

Special Comment

Moody's U.S. Public Finance

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U.S. Federal Stimulus Likely to Relieve Short-term Credit Pressures Facing a Number of Municipal Issuers

Most Affected: State Governments, Public K-12 Schools, Public Universities, Hospitals, Mass Transit

The \$787 billion fiscal stimulus package—the American Recovery and Reinvestment Act of 2009—is likely to have an overall beneficial credit impact on a number of municipal issuers to varying degrees in the near-term. The measure contains both substantially expanded direct funding to issuers, as well as new tax credits and tax-related provisions totaling approximately \$222 billion that will affect the municipal market more broadly. However, this relief is unlikely to create longer term credit benefits for most municipal issuers because many of them face credit challenges that may well persist beyond the two years covered by most of the stimulus actions in the bill.

The stimulus bill is larger in size and scope than previous federal interventions following economic downturns, amplifying and greatly broadening a pattern of expanded federal fiscal assistance following natural disasters such as floods and hurricanes. State governments are the lynchpin to the bill's direct and indirect effects on municipal issuers because states will receive substantial funding directly for their own programs, as well as funding that will assist programs operated by other issuer groups. The credit impact on individual states, as well as some other issuers, will depend largely on the effectiveness with which each state deploys its share of the stimulus funds.

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Key aspects of the stimulus plan include more funding for Medicaid cost sharing as well as new "stabilization" funds that are intended to relieve pressures on the budgets of K-12 schools, public universities and hospitals in 2009 and 2010. Not every school district will receive funds equally, however: allocations will partly depend on decisions made at the federal level. Other issuer groups, notably mass transit agencies and other infrastructure agencies, are expected to benefit directly from increased capital grants, which may replace planned borrowing in the near-term or jump start projects which were reliant on capital markets funding which is now in question. Public universities will also benefit directly from increased tax and other federal subsidies for students.

This report summarizes our perspective of the federal fiscal stimulus package and the credit impact it may have on U.S. municipal issuers. In all cases, how effectively the funds and other stimulus plan incentives are deployed will greatly impact the degree to which credit quality is impacted. A detailed table of the funding provision is provided as an appendix. Our initial credit conclusions are as follows:

- **STATES:** The stimulus may represent the next step in a trend of expanded federal aid to states during periods of fiscal distress, which could help provide a floor for many state credit ratings during this deep recession. The federal role has now expanded from solely providing emergency aid following natural disasters to a far broader role of providing fiscal support during economic downturns. "Stabilization" funds provided to the states and intended primarily to support K-12 education reflect unprecedented federal support for what historically is primarily a state and local expenditure. Combined with a temporary increase in the Medicaid cost-sharing ratio (the Federal Medical Assistance Percentage, or FMAP), states will be able to partly close budget gaps in fiscal 2009 and 2010 that are estimated to total between \$100 billion and \$350 billion.
- **PUBLIC K-12 SCHOOLS and LOCAL GOVERNMENTS:** Many local school districts will receive significant credit-stabilizing support through the near-term restoration of K-12 funds that may have been cut by states during their budget balancing process and from funds dedicated to school construction. The marketability of tax exempt bonds issued by local governments may be improved, particularly ones issued by K-12 school districts, through provisions that create a new category of qualified school construction bonds and that increase tax credits for qualified zone academy bonds. While local governments other than school districts, such as cities and counties, receive limited direct support, they will benefit from a taxable bond option that provides a tax credit of 35% of interest payable, either in the form of a bondholder credit or an issuer credit paid by the U.S. Treasury. In this case the issuer would sell taxable bonds and either the investor or the issuer receives a tax credit in an amount equivalent to the benefit received if the issuer sold tax-exempt bonds.
- **INFRASTRUCTURE ISSUERS:** Infrastructure agencies will benefit from significant new capital grants for public transit, airports, and state revolving funds (SRFs) that finance local water-treatment projects. This support will mitigate negative credit pressure on some of these issuers, especially by providing capital funding that will replace planned borrowing and help prevent debt service coverage ratios from deteriorating further. In other cases, the funding may allow acceleration of planned projects or revive stalled projects that may generate more revenue when the economy revives. Public power issuers will not receive direct funding but stimulus is provided to reduce energy demand from their customers over the long run, which could help those that are at capacity to forgo future borrowing.
- **COLLEGES and UNIVERSITIES:** Public universities are most affected by the stimulus bill as they will receive some budgetary relief from state funding cuts, as well as a likely boost in student demand from a large expansion of Pell grants for low-income students. Research universities, both private and public, will also receive some minor benefits from expanded research funding. Smaller private colleges will not receive material assistance to deal with their growing credit challenges.
- **NOT-FOR-PROFIT HOSPITALS:** Urban hospitals that serve a large share of low-income patients and others funded by Medicaid will benefit from the temporary FMAP change which will partly mitigate revenue pressures currently causing widespread credit weakening. However, the sector is facing serious credit challenges from rising share of uninsured patients caused by job losses and employer cutbacks of health insurance as well as increased federal scrutiny of hospital charity care and community benefits.

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- **HOUSING AGENCIES:** The stimulus measure will have a limited impact on the outlook for the credit of or issuance of bonds by state and local housing finance agencies (HFAs); although additional funding for Public Housing Authorities (PHA) could stabilize that sector as a result of additional funding directed to those entities.

State Governments: Medicaid Cost-Sharing and Stabilization Funds Provide Significant Budgetary Relief

Credit Impact: Stimulus May Help to Limit Negative State Rating Actions in the Near-Term

The new stimulus package provides both direct aid to states to help close budget gaps in the short-term and funds intended to provide longer-term economic stimulus. The effect of the ongoing national economic downturn on state budgets is severe, and Moody's outlook for the state sector is negative. Nearly every state faces a gap between budgeted revenues and expenditures in the current fiscal year, and most states will also need to close forecasted shortfalls in the fiscal 2010 budgets they are now constructing. The combined fiscal 2009 and fiscal 2010 shortfalls are estimated to total between \$100 billion and \$350 billion, forcing states to make wide-ranging budgetary adjustments, including cuts to areas usually off limits to the budget axe such as K-12 education. The scale of the federal aid is substantial, larger and potentially farther reaching than the fiscal relief package provided to states following the early 2000s downturn, which supplied approximately \$20 billion of short-term budget relief.

