August 2004

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Hot Topic in Local Government Ratings

Negative Outlook Assigned To The New Jersey School District Sector; Aa2 And Stable Outlook Affirmed On Chapter 72 Reserve

$7.0 Billion Debt Affected

Moody's anticipates that the forced reduction in school district reserves resulting from the new cap law legislation will bring negative credit pressure to underlying ratings for New Jersey school districts. Despite this expectation and our downgrade of the state's general obligation bond rating to Aa3 (See Moody's report dated July 28, 2004), we have affirmed the Aa2 rating with stable outlook on Chapter 72-secured debt.

The Aa2 enhanced rating with stable outlook for New Jersey school districts reflects Chapter 72's highly liquid reserve that by statute is perpetually sized at 1% for all New Jersey school related indebtedness issued after July 1, 2003 and 1.5% of New Jersey school district related indebtedness issued before July 1, 2003. In addition, the state maintains significant ability to regenerate the fund in the case of a draw and Moody's believes that program mechanics will govern timely bond repayment in the case of an issuer default. Additional information on this program follows:

Chapter 72 Is A Constitutionally Created Fund Located In The State's Fund For Support Of Free Public Schools

The Chapter 72 reserves, authorized in 1980 (NJ 18A:56-19), to make scheduled debt service payments for a defaulting issuer are carved from the State of New Jersey's larger constitutionally created Fund for Support of Free Public Schools. The State is required to transfer the necessary funding (1.5% of New Jersey school-related indebtedness for bonds issued before July 1, 2003 and 1% of bonds issued on or after July 1, 2003) by September 30th per certification of outstanding debt on each June 30th. Funds in either account group (1.5% or 1%) are available to protect against defaults in the other. For example, the state projects that as of June 30, 2004 there will be $7.0 billion in outstanding school related debt resulting in a required reserve of $101.5 million.

SIGNIFICANT DEFAULT TOLERANCE DERIVED FROM INTERCEPTABLE SCHOOL AID, INTEREST EARNINGS AND FROM SALE OF RIPARIAN LAND

Moody's believes that the statutorily dictated revenues available to provide Chapter 72 replenishment will continue to provide strong default tolerance for the current approximately $7.0 billion of debt secured by this program. New Jersey law mandates that interest generated on this fund (typically more than $10 million) and approximately $5 million in revenues derived from the sale and rental of riparian lands (lands that were formerly under water) go first to reserve replenishment. In addition, school district aid associated with the schools issuing under the 1% classification is now interceptable in the event that the Chapter 72 reserves are used to prevent a debt service shortfall. This aid will be transferred or redirected away from the school district by the State Treasurer to the fund for repayment of the district's obligations. Surplus reserves are likely to be transferred to the state's General Fund in support of public schools. We believe that it is important to note that since program inception, this reserve has never been tapped to make a debt service payment.

SOUND AND LIQUID RESERVES DICTATED BY STATUTE RELATIVE TO THE AMOUNT OF OUTSTANDING ENHANCED DEBT

Chapter 72 assets must be invested in either direct obligations of, or in obligations guaranteed by the U. S. government. The additional mandate, requiring that one-third of the portfolio mature within a 12-month period, provides liquidity in the case that reserves are actually needed during the course of the fiscal year to prevent a bond default.

FISCAL OVERSIGHT AND PROGRAM MECHANICS ENSURE TIMELY REPORTING AND DEBT PAYMENTS

Moody's believes that the active oversight provided by the New Jersey Department of Education and Division of Local Government Services in the fiscal affairs of school districts will minimize the frequency and duration of potential debt service shortfalls. This oversight includes approval of budgets, property tax levies and debt service schedules, as well as state aid allocation. Furthermore, once a budget is approved, the legal requirement for New Jersey municipalities to collect and remit school property taxes in full to school districts provides added assurance that debt service obligations will be met.

The program mechanics governing this reserve require an issuer that expects to have a debt service shortfall provide a deficiency certification to the state's Commissioner of Education and Director of the Division of Local Government Services at least 10 days prior to a scheduled debt service payment date. Upon certification from the Commissioner's and Director's offices, the Trustees of the Fund will be immediately notified to make payment to bondholders; payments will be limited to the aggregate value of the reserve fund.

