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UNITED STATES BANKRUPTCY COURT

EASTERN DISTRICT OF CALIFORNIA

SACRAMENTO DIVISION

In re: CITY OF STOCKTON, CALIFORNIA, Debtor.	Case No. 12-32118 D.C. No. OHS-11 Chapter 9 **EXHIBITS A – B IN SUPPORT OF SUMMARY OBJECTION OF FRANKLIN HIGH YIELD TAX-FREE INCOME FUND AND FRANKLIN CALIFORNIA HIGH YIELD MUNICIPAL FUND TO CONFIRMATION OF FIRST AMENDED PLAN OF ADJUSTMENT OF DEBTS OF CITY OF STOCKTON, CALIFORNIA (NOVEMBER 15, 2013)** Date: May 12, 2014 Time: 9:30 a.m. Dept: C, Courtroom 35 Judge: Hon. Christopher M. Klein

EXHIBIT A

US Public Finance

Weekly Credit Outlook

FEATURE ARTICLES

CREDIT IN DEPTH

RESEARCH HIGHLIGHTS

MUNICIPAL BANKRUPTCY UPDATE

RATING CHANGE HIGHLIGHTS

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United Airlines Cutback of Hub Operations at Cleveland Airport Is Credit Negative

On Saturday, United Airlines, Inc. (B2 positive) announced that it will remove its connecting hub at the City of Cleveland, Ohio, Airport Enterprise's (Baa1 stable) Cleveland Hopkins International Airport. United's pullback at Cleveland Airport is credit negative because it will increase airline cost per enplanement, an important indicator of airport market strength, for the remaining airlines at the airport.

United said it will reduce its average daily departures at the airport by 64% by June, resulting in 51% fewer seats available from the airport. The seat change is lower because the cuts are focused mainly on small markets served by smaller regional jets.

Cleveland Airport's estimated airline cost per enplanement was $15.37 in 2013, nearly twice the median for the US airports we rate. Its 2014 budgeted airline cost per enplanement was $13.92, but now could rise to as high as $25.00, based on the lower number of available seats in the market.

The service cuts reduce the airport's market strength because the airport's costs will now be spread across fewer flights and passengers, making it more expensive for all airlines. In addition, fewer passengers will lead to lower concession revenues, which airports use to offset airline costs, so the secondary effect also drives up airline costs at the airport. As a result, the airport will now be more susceptible to flight reductions and will be less likely to see increased service from other airlines.

Cleveland Airport currently has about 245 average daily departures, of which 165, or 67%, are United's. United will reduce departures in equal increments in April, May and June. The airline will continue all but one of its 26 daily flights on larger aircraft, while regional departures will decline 73% to 47 from 174. United's reduced regional jet service reflects the industry-wide trend of phasing out smaller 50-seat planes. Regional jet service has been a challenge for the airport sector and will continue to pose a risk for airports with high concentrations of regional jet traffic.

We had been expecting United to change its flight offering at Cleveland following its merger with Continental Airlines in October 2010. The combined airline's hubs in Newark, New Jersey, and Chicago, Illinois, significantly reduced the need for connecting traffic through Cleveland. The airport had been protected by a five-year agreement between United, Continental and the Ohio attorney general that ends on October 31, 2015. The agreement required United to maintain a base departures commitment of at least 90% of its average daily departures at Cleveland for the first two years, and to maintain this commitment for the remaining three years if the airport met certain profit benchmarks.

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Court Rules Against North Las Vegas' Emergency Gamble, a Credit Negative

On January 21, a Nevada District Court ruled that the city of North Las Vegas (Ba3 negative) improperly used state of emergency powers to balance its budgets. The ruling is credit negative because the already financially challenged city could owe as much as $25 million to $42 million, which is 15% to 25% of its operating revenues. The court found the city used the state of emergency to breach labor agreements with police and fire unions by suspending scheduled wage increases and benefits since fiscal 2013.

The court ruled that the city's ongoing financial distress was not an emergency "related to physical catastrophes and/or unanticipated war-like events" and violated the intent of the state of emergency law. The city contended that the labor agreements were unsustainable and the emergency powers allowed for a balanced budget without drastic reductions to public safety, which would have undermined required police powers. The city plans to appeal the ruling to the Supreme Court of Nevada. The timing and structure of any eventual payment remains unknown.

The ruling, combined with fundamental credit pressures, drove our January 27 downgrade of the city's general obligation limited tax rating to Ba3 from Ba1 and change in outlook to negative. The rating action affected $428 million in debt.

Prior to the ruling, city officials forecast a $24 million budget shortfall in operating funds for the upcoming fiscal year starting July 1. A loss on appeal of the ruling could increase that significantly. The structural deficit is driven by compensation provisions under the public safety labor contracts that prompted the city to call on the state of emergency powers. To balance the budget, as required by state law, officials will have to make deep cuts in spending, some of which will be politically difficult.

Management may look to negotiate significant concessions from labor groups, cut service levels further, or increase property taxes. The city also expects to continue taking the uncommon step of charging outsized payments in lieu of taxes for its water and sewer utilities which account for 20% of operating revenues.

The city continues to grapple with the lingering effects of the deep recession in the Las Vegas metro area. Its tax revenues are improving only modestly as the region's tourism-driven economy continues to recover. Compared to its peers both in the metro area and nationally, North Las Vegas' financial position remains narrow with reserves of only 8% of operating revenues on an audited GAAP basis as of 2013.

The city's financial flexibility is further limited by a moderate fixed costs burden of 24% of operating revenues. This burden is driven by pension contributions, long-term debt service and other post-employment benefits (OPEB). North Las Vegas has a Moody's adjusted net pension liability (ANPL) of $858 million which averaged 4.1 times operating revenues for fiscal years 2010-12, well above the average of 1.0 times for local governments nationally. The city financed many capital projects with long-term debt as the prior housing and economic booms led to substantial growth pressures as its population expanded almost 90% from 2000-10 to nearly 220,000 residents.

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Debt Limit Unlikely to Affect US Creditworthiness or Aaa Rating

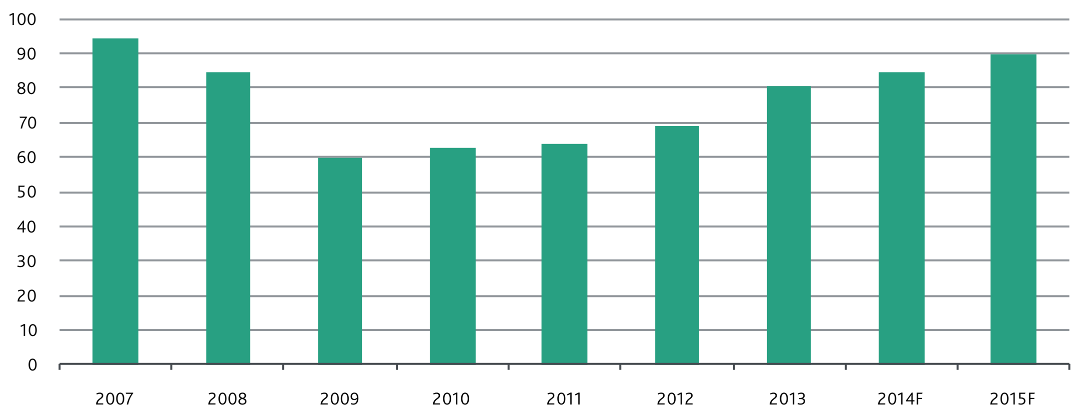
The US federal government statutory debt limit will become effective once again on February 7 after having been suspended since October. We fully expect the debt limit will be raised. Furthermore, we believe that even in the unlikely case in which the debt limit is not raised the US Treasury has the means to continue to pay interest on its debt. We also believe that the Treasury would give interest payments a very high priority in such circumstances. Principal payments coming due can be refinanced, because the debt limit only affects the total amount of debt outstanding, not the authority to issue debt. As a result, the debt limit question does not currently affect the US government bond rating.

Although the Treasury can use "extraordinary measures" to continue spending at normal levels past the February 7 date, the Secretary of the Treasury has indicated that these measures will last a much shorter time than they would have in 2011 or 2013, when the debt limit increase was also in question. Therefore, the timeframe before expenditure cuts would become necessary if the debt limit were not raised is shorter than it would have been earlier. The Treasury Secretary's letter to Congress released last week indicated that cuts could occur at the end of February or early March.