In light of the severity of the current economic decline and its effects on state finances, the federal stimulus package may help buttress state credit ratings that otherwise would be under greater downwards pressure. Additionally, certain elements of the plan are notable because they provide federal funding to areas that primarily are state and local responsibilities, such as K-12 operating expenditures. Our state rating analysis will incorporate how individual states use their share of stimulus assistance relative to the budget shortfalls they face. In that context, the stimulus may mitigate negative rating actions in the near-term. In the medium to long-term, the effects of the stimulus on state credit ratings are more muted. Relative to the size of estimated budget gaps, the assistance the stimulus will provide only partially offsets lost state revenue. Since most of the stimulus measure's budgetary assistance is provided within a two-year horizon, depending on the depth and duration of the current downturn, states could still face weak revenues at the end of that period. Unless states continue to make adjustments to structurally balance their budgets now, they may face greater credit stress when the federal aid runs out.

Our key findings regarding the stimulus package's effect on state governments include:

- The measure may represent the next step in a trend of expanded federal aid to states during periods of fiscal distress. While the federal government historically has provided monetary assistance to states following natural disasters, it has expanded its role in certain circumstances during the past decade. During the downturn in the early 2000s, the federal government provided direct budgetary aid to states through a temporary change in the Federal Medical Assistance Percentage (FMAP) used to determine Medicaid cost sharing and through unrestricted cash payments to states. Following hurricanes Katrina and Rita in 2005, federal legislation granted the states of Louisiana and Mississippi with interest-subsidized bonding capacity. The current plan furnishes a larger Medicaid package, other federal funds that will provide budgetary relief, and a new tax credit bond program that would provide a federal interest subsidy.
- The temporary FMAP change increases by 6.2% the share of Medicaid medical services costs paid by the federal government. States may also receive an additional increase in the federal share of their Medicaid costs through a formula based on the increase in their unemployment rates. The change frees state-sourced funds from one of the largest and fastest growing categories of state spending to help close fiscal 2009 budget gaps and mitigate budget reductions in fiscal 2010.

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- Direct federal funding of K-12 operating expenditures through the measure's \$54 billion of state fiscal "stabilization" grants-in-aid is unprecedented. Traditionally primarily a state and local government function, 82% of the grants are required to be used to restore K-12 funds cut from states budgets to fiscal 2008 levels, and to restore cuts to public higher education. The remaining 18% may be used for general governmental purposes at the state level, which provides additional budget relief.
- The nearly \$28 billion of highway infrastructure funds the measure provides will supplant state debt issuance for roads during the next several years. The funding will accelerate state road building programs while allowing many states with highway bonding programs to limit the degree to which state highway funds are leveraged. Going forward, a long-term solution for declining revenues in the federal highway trust fund will need to be found.

Trend of Federal Fiscal Assistance to States Continues

Federal fiscal assistance to state governments has evolved during the past ten years, a trend the new stimulus measure continues. Historically, the federal government has provided emergency federal aid to states following natural disasters, during the last 20 years through Stafford Disaster and Emergency Assistance Act grants administered by the Federal Emergency Management Agency (FEMA). More recently, the federal government has aided states amid different types of events that cause fiscal distress, as well. During the economic downturn earlier in the decade following the technology bust and the 9/11 terrorist attacks, revenues rapidly declined and states were forced to make wide-ranging budget adjustments; spending reductions in fiscal 2003 and fiscal 2004 totaled approximately \$30 billion. Between fiscal 2002 and fiscal 2006, states also enacted approximately \$24 billion of tax and fee increases. To help mitigate state revenue shortfalls, the federal government enacted measures that provided short-term budgetary relief. Similar to the current stimulus measure, the FMAP ratio was increased from April 2003 to June 2004, providing states with \$10 billion of short-term budget relief. States also received \$10 billion in unrestricted cash assistance through payments made in fall 2003 and fall 2004.

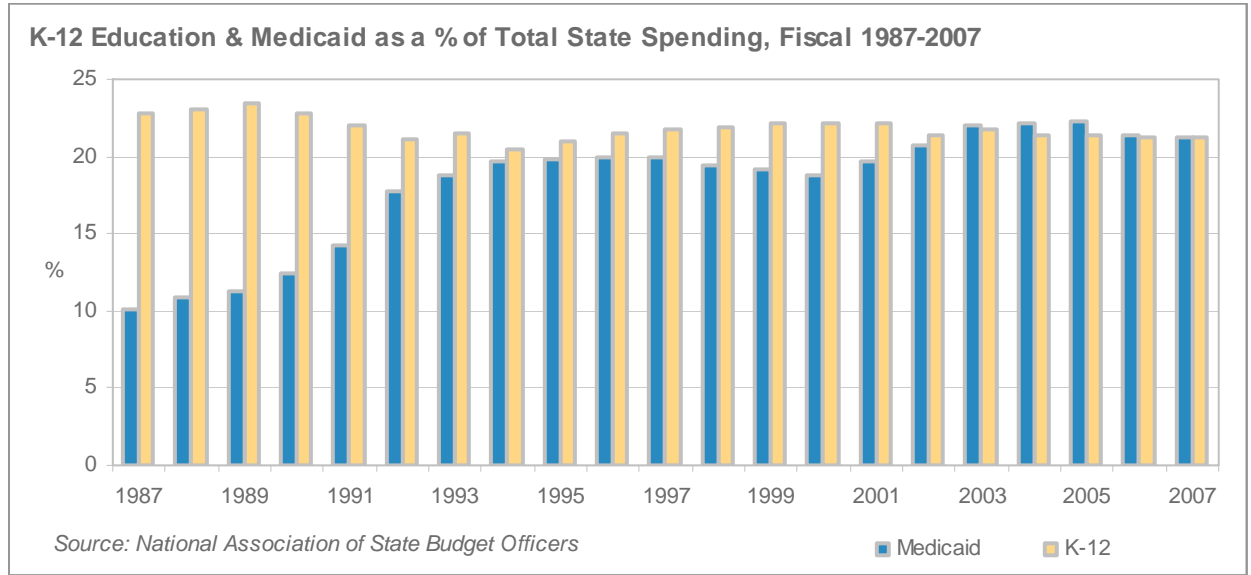
Following hurricanes Katrina and Rita in 2005, the federal government provided assistance beyond normally-expected FEMA aid. Federal support totaled approximately \$123 billion, including \$1.6 billion of tax-exempt Gulf Opportunity Zone and other tax-credit bonding capacity. In 2006, the State of Louisiana issued \$400 million of those bonds and loaned part of the proceeds to localities to provide debt service assistance.

