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Arizona Upgraded to 'AA' from 'AA-' on Good Fund Balances and Expected Structural Balance; Outlook Stable.

NEW YORK (Standard & Poor's) May 20, 2015—Standard & Poor's Ratings Services has raised its issuer credit rating (ICR) on the State of Arizona to 'AA' from 'AA-', as well as raised its rating on the state's general fund appropriation-secured certificates of participation (COPs) outstanding to 'AA-' from 'A+'. The outlook for both the ICR and COP ratings is stable.

"The upgrade reflects what we consider Arizona's good fund balance position, on a budgetary basis, and expected near structural budget balance in fiscal 2016, based on recent above-budgeted growth in tax revenues," said Standard & Poor's credit analyst David Hitchcock. "This follows a period of imbalance triggered by the expiration of a temporary sales tax hike at the end of fiscal 2013," Mr. Hitchcock added.

The state had budgeted in fiscal 2015 for an almost complete drawdown of its large general fund balance in fiscal 2015 and a modest draw on in its budget stabilization fund (BSF); the state now reports revenues significantly above budget because of surging income tax collections that could potentially negate the need to draw on the BSF in 2015. Based on the additional revenues, we foresee no drawdown in the BSF in either fiscal years 2015 or 2016, and only a very small decrease, or possibly an increase, in the general fund balance in fiscal 2016.

The rating on the COPs reflects what we view as:

- The long-term creditworthiness of Arizona; and
- Pledged lease revenues subject to annual appropriation by the state.

Our view of Arizona's long-term creditworthiness, as reflected in our 'AA' ICR, is based on what we consider the state's:

- Diverse economy, with continued strong population growth, and adequate, but below-average and slowly declining income levels, as well as a turnaround in a housing market that had suffered a severe downturn;
- Strong financial position, and anticipated structural balance in fiscal 2015, despite the expiration of a temporary sales tax surcharge at fiscal year-end 2013; and
- Low other postemployment benefits (OPEB) and moderate debt burden.

Partially offsetting factors, in our opinion, are Arizona's:

- Historically cyclical finances, including large general fund balance drawdowns in fiscal years 2007 through 2009; fiscal years 2010 and 2011 would also have reported drawdowns if not for one-time borrowing for ongoing operational purposes, while fiscal 2014 had a large drawdown following expiration of a temporary sales tax; and
- Restrictions on operational flexibility as a result of voter initiatives, notably a two-thirds requirement for a legislative vote to increase state revenues (Proposition 108) and a high bar on

executive or legislative modification of programs or revenues approved by voters (Proposition 105).

In addition, recent litigation has required the state to resume inflation funding for local schools that had not occurred during the recession, and could hamper Arizona's ability to make cuts in future downturns. The state has not fully funded a lower court's mandated increase in school inflation funding — the case is currently on appeal.

For the COPs and lease revenue debt, Arizona's obligation to make lease payments is absolute and unconditional, subject to annual appropriations by the state legislature and annual allocations of such appropriations for lease payments.

The stable outlook reflects recent strong revenue growth and spending restraint that we expect to keep Arizona near structural balance in fiscal 2016 and for the foreseeable future, as well as limited future debt plans.

Although housing may again experience slumps, we do not expect the state to repeat such a severe housing crisis as it did in the last recession for the foreseeable future.

Should large structural budget imbalances develop again, we could adjust our rating or outlook downward.

Rating improvement would likely require improved income levels and lower pension liabilities. We believe Arizona's credit quality is also somewhat constrained by an active voter initiative process and recent court decisions on school funding that are unlikely to change impediments to expenditure flexibility over our two-year outlook horizon.