According to Congressional Budget Office (CBO) baseline projections, total federal government revenues will be sufficient to finance 84% of expenditures during the current fiscal year.[1] As a result, debt issuance is necessary to finance the remaining 16%. Therefore, should the debt limit not be raised, expenditures would have to be cut by 16% during the remainder of the fiscal year. In the 2015 fiscal year, which begins October 1, the CBO baseline projects that revenues will cover 90% of expenditures, implying a 10% reduction, indicating that if such an impasse were to occur again, the effects would be even smaller in fiscal 2015.

Because the budget deficit has declined rather quickly over the past several years after peaking at 9.8% of GDP in 2009, the proportion of expenditures financed by debt issuance has dropped, as shown in Exhibit 1. The last two times that the debt limit was reached and the Treasury resorted to extraordinary measures were during the summer of 2011 and the fall of 2013. Although the debt limit was ultimately raised and expenditures did not need to be reduced, the magnitude of potential expenditure reduction would have been 36% in 2011 and 20% in 2013. Therefore, while a 16% reduction in expenditure this year would still be substantial and cause considerable difficulties, it would nonetheless be more manageable than it might have been in earlier years and create no imminent threat to timely interest payments.

EXHIBIT 1
US Revenues Returning to Pre-Crisis Levels in Relation to Outlays
(Revenues as a percent of expenditures, fiscal years)



Source: Congressional Budget Office, Moody's

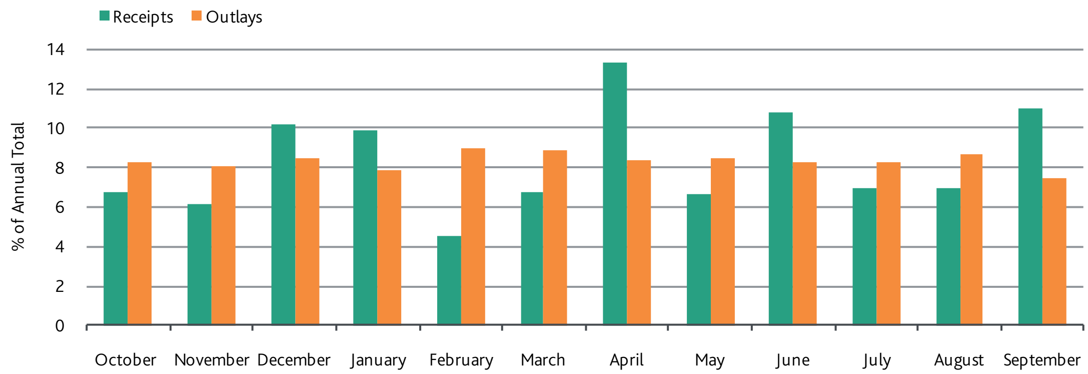
[1] The recent budget agreement, which authorizes somewhat higher discretionary spending, could lower this figure marginally to 83%.

These figures are averages for the fiscal years. However, both revenues and expenditures vary considerably from month to month. As illustrated in Exhibit 2, which shows the average monthly distribution of revenues and expenditures during the past ten years, February has both the lowest share of revenues and the highest share of expenditures. While there is no assurance that this pattern will hold in coming months, it gives an indication of the pressures on spending that could be forthcoming in the absence of a debt limit agreement. The pattern shown for February is behind the Treasury secretary's statement that the extraordinary measures may last for a shorter period than they would have in past years, which occurred at different times of the year.

EXHIBIT 2

Monthly Pattern of Federal Receipts and Outlays

(Average percentages, FY2004-2013)



Source: US Treasury; Moody's

The monthly deficit between revenues and expenditures is typically lower in March, and in April, because of personal income tax receipts, the government records a substantial surplus. Therefore, pressure on the federal budget balance is much reduced in those two months.

The pattern of interest payments on bonds, which is the other important variable in determining the chances of any missed payment, has a favorable profile for March and April. This indicates that, even if the debt limit is not raised for an extended period, the ability of the Treasury to continue to service its debt would not be significantly impaired. The figures in Exhibit 3 use the implied (non-debt) monthly revenue levels based on the 10-year average distribution, as illustrated in Exhibit 2.

EXHIBIT 3

US Government Interest Payments Due February-April 2014

		Interest Payments $ Billion	Interest Payments/Revenue	Amount of Principal Affected $ Billion
February	28	5.9	4.2%	798
March	15	0.5	3.2%	193
	31	6.0		803
April	15	1.8	1.9%	419
	30	5.9		773

Source: US Treasury; Moody's

We fully expect the debt limit will be raised. However, even if it were not, the proportion of estimated revenues during the months of March and April that would need to be devoted to interest payments is quite small, reinforcing the ability of the Treasury to make such payments even while making cuts in other payments. We believe that interest payments would receive a high priority on the list of obligations to be met.

In our view the debt limit is not a significant threat to the ability of the US government to service its debt obligations. Nonetheless, the prospect of the debt limit not being raised on a timely basis and of a consequent major reduction in federal government outlays can have significant effects, albeit temporary, on financial markets. As to the economy, the effects seem to have been rather small last October, since real GDP increased at an annual rate of 4.1% in the third quarter and a preliminary estimate of 3.2% in the fourth quarter.

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2014 Outlook — US Ports

SLOW DEMAND AND VESSEL OVERSUPPLY WILL PUT THE PINCH ON PORTS

- **The main reason for our negative outlook is the continued imbalance between supply and demand in the shipping-line industry, the main customers of most US ports.** This imbalance will put downward pressure on the rates shipping lines pay US ports, stunting industry revenue growth. On the demand side, we estimate that container volume at US ports will rise 2%-3% this year. On the supply side, shipping lines will increase total container capacity nearly 8% in 2014, according to Drewry, outstripping demand for shipments. The result: A highly competitive price environment among shipping lines, which ports rely on for revenue.
- **Ports will feel the pinch.** Given a lack of pricing power over their own customers, shipping lines will reconsider their ability and willingness to pay current fees to the ports. Although multiyear contracts with shipping lines will help ports lock in minimum levels of revenue, shipping lines will look to renegotiate fees or seek concessions when port contracts come up for renewal, ultimately hurting port revenues.
- **The trend in vessel design toward larger ships will require capital investments on the part of ports despite uncertain returns, another reason for our negative view**. This trend has created a widespread need for additional capital expenditures with no significant increase in port industry revenues. Beyond sufficient channel depth, ports will need improvements in cranes, storage facilities and real estate, as well as improved technology and connections to transportation networks in order to stay competitive.
- **What could change our outlook.** If we see signs that total vessel container capacity is moving more in line with container-volume growth and demand for port services, our outlook could shift to stable.

PRESSURE ON SHIPPING LINES TILTS OUR OUTLOOK TO NEGATIVE

Our negative outlook for the US port industry is based on two competing trends that will put the pinch on ports this year: slow economic growth, which is pushing growth in container volume below the historical norm, and an expansion of the shipping fleet. Essentially, shipping fleets are getting bigger in terms of both number and size, but demand in the form of container-volume growth isn't keeping pace. This imbalance will continue to put pressure on shipping lines and the rates they pay US ports.

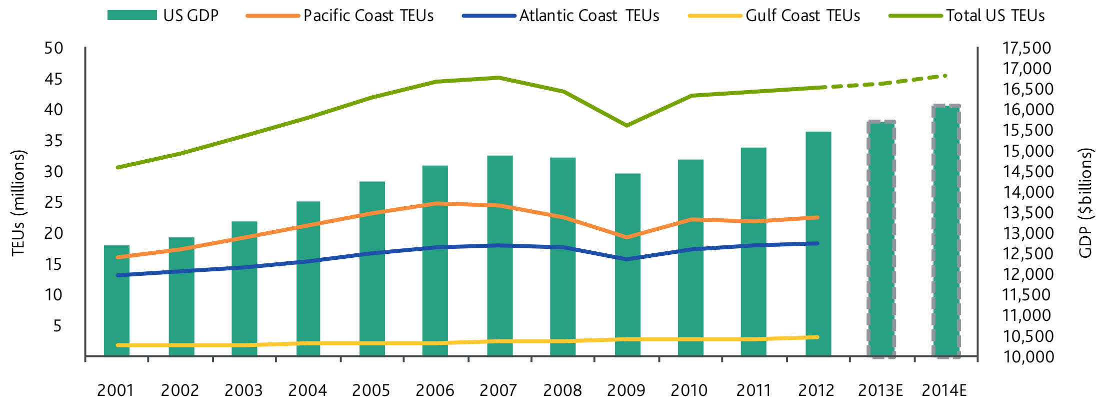
On the demand side, we estimate that container volume at US ports will rise 2%-3% on an industry-wide basis in 2014 (see Exhibit 1), in line with growth in the broader US economy.[2] Although volumes will increase this year for most US ports, the average rate of growth will trail the 7% average annual growth rate in the 15 years leading up to the 2007-09 recession, according to historical data compiled by the American Association of Port Authorities. Please see the appendix on page 7 for a list of US ports included in our analysis.

