MOODY'S
INVESTORS SERVICE

RATING METHODOLOGY

State Aid Intercept Programs and Financings Methodology

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This rating methodology replaces the *State Aid Intercept Programs and Financings* methodology published in December 2017. While this methodology reflects many of the same core principles as the 2017 methodology, we have updated the analytic guidance for assigning program-level ratings to reference the state issuer rating as the starting point of analysis. We have clarified state aid intercept programs are rated, but their position in the hierarchy of state debt and spending priorities is not rated. We have also made editorial changes to enhance readability.

Introduction

This rating methodology explains our general approach to assessing credit risk of rated US state aid intercept programs and issuers that benefit from such programs.

Highlights of this report include:

» An overview of the rated universe

» A summary of the rating methodology

» A description of factors that drive credit quality and ratings

» Comments on the rating methodology assumptions and limitations, including a discussion of certain other rating considerations

This document provides general guidance intended to help the reader understand how qualitative and quantitative risk characteristics are likely to affect rating outcomes for state aid intercept programs and issuers that benefit from such programs. For instance, our analysis for ratings of intercept programs and financings covers factors that are common across all public sector entities but that are not explained in detail in this document,[1] such as environmental, social and governance considerations, as well as factors that can be meaningful on an issuer-specific basis. However, this methodology should enable the reader to understand the qualitative and quantitative considerations that are usually most important for ratings benefitting from these programs.

This methodology includes a chart (Exhibit 3) that provides a summary illustration of our overall standard approach to assigning state aid intercept ratings, using the state's issuer rating as the starting point.

[1] Please see the "Limitations," "Key Rating Assumptions" and "Other Considerations" sections..

This summarized approach for state aid intercept programs and intercept debt issuances does not incorporate every rating consideration. For instance, the chart includes a typical hierarchy of state debt and spending priorities. Actual state debt and spending priorities may change over time, which would be reflected in our ratings. As another example, a state's commitment to the purpose supported by the intercept program (e.g., education) could markedly diminish, or a state could start an intercept program for a much less essential purpose. A state could institute an intercept program with atypically weak mechanics.

In addition, ratings are based on our forward-looking expectations, which may vary from historical performance, and our long-term forward view may be different from our near-term forward view.

We seek to incorporate all material credit risks into our ratings, whether long-term or short-term risks, with the most forward-looking view that visibility into these risks permits. In most cases, nearer-term risks are more meaningful to issuer credit profiles and thus have a more direct impact on ratings. However, in some cases, our views of longer-term trends may have an impact on state aid intercept ratings.

As a result, the ratings of state aid intercept programs and intercept debt issuances may in some cases reflect a wider ratings differential relative to the state's issuer rating than is indicated by Exhibit 3.

This methodology describes the analytical framework used in determining credit ratings for state aid intercept programs and financings. The ratings of the US state that provides program support and, in cases where the intercept does not provide material enhancement, the underlying credit profile of the local government, are important factors in our ratings for intercept programs and financings. In addition, we may consider the ratings of debt obligations of US states, such as general obligation (GO), lease, appropriation and moral obligation debt.

In some instances, our analysis is also guided by additional methodologies that describe our approach for analytical considerations that are not specific to any single sector. Examples of such considerations include but are not limited to the following: how sovereign credit quality affects non-sovereign issuers, how our approach to adjusting pension assets and liabilities reported by US states and local governments is incorporated into our credit analysis, and the assessment of credit support from other entities. A link to documents that describe our approach to such cross-sector methodological considerations can be found in the "Moody's Related Publications" section of this report.

The methodology contains three factors that are important in our assessments for state aid intercept ratings:

» Position in Hierarchy of State Debt and Spending Priorities

» Program Mechanics

» Sufficiency of the Financing Structure

These factors comprise a number of sub-factors.

Scope

This methodology applies to state aid intercept programs and the financings of US local governments and other public entities that benefit from such programs. Generally, state aid intercept programs authorize the state to redirect appropriated but as-yet undistributed aid to a school district or other local entity in order to pay debt service on the entity's debt obligations designated for the intercept, providing a form of credit enhancement. Diverted operating aid is not pledged by the state to intercept debt and intercept debt is not guaranteed by the state. Most of the entities that benefit from these programs are local school districts, but some public colleges and universities, as well as other types of local public entities, benefit as well.

We assign ratings to the intercept programs themselves and to the debt financings that benefit from the programs. We may also assign underlying ratings to debt financings that benefit from state intercept programs; these underlying ratings are based solely on the local debt issuer's own credit quality and do not take into account the benefit of the intercept program. Our approach to assigning those underlying ratings is set forth in other rating methodologies, which can be found by clicking on the link in the Moody's Related Publications section below.

