Bond Case Briefs

Municipal Finance Law Since 1971

How Standard & Poor's Rates U.S. State and Local Government Department Appropriation-Backed Debt.

Appropriation-backed debt is a common financing structure in the U.S. municipal bond market. These obligations come in various forms, but the most prevalent are lease revenue bonds, certificates of participation, and service contract bonds. Payment of debt service on appropriation-backed debt is contingent on the inclusion in the enacted budget of annual appropriations sufficient to cover principal and interest directly (see "USPF Criteria: Appropriation-Backed Obligations," published June 13, 2007, on RatingsDirect).

Occasionally, however, we're asked to review appropriation-backed structures for capital facilities that are less-direct obligations of a state or local government, but which receive support from that government's annual appropriations from departments or agency revenues. Examples of these include bonds whose repayment source is limited to a specific department or agency's resources, rather than the full resources of the government, or debt that a given department issues outside of the general government's typical capital funding program. In these cases, we apply our government department appropriation-backed criteria ("USPF Criteria: Rating Government Department Appropriation-Backed Debt In U.S. Public Finance," Nov. 7, 2007), in conjunction with our appropriation-backed obligations criteria. In analyzing these transactions, we assess the appropriation process, project/financing authorization, and level of state/local government involvement, along with how well the financing structure conforms to our criteria and where the obligation will be accounted for.

Standard & Poor's Ratings Services believes some additional context on how it rates government department appropriations for U.S. state and local governments may be useful to investors and other market participants.

Frequently Asked Questions

How do government department appropriation-backed obligations differ from more traditional appropriation-backed structures?
The main differences are how they authorized and appropriated or budgeted, and the revenues that are available to make the appropriation from. The general government authorizes traditional appropriation obligations and pays them from its general operating funds. Department obligations can come in an array of structures. In some cases, the structures closely resemble traditional appropriation or lease revenue-backed bonds; in others, payments from the state or local government aren't part of the traditional budget appropriation process, and there may be a more limited flow of funds to support the appropriation or a different authorization process from traditional appropriation obligations. The transaction's structural features and the extent to which the state or local government recognizes it as an obligation will determine the strength of the financing relationship to that entity.

Do Standard & Poor's government department criteria replace the broader appropriation criteria when rating these obligations?

No. When rating government department obligations, we use both criteria. As a first step, we apply our broader appropriation-backed obligations criteria to evaluate the structural security features of the bonds. Then, we apply our government department appropriation-backed debt criteria to evaluate the obligation's financing link to the general government, if any. In other words, our government department appropriation criteria don't take the place of our appropriation criteria, but rather provide additional guidance on how to address certain security features that might be similar to those for traditional appropriation debt, but may not have the same direct ties to a state or local government's debt issuance or budgeting process. In analyzing government department obligations, we still rely on our appropriation-backed obligations criteria to evaluate leases, service contracts, or certificates of participation if these are part of the security structure. We rely on our government department criteria to analyze additional key considerations that in turn allow us to evaluate the obligation's link to the general government; the latter assessment helps us determine whether to link the obligation rating to that of the general government or rate it independently.

What are the key considerations Standard & Poor's evaluates when rating government department debt?
Standard & Poor's evaluates certain factors to determine how similar a government department's debt issue is to other debt of the state or local government and what role the obligation plays in the government's overall capital plan and structure. Factors that indicate a strong link to the general government include:

- Payment on these obligations is typically handled at a high level of the government;
- Key decisionmakers in the government are fully aware of the issuances;
- When governments review and discuss their debt levels and affordability, they consider these obligations;
- Despite appropriation risk, controls and mechanisms are in place to ensure uninterrupted payment flows to the obligation; and
- These obligations are a critical component of the government's capital structure.

Can government department obligations achieve ratings as high as those on traditional appropriation structures?
Yes. If a government department obligation meets certain conditions, Standard & Poor's may assign the same rating as it would to an appropriation obligation of the general government (e.g., one notch below the general obligation [GO] rating). To achieve this, the department or agency must demonstrate that it has authority to enter into the contractual agreement by a legislative act or resolution. That is, a government level higher than the department or agency must approve the agreement. It's also important that the state or local government recognize the long-term obligation. We can determine this in several ways, including:

- Assessing whether the relevant department recognizes that the government will seek appropriation and monitor the issue in question in a similar manner as other general government appropriation-backed obligations;
- Demonstrating that payments for these obligations will be included in the budget;
- Prior appropriation-backed obligations of a similar nature in a manner that meets generally accepted accounting principles standards; and
- Obtaining a legal opinion from the obligor's counsel or the government's attorney general that clarifies the nature of the obligation.

Does Standard & Poor's always rate government department appropriation obligations one notch below the GO rating or issuer credit rating?
No. We could rate these obligations one or more notches below the GO rating or the issuer credit rating on the general government or, in certain cases, independently from it. In some cases, the

department of a state or local government has received legislative authority to enter into a contractual obligation for capital purposes, but the state or local government doesn't consider it debt or a direct long-term contractual commitment. For example, a government might be statutorily required to make payments to another agency or department, and that entity then agrees to issue bonds backed by that statutorily mandated payment. In this instance, the government might not view these payment obligations or the appropriation-backed bonds as its own obligation. Although we recognize the strength of the statutorily required payments, these obligations don't benefit from the same treatment at the general government level — that is, the government doesn't view itself as the obligor, and thus we might assign a rating more than one notch below the GO rating on that government. In some other cases, we've been asked to rate transactions issued by an independent agency that perhaps receives funds from the government, but is not itself an agency of the government and has not received formal approval from the government to issue the debt. An example of this is a regional transit authority that is an independent authority, but receives funds from one or more governments. Absent formal approval to issue the debt by the participating government or governments, the government revenues becomes a part of the agency's revenue stream and are incorporated in the analysis as other sources of revenues available to fund the debt service on any appropriation-backed bonds issued. In this case, an evaluation of the agency will likely be necessary to determine the appropriate rating, independent of the ratings on the governments providing the revenues.

Under Standard & Poor's policies, only a Rating Committee can determine a Credit Rating Action (including a Credit Rating change, affirmation or withdrawal, Rating Outlook change, or CreditWatch action). This commentary and its subject matter have not been the subject of Rating Committee action and should not be interpreted as a change to, or affirmation of, a Credit Rating or Rating Outlook.

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