We use container-volume trends as a broad proxy of demand for US port services. As the most easily commoditized of the US cargo segments, container volume reflects trends in manufacturing and international trade, as well as population, consumption and wealth trends, which also affect more specialized cargo segments like dry bulk, liquid bulk and break bulk. As the chart shows, US cargo throughput has followed the ups and downs of the economy over the past decade.

[2] Please see "Global Macro Outlook 2013-15: Navigating Towards Calmer Waters."

EXHIBIT 1

US Cargo Throughput Will Follow US Economic Growth in 2014



Notes: TEU stands for twenty-foot equivalent unit. The dotted lines represent our estimates for 2013 and 2014.
Sources: American Association of Port Authorities, Moody's Analytics and Moody's Investors Service

On the supply side, vessel overcapacity and high fuel costs are putting pressure on global shipping lines,[3] giving them an incentive to consolidate or reduce service levels with ports. According to Drewry Maritime Research, the forward order calendar for container vessels shows that an additional 3 million twenty-foot equivalent units (TEUs) will come on line through 2015,[4] adding approximately 8% more capacity to the existing shipping-industry fleet in both 2014 and 2015. The 8% growth in capacity outstrips the 2%-3% volume growth we expect for 2014.

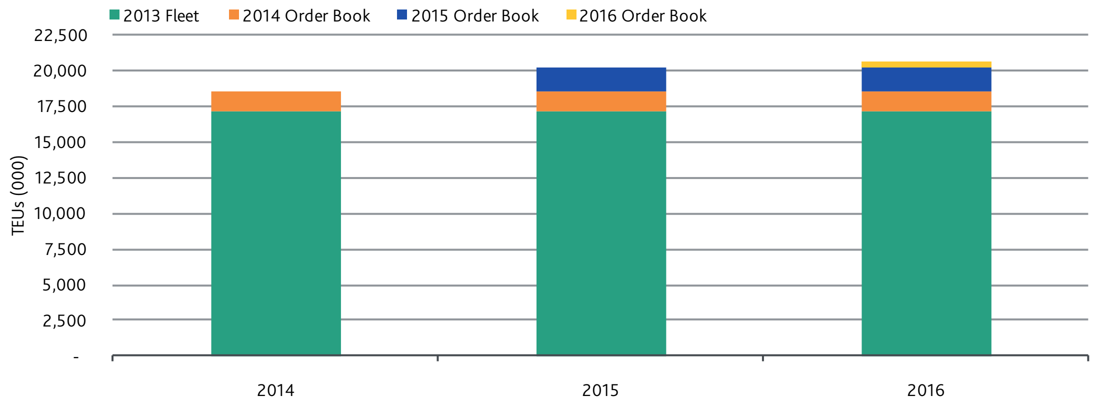
Overcapacity has led to a weak price environment for shipping lines, meaning they will have a tough time passing on price increases to customers and will instead focus on what they pay the ports. Although ports are somewhat protected by multiyear contracts with guarantees that lock in minimum levels of revenue, shipping lines will look to renegotiate current contracts with ports and reduce rates, service levels and guarantees on future contracts, hurting ports' operating revenues. The Port of Seattle (Aa2 stable) is an example. As a result of the loss of the three Grand Alliance shipping lines to the Port of Tacoma (Aa3 stable) and lower container terminal lease rates at the seaport, we expect the Port of Seattle's container terminal revenue to decline approximately 3% for 2013.

For these reasons, we need to see growth in vessel container capacity move more in line with growth in container volume before considering a shift to a stable outlook.

[3] For more information on the global shipping industry, please see "Global Shipping Industry: Sustained Oversupply Keeps Outlook Negative."
[4] Drewry Monthly Analysis of the Shipping Markets, January 2014

EXHIBIT 2

Worldwide Container Fleet and Scheduled Deliveries Will Rise Through 2016



Note: TEU stands for twenty-foot equivalent unit.
Source: Drewry

For more information, please visit the full report.

MUNICIPAL BANKRUPTCY: UPDATE & INSIGHTS

Our monthly section on municipal bankruptcy provides updates and analysis on what's happening with Detroit, Stockton and other high-profile distressed local governments. We welcome your feedback at **munibankruptcytaskforce@moodys.com**.

Highlights of Recent Developments

DETROIT, MI (Caa3 NEGATIVE[5])

Negotiations Continue Between City and Creditors in Lead-Up to Final Plan of Adjustment

» Detroit has filed a lawsuit challenging the validity of its Series 2005 and 2006 Certificates of Participation which total $1.4 billion. In the lawsuit, Detroit claims that the city should have never been allowed to issue the debt because it violated multiple state laws. The filing came after UBS and Bank of America failed to propose a new settlement offer to end the controversial swaps by January 31.

» Emergency Manager Kevyn Orr has provided the first draft of the city's plan of adjustment to creditors. The court-ordered deadline to release a final plan to the public is March 1.

» The state of Michigan has proposed providing $350 million in aid to Detroit over a 20-year period to help the city meet pension obligations and avoid selling part of its art collection. With philanthropic foundations now pledging a total of $370 million and the Detroit Institute of Arts reportedly pledging to contribute an additional $100 million in similar assistance, the total potential contribution has now been raised to $820 million.

» Detroit and its retirees have reached a settlement through mediation to end a lawsuit over health care benefits. Although details of the settlement have not been publicly disclosed, a February 3 hearing on health care benefit changes has been cancelled.

» Discussions continue with Macomb, Oakland and Wayne counties over Kevyn Orr's proposal to lease the city's water department to a new regional authority.

SAN BERNARDINO, CA (UNRATED)

Mediation Progress Reported, CalPERS Appeal Continues

» After mediation on January 9, the presiding judge authorized the city to report "significant progress" to the court.

» San Bernardino representatives have met with the negotiating team for California Public Employees' Retirement System (CalPERS), a sign the city may be looking to trim pension obligations in Chapter 9.

» Mediation is scheduled to resume on February 19.

» CalPERS has filed an appeal of San Bernardino's eligibility for bankruptcy with the Ninth Circuit Court of Appeals.

[5] All ratings are for general obligation debt unless otherwise indicated.

STOCKTON, CA (LEASE REVENUE Caa3 DEVELOPING))

City and Key Creditor Remain at Odds in Advance of Confirmation Hearing

» The scheduled confirmation hearing for the city's plan of adjustment has been postponed by more than two months to May 12.

» Franklin Advisers is only the creditor holding lease-revenue bonds without a deal with the city. Franklin is pursuing an adversary proceeding against the city, which has a scheduled trial date also on May 12. It is also pursuing legal action against creditors that have reached a settlement with the city, including CalPERS.

» The plan proposed by the city calls for Franklin, which holds $35 million of the city's bonds, to get less than 1% of par. If a class of creditors does not approve the plan, the city will likely seek a cramdown.

» Stockton is not looking to reduce pensions in bankruptcy. So, it is not clear whether it can emerge from Chapter 9 and avoid the type of future pension funding challenges that plague Vallejo, a fellow California city that exited bankruptcy and continues to struggle to fund onerous pension payments.

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Within Chapter 9 Framework, Recovery Levels Vary Widely

Factors that influence recovery rates in Chapter 9 vary from case to case. Recovery rates are often inconsistent among creditors with similar security pledges. The amounts can also deviate from what the bankruptcy code provides for certain classes of debt. Recent outcomes in Chapter 9 bankruptcies are distinguished by the circumstances of the particular cases, and therefore do not set broadly applicable precedents.

Bankruptcy courts have limited powers over local governments. Mostly, they provide a supervisory function. The Detroit (Caa3negative), Jefferson County, AL (GO Caa3 review for upgrade) and Stockton, CA (lease revenue Caa3 developing) cases underscore that Chapter 9 provides only a framework for parties to work out claims, and functions as a legal shield to facilitate settlement negotiations. Arguably, this reflects the bankruptcy code's purpose of providing a fresh start for debtors, which is both in the best interests of creditors and feasible, even if the results are not consistent from case to case.