Some debt that is issued by local governments is enhanced by other state programs, including guarantees and asset-backed programs, which are covered by other methodologies.[2]

Rating Approach

This methodology framework comprises two key steps. First, we assign the program-level rating, based on two factors. Then, using the program-level rating, we assign enhanced ratings at the financing-level, based on one additional factor. Each of these factors has a number of sub-factors.

Program-Level Ratings

Program-level ratings are positioned relative to the state's issuer rating, based on two factors: Position in Hierarchy of State Debt and Spending Priorities and Program Mechanics. Program-level ratings represent the highest potential rating that a financing benefiting from that state-aid intercept program can achieve.

EXHIBIT 1

State Aid Intercept Programs and Financings: Program-Level Rating

Rating Factors	Sub-factors
Position in Hierarchy Of State Debt and Spending Priorities	Commitment to the Program
	Essentiality of the Purpose
Program Mechanics	Effectiveness
	Reliability
	Timeliness

Source: Moody's Investors Service

Financing-Level Ratings

Using the program-level rating as a starting point, we assign enhanced ratings to the individual financings that qualify for the intercept program. Financing-level ratings are based on one factor, which has three sub-factors.

[2] For additional details, please see the "Moody's Related Publications" section of this report for a link to our methodologies.

EXHIBIT 2

State Aid Intercept Programs and Financings: Financing-Level Rating

Rating Factors	Sub-factors
Sufficiency of the Financing Structure	Intercept Debt-Service Coverage
	Schedule of State Aid Payments
	Presence of a Paying Agent, Fiduciary Or Conduit Issuer

Source: Moody's Investors Service.

Discussion of Rating Factors

In this section, we explain our general approach for scoring each factor or sub-factor, and we describe why they are meaningful as credit indicators.

The information used in assessing the sub-factors is generally found in or calculated from information in the issuer's financial statements or regulatory filings; in legislation, program documents or bond agreements; or derived from other observations or estimated by Moody's analysts.

Program-Level Rating

There are two key steps in assigning state aid intercept ratings. First, we assign the program-level rating, based on two factors. Then, using the program-level rating, we assign enhanced ratings at the financing level, based on one additional factor. Each of these factors has a number of sub-factors. Exhibit 3 illustrates our standard approach at the end of this section.

Factor: Position in Hierarchy of State Debt and Spending Priorities

Why It Matters

State aid intercept programs are funded by annual appropriations from the state's own-source revenue, which typically consists of non-property taxes levied on businesses and individuals. Although a state's ability to levy these taxes is generally considerable, it is finite, and states often seek to cut costs, including reductions in spending and appropriations to local governments. Thus, there is a hierarchy of debt and spending priorities, and appropriations to local public entities compete with a state's various debt obligations and other operating costs. Given the competition for these funds, it is important to assess where appropriations for intercept programs fit in the hierarchy of state debt and spending priorities.

How We Assess It

We typically assess the state's commitment to the intercept program relative to its commitment to all of its obligations, including its GO, appropriation and moral obligation debt, and other operating expenses. We also incorporate into our assessment of this factor the essentiality to the state of the purpose supported by the program (e.g., education). Its position in the hierarchy places the rating of the program always at least one notch below the state's issuer rating because, while a state may commit to the mechanics of these programs through statute, it does not provide an explicit guarantee of the debt through maturity of the financing, nor is state aid to school districts legally pledged to intercept debt.

Given that intercept programs depend on annual appropriations of state aid, we typically place these programs at or near the same position as other debt that is subject to annual appropriation. In such cases, this effectively means that the intercept's position in the hierarchy typically places the rating of the program one or two notches below the issuer rating. In cases where we view the intercept's position in the hierarchy as equivalent to the position of debt supported by the state's moral obligation,[3] the intercept's position in the hierarchy typically places the rating of the program two notches below the issuer rating, and in some cases more than two notches below. However, the actual position of the intercept program in the hierarchy can vary, based on our overall assessment of the state's commitment to the program and the essentiality of the purpose.

State Commitment to the Intercept Program

We typically assess a state's commitment to the program based on two criteria. The program's placement in the hierarchy of state debt and spending priorities depends on how well the program meets these criteria.

The first criterion is the extent to which the state's commitment to the intercept program is expressed in the state constitution or state statute. This provides a documented legal basis for the intercept program. For intercept programs whose mechanics are outlined in policy documents, procedural memos or memoranda of understanding, but not constitutionally or statutorily authorized, placement in the hierarchy will typically be below the state's annual appropriation bonds and potentially below moral obligation bonds.

