MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns Aa1 to Ohio's $251M GO Highway Capital Improvement Bonds, SeriesR

Global Credit Research - 13 May 2014

$8.5B of general obligation bonds outstanding

OHIO (STATE OF)
State Governments (including Puerto Rico and US Territories)
OH

Moody's Rating

ISSUE	RATING
General Obligation Highway Capital Improvements Bonds Series R (Full Faith and Credit/Highway User Receipts)	Aa1

Sale Amount	$250,735,000
Expected Sale Date	05/28/14
Rating Description	General Obligation

Moody's Outlook STA

Opinion

NEW YORK, May 13, 2014 --Moody's Investors Service has assigned a rating of Aa1 to Ohio's $250.7 million General Obligation Highway Capital Improvements Bonds, Series R. The bonds, which will fund capital improvements of the state's highways, are scheduled to be priced May 28. The outlook is stable.

SUMMARY RATING RATIONALE

The state's Aa1 GO rating reflects strong financial management proven through generally proactive responses to budget shortfalls, recent revenue growth and improved financial position, economic growth that will lag the nation, and moderate, affordable debt, pension and OPEB liabilities. Ohio's highway bonds are also secured by a pledge of state highway user revenues, such as gasoline taxes. Fiscal 2013 highway user receipts were $2.7 billion, compared to $135 million of highway capital improvement debt service. Debt issuance under the highway bond program is limited to $220 million annually, and total outstanding debt is capped at $1.2 billion. There are currently $612.6 million of GO Highway Capital Improvement bonds outstanding.

STRENGTHS

-- Conservative fiscal management demonstrated by rapid reserve rebuilding after the recession

-- Established practice of prompt action to address budgetary shortfalls

-- High levels of internal liquidity including available balances outside the general revenue fund

-- Relatively moderate long-term liabilities that are affordable compared to the state's budget

-- Statutory requirement to deposit surplus year-end revenues to the Budget Stabilization Fund

CHALLENGES

-- Economy that remains vulnerable to external disruptions, given manufacturing industry exposure

-- Lack of certain best financial management practices

DETAILED CREDIT DISCUSSION

ADDITIONAL TAX REFORM PROPOSED IN MID-BIENNIAL BUDGET REVIEW

In the mid-biennial budget review (MBR), the governor proposed additional income tax rate reductions of 8.5% over the next three years, partially offset with rate increases on tobacco taxes and the Commercial Activity Tax, and a new oil and gas severance tax. When combined with the impact of tax reform passed with the 2014-2015 biennial budget, the net revenue impact would lower state General Revenue Fund revenues by $3.1 billion between fiscal 2014 and fiscal 2017. The most-recent proposed tax reform would partially offset the $2.6 billion income tax reduction over the next three years with various tax increases and introduction of a tax on non-cigarette tobacco products, including e-cigarettes, and a new oil and gas severance tax. Reliance on these new untested revenue sources to partially balance the income tax reduction could introduce budget risk, but the state has a recent history of relatively conservative revenue assumptions.

REVENUES THROUGH APRIL SLIGHTLY ABOVE BUDGET

Through April, tax revenue was 14.3% below fiscal 2013 and 1.1% ($261.7 million) above budget. Auto sales and use taxes were 3.4% above budget and 10.8% over prior-year revenues. Year-to-date sales taxes in all other areas were 0.6% below budget, but have narrowed the gap since September. The second largest revenue source, personal income taxes, was 3.9% ($254 million) ahead of budget. Total disbursements were 3.3% below budget through April. Spending in K-12 education was 2.4% ($136 million) over budget through April, which the state attributes to more front-loaded spending patterns under a new funding formula. The state projects this will be balanced with slower spending in the latter part of the fiscal year. In October, the state authorized Medicaid expansion through the Controlling Board, a seven-member panel including legislators and officials that can make certain budgetary adjustments. Expansion was effective on January 1 and will have minimal budgetary impact because the additional enrollment will be covered by an estimated $562 million of federal funds for fiscal 2014. Through April, Medicaid expenditures were 4% (or $500.2 million) below budget, but the state expects these savings are a temporary result of the Affordable Care Act's protracted roll-out.

BIENNIAL BUDGET INCLUDES SIGNIFICANT TAX REFORM

The adopted fiscal 2014-2015 biennial budget includes significant tax reform that would result in net revenue losses of $1.16 billion in fiscal 2014 and $813 million in fiscal 2015. Key elements of the reform include a 10% personal income tax rate reduction over the next three years and a 0.25% sales tax rate increase effective September 2013. The $1.16 billion fiscal 2014 revenue loss will be filled with spending controls and $836 million of fund balance carried over from the prior fiscal year, in part to fund the tax reform. By fiscal 2015, the budget estimates that the gap will be filled with strong baseline revenue growth and $100 million of carryover fund balance. We view the fiscal 2015 budget as vulnerable to slower-than-expected baseline revenue growth, particularly in light of recent fluctuations in Ohio's job growth trends.