In Jefferson County's case, sewer creditors had an overall gross recovery rate of 54.1%[6]. However, the recovery rate varied across creditors. For example, JP Morgan Chase (JPM) had a 31% recovery, while other bondholders with the same legal status recovered 80% (exclusive of insurance proceeds). JPM settled for a relatively small amount compared to its peers with the same legal status. JPM had paid an SEC fine related to a bribery investigation in connection with the transaction.

At the other extreme in the Jefferson County case, Depfa Bank negotiated an overall improvement in its position as holder of variable rate debt put back to it as standby liquidity provider, in return for its consent to the county's bankruptcy recovery plan. Depfa held one of the three series of school warrants; none of these had been impaired, but the bankruptcy was a technical event of default entitling Depfa to a seat at the table. The negotiated exchange did not follow the prescriptions of the law that entitled Depfa to no more than the same recovery as the other school warrant holders.

In the continuing Stockton case, the city has reached agreements with all but one major creditor. Proposed recovery rates for lease revenue and other general fund-supported bonds range from 1% to 100%. The city wants Franklin Advisers to accept a 1% recovery on bonds, which carry a promise to generate payment from all available financial resources and are secured by two golf courses and a public park. Franklin has not agreed to the low recovery rate. Meanwhile, the city's plan calls for full recovery on two lease-revenue bonds secured by administrative buildings that include police and fire stations and libraries. Between these two extremes, holders of pension obligation bonds, which are secured by a bare contractual repayment obligation, would see a 50% recovery.

In the Detroit bankruptcy, negotiations continue with all of the city's creditors. Detroit's water and sewage system creditors remain unimpaired and could benefit from strong legal protections in the form of a likely "special revenue" pledge. In the city's original June 2013 proposal to creditors, the emergency manager outlined a plan that created the potential for either a distressed exchange or haircuts for certain water and sewage system bondholders. The city made this proposal despite the special revenue pledge and apparent statutory lien securing their bonds. The statutory lien would ensure full recovery as long as revenues from the utility operations, less necessary expenses, are available to pay bondholders.

6 Moody's calculation of the difference between the sum of defaulted principal and accrued interest from time of default to point of settlement and the total amount paid to creditors upon settlement.

Types and Recovery Levels Vary in Municipal Bankruptcies

Obligor	Type of Obligation	Recovery Range	Collateral	Comment
Stockton	General Fund supported	1%-100% proposed	Real estate/ facilities	Six separate lease series; not subject to appropriation
	Pension Obligation Bonds	50% proposed	None	Full faith and credit and pledge; not GOULT
	OPEB	0% proposed	None	Retiree health care benefits included in bankruptcy
Central Falls	General Obligation bonds	100%	NA	GO debt given statutory special revenue status
	Commercial lease	50%	Equipment	
	Pensions	45% (approx.)	None	
	OPEB	45% (approx.)	None	
Jefferson County	Sewer Warrants	39%-80%	NA	Special revenue payable from sewer system net revenues
Vallejo	General Fund Supported	60-75%	Real estate/ facilities	Leases not subject to appropriation
	OPEB	20%	None	Retiree health care benefits included in bankruptcy

Source: Moody's

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General Obligation Spotlight: California

PLEDGE PROVIDES STRONG PROTECTION FOR BONDHOLDERS, NOT FULLY TESTED IN BANKRUPTCY

California local government's GO bonds are secured by a pledge of specific *ad valorem* taxes that must be levied to pay debt service on bonds due in a given year. Unlike most states, California local government GO bonds are not secured by a full faith and credit pledge, nor by other assets or revenues beyond the specific taxes levied in conjunction with the debt. Under the state constitution, no municipality may incur GO indebtedness without at least two-thirds voter approval. In the case of school districts, this voter threshold may drop to 55% when additional requirements are met.

The levy to support GO bonds is unlimited in rate and amount and in addition to the statewide 1% *ad valorem* property tax, which is collected on all non-tax-exempt real property and used for local governments' general operating purposes. The tax receipts for debt service are accounted for separately from property taxes for operations, and by terms of the state's constitution, can be used only for the payment of debt service on the related GO bonds.

Importantly, a GO bond levy may only be used for financing the acquisition and improvement of real property. This likely qualifies the GO bond levy as a "special revenue" pledge, but this assertion has not been tested in court. In bankruptcy, special revenue pledges are exempt from an automatic stay, and the municipality must continue making payments on GO bonds during the process. Bankruptcy law defines special revenues to include, in addition to enterprise system revenues, taxes levied to finance specific local government projects. Such project specific revenues would be distinct from taxes for general operations. In the Sierra Kings Health Care District (Baa3) bankruptcy decision in 2011, the court affirmed an agreement between the insurer and the hospital district allowing for uninterrupted debt service payments. Since the issue was never litigated, whether the characterization of a GO pledge as special revenue has applicability beyond this specific case has not been answered.

California school and community college district GOs have an additional security feature. The county in which they are located levies and collects taxes and pays GO bonds on their behalf. This structure likely places debt service and bond proceeds outside of a bankruptcy estate, though whether school districts can file for Chapter 9 remains unclear and the issue has not recently been litigated.

Some other municipal securities come with a promise to repay debt service through a lease or pension/judgment/settlement obligation structure (POB/JOB/SOB). These pledges are equivalent to a full faith and credit contractual promises to repay debt from all legally available sources, with the key distinction being that the lease payments are conditioned on the continuing use of the leased asset such as a parking garage. In the event that the asset is no longer usable, the lease payments must be reduced in proportion to the reduction in use[7].

Unlike a GO, the lease and unconditional obligation securities do not benefit from the local government's unlimited ability to raise property taxes to pay debt service. Instead, the protection is the local government's unconditional promise to repay the debt from all available financial resources, limited by revenue-raising restrictions and fixed expenditures. Consequently, the bonds are more susceptible to impairment in bankruptcy than GO debt.

7 Lease structures generally provide more security to bondholders than obligation bonds, because bondholders can take over the leased property in a default.

California General Obligation Pledges

		Ad Valorem Property Tax ("GO") Pledge	Lease Revenue	Pension/ Judgment/ Settlement Obligation Bonds
Nature of Pledge	The municipality pledges all available financial resources not otherwise pledged, effectively a full faith and credit promise.	No	Yes	Yes
	Property tax is unlimited as to rate or amount	Yes	No	No
	The issuance of type of debt requires voter approval	Yes	No*	No
Legal Protections	Taxes pledged to bondholders are from a separate levy dedicated solely to debt service	Yes	No	No
	Even if the pledge is not separate or solely dedicated, debt service has budgetary priority over other expenses	No	No	No
	The GO pledge encompasses all available revenues even if otherwise pledged (clawback)	No	No	No
	The pledged tax receipts held outside of local government control for the benefit of bondholders only	Yes**	No	No
Other	A local government has defaulted on the pledge	No	Yes	Yes

* With exceptions, typically a city's charter that requires voter approval for certain types of lease-backed obligations.

**This applies to all school and community college districts. For cities, it applies on a case-by-case basis.

Source: Moody's

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General Obligation Spotlight: Pennsylvania

STATE PROVISIONS PROVIDE UNLIMITED TAX PLEDGE FOUND IN MANY STATES

Local governments in Pennsylvania, other than school districts, can issue general obligation debt in the form of unlimited tax (GOULT) bonds backed by a full faith and credit pledge. School district GO debt can have either a GOULT or a limited tax (GOLT) pledge.

Local governments other than school districts have the right to levy unlimited *ad valorem* taxes on real property. Additionally, state law requires local governments to budget necessary funds to pay debt service through appropriations of net revenues. Guaranteed debt, issued by many local enterprise systems as revenue bonds wrapped with a GOULT guarantee, is common.

School districts are prohibited by Pennsylvania's Tax Payer Relief Act (Act 1) from increasing their annual property tax rates above the level of an inflation-based index[8]. Unless a district's debt falls under an exception to Act 1, the district is unable to raise the millage rate above the cap, making the debt a limited tax pledge. The exceptions to Act 1, which enable debt to carry a GOULT pledge, include debt issued before 2006 (and new issuances to refund such debt) and debt approved by voter referendum at the time of issuance.