New Stimulus Package Expands Size, Scope of Federal Aid

The current economic downturn has more severely affected state finances than the early 2000s recession. As a result, expenditure reductions have been notably wide-reaching: even K-12 education spending, normally held-harmless from budget cuts, has not been spared in some states. The new stimulus package expands the size and scope of federal fiscal assistance. The temporary increase in the FMAP ratio (the pre-stimulus average is 57% federal funds and 43% state funds) will help states balance their budgets in the short-term more than any other aspect of the plan. State Medicaid spending has grown rapidly, and in recent years has accounted for nearly 22% of total state spending, and even surpassed K-12 education spending in fiscal years 2003, 2004 and 2005 (see Figure 1). The FMAP change will increase by 6.2% the share of total Medicaid costs paid by the federal government for two federal fiscal years, retroactive to October 1, 2008 (the start of federal fiscal 2009). States may qualify for an additional FMAP increase based on the increase in their unemployment rates. Combined, the Medicaid provision will provide states with \$86.7 billion through December 30, 2010 that will free state-source funds to be used for other budget balancing purposes.

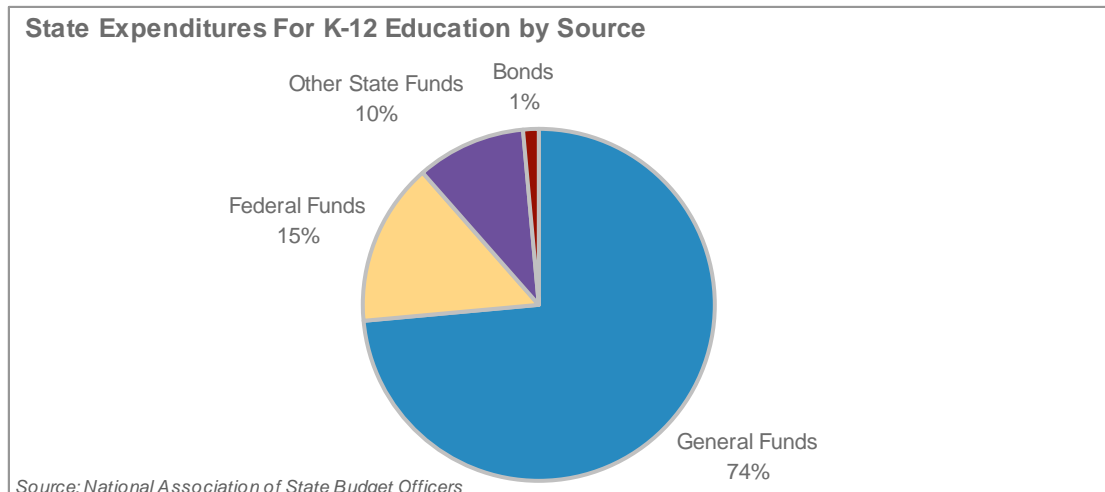
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Figure 1



The current stimulus measure also creates a federal “state fiscal stabilization fund, used to provide short-term cash grants to states; the funding totals \$54 billion. Of that amount, \$39.5 billion (82% of the total) must be used first to restore local K-12 education budgets in fiscal 2009, 2010 and 2011 to the level of state support they received in fiscal 2008 (or fiscal 2009 if it is greater), and then to restore state support to public higher education institutions. The remaining 18% of the “state fiscal stabilization fund” may be used for general government purposes. By comparison, the cash payments states received in the 2003 federal stimulus were unrestricted. Federal operating support for K-12 education is particularly extraordinary. Elementary and secondary education spending historically has been primarily a state and local function, and nearly three-fourths of state spending on K-12 comes from their own general funds while federal funds have supported specific mandates or target grants-in-aid (see Figure 2). The stimulus package requires that the secretary of education allocate 61% of the “stabilization” funds through a formula based on the proportion of a state’s population that is between ages 5 and 24, and the remainder based on total population. The remaining 39% of federal stabilization funding may be used by states for general government purposes. Further, the measure establishes \$5 billion of education incentive grants to states. To receive such grants, states are required to maintain fiscal 2009 and 2010 K-12 and higher education spending at least at fiscal 2006 levels.

Figure 2



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Increased Federal Funds for Highways Will Limit State Debt Issuance

The aid package also provides states with \$28 billion of highway infrastructure funds. States are required to give priority to projects that can award contracts within 120 days of the stimulus package's enactment, are already included in the state's approved Statewide Transportation Improvement Plan (STIP), and that are projected to be completed within three years. The infusion of federal funds during that period is expected to limit the issuance of state debt for road building. While some states issue general obligation debt for highway construction, many support their road programs through highway funds that receive state motor fuels tax revenues, vehicle registration and license fees, and other motor vehicle-related revenues. In the medium-term, the increased federal dollars will limit the degree of leverage against those highway funds and may have a stabilizing impact on outstanding ratings secured by those revenues. Going forward, concerns still exist regarding declining dedicated revenues in the federal transportation trust fund and the support that fund is able to provide to states.

