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Fitch Affirms Pennsylvania's IDR at 'AA-'; Outlook Revised to Stable

Fitch Ratings-New York-30 July 2019: Fitch Ratings has affirmed the Commonwealth of Pennsylvania's Issuer Default Rating (IDR) at 'AA-'. The Rating Outlook is revised to Stable from Negative.

Additionally, Fitch has affirmed the 'AA-' ratings on the commonwealth's outstanding general obligation (GO) bonds, the 'A+' and 'AA-' ratings on bonds supported by commonwealth appropriations or otherwise capped at the commonwealth's IDR, and the 'A+' ratings on the commonwealth school credit enhancement programs linked to the commonwealth's IDR. Bonds and programs linked to the IDR are listed at the end of this release.

The Rating Outlook for all debt is revised to Stable.

SECURITY

The GO bonds are direct and general obligations of the Commonwealth of Pennsylvania, with its full faith and credit pledged.

The appropriation-backed bonds issued by the commonwealth financing authority (CFA) and the Pennsylvania Economic Development Financing Authority (PEDFA) are supported by annual, or continuing in the case of CFA, appropriations. While the CFA appropriation does not require annual renewal, it can be amended or repealed by the legislature.

The motor license fund-enhanced (MLF) subordinate special revenue bonds are payable in the first instance from a junior pledge on the trust estate, which consists primarily of residual toll revenues. Ultimate security for the bonds, and the rating, rest with the ability to access certain monies in the Commonwealth's MLF to fund debt service if necessary.

The ratings on the various school credit enhancement programs reflect Pennsylvania's overall credit quality, as well as the breadth and strength of the commonwealth's school aid intercept statutes and associated security features.

ANALYTICAL CONCLUSION

The Outlook revision to Stable from Negative reflects the commonwealth's timely enactment of a fiscal 2020 budget that makes continued strides towards structural balance, while also making a notable deposit to its rainy day fund. After multiple delayed budgets, the fiscal 2020 budget was the second consecutive year with an on-time budget. A robust, and unanticipated spike in fiscal 2019 revenue collections provided essential support for these improvements.

The 'AA-' IDR reflects Fitch's view that despite these gains, Pennsylvania continues to rely on non-recurring budget measures which reduces its financial resilience. The commonwealth is more at risk in the event of a moderate economic downturn than many other states. Pennsylvania, like nearly all U.S. states, continues to benefit from broad budgetary powers as reflected in ongoing efforts to

reduce baseline spending and enact recurring revenue changes. But fiscal pressures in the form of a structurally unbalanced budget, brought on by rising fixed costs, modest baseline revenue growth and a historically contentious decision-making environment have limited the commonwealth's fiscal flexibility.

Economic Summary

Pennsylvania's broad economy is growing, but at a slower pace than the U.S. Below-average demographics, including population growth that has lagged the nation's for several decades, represent a long-term drag on economic growth. Ongoing development of Pennsylvania's significant natural gas reserves could mitigate that concern, but that potential is tempered by fluctuations in natural resource markets. Overall, the state's economy provides a solid base for future potential revenue growth to help manage ongoing expenditure pressures.

KEY RATING DRIVERS

Revenue Framework: 'aa'

Fitch expects Pennsylvania's revenues will continue to reflect the depth and breadth of the economy but also its slower pace of growth. The commonwealth has complete legal control over its revenues.

Expenditure Framework: 'aa'

Pennsylvania maintains solid expenditure control with broad executive authority over spending and a low burden of carrying costs for liabilities. Medicaid remains a key expense driver, as with all U.S. states.

Long-Term Liability Burden: 'aaa'

The commonwealth's long-term liability burden is low. A recently completed ramp-up to making full actuarially determined contributions could slow future growth in net pension liabilities and lead to liability declines, if maintained over time and if actuarial assumptions are met.

Operating Performance: 'a'

Pennsylvania retains strong gap-closing capacity, but at a level below that of most U.S. states. The ongoing and regular reliance on non-recurring measures has eroded the state's general budgetary flexibility. Pennsylvania's rainy day fund balance has improved but remains small relative to the state's overall budget. The commonwealth is somewhat less exposed to revenue volatility from U.S. economic cycles than most states, offsetting some of the risk of a moderate downturn on its operating profile.

