indicated rating is then adjusted up or down, in minimum half-notch increments, for applied notching considerations. A half-notch adjustment up or down may not necessarily result in a change to the final score, depending on the raw grid-indicated score. The outcome of this weighted average approach is one input into our credit analysis of local government General Obligation bonds.

We use both historical and projected financial results in the rating process. Moody's ratings are forward-looking and incorporate our expectations for future financial and operating performance. Accordingly, we may make adjustments to the quantitative factors based on anticipated near-term

¹⁰ See [Moody's Approach for Assessing the Rating Impact of Debt Payments That Are Missed for Operational or Technical Reasons](#) (April 2013)

results. In some cases, confidential information that we cannot publish may inform our expectations for future performance. In other cases, we estimate future results based upon past performance, industry trends, near-term borrowing plans, and other factors. Historical results help us understand patterns and trends for a local government's performance as well as for peer comparison.

Indicated Rating	Overall Weighted Score
Aaa	0.5 to 1.5
Aa1	1.5 to 1.83
Aa2	1.83 to 2.17
Aa3	2.17 to 2.5
A1	2.5 to 2.83
A2	2.83 to 3.17
A3	3.17 to 3.5
Baa1	3.5 to 3.83
Baa2	3.83 to 4.17
Baa3	4.17 to 4.5
Ba1	4.5 to 4.83
Ba2	4.83 to 5.17
Ba3	5.17 to 5.5
B1	5.5 to 5.83
B2	5.83 to 6.17
B3 and below	6.17 to 6.5

Assumptions, Limitations and Rating Considerations Not Covered in the Scorecard

This methodology and scorecard describe generally how we formulate ratings for counties, cities, school districts, and special districts in the US. The methodology and scorecard reflect current rating practices, and capture the factors we believe are most relevant to local governments' long-term credit quality, but it is not an exhaustive discussion of all factors that Moody's analysts consider in every US local government rating.

The rating methodology scorecard incorporates a trade-off between simplicity that enhances transparency and greater complexity that would enable the scorecard to map more closely to actual ratings. The scorecard's four rating factors and 12 subfactors do not constitute an exhaustive treatment of all of the considerations that are important to local government ratings.

In choosing metrics for the methodology scorecard, we have excluded certain factors that are important to ratings but may be either subjective or based on predictions about future events, although such considerations may be important in individual rating determinations. Accordingly, ranking the factors by rating category in a grid would in some cases suggest too much precision and stability in the relative ranking of particular local governments. The expectation that a local government's budgetary process may reach stalemate in the upcoming budgetary cycle is an example of a factor that has not been included in the scorecard but may factor into a rating.

Ratings may also reflect circumstances in which the actual weighting of a particular factor or subfactor is significantly different from the weighting suggested by the scorecard. For example, a local government's multi-year spending trend, severe illiquidity, or persistent retirement system underfunding may pressure the financial stability of the local government so significantly that we feel the scorecard-assigned weighting of one particular factor or subfactor is insufficient. This variation in weighting as a rating consideration can also apply to factors not represented in the scorecard.

Our ratings incorporate expectations for future performance, while much of the information used in the scorecard is historical. In some cases, our expectations for future performance may differ from past performance, and may affect the rating.

How the US Government Bond Rating Can Affect a Local Government Rating

Outside the United States, subsovereign ratings are generally capped at the level of the sovereign, with few exceptions. Given their degree of independence from the credit condition of the US government, the large majority of local governments could be rated higher than the sovereign if the US government were to be downgraded by one notch. Certain local governments, however, have greater exposure to potential federal cuts or are highly dependent on federal employment, procurement, or transfer payments. Therefore their ratings are capped at the sovereign rating¹¹.

Moody's analysis to determine whether a municipal rating is linked to the US government's rating focuses on specific metrics such as federal procurement activity, federal employment and healthcare employment as indicators of economic sensitivity. Medicaid expenditures for states and public hospital expenditures for local governments as indicators of direct exposure to federal spending are also considered, along with the presence of short-term or puttable debt as an indicator of exposure to capital markets disruptions.

¹¹ See Moody's, "[How Sovereign Credit Quality May Affect Other Ratings](#)", published February 2012.