Local Governments: Stimulus Provides Direct Support to K-12 School Districts; Cities and Counties Benefit Less Directly

The federal stimulus package is expected to help moderate the impact of negative budgetary pressures faced by local governments over the near-term and could help stabilize ratings in this sector given the backdrop of economic weakness that may otherwise result in downward pressure on the ratings. A wide range of services should be directly impacted by the package, from education and public safety to rural infrastructure projects. Less direct, but still significant, are the benefits to local governments derived from local infrastructure projects, Medicaid and COBRA changes, and direct funding of projects in rural areas.

Though the stimulus package is expected to provide much needed near-term relief to local governments, it also creates an unprecedented reliance on federal funding at the local level that may have a longer-term negative impact on credit. The package raises the risk that a broad array of local governments will come to rely too heavily on one-time funding for ongoing services and that inevitable service cuts are simply being delayed.

K-12 School Districts Benefit Directly from Operating and Capital Infusions

K-12 school districts stand to benefit directly from the stimulus package, though credit quality in this sector is not expected to improve in the near-term given weak growth in local revenue sources and the expectation of declining reserves to help close upcoming budget gaps. As noted earlier, 82% of the \$54 billion in state fiscal stabilization grants will be allocated in 2009 and 2010 to restore state K-12 funding to the higher of fiscal 2008 or 2009 levels. This is expected to have a greater positive impact in states where K-12 resources are dominated by state funding rather than local revenues, such as property and sales taxes, which are more likely to be flat-to-declining during the 2009-2010 period. Indeed, in many states, overall funding for K-12 operations over the near-term will likely be insufficient to maintain adequate service levels and the use of general fund reserves is expected to make up the shortfall. The stimulus package also includes \$13 billion in aid for disadvantaged students and \$12.2 billion for special education programs, providing additional near-term, though temporary, resources for K-12 schools.

In addition to operating support, school districts should also benefit from a variety of provisions in the package aimed at improving school facilities and lowering the cost of borrowing. The greatest impact could come from the nearly \$9 billion to be spent on school construction. While this wouldn't be general fund relief, it could enable capital projects to go forward that otherwise might not have had full funding.

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Benefits to Cities and Counties Are Mostly Indirect

City and county general fund operations stand to benefit less directly than K-12 schools, and credit quality in these sectors is not expected to strengthen materially over the near-term as a result of federal stimulus. For cities, perhaps the greatest impact will stem from \$4 billion of state and local law enforcement assistance and community policing funds outlined in the package, which could help moderate the impact of negative budgetary pressures. While immediately helpful, these funds may encourage local governments to increase service levels in the near-term to unsustainable levels (as was the case with the COPS funds in the 1990s). Use of these funds will also delay what are likely to be inevitable public safety service reductions over the longer-term given the deeper structural budget problems that could remain for many local governments beyond the final 2010 distribution of stimulus funding.

Perhaps the greatest benefits to counties from the stimulus package will result from the expansion of Medicaid and the extension of COBRA benefits. While additional Medicaid funding isn't money the counties would have spent otherwise (only counties in California and New York State pay a share of Medicaid costs), and therefore does not offset existing expenditures, it does help fund additional services. What remains unclear, however, is whether the matching component of this program would be simply maintenance of current efforts or additional matching. If the latter, it is doubtful that counties would be able to find additional matching funds given existing fiscal pressures. Indeed, counties may actually benefit more from the \$24 billion extension of COBRA benefits given that fewer people will be uninsured, and therefore fewer would be expected to seek services in county hospital emergency rooms.

Since relatively few of the federal programs that are being expanded are funded from cities' and counties' general funds, the increase in federal funding doesn't directly offset much of the general fund revenue and expenditure pressures that local governments are facing as a result of the economic downturn. Though it won't have much of an impact on city and county general funds, much of the stimulus bill's infrastructure spending will nevertheless be well received by local governments. The more significant benefits on the local level are likely to be indirect in the form of fewer lost jobs, fewer foreclosures and, ultimately, less of a reduction in sales and other economically-sensitive tax revenues.

Although they represent a relatively small share of rated debt outstanding, rural communities will directly benefit from funding for a variety of needs including economic assistance, watershed and flood protection, and utilities. State bond bank programs, which typically cater to these smaller issuers, may see reduced issuance in the near-term as \$4.3 billion of direct federal loans and grants displace some of their program borrowing. The package also includes \$6 billion of additional SRF loans that will also reduce direct issuance of enterprise-supported revenue bonds by local governments.

Infrastructure Sectors: Increases in Grant Formulas May Offset Planned Borrowing in the Short-Term

The stimulus package contains sizeable funds for capital projects in the infrastructure sectors. Funds are generally appropriated through existing programs, are required to be spent rapidly, and notably include:

- Significant new capital grants for airports, public transit, and state revolving funds for water and sewer systems (SRFs). In some cases Moody's expects these capital funds will replace planned borrowing and in other cases it will accelerate planned projects or revive stalled projects.
- Taxable private activity bond (PAB) issuance should increase from airports and ports with their 2-year exemption from the Alternative Minimum Tax (AMT).
- Large new spending for dredging, security, and on multi-modal transportation projects may increase the competitiveness of U.S. ports.
- Federal spending on energy efficiency could curtail demand for public power, but also move the nation towards less carbon emissions.

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Airports: Grants Accelerate Projects; AMT Provision Will Boost Taxable Borrowing

The receipt of \$1.1 billion of discretionary Airport Improvement Program (AIP) grants will likely accelerate the timeline of projects that would have been funded by future AIP grants. Those projects are expected to be targeted for improvements to security, safety, and capacity improvements. In some cases, this capital funding may replace future planned bond issues, or it may fund planned projects that had been slowed or scaled back due to economic conditions. The bill does not require airports to provide the standard match of AIP funds, which will especially benefit airports with limited capital resources. Airports will also benefit from \$1 billion of additional security spending for the Transportation Safety Administration, which will make the processing of passengers and baggage more efficient. Additionally, airports are expected to benefit from a temporary exemption of PABs from the AMT because they frequently use PABs for projects which support private airlines. This provision includes the ability to refund AMT debt issued between December 31, 2003 and January 1, 2009. Due to these provisions, Moody's expects additional taxable borrowing from airports for the remainder of 2009.

