

New Issue: Moody's Assigns Aa2 to \$165M of Ohio lease appropriation bonds; outlook stable

Global Credit Research - 19 Dec 2014

State has \$1.6B of appropriation-backed debt outstanding

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

Moody's Rating

ISSUE	RATING
Capital Facilities Lease-Appropriation Bonds, Series 2015A (Administrative Building Fund Projects) (Tax-Exempt)	Aa2
Sale Amount	\$61,975,000
Expected Sale Date	01/12/15
Rating Description	Lease Rental: Appropriation
Capital Facilities Lease-Appropriation Bonds, Series 2015A (Transportation Building Fund Projects) (Tax-Exempt)	Aa2
Sale Amount	\$85,600,000
Expected Sale Date	01/12/15
Rating Description	Lease Rental: Appropriation
Capital Facilities Lease-Appropriation Bonds, Series 2015B (Administrative Building Fund Projects) (Federally Taxable)	Aa2
Sale Amount	\$18,025,000
Expected Sale Date	01/12/15
Rating Description	Lease Rental: Appropriation

Moody's Outlook STA

Opinion

NEW YORK, December 19, 2014 --Moody's Investors Service has assigned Aa2 ratings to Ohio's \$165 million Capital Facilities Lease-Appropriation Bonds Series 2015A and 2015B. Proceeds of the bonds, scheduled to price the week of January 12th, 2015, will help finance state transportation projects and capital projects at a variety of other state facilities.

SUMMARY RATING RATIONALE

The Aa2 ratings, a notch below the state's Aa1 general obligation (GO) rating, reflect the need for biennial legislative appropriation of lease payments backing the bonds. There are no bondholder remedies in the event of non-appropriation. However, roughly a fifth of the state's net tax-supported debt is subject to appropriation, and the importance of maintaining access to the capital markets provides strong incentive for future legislatures to make the required appropriations.

The state's Aa1 GO rating is supported by strong and proactive financial management, including timely response to budget shortfalls and moderate, affordable debt, pension and other post-employment benefit (OPEB) liabilities. Recent revenue growth has helped improve the state's financial position, mitigating exposure to an economy that

that will lag the nation.

STRENGTHS

- Conservative fiscal management including sound budgeting and proactive responses to 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 in the Budget Stabilization Fund

CHALLENGES

- Economy that remains vulnerable to manufacturing industry exposure
- Potential revenue reductions from tax reform that could threaten the state's balanced financial operations
- Lack of certain best financial management practices

DETAILED CREDIT DISCUSSION

BONDS ARE SECURED BY LEASE AGREEMENTS WITH OHIO PUBLIC FACILITIES COMMISSION

The 2015A and 2015B bonds are secured by two separate lease agreements between the Ohio Public Facilities Commission (OPFC), as lessor, and two state government units: the

Department of Transportation (DOT) and the Department of Administrative Services (DAS). Appropriations for each department's lease obligations are provided separately. The OPFC is a state agency composed of six state officials: the governor, attorney general, state auditor, secretary of state, treasurer, and budget director. Although OPFC is the lessor, pursuant to each lease agreement, the lessees (DOT and DAS) are required to make lease payments to the treasurer. The lease payments are assigned and remitted directly to the trustee at least two days prior to the debt service payment dates.

The lease agreements stipulate that the obligation to make rental payments is contingent only on the appropriation of funds by the legislature, and not on whether the financed projects are in use. Rental payments are not subject to termination, abatement or set-off, except in the event the legislature does not appropriate funds. Interest payment dates (October 1 and April 1) are far enough removed from the July 1 start of the state's fiscal biennium to limit risk of an event of non-appropriation due to late budget adoption. There are no debt service reserve funds associated with these issues, and there are no bondholder remedies in the event of non-appropriation. The ratings are also supported by the treasurer's explicit authority under the enabling legislation to issue lease revenue obligations for capital facilities on behalf of state agencies. The importance of maintaining continued market access for subject-to-appropriation lease debt, in general, provides a strong incentive to continue making appropriations in a timely manner. About a fifth of Ohio's net tax-supported debt requires appropriation for payments.

