Local Government Credit Ratings

Fitch Ratings

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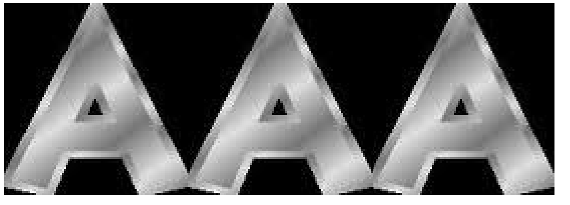
What is a Rating?

- Forward-looking **independent** assessment of credit quality
- Letter representation of the **likelihood of full and timely repayment** over the life of a specific financial obligation
- Key factor: issuer's **ability** and **willingness** to pay on time
  - Ability to pay - quantitative
  - Willingness to pay - qualitative
- Bands of credit quality: AAA, AA, A, BBB …
  - "+" and "-" to denote relative status within major rating categories (not used for 'AAA' or categories below 'B')
  - Outlooks signal trends
  - Watches signal events



Long-term Rating Scale for Public Finance Obligations

Investment grade

AAA: Highest credit quality; lowest expectation of default risk - exceptionally strong capacity for payment of financial commitments unlikely to be adversely affected by foreseeable events

AA: Very high credit quality; very low default risk – very strong capacity for payment of financial commitments not significantly vulnerable to foreseeable events
[This is the average GO rating for local governments.]

A: High credit quality, low default risk – strong capacity for payment of financial commitments might be more vulnerable to adverse economic conditions

BBB: Good credit quality, currently low expectations of default risk – adequate capacity for payment of financial commitments but adverse economic conditions are more likely to impair this capacity

Long-term Rating Scale for Public Finance Obligations

Non-investment grade

BB: Speculative; elevated vulnerability to default risk, particularly in the event of adverse economic conditions over time

B: Highly speculative; material default risk - while financial commitments are currently being met, capacity for future payments is vulnerable to economic deterioration

CCC: Default is a real possibility

CC: Default is probable

C: Default is imminent or inevitable

D: Default

Short-term Rating Scale for Public Finance Obligations

For obligations up to 36 months (e.g. TANs, RANs, TRANs, BANs)

F1+: Highest short-term credit quality and strongest intrinsic capacity for timely payment of financial commitments

F1: Very high short-term credit quality and very strong intrinsic payment capacity

F2: Good short-term credit quality and good payment capacity

F3: Fair short-term credit quality and adequate payment capacity

B: Speculative short-term credit quality, minimal payment capacity, and heightened vulnerability to adverse economic conditions

C: High short-term default risk

D: Default

Rating Outlooks and Watches

Rating Outlooks:

Expected movement in primary credit factors over next 24 months

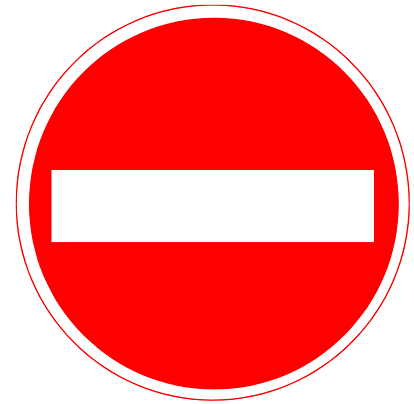
- ***Stable***
- ***Positive*** if credit characteristics trending positive (must be surveilled within 12 months)
- ***Negative*** if credit characteristics trending negative (must be surveilled within 12 months)
- ***Evolving*** if credit characteristics a mix of positive and negative (must be surveilled within 12 months)

Rating Watches:

Heightened probability of a rating change; event-driven; either exact rating implications of an event are undetermined, or the rating implications are known but the triggering event has yet to occur (e.g. regulatory approval); must be surveilled within six months

- ***Positive*** if potential upgrade
- ***Negative*** if potential downgrade
- ***Evolving*** if ratings might be raised, lowered, or affirmed

A Rating is NOT:



- Buy/sell or pricing recommendation
- Opinion about present or future market value
- Prediction of specific percentage of default likelihood over given time period, or possible loss severity in the event of a default (focus = vulnerability to default)
- Judgment or statement regarding any aspect of public policy
- Political statement in favor of or against a particular person or administration
- Dictate of what should be done or how a matter should be handled
- A ‘report card’

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Rating Process

The Rating Process

- The Beginning: Decision and documents
- The Middle: Information collection, rating presentation, and questions
- The End: Rating committee, communication and dissemination through the financial newswires and Fitch Ratings' website
- Appeal process, if necessary
- Surveillance – ongoing reporting requirements by issuer

Surveillance Cycle

Six month review:

- All rating watches
- Long-term ratings ‘B+’ and below
- Short-term ratings ‘F2’ and ‘F3’

12 month review:

- Rating outlook negative, positive, or evolving
- Long-term ratings ‘BBB’ and ‘BB’ categories
- Short-term ratings ‘F1+’ and ‘F1’ (if debt term longer than 12 months)

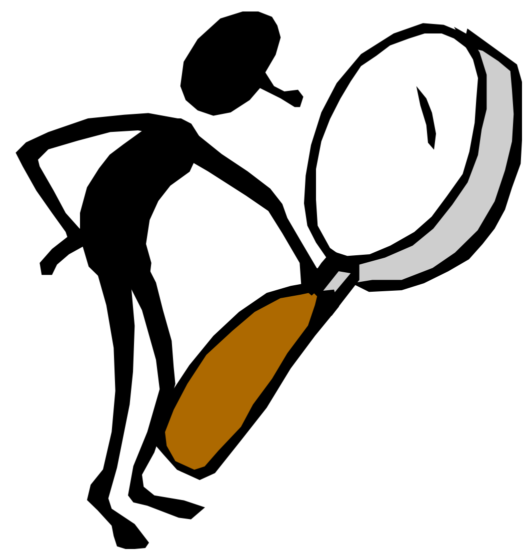
24 month review:

- Ratings ‘AAA’, ‘AA’, and ‘A’ categories, rating outlook stable

Tax-Supported Rating Criteria

To determine the credit quality of a tax-supported security, Fitch considers the legal pledge, lien status, indenture requirements, and relevant statutes within the context of four major factors, their trends, and how they interact:

1. The issuer's debt and other long-term liabilities
2. The local economy and tax base
3. The issuer's financial operations
4. The issuer's management and administration



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The Security Being Rated

How Strong is the Legal Pledge?

Stronger:

- Voter-approved unlimited tax general obligation (ULTGO) or first lien on a broad-based revenue stream
- Additional bonds test >2.0x historically (for special tax bonds)
- Cash-funded debt service reserve (for special tax or appropriation-backed debt)

Midrange:

- Voter-approved limited tax general obligation (LTGO)
- First lien on a fairly diverse revenue stream
- Additional bonds text 1.5x – 2.0x historically
- For appropriation-backed debt: covenant to budget and appropriate lease payments, essential assets

Weaker:

- Lien on a narrow revenue stream
- Additional bonds test <1.5x
- For appropriation-backed debt: non-essential assets; costly project of questionable feasibility

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Debt and Other Long-term Liabilities

Elements of Credit Analysis: Debt

- Debt and capital plan – future issuance? future operating costs of new facilities?
- Affordability / flexibility / debt service coverage
- Dedicated funding sources; ultimate general fund backstop pledge?
- Pay-as-you-go practices
- Exposure to short-term debt, variable-rate debt, derivatives, etc.
- Pension liabilities
- Other post-employment benefit (OPEB) liabilities
- Litigation liabilities

Pension / OPEB Liabilities

Not directly included in an issuer's debt ratios. Somewhat more variable future commitments since they are influenced by a variety of actuarial, accounting, and investment assumptions, and other policy decisions. OPEBs are legally softer obligations and modification is usually easier. Defined contribution plans are considered part of the issuer's operating budget.

