

MOODY'S

INVESTORS SERVICE

REQUEST FOR COMMENT

Tax Increment Debt

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Request for Comment

This Request for Comment describes our proposed methodology for rating tax increment bonds in the US. The approach described in this methodology applies to bonds secured by incremental property tax revenues only.

The proposed methodology includes a scorecard that assigns weights and values to the factors we consider consistently most important in tax increment bond analysis.

We currently rate the debt of 65 redevelopment or economic development agencies, relating to over 110 unique tax increment financing (TIF) project areas. Tax increment bonds issued in California, known also as tax allocation bonds (TABs), comprise 80% of the rated credits. If the proposed methodology is adopted, we expect that approximately one-half of our California Tax Allocation Bond (TABs) ratings could be upgraded, while approximately 10% of our non-California tax increment ratings could be downgraded. See section titled, "California Tax Allocation Bonds" for additional information on California TABs.

We invite market participants to respond to this Request for Comment (RFC) by March 6, 2015 by submitting their comments on the [Request for Comment](#) page on www.moodys.com.

The methodology is presented in draft form during the RFC period. Upon appropriate consideration of received comments, unless such comments lead to further changes, we will adopt and publish the revised methodology. Once published, the Tax Increment Debt Methodology will update and replace the methodology titled, [California Tax Allocation Bonds](#), December 2013, and provide market participants with a nationwide tax increment methodology.

Rating Methodology: Tax Increment Debt

This methodology explains how we evaluate the credit quality of debt supported by incremental property tax revenues only. The approach described in this methodology thus does not apply to bonds supported by incremental sales tax revenue or any other non-property tax increment. Similarly, “double-barreled” tax increment bonds that are supported by additional pledged revenues will be rated based upon the stronger pledge. For example, we will continue to rate tax increment debt that is additionally secured by a general obligation pledge based on the US Local Government General Obligation Debt methodology published in January 2014.

The primary factors considered in our proposed tax increment bond credit analysis are:

- » socioeconomic context
- » project area characteristics / tax base
- » financial strength, and
- » debt and legal structure

These key credit factors are all evaluated in the context of the issuing governments' legal and governance framework which may vary significantly from state to state. This methodology is intended to provide general guidance to investors, borrowers and other interested market participants on how key credit characteristics are likely to affect rating outcomes. This methodology does not include an exhaustive treatment of all the factors that are reflected in our ratings, but should enable the reader to understand the considerations that are usually most important for ratings in this sector.

The proposed methodology replaces and expands our California Tax Allocation Bonds methodology, published December 2013. While reflecting many of the same core principles that we have used to assign ratings in the past, this updated methodology standardizes the analysis for tax increment bonds across the nation and introduces a scorecard. The scorecard is composed of: (1) a “Standard Approach” applicable to all tax increment debt nationally except for California; and (2) a “California TABs Approach”, which introduces an additional credit factor and modifies and reweights others within the Standard Approach. The “California TABs Approach” reflects the unique features of tax increment debt in California following the state legislature's dissolution of all of the redevelopment agencies in the state and the associated substantial structural changes in the flow and allocation of tax increment revenues. In addition, we have calibrated this California TABs approach to incorporate the successor agencies' experience over the last three years in implementing the legislative changes. This positive experience with respect to continued timely payment of debt service may lead to approximately half of our TAB ratings being upgraded by an average of one to two notches.

The purpose of the scorecard is to provide a reference tool that market participants can use to approximate most rating outcomes within the tax increment debt sector. The scorecard provides summarized guidance for the factors that we generally consider most important in assigning ratings to these credits. However, the scorecard is a summary that does not include every rating consideration. The weights in the scorecard for each factor represent an approximation of their importance for rating decisions. In addition, we created the scorecard based on historical results while our ratings are based on forward-looking expectations. As a result, we would not expect the scorecard-indicated rating to match the actual rating in every case.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

Introduction

This methodology covers debt secured by incremental property taxes generated within a tax increment financing (TIF) district. In most cases the legal, pledged security for debt in this sector is the incremental property tax revenues minus any reductions through tax sharing agreements, pass-throughs¹ or other statutorily required set-asides.

Local government redevelopment agencies form tax increment financing districts to encourage economic development in areas determined to be blighted or in need of redevelopment. Financed projects typically include roads, street lights, landscaping, sidewalks, water and sewer systems, flood control, or public safety facilities, though just about any project intended to foster economic development may be financed.

Tax increment financings operate on the assumption that successful economic development will result in higher assessed values (AV) than would have otherwise occurred. Tax increment revenues are derived from the capture of property tax revenues generated on the assessed valuation growth within a district or project area after the commencement of the project. Upon the formation of a project area, the tax base is frozen for the purposes of calculating the distribution of property taxes to overlapping tax entities such as the city, school districts, and the county.

Tax base growth above that frozen level – the “incremental assessed valuation” -- is defined as the difference between the project area’s total current assessed valuation and the original assessed valuation (or base year value) when the project area was created. Mathematically, incremental assessed valuation equals total assessed valuation minus the base year value. Gross tax increment revenues equal incremental AV multiplied by the applicable tax rates.

The tax rates from the city and other overlapping entities can of course change, but outside of California the tax increment district gets the benefit of any increased tax rate applied to the incremental assessed valuation. At the same time, tax increment entities or redevelopment agencies have no taxing or levying power themselves, and are also exposed to declines in the tax base or levy². In California, the state’s constitution limits property tax rates to 1% of assessed valuation with exceptions primarily limited to increases for voter approved GO debt. In California AV changes alone determine tax increment revenue changes from year to year.

Redevelopment agencies “passively” receive tax increment revenues and have no ability to raise the local property tax rate or otherwise exert any control over tax revenues. The relevant property tax is set by other overlapping taxing entities, such as cities, towns, school districts and counties, or as indicated above for California, they are strictly controlled by state law. Since these redevelopment agencies cannot adjust the tax rate, the issuance of TIF debt does not create an additional tax burden for taxpayers within a project area. Instead, such issuance redistributes existing property taxes away from the overlapping entities to the TIF issuer.

In some cases issuers of tax increment debt are local governments with taxing powers such as a cities or counties. TIF issuers that are cities or counties may have more revenue flexibility as these local governments can set tax rates designed to provide incremental taxes sufficient to support tax increment debt. However, they still would not have any ability to adjust the portion of tax increment derived from tax levies on school districts, park districts or other overlapping taxing entities.

¹ These are payments made under tax-sharing agreements with other local governments such as school districts, cities or counties.

² Redevelopment agencies, for the purposes of the report, unless otherwise noted, will refer to agencies that do not have taxing powers and are separate legal entities from the local government (e.g. a city) that may have created them.

