Rating Methodology

Moody's
U.S. Public Finance

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Credit Aspects of Build America Bonds

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Revision

Moody's has issued a revised report related to the credit aspects of Build America Bonds originally issued last month. The revised report eliminates references to Recovery Zone Facility Bonds that were erroneously characterized in the initial report as a type of Build America Bonds.

Summary Opinion

Build America Bonds ("BABs") have begun to expand the market for state and local government issuers of bonds by attracting non-traditional municipal bond buyers to this emerging taxable bond market segment. Many of these bonds are structured like traditional taxable corporate securities with long-term bullet maturities and either no call provisions or "make whole" call provisions. Others have characteristics of traditional municipal bonds, with an amortizing structure and optional 10-year call provisions. It is unlikely that, in isolation, these structural elements would have a significant impact on an issuer's credit. However, over time, if non-callable, non-amortizing BABs were to grow as a percentage of an issuer's outstanding debt, these structural elements could negatively impact the way we view that issuer's financial flexibility.

Build America Bonds can be issued with either a tax credit offered to an investor or a rebate to the issuer for a portion of interest payable to investors. In the current market, this feature has produced a net cost of funds for many issuers that is lower than the tax-exempt equivalent rate, particularly for longer dated maturities. The strongest of these bonds will be structured so that the issuer remains responsible for the full debt service payment. In cases where the issuer only pledges to pay the taxable interest net of the federal subsidy, we will assess the issuer's management team to ensure that they have the depth and breadth of experience to manage the BABs program. We will also assess an issuer's alternative sources of repayment to assure timely and full payment of debt service in the event payment from the federal government is interrupted.

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The Build America Bonds Program

Build America Bonds were created by the American Recovery and Reinvestment Act of 2009 ("ARRA") to expand the market for state and local government bonds. BABs must be designated as such by the issuer and they must be issued before January 1, 2011. To date, in excess of $17 billion[1] of BABs have been issued by states and local governments, universities, transportation authorities and utilities. Institutional investors, including insurance companies, pension funds and money managers, have been the primary purchasers. BABs are expected to remain popular among issuers as long as they provide a lower net cost of borrowing than traditional tax-exempt bonds for public finance issuers. The future supply of BABs will largely depend on the relationship between the tax-exempt and taxable yield curves and credit spreads in each market.

The ARRA authorizes state and local governments to issue two general types of taxable governmental bonds – tax credit and direct payment – with federal subsidies for a portion of interest payable on the bonds. Both of these types of bonds are referred to as Build America Bonds. "Tax Credit" bonds provide a federal subsidy to investors through federal tax credits in an amount equal to 35% of the total coupon interest payable by the issuer. "Direct Payment" bonds provide a federal subsidy paid to state or local governmental issuers by the U.S. Treasury Department in an amount equal to 35% of the total interest payable on the bonds. A variation of the "Direct Payment", "Recovery Zone Economic Development Bonds" provide for a 45% federal subsidy paid to state or local governmental issuers.

While the amounts of "Tax Credit" and "Direct Payment" bonds with the 35% federal subsidy are not limited as to amount, the Recovery Zone Economic Development Bonds are limited to $10 billion nationally. Volume cap allocations for these Recovery Zone Economic Development Bonds will be made in proportion to each state's 2008 state employment decline as it relates to the national employment decline.

To date, no "Tax Credit" bonds have been issued as BABs. When and if they are issued, proceeds can be used for any purpose allowed under Section 103 of the federal tax code. Proceeds can be used to fund capital projects and working capital. These tax credit bonds can be issued to raise new money or to refund outstanding obligations.

"Section 103(a) provides that gross income does not include interest on any State or local bond. Section 103(c) provides that the term 'State or local bond' means an obligation of a State or political subdivision thereof. Treas. Reg. 1.103-1(b) provides that obligations issued by or on behalf of any State or local governmental unit by constituted authorities empowered to issue such obligations are the obligations of such a unit.

"The Internal Revenue Code does not define the term 'political subdivision'. However, Treas. Reg. 1.103-1(b) provides that the term 'political subdivision' denotes any division of any state or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit. As thus defined, a political subdivision of any state or local governmental unit may or may not, for purposes of this section, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of any such unit. Rev. Rul. 78-276, 1978-2 C.B. 256, states that a 'political subdivision' has been defined consistently for all federal tax purposes as denoting either (1) a division of a state or local government that is a municipal corporation, or (2) a division of such state or local government that has been delegated the right to exercise sovereign power."