The adopted budget includes reasonable 0.3% and 5% baseline tax revenue growth rates in fiscal 2014 and 2015, respectively. Including the impact of tax reforms, total tax revenues are budgeted to decline 4.9% in fiscal 2014 and grow 8% in fiscal 2015. The strong 8% growth in fiscal 2015 assumes additional growth in domestic insurance taxes and sales taxes on managed care companies due to the Affordable Care Act. Baseline sales taxes are projected to grow 4.1% and 4.7% in fiscal 2014 and 2015, which is in line with 4.4% year-over-year growth in fiscal 2013. Baseline personal income tax is conservatively projected to decline 0.7% in fiscal 2014 due to the acceleration of income into 2012 to avoid higher federal taxes. Fiscal 2015 income taxes are budgeted to rebound with 6.9% growth.

General Revenue Fund (GRF) appropriations (including federal funding) are budgeted to grow 10.3% over the fiscal 2013 level to $30.3 billion in fiscal 2014 and another 4.7% to $31.7 billion in fiscal 2015. The state-only portion of the GRF is budgeted to grow 6.7% and 4.2%, respectively, in fiscal 2014 and 2015. The adopted budget includes 230,000 new Medicaid participants (the woodwork effect) and various Medicaid reforms to accommodate the Affordable Care Act. The state's originally adopted budget contained Medicaid appropriation increases of 12.2% in fiscal 2014 and 6.5% in fiscal 2015, despite various cost-containment measures. The state's Medicaid cost containment in the past two years has successfully lowered actual expenditures below budgeted levels. Other key appropriations in the biennial budget include 5.9% and 5.7% growth in K-12 funding from the GRF, and 1.8% and 2.6% increases for higher education.

STRONG FISCAL 2013 FINANCIAL PERFORMANCE; RESERVES ALSO AUGMENTED BY JOBS OHIO PAYMENT

The state made its third consecutive deposit into the Budget Stabilization Fund (BSF) in early fiscal 2014, bringing the fund to $1.48 billion (5% of fiscal 2013 general revenue fund revenues), its statutory maximum. Based on continued strong revenue performance and below-budget spending, as well as $500 million from the lease of the state's liquor enterprise to JobsOhio, the state made a $996 million deposit to the BSF. This will be the first time since fiscal 2000 that the BSF is funded to its statutory maximum. The statutory requirement to deposit surpluses in excess of 0.5% of general revenue fund revenues into the Budget Stabilization Fund generally accelerates reserve restoration, although the legislature has diverted surpluses to other uses in past years.

The state's financial position has also improved on a GAAP basis. Fiscal 2013 audited results reflect an increase in available fund balance (unassigned fund balance, including the BSF, plus assigned fund balance) to $3.3 billion (13.3% of GRF revenues) from $1.25 billion (5% of revenues) in fiscal 2012.

The long-term lease of the state liquor enterprise to JobsOhio that provided for the $500 million BSF contribution terminates in January 2038. In addition to the up-front payment, the state will receive 75% of excess net profits above an agreed-upon threshold. Litigation filed in April 2011 challenges the creation of JobsOhio, a non-profit corporation formed to lease the enterprise. The state Supreme Court in November heard arguments on the case and has yet to issue a decision.

ECONOMY REMAINS STABLE OVERALL, DESPITE SLOWING JOB GROWTH

The Midwest region's initially strong post-recession growth has slowed, and Ohio's recent trends are slightly lagging the region. The manufacturing, healthcare and energy sectors have been key components of Ohio's stabilized economy, although job growth trends have been somewhat mixed in recent months. In the 12 months ending March 31, Ohio's non-farm employment grew only 1.02%, down from approximately 2% in mid-2012, and below the nation's 1.66%. Nonfarm jobs remain 171,000 short of the 2006 peak, and, at 5.28 million in February 2014, Ohio's employment has fallen back to 1996 levels. The state's unemployment rate has declined in the past several months, to 6.1% in March from 7.4% in October. The unemployment rate is now below the US rate of 6.7%. Some of the March unemployment rate decline is attributable to the 0.19% decline in labor force. Prior to March, the state's labor force has been stable for the first time since mid-2009, with flat or slightly improving trends since June 2013.

The state's personal income growth has been at or above the nation's level since mid-2011. Ohio's preliminary 2013 per-capita personal income ($40,865) improved slightly relative to the US, to 92%, from 90% in 2008.

Eastern Ohio has benefited from growing exploration of the Marcellus and Utica shales, which are encouraging private investment in drilling, steel manufacturing, and natural gas and petroleum processing. According to Moody's Analytics, manufacturing will continue modest growth in 2014 as sectors like aerospace make up for softening in auto manufacturing and steel tubular manufacturing. The healthcare sector will provide medium-term stability, but is also currently hampered by lower Medicaid reimbursement rates. In addition, government employment has contracted in the past 12 months, declining 1.2%. Manufacturing and healthcare expansion will encourage economic growth in 2014, but growth will lag the nation due to negative demographic trends.