Appendix A: US Local Government General Obligation Scorecard

	<i>Very Strong</i>	<i>Strong</i>	<i>Moderate</i>	<i>Weak</i>	<i>Poor</i>	<i>Very Poor</i>	
	Aaa	Aa	A	Baa	Ba	B & Below	Weight
Economy/Tax Base (30%)							
Tax Base Size: Full Value	> \$12B	\$12B ≥ n > \$1.4B	\$1.4B ≥ n > \$240M	\$240M ≥ n > \$120M	\$120M ≥ n > \$60M	≤ \$60M	10%
Full Value Per Capita	> \$150,000	\$150,000 ≥ n > \$65,000	\$65,000 ≥ n > \$35,000	\$35,000 ≥ n > \$20,000	\$20,000 ≥ n > \$10,000	≤ \$10,000	10%
Socioeconomic Indices: MFI	> 150% of US median	150% to 90% of US median	90% to 75% of US median	75% to 50% of US median	50% to 40% of US median	≤ 40% of US median	10%
Finances (30%)							
Fund Balance as % of Revenues	> 30% > 25% for School Districts	30% ≥ n > 15% 25% ≥ n > 10% for SD	15% ≥ n > 5% 10% ≥ n > 2.5% for SD	5% ≥ n > 0% 2.5% ≥ n > 0% for SD	0% ≥ n > -2.5% 0% ≥ n > -2.5% for SD	≤ -2.5% ≤ -2.5% for SD	10%
5-Year Dollar Change in Fund Balance as % of Revenues	> 25%	25% ≥ n > 10%	10% ≥ n > 0%	0% ≥ n > -10%	-10% ≥ n > -18%	≤ -18%	5%
Cash Balance as % of Revenues	> 25% > 10% for School Districts	25% ≥ n > 10% 10% ≥ n > 5% for SD	10% ≥ n > 5% 5% ≥ n > 2.5% for SD	5% ≥ n > 0% 2.5% ≥ n > 0% for SD	0% ≥ n > -2.5% 0% ≥ n > -2.5% for SD	≤ -2.5% ≤ -2.5% for SD	10%
5-Year Dollar Change in Cash Balance as % of Revenues	> 25%	25% ≥ n > 10%	10% ≥ n > 0%	0% ≥ n > -10%	-10% ≥ n > -18%	≤ -18%	5%
Management (20%)							
Institutional Framework	Very strong legal ability to match resources with spending	Strong legal ability to match resources with spending	Moderate legal ability to match resources with spending	Limited legal ability to match resources with spending	Poor legal ability to match resources with spending	Very poor or no legal ability to match resources with spending	10%
Operating History: 5-Year Average of Operating Revenues / Operating Expenditures	> 1.05x	1.05x ≥ n > 1.02x	1.02x ≥ n > 0.98x	0.98x ≥ n > 0.95x	0.95x ≥ n > 0.92x	≤ 0.92x	10%

	<i>Very Strong</i>	<i>Strong</i>	<i>Moderate</i>	<i>Weak</i>	<i>Poor</i>	<i>Very Poor</i>	
	Aaa	Aa	A	Baa	Ba	B & Below	Weight
Debt/Pensions (20%)							
Net Direct Debt / Full Value	< 0.75%	0.75% ≤ n < 1.75%	1.75% ≤ n < 4%	4% ≤ n < 10%	10% ≤ n < 15%	> 15%	5%
Net Direct Debt / Operating Revenues	< 0.33x	0.33x ≤ n < 0.67x	0.67x ≤ n < 3x	3x ≤ n < 5x	5x ≤ n < 7x	> 7x	5%
3-Year Average of Moody's Adjusted Net Pension Liability / Full Value	< 0.9%	0.9% ≤ n < 2.1%	2.1% ≤ n < 4.8%	4.8% ≤ n < 12%	12% ≤ n < 18%	> 18%	5%
3-Year Average of Moody's Adjusted Net Pension Liability / Operating Revenues	< 0.4x	0.4x ≤ n < 0.8x	0.8x ≤ n < 3.6x	3.6x ≤ n < 6x	6x ≤ n < 8.4x	> 8.4x	5%

Scorecard: US Local Government General Obligation Bonds

Adjustments/Notching Factors	
<i>Description</i>	<i>Direction</i>
Economy/Tax Base	
Institutional presence	up
Regional economic center	up
Economic concentration	down
Outsized unemployment or poverty levels	down
Other analyst adjustment to Economy/Tax Base factor (specify)	up/down
Finances	
Outsized contingent liability risk	down
Unusually volatile revenue structure	down
Other analyst adjustment to Finances factor (specify)	up/down
Management	
State oversight or support	up/down
Unusually strong or weak budgetary management and planning	up/down
Other analyst adjustment to Management factor (specify)	up/down
Debt/Pensions	
Unusually strong or weak security features	up/down
Unusual risk posed by debt/pension structure	down
History of missed debt service payments	down
Other analyst adjustment to Debt/Pensions factor (specify)	up/down
Other	
Credit event/trend not yet reflected in existing data sets	up/down