In order to issue GO debt, the Pennsylvania Local Government Debt Act (Debt Act) requires local governments to enter into a specific covenant outlined in the ordinance to make payments. In addition to property taxes, local governments can rely on other revenues that include real estate transfer taxes, sales taxes, earned income taxes, fines and forfeitures, investment earnings and licenses and permits.

The Debt Act provides creditors with the right to judicial remedies if local governments fail or refuse to adequately budget the needed funds for GO debt service. If a municipality defaults, then the bondholders can sue the municipality and petition a court for an order of mandamus, directing payment from the local government's first available funds. A declaration of bankruptcy would trump these remedies, however, if the municipality filed before the plaintiff could obtain a judgment.

8 The Philadelphia School District (Ba2 negative) is limited to tax increases authorized by the state legislature or the city council of Philadelphia (A2 stable), instead of an index-based cap.

Pennsylvania General Obligation Pledge

		GOULT	Certain School District ULT Pledges	Certain School District LT Pledges
Nature of Pledge	The municipality pledges its full faith and credit (all available financial resources not otherwise pledged)	Yes	Yes	Yes
	Property tax is unlimited as to rate or amount	Yes	Yes*	No
	The issuance of type of debt requires voter approval	No	No*	Yes
Legal Protections	Taxes pledged to bondholders are from a separate levy dedicated solely to debt service	No	No	No
	Even if the pledge is not separate or solely dedicated, debt service has budgetary priority over other expenses	No	No	No
	The GO pledge encompasses all available revenues even if otherwise pledged (clawback)	No	No	No
	The pledged tax receipts held outside of local government control for the benefit of bondholders only	No	No	No
Other	A local government has defaulted on the pledge	Yes	No	No

Source: Moody's

*With exceptions to Act 1

FEDERAL BANKRUPTCY AND PENNSYLVANIA LOCAL GOVERNMENTS FINANCIAL RECOVERY ACT

The Pennsylvania Financially Distressed Local governments Act (Act 47) authorizes insolvent local governments in Pennsylvania to file for bankruptcy protection under Chapter 9. However, the state has been reluctant to allow local governments to seek bankruptcy protection, preferring them instead to resolve issues outside of bankruptcy. Most recently, the state opposed the bankruptcy filing of Harrisburg (unrated), and the case was ultimately dismissed by the court. Harrisburg subsequently negotiated a settlement under which creditors of GO-guaranteed debt took losses and did not seek to enforce judicial remedies.

Notable Municipal Bankruptcy Filings

Issuer	Year	Outcome
North and South Shenango Joint Authority (A3, no outlook)	1981	Dismissed
Carroll Township Authority (unrated)	1990	Dismissed
Westfall Township (unrated)	2010	Approved (no effect on GO Debt)
City of Harrisburg (unrated)	2011	Dismissed

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General Obligation Spotlight: Rhode Island

STATUTORY LIEN STRENGTHENS UNLIMITED TAX PLEDGE FOLLOWING CENTRAL FALLS BANKRUPTCY

In Rhode Island, all GO debt is backed by the full faith and credit of cities and towns, including a pledge to levy *ad valorem* taxes on all taxable property without limits on rate or amount. All revenues collected by municipalities to fund operations and debt service, including property taxes, are aggregated in a city's operating and enterprise funds.

Prior to July 2011, debt service payments were effectively on parity with other operating expenses of a municipality. As Central Falls (B1 positive) approached a likely Chapter 9 bankruptcy filing that year, state lawmakers chose to take action to enhance capital market access for municipalities by giving bondholders a first lien on all property taxes levied by a local government.

The resulting statutory lien mandates that debt service must be paid with higher priority than other operating expenses, effectively advancing all municipal bondholders ahead of other classes of creditors. The law, which amended Section 45-12-1 of the General Laws of Rhode Island, applies not only to all future GO debt issuances, but to all GO debt issued prior to the 2011 enactment.

The law also specifies that any municipal employee or official who deliberately violates any priority-of-payment provisions is held personally liable to the municipality for any amount not disbursed in accordance with the defined appropriations. Furthermore, any municipal employee or official who violates any of these provisions is subject to removal.

Rhode Island GO Debt

Nature of Pledge	The municipality pledges its full faith and credit (all available financial resources not otherwise pledged)	Yes
	Property tax is unlimited as to rate or amount	Yes
	The issuance of type of debt requires voter approval	No
Legal Protections	Taxes pledged to bondholders are from a separate levy dedicated solely to debt service	No
	Even if the pledge is not separate or solely dedicated, debt service has budgetary priority over other expenses	No
	The GO pledge encompasses all available revenues even if otherwise pledged (clawback)	Yes
	The pledged tax receipts are held outside local government control for the benefit of bondholders only	No
Other	A local government has defaulted on the pledge	No
	The pledge is a statutory lien	Yes

Source: Moody's

When Central Falls emerged from bankruptcy in September 2012, its final plan of adjustment paid holders of GO debt in full, while imposing cuts of up to 55% for the city's pension beneficiaries. Although retirees initially challenged the law's validity, they settled with the city. No precedent was set on the legality of a statutory lien in bankruptcy, particularly with regard to debt issued before the law's enactment. Hence, the validity of the secured status for GO bonds remains untested in court.

DEFINITION OF THE MONTH

Secured and Unsecured Claims: Refers to categories of debt under the bankruptcy code. Secured debt is debt that benefits from a pledge of cash collateral, a mortgage or another lien on assets that gives preferential treatment to certain creditors. In contrast, unsecured claims do not have any claim on specific assets. Secured debt has a higher degree of protection than unsecured, since creditors are entitled to receive payment in full up to the value of the pledged asset. If the value of the asset is less than the value of the claim, bankruptcy law treats the difference as an unsecured claim. In a bankruptcy, unsecured creditors compete with other unsecured creditors for repayment. A debtor's funds or assets available to pay unsecured claims are what remains after secured creditors and certain others are paid.

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RESEARCH HIGHLIGHTS

Contingent Liabilities and Enterprise Risk Continue to Weigh on US Local Governments

Guaranteeing the debt of non-essential, non-core enterprises can have a devastating impact on the credit quality of local governments. Although numbers remain small, more local governments assumed enterprise risk during the economic downturn and slow recovery. Non-essential, non-core enterprises are much riskier than general government and essential public services because of their limited abilities to increase revenues in a competitive market environment. A third of the twelve local government defaults since 1970 have been sparked by a failure of some non-essential enterprises with guaranteed.

Lower Liabilities, Higher Costs: Pensions Still Weigh on US Local Governments in 2014

Defined benefit pension costs will continue to weigh on municipal budgets in 2014 despite declining pension liability measures. Rising budget costs primarily reflect the cumulative damage from previous investment losses, failure to fully prefund promised benefits, and timing lags built into actuarial and budget rules. The ability of local governments to address pension liabilities will become clearer in 2014 based on the outcome of pending lawsuits, legal proceedings and other pension reform efforts.

RATING CHANGE HIGHLIGHTS

Saratoga County (NY) Downgraded to Aa2; Outlook Negative

Feb. 3 – We downgraded the rating on Saratoga County (NY) to Aa2 from Aa1, affecting $59.6 million in general obligation debt. The outlook is negative. The downgrade reflects the county's narrow financial reserves from nine years of operating deficits mostly associated with its nursing home enterprise, Maplewood Manor. Despite the expected receipt of one-time revenues in the near term, the negative outlook reflects the potential for ongoing fiscal stress due to structurally imbalanced budgets. The outlook also reflects our expectation that the county will be challenged to increase reserves to historical levels. The Aa2 rating incorporates the county's sizeable tax base with above average wealth levels, which benefits from development in the technology sector; and a low debt burden with modest future borrowing plans.

District of Columbia Housing Finance Agency Upgraded to A2; Outlook Stable

Jan. 31 – We upgraded the issuer rating of the District of Columbia Housing Finance Agency (DCHFA) to A2 from A3. The outlook is stable. The upgrade reflects the agency's solid financial performance, strong portfolio performance, and low risk profile. DCHFA has a solid combined fund balance of $130 million and a multi-family portfolio that generates substantial revenues.