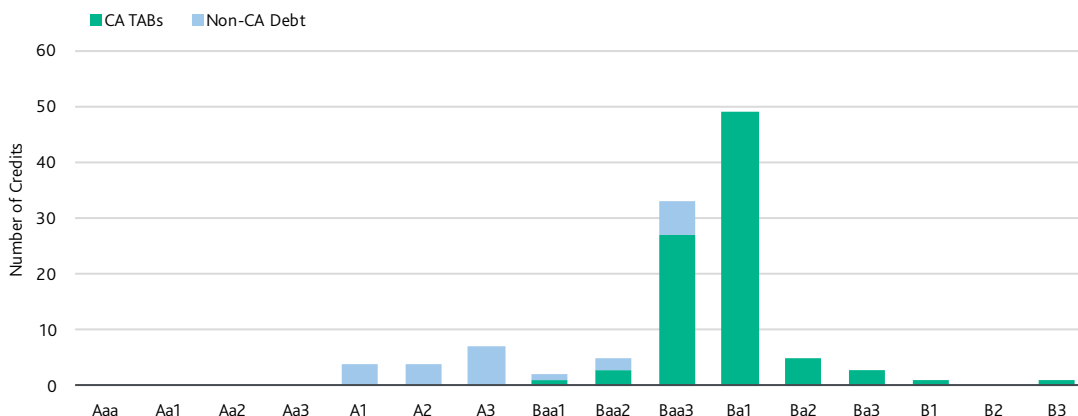
Defining the Tax Increment Debt Universe

We rate the debt of 65 redevelopment or economic development agencies, relating to over 110 unique tax increment financing project areas. Tax increment bonds issued in California, known also as tax allocation bonds, comprise 80% of the rated credits. As indicated earlier, this methodology focuses exclusively on property tax increment bonds and generally does not apply to credits also supported by a stronger pledge such as a general obligation (see page 7). This methodology accordingly excludes these GO-backed project area financings.

Moody's-rated tax increment debt has widely varying credit quality (See Exhibit 1). California TABs comprise the majority of the portfolio, and these ratings are currently clustered around Ba1. These low average ratings resulted from the increased risks following the state's dissolution of all redevelopment agencies (RDAs) in February 2012 and the associated structural changes to the flow of pledged funds meant that each "successor agency" was allocated no more than sum-sufficient debt service coverage going forward. While the other credit fundamentals for California TABs were in many cases relatively strong, this structural change along with the dissolution process itself created significant administrative risks to timely debt service payment. This threat largely trumped other credit factors while the successor agencies worked to understand and implement new procedures. In contrast, the non-California tax increment debt ratings range from A1 to Baa3 with a median rating of A3.

EXHIBIT 1

Moody's Rated Tax Increment Debt Universe



Source: Moody's Investors Service

The median Ba1 rating for the tax increment sector is lower than the median of other municipal sectors, but it still indicates a low risk of payment default. See [US Municipal Bond Defaults and Recoveries, 1970-2013](#) for more information on default rates.

Overall, tax increment debt ratings reflect the following inherent credit weaknesses, dominated by their inherently passive nature:

- » Tax increment districts and redevelopment agencies have little or no revenue flexibility, and limited ability to adjust to a changing real estate market or economic environment
- » The security pledge is relatively narrow and does not benefit from the broad security pledge of either the resources of the agency's operating funds or the taxing capacity of a larger, more diverse tax base
- » Pledged property tax revenues are dependent on economic development for long-term growth

- » Project areas tend to be small relative to the tax bases that support other rated local government obligations
- » Tax increment districts typically have significant taxpayer concentration
- » Tax increment revenues are highly sensitive to real estate trends, with the associated incremental AV and property taxes experiencing higher volatility than the project area's total assessed value
- » A state can rapidly alter the operating landscape and legal framework for tax increment debt, as California experience demonstrates.

In the Moody's-rated universe, there is only one instance of a TIF issuer defaulting on debt. This was on the subordinate TABs (rated B3) issued by the Victor Valley Economic Development Authority. The default initially occurred in December 2011 and has been repeated every year since. These serial defaults were primarily attributable to the loss of tax increment revenue due to a collapsing real estate market and associated downward assessed value adjustments. The initial default in 2011 was cured in March of the following year, though the authority re-defaulted in subsequent years. See case study on page 23.

California Tax Allocation Bonds

In February 2012, state legislation dissolved all California Redevelopment Agencies (RDAs), replacing them with "successor agencies" and changing the flow of pledged revenues to holders of tax allocation bonds (TABs). Where the RDAs once received the total pledged increment, which meant that bondholders enjoyed the protection of excess debt service coverage, the successor agencies now receive revenues just sufficient to cover debt service and other enforceable obligations approved by the state.

The legal flow of funds was ostensibly not affected. The successor agency still receives—and bondholders are legally entitled to—the first of the pledged incremental revenues, net of senior pass-throughs. Actual allocation of cash to the agency, however, is limited to the amount necessary to achieve sum-sufficient annual debt service coverage and pay for other enforceable obligations. This cash allocation from the county tax collector to the agency occurs only twice per year. Among the new administrative challenges this created was ensuring that adequate revenue was set aside to cover different semi-annual debt service requirements, before the remainder of the legally available pledged revenues were diverted to other obligations and overlapping entities.

To reflect this disparity and the introduction of new administrative risks in the payment of TAB debt, we downgraded California TABs by a median of four notches from their pre-dissolution levels. In this proposed scorecard, we are introducing a California TABs specific framework ("California TABs approach") to more appropriately reflect the risks posed by the TAB structure now that many of the administrative details and challenges of the new structure have been worked out and proven over several years of operations. In shutting down the RDAs, the state also imposed a prohibition on any new money debt. Closing the lien on these bonds is a credit positive development.

The typical California TAB, like TIFs in other states, is secured by the specifically-pledged, incremental property tax revenues generated from a single redevelopment project area³. The state's redevelopment dissolution laws did not change this basic legal structure, though it weakened the overall framework and agency incentives for tracking pledged revenues by project area and revenue type (e.g. "housing" vs. "non-housing"). The dissolution law generally speaks only to agency revenues

³ "Housing" tax allocation bonds were typically supported by a pledge of 20% of the tax increment revenue of all of an agency's project areas. The proceeds of these bonds were used for affordable housing purposes.

rather than specific pledged revenues, and the TIF issuer that originally issued the bonds has been replaced by a substantially smaller successor agency. The successor agency is primarily tasked with winding down the original RDA's liabilities, and disposing of its assets while passing through sufficient incremental property tax revenues to fund annual debt service.

Incremental revenues are a product of a redevelopment project area's incremental assessed valuation and the basic tax rate in all California jurisdictions of 1%.⁴ The dissolution laws, while not altering the legal security under a TAB's indenture, in many cases materially altered the flow of funds and their administration. Instead of the redevelopment agency receiving all of the incremental revenues over the course of the fiscal year, making allocations to specific project areas, and enjoying the substantial credit benefit of excess debt service coverage—significant given the passive revenue-raising nature of the TAB itself—the successor agency, post-dissolution, now receives a lump sum, semi-annual incremental revenue allocation from its county auditor-controller from the total tax increment revenues deposited in the successor agency's Redevelopment Property Tax Trust Fund.⁵

The allocation is only sum-sufficient to pay the successor agency's TAB debt service and other obligations approved by the state (collectively, "enforceable obligations"). However prior to this allocation, the auditor-controller allocates monies to senior and subordinate pass-throughs. In the event that this allocation results in a shortfall for debt service, the auditor-controller audits the agency's available and expected cash from asset sales. If necessary, the auditor-controller then reallocates funds to the agency for the next debt service payment from subordinate pass-throughs. Excess incremental revenues, if any, after payment of subordinate pass-throughs and enforceable obligations, do not flow through to the agency, as in the past, but from the county to overlapping taxing entities.

