

October 13, 2011

Arizona Transportation Board; Gas Tax

Primary Credit Analyst:

David G Hitchcock, New York (1) 212-438-2022; david_hitchcock@standardandpoors.com

Secondary Contact:

Sussan Corson, New York (1) 212-438-2014; sussan_corson@standardandpoors.com

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Credit Profile		
US\$476.805 mil sub hwy rev bnds ser 2011 due 07/01/2036		
<i>Long Term Rating</i>	AA+/Negative	New
Arizona Dept of Transp hwy sr lien		
<i>Long Term Rating</i>	AAA/Negative	Outlook Revised
Arizona Transp Brd hwy		
<i>Long Term Rating</i>	AAA/Negative	Outlook Revised
Arizona Transp Brd hwy subord lien		
<i>Long Term Rating</i>	AA+/Negative	Downgraded
Arizona Transp Brd hwy sr lien		
<i>Unenhanced Rating</i>	AAA(SPUR)/Negative	Outlook Revised
Many issues are enhanced by bond insurance.		

Rationale

Standard & Poor's Ratings Services lowered its rating on Arizona Transportation Board's subordinate-lien highway revenue bonds to 'AA+' from 'AAA'. Standard & Poor's also revised the senior-lien rating outlook to negative from stable and affirmed its 'AAA' rating on the board's senior-lien highway revenue bonds. At the same time, Standard & Poor's assigned its 'AA+' rating, with a negative outlook, to the board's subordinated highway revenue bonds series 20011.

The downgrade and outlook revision reflect ongoing changes in state allocations of pledged revenues, which have diminished debt service coverage levels. If debt service coverage declines from its current strong level due to the continued diversion of highway user taxes from the pledged state highway fund for other state operating purposes, or due to deteriorating highway user taxes, a further downgrade may result.

The ratings reflect our opinion of:

- A growing and diverse statewide economic base of 6.3 million people generating pledged transportation-related revenue;
- Coverage of maximum annual debt service (MADS) on senior-lien debt that is expected to fall from 4.61x in fiscal 2011, using new senior-lien MADS after this partial refunding, to a still-strong 3.46x in fiscal 2012, based on state projections and legislative reallocation of highway revenues;
- Coverage of subordinate-lien MADS after this sale that is expected to fall from 3.30x in 2011 to a still-strong 2.48x in fiscal 2012;
- The state's statutory reallocations of highway user taxes that are deposited in the pledged state highway fund that in effect has lowered the share of total highway user taxes allocated to the pledged state highway fund from 48% of total highway user taxes in fiscal 2008 to a projected 31% of total highway user taxes in fiscal 2012; and
- Strong legal provisions, consisting of a 4x MADS additional bonds coverage test (ABT) by historical revenues for the senior-lien bonds and a 3x test for the subordinate-lien bonds.

The lack of a debt service reserve for either lien is offset largely by currently high coverage of debt service, while plans to issue a moderate \$200 million of additional new money bonds by 2016 will require future debt service coverage high enough to meet the strong ABTs.

About \$100 million of the series 2011 bonds will fund part of the Arizona department of transportation's ongoing capital plan, with the rest of bond proceeds refunding senior-lien debt into subordinate-lien debt. After this sale and refunding of senior-lien debt, the board expects to have about \$1.1 billion of senior-lien highway bonds and \$680 million of subordinate-lien bonds outstanding, which could vary depending on the size of the amount of senior-lien bonds refunded.

The senior-lien bonds are secured by a first lien on a diverse collection of motor vehicle and related fuel fees and taxes allocated to the state's highway fund, while the subordinate-lien bonds receive a second-lien pledge, after payment of prior senior-lien debt service. Pledged revenues include fuel taxes; vehicle registration fees; motor vehicle license in-lieu-of tax (MVT); and commercial motor carrier, license, and other fees levied by the state, all of which are initially deposited in the Arizona Highway User Fund. After annual prior transfers to state funds for highway public safety, and other prior diversions annually allocated by the state, 50.5% is deposited under current statutory law into the Arizona Highway Fund, where it becomes pledged revenue and can be used only for highway and other transportation-related expenses. The remaining 49.5% goes to local governments for transportation purposes. In fiscal 2011, \$504.1 million was deposited to the pledged highway fund, out of the \$1.21 billion in total highway user fund revenues collected in fiscal 2011. From its \$1.38 billion peak in fiscal 2007, total highway user taxes have declined 12.8% through 2011. However, because of increased prior diversions before deposit in the pledged highway fund, the pledged highway fund declined a greater 26.2% from its 2008 peak of \$650.9 million. The state projects that highway user taxes will increase 0.9% in fiscal 2012, but that pledged state highway fund revenues will fall 23.1% due to increased prior state diversions of revenues for state budget relief.