Two Oregon Local Governments Limited Tax Pension Obligations Downgraded

Jan. 28 – We downgraded to A3 from Aa3 the rating on Oregon Local Governments Limited Tax Pension Obligations, Series 2002, affecting $207 million, and to A1 from Aa3 the rating on Oregon Local Governments Limited Tax Pension Obligations, Series 2005, affecting $170 million. The downgrades primarily reflect the deteriorated credit quality of some of the underlying pool participants. The ratings also incorporate the overall sound structure of these unenhanced pools. Series 2002 is an unenhanced pool secured by the full faith and credit pledge of the 10 participants: the counties of Benton, Columbia, Deschutes and Lane, the cities of Albany, Cottage Grove, Eugene, Lebanon, and Silverton, and the Port of Portland. Series 2005 is an unenhanced pool secured by the full faith and credit pledge of the 12 participants: the counties of Columbia and Umatilla, the cities of Corvallis, Dallas, Milwaukie, Monmouth, Oregon City, Pendleton, Salem, as well as the Port of Portland, Metro and Clackamas County Fire District.

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EXHIBIT B

MOODY'S
INVESTORS SERVICE

Without Pension Relief, Bankrupt California Cities Risk Return to Insolvency

Detroit Ruling Creates Opportunity to Challenge Pension Liabilities in California

Nearly three years after exiting Chapter 9 bankruptcy, Vallejo, CA (not rated) continues to struggle with mounting pension obligations. The two California cities currently in bankruptcy, San Bernardino (not rated) and Stockton (lease revenue bonds, Caa3 developing), face pension challenges similar to Vallejo's. If these cities fail to overhaul their pension obligations before exiting Chapter 9, these growing pension liabilities could over time become increasingly burdensome.

Like most California cities, Stockton's and San Bernardino's employees' pensions will require increasing city contributions. But unlike most of their peers, cities emerging from bankruptcy are likely to have budgets that are very thinly balanced, limited revenue growth prospects, and little in the way of financial reserves.

Last December, the federal judge in the Detroit bankruptcy case ruled the city's pension liabilities are contracts and can be modified in Chapter 9, becoming the first bankruptcy court to opine on this issue. The decision could influence the San Bernardino and Stockton cases, but the ruling is nonbinding on federal bankruptcy judges in California and limited by aspects of Michigan law.

Our key observations:

» **Pension liabilities in California could enjoy greater protection than some types of debt, if the California Public Employees Retiree System (CalPERS, enhancement program rated Aa3 stable) succeeds in preventing cities from adjusting pension liabilities through Chapter 9.** If municipalities fail to alter CalPERS obligations in bankruptcy, either because the litigation is too costly or CalPERS wins in court, pension obligations will have an effective senior priority over other unsecured debt, including lease-backed and pension obligation bonds.

» **CalPERS argues it is an "arm of the state" and outside of bankruptcy court jurisdiction.** In bankruptcy, courts cannot interfere with a state's control of its local governments. Only litigation will determine if CalPERS' claims are valid.

» **San Bernardino faces an uphill battle should it choose to challenge CalPERS.** The city could point to the Detroit ruling in seeking to reduce its pension liabilities in bankruptcy, but the success of that strategy would require the bankruptcy judge to agree that pensions are contracts subject to restructuring in Chapter 9. Stockton is unlikely to pursue this strategy.

» **Vallejo's post-bankruptcy experience provides a warning for Stockton and San Bernardino.** Vallejo's current budget challenges are largely driven by its failure to alter its pension obligations to CalPERS in bankruptcy. So far, Stockton's decisions in bankruptcy have closely matched Vallejo's approach, and it is likely to continue on this path. San Bernardino may challenge CalPERS.

CalPERS Pensions Could Enjoy Greater Protection Than Other Debt

If no California municipality successfully modifies pensions in bankruptcy, investors in California lease-backed and pension obligation debt will likely experience lower recovery rates relative to pensions in bankruptcy. Previously, we assumed that the recovery rates would be similar, considering the generally unsecured nature of pensions and these two types of municipal debt. If San Bernardino challenges CalPERS and loses, CalPERS could establish a legal precedent that its pensions are senior to unsecured obligations. If San Bernardino chooses not to challenge CalPERS, CalPERS pensions would increasingly appear to be *effectively* senior to all other unsecured obligations. So far, none of the few municipalities that have entered bankruptcy have challenged CalPERS to reduce pension liabilities. If municipalities continue to avoid cutting pensions in bankruptcy in order to avoid the difficulties involved in challenging CalPERS, pensions would effectively become senior to all of a municipality's other unsecured obligations even if not judicially determined to be so.

CalPERS Argues It Is Outside a Bankruptcy Court's Jurisdiction

CalPERS' principal argument against municipalities adjusting pension obligations in Chapter 9 is that CalPERS falls outside the bankruptcy court's jurisdiction. A bankruptcy judge cannot interfere in the relationship between a state and its local governments. CalPERS contends it is an "arm of the state," so local governments cannot impair their obligations to CalPERS through Chapter 9. California cities that try to restructure CalPERS pensions in bankruptcy must successfully overcome this threshold argument in court.

CalPERS contends that its relationship with municipalities is meaningfully different from Detroit's relationship with its pension systems, retirees and employees. In the Detroit bankruptcy, the court ruled that Detroit's pension obligations are based on contracts. Since bankruptcy law permits contract impairment, Detroit may seek to alter its pension obligations in its plan of adjustment. Detroit has two single-employer pension plans managed by trustees of each system. The systems were established by city ordinance, and the trustees act as fiduciaries on behalf of the city's employees and retirees.

CalPERS acts as an intermediary between local governments and their employees/retirees by managing pension assets and paying benefits to retirees. But unlike Detroit, this fiduciary relationship is created by a state statute requiring local governments to make pension payments to CalPERS. Even when employees retire, local governments are obligated under state law to make pension payments as determined by CalPERS. Normally, these pension payments cover current normal costs and the amortization of any unfunded liabilities.

CalPERS maintains this fiduciary relationship with retirees even if the municipality no longer uses CalPERS as its pension agent. By law, local governments must pay down a termination liability in order to cancel their contract with CalPERS. The termination liability is calculated by CalPERS using a risk-free discount rate since the termination payments must cover all future benefits for employees covered at the time of the termination.[1] The termination liability is significantly larger than a local government's reported unfunded liability, because the termination discount rate is much lower than the assumed investment return that CalPERS normally uses to calculate liabilities and annually required contributions.

1 While the law requires that local governments make a termination payment, whether the payment is a lump-sum or structured over multiple years remains unclear.

Central Falls, RI (B1 positive) is the only municipality to adjust its pensions in bankruptcy without judicial intervention. In 2011, the city reached an agreement with its retirees to cut its unfunded pension liabilities by half. Like Detroit, Central Falls uses single-employer pension funds.

As San Bernardino develops its plan of adjustment, CalPERS is challenging San Bernardino's eligibility for Chapter 9 in a federal appeals court. The city remains in mediation with CalPERS and other parties, some of which could look for an entryway to leverage the Detroit decision in negotiations.

If San Bernardino does not challenge CalPERS in court, it could still seek a settlement to alter the timing of its approximately $17 million in missed payment obligations, rather than cutting the amount. However, CalPERS asserts it "does not have the right to 'forgive' or reduce employer contributions which are necessary to sustain the soundness of the system and ensure the payment of promised benefits."[2] The city's missed payments are only a small fraction of the city's total accrued CalPERS liability and future costs related to the benefit formula in place for existing employees.

San Bernardino Would Face an Uphill Battle Challenging CalPERS

CalPERS' arguments regarding its status as a state agent are untested in bankruptcy. San Bernardino could argue that the Detroit decision establishes a legal framework for reducing pension obligations, but the city faces an uncertain and potentially costly legal battle. If the city chose to challenge CalPERS in bankruptcy, its first step would be to successfully demonstrate that its relationship with CalPERS is based on a contract. Contracts of any sort are subject to adjustment in bankruptcy according to the Detroit bankruptcy court's reasoning, even contracts protected under state constitutions.

If San Bernardino were to persuade the bankruptcy court that pensions are contracts, the city would still face a complicated route towards reducing its overall pension liability and annual payments. CalPERS is not likely to agree to modify the terms of its pension contracts. Without CalPERS' agreement, San Bernardino would have to reject its contract with CalPERS in order to reduce its liability to the system. In bankruptcy, parties can accept or reject certain contracts. If San Bernardino chose to reject its CalPERS contract, under California law the city would then face a large termination liability to CalPERS.

CalPERS estimates San Bernardino's termination liability would be approximately $1.2 billion. This is much higher than San Bernardino's as-reported June 2012 unfunded accrued actuarial liability (UAAL) of $189 million because CalPERS uses a much lower discount rate to calculate the termination liability (Exhibit 1).