Focus of pension analysis:

- Magnitude of unfunded actuarial accrued liability (UAAL)
- Funded ratio (stable or improving? > 70% = adequate; < 60% = weak)
- Measures of affordability (e.g. liability as a percentage of the resource base providing the funding; the percentage of the government's budget needed to make pension contributions)
- Actuarial and other assumptions (Fitch considers funded ratios @ 7% investment return)

Credit positives: Well-funded pension plans; consistent funding of actuarially determined annually required contribution (ARC); where the unfunded liability is sizable, credible plans to reduce it over time (though positive budget impacts, especially from new pension tiers, take time to accumulate)

Credit concerns: High or increasing unfunded liability; annual contributions consistently below the ARC; limited ability to modify future entitlements

Debt “Red Flags”

- Large issuance for non-essential project
- Controversy or lack of governing body consensus about the project
- Unconventional legal structure
- High level of variable rate debt and/or swap obligations (> 15% of total debt)
- Debt refinancing/restructuring that increases debt service in later years
- Low pension funding ratio (< 70%), especially when annual payments are < ARC
- Aggressive discount rate or other overly optimistic pension/OPEB assumptions
- Large OPEB liability with no plan for addressing funding or benefit levels

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Local Economy and Tax Base

Elements of Credit Analysis: Socio-economic Factors

- Provides important context - does the issuer's economic base support balanced ongoing operations and debt repayment? What are potential future financial resources and debt challenges?
- Quality of life attraction
- Tax base composition (residential/commercial/industrial/agricultural)
- Socio-economic status of population repaying the debt
- Local employment market

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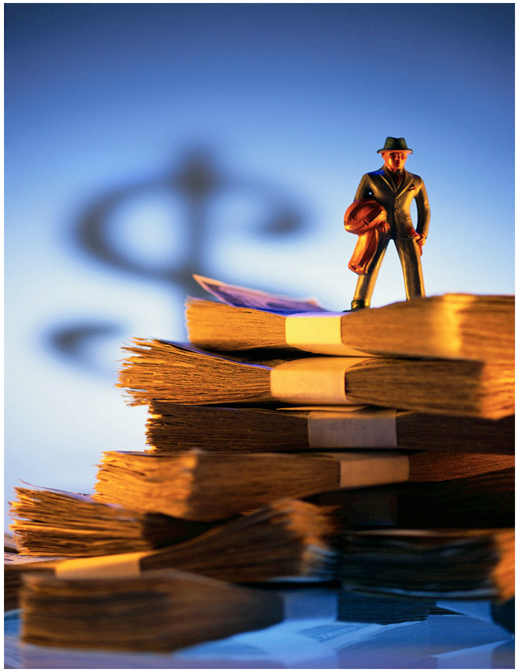
Financial Operations

Elements of Credit Analysis: Financial Performance

- Structurally balanced operations
- Revenue and expense composition and trends
- Liquidity / cash flow
- Prudent reserves
  - Unreserved general fund balance
  - Budget stabilization fund
  - Rainy day reserve fund (automatic funding? limited uses? replenishment requirements?)
- Legal restrictions
- Use of non-recurring revenues
- Contingency planning
- Investment policies and practices



Revenue and Spending Limitations

- Establishing and adhering to policy guidelines is a credit positive.
- Onerous statutory or constitutional operating limitations are potential credit risks.
- An inability to raise revenue or fund programs to adequate levels due to political or other practical concerns can have long-term implications for an issuer's financial or economic health.
- In the event of taxpayer dissatisfaction, environments with easy access to the voter initiative process could see government's legal ability to raise revenues curtailed by voter initiative or legislative action.