RATING SENSITIVITIES

Commitment to Restore Fiscal Balance: Fitch anticipates the commonwealth may be challenged in continuing its current path of slow progress in reducing the imbalance through new recurring revenues, expenditure reductions or a mix of both. A pattern of weakening fiscal practices during the ongoing national economic expansion, including growth in the structural deficit, could trigger a downgrade. Conversely, a sustained shift away from non-recurring items to balance the state's annual budgets, continued improvements in fiscal decision-making, and gains in the commonwealth's fiscal resilience such as through further additions to the rainy day fund, could all support an upgrade.

IDR-Linked Ratings: The ratings on the various related ratings linked to or capped by the IDR are sensitive to changes in that rating.

ECONOMIC RESOURCE BASE

CREDIT PROFILE

Revenue Framework

Pennsylvania's personal income tax and sales and use tax serve as the primary revenue sources, accounting for approximately three-quarters of general fund revenues. Fitch anticipates Pennsylvania's overall revenue growth trend will remain modest, underscoring the importance of developing recurring solutions for the commonwealth's structural budget imbalance.

Historical revenue growth, adjusted for the estimated effect of policy changes, has been near the rate of inflation over the past 10 years. YoY growth was robust leading into the Great Recession, but has moderated considerably since the recessionary declines in fiscal years 2009 and 2010. Fitch anticipates the long-term trend for revenue growth will remain in line with inflation and trail the pace of national economic growth given Pennsylvania's slowly growing economy.

The commonwealth has no legal limitations on its ability to raise revenues through base broadenings, rate increases, or the assessment of new taxes or fees.

Expenditure Framework

As in most states, education and health and human services spending are Pennsylvania's largest operating expenses. Education spending is the largest expense from state funds as the commonwealth provides significant resources for local school districts and the public university and college system, but health and human services spending is likely to outpace it in future years given recent trends. Medicaid is the largest component of health and human services spending.

Pension contributions have grown considerably over the past several years as the commonwealth ramped up spending in line with a statutory plan enacted in 2010 to achieve full actuarial contributions. Having reached full funding under that plan in fiscal 2017, state spending increases should moderate, assuming actuarial assumptions for the pension plans are met. Fitch does not anticipate pension contributions will be a material driver of the pace of overall expenditure growth going forward.

Spending growth in the commonwealth, absent policy actions, will likely be in line with to marginally above revenue growth, driven primarily by Medicaid. The fiscal challenge of Medicaid is common to all U.S. states, and the nature of the program as well as federal government rules limits the states' options in managing the pace of spending growth. Federal action to revise Medicaid's programmatic and financial structure appears less likely in the near term given divided control in Congress.

Like many states, Pennsylvania has implemented various measures to control Medicaid growth, with a recent shift to managed care for the long-term care population being the most recent and one of the most potentially significant. The transition has been complicated and the commonwealth phased it in geographically to manage implementation issues. To date, the managed care transition has led to some volatility in Medicaid spending as the state increases spending to address unanticipated transition costs, particularly for fiscal 2019 as discussed below. Fiscal 2020 is the last transition year. Fitch will closely monitor the commonwealth's ability to manage another material increase in transition costs, and whether the shift to managed care allows for long-term savings and/or more predictable Medicaid budgeting.

Pennsylvania retains solid expenditure flexibility. The low carrying cost metric of approximately 5% of governmental fund expenditures in fiscal 2018 includes debt service, actuarial pension funding demands, and other post-employment benefits (OPEB) pay-go costs. Pension costs reflect the state's contributions to the state employees' retirement system (SERS) and a modest contribution to the public school employees' retirement system (PSERS) for certain employees. It excludes state appropriations made to school districts to reimburse them for a portion of their pension

contributions.

Like most states, Pennsylvania's operating budget goes largely toward the funding of services rather than direct service delivery, allowing the commonwealth to shift costs to lower levels of government in times of fiscal stress and thereby providing a key source of flexibility. However, the challenges faced by the commonwealth in agreeing on annual budgets until last year reflect practical limits on Pennsylvania's expenditure flexibility.

Long-Term Liability Burden

Pennsylvania maintains a low long-term liability burden. Per Fitch's November 2018 State Pension Update report, the commonwealth's total debt and net pension liabilities of approximately \$41 billion equaled 6% of 2017 personal income, matching the 50-state median. Based on the most recently available data, Pennsylvania's current long-term liability burden for debt and pensions remains approximately 6% of 2018 state personal income.