In order to reflect these risks, the California TABs Approach introduces an additional subfactor—Flow of Fund Structure—and modifies the debt service coverage factor. Given the dominance of these structural elements, the California TABs scorecard further limits the ratings benefit from higher annual debt service coverage levels and from other elements through re-weightings of the socioeconomic, economic diversity, and additional bonds test factors in comparison to the Standard Approach. Our calibration of the California TABs Approach takes into account the generally smooth implementation of legislative changes in terms of timely debt service payment since the redevelopment agencies were dissolved in 2012. This new calibration may lead to upgrades to up to half of the California tax allocation bonds.

As noted, a weakness of the post-dissolution California TIF project areas relative to those in other states is that the primary government-sponsored vehicle for economic development has been eliminated. With the elimination of the RDAs and the closed lien on existing TABs, tax base growth will likely be less than had the RDAs not been dissolved. In September 2014, California passed legislation authorizing the creation of development areas, known as Enhanced Infrastructure Financing Districts (EIFDs), supported by tax increment. The structure of and the prerequisites for establishment of the EIFDs and issuance of debt differ markedly from the former RDAs. See the discussion box titled, *New Laws in California Provide for Enhanced Infrastructure Financing Districts*, on p. 7 that details the legislation enacted in 2014.

⁴ Minor exceptions exist where the property tax rate also includes pre-1988 GO bond levies and/or property tax override levies.

⁵ The Redevelopment Property Tax Trust Fund holds monies collected from all of a successor agency's project areas. Monies generally are not segregated by project area.

New Laws in California Provide for Enhanced Infrastructure Financing Districts

In September 2014, California passed legislation allowing for the creation of Enhanced Infrastructure Financing Districts (EIFD). The districts are an attempt to restore tax increment financing as a means of financing local infrastructure projects after the dissolution of the state's redevelopment agencies in 2012. The new law improves upon prior legislation allowing the creation of infrastructure financing districts (IFD) to fund a variety of projects such as environmental mitigation, street improvement, and water and sewer improvements.

While not as expansive as the redevelopment agency law, the new legislation also reduces the barriers to creating IFDs and expands the types of projects that can be backed by TIFs. Under the new legislation, an enhanced IFD can be established with approval from just the overlapping taxing entities' governing bodies, rather than a two-thirds supermajority of eligible voters within the district. Also, an enhanced IFD can issue debt for infrastructure improvements with the approval of just 55% of voters within a district, compared to the more difficult two-thirds previously required. The legislation also prohibits the diversion of revenues away from K-14 education, ensuring no state General Fund impact.

Given the historic demand for tax increment financing in California and the gap left by the dissolution of the RDAs, it is likely that over the long-term this legislation will spur new TIF issuance in the state. However, it may be a few years before a district can be formed and generate sufficient increment to secure debt.

California TAB Ratings

Since the original dissolution of the TABs, the successor agencies have had sufficient time to work out the new administrative procedures necessary to deal with the structural changes and the sum-sufficient debt service flows. Implementation of the dissolution legislation has generally gone smoothly in terms of full and timely debt service payment. We rate the TABs of 47 successor agencies and these credits have a median rating of Ba1. If this methodology is adopted, we will place the California TABs on review for upgrade. Our prior downgrades incorporated the structural changes that weakened the overall credit profile of TABs, as well as the administrative and procedural challenges created by the legislation. Our review will take into account the degree to which these challenges have been met over the last three years, which might warrant multi-notch uplift. It is possible that approximately one-half of the California TABs could be upgraded by an average of one to two notches upon completion of the review, following publication of the final methodology.

The Relationship between General Obligation (GO) and Tax Increment Debt Ratings

In cases where the issuer of TIF debt also has general obligation debt outstanding⁶, we typically rate the tax increment bonds lower than the corresponding general obligation rating. There are several characteristics of tax increment bonds that render them inherently weaker than general obligation debt; some of which have already been discussed above. The primary attribute is that the tax allocation pledge is passive and dependent upon the tax levies of other governmental entities. Issuers of tax increment debt have a limited ability to adjust to changing economic and real estate market environments and are particularly sensitive to changes in their tax base. Redevelopment agencies typically have no ability to levy new property taxes to offset revenue declines. The relevant property

⁶ This includes cities or other municipalities that have closely related but legally separate redevelopment agencies.

taxes are set by law or the overlapping taxing entities and only growth in the incremental valuation can increase revenues⁷.

In addition, tax increment project areas are usually smaller components of a local government's tax base and the tax increment revenues are generated from more economically limited and less diverse tax bases. Taxable values, therefore, are almost always represented by a smaller number of taxpayers for the TIFs than for the related city's total tax base. In addition, TIF project areas are typically highly leveraged, issuing the maximum amount of debt they can in order to finance the greatest level of economic development. Debt service coverage levels, therefore, tend to be fairly narrow.

We will assess the extent to which the funds of the project area are segregated from those of the municipality's general operations. We will also evaluate the flow of funds to determine the local government's involvement in collection and distribution of monies for debt service on the tax increment bonds. We will also seek to understand any financial arrangements between the local government's operating funds and its economic development activities. In cases where the local government has a strong credit profile and assumes a supportive stance towards the TIF district, the tax increment debt's credit quality may be enhanced by a close legal or governance relationship. Conversely, this same close relationship would be detrimental to the TIF's credit quality if the local government is facing severe, financial challenges. For example, we may have heightened concerns regarding a city's continued allocation of funds for tax increment bond debt service if the city is facing a revenue shortfall related to its own debt obligations.

TIF Debt in Bankruptcy

Debt secured by a tax increment pledge should be insulated from the overlapping taxing entity's bankruptcy. Under Chapter 9 of the bankruptcy code, a lien on "special revenue" bonds remains valid and enforceable even if the issuer is granted bankruptcy protection. Tax increment revenues are explicitly included in the definition of "special revenues".

The bankruptcy code's explicit designation of TIF debt as "special revenue" is a key strength of the pledge. When a debtor files for bankruptcy protection, the "automatic stay" applies. This feature of the bankruptcy code stops all creditor recovery actions against the debtor and prevents the borrower from liquidating assets to pay claims. To preserve all of the assets of a borrower for reorganization, the automatic stay takes effect the moment the debtor files its petition. Even if the petition is later rejected by the court, the automatic stay would apply as soon as the petition is filed. Under the code a "special revenue" pledge is exempt from the automatic stay. Since the bankruptcy code defines TIF debt as "special revenue," it enjoys a credit advantage over a general obligation pledge that is not a "special revenue."

A few recent bankruptcy cases are positive for investors in tax increment bonds including the Detroit Downtown Development Authority (DDA) (Not Rated) which is a separate legal entity from the City of Detroit (Ca GO rating). The city of Detroit filed for bankruptcy in July 2013. The City collects portions of the tax increment and remits payments to the DDA for debt service. The tax increment bonds of DDA were unaffected by the bankruptcy, did not appear in the plan of adjustment, and debt service continued to be paid when due. Similarly, debt issued by the City of Vallejo, CA's former redevelopment agency (a blended component unit of the City) was not impaired under the City's bankruptcy, and debt service payments also continued uninterrupted.