The second criterion is a demonstrated history of state support for the sector that benefits from the program. Indicators of strong state support include, but are not restricted to, a high proportion of a state's budget allocated to the sector, the relative stability of that funding and indications that support for the sector will not waver. For programs that do not have strong state support, placement in the hierarchy will typically be below the state's annual appropriation and moral obligation bonds.

Essentiality of the Purpose

To assess this sub-factor, we may consider evidence that the sector supported by the program serves a purpose that is central to the state's fundamental role and core responsibilities. Such evidence includes the enshrinement of a purpose in a state's constitution or long-standing statutes. For example, most states have constitutional requirements for providing education and also may require that it be "general," "uniform" or "thorough and efficient." Intercept programs for education, which is the most common type of state aid intercept program, generally meet the standard for strong essentiality of purpose. Some other purposes may have lower essentiality to the state.

How We Position a Program in the Hierarchy Relative to the State's Issuer Rating and the Ratings of Other Obligations

In considering a state aid intercept program's position in the hierarchy of the state's obligations, we assess the state's commitment and the program's essentiality relative to appropriation and moral obligation debt.

We typically position a state aid intercept program that meets the criteria for strong commitment and strong essentiality of purpose at the same level in the hierarchy as the state's appropriation obligations for more essential purposes. In the absence of such obligations, that program's position in the hierarchy typically places the program rating one notch below the state's issuer rating.

When the legal basis for the state's commitment is strong (for example, expressed in a state statute or the state constitution) but where there is no history of state support for the purpose of the program or where the program supports a purpose with lower essentiality, we typically position the intercept program in the hierarchy at the same level as the state's appropriations for less essential purposes or at the level of its

3 A moral obligation is a form of credit enhancement typically provided by a government to another entity. Generally, a highly creditworthy government pledges its moral obligation to enhance a specific borrowing by a government of lesser credit quality.

moral obligation debt. In the absence of such obligations, that program's position in the hierarchy typically places the program rating two notches below the state's issuer rating.

A program's position in the hierarchy may place its rating more than two notches below the issuer rating when any one of the following applies: the legal basis is weak or uncertain; ongoing state support is fundamentally in question; or the essentiality of purpose is fundamentally in question. Failure to adequately fund a sector or significant lapses in oversight are strong indicators of weakened support for that sector. In our assessment, we would consider these and other meaningful indicators that the purpose is not considered essential to the state.

Factor: Program Mechanics

Why It Matters

A program's mechanics are important because they outline the processes and responsible parties for various actions over specified time frames. A program with clearly documented, institutionalized procedures with well-defined responsibilities and a proven track record is more likely to make reliable, timely payments going forward than a program with mechanics that are not clearly defined, or a program whose managers have demonstrated a lack of awareness that payments are required, or have made intercept payments with a substantial delay.

How We Assess It

Our assessment of this factor is typically based on the effectiveness, reliability and timeliness of the program mechanics. This assessment helps determine whether we assign a program-level rating that is at the same level as, or lower than, the program's position in the hierarchy of state debt and spending priorities.

Effectiveness

Procedures for a state aid intercept program's operation are generally detailed in a state statute, memoranda of understanding or agreements, written policies or other legal documents. In considering the effectiveness of a program's mechanics, we assess the clarity and specificity in the documentation of intercept authorization and processes. These include the authority of the state to intercept current-year state aid and divert it to bondholders, the procedures whereby the state is notified to initiate the intercept process, and the procedures for the remittance of appropriated state aid to the trustee or bond paying agent in order to make debt-service payments.

Reliability

In assessing the reliability of the program's mechanics, we consider the expected functioning of the program, including its historical track record, and the track record of the state's awareness and oversight of the intercept program and entities in the relevant sector. The mechanics of the most reliable programs include a direct, scheduled payment of state aid to a trustee for a debt-service payment on a specific date, usually on or before the debt-service due date. Other than these programs that are used on a regular basis, the functioning of most state aid intercept programs has not been tested because the programs generally support sectors that rarely require state intervention to make debt-service payments in full. In the absence of a history of program utilization, we assess the state's historical awareness and oversight of the sector to determine program reliability.

Timeliness

We typically assess timeliness of the program based on when we expect intercepted funds to be remitted to bondholders relative to debt-service due dates. Most intercept programs have mechanics that are designed to ensure payment on or before the scheduled debt-service due date of the underlying bond (pre-default mechanics).

However, some intercept programs are structured to make debt-service payments within a short period after the due date of the bond (post-default mechanics). We refer to this short period as the intercept grace period, provided it does not exceed approximately 30 days. The structural mechanics are disclosed in the program's governing documents, although the underlying municipal bond documents typically do not define the term, nor is there a grace period for late payments.