Financial Performance “Red Flags”

- No projections for current year ending fund balances and outyear results
- Lack of “what-if” scenarios and tiered contingency plans to address them
- Weakening fund balance, reserves, and liquidity trends
- Reduced financial flexibility; increased reliance on short-term borrowing
- Large amount of receivables (particularly interfund) carried forward from year to year
- Notable mismatch between revenues and spending growth trends; reliance on one-time budget solutions
- History of negative budget-to-actual variances
- Difficulty in obtaining elected officials’ support for tax / fee / rate increases
- Difficulty in gaining elected officials’ support for cost cutting, including service reductions.
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Management and Administration

Elements of Credit Analysis: Management

Management practices and actions can positively or negatively influence the previous major credit factors, affording stronger ratings to entities with limited economic or financial resources or weaker ratings to more diverse or affluent communities

- **Strategic planning**
- **Written, adopted financial management policies**:
  - Implemented?
  - Followed?
  - Fiscal discipline maintained even during downturns?
- **Conservative budget estimates**
- **Regular financial monitoring**
  - e.g. intrayear budget reviews to identify budget gaps as early as possible
- **Disclosure practices**, including compliance with reporting standards
- **Tenure / experience** / ability to work cooperatively with elected officials
- **Labor relations**
- **Taxpayer satisfaction**
- Responses to current economic situation – **contingency planning**

Management "Red Flags"

- Opaque management/governance (e.g. between special districts or authorities and the city/county government)
- Unable to explain variances either between budgeted and actual results or actual results from one fiscal year to the next
- Budgeting or economic assumptions appear overly aggressive
- Risk-taking that appears to be outside the norm (e.g. buying land in the hopes of flipping it to a developer, complicated derivatives)
- Misalignment between management and elected officials.
- Difficulty in obtaining labor concessions and/or onerous and/or long term labor contracts with unaffordable salary commitments

Disclosure "Red Flags"

- Late release of audited financial data
- Qualified audit opinion
- Deficiencies or material weaknesses in internal controls
- Inability to provide standard data (e.g. unaudited year-end results)
- Non-compliance with standard government accounting practices

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Appendix 1: Credit Attributes

Attributes: Stronger Credits

Debt and other long-term liabilities:

- Debt per capita < $2,000; debt to market value < 2%; low debt service burden < 5% of spending
- Modest future capital/debt needs; CIP updated regularly
- Rapid debt amortization , > 65% in 10 years
- Predominantly fixed-rate debt (< 15% variable rate)
- Consistent full funding of pension ARC (UAAL < 20%)
- Effective efforts to reduce OPEB liability

Financial operations:

- Diverse, stable, broad-based, flexible sources of operating revenues
- Ample ability to adjust spending without undue service impacts
- Consistently positive operating margins
- Consistently sound reserve levels
- Substantial available liquidity without borrowing

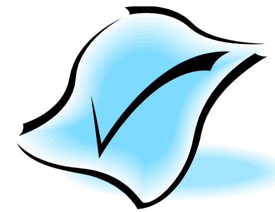
Local economy and tax base:

- Broad, diverse, stable economy
- Taxpayer concentration < 10% for top 10
- Consistent, moderate population and employment growth
- Major employer stability and diversity
- Robust wealth indicators
- Moderate tax burden relative to area and similar communities

Management and administration:

- Highly efficient decision-making process
- High performing elected officials, management
- Good management-labor relations
- Financial management: prudent policies consistently followed; conservative budgeting process; regular financial management reviews; contingency planning; long-term planning; timely reporting

Attributes: Midrange Credits



Debt and other long-term liabilities:

- Debt per capita \$2,000 - \$4,000; debt to market value 2% - 5%; debt service burden 5% - 10% of spending
- Manageable future capital/debt needs; periodic CIP
- Moderate debt amortization , 40% - 65% in 10 years
- Mostly fixed-rate debt (15% - 25% variable/short-rate)
- Consistent full funding of pension ARC (UAAL < 30%)
- Some efforts to reduce OPEB liability

Financial operations:

- Somewhat concentrated operating revenue with some flexibility to increase
- Some ability to adjust spending (potential service and timing impacts)
- General trend of positive operating margins
- Satisfactory reserve levels with some fluctuation
- Sound available liquidity with limited borrowing

Local economy and tax base:

- Fairly diverse economy
- Taxpayer concentration 10% - 15% for top 10
- Stagnant or rapidly growing population
- Moderately diverse employment base with some concentration
- Sound wealth indicators

Management and administration:

- Efficient decision-making process
- Satisfactorily performing elected officials, management
- Reasonably productive management-labor relations
- Financial management: reasonable policies usually followed; realistic budgeting process; able to make midyear adjustments; timely reporting

Attributes: Weaker Credits

Debt and other long-term liabilities:

- Debt per capita > $4,000; debt to market value > 5%
- High debt service burden > 10% of spending
- Large future capital/debt needs; no published CIP
- Slow debt amortization , < 40% in 10 years
- Predominantly fixed-rate debt (> 25% variable-rate)
- Inconsistent full funding of pension ARC (UAAL < 30%)
- Limited efforts to reduce OPEB liability

Local economy and tax base:

- Small, limited, or concentrated economy
- Taxpayer concentration > 15% for top 10
- Declining or extremely rapid population growth
- Industry or employer dominance
- Below-average wealth indicators

Financial operations:

- Severely limited revenue flexibility; revenue declines
- Little spending flexibility
- Trend of negative operating margins
- Low reserve levels without replenishment plans
- Low liquidity; reliant on short-term borrowing (< 15% of general fund receipts)

Management and administration:

- Cumbersome decision-making process
- Unsatisfactorily performing elected officials, management
- Problematic management-labor relations
- Financial management: non-existent or inconsistently followed policies; optimistic budgeting process; inflexible budget adjustment process; inadequate reporting

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Appendix 2: Revenue-supported Debt

Water/sewer, public power, and solid waste enterprise bonds

Revenue-supported Debt Ratings Analysis

Governance: Governing body's effectiveness in establishing and implementing policies

Management: History of successfully meeting strategic goals, responding to changeable operating environment, planning for the future, and meeting industry best practices

Operating profile:

- **Business strategy:** Market position relative to customer demand, industry characteristics, competition, strategic planning, operational flexibility
- **Operational effectiveness:** Ability to generate sufficient resources from operations is evaluated through analysis of revenues (pricing, regulatory/political/market limitations on price levels, customer demand) and expenditures (cost containment, industry-specific factors affecting inputs such as raw materials)
- **Market context:** Market share trends, rate competitiveness, industry reputation, geographic coverage, product differentiation
- **Regulatory issues:** Ability to maintain stable operations in the face of changing external regulation
- **Capital planning and management:** Capital improvement plan flexibility and dedicated funding; deferred maintenance

Revenue-supported Debt Ratings Analysis cont'd

Debt profile:

- **Purpose:** Are planned capital investments justified? Can planned debt be serviced by existing operations (a credit strength)? If relying on incremental revenue to be generated by new capital assets, what is the project completion risk?
- **Magnitude:** Debt size and debt service levels compared to peers; historical and projected revenue streams; issuer's overall cost structure. Investment-grade ratings generally require coverage of debt service by earnings before capital costs (unless extraordinary pricing flexibility or available liquidity).
- **Structure:** Security pledge, interest rate mechanisms, demand features, performance covenants, principal amortization. Most stable configuration = fixed-rate bonds with amortizing principal within the assets' expected life. For variable-rate debt, how will the issuer manage interest rate and liquidity risk?
- **Legal provisions:** Security pledge, rate covenant, default provisions, additional bonds test, reserve requirements, bank bond provisions (if variable rate demand bonds have to be purchased by the liquidity provider).

Financial profile:

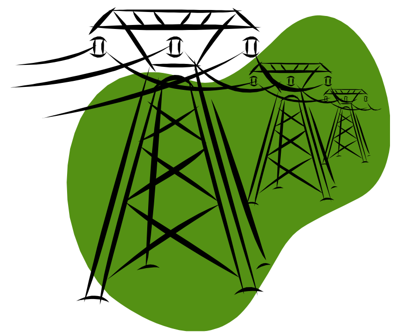
- **Performance metrics:** Historical and projected financial results; stress tests for major forecast assumptions; debt level; key rating consideration = issuer's ability to generate resources from its operations sufficient to fund capital renewal and comfortably meet its debt service obligations.