STATE WILL USE RECENTLY-INCREASED RESERVES TO PARTIALLY BALANCE TAX REFORM

During the mid-biennial review, the state adopted various tax reforms that decrease fiscal 2015 and 2016 revenues by a manageable \$388 million and \$76 million, respectively. These reforms include a temporary increase of the small business tax deduction for calendar 2014, increases to the earned income tax credit and the state income tax personal exemption, and an acceleration of the final phase of the income tax rate reduction that was adopted with the 2014-2015 biennial budget. While the incremental impact is modest, the revenue impact is significant when combined with tax reform adopted at the beginning of the biennium (as discussed further below). The combined fiscal 2014 and fiscal 2015 net revenue impact of all the tax reform will be a \$2.4 billion reduction, 6% of combined tax receipts.

The state plans to use accumulated fund balances to cover certain temporary reforms and the phase-in of permanent income tax reductions. General Revenue Fund balances are projected to fall to \$632 million (3% of revenues) at the end of fiscal 2015, from a recent high of \$2.3 billion (11% of revenues) in fiscal 2013.

Key elements of the initial 2014-2015 tax reform include a 10% personal income tax rate reduction over the next three years and a 0.25% sales tax rate increase that took effect September 2013. The \$881 million fiscal 2014 revenue loss was offset through spending restraint and approximately \$963 million of fund balance carried over from Fiscal 2013. By fiscal 2015, the budget estimated that the gap would be filled with moderate baseline revenue

growth and \$748 million of carryover fund balance. While fund balances have been supported by favorable financial performance, 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.

SOUND BUDGET MANAGEMENT IMPROVES STABILITY THROUGH ECONOMIC RECOVERY AND TAX REFORM

Ohio's conservative budget management and continued economic growth have led to favorable financial performance, allowing for gradual absorption of tax reform impacts. The state's recent budgetary cash balance levels exceeded expectations, reaching \$1.7 billion (8.4% of revenues) in fiscal 2014, compared to an original projection of \$726 million. Despite the fiscal 2014 tax reform and fiscal cliff impact, income taxes exceeded budget by 2.7% (\$215 million). The state budgeted a 17% decline in fiscal 2014 income taxes, which included the impact of an 8.5% income tax reduction, various other reforms and a 1% decline caused by taxpayer reaction to the fiscal cliff. Total fiscal 2014 tax receipts exceeded budget by 0.9% (\$175.5 million). In addition, actual fiscal 2014 disbursements were 3.4% (\$1.1 billion) below budget. Results through November 2014 continue this trend: tax receipts were 2.2% above budget and disbursements were 3% below budget.

BIENNIAL BUDGET REFLECTS HIGH COST GROWTH AND REASONABLE REVENUE ASSUMPTIONS

The biennial budget, as adopted in June 2013, included 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 were budgeted to decline 4.9% in fiscal 2014 and grow 8% in fiscal 2015. With the mid-biennial review, the state adjusted total fiscal 2015 tax receipts down to \$21 billion from \$21.6 billion, incorporating both the additional tax reform (\$409 million) and baseline adjustments (\$140 million). The growth assumption has therefore declined to 4.4% from 8%, which also incorporates the higher-than-expected fiscal 2014 receipts.

While the mid-biennial review incorporated minor adjustments to General Revenue Fund (GRF) appropriations, total budgeted growth (including federal funding) is essentially unchanged. Appropriations were budgeted to grow 4.7% to \$31.7 billion in fiscal 2015, following projected growth of 10.3%, to \$30.3 billion, in fiscal 2014. The state-only portion of the GRF grew by 5.3% in Fiscal 2014 (not including transfers), and is expected to grow by 4.2% in fiscal 2015. The adopted budget includes 230,000 new Medicaid participants and various Medicaid reforms to accommodate the federal 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 a \$996 million deposit - its third consecutive deposit - into the Budget Stabilization Fund (BSF) early in fiscal 2014. At \$1.48 billion (5% of fiscal 2013 general revenue fund revenues), the BSF has reached its statutory maximum for the first time since fiscal 2000. 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 general fund balance (unassigned fund balance, including the BSF, plus assigned fund balance) to \$3.3 billion (13.2% of GRF revenues) from \$1.25 billion (5% of revenues) in fiscal 2012. As discussed above, we expect these balances to decline during the next two years as the state implements tax reform.