Some of these programs have a specified time frame after the debt-service due date by which debt service will be remitted. Others do not specify the time frame. The intercept grace periods for these programs are built into the program mechanics, and we generally view a grace period under which the intercept payment is made within approximately 30 days of the debt-service due date as essentially equivalent to pre-default payment mechanics, because the loss associated with one payment that will be received in full within a few days or weeks of the stated payment date is typically minimal.

We view payment delays of this nature as procedural and fundamentally different from a typical bond default, because the potential for a payment delay has extremely limited meaning with respect to expected loss. This differentiates a technical payment delay from a payment default in most other sectors, where such a default usually signals a situation that entails significant loss, e.g., a restructuring. Also, the potential for technical payment delays before the intercept is triggered is disclosed in legislation, program documents or bond agreements. As a reference point, in most non-municipal finance sectors, bond indentures often include a defined grace period, most often about 30 days. Another reason for this approach is that some states whose programs incorporate an intercept grace period have consistently chosen to make intercept payments prior to the debt-service due date.

Actions by the state could change our expectations related to a state's awareness of and consideration for the debt-service due date of intercept debt. Should a state alter its program mechanics to move from a pre default to a post default program, or to extend the intercept grace period outlined in legislation, program documents or bond agreements, we may reassess the state's commitment to the program. The program's position in the hierarchy of state debt and spending priorities could place the program rating further from the state's issuer rating, even if the change would provide for payment within 30 days of the debt-service due date.

We view programs that are not clear on the timing of remittance of intercept payments as incrementally weaker, although not significantly weaker in a state that has demonstrated strong sector oversight and prompt intercept payment when needed.

Assigning the Program-Level Rating at the Same Level as the Program's Position in Hierarchy of State Debt and Spending Priorities

We typically assign a program-level rating at the same level as the program's position in the hierarchy of state debt and spending priorities if we determine that the program mechanics are highly effective, highly reliable and timely.

We characterize program mechanics as highly effective if the state has clear authorization to intercept the current year's appropriated and scheduled payments of state aid to a local entity and to divert the aid to pay debt service. We may also consider whether the documentation of processes for notification and remittance of intercepted state aid is clear and specific, and designates parties that are responsible for each stage of the process.

We characterize program mechanics as highly reliable if there is a demonstrated history of successful program utilization resulting in payment of debt service. In the absence of a history of utilization of the program, we typically characterize program reliability as high if there is a record of strong state oversight of the relevant sector. Indicators of strong state oversight include requirements for annual financial reporting to the state and the existence of state programs to monitor and assist local entities.

We characterize program mechanics as timely if there is clear documentation that the debt-service payment will be made on or prior to the debt-service payment date, or after the debt-service payment date but within the intercept grace period.

Assigning the Program-Level Rating One Notch Below the Program's Position in Hierarchy of State Debt and Spending Priorities

We typically assign a program-level rating one notch below the program's position in the hierarchy of state debt and spending priorities if the program's mechanics are highly effective and reliable, but timeliness is uncertain.

We consider a program's timeliness to be uncertain when the program documentation does not clearly outline the timing for notification and remittance of state aid to pay debt service or when the delay exceeds approximately 30 days, because these instances could increase the likelihood that payment will be delayed beyond a short period after the debt-service due date. In the case of a program in a state with a strong record of sector oversight and a strong record of intervention and assistance to local governments when needed, we typically limit the rating differential to one downward notch, because we generally expect that the likelihood of an extended delay in notification and remittance is quite low.

Assigning the Program-Level Rating Two or More Notches Below the Program's Position in Hierarchy of State Debt and Spending Priorities

We typically assign a program-level rating two or more notches below the program's position in the state hierarchy of debt and spending priorities when the mechanics of a state aid intercept program are not highly effective or reliable, or when timeliness is highly uncertain.

When the effectiveness level is high, but reliability is not high (typically, either a history of weak functioning[4] or no history of program utilization combined with weak oversight of the sector or lack of intervention in assisting financially stressed local entities), or there are timing weaknesses (typically, the intercept payment is more than a month after debt-service is due or unclear, and we expect that the delay in payment will be substantial), the program-level rating is generally two or more notches below the position of the program in the state's hierarchy of debt and spending priorities. To arrive at the number of notches below the position in the hierarchy, we assess the severity of weaknesses in reliability and expected

[4] Functioning of the program primarily relates to the state's track record of adhering to its program mechanics. If a state makes a payment beyond both the debt-service due date and the date outlined in legislation, program documents or bond agreements, the reliability of the program previously assessed as high would likely be reassessed, leading to further notching down from the program's position in the hierarchy, even if the payment is made within 30 days of the debt-service due date.

timeliness. A program with a record of making substantially delayed intercept payments will typically be rated more than two notches below the program's position in the state's hierarchy of priorities.