Debt levels primarily reflect borrowing for various capital needs including facilities, transportation, and water and sewer infrastructure. The commonwealth uses a mix of GO and appropriation-backed bonds. Approximately two-thirds of outstanding debt is GO. The state has used multiple entities and mechanisms to issue appropriation debt, which is used primarily for water and sewer needs, economic development initiatives, and most recently to support public school capital projects. Fitch's calculation incorporates approximately \$697 million in project debt associated with the Rapid Bridges Replacement availability payment-based public private partnership (P3) entered into by the commonwealth's department of transportation.

In 2018, Pennsylvania issued \$1.5 billion of operating debt as appropriation-backed bonds through the CFA. Proceeds were used primarily to address an unanticipated revenue shortfall in fiscal 2017 and allowed the commonwealth to restore budgetary balance in its general fund. Pennsylvania issued the bonds as tobacco master settlement bonds, intending to redirect settlement revenues to cover debt service, but with a general fund appropriation backstop common to most CFA debt.

Pennsylvania's pension obligations are for SERS and PSERS. SERS includes state employees and employees of certain state-related organizations, and the commonwealth bears the vast majority of the system's liability. PSERS includes public school employees, and the liability is shared between local school districts and the commonwealth. Pennsylvania makes a small direct PSERS contribution and also provides much more sizable reimbursements to school districts for their direct pension contributions. Accordingly, under GASB 68, the commonwealth bears just a small share of the system's liability commensurate with its own direct system contributions.

The commonwealth contributions were consistently short of the actuarially calculated amounts for both SERS and PSERS for many years, but the percentage paid steadily increased in line with legislation enacted in 2010, and reached full actuarial contributions for both systems in fiscal 2017. Recent benefit changes will shift new hires to a hybrid pension with a defined contribution component, among other changes, with savings to the commonwealth likely to accrue only gradually, with workforce turnover.

Operating Performance

Pennsylvania's ability to respond to cyclical downturns relies on the superior budget flexibility common to most states, but has been limited by slow progress in addressing an ongoing structural imbalance and, until very recently, the lack of meaningful reserves. Given continued reliance on non-recurring budgetary measures throughout the current period of economic growth, Fitch anticipates Pennsylvania would have fewer balancing options available to it than most states in a moderate downturn. Mitigating this, Fitch's FAST model highlights that the commonwealth's revenue base has

proven less exposed to national economic cyclicity than other states. Despite continued steps to moderate spending growth, the fiscal 2019 budget continues a pattern of modest recurring revenue changes that are insufficient to fully support the expenditure base.

The commonwealth depleted its rainy day fund during the Great Recession but did make a modest contribution at the end of fiscal 2018 of approximately \$22 million and a more sizable \$317 million deposit at the end of fiscal 2019. During the economic expansion, Pennsylvania had repeatedly suspended a statutory requirement to dedicate 25% of any unappropriated general fund balance to its Budget Stabilization Reserve Fund (BSRF). General fund balances, when available, had instead been used to support annual budget needs. Solid revenue growth in fiscal 2018 allowed the commonwealth to exceed its modest budgeted BSRF contribution of roughly \$10 million. Unexpectedly strong revenues in fiscal 2019 allowed the commonwealth to make a more substantial contribution.

Throughout the current national economic expansion, Pennsylvania has continued to employ non-recurring budgetary measures. The commonwealth has utilized fund transfers, changes in timing of state expenditures, and one-time revenue sources (including operating debt) to achieve annual budgetary balance in recent years. Pension funding deferrals, a budget balancing tool used consistently in the past, ended in fiscal 2017 and the commonwealth has made some progress in reducing the reliance on non-recurring measures overall. The fiscal 2020 budget includes approximately \$600 million in various one-time measures, or 2% of the enacted general fund appropriations. The 2019 budget relied on more than \$1.0 billion such measures, and the fiscal 2018 budget relied on even more including the \$1.5 billion in tobacco settlement revenue-supported operating debt noted earlier.

The difficulty in addressing fiscal challenges has led to repeated delays in budget enactment, particularly when control of the executive and legislative chambers has been split along partisan lines. Until the fiscal 2019 budget, every fiscal year under the current Democratic governor (who took office in January 2015 facing a Republican-controlled legislature), has started without a full budget in place. In fiscal 2016, the delay lasted approximately nine months and in fiscal 2018 the delay lasted into the fourth month of the fiscal year. In 2018, with gubernatorial and legislative elections looming, all sides enacted an on-time budget for fiscal 2019. The 2020 budget process benefited from both above-budget revenues in fiscal 2019 that mitigated potentially difficult fiscal choices, and a gubernatorial executive budget that did not include any significant tax policy changes which had been a sticking point in prior year's budget negotiations.