Ports: Increased Federal Spending Will Improve Competitiveness of U.S. Ports

Aid to seaports is not explicitly included in the stimulus package, so the extent of the broader benefits will vary based on state-by-state priorities and the degree to which ports are linked to broader transportation projects that are funded. The stimulus package includes an additional \$250 million of grants for federally-required security upgrades. The waiver of the current 25% local match requirement will provide a modest financial benefit for seaports. Additionally, \$2.1 billion is allocated to the Army Corps of Engineers for operations and maintenance, which is likely to include dredging. These funds, in addition to other transportation-related funding may improve U.S. ports' competitive position with deeper, wider channels, and more efficient multi-modal freight movement. Similar to airports, additional taxable borrowing from ports may result from the 2-year exemption of PABs from the AMT. Moody's expects ports will indirectly benefit from this legislation; while it may improve ports' efficiency and competitive position, it is unlikely to significantly change their credit position.

Public Power: No Direct Funding, Although Some Broader Credit Effects

The primary focus of the funding in the stimulus bill is to move the electric industry towards less carbon emissions, while also creating new jobs in the energy sector. We expect some direct funding grants that public power electric utilities will participate in but the stimulus funding on energy is spread broadly through the industry. Significant federal funding is geared towards energy efficiency programs, which is intended to reduce demand for power. For example, \$5 billion is allocated to weatherization programs. The bill provides a major subsidy to renewable energy projects and more efficient transmission grids as part of a broader plan to lessen the use of fossil fuels. For example, the Western Area Power Administration (WAPA) has significant new borrowing authority from the U.S. Treasury to improve the transmission grid that would allow additional wind generation to be transmitted to markets. There is also \$4.5 billion in funding to modernize the transmission grid and for security and reliability of the grid. Public power electric utilities will indirectly benefit from these expenditures. The bill provides funds for development of new technologies to capture carbon emissions in the combustion process at coal fired generating stations. Public power electric utilities will be eligible for tax credit bonds for renewable energy projects but the amount of funding is small relative to the cost some utilities face to meet state renewable energy portfolio standards.

State Revolving Funds for Water and Sewer Systems: Large Funding Increase Not Expected to Have Credit Impact on SRFs; May Reduce Future Borrowing

The \$6 billion (\$4 billion for clean water projects and \$2 billion for drinking water projects) of additional funding will be nearly four times the fiscal 2008 annual appropriation for state revolving funds. The requirement to distribute funds within 12 months may challenge some SRFs, which must meet existing required underwriting criteria before approving project funding. The bill does not specify the form of distributions from the SRFs,

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which could either be made as grants or loans. Grants, as opposed to the current practice of making low- or zero-cost loans, would alter the nature of many SRF programs and may reduce the long-term capitalization benefits of this additional funding. Moody's expects that the stimulus funding will reduce the level of SRF borrowing expected over the next several years, and offer local water and sewer systems an affordable alternative to bond issuance.

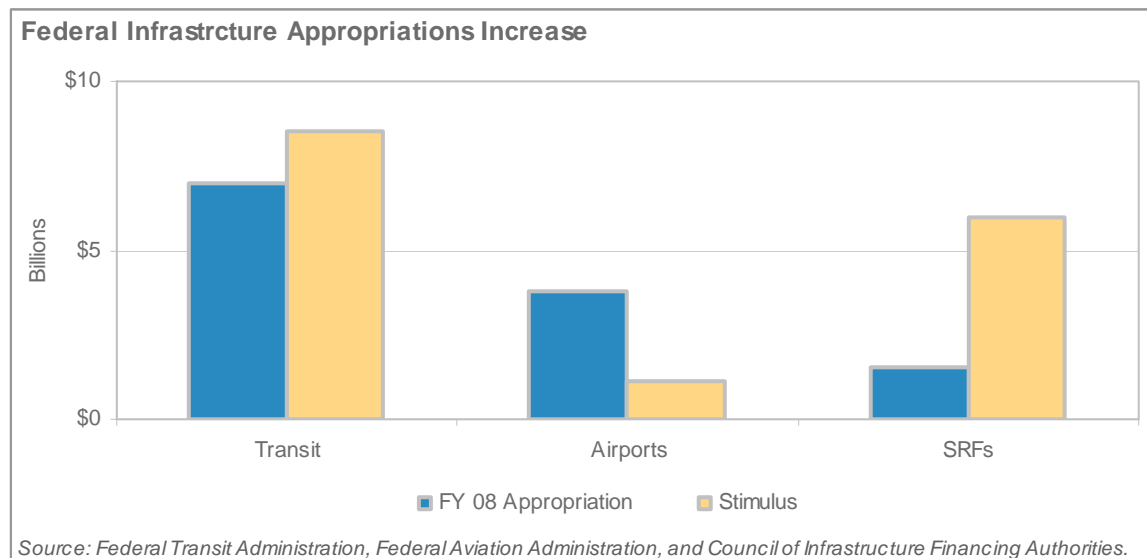
Toll Roads: Minimal Credit Impact Expected

We expect the proposed federal economic stimulus package will have a minimal direct credit impact on the existing toll road sector. Existing toll agencies currently receive no direct federal aid, and will receive no direct federal aid from the stimulus package. While the stimulus contains \$27.5 billion for surface transportation, these funds will be channeled through the existing federal transportation programs administered by the states. An additional \$1.5 billion is appropriated for competitive grants to state and local government transportation projects. Stimulus funding will focus on immediate and short range spending, whereas the toll agencies are more focused on possible credit enhancements to their enterprises, such as the liberalization of the rules governing the tolling of interstates and other federal aid highways through the transportation reauthorization bill due for renewal later this year. An indirect impact could be an acceleration of certain fully permitted projects at the state department of transportation level for which insufficient funding is currently unavailable, which may spur existing toll agencies to undertake related projects. Additionally, an exemption for PABs from the AMT could stimulate new private investment in the sector, particularly for new or start-up projects.