When effectiveness is not high, the program-level rating is likely to be more than two notches below the program's position in the hierarchy of state debt and spending priorities. We consider a program to have low effectiveness, with greater risk of a protracted delay of a debt-service payment, when there is not clear state authorization to intercept and divert a local entity's current-year aid, or there is not clear documentation of notification and remittance procedures in legislation, memoranda of understanding or financing documents. To arrive at the number of notches below the position in the hierarchy, we assess the severity of these weaknesses.

The Financing-Level Rating

Once we have assigned the program-level rating, we assign enhanced ratings to the individual financings that qualify for the intercept program. Financing-level ratings are based on one factor, which has three sub-factors.

Factor: Sufficiency of the Financing Structure

Why It Matters

Financing structure sufficiency encompasses the adequacy of intercepted aid to cover debt service, which depends upon amount, timing, and notification. The sufficiency of the financing structure of a state aid intercept program is important in order for the program to operate as designed at the individual financing level. A program with strong, clearly outlined mechanics may be weakened in its application to a particular financing by a lack of sufficient aid revenues, a timing mismatch between state aid disbursement and debt-service due dates, or late notification of a funding shortfall by the local entity.

How We Assess It

In order to arrive at the financing-level rating, we assess the following aspects related to the sufficiency of the financing structure: intercept debt-service coverage, the schedule of state aid payments and whether a paying agent, fiduciary or conduit issuer is present. Based on this assessment, the financing-level rating may be the same as the program-level rating, or it may be notched down from the program-level rating.

Intercept Debt-Service Coverage

Why It Matters

The ratio of annual interceptable state aid to annual intercept debt service is important because it provides a broad view of the sufficiency of the interceptable aid allocated to the local entity to cover all of its intercept debt-service payments for that year.

Typically, state aid is distributed to a local entity in multiple portions throughout the fiscal year, often monthly, although amounts tend to vary at different times of the year. Debt-service payments are also generally paid on various dates throughout the year, and the size of these payments also usually varies.

A debt-service coverage ratio of less than 100% indicates an increased risk that there will be insufficient appropriated but undistributed aid at some point in the year to fully make up a shortfall in periodic debt-service payments. Conversely, a debt-service coverage ratio that is well above 100% indicates a decreased risk of such an insufficiency. Therefore, as annual debt-service coverage falls close to or below 100%, we may place a greater emphasis on the schedule of state aid payments relative to the schedule of debt-service payments to assess risk of insufficiency.

How We Assess It

The numerator is total annual interceptable state aid appropriated to a local entity, and the denominator is the local entity's total debt service due in the current year.

In calculating this ratio, to the extent that interceptable aid includes funds designated for other purposes (e.g., charter schools or pensions), we typically adjust interceptable aid downward to exclude these designated funds. In assessing whether the ratio will be at or above 100% on a forward basis, we typically consider both historical metrics and trends.

The ratio is assumed to be at least 100% for issuers that have effectively unlimited access to the state's appropriated funds for the purpose of the intercept (e.g., education).[5]

Schedule of State Aid Payments

Why It Matters

The schedule of state aid distribution relative to the schedule of debt-service payments is important because it can affect the sufficiency of available interceptable state aid to cover individual debt-service payments. For example, if the state distributes most of its aid early in the fiscal year and the local entity has a large debt-service payment late in the year, there may be insufficient remaining interceptable aid that the state can divert to pay bondholders in the event that the local entity is unable to pay with its own funds.

Some state aid intercept programs are authorized to advance funds in order to make debt-service payments on behalf of a local entity without limitation, even if the entire appropriation to the entity has been fully distributed. Other programs have the authority to borrow from the following year's appropriation to make a debt-service payment on behalf of a local entity. Some programs do not require appropriations at all to pay debt service on behalf of borrowers. These program features eliminate the risk that the financing structure will be insufficient because of a mismatch between the timing of state aid payments and intercept debt-service payments.

How We Assess It

We review the schedule of state aid disbursement to understand the amount of state aid that is available for intercept throughout the fiscal year and compare it with the debt-service payment dates. We assess whether the timing of distribution of aid leaves sufficient funds available to cover debt-service payments throughout the year.