The commonwealth's Independent Fiscal Office (IFO; an office created by statute several years ago and technically part of the legislature) reports every November or December on its five-year outlook for the commonwealth's fiscal position, including an estimate of the projected general fund structural budget position based on estimated revenue growth and a current services expenditure projection. The IFO's estimates since December 2015 have indicated clear progress in the commonwealth's efforts to address its structural imbalance, but also the magnitude of the remaining challenge. The IFO's projected general fund ending balance in fiscal 2021 improved from negative \$2.9 billion in the December 2015 forecast to negative \$1.6 billion in the November 2018 forecast, which incorporates effects of the commonwealth's enacted fiscal 2019 budget plan. The projected fiscal 2021 deficit is 5% of projected general fund expenditures for that year.

Current Developments

Robust Fiscal 2019 Revenues Support Mid-Year Spending Needs and Reserves Funding

Preliminary results through the end of fiscal year 2019 in June indicate general fund revenues out-

performed the budgeted estimate by nearly \$900 million, or 2.6% providing fiscal relief for mid-year pressures and allowing the state to make a deposit to its rainy day fund, boosting fiscal resilience. Corporate net income collections exceeded the estimate by \$471 million reaching \$3.4 billion (up 18% from fiscal 2018), while sales tax revenues were \$347 million ahead of the estimate for a preliminary total of \$11.1 billion (up 6.9%). Personal income tax revenues of \$14.1 billion were in line with the enacted budget estimate.

The robust gains in corporate and sales tax collections are likely to moderate in fiscal 2020. Fitch attributes at least some of the corporate gains to the 2017 federal tax changes including one-time repatriation of foreign income. Sales tax revenues may have received a boost following last June's Wayfair Supreme Court decision authorizing states to levy sales taxes directly on remote sellers, including online retailers. Adding new filers in fiscal 2019 could have driven revenue gains in fiscal 2019 but they will be built into the base going forward.

The revenue gains proved critical in fiscal 2019 as the commonwealth faced nearly \$700 million in mid-year spending needs due to ongoing litigation that held up a \$200 million fund transfer from the Pennsylvania Professional Liability Joint Underwriting Association (JUA) and nearly \$500 million in supplemental costs for Medicaid. The supplemental Medicaid costs came as the state implemented the next phase of its transition of long-term care provision to a managed care model. Pennsylvania reported implementation in the densely-populated southeastern section of the state in fiscal 2019 proved more costly than anticipated. Fiscal 2020 is the final year of implementation for the managed care transition and the administration does not anticipate a similar spike in costs given the less complex nature of the affected geographic region.

Even after addressing these supplemental spending needs, the commonwealth still had more than \$300 million available for deposit into its rainy day fund. The fund currently holds \$340 million, a modest 1% of the fiscal 2020 appropriations - it peaked at \$755 million in fiscal 2009 before it was fully drawn down in fiscal 2010 during the Great Recession.

2020 Budget Adoption Proceeds Smoothly - One-Time Measures Reduced

Enactment of a second consecutive on-time budget could reflect a possible shift away from a recent trend of impasses, though the strong revenue position certainly eased passage. Also, the governor did not include material tax policy changes in his original executive budget plan, which Fitch believes eased negotiations with the legislature for the fiscal 2020 budget. Separate from the budget, the governor proposed a natural gas severance tax to support a range of capital project initiatives. The legislature may take up the proposal when it returns for its fall session.

The enacted budget incorporates modest general fund revenues growth with tax revenues up 2.5% from actual results for fiscal 2019. Growth in personal income, sales, and corporate taxes are all projected to slow from relatively robust, and likely one-time gains in fiscal 2019. General fund spending is up modestly as well at less than 2% annually with a \$300 million overall increase in K-12 education funding with a \$160 million increase in basic education aid flowing through the Fair Funding Formula. The budget incorporates a number of one-time items (including, once again, a \$200 million JUA transfer which is the subject of ongoing litigation - to date, all decisions in the cases have gone against the commonwealth), reflecting Pennsylvania's ongoing structural budget challenges. But the magnitude appears lower than in past years, and the budget also incorporates a nearly \$200 million surplus providing some cushion.