The long-term lease of the state liquor enterprise to JobsOhio that provided for the \$500 million GRF 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. In June 2014, the state Supreme Court dismissed litigation filed in April 2011 challenging the creation of JobsOhio, a non-profit corporation formed to lease the enterprise.

ECONOMY REMAINS STABLE OVERALL, DESPITE SLOWING JOB GROWTH

After a strong initial post-recession recovery, Ohio's job growth has been below the national average. In the 12 months ending October 31st, 2014, Ohio's non-farm employment grew only 0.7%, down from approximately 2.3% in mid-2012, and below the nation's 2%. Nonfarm jobs remain 149,000 short of the 2006 peak, and, at 5.3 million in September 2014, Ohio's employment has fallen back to 1996 levels. The state's unemployment rate has been

below the US rate since February 2014 and was 5.0% in November (preliminary), compared to 5.8% for the US. The state's personal income growth has been at or above the nation's since mid-2011. Ohio's preliminary 2013 per-capita personal income (\$41,049) improved slightly relative to the US, to 92%, from 90% in 2008.

Overall, manufacturing, healthcare and professional services have been key components of Ohio's stabilized economy. According to Moody's Analytics, Ohio's recovery will lag the nation due to weaker demographics, but the state's economy will strengthen through 2014 and early 2015, due to strong car and aerospace manufacturing, high healthcare demand, and growing professional services such as consulting and computer design, in Cincinnati and Cleveland.

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 2.7% 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 \$553 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 \$3.13 billion of same-day liquid assets as of September 30, 2014, on a discounted basis, and has access to an additional \$1.2 billion of weekly liquidity (discounted).

The state is a party to five swap agreements with a combined notional principal of \$434 million that hedge interest rate risk on its variable-rate 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, 2014, the combined mark-to-market value of the swaps was negative \$49.9 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 its northern region (within a 75-mile range of the Ohio Turnpike) with proceeds of 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 reported funded ratio for the state's largest pension fund improved to 82% in 2013 from 77%. This reflects both improved investment returns and the impact of pension reform.

Based on the state's fiscal 2013 pension data, we have calculated that its adjusted net pension liability (ANPL) was 33% of revenues. The 50-state median ANPL to revenues is 60.3%, and Ohio ranks 41st 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 include the three major state plans, the Ohio Public Employees Retirement System, the State Teachers Retirement System, and the Highway Patrol Retirement System.

In September 2012, Ohio approved pension reform legislation that ensures state plans comply with a 30-year amortization period, assuming level contributions at 14% of payroll. 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 for STRS. The state estimates that the reform reduced the OPERS and STRS liabilities by \$3.2 billion and \$15.7 billion, respectively, although the state's share of the STRS liability is minimal.

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 substantially, 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 can be changed for future and current employees. The state's pay-go portion in 2012 for OPEB was about \$75 million, a minimal portion of its budget.

OUTLOOK

The stable outlook for Ohio is based on our expectation that reasonable budget assumptions and proactive financial management will support a satisfactory 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

- 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
- Weakening of GAAP-basis general fund balances and liquidity position below current expectations
- Persistent economic weakness, reflected in below-average employment, personal income or demographic trends

RATING METHODOLOGY

The principal methodology used in this rating was The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in December 2011. Please see the Credit Policy page on www.moody.com for a copy of this methodology.

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Analysts

Aaron Ampaw
Lead Analyst
Public Finance Group
Moody's Investors Service

Edward Hampton
Backup Analyst
Public Finance Group
Moody's Investors Service

Nicholas Samuels
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



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