Presence of a Paying Agent, Fiduciary or Conduit Issuer

Why It Matters

Many, although not all, municipal debt financings include the use of a third-party paying agent, fiduciary (such as a trustee) or an experienced conduit issuer (such as a state building authority). The paying agent, fiduciary or conduit issuer is responsible for tracking that available funds to be used for debt-service payments are sufficient and for notifying the state of insufficient funds on deposit to make debt-service payments. Without such a paying agent, fiduciary or conduit issuer, bondholders generally must depend on the local entity that is benefitting from the intercept to notify the state of a funding shortfall for a debt-service payment. At times, there can be political incentives for a local entity to underestimate its constraints rather than notify higher authorities. A requirement to notify the state that only applies to the local entity generally increases the risk that payment will be delayed beyond the short grace period incorporated in

[5] For example, some states give school districts the ability to access the entire pool of interceptable state aid for education for the current year or to access aid for that district that may be appropriated in future years.

legislation, program documents or bond agreements. When programs authorize state aid to be automatically sent to the paying agent, fiduciary or conduit issuer on a scheduled basis, rather than to the district itself, the need for notification from the district is eliminated.

How We Assess It

We review the financing documents to assess whether a paying agent, fiduciary or conduit issuer is present.

Assigning the Financing-Level Rating at the Same Level as the Program-Level Rating

We assign a financing-level rating at the same level as the program-level rating if debt-service coverage and the schedule of state aid disbursement are sufficient, and if a paying agent, fiduciary or conduit issuer is present in the debt-payment structure.

We consider debt-service coverage to be sufficient when total annual interceptable state aid provides at least 100% of a local entity's annual debt service supported by the program. We consider the schedule of state aid disbursement to be sufficient when state funding is distributed on a schedule that allows for enough aid to be available at or within a very short period of all debt-service due dates. When a financing structure meets these two criteria and the debt payment structure includes a paying agent, fiduciary or conduit issuer, we assign a financing-level rating that is the same as the program-level rating.

Assigning the Financing-Level Rating One Notch Below the Program-Level Rating

We assign a financing-level rating one notch below the program-level rating if interceptable annual state aid provides less than 100% of annual debt service benefitting from the program, or state aid is disbursed on a schedule that results in insufficient aid available at or near all debt-service due dates (though not likely to extend the timing of payment beyond a short period), or a lack of a paying agent, fiduciary or conduit issuer adds materially to the risk of payment delay.

The lack of a paying agent, fiduciary or conduit issuer for a financing that has sufficient debt-service coverage and a sufficient schedule of state aid payments will generally also result in a financing-level rating that is one notch below the program-level rating. However, we do not typically view the lack of a paying agent, fiduciary or conduit issuer as a reason to further notch downward when uncertain timeliness is already reflected in downward notching at the program-level rating (please see Factor 2, Program Mechanics).

Assigning the Financing-Level Rating Two Notches or More Below the Program-Level Rating

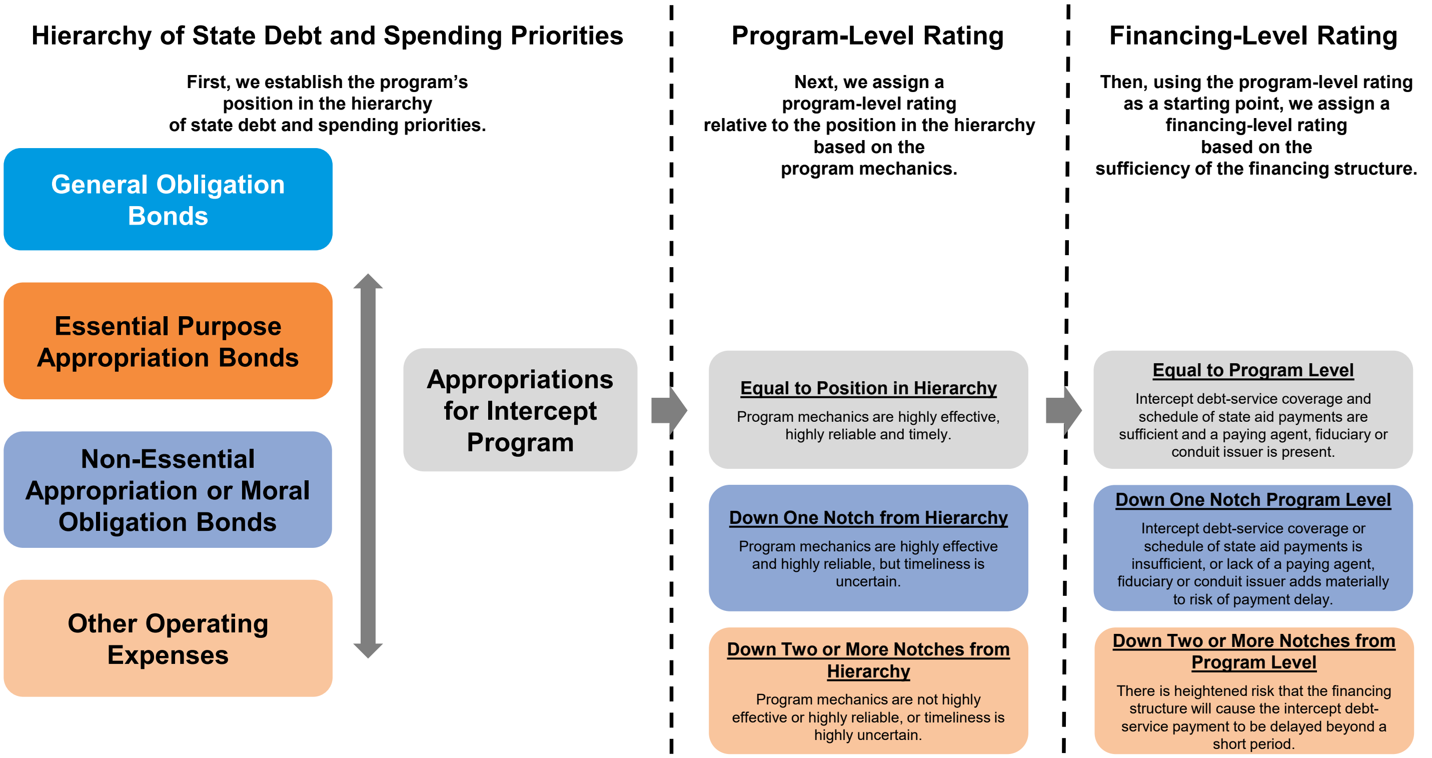
We assign a financing-level rating two notches or more below the program-level rating when there is heightened risk that the financing structure will result in a delayed debt-service payment beyond a short period. To arrive at the number of notches below the program-level rating, we assess how long the delay will likely be, based on available state aid, the schedule of state aid distributions and the timing of debt-service due dates.