Appendix B: Moody's Pension Adjustments

The steps we take to adjust reported pension liabilities are:

- » **Allocating cost-sharing plan liabilities.** We allocate to state and rated local governments their proportionate shares of cost-sharing plan (CSP) liabilities based on the share of total plan contributions represented by each participating government's reported contribution. In cases where there is a known actuarially required contribution (ARC) that is greater than the actual contribution, the entity's proportional share will be calculated using the employer ARC relative to the plan ARC.

As governments begin to report their specific shares of CSP liabilities, as expected in the next few years under new GASB standards, we will use these disclosed liabilities rather than the calculated proportional share approach, provided the disclosed liability in each case appears to be reasonable based on our understanding of the government's relationship with the CSP.

- » **Discounting accrued liabilities using a market discount rate.** We use Citibank's Pension Liability Index ("Index") and a common duration of 13 years to adjust each plan's reported actuarial accrued liabilities (AAL). The Index is composed of high credit quality (Aa rated or higher) taxable bonds and is duration-weighted by Citibank for purposes of creating a discount rate for a typical pension plan in the private sector. The reported AAL is projected forward for 13 years at the plan's reported discount rate and then discounted to the present using the Index's value as of the valuation date. This calculation results in an increase in AAL of between 13% and 14% for each one percentage point difference between the Index and the plan's reported discount rate.

As governments and CSPs begin to report plan-specific duration estimates, as expected in the next few years under new GASB standards, we will use these disclosed estimates rather than the 13-year common assumption in the calculation of adjusted accrued liabilities.

Determining the value of plan assets. We value plan assets at the reported market or fair value as of the valuation date.

Note: Market asset values at present are not commonly disclosed for many local government pension plans, but are expected to become available as new GASB reporting standards are implemented in the next few years. Until this data is more consistently available, we will continue to use reported actuarial values of plan assets, but will deduct any reported asset amounts related to deferred contributions receivable.

- » **Calculating adjusted net pension liability.** The difference between the adjusted liabilities and the market or fair value of assets is the adjusted net pension liability. This is the number that Moody's will use to calculate the pension liability ratio incorporated in the local government GO scorecard, as per our rating methodology. Further, our calculation of the adjusted net pension liability for a general government attempts to exclude the portion that is attributable to self-supporting enterprises, if information supporting that conclusion is available.
- » **Amortizing adjusted net pension liability.** The adjusted net pension liability is amortized over a 20-year period on a level dollar basis, using the interest rate provided by the Index. This measure will be considered by rating committees along with other supplementary information about a government's pension obligations.

US Public Finance

Applying Moody's Adjustments to a Government's Pension Liability

Indicative Calculation Example

	(\$000)
Reported AAL	\$50,000,000
Asset Market or Fair Value	\$40,000,000
Assumed investment rate of return	8.00%
Valuation date	6/30/2010
Citibank Pension Liability Index at valuation date	5.47%
Government A contributions to plan / Total employer contributions to plan (i.e. Government A's proportional share)	17.0%
AAL projected forward 13 years at 8.00%	\$135,981,186
Discounted at 5.47%	\$68,045,989
Adjusted net pension liability (ANPL)	\$28,045,989
Government A's 17%share of ANPL	\$4,767,818
Government A's amortization of ANPL	\$397,975

Appendix C: Criteria for Sufficient Information to Assign or Maintain Ratings

If, in our opinion, sufficient information to effectively assess creditworthiness is not available and is unlikely to soon become available, we will decline to assign ratings, or we will withdraw outstanding ratings for a rated entity. If we do not have audited financial statements within 12 months after the end of the fiscal year and do not have sufficient, reliable information to support a credit analysis, we will withdraw the rating. To support ratings on entities with material pension liabilities, we expect regular updates to pension valuations or equivalent measures.

In the US public finance sector, pension valuations commonly lag a government's financial reporting date by six to 12 months. We would view valuation information that lags by more than 24 months to be non-timely and as possible grounds for rating withdrawal.

Appendix D: Framework for Measuring Enterprise or Contingent Liability Risk

Contingent liabilities represent a key credit risk for the small subset of local governments that provide debt guarantees or other financial support for non-essential enterprises and projects. Through the economic downturn and recovery there has been an increase in the number of failing non-essential or otherwise risky enterprises, which have the potential to weigh on local governments that have provided guarantees for these enterprises. Therefore, we may make a downward adjustment to the Finances category score for “Outsized Enterprise or Contingent Liability Risk.”

