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Jacksonville Seeking Utility Payments to Avoid Cut: Muni Credit.

Jacksonville, Florida, with the third most underfunded pensions of the largest U.S. cities, is considering an unprecedented solution that may preserve its credit rating at the expense of its utility's.

Jacksonville, rated the second level of investment grade by Moody's Investors Service, wants JEA, which provides water and electricity to the state's most populous city, to contribute \$40 million annually to help avoid a downgrade. The utility, ranked two steps lower and trying to dodge a cut of its own, says it can't afford the payment.

The city's effort shows how the creditworthiness of municipalities is under pressure with state and local government pensions underfunded by at least \$1 trillion, according to a January report by the Nelson A. Rockefeller Institute of Government in Albany, New York. Taking money from JEA may ultimately help the city and hurt the utility, according to Wasmer, Schroeder & Co.'s Reid Tomlin.

"The situation can be a zero-sum game if the city of Jacksonville is punting this to the utility," said Tomlin, director of municipal research at the Naples, Florida-based firm, which oversees about \$3.5 billion in munis, including JEA debt. "If you take money from the utility, there could be credit implications there as well."

Reducing Benefits

Cities across the country have scaled back retiree benefits and searched for revenue to cover growing pension liabilities. Los Angeles and Jersey City, New Jersey, raised the retirement age and reduced payments. Allentown, Pennsylvania, leased its water and sewer system last year to help pay its pension costs.

Among the 25 largest U.S. cities, only Chicago and Philadelphia have pensions that are more underfunded than Jacksonville's, according to a November report by Morningstar Inc. (MORN)

JEA's "first obligation is to the ratepayers," not solving the city's pension woes, said Mike Hightower, chairman of the utility's board.

"My initial reaction was, we don't have \$40 million," Hightower said. "If we had \$40 million, first we would either give it to back to our ratepayers or we would be reducing our debt."

Cost Cutting

Jacksonville Mayor Alvin Brown, who proposed the JEA plan, said that the utility could cut costs to offset the extra payment and avoid a downgrade. The utility already transfers about \$106 million annually to the city.

"For JEA to be successful, the city has to be successful," Brown said.

Pension costs in Jacksonville have risen more than six-fold since 1992 and now account for about 19 percent of its \$983.7 million annual budget.

The pension for police officers is 39 percent funded, and the city's total \$5.2 billion unfunded liability is four times the size of its operating revenue, the fourth-highest ratio in the nation, according to Moody's.

"There's a finite number of resources available to the operating budget and the pension has consumed an increasingly larger share very quickly," said Michael Rinaldi, a Fitch Ratings analyst in New York.

Investment Performance

The shortfall stems from underperforming investments and generous retiree benefits, said David Draine, who has studied the city as a senior researcher at Pew Charitable Trusts. The Philadelphia-based non-profit is providing free advice to Jacksonville and other cities trying to reduce pension costs.

Moody's said it may downgrade Jacksonville by one or two steps from Aa1 by mid-April, because of rising pension costs, Dan Seymour, a Moody's analyst, wrote in a Jan. 15 report.

Fitch rates JEA's bonds AA, its third-highest grade, with a stable outlook. Christopher Hessenthaler, a Fitch analyst, wrote in a Feb. 7 report that the Jacksonville mayor's plan is a "credit concern" for JEA, formerly called the Jacksonville Electric Authority.

Aside from the pension costs, Jacksonville's financial profile is improving, with seven consecutive years of budget surpluses and a "strong" growth in reserves, Rinaldi said. The city's unemployment rate was 5.6 percent in December, lower than U.S. rate of 6.6 percent in January. The U.S. Navy is the city's largest employer.

'Stable' Finances

Jacksonville has "a history of sound, stable financial performance, despite the pension pressures," he said. "They have a very good track record with respect to generating surpluses at year-end."

Jacksonville, with a population of about 836,500, is holding off on new bond sales until adopting a solution to the pension shortfall, said C. Ronald Belton, Jacksonville's chief financial officer. Borrowing costs may go up further if the city is downgraded, he said.

JEA is in the process of selling about \$74 million in refunding revenue bonds.

Brown said a \$560 million contribution from JEA — \$40 million annually for 14 years — may help the city's pension system become 80 percent funded by 2028. Brown said his plan, which includes scaling back some retiree benefits, may save the city \$2.75 billion over 35 years.

The utility serves more than 400,000 customers and had revenue of \$1.9 billion in 2012. It has \$5.6 billion in debt, which is "high" and stands as "a sensitivity to its rating," Hessenthaler said.

Negative Outlook

Jacksonville had \$2.5 billion in outstanding bonds, according to an August report by Moody's that described the debt level as "moderate."

In July, Brown unsuccessfully attempted to reduce worker benefits to bring down pension costs. The City Council killed the plan.

A month later, Fitch changed its outlook on Jacksonville bonds to negative, threatening to downgrade the city's AA rating, the company's third highest rating, "at least one notch" if the pension overhaul effort stalls. The city has not been downgraded in at least 12 years.

A city-commissioned task force has been seeking ways to cut pension costs, which have crowded out spending on education, public safety and social services.

Hightower, the JEA official, said the utility's board would consider the city proposal. The mayor has offered to help JEA find savings in its \$1.8 billion budget to offset the additional payment. If JEA's seven board members, appointed by the mayor, sign off on the extra payment, the city council could then ratify it as part of a pension rewrite.

Yield Spread

JEA revenue bonds maturing in October 2031 traded Feb. 5 with an average yield of 3.98 percent, or about 1.94 percentage points above benchmark munis, according to data compiled by Bloomberg. The spread was the highest since April.

The average yield spread on some Jacksonville bonds has risen since Fitch revised the city's outlook to negative in August, Bloomberg data show. Limited-obligation bonds maturing in October 2030 have had an average spread of 1.47 percentage points over benchmark debt since Aug. 27. In the five months before the outlook changed from stable to negative, the extra penalty averaged 1.18 percentage points.

Unlike other cities facing pension shortfalls, Jacksonville has not skipped payments on its required annual contribution to retiree benefits.

Jacksonville has funded its growing pension obligation by cutting services, reducing its payroll and raising taxes, Belton said. With the pension contribution set to increase to \$181 million this year and continue rising, the city is looking for a plan to pay down the unfunded liability without gutting social services.

"We need to deliver if we want to maintain and enhance our city's already strong credit rating," Brown, a 52-year-old Democrat, said at a Jan. 29 meeting of Jacksonville's Retirement Reform Taskforce. "A downgrade in that credit rating would not only hurt our city prestige but also hurt taxpayers."

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