Revenue-supported Debt Ratings Analysis cont'd

Revenue bond ratings are <u>not:</u>

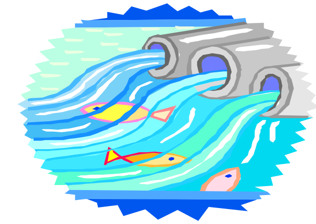
- Notched from the service area's GO bond rating
- Capped by the service area's GO bond rating

In some cases, Fitch rates an entity's utility revenue bonds higher than its GOs.



Water/Sewer Debt Ratings Analysis

Characteristics of a strong water/sewer bond



Debt profile:

- Existing/projected debt per customer of $1,500 or less
- Existing/projected debt per capita of $500 or less
- Debt funding of capital of 50% or less
- Debt amortization of 90% or greater in 20 years
- Rate covenant of > 1.25x ADS by net revenues
- Additional bonds test of > 1.25x MADS by historical net revenues
- Cash-funded debt service reserve at legal maximum

Financial profile:

- Total debt service coverage of 2.0x or more
- One year or more of days cash & days working capital
- Free cash relative to depreciation of 100% or more
- Residential charges for individual or combined water/ sewer utilities < 0.6% or 1.2% of median household income respectively
- Significant percentage of revenues recovered through base charges (rather than volumetric charges)

Operating profile:

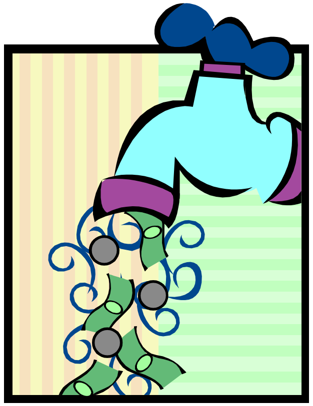
- Customer accounts stable or growing < 1% annually
- Top 10 customers represent 5% or less of revenues
- No customer accounts for > 2% of revenues
- Treatment capacity > 40% of demand or flows
- Annual renewal of 100% or more of depreciated assets
- Unbilled water of < 10%
- Full regulatory compliance

Governance and management:

- Extensive utility sector experience
- Objective, engaged governing body that does not exert political pressure
- Strong governing body/management communication
- For wholesalers, coordinated members
- Frequent forecasting/planning analysis
- Well-developed and documented policies and procedures

Water/Sewer Debt Ratings Analysis – Key Ratios

- Total outstanding long-term debt per customer
- Projected debt per customer – year 5
- Total outstanding long-term debt per capita
- Projected debt per capita – year 5
- Three-year historical average senior lien annual debt service (ADS) coverage
- Senior lien ADS coverage
- Minimum projected senior lien ADS coverage
- Three-year historical average all-in ADS coverage
- All-in ADS coverage
- Minimum projected all-in ADS coverage
- Days cash on hand
- Days of working capital
- Free cash as percentage of depreciation



Public Power Debt Ratings Analysis – Key Considerations

Governance and management strategy:
- Type of governing body
- Management/governing body relationship
- Management's experience and industry knowledge
- Business strategy and planning
- Management's track record at achieving financial and strategic goals
- Relationship among members of joint-action agencies and generation and transmission (G&T) cooperatives

Assets and operations:
- Generation mix
- Generation facilities' historical operating performance
- Load balance or shortfall, plans for meeting additional power needs
- Environmental concerns and compliance
- Fuel supply and hedging contracts
- Off-system power sales/purchases
- Distribution and transmission issues

Cost structure:
- Federal/state regulatory oversight
- Rate-raising flexibility and competitiveness
- Rate adjustment process to ensure timely and adequate cost recovery
- Structure and use of fuel or purchased power adjustment mechanism
- Average total power supply cost relative to peer group
- Generating plant production costs relative to similar plants
- Average wholesale cost of power for joint-action agencies and G&T cooperatives
- Average retail rates by customer classification and comparison to peers