As discussed under subfactor 4.a, Debt to Full Value, our calculation of an issuer’s debt includes all third-party debt guaranteed by that issuer. Our calculation of debt subtracts out guaranteed (or direct) debt for essential enterprises that are covering debt service from their own operations. However, we do not subtract guaranteed debt for non-essential enterprises, even if a history of self-support exists.

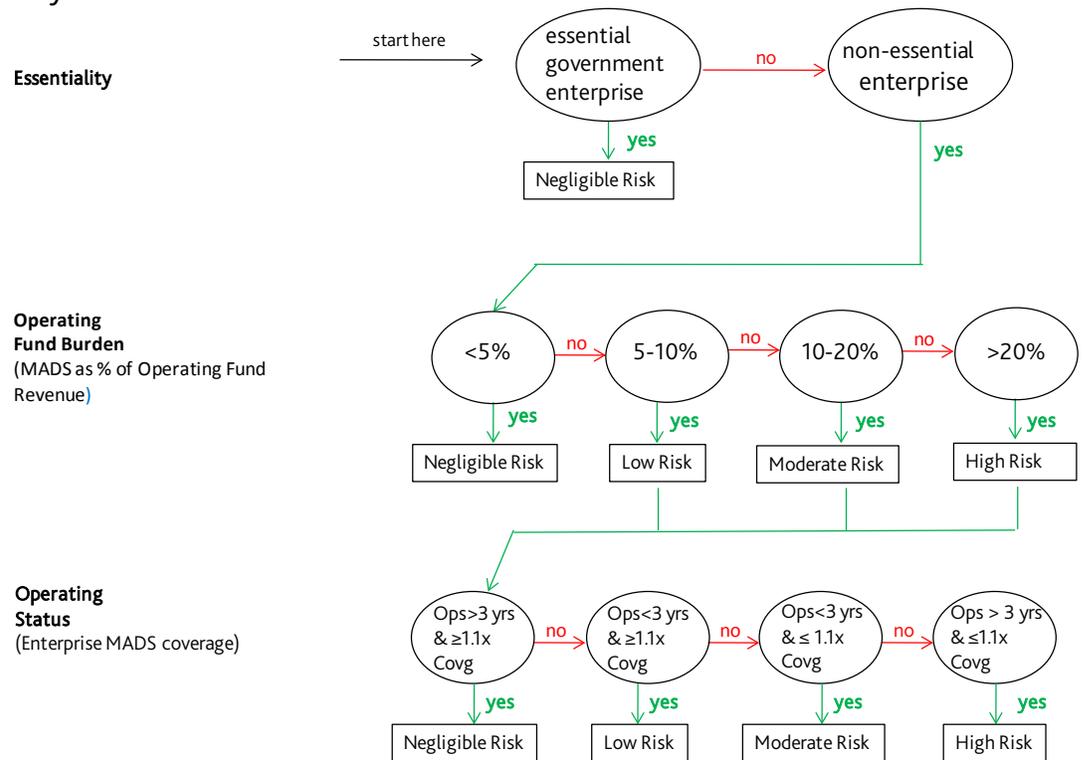
In addition, enterprise or contingent liabilities can pressure an issuer’s finances, when the enterprise fails to perform as expected and the issuer must pay its debt service. We consider a below-the-line adjustment to the Finances score in the scorecard after analysis of additional factors that determine the magnitude of contingent liability risk. These factors include:

- » Effect of non-essentiality of the guaranteed enterprise or project on likelihood or willingness of local government to honor obligation.
 - Generally, we consider water, sewer, stormwater, electric and gas enterprises to be “essential government enterprises” because they tend to be necessary to the health and welfare of the community and are therefore likely to garner strong public support; as businesses, they enjoy a relatively inelastic demand. They also often enjoy a monopoly within the service area, insulating them from competition from the private sector. We will not typically make additional adjustments to the scores of issuers who have guaranteed debt for such enterprises. Less or non-essential enterprises, such as sports arenas, recreation facilities or economic development projects that are directly exposed to market forces, may have limited support and at higher risk of unwillingness by the obligor to honor the liability.
- » Local government’s financial ability to cover debt service
 - In order to account for the potential full effect of a contingent liability to the local government’s operations, we look at the maximum annual debt service (MADS) of the guaranteed debt of the enterprise relative to total operating fund revenues. In general, we consider MADS that falls below 5% of operating fund revenues to present little or minimal risk to a local government’s operations. Once MADS goes above 20% of revenues, we believe the risk is high.
- » Likelihood of the enterprise’s need for financial support from the local government
 - Once we have established the risk to the local government’s operations of the full contingent liability, we explore the likelihood that an enterprise or project’s net revenues will fall short of full debt service. The history of the enterprise’s operations and track record of MADS coverage provide key data to assist in determining the risk the local government will need to