STATE DEBT BURDEN REMAINS MODERATE

Ohio has maintained a moderate debt burden relative to other states. The state's debt burden is consistent with the 50-state median, at 2.8% of personal income, and has declined over time relative to other states. Ohio ranks 26th among states based on net tax-supported debt as a percentage of personal income, down from 20th in 2005. Ohio has about $586 million of variable-rate debt outstanding, for which the state has maintained an internal liquidity program for tendered bonds that are not remarketed. The ratings on these bonds are VMIG 1, reflecting the state's strong management of available liquid resources. Ohio had $4.1 billion of same-day liquid assets as of March 31, 2014, on a discounted basis, and has access to an additional $942.6 million of weekly liquidity (discounted).

The state is a party to five swap agreements with a combined notional amount of $449 million that hedge interest rate risk on its variable obligations. Collateral posting requirements are pegged to rating levels starting at A3 and lower, and termination provisions are triggered if the state's rating falls below Baa3 (Moody's) or BBB- (S&P). Triggers at these low rating levels introduce minimal risk to the state. As of June 30, 2013, the combined mark-to-market on the swaps was negative $55.8 million.

In April 2014, the state authorized $2.4 billion of additional capital expenditures for the fiscal 2015-2016 biennium, of which $2.17 billion will be funded with debt. The state authorized $1.46 billion of general obligation debt and $634 million of appropriation-backed borrowing. Moody's expects that, net of principal pay-downs, the state's debt burden will remain relatively stable with this additional borrowing.

Like many states in the US, Ohio has been evaluating ways to fund transportation projects. The state has opted to fund $1 billion of transportation projects in the northern region (within a 75-mile range of the Ohio Turnpike) with debt issued in 2013 by the Ohio Transportation and Infrastructure Commission, secured by toll revenues of the turnpike. An additional $500 million is expected to be issued for state transportation projects over the next five years.

PENSION AND OPEB LIABILITIES ARE AFFORDABLE

Ohio's pension liability and annual contributions remain affordable despite the growth in liability and declines in the reported funded ratio since 2008. After several consecutive years of declines in funded ratio, the funded ratio for the state's largest pension fund improved to 81% in 2012 from 77%. This reflects both improved investment returns and the impact of pension reform (discussed below).

Based on the state's fiscal 2012 pension data, we have calculated that its adjusted net pension liability (ANPL) was 32.0% of revenues. The 50-state median ANPL to revenues is 63.9%, and Ohio ranks 42nd in this ratio. Our adjustments to reported state pension data include the common 20-year amortization period, as well as an assumed 13-year duration of plan liabilities and a market-based discount rate to value the liabilities, rather than the long-term investment return used in reported figures. Our adjusted liability amounts currently exclude the state's smallest plan, the highway patrol retirement system (HPRS), which reported an unfunded liability of $966.3 million in the most recent actuarial valuation as of December 31, 2012.

In September 2012, Ohio approved pension reform legislation that will return the state's plans to a 30-year amortization, assuming level contributions at 14% of payroll. Favorably, benefits are not guaranteed by the state, and are not subject to collective bargaining. The reform took effect in January 2013 and reduces benefits in OPERS (members only) and STRS (members and retirees), and also increases contributions in STRS. The state estimates that the reform reduced the OPERS and STRS liabilities by $3.2 billion and $15.7 billion, respectively.

Unlike most states, which fund other post-employment benefit (OPEB) obligations on a pay-as-you-go basis, Ohio's OPEB programs have substantial assets ($17.1 billion) pledged to cover liabilities. After the 2012 reforms, OPEB liabilities dropped materially, and the state's aggregate funded ratio as of the most recent valuations is 65%. Pension and OPEB benefits are not vested until an employee retires, and contribution requirements and benefit levels could be changed for future and current employees. The state's pay-go portion in 2012 for OPEB was about $110 million, a minimal portion of its budget.

OUTLOOK

The stable outlook for the State of Ohio is based on our expectation that reasonable budget assumptions and proactive financial management will continue to support an improved financial position. It also reflects our view that the state's economy will remain stable, despite relatively weak demographic trends.

WHAT COULD MAKE THE RATING GO UP

- Significant increase in reserves and fund balance position meaningfully above historic levels

- Economic performance that exceeds national averages over an extended period

WHAT COULD MAKE THE RATING GO DOWN

- Evidence of financial deterioration, including a return to budgetary structural imbalance

- Sustained weakening of GAAP-basis general fund balances and liquidity position

- Persistent economic weakness, reflected in below-average employment growth, personal income growth or demographic trends

The principal methodology used in this rating was US States Rating Methodology published in April 2013. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

Please see the ratings tab on the issuer/entity page on www.moodys.com for additional regulatory disclosures for each credit rating.

Analysts

Baye Larsen
Lead Analyst
Public Finance Group
Moody's Investors Service

Edward Hampton
Additional Contact
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653

Moody's Investors Service, Inc.
250 Greenwich Street
New York, NY 10007
USA

MOODY'S
INVESTORS SERVICE