

SPECIAL COMMENT

Washington State Municipalities – Exposure to Underperforming Enterprises Poses Risk to Sponsor Cities

Table of Contents:

SUMMARY	1
BACKGROUND ON WASHINGTON PFDS	1
WEAK REVENUE PERFORMANCE IS A KEY CHALLENGE FOR STRUGGLING PFDS	2
DEBT STRUCTURE CAN COMPOUND RISKS	2
CITIES DOWNGRADED DUE TO WEAK PFDS	2
APPENDIX A	4
WASHINGTON PFDS AND DEBT OUTSTANDING	4

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Summary

Many State of Washington municipalities are experiencing pressure related to their guarantees of debt issued by public facility district (PFDs) enterprises that are now struggling. As a result, several city ratings throughout the state have been lowered. While more downgrades are possible, we do not anticipate further defaults in the near-term. In recent years, the trend of poor operating performance and declines in PFD sales tax revenue has intensified the pressure on cities and counties with PFD debt exposure. For these issuers, negative credit pressure is driven by their obligation to provide loans for pressured PFD enterprises, and to pay debt service on enterprise bonds that they guarantee with their G.O. pledge.

Background on Washington PFDs

PFDs are municipal corporations of the State of Washington with independent taxing authority under the state constitution. There are two applicable statutes, one for counties and another for cities, towns, or joint arrangements between them. The PFDs are able to access a 0.033% state sales tax rebate and utilize these funds to help construct regional event centers in counties throughout the state with the goal of providing civic and economic benefits to the region. Financings are typically supported by net revenues of the facilities which include the state sales tax rebate, gate fees, concessions, and in some cases an excise tax on hotel services and lodging. Currently there are 25 districts in the state that operate under a resolution, or inter-local agreement with the city or county in which they were formed, and 18 PFDs with a combined \$482 million of debt. The districts have established a variety of regional centers including convention centers, fixed-seat arenas, theatres, museums, and trade centers.

To fund the construction of these facilities, PFDs issued limited tax and revenue bonds, most often with a guarantee provided by the sponsoring municipality. In a typical structure, the PFD enters into a contingent loan agreement under which the city agrees to loan the PFD necessary funds to pay debt service if the district is unable to do so on its own. In some cases, the city also provides operational support to the PFD, but this support is usually capped at a specific dollar amount.

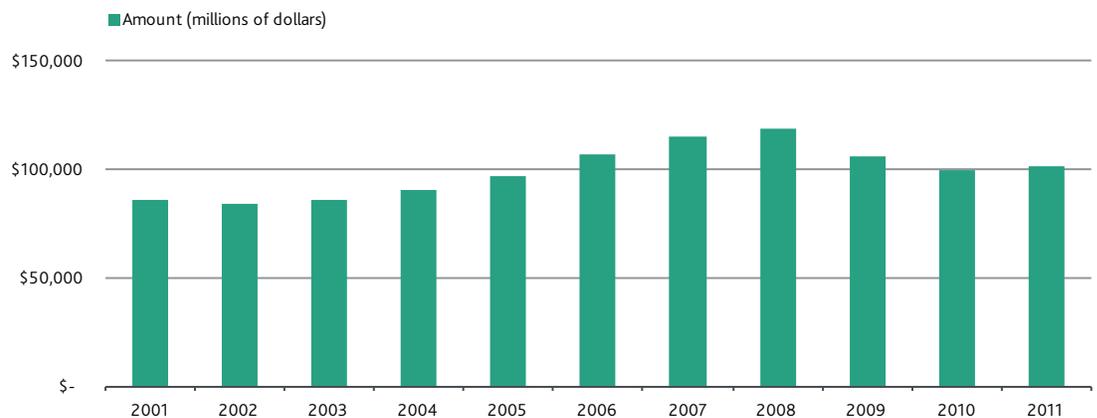


Weak Revenue Performance is a Key Challenge for Struggling PFDs

Construction of many of the debt-funded event centers occurred between 2001 and 2006 when the economy was booming. As such, many of these projects were embarked using optimistic revenue projections that assumed persistently strong economic growth. However, over the last four years, many PFDs have suffered operating losses as a result of declining revenues and subdued retail sales sparked by the economic downturn. Retail sales grew by a modest 1.8% in FY 2011, but the increase was not enough to recover the deep declines in 2009 and 2010 which totaled 10.4% and 6.0%, respectively (Exhibit 1). As a result of depressed sales tax and event revenues, some cities have had to provide financial support to the PFD as prescribed in the contingent loan agreement. This support adds stress to cities that are already facing other budgetary challenges.

EXHIBIT 1

Washington State Taxable Retail Sales



Source: Washington State Economic and Revenue Forecast Council Update, January 2012

Debt Structure Can Compound Risks

PFD-related credit risks are exacerbated by weak debt structures, especially those that assume growing sales taxes and, in some cases, utilize variable rate debt. Reflecting optimistic sales tax projections, PFD debt service has typically been structured to increase at a similar growth rate over the life of the bonds. Under current law, the PFD can collect the sales tax rebate for 25 years. Some boards have considered seeking a state legislative resolution to extend the rebate by 15 years, allowing them to restructure debt service for longer terms. However, the resolution may face opposition by the state, which is facing pressure to increase their revenues to pay for public education and social services.