Overall Standard Approach to Assigning State Aid Intercept Ratings

The chart below illustrates our overall standard approach and typical ratings in comparison to other state-level debt and expenditures. First, we assign the program-level rating, based on the program's position in the hierarchy of state debt and spending priorities and on the program mechanics. Then, using the program-level rating as a starting point, we assign enhanced ratings at the financing-level, based on the sufficiency of the financing structure.

EXHIBIT 3

Overall Standard Approach to Assigning State Aid Intercept Ratings



Source: Moody's Investors Service

Other Considerations

Program-level ratings and enhanced financing-level ratings based on state aid intercepts reflect additional considerations. These include but are not limited to the following: expectation of meaningful delays in the payment of debt service, delays in the adoption of a state budget, unexpected or severe cutbacks in state appropriations, and changes in state aid distribution patterns or formulas.

In choosing factors and metrics for this rating methodology, we did not explicitly include certain important factors that are common to all issuers, such as the quality and experience of management, assessments of governance as well as environmental and social considerations, and the quality of financial reporting and information disclosure, among others.

Ratings may also include additional factors that are difficult to quantify or that have a meaningful effect in differentiating credit quality only in some cases, but not all. Such factors include financial controls, exposure to uncertain licensing regimes and possible government interference in some countries. Regulatory, litigation, liquidity, technology and reputational risk as well as changes to consumer and business spending patterns and macroeconomic trends also affect ratings.

For example, liquidity is a consideration frequently critical to ratings; however, in other circumstances, it may not have a substantial impact in discriminating between two issuers with a similar credit profile. As an example of the limitations, ratings can be heavily affected by extremely weak liquidity that magnifies default risk. However, two identical issuers might be rated the same if their only differentiating feature is that one has a good liquidity position while the other has an extremely good liquidity position, unless these are low rated issuers for which liquidity can be a substantial differentiator for relative default risk.

Expectation of Meaningful Delays in the Payment of Debt Service

Our framework for rating typical state aid intercept programs and financings incorporates our general expectation that delays in remittance of state aid beyond debt-service due dates will be short, which generally results in ratings that are relatively close to the state's appropriation and moral obligation debt ratings.

In the case where we expect that a debt-service payment will be materially delayed beyond the intercept grace period (or an equivalent period for programs with no specified payment time frame), the typical notching framework will likely not capture our view of the full credit risk. Instead, we would typically consider how rapidly we expect the debt-service payment will be remitted, and the extent to which delay in any one payment may be followed by delays in future payments, or payments that will be missed altogether. We may also consider whether this credit weakness relates solely to the enhanced bonds for the particular local entity, or whether it signals a weakness in the intercept program itself, with applicability to financing-level ratings of other local entities. In such cases, the financing-level rating or the program-level rating may be multiple notches below the level indicated in the typical framework. In cases of significant weakness, where we have data on the underlying issuer, we may incorporate the underlying credit quality of the local entity into our analysis of the enhanced financing-level rating.