There are three generally acknowledged sovereign powers of states:

- Power to tax
- Power of eminent domain
- Police power

Source: Internal Revenue Service, United States Department of the Treasury, Tax Exempt Interest Under Section 103 of the Internal Revenue Code, Internal Revenue Service National Office Technical Advice Memorandum 200646017

[1] BABs issuance totaled $23 billion as of August 14, 2009.

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The potential uses of proceeds from "Direct Payment" bonds, however, are more limited. They may only be utilized to finance capital expenditures. They may not be used for working capital or refundings.

Tax Credit BABs

- Capital expenditures
- Working capital
- New money
- Refundings
- Tax credit equal to 35% of interest
- No issuance cap

Direct Payment BABs

- Capital expenditures
- Issuance costs
- Reasonably required reserves
- New money
- 35% federal subsidy
- No issuance cap

Recovery Zone Economic Development Bonds are targeted to recovery zones – areas designated by the issuer as having significant poverty, unemployment, rate of home foreclosures, or general distress, any area designated by the issuer as economically distressed by reason of the closure or realignment of a military installation pursuant to the Defense Base Closure and Realignment Act of 1990, or any area for which a designation as an empowerment zone or renewal community is in effect as of February 17, 2009. They may be issued by states, counties, large municipalities, the District of Columbia and any possession of the United States.

Recovery Zone Economic Development Bonds may be used to promote development or other economic activity in a recovery zone including capital expenditures paid or incurred with respect to property located in a recovery zone, expenditures for public infrastructure and construction of public facilities, and expenditures for job training and educational programs. They can be issued for capital expenditures to promote development or other economic activity in a recovery zone. They may not be issued as refunding bonds, but may be issued to reimburse otherwise eligible expenditures that were paid or incurred after February 17, 2009 that were financed originally with temporary short-term financing issued after February 17, 2009.

Recovery Zone Economic Development Bonds

- To promote development or other economic activity in a recovery zone
  - public infrastructure
  - job training and educational programs
- New money and reimbursement of eligible expenditures paid or incurred after 2/17/09 that were financed originally with temporary short-term financing
- 45% federal subsidy
- Limited to $10 billion nationally

The first of these Build America Bonds transactions were structured along the lines of corporate bonds with long-term bullet maturities and either no call provisions or "make whole" call provisions. Now, however, some of the smaller BABs transactions are being structured with serial maturities and 10-year call provisions that mirror traditional tax-exempt call provisions. Depending on the size of a BABs offering, if a small issuer were to structure a transaction using a bullet maturity, Moody's might be concerned about the ability of the issuer to pay the bonds, when due – especially if there were no mechanism for putting away funds on an annual basis. Even with a large issuer, it is possible that a traditional corporate structure might be used to push debt out longer than the norm.

Reliability of the Interest Rate Subsidy

Much has been written about the reliability of interest rate subsidy payments offered by the federal government through the Build America Bonds program. The United States government has a long history of following through with its financial commitments even if policy subsequently changes, and Moody's is, therefore, confident that the federal government will make these payments in keeping with guidance that it has published. While these subsidies are subject to withholding by the federal government and the program is scheduled to sunset at the end of 2010, we believe that the federal government will continue to make subsidy payments to issuers for the life of the bonds issued prior to January 1, 2011. It is important, however, in light of the fact that the federal government will hold the purse strings, to evaluate how any backstops to the federal subsidy might function. These backstops will be particularly important when a debt service payment is designed to be made partially from the federal subsidy.

Interest rate subsidies are characterized as tax refunds under the law and are, therefore, subject to offset and withholding due to counterclaims by the federal government. This withholding mechanism could be developed into a forceful tool by the federal government to reach resolution on non-compliance and financial disputes with public finance issuers to the extent that these occur. As such, there is some risk that the federal government might withhold payment from these issuers under certain circumstances not necessarily related to BABs issuance or the project for which they are issued. It is more likely that a subsidy withholding would be utilized in transactions involving issuers that are in some way regulated by the federal government, such as utilities, or those that receive federal grant funding, such as transportation agencies.

Management of Build America Bonds

The federal interest rate subsidies depend on (i) an election to issue Build America Bonds, (ii) submission of a tax form to report the issuance of the BABs to the IRS, and (iii) application for interest rate subsidies—either semi-annually for fixed rate bonds or quarterly for variable rate bonds. Therefore, it will be important to evaluate the strength of the issuer's management of the program. This is especially important when debt service payment is dependent on receipt of the federal subsidy. The strongest management will have written procedures directing certain individuals to file semi-annual or quarterly applications. Consistent with the experience of treasury management and established procedures we look for in our assessment of self-liquidity programs, we will look for professional management of the federal subsidy application function. The evaluation of the strength and depth of management will be less important in those instances where the issuer is not dependent on the federal interest rate subsidy to make debt service payments and where the issuer has a comfortable liquidity position as it relates to debt service demands.