subsidize the debt service. We consider the enterprise to pose little or no risk if it has at least a 3-year operating history that demonstrates 1.1 times coverage of MADS from net revenues. The magnitude of the risk increases with a shorter history of adequate coverage and even more so if there is a history of coverage falling below 1.1 times.

The flow chart below illustrates the analysis that we undertake to determine the magnitude of contingent liability risk to determine whether, and by how much, to adjust the scorecard based on contingent liability risk. There may be additional considerations we include in our analysis as well. If the enterprise's liquidity is constrained, for example, it may need additional external support from the local government when revenues cannot cover expenditures.

Analytic Factor



Source: Moody's

Moody's Related Research

The ratings assigned in this sector are primarily determined by this rating methodology. Certain broad methodological considerations (described in one or more cross-sector methodologies) may also be relevant to the determination of specific ratings in this sector. Potentially related cross-sector rating methodologies can be found [here](#).

For data summarizing the historical robustness and predictive power of credit ratings assigned using this credit rating methodology, see [link](#).

Special Comments:

- » [US Municipal Bond Defaults and Recoveries, 1970-2012, May 2013 \(151936\)](#)
- » [Key Credit Considerations for Municipal Governments in Bankruptcy, January 2012 \(136814\)](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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Evaluating Pension/OPEB Obligations Under Standard & Poor's U.S. Local Government GO Criteria

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Evaluating Pension/OPEB Obligations Under Standard & Poor's U.S. Local Government GO Criteria

Pension and other postemployment benefit (OPEB) obligations are measured under many sets of assumptions and methods and reported according to different sets of standards. Thus, various metrics can be used to evaluate the financial health of a pension or OPEB plan and its plan sponsor. This article will explain some of the metrics Standard & Poor's Ratings Services uses under our recently released U.S. local government general obligation (GO) criteria to further evaluate the risks posed by these liabilities. According to the criteria, the primary focus of our analysis of a local government's pension or OPEB liability is not that the liability will grow or the funded ratio will fall, but whether it requires significant—or significantly increasing—contributions over the medium term. Limited resources or no credible plan for how to pay for these benefits could exacerbate the situation.

Our credit analyses evaluate a local government's near- to medium-term budget stress caused by payments of pension or OPEB contributions and management's actions to reduce that stress. We recognize that most local governments participate in multiple-employer, cost-sharing, state-run pension or OPEB plans, leaving them with few, if any, options to lower the underfunded liability and control the growth rate of their contributions. This focuses our attention on the contributions themselves and the local government's strategy for how to fund them, rather than the size of the unfunded liabilities.

Under Standard & Poor's new local government GO criteria, we make a negative qualitative adjustment to a local government's debt and contingent liabilities score if it has "an unaddressed exposure to large unfunded pension or OPEB obligations, leading to accelerating payment obligations over the medium term that represent significant budget pressure. If there is a plan to address the obligations, the final score worsens by one point; otherwise, the score worsens by two points." (See table 14 of the local GO criteria.) For us to determine whether to apply the adjustment, we consider the variables raised by the criteria:

- Magnitude,
- Timeframe,
- Trends, and
- Managerial actions.

We assess each of these variables to determine the credit impact these obligations can have.

The primary source of quantitative data for this portion of a Standard & Poor's GO credit analysis will be financial statements; the secondary source will be actuarial valuation reports.

Magnitude

Current budget impacts can be measured with a carrying charge. For our purposes, a local government's combined pension and OPEB carrying charge is the sum of its required pension contribution(s)(1), and OPEB contribution(s)(2),

measured as a percentage of its total governmental funds expenditures. Note that if a local government sponsors or participates in more than one pension plan or more than one OPEB plan, the required contributions to all plans will be summed for this calculation. In this way, we can determine the total portion of the most recent annual budget dedicated to pension and OPEB costs.