⁷ If the issuer of the tax increment debt is the city or county, it may have some ability to adjust the levy, however the tax increment district would still be subject to tax rate changes for overlapping districts.

The Scorecard

Our tax increment debt scorecard provides a composite score of the credit profile based on the weighted factors we consider most important, universal, and measurable. The scorecard also incorporates other credit considerations that reflect common though not universal credit strengths and weaknesses and other qualitative and idiosyncratic features of individual credits. The scorecard is designed to enhance the transparency of our rating approach by identifying critical factors as a starting point for analysis, along with additional considerations that may affect the final rating assignment.

The purpose of the scorecard is not to determine a final rating, but rather to provide a standard platform from which to begin viewing and comparing tax increment financing credits. It therefore acts as a starting point for a more thorough and individualistic analysis.

The scorecard-indicated rating will not match the actual rating in every case, for a number of reasons including:

- » Our methodology considers forward looking expectations that may not be captured in historical data
- » The scorecard is a summary that does not include every rating consideration
- » In some circumstances, the importance of one factor may exceed the average weight used in the scorecard

The following is the tax increment scorecard composed of the standard weightings and metrics for all tax increment debt except for California TABs (“the Standard Approach”) and a version solely applicable to California TABs (“the California TABs Approach”). The approaches are similar except the California TABs Approach has an additional subfactor, modified subfactor weightings and different scoring for the debt service coverage subfactor.

Standard Approach (National, Non-California)

EXHIBIT 2

Scorecard Rating Factors- Standard Approach

Broad Factor Weighting	Factor Weighting	Subfactor	Measure	Subfactor Weighting
Socioeconomic Context	10%	Socioeconomic Context	Median Family Income as a % of US	10%
Project Area Characteristics / Tax Base	35%	Tax Base Size	Incremental AV	10%
		Economic Diversity	Top Ten Taxpayers' AV as a % of Incremental AV	15%
		Tax Base Volatility	Ratio of Incremental AV to Total AV	10%
Financial Strength	25%	Debt Service Coverage	MADS Coverage	20%
		Revenue Trend	3-Year CAGR of Tax Increment Revenue	5%
Debt/Legal Structure	30%	Additional Bonds Test		20%
		Debt Service Reserve Fund Requirement		10%
Total	100%			100%

California TABs Approach

EXHIBIT 3

Scorecard Rating Factors- California TABs Approach

Broad Factor Weighting	Factor Weighting	Subfactor	Measure	Subfactor Weighting
Socioeconomic Context	5%	Socioeconomic Context	Median Family Income as a % of US	5%
Project Area Characteristics / Tax Base	30%	Tax Base Size	Incremental AV	10%
		Economic Diversity	Top Ten Taxpayers' AV as a % of Incremental AV	10%
		Tax Base Volatility	Ratio of Incremental AV to Total AV	10%
Financial Strength	25%	Debt Service Coverage	MADS Coverage	20%
		Revenue Trend	3-Year CAGR of Tax Increment Revenue	5%
Debt/Legal Structure	40%	Additional Bonds Test		5%
		Debt Service Reserve Fund Requirement		10%
		Flow of Funds Structure		25%
Total	100%			100%

We intentionally limited our scorecard metrics to major rating drivers that are universal to most issuers of tax increment debt. Outside of these drivers, we may adjust the grid score for a variety of other credit considerations. These are more idiosyncratic factors that are likely not to apply to all issuers but can nevertheless significantly impact credit quality. The scorecard score is based on the quantitative “above-the-line” rating factors combined with any of these other additional credit considerations. The scorecard offers a guideline for discussion but does not determine the final rating. The rating is determined by a committee, which considers, but is not bound by the scorecard score.

Discussion of Key Scorecard Rating Factors

Factor 1: Socioeconomic Context (Standard Approach 10%, California TABs Approach 5%)

EXHIBIT 4

Subfactor	Measure	Weight	Aaa	Aa	A	Baa	Ba	B
Socioeconomic Context	Median Family Income as a % of US	10% (Standard Approach) 5% (California TABs Approach)	> 150% of US level	150% to 90% of US level	90% to 75% of US level	75% to 50% of US level	50% to 40% of US level	< 40% of US level

Why it matters

The economic vitality, strength, and resilience of the population of an economic region heavily influence the individual project area's long-term ability to generate adequate incremental tax revenue to meet debt service needs. We evaluate the general economic health of not only the project area but the larger economic setting and uses resident income levels in the local economic region as a proxy.

Input: Median family income, expressed as a percentage of the US median

We believe median family income (MFI) is the best proxy for economic strength of the local population. Above-average income levels also indicate desirability of the area and economic development potential. A strong socioeconomic profile can also serve to mitigate potential property tax delinquencies. We will typically use the MFI of an overlapping local government, often a city or county, as project area income levels are seldom available.

The median family income breakpoints in this scorecard are aligned with the ones in our [US Local Government General Obligation Debt](#) methodology.

While MFI is our primary proxy for wealth of a district, other indicators that factor into our analysis include per capita income, unemployment rate, poverty rate, home foreclosures, and median home values. We may also review additional factors when the tax base is substantially commercial or industrial.

We weight this factor lower in the California TABs Approach compared to the Standard Approach as greater analytical emphasis is focused on the flow of funds post dissolution of the California TABs.

Socioeconomic Context- other credit considerations

Additional local economy strength or weakness: Income measures are usually only readily available for the city or county as a whole and not for the specific project area. We may use this adjustment, up or down, if we believe the MFI statistic incompletely or inaccurately depicts the income levels of the individual project area. In highly industrial or commercial project areas, we may adjust the score to reflect the strength or weakness of the predominant sectors.

We may also make adjustments if other economic indicators such as high unemployment or foreclosure rates, materially alter the overall credit profile but are not fully captured in the scorecard's primary credit metrics.

Other

Factor 2: Project Area Characteristics / Tax Base (Standard Approach 35%, California TABs Approach 30%)

EXHIBIT 5

Subfactor	Measure	Weight	Aaa	Aa	A	Baa	Ba	B
Size	Incremental AV	10%	> \$12B	\$12B ≥ n > \$1.4B	\$1.4B ≥ n > \$240M	\$240M ≥ n > \$120M	\$120M ≥ n ≥ \$60M	< \$60M
Economic Diversity	Taxpayer Concentration (Top Ten Taxpayers' AV as % of Incremental AV)	15% (Standard Approach) 10% (California TABs Approach)	< 2%	2% ≥ n > 5%	5% ≥ n > 10%	10% ≥ n > 20%	20% ≥ n ≥ 35%	> 35%
Tax Base Volatility	Ratio of Incremental AV to Total AV	10%	> 95%	95% ≥ n > 90%	90% ≥ n > 85%	85% ≥ n > 80%	80% ≥ n ≥ 60%	< 60%

Why It Matters

The size, diversity and volatility of the project area all play an important role in gauging the likelihood that pledged revenues will be sufficient to make TIF debt service payments when due.