Transit: Significant Capital Funds Will Improve Systems; May Replace Some Planned Borrowing

The stimulus bill invests \$8.5 billion in mass transit capital projects through several existing transit aid programs, or more than 120% of the entire previous year's appropriations for these programs. Transit entities would not be required to match the money, but would be required to spend the funds rapidly. Moody's expects transit entities to aggressively spend the funds on projects in their existing capital improvement plans, which in many cases would eliminate the need for debt issuance; however some transit agencies may use the funding to leverage larger debt-funded projects. Moody's does note the "use-it-or-lose-it" funding provisions may strain the management capabilities of some transit agencies, particularly at a time when many are reducing staffing due to slow sales tax collections, which secures most transit debt as well as provides operating subsidies. Moody's considers these investments to be a credit positive as they attract new transit riders and represent a major new federal commitment, however we do not expect it to cause ratings changes in the sector over the short- or medium-term. The stimulus package also contains significant new capital funding for Amtrak, a credit positive for that entity.

Figure 3



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Higher Education: Public Universities & Community Colleges Likely to Benefit Most

The stimulus package should moderate the impact of budgetary pressures over the near term and may help mitigate current negative credit pressure, in particular for public institutions that depend on state aid to support operations. Public universities and community colleges are expected to be the main beneficiaries of direct relief made through various channels from \$30 billion of increased student aid, \$54 billion of support to public institutions (to be shared with k-12 education), and nearly \$16 billion of research funding that is expected to flow through to higher education institutions. These investments are substantial, but the mechanism for allocating funds, and the timeliness of delivery of funds over the next two years, remains unclear and is unlikely to alleviate all the budgetary pressures facing the higher education sector at this time. Nonetheless, this aid is expected to provide a degree of temporary relief and additional time for management and university boards to revisit budget assumptions and adjust where appropriate.

Private colleges and universities are expected to receive much less in direct benefits. Private institutions currently face significant pressure on financial aid budgets and the risk of missed enrollment targets and net tuition revenue budgets for some universities. The substantial increase in Pell Grants and tax credit provided in the stimulus package may help alleviate budgetary pressures for some, especially urban, private colleges and universities. But overall, private institutions will likely remain stressed by liquidity shortfalls due to their greater reliance on higher net tuition per student, investment income and private gifts. As stated in our 2009 U.S. Higher Education Outlook, university management and governance oversight during this critical period will be even more important than in the past in determining the credit impact on higher education institutions. Management's responsiveness to continued challenges and governance of organizations under stress will likely play significant roles in how well a university will weather the challenges that will remain in these current economic times.

The stresses in this sector that might be reduced by the stimulus bill include:

- **Student Tuition Affordability:** A steep decline in net worth and income for many households will dampen willingness and ability to pay high tuition rates, while access to student loans has become somewhat more limited. Increased student grants and loans may reduce the number of students that choose a lower-cost institution than they had originally planned. A substantial Pell grant increase in the stimulus could particularly benefit public institutions and community colleges in the near term as Pell grants cover a much larger share of tuition costs at these institutions than at most private universities. The \$17 billion in discretionary funding will nearly double the funding for Pell grants over the next two years, raising the maximum Pell grant award for the next two years and is expected to eliminate the current \$5 billion shortfall in the program. The stimulus also provides for \$13 billion in expanded tax credits for higher education. The provisions should provide students with more affordability and accessibility while alleviating some budgetary pressures for both public and private institutions.
- **State Funding of Public Institutions:** Direct funding to public universities and community colleges through increased state aid should reduce steep budget cuts currently planned at many institutions. The stimulus package provides for \$40 billion of the \$54 billion state stabilization fund to be used first to restore K-12 funding to fiscal 2008 levels and then to higher education. As political pressure mounts to keep tuition rates and increases low, restoring state aid levels will allow universities to institute smaller tuition and fee increases, providing more affordability to student and the ability to absorb higher enrollment. These stabilization funds may also be used to fund capital construction at public institutions. Although timing and implementation are uncertain, these funds may supply new funding sources to allow universities to maintain capital programs for necessary renovations to infrastructure.

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- **Research Funding:** The stimulus bill's \$16 billion increase in general research funding should flow through to higher education, as this sector is typically the largest beneficiary of federal research and development budgets. In particular, the stimulus package provides an additional \$10 billion to the National Institutes of Health of which \$1.5 billion will be used to renovate university facilities possibly reducing the need for borrowing.

Indirect stimulus support will have a substantial impact as well. In particular, community colleges may be beneficiaries of increased investments in employment and training programs while alterations in several tax provisions, including an increase in bank qualified debt, may provide greater choice and access to capital funds for smaller private institutions.

In broadest terms, the federal government's ability to boost the struggling economy will alleviate longer-term pressures for higher education institutions and bring stability to the sector. Our outlook remains negative at this time as institutions, particularly private universities, continue to face risks such as the impact of investment losses on operations and philanthropy, illiquidity of balance sheets, amplified by alternative investments and volatility in debt markets as well as variable rate debt structures. Restoring confidence in the capital markets will, over time, provide more liquidity for endowments and balance sheets while stabilizing the variable rate debt market.

Not-for-Profit Hospitals: Stimulus Mitigates, but Does Not Eliminate Substantial Recession-Driven Risks

The federal stimulus plan calls for \$127 billion in stimulus funds that will increase the federal share of Medicaid funding (\$87 billion), provide \$40 billion to fund temporary health insurance for the unemployed, and provide funding for investment in information technology. Moody's views the stimulus plan overall as a credit positive for not-for-profit hospitals that will partly mitigate reimbursement and other revenue pressures currently causing widespread credit weakening in the sector. The stimulus plan may also introduce new challenges for the industry in the form of increased regulation and federal scrutiny of charity care funding and community benefit. Driven by increased unemployment and loss of commercial insurance coverage, hospitals have reported changes in payer mix, reflected by a shift out of commercial pay into Medicaid (see Figure 4). As a result, several states have reported record increases in Medicaid enrollment. Medicaid enrollment growth is compounded by reimbursement pressures, with 22 states implementing or proposing cuts to Medicaid in the last twelve months and 39 states projecting budget deficits in fiscal 2010. In the absence of the stimulus package, Moody's would expect not-for-profit hospitals to continue experiencing reduced top line revenue growth in the face of increasing Medicaid payer mix and reduced Medicaid reimbursement rates, resulting in marginally reduced profitability in the medium term. Moody's expects all not for profit hospitals, but especially providers with high Medicaid payer mix, notably academic medical centers, safety net providers, and children's hospitals to benefit more from the package.