Under our new local GO criteria, we would consider a combined pension and OPEB carrying charge approaching or exceeding 10% elevated, leading to further review. A carrying charge at this level warrants further review, in our view, because it could be a marker of significant budget pressure in the medium term, if not currently. However, we will consider whether the carrying charges are elevated because a local government is intentionally overfunding the actuarially required amounts (in the case of a pension plan) in an effort to accelerate the pre-funding of its liabilities. We recognize that substantial flexibility to increase revenues or decrease nonpension- and OPEB-related expenditures could allow a local government to absorb carrying charges of 10% or higher into its budget without undue stress and, conversely, that limited flexibility could indicate carrying charges below 10% would cause stress. As such, Standard & Poor's will analyze the magnitude of each local government's carrying charge in relation to the magnitude of its fiscal flexibility, as well.

We also review OPEB carrying charges separately from pensions. These benefits, unlike pensions, typically do not vest and, thus, are not pre-funded because they can be taken away or modified if state laws do not expressly prohibit this or they are not contractual. Under our new local GO criteria, OPEB carrying charges exceeding 5% and limited flexibility to change or amend these benefits could also be a marker of significant budget pressure in the medium term, warranting consideration of the negative adjustment to the debt score, if the government does not have resource flexibility. We will consider whether the OPEB carrying charge is elevated because a local government is funding more than its pay-as-you-go-cost in an effort to pre-fund the liability. The size of the OPEB carrying charges will also be evaluated relative to the ability and political will to adjust the benefits, control costs, adjust other expenditures, or raise additional revenues to avoid budget pressure in the medium term.

We assess medium-term carrying charge growth by reviewing the magnitude of the obligations and--for pension plans--the funded ratios. OPEB plans are typically unfunded if the benefits do not vest and can be reduced or altered. Therefore, a local government that sponsors or participates in an OPEB plan that is entirely unfunded or has a low funded ratio will not necessarily receive a negative adjustment to its debt and contingent liabilities score because it may not lead to medium-term budget stress.

We start by reviewing the largest pension plan the government sponsors and/or participates in because, generally speaking, larger obligations require larger contributions and, consequently, pose greater credit risk than smaller ones. For example, the nominal amount of an actuarially required contribution for a 90% funded multibillion-dollar liability will be much larger than the contribution for a plan with a \$500,000 liability that is 60% funded. However, a plan that has an extremely low funded ratio, such as 40%, regardless of how large or small its liability, bears further review as it could lead to increasing contributions in the medium term.

The liability we review is determined by the type of plan the local government sponsors and/or participates in. For those in multiple-employer cost-sharing plans, a low funded percentage of the overall plan will lead to increased contributions for all, as opposed to specific governments participating in the plan. As such, we will review the overall

funded ratio for that type of plan to try to determine if it will lead to increasing contributions. In an agent multiple-employer or single-employer plan, we will review the liability specific to the local government we are rating. In addition, Standard & Poor's will analyze other plans if it appears the magnitude of their corresponding contributions could substantially increase in the medium term, thereby causing financial pressure for the local government.

Future carrying charges can increase rapidly when a pension plan is underfunded. If a low funded ratio hasn't already led to increased contributions, it is likely in the medium term. If contributions are increasing, local governments could be forced to pay them in ways that weaken credit quality, such as using operating reserves. To assess whether a plan is underfunded, Standard & Poor's will look at its actuarial funded ratio(3), which indicates the sufficiency of the assets set aside in a trust to fund the liabilities due. While the ideal pension plan actuarial funded ratio is 100%, an actuarial funded ratio of 80% or greater, in our opinion, represents adequate progress toward funding future liabilities. We recognize that pension liabilities are long-term obligations and that funded levels may fluctuate over time. If the actuarial funded ratio(s) of the pension plan(s) a local government participates in or sponsors is less than 80%, this could represent evidence of future carrying charge growth and will be an area of analytic focus.

Timeframe

Our analyses, using the new local government criteria, seek to be forward-looking and identify projected continued credit strength or deterioration. Therefore, we will be analyzing budget impacts from growing pension or OPEB funding requirements over the medium term, which we consider the next two to three years. This is consistent with our treatment of significant additional debt plans over the medium term, given both pension/OPEB and debt payments are fixed costs that can cause budgetary stress.

Trends

We analyze trends in funded ratios and contributions, both required and actual, to identify impending budget stress caused by pension or OPEB obligations. We believe that a decreasing trend in funded ratios or in the percentage of required contributions actually contributed will likely lead to an increase in contributions and potential budget stress in the future.

Given that our analysis focuses on the medium term, we are particularly interested in the speed at which the required contributions are increasing. Rapidly increasing required contributions pose greater budget stress than modest increases for which the local government can prepare. A minor drop in the funded ratio may necessitate a small increase in contributions over the long term, while a major drop may require substantially higher contributions as early as the next fiscal year and for several years to come, depending on investment performance and asset-smoothing methods.