Subfactor 2a: Size (10%)

Input: Incremental assessed valuation, expressed in dollars

A larger incremental valuation⁸ generally provides a broader and more diverse pool of property taxpayers with greater stability. Conversely, smaller project areas tend to be less diverse and more dependent on a smaller number of taxpayers. These tax bases are more susceptible to shocks such as fires, localized natural disasters or the closure of a major employer that reduces taxable property values. Larger tax bases are inherently better able to absorb and rebound from these kinds of stresses.

Absent offsetting strengths, tax increment bonds supported by project areas with very small tax bases would likely not achieve an investment grade rating. All things being equal, the larger the project area, the higher the rating, though this is more a function of actual and potential economic diversity than of sheer geographic or incremental valuation size. The benefits of increased size also diminish rapidly once a reasonable threshold of economic diversity and sustainability is reached. For example, the difference between a project area with a \$1 billion incremental valuation and a \$2 billion project area may result in rating distinctions, other factors being equal. But substantially larger project areas, with \$3 billion-\$4 billion incremental valuations, would not automatically nor necessarily enhance credit quality.

Subfactor 2b: Economic Diversity (Standard Approach 15%, California TABs Approach 10%)

Input: Top ten taxpayers' total assessed valuation, expressed as a % of total incremental assessed valuation

TIF districts with concentration exposure may experience a significant loss of incremental revenue from bankruptcy, delinquency or relocation of a major taxpayer to outside the district. Project areas with property held by diverse taxpayers, including highly residential project areas, tend to exhibit more stability and resilience.

⁸ Assessed value is the public assessor's valuation of property for the purposes of taxation and may differ from full or market value. In cases where the assessed and market values differ materially, Moody's may make upward adjustments to the scorecard rating. Methods of calculating assessed value vary by state.

Our evaluation and measurement of taxpayer concentration is notably based on individual taxpayers' total valuation relative to the project area's incremental valuation. An alternative approach would be to use total valuation rather than incremental valuation as the denominator in this ratio. This is often how taxpayer concentration is presented in bond offering documents. Our use of incremental valuation reflects the fact that the loss of a taxpayer would generally come entirely from the incremental valuation, with none of the loss coming out of the base valuation. The base valuation would remain at its originally established level, even if the total valuation losses from the largest taxpayers or otherwise were greater than the entire incremental valuation. Incremental valuations in that rare, but not unknown case would be negative, and the project area would generate no revenues at all.

To facilitate comparability of credits with widely divergent mixes of debt service coverage and taxpayer composition, we evaluate the extent to which debt service coverage can withstand the loss of property tax revenues from not only the largest taxpayer, but of the ten largest. If the loss of revenues from the single largest taxpayer would result in less than sum-sufficient coverage from pledged revenues, it is unlikely that we would assign the bonds an investment grade rating. However, sufficient coverage to withstand the loss of taxes from all ten top taxpayers would demonstrate relatively strong credit quality.

Such losses would most likely occur from payment delinquency, but it might also result from the taxpayer's departure from the project area or the property's purchase by a tax-exempt entity, such as a university or even the federal government. Complete physical loss of the largest taxpayers' assessed valuation is an extreme and very unlikely scenario since even raw land generally has a positive value. But it is a useful proxy for various more likely and complex scenarios, including revenue losses from successful taxpayer appeals, the downward reassessment of the largest taxpayers' assessed valuations, and the largest taxpayers' property tax delinquencies.

While the implications of a delinquency may be temporary and are not as uniform across issuers as the actual loss of assessed valuation, the bottom line effect can be the same. The immediate revenue difference between delinquencies and tax base loss is due to the varying ways that local governments allocate property tax delinquencies. Unless clearly demonstrated otherwise, we assume that any property tax delinquencies would reduce the gross revenues available to pay debt service on TIF bonds. This is effectively the same as removing the top taxpayers' assessed valuation from the project area's incremental assessed valuation.

While taxpayer concentration is still an important consideration in our reviews, we weight this factor lower in the California TABs Approach compared to the Standard Approach to account for the greater analytical emphasis placed on the flow of funds post California RDA dissolution.

Subfactor 2c: Tax Base Volatility (10%)

Input: Ratio of incremental assessed valuation to total assessed valuation

We use the ratio of the most recent year's incremental AV to total AV to gauge potential volatility of the tax base.

The relative risk of tax base contraction in any one project area depends primarily on the ratio of incremental to total AV. If, for example, the incremental AV is only half the total AV, an across the board reduction in property values would double the loss on the incremental AV compared to total AV. The lower the ratio of increment to total, the greater this multiplier effect. For example, if the incremental AV is only 25% of the total, a seemingly modest 2% across the board reduction in total AV would represent an 8% reduction in the increment, and therefore an 8% reduction in tax

increment revenues. Given this risk, absent offsetting strengths such as high debt service coverage and high additional bonds test levels, credits where the ratio is significantly below 80% would likely receive lower rating than those whose ratio of incremental to total taxes are higher.

Project area characteristics / tax base - other credit considerations

Level of and potential for development: Project areas that are established and fully built out may yield a greater level of certainty in projecting tax increment revenue; however, they also have less growth potential. A district or project area with a large amount land available for development introduces opportunities as well as uncertainty, given that future development is subject to financing, construction and developer risks.

We review the level of development in the context of the debt repayment schedule. Project areas that are dependent on future tax base growth to cover their future debt service obligations are more speculative and would not likely receive an investment grade rating. However, improvement to credit quality may occur in situations when there is significant development in the latter stages and the completion would materially impact the project area.

Geographical size: The small physical size of a project area can introduce additional credit risk due to a higher sensitivity to natural disasters. California is often associated with earthquake exposure, but wildfire risk is present in some regions and can be more common. The 1991 Oakland Hills fire covered 1,520 acres in a single high density suburban area. Other locales could be severely affected by flooding, hurricanes, or tornadoes. While, sustained, long-term depression of property values is rare in these situations, a geographically small project area has vulnerabilities that generally detract from overall credit quality.

Institutional presence: Some types of properties such as universities or military bases can offer stability to the local economy and may not be captured in the project area characteristics. The anchoring influence of an institution can strengthen a TIF district's credit profile.

Sector concentration of largest taxpayers: A large exposure to a single industry poses risks that might not be captured in the scorecard's taxpayer concentration metric. TIF debt credit quality would be weakened if a large portion of the tax base operates in a single industry, or in especially volatile, unpredictable, and weak sectors.

Credit quality of largest taxpayers: In cases where the scorecard indicates very high tax payer concentration, we may adjust the score up or down if the credit quality of the largest taxpayer(s) is known. This upward adjustment may occur if the large taxpayer is rated by Moody's and the high concentration is mitigated by a very strong, stable credit profile with no history of material appeals. Similarly, a very weak, large tax payer may prompt us to adjust the score lower.

Land use composition and tax status: Project areas that display a very high concentration in industrial or commercial land use may reflect additional risk. Commercial and industrial enterprises are relatively more sensitive to business cycles than residential taxpayers. Businesses also pose additional appeals risk, and they typically have greater resources to contest assessed valuations. All else being equal, residential land use results in a more stable tax base than industrially- and commercially-oriented project areas, though this distinction was somewhat less pronounced in the most recent real estate downturn.

Conversion of the tax-status and use of property can considerably diminish or augment the tax increment revenues in a short span of time. A state or local government's sale of surplus property to private citizens or for-profit entities would add to the tax rolls and be a credit positive for TIF debt.