[2] "Summary of CalPERS Legal Position in Municipal Bankruptcies" delivered to CalPERS Board of Administration on September 12, 2012.

EXHIBIT 1

San Bernardino's CalPERS Termination Obligation Greatly Exceeds Liabilities As-Reported

	Date	AAL	AVA	UAAL	Discount Rate
Misc.	6/30/2012	$446,677,440	$366,216,556	$80,460,884	7.50%
Safety	6/30/2012	$614,962,254	$506,240,356	$108,721,898	7.50%
Total		$1,061,639,694	$872,456,912	$189,182,782	
Termination Basis					
Plan	**Date**	**Termination Liability**	**MVA**	**Unfunded Termination Liability**	**Termination Discount Rate**
Misc.	6/30/2012	$804,471,348	$316,290,288	$488,181,060	2.98%
Safety	6/30/2012	$1,185,788,115	$422,274,719	$763,513,396	2.98%
Total		$1,990,259,463	$738,565,007	$1,251,694,456	

Source: CalPERS; termination discount rate as of June 30, 2012.

AAL: Actuarial Accrued Liability

AVA: Actuarial Value of Assets

MVA: Market Value of Assets

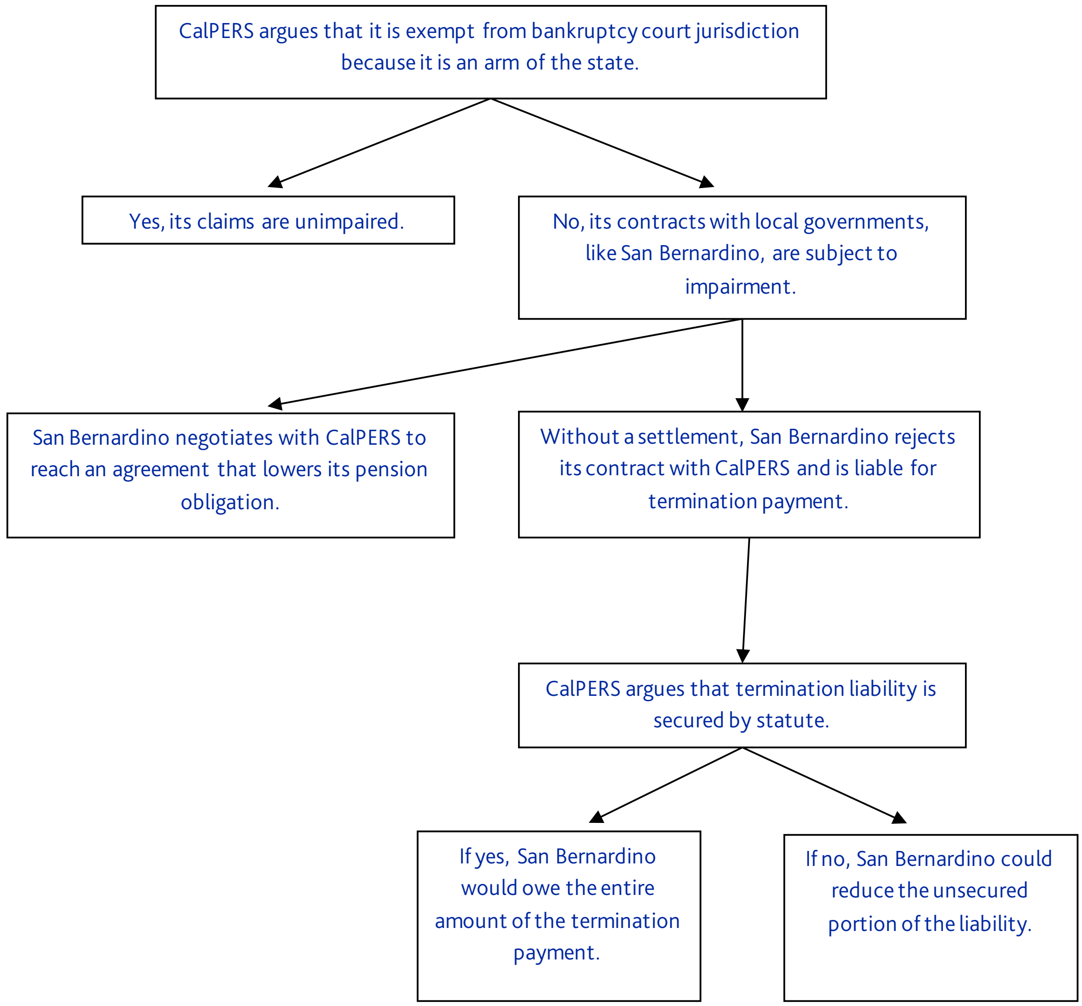
Another issue that would arise if San Bernardino cancels its contract with CalPERS would be whether the unfunded portion of the termination liability is secured or unsecured. Secured claims have a higher degree of protection in bankruptcy. In general, secured creditors are entitled to receive full payment up to the value of their claim, as long as the value of the property that is securing the claim is equal to or more than the claim itself. A municipal debtor is permitted to reduce unsecured claims by almost any amount, as long as it is fair and equitable, in the interests of creditors, and feasible.

In San Bernardino's case, part of the value of the termination liability would be secured by the assets CalPERS has accumulated on behalf of the city's employees. The difference between the pension asset values and the termination liability (the Unfunded Termination Liability in Exhibit 1) would be a point of contention. CalPERS asserts that in the event of termination it is "entitled to priority over unsecured creditors" and that California law "provides that CalPERS has a lien on all assets of a municipality to secure all liabilities of the municipality to CalPERS." Alternately, San Bernardino could significantly reduce its overall pension liability and annual payments to CalPERS if this portion of the termination payment is considered an unsecured claim. In this scenario, CalPERS would still be responsible for distributing the remaining assets to retirees, but at a reduced amount.[3]

[3] See CA Government Code, sections 20570-20593

EXHIBIT 2

San Bernardino Confronts Complex Series of Legal Issues before Modifying Its Pension Liabilities



Source: Moody's Investors Service

Stockton Unlikely to Challenge CalPERS

Regardless of San Bernardino's bankruptcy case, Stockton is far less likely to address its two underfunded pension plans in Chapter 9, because it is much further along in the Chapter 9 process. In addition to any reluctance to challenge CalPERS, Stockton has argued that providing a CalPERS pension with the current benefit levels is integral to recruiting public safety workers. However, the city still faces the possibility that it will need to confront unfunded pension liabilities if it cannot reach a deal with Franklin Advisers before a May 2014 confirmation hearing. Franklin is the sole investor in a series of lease revenue bonds issued by Stockton. Franklin is initiating legal action against the city and other Stockton creditors, including CalPERS. The hearing could force Stockton to demonstrate that its plan meets the requirements of the bankruptcy code. If the court does not confirm Stockton's plan, the city would likely have to renegotiate with its creditors, which could include CalPERS.

Vallejo's Post-Bankruptcy Financial Woes Serve as Warning to Stockton and San Bernardino

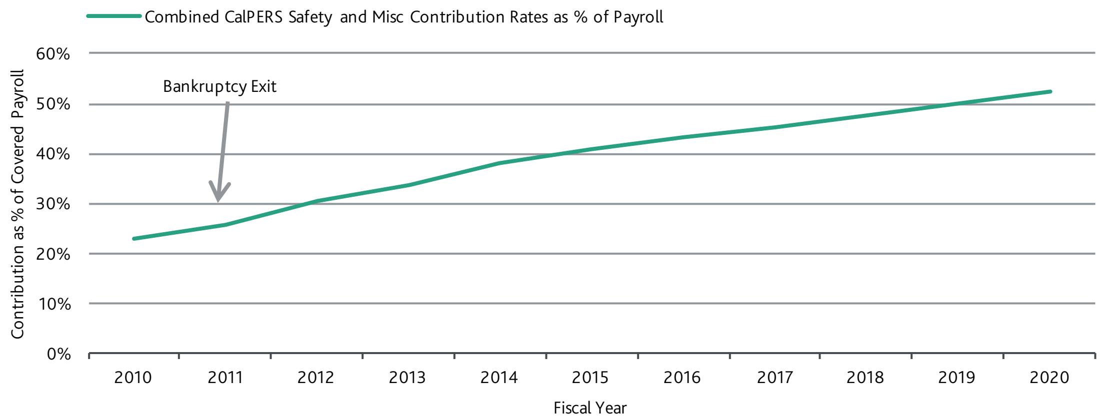
As Vallejo is discovering since it exited bankruptcy in 2011, when an already financially weak city avoids dealing with pensions in bankruptcy, it can create a significant impediment to a successful, long-term restructuring. The city has a persistent structural budgetary imbalance, and it risks a second bankruptcy filing if its continues on its current path.