In addition to measuring what a local government should be contributing to its pension plan(s) (according to its actuary or legislation), Standard & Poor's evaluates what a local government actually has been contributing to its pension plan(s). Contributing less than required generally leads to larger contributions down the road, and the smaller the percentage of required contributions that is actually contributed, the sooner the increased contributions will be

required. Standard & Poor's collects data on all contributions actually made to all plans a local government participates in or sponsors. The degree to which a local government contributes less than its full required contribution(s) could be an indication of either short-term cash flow issues or management's willingness to defer difficult decisions, both of which could be credit concerns. Certain states allow local governments participating in their multiple-employer plans to contribute less than the required amount in certain years without further penalties. While states may allow these options, we will review each local government's reasons for taking advantage of such an option. A declining trend in the percentage of the required contribution actually contributed typically has credit implications because it most likely means either the pension costs are unaffordable for the local government or it chooses to prioritize spending elsewhere in the budget.

Managerial Actions

If the magnitude of and trend in pension or OPEB metrics indicates a current or potential material budget impact, we evaluate whether management is taking action to handle or prepare for it. If a local government has taken action or developed a plan that we believe is credible and will address its exposure to increased pension or OPEB funding requirements, the debt score will only worsen by one point. On the contrary, if no plan exists or, in our view, it is weak or unrealistic, the local government's debt score will worsen by two points.

In assessing a managerial plan, we first identify the type of plan(s) a local government's employees participate in: cost-sharing multiple-employer state plans, agent multiple-employer state plans, or single-employer plans. In a cost-sharing plan, a local government has no control over benefit levels, plan assumptions, or contributions because all three are decided at the state level. In this case, we would evaluate management's awareness of--and ability to react to--future contribution increases communicated at the state level. Options may include cutting operating expenditures, using dedicated reserves, or proposing a levy increase to voters. In an agent multiple-employer plan, the local government has control over benefit levels and may reduce the liability and, consequently, required contributions, by lowering them. In a single-employer plan, the local government can change assumptions, benefit levels, or contribution levels.

Viable managerial actions depend on the level of control a local government has over assumptions, benefits, and contribution levels. Examples of such actions include:

- Reducing benefits for current retirees, current employees, or new employees
- Cost-control initiatives;
- Increasing employee contributions;
- Establishing and beginning to fund a revocable or irrevocable OPEB trust;
- Identifying a new revenue stream, portion of an existing revenue stream, or portion of year-end surpluses to fund increasing contributions; and
- Closing an existing plan to new employees.

In our opinion, the more significant the payment obligation, the more significant and timely management's response needs to be. For example, we would likely consider increasing contributions significantly for a very poorly funded plan a credible action, while increasing them only slightly may not be. Another example is the choice of the type of OPEB

trust to establish and fund. In our opinion, an irrevocable trust reduces credit risk more than a revocable trust because the funds are secured only for paying OPEB benefits. Funds in a revocable OPEB trust may be released for other uses, so management's intentions must also be discussed for Standard & Poor's to gain comfort that the funds will remain set aside for OPEB benefits alone.

Market Analysis Versus Credit Analysis: Standard & Poor's View

We assess magnitude, timeframe, trends, and managerial actions to factor the risks posed by underfunding pension and OPEB plans into our credit analyses. We are not, however, currently calculating an alternative estimate of pension liabilities or contributions. Given the sheer number of assumptions and methods involved, we believe that a revised estimate of the calculations using the few assumptions and methods that we could feasibly alter for comparative purposes would be at the expense of accuracy.

Our analysis seeks to be forward-looking and identify budget stress from large pension or OPEB obligations over the medium term. Pension and OPEB obligations are a key part of a local government's debt and contingent liabilities score. As mentioned in our recently published view on how the implementation of GASB Statement Nos. 67 and 68 will affect our credit analyses (see "Credit FAQ: Standard & Poor's Approach to Pension Liabilities In Light Of GASB 67 and 68," published July 16, 2013), we view them as long-term liabilities that must be funded over time. While the funding schedule can be more flexible than for a fixed-debt repayment, it can also be more volatile and cause fiscal stress if not properly managed. Therefore, our focus is on the obligations' near-term affordability and management's ability to fund this liability on an ongoing basis.