Conversely, a university that is pursuing a land acquisition strategy could erode the tax base and weaken debt service coverage.

Historical incremental and total tax base value trends: we review historical incremental and total tax base value trends to gain insight into the growth trends and performance of the tax base in the last few years as well as through various economic cycles. We also examine the magnitude of a project area's peak to trough decline, as it may provide insight into how the tax base will perform in future downturns. Project areas demonstrating exceptional resilience and growth through various economic conditions would generally be considered stronger credits than areas showing a history of poor AV growth combined with high volatility. We note that this adjustment relates to actual past tax base trends while the incremental AV to total AV ratio discussed earlier measures the *potential* future volatility.

Inflationary base AV: Inflationary adjustments to the "base" with potential to reduce incremental AV may result in rating adjustments.

Other

Factor 3: Financial Strength (25%)

EXHIBIT 6									
SubFactor	Measure	Weight	Aaa	Aa	A	Baa	Ba	B	Caa
Debt Service Coverage	MADS Coverage (Standard Approach)	20%	> 4.5x	4.5x ≥ n > 3.5x	3.5x ≥ n > 2.0x	2.0x ≥ n > 1.3x	1.3x ≥ n ≥ 1.0x	< 1.0x	
	MADS Coverage (CA TABs Approach)		> 6.5x	6.5x ≥ n > 4.5x	4.5x ≥ n > 3.5x	3.5x ≥ n > 2.0x	2.0x ≥ n > 1.3x	1.3x ≥ n ≥ 1.0x	< 1.0x
Revenue Trend	3-year Compound Average Growth Rate (CAGR) of Tax Increment Revenues	5%	> 10%	10% ≥ n > 5%	5% ≥ n > 0%	0% ≥ n > -2%	-2% ≥ n ≥ -5%	< -5%	

Why it matters

Given the passive nature of tax increment debt, our evaluation of financial strength and performance put particular focus on pledged revenues relative to debt service, as well as trends in revenue performance. Additional credit factors which will be addressed in the "Financial strength – other credit considerations" section include factors that impact this coverage including: delinquencies, appeals, changes in tax rates and tax revenue caps.

Subfactor 3a: Debt Service Coverage (20%)

Input: Maximum annual debt service (MADS) coverage

The debt service coverage ratio is our primary metric for assessing the financial strength of tax increment debt. Higher coverage provides a greater buffer against swings in incremental valuations and the associated tax revenues. This metric effectively gauges the extent to which the available revenues could be impaired before a revenue shortfall would occur.

Our debt service coverage metric focuses on the coverage of maximum annual debt service (MADS). We measure MADS coverage by dividing the most recent year's collected and available, legally pledged tax increment revenue by the largest amount of total debt service payment on all outstanding parity bonds due in any single future year. MADS coverage indicates the extent to which future peak debt

service can be covered from the most recent completed year's pledged revenues. While most tax increment bonds we rate have a level debt service schedule, this is an important metric for project areas that have an ascending debt service schedule that requires future tax base growth for full debt repayment. In these cases, MADs may not occur for many years in the future so current year MADs is likely to be low. Our rating will incorporate the number of years until MADs, the level of growth needed to achieve coverage and the likelihood of achieving this growth rate.

When an issuer has senior and subordinate debt, we also look at total debt service coverage. We review annual and MADS coverage based on total, combined pledged revenues divided by the combined debt service on senior and subordinate bonds. This is often a very different measure from the legally defined coverage. For example, the debt service coverage calculation on subordinate bonds uses subordinate debt pledged revenues divided by subordinate debt service. This approach can produce coverage that is much higher than our measure, whether MADS or annual debt service is used. This higher coverage however is much more sensitive to changes in revenues and expenditures than the overall coverage measure we use, and which we think a more accurate gauge of risk. A total debt service coverage ratio of below 1 for all of the project area's debt is an important threshold because it indicates the tax base has contracted to such a level that tax increment revenues are insufficient to cover the project area's debt service. A project area with below 1x coverage for all debt is also not generating excess funds that could be reinvested in additional economic development activities- a key driver of AV growth.

Other factors heavily influence our assessment of the sufficiency of the debt service coverage at a given rating level. A very low increment to total valuation level results in potentially higher revenue volatility. A very strong debt service coverage level could compensate for this weakness. Similarly, the lack of a debt service reserve fund or the presence of a weak surety provider would be partially mitigated by a well above-average debt service coverage level.

MADS Coverage- California TABs Approach

The California TABs Approach also takes into account the maximum annual debt service coverage. The debt service coverage ratio for California TABs is a function of the tax increment revenues, pass-through payments and debt service. In contrast to the legal coverage calculation specified in bond documents, we calculate this ratio net of all pass-through payments without regard to whether they were subordinated to TAB debt service or not. This calculation effectively gauges the extent to which the available revenues could be impaired before a revenue shortfall requiring the cash flow reallocation process discussed earlier to be initiated.

Given the structural limitations and administrative risks introduced in the TAB framework as well as the state's demonstrated willingness to interfere with debt repayment cash flows, we assign less benefit to higher coverage levels for this subfactor compared to the Standard Approach used for non California tax increment debt. Failure to generate sufficient semi-annual coverage, as discussed in the following paragraph, triggers a reallocation process that increases the administrative risk that is already present in the TAB structure. The dissolution legislation also does not permit successor agencies to accumulate any assets or reserves for discretionary purposes including the payment of debt service (other than a debt service reserve fund specified in the governing bond documents). The cash flow coverage is therefore just 1x or sum-sufficient except in the limited cases where the project area is not generating even sufficient increment to cover their senior pass throughs and debt service.

Although not a scorecard input, for California TABs we also closely review semi-annual coverage in addition to annual coverage due to the 2011 and 2012 legislation that created a new pattern of tax increment revenue distribution. Under current law the county auditor-controller establishes a Redevelopment Property Tax Trust Fund for each former RDA. All incremental property tax

revenues for a successor agency are deposited into this fund. Twice a year, the auditor-controller distributes monies from the fund. First, the auditor-controller calculates and allocates monies to local governments for pass-through payments (senior and subordinate). Then, funds are allocated to the successor agency to meet its enforceable obligations in the coming six months in the following order of priority: debt service payments on TABs, debt service payments on revenue bonds, and then other enforceable obligations. In the event that this allocation results in a shortfall for debt service, the auditor-controller audits the agency's available and expected cash from asset sales. If necessary, the auditor-controller then reallocates funds to the agency for the next debt service payment from subordinate pass-throughs.

This cash flow allocation process for TABs creates risks associated with the uneven nature of the semi-annual payment of debt service. In the semi-annual period with the larger debt service payment (when both principal and interest are due), shortfalls could arise even if annual revenues are more than sufficient to meet annual debt service. We review semi-annual coverage calculations and the likelihood the county-auditor would have to commence the reallocation process detailed in the prior paragraph. We also review the steps, if any, the successor agency is taking to mitigate the risks resulting from uneven debt service and cash flow in the two semi-annual periods. For example, some successor agencies have utilized a provision in the governing legislation that allows the set-aside of reserves in advance if the next period's tax increment revenue distributions from the RPTTF are expected to be insufficient to pay debt service.