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Figure 4



Federal Medicaid Assistance Percentage (FMAP)

The largest part of the stimulus plan addresses the Federal Medicaid Assistance Percentage (FMAP), which represents the share of the total cost of Medicaid services funded by the federal government. FMAP increases effectively increase the federal share of Medicaid funding by \$87 billion. Historically, the federal government paid an average FMAP of 57%, with states funding the remaining 43%. As a result of the stimulus package, the federal share is expected to increase to 63%. FMAP, which is updated annually, will undergo a recession adjustment period, with payment increases retroactive to October 1, 2008 until December 31, 2010, effectively ensuring that states will not face a reduction in FMAP for two years. Additional FMAP increases will be made available to those states that have experienced a 1.5% increase in unemployment. 22 states have already implemented or proposed Medicaid cuts.

Health Insurance for Unemployed Workers

In aggregate, the stimulus plan also appropriates \$40 billion to expand health insurance for the unemployed, with \$29 billion in the form of COBRA benefits (Consolidated Omnibus Budget Reconciliation Act). In the case of recent job loss, COBRA allows for 18 months of continued healthcare coverage for individuals and direct family members. The stimulus funds effectively offers a 65% federal subsidy for up to twelve months for COBRA payments retroactive to August 31, 2008 and before January 1, 2010, which we believe will increase the number of unemployed that maintain and preserve insurance coverage and tempers further increases in bad debt and self pay.

\$20 Billion to Fund Information Technology

The stimulus package aims to accelerate the adoption of Health Information Technology (HIT) systems by doctors and hospitals. Medicare and Medicaid reimbursement will be the primary vehicle to incentivize hospitals to invest in HIT by increasing DRG (diagnosis related groups) payments to hospitals. Funded by \$20 billion of stimulus funds, DRG payments will increase for four years. Following the four year period, hospitals that are not in compliance with information technology standards may be subject to a clawback of these supplementary revenues at that time. While Moody's views the funding for HIT as a credit positive, investment in HIT often spans multiple years and significant capital outlays that will require heavy investment in the near term in order to avoid clawback provisions

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Housing Finance Agencies: Stimulus Bill Results in Limited Impact on Credit Quality

The stimulus bill is likely to have a limited impact on both the credit outlook for the state and local housing finance agencies (HFAs) and on the issuance of bonds in this sector; although additional funding for Public Housing Authorities (PHAs) could stabilize that sector as a result of additional funding directed to those entities.

The stimulus bill contains provisions for an increased funding of various housing programs which may become available to the HFAs. Most of this additional funding is not geared toward bond programs or loans financed by bonds and therefore, is likely to have a limited impact on the performance of the state and local HFAs and their bond programs. Additional funds for public housing capital funds could have an impact on the PHA sector however. Moody's rates bonds backed by public housing authority Capital Funds^{*} and currently has a negative outlook on this sector's bonds, based on six consecutive years of declining appropriations[†]. The current bill provides a near doubling to \$4 billion of the 2008 FY appropriation of \$2.4 billion for this program. As the ratings of bonds backed by these funds are tied, in part, to the funding levels of the program, additional funding should improve the outlook for the sector. However without knowing at this point how this additional funding will be allocated to the PHAs, it is unclear what impact it will have on the bonds of the individual PHAs.

Housing bond issuance is unlikely to be impacted by the legislation. A major obstacle facing state and local HFAs in issuing bonds is the relatively high interest rates these issuers currently have to pay to sell their bonds. As a result, HFAs are only able to offer mortgage rates to borrowers at rates significantly above the conventional mortgage rates available in the market which limits the demand for their loans. Conventional mortgage rates may continue to be lower for the near term or become even lower with the Federal Reserve's decision to purchase hundreds of billions in mortgage-backed securities. As long as these trends continue, we expect issuance of state and local HFAs to be significantly dampened.

While the stimulus bill contains provisions that expands AMT exemptions for housing bonds to all private activity bonds, it does not address current market conditions that have made it particularly difficult for state and local HFAs to issue bonds for single or multifamily housing. We expect these trends to continue, notwithstanding the current provisions that address tax exempt bonds.

Broad Municipal Market Effects: Provisions May Stimulate Bond Issuance by Small Issuers

The enacted stimulus measure includes several provisions that may affect issuance of municipal bonds. A variety of tax provisions are aimed at improving the marketability of tax exempt bonds issued by local governments, much of which is aimed directly at K-12 schools. For example, the package includes \$11 billion of tax credits in each of 2009 and 2010 for a new qualified school construction bond program and \$1.4 billion of tax credits for qualified zone academy bonds. A taxable bond option is also included for all local governments, including schools, which provides a tax credit of 35% of interest payable, either in the form of a bondholder credit or an issuer credit paid directly by the U.S. Treasury.

The federal stimulus package also includes a provision that increases the eligibility limit for bank qualified (BQ) bonds to \$30 million from \$10 million. This change benefits mostly smaller and mid-size issuers, particularly in the local government and not-for-profit sectors, by expanding their base of potential bond investors and ultimately providing a lower cost of capital. The increased BQ limit could also improve access to the currently challenging capital markets for certain lower rated entities by increasing the incentive for local banks to lend to local issuers in need of financing.