Cities Downgraded Due to Weak PFDs

Below, we identify several cities that have been downgraded because of stress from a city-supported PFD.

City of Wenatchee

In December 2011, the Greater Wenatchee Regional Events Center Public Facilities District defaulted on \$41.8 million of Bond Anticipation Notes (BANs unrated) backed by a contingent loan agreement with the City of Wenatchee (GO A3; LTGO Baa2, NEG outlook). The city pledged to provide interest payments as long as the notes were outstanding. Several months prior to the default, the city

attempted to gain approval for a new contingent loan agreement to provide long-term financing for the BANs. The state court invalidated the proposed contingent loan agreement, finding that the loan constituted debt of the city which, if issued, would exceed the city's statutory debt limit. The court found that the obligation created by the contingent loan agreement was absolute and exposed the city's general fund and general taxing authority to liabilities far in excess of the city's statutory and constitutional limitations. Absent any viable takeout financing alternatives, the PFD's BANs eventually defaulted. We downgraded the city's LTGO rating from A1 to Baa2 on November 2, 2011 because of litigation risks and continued financial stress.

Recent update: On April 17, voters in the Greater Wenatchee Regional Events Center Public Facilities District, WA (PFD) approved a new 0.1% district-wide sales tax as part of the overall financing for the operation of a 4,300 seat sports and entertainment arena which opened in October 2008. The sales tax will be an additional revenue source, helping secure long-term bonds to be issued by December 2013 to refinance \$41.8 million of the PFD's defaulted bond anticipation notes (not rated). The new PFD sales tax authorization is a credit positive for the City of Wenatchee (A3 negative) because it reduces its financial burden and limits litigation risks stemming from its contingent loan agreement backing \$36.6 million of the defaulted PFD notes.

City of Kent

On February 6, we downgraded the limited tax G.O. rating of the city of Kent from Aa3 to A1 and assigned a negative outlook. The downgrade reflects the city's significantly deteriorated financial position and ongoing risks related to PFD exposure. The city has been paying debt service on the PFD's bonded debt, and covering operating losses (averaging \$430,000 per year between FY 2009-2011) of the Kent Events Center. Total debt service of the PFD was \$3.7 million in 2010, of which the city paid \$3.1 million. Debt service escalates annually to a peak of \$5.8 million in 2032. As of the end of 2011, the city had a low direct debt burden of 0.7% consisting of \$78.0 million of limited tax GO bonds. However, the PFD has a combined \$61.7 million of sales tax and revenue bonded debt outstanding, which effectively doubles the city's debt burden.

Appendix A

Washington PFDs and Debt Outstanding

PFD Name	Amount of PFD Debt as of 12/31/2010 (in 000's)	Moody's PFD Rating (LTGO or Special Tax)	Guarantor(s) of PFD Debt	Moody's Rating of Guarantor (LTGO)
Spokane PFD	\$ 92,900	A1/ NEG	N/A	N/A
Vancouver PFD *	68,000	NR	City of Vancouver	Aa3/NOO
Kent Special Events Center PFD	61,700	NR	City of Kent	A1/NEG
Everett PFD	52,800	NR	City of Everett	Aa3/NOO
Greater Wenatchee PFD	42,000	NR	City of Wenatchee	Baa2/NEG
Lynnwood PFD	28,400	NR	City of Lynnwood	NR
Greater Tacoma Regional Convention Center PFD	23,050	NR	City of Tacoma (obligor)	Aa3/NEG
Grays Harbor PFD	17,500	NR	City of Ocean Shores	NR
Kennewick PFD	12,800	A1/NOO	City of Kennewick	Aa3
Yakima Regional PFD	12,020	NR	City of Yakima (obligor)	A1/NOO
Cowlitz County PFD**	11,685	NR	Cowlitz County	A1/NOO
Kitsap Public PFD	11,400	NR	Kitsap County	Aa3/NOO
Bellingham-Whatcom PFD	10,000	Aa3/NOO	City of Bellingham	Aa2/NOO
Edmonds PFD	9,500	Aa3/NOO	City of Edmonds	Aa3/NOO
Skagit County Regional PFD**	8,500	NR	Skagit County (includes loan from the city of Longview)	Aa3/NOO
Richland PFD	6,300	Aa3/NOO	City of Richland	Aa3/NOO
Lewis County PFD	5,800	A1/NOO	Lewis County	NR
Capital Area Regional PFD	7,210	NR	Cities of Lacey and Olympia	Aa3/NOO
South Snohomish County PFD	-	NR		
Pasco Public PFD	-	NR		
Washington State MLB Stadium PFD	-	NR		
Snohomish County PFD	-	NR		
Lacey PFD	-	NR		
Olympia PFD	-	NR		
Walla Walla PFD	-	NR		

*Vancouver PFD debt issued through redevelopment agency

**Debt outstanding as of 12/31/2008

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