Before fiscal 2007, the state experienced what we view as strong growth in highway user taxes due to growth in the state's population and economy. Highway user taxes grew 28.4% between fiscals 2002-2007.

In previous years, the state has made modifications to the prior allocation of highway user tax revenues, including a \$118 million diversion in 2005 for state general fund budget relief, whose impact at that time was mitigated by strong growth in highway user tax revenues. However, in 2011, as part of its fiscal 2012 budget, the state enacted prior diversions of highway user tax revenues for state budget relief purposes, which had a bigger impact. The net effect will be about a \$126 million loss to the pledged state highway fund, which the state projects will amount to about 25% of fiscal 2011 pledged revenue.

Diversions of pledged revenues for state budget purposes in fiscal 2012 include distribution of \$120.7 million from the state highway user revenue fund to the department of public safety, that the state expects will reduce the distribution to the state highway fund by \$61.0 million, a transfer of \$105.8 million to the state general fund of motor vehicle license (in lieu) taxes, a transfer of \$4.1 million from the state highway fund share of the state highway user revenue fund distribution to the 10 least populated Arizona counties, and a change to make permanent an earlier 2010 five-year motor vehicle license (in lieu) tax registration transfer from the state highway fund to the state general fund. One change will provide additional pledged revenue. The state changed the earlier redistribution of \$86.9 million from the pledged highway fund to the department of motor vehicles instead to a prior distribution from the highway user revenue fund. Because only 50.5% of the highway user fund is distributed to the pledged state highway fund, this reduces the loss to the state highway fund from \$86.9 million to \$42.9 million, a net gain of

\$43.0 million to the highway fund.

The senior-lien bonds have a 4x ABT and the subordinate-lien bonds have a 3x ABT, both of which we consider very strong. The state can issue the currently selling debt under the ABTs, which calculate debt service coverage based on historical revenues, despite project coverage that will be below the subordinate-lien ABT. Historical fiscal 2011 pledged state highway fund revenues provide 4.61x and 3.30x coverage of MADS after this sale. However, the state projects pledged revenues will drop after the scheduled fiscal 2012 state reallocation of pledged revenues. We calculate, based on the state 2012 revenue projection, MADS coverage of senior and subordinate debt of 3.46x and 2.48x. The state next plans to sell about \$200 million of additional new money debt in 2016, although this would likely require growth in pledged revenues, or greater reallocation into the pledged highway fund. Combined senior and subordinate MADS is expected to be \$152.8 million in fiscal 2012 after this debt sale, with debt service staying relatively level through 2020.

(For further information on the state's general economy and credit characteristics, please refer to the full analysis on Arizona's lease-secured debt rating published April 14, 2011, on RatingsDirect on the Global Credit Portal.)

Outlook

The negative outlook reflects ongoing changes in state allocations of pledged revenues, which have diminished debt service coverage levels. If debt service coverage declines from its current strong level due to the continued diversion of highway user taxes from the pledged state highway fund for other state operating purposes or due to deteriorating highway user taxes, a further downgrade may result. If debt service coverage is significantly boosted through larger state allocations to the pledged state highway fund, or by growth in highway user taxes, we could revise the outlook to stable.

State Economy

Arizona's population rose 28.6% to 6.6 million between 2000 and 2009, and the state has consistently ranked as one of the fastest growing during the past decade. (By contrast, the national population growth during the same period was 9.1%.) This population growth has continued even during a recent period of payroll declines, rising unemployment, and stressed real estate. The state's age-dependency ratio is the second highest in the nation (65), reflecting a higher proportional share of demand for education and social services. For Arizona, this ratio indicates both a relatively large portion of population under 18 as well as an above-average number of residents over 65, reflecting in part the state's status as a retirement destination.

For most employment sectors, the proportion of the Arizona jobs within each is approximately in line with the national proportion, with a few exceptions. Reflecting the rapid growth throughout much of the past decade, construction represents a higher proportion of jobs; however, this sector has fallen with the recession and real estate downturn. In addition, Arizona had relatively fewer manufacturing and information jobs than the national proportion. According to the Bureau of Labor Statistics (BLS), Arizona's annual average unemployment rates were 9.7% and 10% in 2009 and 2010, respectively, which were above the national averages for the same periods. According to the BLS, the state's July 2011 seasonally adjusted unemployment rate was 9.4%, above the national rate of 9.1%.