The city's adopted fiscal 2014 budget noted a structural imbalance of $5.2 million, or approximately 6% of its adopted General Fund budget, that was projected to reach $8.9 million in fiscal 2015 without corrective measures. Like all California cities, Vallejo has limited options to increase revenues, and according to its budget message it has a "well below fiscally prudent reserve level" of 5% of expenditures.

More recently, the city estimated that it has reduced its structural imbalance to roughly $2 or $3 million through several actions, including further reductions to retiree health costs for some employee groups. However, the city's annual pension contribution requirements to CalPERS will continue to pressure its finances. Based on CalPERS' latest actuarial valuations, Vallejo's annual pension contribution rates will continue to increase (Exhibit 3). These projections do not yet reflect additional rate increases that CalPERS enacted on February 18, associated with certain changes in actuarial assumptions such as mortality rates. The city expects the annual pension contributions for its public safety employees will exceed 70% of payroll by fiscal year 2020 when accounting for the impact of the latest rate increases.

EXHIBIT 3

Vallejo's Rising Pension Costs Threaten Finances Post-Bankruptcy



Sources: CalPERS 6/30/2012 and 6/30/2012 actuarial valuations for Vallejo Safety and Miscellaneous plans, and Moody's projections. Projections based on CalPERS' 3% annual payroll growth assumption and projected contribution rates provided by CalPERS.
Note: Projections do not reflect additional rate increases adopted by CalPERS on February 18, 2014.

Vallejo substantially restructured its compensation structure, including significant cuts to retiree health care benefits, but by failing to address its pension liabilities it remains vulnerable to increasing annual payments. The city did not attempt to change the pension benefit formulas for existing employees' future accruals, opting not to challenge California legal precedents that an employee's pension benefit formula is established as of the employee's hire date and cannot be reduced going forward without providing offsetting benefits.

Vallejo's reforms in bankruptcy to retiree health benefits reduced its associated unfunded liability from \$135.4 million in 2008 to \$81.2 million in 2009. The city also increased employee pension contributions through the elimination of "pickups," where the city had previously covered employee pension payments. Additionally, the city implemented lower benefit tiers for new hires in certain employee groups, an approach similar to Stockton's current bankruptcy plan. With the exception of the bankruptcy judge rejecting one of Vallejo's labor contracts, all the changes could have been implemented through bargaining outside Chapter 9.

The financial challenges Vallejo is experiencing after failing to modify its CalPERS pension liabilities in Chapter 9 could foreshadow future difficulties for Stockton and San Bernardino.

Stockton Bankruptcy Plan Mirrors Vallejo's in Key Features

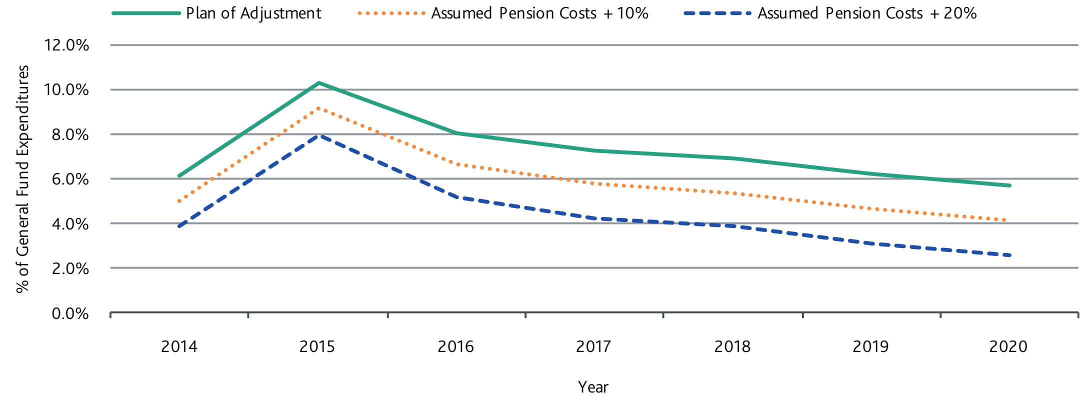
Like Vallejo, Stockton has not sought to alter vested pension benefits in Chapter 9. Instead, the city has focused on debt reduction, changes to healthcare benefits, salary controls, employee pension contribution increases and lower pension benefit tiers for new hires. Stockton's plan eliminates post-retirement health care benefits, which comprise the bulk of its combined non-debt related savings.

Stockton's projections show little margin to absorb unanticipated pension cost increases. Cost increases could result from actuarial losses, such as worse-than-expected investment performance, or from unanticipated contribution rate hikes. The city's plan of adjustment projects declining reserves following a sharp one-year increase in fiscal 2015. If the city's annual pension contributions increase by 10% to 20% more than assumed in the plan, its projected reserves would narrow without an offsetting budgetary adjustment (see Exhibit 4).

EXHIBIT 4

Stockton Plan of Adjustment Projects Reserves Will Remain Narrow

Reserve levels further sensitive to higher than expected pension costs



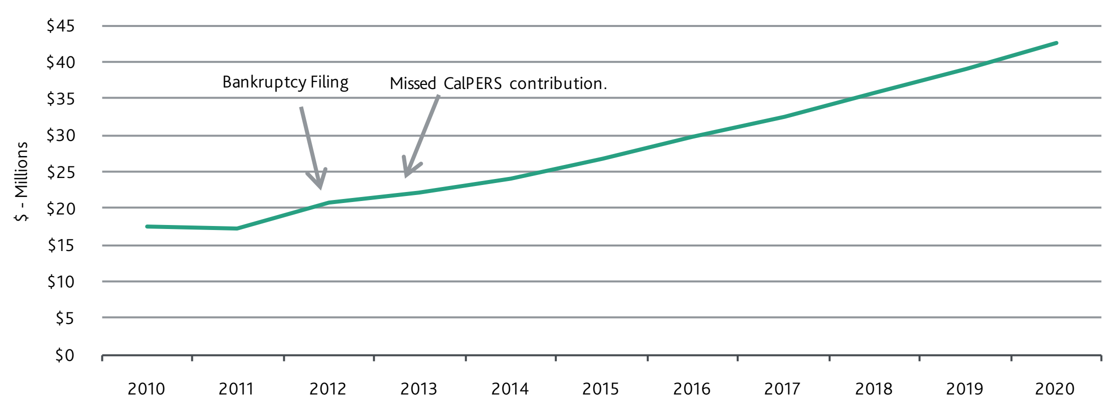
Source: City of Stockton Plan of Adjustment , Moody's Investors Service

San Bernardino Has Pension Challenges Similar to Vallejo and Stockton

San Bernardino's approach toward addressing its CalPERS liability in bankruptcy is not publicly known. Failing to lower its accrued liability, however, carries risks similar to what Vallejo and Stockton face. Like those two cities, San Bernardino's costs for its two pension plans are rising (see Exhibit 5). San Bernardino found it too financially burdensome to pay its entire CalPERS contribution in fiscal 2013, indicating that annual pension contribution increases will be difficult for the city to absorb without restructuring other expenditures. The restructuring of expenditures is a key objective of a bankruptcy proceeding, but the question will remain whether San Bernardino will have restructured enough, given the steady increases required to fund its pensions.

EXHIBIT 5

San Bernardino's CalPERS Pension Costs Projected to Increase



Source: CalPERS 6/30/2011 and 6/30/2012 actuarial valuations for San Bernardino's Safety and Miscellaneous plans. Payroll assumed to grow at 3% annually following 2012, per CalPERS actuarial assumptions.

Moody's Related Research

Sector Comments:

» Lower Liabilities, Higher Costs: Pensions Still Weigh on US Local Governments in 2014, February 2014 (163529)

» Courts Offer Contrasting Outcomes for California Cities Seeking Retirement Benefit Cuts, January 2014 (162626)

» Stockton, California, Clears Hurdle in Bankruptcy Exit, a Credit Positive, November 2013 (160212)

Special Comment:

» Key Credit Considerations for Municipal Governments in Bankruptcy, January 2012 (136814)

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