Typically, TABs have level debt service until maturity. However, the proportion of debt service paid in the one semi-annual period in which both principal and interest is due becomes an increasingly larger share of the total annual debt service payments as the bond nears maturity. Assuming no growth in the tax base, and therefore no growth in revenues, the typical TAB would see a continued deterioration of coverage in the semi-annual period in which the principal payment is made.

Subfactor 3b: Tax Revenue Growth (5%)

Input: Three year compounded annual growth rate of tax increment revenues

The 3-year compounded annual growth rate (CAGR) of tax increment revenues provides us with a quantitative indication of possible revenue growth and stability over the near to medium-term. The use of a three year metric works to smooth potentially volatile annual fluctuations in tax revenues of one project area relative to revenues of another. It is important to note that risk associated with potential volatility in a given project area's tax revenue stream is captured in other key metrics such as ratio of incremental to total valuation, and to a lesser extent, taxpayer concentration.

The 3-year CAGR for tax increment revenues can also be an indirect indication of tax base stability over time as revenues are derived from incremental tax base growth.

We recognize that unusually high multi-year revenue growth may be indicative of a small, fast growing district with a low increment to total valuation. Therefore, any three year CAGR in excess of 10% is given the same score on the scorecard, whether it is 11% or 21%.

We also review longer term revenue trends including peak to trough declines and, if available, revenue performance through various economic cycles. We will also factor in if the longer trend deviates from the three-year pattern. See "Case Study #3: Bunker Hill Project Area – Real Estate Market Declines Puts TABs in Peril" on p. 25.

Financial strength - other credit considerations

Tax increment revenue limit caps: Our analysis includes a review of any legislation, ordinances, and plan amendments that limits the amount of tax increment revenue received or the duration of the collection of such revenues. These caps can materially impact the credit quality of tax increment bonds if the revenue limit is expected to be reached prior to the final maturity of the bonds. We will examine the likelihood that a revenue limit could be reached prior to such final maturity given current and projected tax base growth. Any plan elements mitigating these constraints are also reviewed, including if any a covenant to escrow tax increment revenues if projections indicate there is danger of reaching the revenue cap. See “Case Study #2: Tax Increment Revenue Limits Pose Risks to TIF Credit Quality” on p. 24.

Property tax appeals: Successful assessed valuation appeals and the associated refunds pose a significant threat to tax increment debt credit quality since they can sharply reduce tax increment revenues. Moody's ratings reflect our consideration of the risk of successful assessed valuation appeals. One factor is to examine outstanding appeals for a specific project area in the context of the success of appeals in recent years, while recognizing that even this specific history is not necessarily predictive of future appeals outcomes. We also evaluate the trend in the level of appeals, as well as indicators of local economic conditions, which will likely affect property values and, therefore, appeal success rates. The nature and rate of recent property value growth are also important considerations. Has the growth been from clearly identifiable new construction or reassessments? How recent is the growth? Recent assessed valuations are more likely to reflect recent market values. The owners of such recently assessed properties are more likely to successfully appeal their properties' assessed valuation when the market turns down.

The near-term cash flow implications of successful appeals are a final consideration. Property value appeals are rarely for a single year. Once an appeal is resolved, refunds, if required, are typically given for multiple years, multiplying the impact on the issuer's cash flow that year. Our view of the credit quality of tax increment debt will be diminished if we believe there is a realistic chance that appeals will be successful and significantly reduce debt service coverage.

Change in tax rates: Redevelopment agencies typically have no ability to set tax rates in their project areas. Outside California, this power lies with overlapping municipalities such as cities, counties or school districts. Within California, the tax rate is generally fixed by the state's constitution to just 1% with very limited exceptions. We will review any actual or proposed changes in tax rates and the impact on the project areas' revenues. Our rating on tax increment debt will take into account actual or anticipated tax rate changes that introduce uncertainty over the adequacy of future debt service coverage levels.

Reserves: An issuer with significant unrestricted reserves that are expected to be available for debt service payment is better able to manage volatility and declines in tax increment revenues. The presence of these reserves would strengthen the credit profile of the tax increment debt.

Semiannual Debt Service Coverage [for the California TABs Approach]: The credit profile of project areas that are generating sum-sufficient debt service coverage on an annual basis but not semiannually would have increased risk due to the administrative risk associated with cash flow reallocation processes discussed earlier.

*Other***Factor 4: Debt/Legal Structure (Standard Approach 30%, California TABs Approach 40%)**

EXHIBIT 7

Subfactor	Weight	Aaa	Aa	A	Baa	Ba	B
Additional Bonds Test	20% (Standard Approach) 5% (California TABs Approach)	> 3.0x OR a closed lien	3.0x to 1.76x	1.75x to 1.26x	1.25x to 1.0x		No limit
Debt Service Reserve Fund Requirement	10%	1-year MADS Cash funded or with high rated surety provider (A rated or higher)	Standard 3-prong test Cash funded or with high rated surety provider (A rated or higher)	Less than 3-prong test Cash funded or with high rated surety provider (A rated or higher)	Any DSRF with Baa rated surety provider	Any DSRF with Ba rated surety provider	No DSRF or B rated or lower or unrated surety provider
CA TABs Flow of Fund Structure (CA TABs Approach Only)	25%					Weak post-RDA dissolution flow of funds	

Why it matters

The debt's legal structure is a vital component of our tax increment methodology, since it provides bondholder safeguards that provide a buffer against non-payment in the event of a tax increment revenue shortfall. For tax increment debt, we expect a basic level of legal protection that typically includes a clear definition and calculation method of the pledged revenues, an additional bonds test limiting the issuance of future parity debt, a debt service reserve fund, and a defined flow of funds. As the weakened flow of funds is an integral part of our credit analysis for California TABs, we include a separate subfactor in the California TABs Approach.

Subfactor 4a: Additional Bonds Test (Standard Approach 20%, California TABs Approach 5%)

The provisions under which a project area is permitted to issue additional parity bonds is essential to the determination of credit quality of TIF debt. These provisions set forth the minimum debt service coverage levels to be maintained for existing bondholders, and other conditions required to issue additional parity debt. A strong additional bonds test is intended to maintain a defined, minimum level of coverage protection over the life of the bonds.

Highly-leveraged TIF debt with a low additional bonds test will ordinarily result in a lower rating level compared to a modestly-leveraged TIF bond with a high ABT. We also consider whether the ABT is applied historically or prospectively, the latter of which is generally less conservative given that prospective ABTs usually assume property tax growth. However, when the real estate market is in decline, applying the ABT historically is less conservative than a prospective ABT, given the higher historical property tax performance relative to current and projected performance. Of note, the majority of ABTs for Moody's-rated TIF issuers are in the 1.15x to 1.50x range, except for California TABs which have closed liens resulting from the dissolution of the redevelopment agencies.

All California TAB debt is closed lien resulting from RDA dissolution legislation. We weight this factor lower in the California TABs Approach compared to the Standard Approach and place greater analytical emphasis on the Flow of Funds factor, reflecting the readjustment of cash flows post California RDA dissolution. The closed lien is a positive credit factor but it is not a differentiating credit factor across California TABs; further the implementation of the dissolution legislation rendered the closed lien a necessary feature, rather than a structural enhancement. The successor agency only

receives a sum-sufficient distribution to pay debt service and other approved obligations and as such would not receive sufficient revenues to meet an ABT greater than 1.