^{*} See "Moody's Approach to Rating Housing Public Authority Capital Fund Grant Anticipation Bonds", May, 2000 (Report No. 55566)

[†] See "2008-09 Outlook for Public Housing Authority Capital Fund Securitizations," July, 2008 (Report No. 109692)

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Conclusion: Positive Near-term Credit Impact But Longer-term Challenges May Continue

The federal stimulus package benefits municipal credit quality in the near term to varying degrees. The measure's combination of direct funding, tax-related provisions and tax credits provide near-term relief from declining revenues amid a broad, deep recession that is likely to mitigate short-term credit pressures. The stimulus contains provisions that will mitigate difficult cuts to education and public safety in the short-term, and will help moderate the impact of other spending pressures; the degree of credit pressure on municipal issuers will depend on how quickly the economy recovers. The stimulus provides a substantial, but partial, replacement of lost revenues. If economic recovery is not substantial enough to restore revenue by the time most federal assistance runs out within the next two years, municipal issuers may face renewed, or even greater credit stress.

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Sector	Provision	\$ [‡]	Credit Impact
States	Temporary increase in the Federal Medical Assistance Percentage (FMAP)	\$87 billion	Immediate budget relief through increase in federal share of Medicaid costs for one of the largest categories of state spending.
	State Fiscal Stabilization funds	\$54 billion	Helps states to restore cuts made to K-12 and higher education budgets. Funds reflect unprecedented targeted aid to support state operations amid fiscal downturn.
	Highway infrastructure funds	\$28 billion	Increases federal highway aid to states through federal fiscal year 2010. In the short-term, the funds are expected to supplant state debt issuance for road projects and will ease the burden on highly-leveraged state highway funds. The measure does not solve the long-term problem of declining revenues in the federal highway trust fund.
Local Governments	State Fiscal Stabilization, Education for the Disadvantaged and Special Education Funds to Restore K-12 Budget Cuts and Preserve Programs	Portion of \$64.7 billion	Greatest positive impact in states where K-12 resources are dominated by state funding rather than local revenues.
	School Rehabilitation and Modernization Funds	\$9 billion	Does not provide general fund relief, but could enable capital projects to go forward that otherwise might not have had full funding.
	Law Enforcement Assistance	\$4 billion	Moderates short-term negative budgetary pressures, but may encourage local governments to increase service levels in the near-term to unsustainable levels.
Infrastructure Sectors			
Airports	Airport Improvement Fund Grants	\$1.1 billion	Accelerates air-side capital projects; may cause some reduction in planned borrowing
	Transportation Safety Administration Spending	\$1 billion	Increases efficiency of passenger and baggage processing
Ports	Infrastructure Funding: Army Corps of Engineers and multi-modal transportation		Increases efficiency due to improved navigation and multi-modal freight movement
Public Power	Energy Efficiency Programs	\$8.2 billion	Will reduce demand for electricity, if not managed well could be a concern for utilities that have excess electric generation capacity
	Renewable Energy Projects	\$1.6 billion	One-third of the Clean Renewable Energy Bonds (CREBS) authorization will go to public power utilities to finance new renewable energy projects
	Smart Energy Grid	\$11 billion	Public power utilities should broadly benefit from the funding of modernization of the electric grid including new security and reliability projects
SRFs	Additional Federal Grants for Water and Sewer Projects	\$6 billion	May reduce expected borrowing from SRFs
Transit	Transit Grants	\$8.5 billion	Accelerates capital projects which may increase ridership; may cause some reduction in planned borrowing
	Security Grants	\$250 million	Assists ports in achieving federal security mandates; financial benefit of elimination of match requirement

[‡] Dollar amounts are not additive, but represent the overall impact of key stimulus provisions.

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Sector	Provision	\$ [†]	Credit Impact
Higher Education	State Aid for Education	Portion of \$54 billion	Should dampen budget cuts currently planned at many institutions and will allow universities to institute smaller tuition increases, providing more affordability to students, the ability to absorb higher enrollment and may fund necessary infrastructure improvements.
	Scientific Research	\$16 billion	Research funding increases should flow through to higher education, as this sector is typically the largest beneficiary of federal research and development budgets.
Not-for-Profit Hospitals	Temporary increase in the Federal Medical Assistance Percentage (FMAP)	Portion of \$87 billion	Mitigates Medicaid reimbursement pressure at not-for-profit hospitals and decline in payer mix at a time when several states have reported record increases in Medicaid enrollment. Greatest benefit for providers with high Medicaid payer mix: academic medical centers, safety net providers, and children's hospitals. In absence of the stimulus package, Moody's would expect not-for-profit hospitals to continue experiencing reduced top line revenue growth, resulting in marginally reduced profitability in the medium term.
	Federal subsidy to extend COBRA health care benefits for unemployed workers	Portion of \$24 billion	Federal subsidy that helps unemployed workers keep health benefits longer will temper further increases in bad debt and self-pay at not-for-profit hospitals.
	Health Information Technology Incentives	\$20 billion	Temporarily increases diagnosis related groups payments to hospitals to encourage investment in health information technology. Substantial capital investment in health information technology would be required to avoid a clawback provision
Housing Finance Agencies	Public Housing Authority Capital Funds	\$4 billion	Nearly doubles federal funds for Public Housing Authority (PHA) capital funds following six consecutive years of declining appropriations which will likely improve the outlook for the PHA sector.

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Related Research

Special Comments

- The U.S. Government's Financial Stability Plan, February 2009 (114769)
- Credit Uncertainties: Public Sector 2009, January 2009 (114076)
- Impact of the Credit Crisis and Recession on Local Governments, December 2008 (112225)
- Impact of Credit Market Turmoil and Weaker Economy on U.S. Public Infrastructure, December 2008 (112999)
- State Housing Finance Agencies - Sector Outlook, November 2008 (112789)

Outlooks

- 2008-09 Outlook for Public Housing Authority Capital Fund Securitizations, June 2008 (109692)
- Outlook Remains Negative for U.S. States: Federal Fiscal Stimulus May Moderate Recession's Effects on U.S. States; Impact from Recession Will Not be Equal, February 2009 (114526)
- U.S. Higher Education Outlook, January 2009 (113886)
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