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Rating Update: MOODY'S DOWNGRADES ARIZONA TRANSPORTATION BOARD'S HIGHWAY REVENUE BONDS (SENIOR LIEN) TO Aa1 FROM Aaa AND SUBORDINATED LIEN BONDS TO Aa2 FROM Aa1; OUTLOOK IS STABLE

Global Credit Research - 07 Sep 2011

$1.6 Billion Debt Affected

State
AZ

Opinion

NEW YORK, Sep 7, 2011 -- Moody's has downgraded the rating on the Arizona Transportation Board's Highway Revenue Bonds (Senior Lien) to Aa1 from Aaa. At the same time, Moody's has downgraded the rating on the Board's Subordinated Highway Revenue Bonds to Aa2 from Aa1. The rating action affects $1.27 billion senior lien and $330 million subordinated lien bonds. The outlook on the ratings is stable.

RATING RATIONALE

The rating action is primarily attributable to legislation enacted in conjunction with the State of Arizona's fiscal 2012 budget. The legislation changes the allocation of highway user revenues, significantly reducing the deposits into the State Highway Fund (SHF), which secure the Highway Revenue Bonds. As a result, coverage of maximum annual debt service by pledged revenues will drop below the additional bonds test requirements for both the senior and subordinated bonds. At the same time, the ratings also reflect current statutory provisions which require the State, in the event that SHF revenues are insufficient, to pay debt service from broader, unpledged HURF revenues.

STRENGTHS

* The essentiality of the statewide highway program and constitutional requirements that most highway user revenues can only be used for transportation-related purposes.

* The broad, statewide base of the taxes and fees that constitute underlying highway user revenues, which should result in steady growth as the economy recovers.

* Still high, although significantly reduced, coverage of maximum annual debt service by pledged SHF revenues.

* Additional bonds tests of 4.00 times MADS for the senior bonds and 3.00 times MADS for the senior and subordinated bonds combined.

* Statutory provisions which require that the State pay debt service from the broader HURF revenues in the event that pledged SHF revenues are insufficient.

CHALLENGES

* The State's ability to divert, and history of diverting, revenues away from the SHF, negatively affecting coverage on the bonds by pledged revenues.

* Continued weak economic conditions which will likely limit growth in underlying highway user revenues in the near term.

DETAILED CREDIT DISCUSSION

LEGISLATIVE DIVERSIONS HAVE REDUCED COVERAGE ON THE BONDS BY PLEDGED REVENUES

The senior and subordinated bonds are secured by a first and second lien, respectively, on highway user revenues deposited in the State Highway Fund (SHF). Highway user revenues consist of fuel taxes, vehicle registration fees, vehicle license (in lieu) taxes, and other transportation-related fees. Pursuant to the constitution, the majority of these revenues may only be used for transportation-related purposes. Upon receipt, highway user revenues are deposited in the Highway User Revenue Fund (HURF).

Within constitutional limits, the State legislature controls the allocation of highway user revenues from the HURF to various transportation-related purposes including the SHF, which is the primary operating fund of the Arizona Department of Transportation. The legislature has changed the allocation of highway user revenues in the past, generally to address General Fund budget pressures. A diversion in fiscal 2009 contributed, along with economic conditions, to a 22.3% reduction in SHF revenues in that year.

Legislation enacted in conjunction with the State's 2012 budget would result in a further reduction in pledged SHF revenues. Assuming no growth in underlying highway user revenues from fiscal 2011, fiscal 2012 SHF revenues would provide 3.14 times coverage of maximum annual debt service on the senior bonds and 2.41 times coverage on maximum annual debt service on the senior and subordinated bonds combined. Both of these coverage levels are below the additional bonds test requirements of 4.00 and 3.00 times respectively.

CURRENT STATUTES REQUIRE PAYMENT FROM BROADER, NOT-PLEDGED HURF REVENUES

Although revenues of the broader Highway User Revenue Fund (HURF) are not pledged to payment of the bonds, current statutory provisions require the State, in the event that SHF revenues are insufficient, to pay debt service from HURF revenues. Assuming no growth, fiscal 2012 HURF revenues provide 9.02 times coverage on maximum annual debt service on the senior lien bonds and 6.93 times coverage on maximum annual debt service on the senior and subordinated bonds combined.

Outlook

The outlook on the Highway Revenue Bonds is stable, reflecting the modest growth in highway user revenue in 2011 following three years of economically driven declines. The outlook also reflects the expectation that future diversions of pledge SHF revenues will be limited due to reduced General Fund budget pressures and the essentiality of the programs funded from the SHF.

WHAT COULD MOVE THE RATING-UP

* A significant improvement in coverage of debt service by pledged revenues combined with effective legal limitations on the ability of the State to divert pledged revenues going forward.

* A broadening of pledged revenues to include all HURF revenues.

WHAT COULD MOVE THE RATING--DOWN

* A substantive decline in pledged SHF revenues which further reduces coverage levels, either as a result of economic trends or new legislative diversions.

* Any substantial weakening of the current statutory provisions which require the State to pay debt service from the broader HURF revenue is necessary.

The principal methodology used in this rating was Piercing the G.O. Ceiling published in December 2008. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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