Notes

(1) A required pension contribution, for our purposes, means a contribution that is either statutorily, contractually, or actuarially required. A contractually required contribution is an amount, typically a percentage of covered payroll, agreed upon in a contract, or collective bargaining agreement, that must be contributed to a pension plan on an annual basis. An actuarially required contribution is the sum of a plan's normal cost (present value of benefits earned during the current year) and an amortization of its unfunded actuarial accrued liability. A statutorily required contribution is an amount, typically a percentage of covered payroll, written into state statutes that must be contributed to a pension plan on an annual basis.

(2) A required OPEB contribution, for our purposes, means the contribution a local government is requiring of itself to contribute on an annual basis, be that its pay-as-you-go cost, actuarially required amount, some combination of the two.

(3) A plan's actuarial funded ratio is the ratio of its actuarial value of assets to its actuarial accrued liabilities. Note that a new metric(s) may be used to assess funded status once the actuarial funded ratio is no longer reported under the new GASB Statement Nos. 67 and 68.

Related Criteria And Research

Related Criteria

USPF Criteria: Local Government GO Ratings Methodology And Assumptions, Sept. 12, 2013

Related Research

Credit FAQ: Standard & Poor's Approach to Pension Liabilities In Light Of GASB 67 and 68, July 16, 2013

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Attachment C

MARCH 31, 2014

Local Pension & OPEB Study Commission



DRAFT

Recommendations to the Governor and General Assembly
Working Document

Next Steps

Pension and OPEB funding issues continue to exist on the local level. The problems are in many instances both severe and urgent, and continued oversight and work with the municipalities is needed to ensure both fiscal stability for the municipalities, and pension and health care security for municipal employees and retirees.

There is a very real debate over how much guidance is welcomed or expected by municipalities but the overarching goal is to provide security and stability for municipalities, retirees, and citizens. Awareness and education is not a compelling enough outcome for the Commission. Recommendations are required by the statute and we should agree to put forth those recommendations that will deliver results.

Recommendations - For discussion purposes

1. Create an optional pathway to MERS that interested communities can follow:
 - Consider providing one-time incentives
 - Provide specific period to reach benchmark funding requirements
 - Allow for re-amortization of recalculated unfunded liability
 - Allow members to retain existing service credits
 - Provide for state/school aid offset in the event of failure to make required funding payments.
2. Amend legislation (R.I. General Laws §44-35-10, §16-2-21.6, §45-5-22) related to collective bargaining fiscal impact statements to include additional language expanding the impact statement to include not only fiscal impact during the term of the proposed contract but also include the proposed contract's future impact for pension and OPEB changes. This would help in identifying any changes in costs as it relates to health care, pension, and OPEB costs for municipalities.
3. Establish continued funding through the Municipal Incentive Aid program for municipalities if certain criteria are met.
 - Amend the statute for municipal incentive aid: if a municipality is not eligible to receive the aid in FY 2014, the respective amount would be reappropriated into the following fiscal year, at which time the amount reappropriated would be distributed to the municipality provided that the municipality has satisfied the eligibility requirements for the prior fiscal year and the current fiscal year. This recognizes that the timing for meeting the guidelines for some municipalities will not impose an unintended punitive effect.
 - Amend the statute so that the Required Funding Contribution only applies to municipalities that have a funded ratio below 100%. The statute requires that pension plans that are not in critical status fully fund the Required Funding Contribution in order to receive the incentive aid.

4. Provide a mechanism for continued oversight of local pension plans (and OPEB plans) to ensure implementation of adopted FIPs, timely submission and governing body approval of FIPs for newly critical pension plans.
 - Develop a stakeholder group of all local plans along with Department of Revenue, Treasury and Office of Auditor General
 - Put FIP guidelines in statute or regulation.
5. Require the State Investment Commission to administer a program which invests assets of locally-administered pension plans on a voluntary basis.
6. Include criteria that the “critical status” of a locally-administered pension plan would be considered under the provisions of the Fiscal Stability Act.
7. Require that plans comply with GASB standards for actuarial methodology, such as entry age normal, smoothing, and actuarial assumptions.
8. Establish penalties if a municipality does not fund its locally-administered pension plan’s Required Funding Contribution.
9. Require the submission of OPEB valuations, similar to the requirements for pension valuations, to the Auditor General and Division of Municipal Finance. Consider annual or two year cycles.
10. Establish a state-wide OPEB trust to maximize efficiencies and investments for local plans. Consider whether a trust should be created by the State or as a collaborative of cities and towns. Both could be established to administer benefits and/or pooling of investments.
11. Require a funding improvement plan for OPEB, similar to the FIP for pensions.

Other ideas?