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Fitch: Minnesota's Unresolved Political Dispute Clouds Next Legislative Session.

Fitch Ratings-New York-06 December 2017: As Fitch Ratings expected, last Friday Minnesota made the $1.9 million interest-only debt payment on certificates of participation (COPs) that were issued in 2014 to fund a legislative office facility. Debt service on the 2014 COPs has become embroiled in a dispute between Governor Dayton and the Minnesota legislature as a result of the governor's line-item veto of the legislature's biennial budget appropriation in May 2017 following the legislature's adjournment. The state has the option to fund debt service on the 2014 COPs from either the department of administration's or the state senate's budget but, as a practical matter, since issuance it has funded debt service through the senate budget.

Although Fitch is confident of the state's ability and willingness to ensure full and timely payment of debt service on June 1, 2018 — the next scheduled payment date for the COPs — a failure to resolve the impasse in the upcoming legislative session would suggest a level of political dysfunction that is inconsistent with Fitch's current ratings on the state. The dispute comes at a time of strong economic and revenue performance for Minnesota and, in fact, centers on a disagreement over the use of surplus funds related to the size of adopted tax cuts.

Budget negotiations during periods of divided government in Minnesota have often been marked by brinksmanship. As Fitch rates to fundamental credit quality rather than political posturing, this has not kept the state from being rated 'AAA' with a Stable Rating Outlook.

What makes the current impasse unusual is that it has the potential, albeit remote, to affect a debt service payment, and resulted in the legislature bringing suit against the governor following his line-item veto. Members of the legislature have also stated publicly that they will not prioritize debt service over operations if the carryover funds they are currently relying on to fund operations near depletion. The Minnesota Supreme Court ordered the parties into mediation in September and ultimately declared the governor's line-item veto of the legislature's biennial budget appropriation constitutional on Nov. 16, 2017. While the question of the veto's constitutionality has been resolved, the two sides have so far failed to come to a political solution.

The legislature has sufficient carryover funds to support operations through Feb. 2018, and is scheduled to reconvene for a regular session on Feb. 20. Fitch expects one of its first acts will be to pass a supplemental appropriation to fund its operations, including COPs debt service, through the 2018-19 biennium. The governor could potentially veto that supplemental appropriation; however, the legislature would then have the option of overriding his veto by a two-thirds majority vote. Whatever twists and turns the disagreement between Governor Dayton and the legislature takes, Fitch expects the two sides to arrive at a resolution via the normal political process before the 2018 legislative session ends.

The next payment on the 2014 COPs on June 1, 2018 totals just $4.1 million. Fitch believes ample time and resources exist for the situation to be resolved ahead of that date. However, if the dispute persists into the spring and the parties are unable to reach a political resolution, Fitch would see

this as a sign that Minnesota's political discord has risen to the point where it is becoming inconsistent with the profile of a 'AAA' rated U.S. state credit.

Fitch would take the failure to achieve sustainable funding of the legislature in the regular session as a sign of significant dysfunction. An event of this kind, particularly if coupled with further statements by members of the legislature to the effect they do not regard payment of debt service as a priority, would likely result in Fitch downgrading the ratings of not only the series 2014 COPs directly affected by the conflict but also Minnesota's Issuer Default Rating (IDR) and the ratings on all of the state's general obligation (GO) and related debt.

Fitch's 'AAA' IDR on the State of Minnesota is based on the state's solid and broad-based economy, a revenue structure well designed to capture economic growth, a low long-term liability burden, and strong control over revenues and spending. In conjunction with a sophisticated approach to reserve funding, these features leave the state exceptionally well-positioned to manage through economic cycles while maintaining a high level of financial flexibility. The 'AA+' rating on appropriation-supported debt, one notch below the state's IDR, reflects the slightly higher degree of optionality associated with payments that are subject to appropriation.

The 2014 COPs are secured by biennially-appropriated payments made under a lease-purchase agreement between the state's commissioner of management & budget and the state's commissioner of administration. The department of administration's appropriation for fiscal 2018, which was enacted in May, totals $24 million; it was not sized with the expectation of funding debt service on the COPs. If the department of administration does not have sufficient funds available to cover the June 1, 2018 debt service payment (in the absence of legislative action), the state could take other administrative actions to ensure the payment is made. Alternatively, a court could be asked to find that the lease payment for the COPs is a core spending item that should be funded even in the absence of an appropriation.

Ultimately, however, Fitch's expectation for a U.S. state rated at Minnesota's level is that it will act in a way that ensures full and timely payment of all its debt. Prolonged political brinksmanship is inconsistent with that expectation.

Contact:

Michael D'Arcy
Director
+1-212-908-0662
Fitch Ratings Inc.
33 Whitehall Street
New York, NY 10004

Laura Porter
Managing Director
+1-212-908-0575

Media Relations: Sandro Scenga, New York, Tel: +1 212-908-0278, Email: sandro.scenga@fitchratings.com.

Additional information is available on www.fitchratings.com