The gross state product per capita is 84% of the nation. Growth in gross state product per capita is generally in line

with the national average, although Arizona tends to have faster growth during expansionary periods and correspondingly slower growth during recessionary periods. Indicating some propensity for economic volatility, gross state product since 2000 has grown faster than the U.S. average six of the nine years through 2009, although the state was below average in 2008 and 2009. Per capita personal income was \$33,244 in 2009, representing 84% of the national per capita personal income. However, Arizona's economic development prospects remain good, in our view. Over the past decade, the state has continued to attract investment and employers, including those leaving California, due to its lower costs of living and of doing business. The state's Sunbelt location has helped drive the service and leisure industries as well. Maricopa County and Pima County, home to Phoenix and Tucson, respectively, make up 75% of the population and a higher proportion of employment. Ties to higher education, transportation infrastructure, and low-cost housing have helped both metropolitan areas expand.

Issuer/Operations

The Arizona Transportation Board plans for, and approves, the capital budget of the Arizona state highway system. The governor and legislature determine the operating budget of the Arizona Department of Transportation. The transportation board consists of seven members from six transportation districts within the state, with two members from Maricopa County. The governor appoints members to six-year terms. Board responsibilities include issuing bonds for state highway purposes and establishing and planning the state highway system.

The transportation department administers the state highway system and the state-owned airport at the Grand Canyon. Its responsibilities include motor vehicle and aircraft registration and law enforcement, transportation planning and design, and construction of transportation facilities. The governor reviews the transportation department's budget, and funds are appropriated by the legislature. The transportation board approves the department's capital budget.

Arizona Department of Transportation's funding for statewide transportation projects comes primarily from:

- State user fees, such as gas tax, registration, commercial motor carrier, and license fees, deposited in the pledged state highway user revenue fund;
- Excise tax revenues through the Maricopa County Regional Area Road Fund;
- Bond issues associated with these revenues;
- Federal funds; and
- Interest income and other available funds of the transportation department.

State agencies and statutes in Arizona are subject to automatic termination to encourage systematic legislative review of state agencies and statutes unless the legislature takes affirmative action to continue the agency's or statute's existence. The department and the board are scheduled for termination on July 1, 2016, and Title 28, Arizona Statutes, as amended--which contains most of the state's transportation laws, including provisions relating to fees and taxes pertaining to the registration, operation, and use of motor vehicles and motor vehicle fuel taxes, the Arizona Highway User Revenue Fund, and the Arizona Highway Fund, as well as traffic laws--is scheduled for termination on Jan. 1, 2017.

Since the enactment of the sunset laws, the transportation board's authority and the provisions relating to the fees and taxes pertaining to the registration, operation, and use of motor vehicles and motor vehicle fuel taxes have been reviewed twice, and the existence of each was continued. To protect bondholders, the law requires the state to

assume debt service payments of any state agency that has been terminated. The law also provides that as long as any debts remain outstanding, the excise tax and pledge of revenue must remain in place.

Pledged Revenues

Highway user taxes deposited into the state's highway user revenue fund consist of motor vehicle fuel taxes, MVT taxes, motor vehicle registration fees, motor vehicles operators' license fees, and motor carrier taxes. Tax rates and fees have been adjusted from time to time, and increases flow into the highway user revenue fund. In fiscal 2011, after a 1.3% increase in gallonage consumption in fiscal 2011, fuel taxes accounted for 52.7% of total highway user revenues of \$1.21 billion. Other major revenue sources include motor vehicle license (in lieu) taxes (an ad valorem tax that increases with the value of vehicles) at 26.7% of total highway user taxes, and motor vehicle registration fees at 13.0%.

Arizona Transportation Board							
--Fiscal year-end June 30--							
(000's)	2006	2007	2008	2009	2010	2011	State projection 2012
Highway user taxes collected	1,331,625	1,382,474	1,344,477	1,248,583	1,194,417	1,205,073	1,216,300
Pledged state highway fund	623,040	674,141	650,900	505,536	500,768	504,110	378,610
% of highway tax distributed to highway fund	46.8	48.8	48.4	40.5	41.9	41.8	31.1
Coverage of future senior-lien MADS (x)	5.70	6.16	5.95	4.62	4.58	4.61	3.46
Coverage of combined senior- and junior-lien MADS (x)	4.08	4.41	4.26	3.31	3.28	3.30	2.48

Source: Arizona Department of Transportation; Standard & Poor's calculations.

Related Criteria And Research

USPF Criteria: Special Tax Bonds, June 13, 2007

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