Commonwealth Financing Authority Bonds Rating Details

The revenue bonds are limited obligations of the authority secured by service fees paid by various

commonwealth agencies to the Commonwealth Financing Authority (CFA) and assigned to the trustee. Act 85 of 2016 established a continuing appropriation of Article II revenues from Pennsylvania's general fund to a restricted account to be used for debt service. The continuing appropriation does not require annual renewal but can be amended or repealed by the legislature.

For additional information on the CFA revenue bonds please see "Fitch Rates Pennsylvania Commonwealth Financing Auth's \$540MM Rev Bonds 'A+'; Outlook Negative", published April 26, 2019 at www.fitchratings.com.

Pennsylvania Economic Development Financing Authority Bonds for Convention Center Rating Details

The convention center is leased by the commonwealth to the Convention Center Authority and operated via an operating agreement, under which obligations to cover operating deficits, net debt service in the event of a shortfall in intended repayment revenue streams, and capital funding requirements are shifted to the commonwealth from the prior owner, the city of Philadelphia. The intended repayment source for the bonds are certain defined revenues to be received from the city of Philadelphia and the commonwealth but the commonwealth covenants to seek annual appropriations from its General Assembly for amounts beyond those available from the intended sources as necessary to meet its contractual obligations associated with the center. These include, among other items, payment of debt service on the bonds. This appropriation backstop is the basis for the rating, one notch below Pennsylvania's IDR.

Pennsylvania School Credit Enhancement Programs Rating Details

The 'A+' rating on the school credit enhancement programs reflects Pennsylvania's overall credit quality, as well as the breadth and strength of the commonwealth's school aid intercept and direct payment statutes, and associated security features. Sections 633, 785(a) and 785 (b) of Pennsylvania's public school code allow school districts to participate in the intercept program and direct payment programs, and outline the mechanics. Participating school districts must enter into interagency agreements authorizing and directing the Secretary of Education and State Treasurer to either intercept state appropriations and redirect towards debt service (section 633 and 785(a) programs) if a district does not pay itself, or to directly pay the paying agent before aid flows to the district (section 785(b) program). For the intercept programs, Fitch only rates bonds where the district enters into agreements that utilize a sinking fund or similar structure that ensures the intercept will provide timely debt service payments. The one notch-distinction from Pennsylvania's IDR reflects the appropriation risk for state school aid.

Penn Turnpike MLF-Enhanced Bonds Rating Details

The 'AA-' rating is based on the commonwealth's statutory and legal commitments to draw upon certain reserved funds in its Motor License Fund (MLF) to make up any deficiency in debt service deposits. To date, the bonds have been paid from their intended source, the Pennsylvania Turnpike Commission's general reserve fund derived from toll revenues. The MLF receives a variety of fuel and other vehicle-related revenues and has historically exhibited large daily balances. Legislative appropriation is not required to access the MLF to cover a debt service deposit deficiency. Pennsylvania's ability to borrow from the MLF to support its general fund (as it has done as recently as fiscal 2018), and the lack of a direct pledge of MLF revenues, limits the rating on the bonds to the state's IDR.

For additional information on the MLF-enhanced bonds please see "Fitch Rates \$87MM PA Turnpike Comm's Motor License Fund-Enhanced Bonds 'AA-'; Negative Watch", published Nov. 29, 2017 at

www.fitchratings.com.

Related Ratings

Fitch has affirmed the following ratings that are supported by commonwealth appropriations and therefore linked to the commonwealth's IDR, or otherwise capped at the IDR, as listed below. The ratings carry the same Stable Outlook as the IDR:

- Pennsylvania Turnpike Commission motor license fund-enhanced turnpike subordinate special revenue bonds at 'AA-';
- Pennsylvania Commonwealth Financing Authority appropriation-backed debt at 'A+';
- Pennsylvania Economic Development Financing Authority revenue bonds (Convention Center Project) bonds at 'A+';
- Pennsylvania School Credit Enhancement Intercept Program (PA), State School Bond Program Rating (Intercept Program) - Section 633 at 'A+';
- Pennsylvania State Public School Building Authority (PA), State Building Authority Intercept - Pennsylvania State Public School Building Authority - 785(a) at 'A+';
- Pennsylvania School Credit Enhancement Direct Pay Intercept Program (PA), State School Bond Program Rating (Direct Pay Intercept Program) - Pennsylvania State Public School Building Authority Direct Pay - 785(b) at 'A+'.

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In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

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