

MOODY'S

INVESTORS SERVICE

Rating Action: Moody's downgrades Pennsylvania's general obligation rating to Aa3 from Aa2; outlook stable

Global Credit Research - 21 Jul 2014

Approximately \$13.1 billion in general obligation and related debt affected

New York, July 21, 2014 -- Moody's Investors Service has downgraded the Commonwealth of Pennsylvania's outstanding \$11.1 billion general obligation bonds to Aa3 from Aa2. We have also downgraded the ratings assigned to \$2 billion of appropriation-backed bonds by one notch, as well as the programmatic ratings assigned to the state's intercept programs. The outlook is stable

SUMMARY RATING RATIONALE

The downgrade of the general obligation rating to Aa3 reflects the commonwealth's growing structural imbalance, exacerbated by the fiscal 2015 enacted budget that depends on non-recurring resources; a weak GAAP balance position that will further deteriorate based on the budget's one-time measures; and the expectation that large and growing pension liabilities coupled with modest economic growth will limit Pennsylvania's ability to regain structural balance in the near term.

The stable outlook reflects the commonwealth's diverse economy but below average growth, its recent history of improved governance reflected in timely budget adoption, and strong executive powers to control spending midyear..

STRENGTHS

- * Diverse, broad, and relatively stable economy, with wealth levels slightly above the national average, buttressed by its large health and higher education sectors
- * Recent improvements in governance, resulting in consecutive timely budgets
- * Strong executive authority to cut or freeze appropriations mid-year

CHALLENGES

- * Large and growing structural imbalance that reflects underperforming revenues, the continued use of one-time measures in the budget, and the ongoing deferral of restoring reserves
- * High combined debt position driven by moderate bonded debt levels but growing unfunded pension liabilities as Pennsylvania continues to underfund pension contributions
- * Demographic trends that limit long-term growth prospects given the age and slow growth of Pennsylvania's population

Outlook

The stable outlook reflects our expectation that the commonwealth's diverse economy has stabilized but will grow slower than the US on average. Additionally, the recent history of improved governance, reflected in timely budget adoption and proactive financial management, will spur the commonwealth to proactively manage its budget to prevent additional weakness of its financial position despite the challenge of growing fixed costs.

WHAT COULD MAKE THE RATING GO UP

- * Material reduction in long-term liabilities, including unfunded pension liabilities, and their associated budgetary pressure
- * Budgetary and financial management actions that supports financial flexibility and structural balance, including replenishment of reserves

*Higher than expected economic growth that accelerates sustained revenue gains above budgeted projections

WHAT COULD MAKE THE RATING GO DOWN

*Growth in long-term liabilities, increase in fixed cost pressures, or additional deferral of pension costs

*Further declines in financial position that pressure liquidity

*Further economic deterioration that leads to worse-than-expected revenue performance

The principal methodology used in these ratings were US States Rating Methodology published in April 2013. The additional methodologies used in these ratings were US Local Government General Obligation Debt published in January 2014 and The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in December 2011 .The principal methodology used in the programmatic ratings was State Aid Intercept Programs and Financings: Pre and Post Default published in July 2013. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

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