Timing of Interest Rate Subsidy Receipts

While the federal government's guidance requires that application for subsidy payments be made not more than 90 days and not less than 45 days prior to interest payment dates for fixed rate bonds and within 45 days of the last debt service payment within a quarter for variable rate bonds, and the U.S. Treasury has said that issuers should expect to receive requested payments within 45 days of the date that a processible Form 8038-CP is filed with the IRS, there can be no assurance that the interest rate subsidy will be received by the issuer prior to the date on which debt service is due to be paid to investors. Therefore, the basic programs will not rely on receipt of these subsidy payments in order to make debt service payments in whole and on time. Instead, receipt of the federal subsidy by the issuer of the BABs will be independent of the payment of debt service. For transactions structured like this, our analysis of the credit would incorporate management of the program to the extent that the subsidy is a meaningful amount of money in the context of the particular underlying credit.

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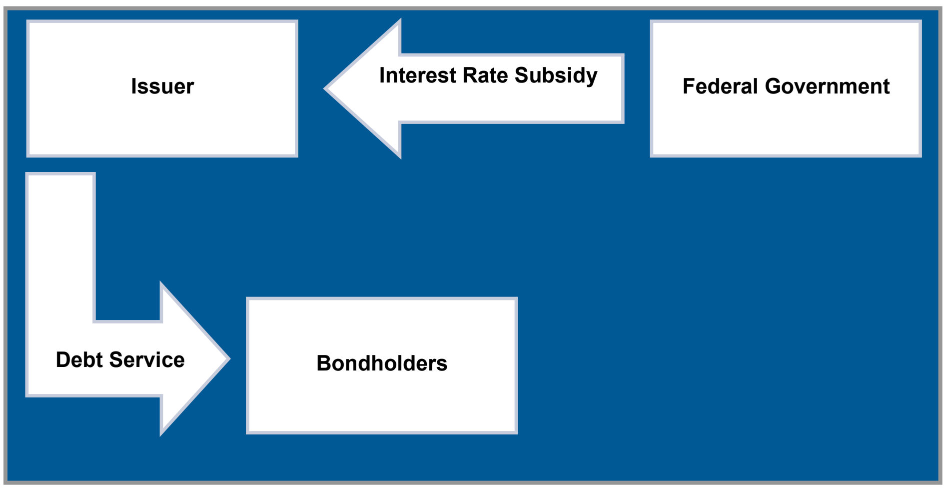
Fixed Rate Bonds

- Application for subsidy due not more than 90 days and not less than 45 days prior to applicable interest payment dates
- U.S. Treasury expects to pay subsidy within 45 days of the date that a processible Form 8038-CP is filed with the IRS.

Variable Rate Bonds

- Application for subsidy is due the 45th day after the last interest payment date within the quarterly period for which reimbursement is requested.
- U.S. Treasury expects to pay subsidy within 45 days of the date that a processible Form 8038-CP is filed with the IRS.



For those programs that depend on the receipt of federal interest subsidies to complement another source of revenue to make a full debt service payment, some contingency must be in place to bridge potential gaps in application for and receipt of federal interest rate subsidies. This contingency could be in the form of a debt service reserve fund or other designated available liquidity.

In the event a reserve fund is put in place to bridge timing differences between receipt of federal interest rate subsidies and debt service payments, Moody's will examine whether someone, such as a trustee, has the responsibility, prior to the debt service payment date, to determine whether adequate monies are on deposit in the debt service fund to make full debt service payments. Whatever the source of funds, Moody's will determine whether funds are expected to be sufficient and liquid when needed to make debt service payments and that, once tapped, they are expected to be replenished in time to have sufficient funds on hand to cover the amount expected to be received in the form of a federal interest rate subsidy for the next interest payment date. In this instance, the evaluation of management is critical as a late or missed filing of a rebate application could result in a lack of funds with which to replenish a reserve fund.