Delays in State Budget Adoption

Most states adopt their annual budgets within a month of the beginning of the fiscal year, allowing for appropriation of the state aid to local entities that provides the funds used in intercept programs.

Occasionally, a state fails to adopt its budget within a month of the beginning of the fiscal year. Some states have statutory provisions that authorize their intercept programs to operate, allowing funds to continue to flow during state budget delays. In a state without such provisions, the program generally does not function until the budget is passed, and a budget impasse can materially weaken the credit standing of the intercept program and the enhanced bonds, such that the typical framework will likely not apply.

In these cases, we estimate the likely duration of the budget delay, in light of the political and structural barriers to budget passage, and assess any ancillary actions by the state to mitigate the effect of the impasse on intercept programs. A prolonged budget impasse, unless mitigated, generally causes a meaningful downward assessment of the state's commitment to the intercept program; thus, the position of the intercept program in the state's hierarchy of debt and spending priorities may be much lower than the typical framework. Furthermore, we typically consider that the incidence of a budget impasse, in the absence of evidence to the contrary, increases the likelihood that a state will also incur meaningful budget delays in future years.

Unexpected or Severe Cutbacks in State Appropriations

States often balance their own budgets by cutting state aid appropriations to local entities. Small cutbacks do not generally impair the normal functioning of a state aid intercept program. Reductions in state aid appropriations that are unexpected or severe, however, could cause us to reassess the state's commitment to the sector supported by the intercept; thus, the position of the intercept program in the state's hierarchy of debt and spending priorities may be much lower than the typical framework. Severe reductions in aid could also cause a material downward assessment in our view of the sufficiency of the financing structure, because they will reduce debt-service coverage from available interceptable state aid.

Changes in State Aid Distribution Patterns or Formulas

States occasionally change the formulas that allocate the state aid funding to local entities, advantaging some and disadvantaging others, or shifting state aid to pension funding from operations. They also periodically change the schedule of distribution of aid to local entities, which can result in reduced sufficiency of state aid to cover periodic debt-service due dates.

In these cases, we typically consider how such changes in distribution affect our view of the state's commitment, program mechanics and sufficiency of the financing structure and assess the effect, if any, the changes have on the program's position in the hierarchy of state debt and spending priorities, the program-level rating or the financing-level rating. Depending on the breadth and severity of the changes, the typical framework may not apply, and program-level or financing-level ratings may be multiple notches lower than the typical framework would indicate.

Key Rating Assumptions

For information about key rating assumptions that apply to methodologies generally, please see *Rating Symbols and Definitions*.[6]

Limitations

In the preceding sections, we have discussed the key factors and many of the other considerations that may be important in assigning ratings. In this section, we discuss limitations that pertain to the overall rating methodology.

General Limitations of the Methodology

This methodology document does not include an exhaustive description of all factors that we may consider in assigning ratings in this sector. Issuers in the sector may face new risks or new combinations of risks, and they may develop new strategies to mitigate risk. We seek to incorporate all material credit considerations in ratings and to take the most forward-looking perspective that visibility into these risks and mitigants permits.

Ratings reflect our expectations for an issuer's future performance; however, as the forward horizon lengthens, uncertainty increases and the utility of precise estimates typically diminishes. Our forward-looking opinions are based on assumptions that may prove, in hindsight, to have been incorrect. Reasons for this could include unanticipated changes in any of the following: the macroeconomic environment, general financial market conditions, disruptive technology, or regulatory and legal actions. In any case, predicting the future is subject to substantial uncertainty.

While our ratings reflect both the likelihood of a default on contractually promised payments and the expected financial loss suffered in the event of default, the overall standard approach illustrated in Exhibit 3 is principally intended to capture fundamental characteristics of state aid intercept programs and intercept debt. As a debt instrument becomes impaired or defaults, or is very likely to become impaired or to default, ratings typically include additional considerations that reflect our expectations for recovery of principal and interest, as well as the uncertainty around that expectation.

6 A link to *Rating Symbols and Definitions* can be found in the "Moody's Related Publications" section.

Moody's Related Publications

Credit ratings are primarily determined through the application of sector credit rating methodologies. Certain broad methodological considerations (described in one or more cross-sector rating methodologies) may also be relevant to the determination of credit ratings of issuers and instruments. A list of sector and cross-sector credit rating methodologies can be found here.

For data summarizing the historical robustness and predictive power of credit ratings, please click here.

For further information, please refer to *Rating Symbols and Definitions*, which is available here.

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