Reduction In Local Reserves Will Cause Downward Pressure On Underlying School District Ratings

Moody's believes that new constraints on reserves could severely limit school district financial flexibility and may result in negative pressure on underlying New Jersey school district ratings. Although all school districts in New Jersey will continue to benefit from the above-referenced state reserve fund, currently rated Aa2/stable outlook, for general obligation bond issuance, the underlying financial profile of each school district is likely to change. This is because the state enacted property tax relief legislation for local governments prior to the end of the state of New Jersey's 2004 fiscal year (June 30, 2004). Through amendments to P.L. 1996, c.138 (C.18A:7F-5), allowable surpluses for public school districts were reduced and allowable expenditure increases for school districts were also reduced.

REDUCTION IN ALLOWABLE SURPLUS

Moody's expects the new law to result in lower reserves and less financial flexibility for New Jersey school districts. The law reduces the amount of allowable surplus that may be maintained by a school district. For the current 2004-2005 school budget year, any undesignated general fund balance in excess of 3% or $100,000, whichever is greater, must be appropriated as a revenue in the following year's budget, thereby minimizing the revenues required to be raised from property taxes. Further, any appropriation of surplus made, following the April 2004 school budget election and prior to July 1, 2004, to a district's capital reserve account or maintenance reserve account or to increase spending of the 2003-2004 school year is void unless a district demonstrates to the Commissioner of Education that the appropriation was necessary to meet the core curriculum content standard for the 2003-2004 school year.

Beginning next year (2005-2006 school year), the maximum surplus will be lowered again to the greater of 2% or $100,000 – among the lowest school district reserve levels in the country. Any undesignated general fund balance in excess of this amount will be required to be appropriated as a revenue in the future year's budget. These very narrow reserves will significantly limit financial flexibility and may result in underlying credit rating downgrades for New Jersey school districts.

BUDGETARY CAPS

The new lower caps on expenditure increases will create more demand for under five-year lease purchase transactions, as school districts seek to minimize the annual impact of equipment purchases, and pooled bond financing in lieu of leasing, as districts seek to obtain a low cost of borrowing without adding to their operating budgets. Effective for the school year 2005-2006, budget increases are limited to 2.5% of the prior year's net budget or the cost of living increase, whichever is greater unless the budget proposal is approved by the voters or the respective board of school estimate. While the new law maintains additional adjustments for particular spending items including, most importantly, debt service, it eliminates the adjustment available to certain school districts for the receipt of early childhood program aid and demonstrably effective program aid, and limits the adjustment of courtesy busing services. Adjustments to the budget, outside of this expenditure cap may be made for changes in enrollment, certain capital outlay expenditures, certain pupil transportation services, expenditures incurred in connection with the opening of a new school facility and special education costs per pupil in excess of $40,000.

Within the total cap increase limitations are similar limitations on advertised per pupil administrative costs for school year 2005-2006 (may not be greater than 2.5% or the cost of living, whichever is greater or the per pupil administrative cost limits for the district's region as determined by the Commissioner of Education). Thereafter, only with approval by the Commissioner of Education, school districts will be allowed to increases equivalent to increases in the cost of living or 2.5%, whichever is greater, in administrative costs per pupil related to increases in enrollment, administrative positions necessary as a result of mandated programs, administrative vacancies and non-discretionary fixed costs.

The law reduces by 50%, beginning with the 2004-2005 budget year, the amount that a school district may "bank" and then use to increase its budget cap in the succeeding two school years, again, limiting financial flexibility.

Conclusion

While Moody's affirms its Aa2 rating with a stable outlook on New Jersey school district bonds based on the strength of the state's Chapter 72 reserve, recent legislative changes projected to limit the financial flexibility of school districts are expected to result in downward rating pressure on the underlying ratings of New Jersey school districts.

Related Research

Special Comments

Moody's Expects Decelerated Borrowing for New Jersey Local School Districts, January 2004, #80992

Moody's Affirms Aa2 Rating on Chapter 72 Bonds Despite Expectation of Significant Legislative Change, June 2003, #77869

Rating Update

New Jersey (State of), July 2004

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Report Number: 88269

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