Public Power Debt Ratings Analysis – continued

Financial performance and legal provisions:

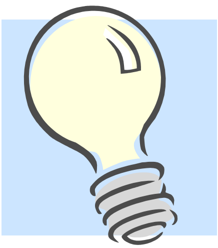
- Five-year analysis of key cash flow, liquidity, leverage ratios
- Financial policies
- Financial projections (key assumptions reasonable?)
- Existing and future debt characteristics
- Financial analyses of largest member of joint-action agencies and G&T cooperatives
- Indenture provisions and bond security features
- Type, length, and renewal terms of wholesale power contracts
- Material pending litigation

Customer profile and service area:

- Economic and demographic makeup and trends
- Customer composition (including breakout of kWh sales and revenues)
- Customer revenue or business sector concentration
- Service area profiles of member systems for joint-action agencies and G&T cooperatives

Key financial ratios:

- Funds available for debt service (FADS)
- Debt service coverage
- Coverage of full obligations
- Debt as % of FADS
- Days cash on hand
- Days liquidity on hand
- Equity as % of capitalization
- Debt service as % of operating expenses
- Debt per customer
- Variable rate debt as % of total debt
- Operating margin
- Capital expenditures as % of depreciation and amortization
- Free cash flow as % of capital expenditures
- Net debt coverage by net utility plant
- General fund transfers as % of operating revenues



Solid Waste Debt Ratings Analysis

Credit and risk factors of governance and management, and the operational, debt, and financial profiles build in complexity from Tier 1 to Tier 3 credits:

Tier 1 credits: Basic collection systems, with disposal contracted out

Tier 2 credits: Collection and landfill disposal systems

Tier 3 credits: Waste-to-energy facilities, sometimes including Tier 2 systems

Highest solid waste revenue bond ratings associated with municipal ownership/operation, with revenue structures benefiting from user fees or assessments collected regularly with property tax/utility bills (typically Tier 1 systems).

Other positive credit factors: Strong waste supply contracts (especially "put or pay" contracts); limited contract renewal risks; economically competitive system; strong service area; sound debt service coverage; high reserve levels; centralized decision-making processes; unilateral ability to set rates and adopt budgets; high billing collection rates; high proportion of residential customers (more stable waste volume).

Negative credit factors: Revenue dependence on waste supply from lower rated corporate participants and a competitive market in which the system does not have competitive rates (typically Tier 3 systems); concentrated customer base and narrow service area; waste contracts or permits with significant renewal risks; liberal rate covenants and additional bonds tests (include projections/reserves); ascending debt service schedules dependent on growth.

Risk mitigants: Strong cash balances, legal covenants, and historical debt service coverage; ability to replace private sector participants; credit structures insulating bondholders from corporate bankruptcy risks; operator performance bonds; contracts/agreements with expirations that match those of debt; high credit quality of guarantor agency.

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Appendix 3: Short-term Debt

Tax-supported Short-term Debt Ratings Analysis

Cash flow borrowings – Tax/Revenue Anticipation Notes (TANs, RANs, TRANs):

- Generally used to offset lumpiness in an entity's cash flow schedule
- Credit factors:
  - Long-term credit characteristics
  - Cash flow – historical and forecast
  - Note repayment coverage
  - Borrowing as a percentage of total receipts
  - Liquid internal borrowables
  - Structural or legal features (e.g. timing of advance note repayment set-asides)

Bond Anticipation Notes (BANs):

- Generally used as interim financing for capital projects
- Credit factors:
  - Market access (since ability to refinance the notes at maturity usually depends on issuing additional debt): focus on issuer's (a) long-term credit characteristics, (b) past success in selling similar notes, and (c) general track record in debt markets
  - Necessary project approvals (when BAN proceeds being used to fund early stages of a capital project)
  - Additional pledge of GO or other revenue source if market access is denied

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