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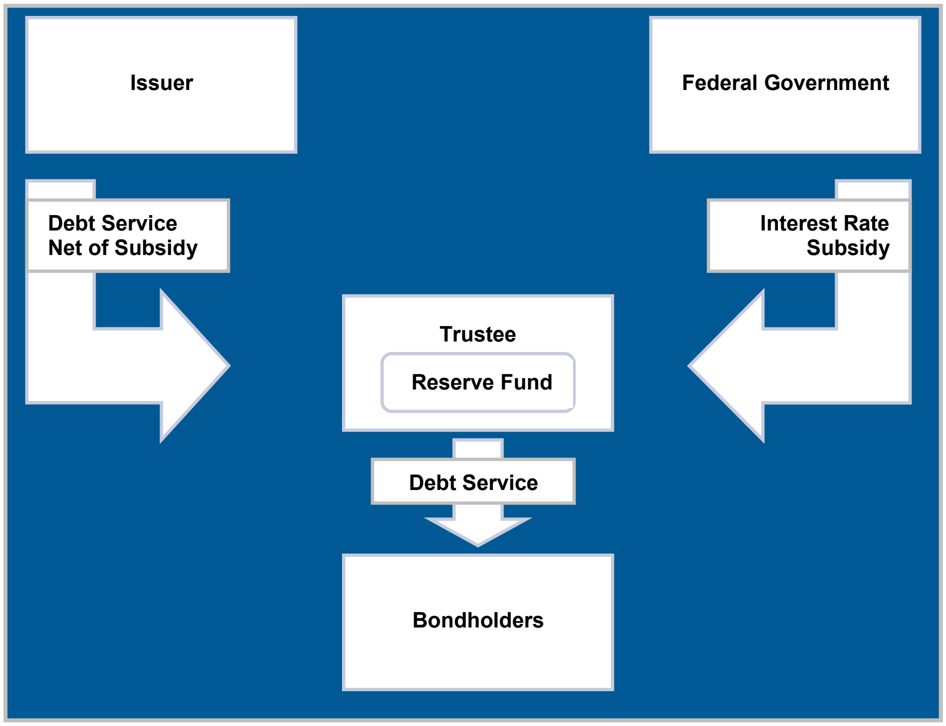

Legal Covenants

Revenue bond issues supported by tolls, fees, or other charges typically incorporate a rate covenant and an additional bonds test, each of which is calculated by dividing pledged revenues by debt service. The ratios change depending on what is included in the numerator and denominator. For instance, if the bond documents treat the federal subsidy as a pledged revenue, the numerator will increase. Conversely, if the documents treat the federal subsidy as an offset to debt service, the denominator will decrease. When comparing ratios of one issuer to those of another, it will be important for Moody's to understand what is included and to adjust the ratios so that we are assured of comparability. We will adjust these ratios to include the federal subsidy as a pledged revenue and ensure that the total debt service is reflected in these ratios.

Conclusion

When assessing the credit of a BABs issuer, Moody's analysts will initially be most focused on the reliability of sufficient monies to pay debt service in whole and on time. To the extent that an issuer is relying on receipt of the subsidy in order to make full debt service payments, Moody's analysts will assess the ability of management to carry out the program and explore alternative sources of capital, assess the quality and availability of short-term liquidity, mechanisms in place to access it, and investment parameters. To the extent that BABs are issued as non-callable debt, Moody's analysts will also assess the effect of BABs on an issuer's future financial flexibility.

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Appendix

Partial List of Build America Bonds Rated by Moody's

States

- California
- Indiana
- Iowa
- Kentucky
- Louisiana
- New Jersey (New Jersey Transportation Trust Fund Authority)
- Texas
- Wisconsin

Local Governments

- Allegheny County, PA
- Arlington County (Industrial Development Authority), VA
- Bexar County Hospital District, TX
- Cedar Rapids, IA
- Cook County, IL
- Danville (City of), VA
- Dawson Independent School District Finance Corporation, KY
- Derby (City of), KS
- Fayette County School District Finance Corporation, KY
- Graves County School District Finance Corporation, KY
- Jessamine County School District Finance Corporation, KY
- Johnson County Unified School District No. 233, KS
- Lexington & Richland Counties School District No. 5, SC
- Meade School District Finance Corporation, KY
- Mequon (City of), WI
- Mercer County, NJ
- Milwaukee County, WI
- Minooka Fire Protection District, IL
- Oconomowoc (City of), WI
- Pendleton County School District Finance Corporation, KY
- Santa Monica-Malibu Unified School District, CA
- Sedgwick County Unified School District 259 (Wichita), KS
- Skokie Village, IL
- Upper Arlington (City of), OH

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Local Governments, *continued*

- Van Buren Public Schools, MI
- Walworth County, WI

Mass Transit

- Metropolitan Transit Authority of Harris County, Texas
- Utah Transit Authority
- Washington Metropolitan Area Transit Authority

Universities

- Southern Illinois University
- University of Michigan
- University of Minnesota
- University of Virginia

Turnpike Authorities

- Illinois State Toll Highway Authority
- New Jersey Turnpike Authority
- North Carolina Turnpike Authority
- North Texas Tollway Authority

Utilities

- San Antonio CPS Energy Utility, TX

Water & Sewer Authorities

- Metropolitan Water District of Southern California

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