Subfactor 4b: Debt Service Reserve Fund Requirement (10%)

Debt service reserve funds (DSRF) are a typical feature of tax increment debt and an important credit feature due to the limited — if any — ability of redevelopment agencies to adjust tax rates. The DSRF ensures payment of debt service in the event of a shortfall in pledged revenues, and typically gives the agency a year to find a more permanent resolution. Generally, any legal structure that allows the DSRF to be funded below future debt service payments—whether at inception or upon reaching certain milestones—detracts from the overall strength of the credit.

Our rating scorecard ranks the relative strength of debt service reserve funding requirements with the most common being the industry norm of the lesser of the standard three-prong test (i.e. 10% of initial principal, maximum annual debt service, or 125% of average annual debt service).

An issuer's use of a surety rather than cash to meet its debt service reserve requirement, in and of itself, does not usually result in a rating distinction unless the surety provider is unrated or in the Baa category or lower. However, for weaker credits characterized by narrow debt service coverage and an increased likelihood that the DSRF will be accessed, we may assign a greater weight to the DSRF requirement than is indicated by the standard scorecard weighting.

Interest earnings on a cash-funded reserve, if pledged, will not be explicitly included in our coverage calculations and related stress tests. Our exclusion of such revenues is based on the relative uncertainty of investment returns and their ability to release the cash and substitute a surety, thereby foregoing all future interest earnings.

Subfactor 4c: Flow of Funds Structure (California TABs Approach only, 25%)

This factor reflects the increased risks in California TABs resulting from the transformative legislation that modified the existing flow of funds and created risks in the implementation of the legislation.

The dissolution laws, while not ostensibly altering the legal security under a TAB's indenture, in many cases materially altered the flow of funds and their administration. Instead of the redevelopment agency receiving all of the incremental revenues over the course of the fiscal year, making allocations to specific project areas, and enjoying the substantial credit benefit of excess debt service coverage—significant given the passive revenue-raising nature of the TAB itself—the successor agency, post-dissolution, now receives a lump sum, semi-annual incremental revenue allocation from its county auditor-controller from the total tax increment revenues deposited in the agency's Redevelopment Property Tax Trust Fund. The allocation is only sum-sufficient to pay the successor agency's TAB debt service and other obligations approved by the state (collectively, "enforceable obligations"). However prior to this allocation, the auditor-controller allocates monies to senior and subordinate pass-throughs. In the event that this allocation results in a shortfall for debt service, the auditor-controller audits the agency's available and expected cash from asset sales. If necessary, the auditor-controller then reallocates funds to the agency for the next debt service payment from subordinate pass-throughs. Excess incremental revenues, if any, after payment of subordinate pass-throughs and enforceable obligations, do not flow through to the agency, as in the past, but from the county to overlapping taxing entities. This is a significant credit weakness. While these administrative processes do add additional risk to the credits, we have calibrated the scorecard to factor in the generally smooth administration and implementation of the dissolution laws with respect to timely debt service payment.

The likelihood that the county auditor-controller will need to commence cash flow reallocation procedures will increase throughout the life of a transaction if the tax base doesn't grow and the successor agency does not request and set aside the full, annual debt service in the initial six month period. Assuming no growth in the tax base, and therefore no growth in revenues, the typical TAB would see a continued deterioration of semiannual coverage in the principal payment period over time. Typically, TABs have level debt service until maturity. However, the proportion of debt service paid in the one semi-annual period in which both principal and interest is due becomes an increasingly larger share of the total annual debt service payments as the bond nears maturity.

Debt/legal structure – other credit considerations

Debt issuance limitations: We review any types of restrictions which could serve to mitigate the impact of a low ABT. For example, limitation on the total amount of debt that can be issued or the amount of property tax revenue collected may effectively limit the amount of future issuance. These factors may result in an upward notching factor to the grid-indicated rating, especially if the ABT is low and the legal limitation is deemed to mitigate the low ABT. In other words, this notching may be applied to offset the impact that a low ABT score has on the grid-indicated rating.

Exposure to bank supported variable rate debt and/or swaps, or other unusual debt structure: The risks of a debt portfolio can be magnified with bank supported variable rate debt. This debt structure introduces bank risk, remarketing risk and rollover risk. An unfavorable valuation on a swap could result in collateral posting requirements pressuring the cash flows of the TIF. Other non-traditional debt structures will be evaluated on a case-by-case basis.

Other

Other Credit Considerations

The following are other factors that may be integral to our credit review and could result in additional adjustments to the scorecard-indicated rating:

Governance: We evaluate the legislative framework in which the TIF district operates. Our ratings take into account the state and local laws governing the creation and operation of a TIF district. We also review any new legislation that alters this framework. As we have discussed, the laws that dissolved the California redevelopment agencies in 2012 weakened the credit profile of TABs resulting in multi-notch downgrades in 2012 and 2013. The extent to which laws and policies enhance or detract from the core security of the tax increment debt is the key determinant of the impact on credit quality.

We review the structural features of the enabling legislation and the effect on tax increment revenues. This includes an evaluation of the provisions related to:

- » *Amendment to project areas.* This would include adding or removing properties. In the cases where the district is including additional properties into their tax base, this would result in a stronger credit profile for the tax increment debt.
- » *“Opt-out” rights.* Many states have provisions that allow certain local governments, often school districts, to opt-out of contributing to TIF project areas. Any ability on the part of a municipality to “opt out” after the creation of the district and issuance of tax increment bonds would be a credit negative.

- » *Allocation of surplus revenues.* Some states permit extra tax increment revenues to flow back to the overlapping taxing entities. Others provide mechanisms for the redevelopment agencies to retain the surplus funds. Legal availability of these monies for debt service would be a credit strength.
- » *Assessment and collection practices.* The method of assessing properties, levying property taxes, and determining tax increment values and revenues varies across the country and impact tax revenue performance. We also look at the local government's method of collection and the safeguards in place to minimize delinquencies. An example of a state's laws that enhance security is the mechanism of allocating delinquencies in Oregon. Oregon has a statutory method of both distributing property tax revenues and assessing delinquencies on a county-wide basis and applying them uniformly across all taxing districts. Under this method, the non-payment of taxes by a property owner in the project area would not have a significant direct impact on the TIF district and would only slightly weaken the county's overall collection rate. Most California counties also use the "Teeter method" of property tax administration, whereby the county retains all delinquencies and makes the overlapping entities whole in exchange for the future penalties and interest payments when delinquencies are cured.

Depending on the performance of the TIF district, certain structural features may take on enhanced performance.

Management: While tax increment debt issued by a redevelopment agency is a passive security, management (and the municipality or council overseeing the agency) can impact the long-term growth and adequacy of the tax base and associated tax increment revenues. Management's vision for the development area, choice of projects to pursue, debt strategy (including choice of structures and utilization of derivatives), reserve policy, and input into the terms of developer and tax sharing agreements all contribute to the credit profile of the TIF area. In limited circumstances, exceptionally strong or weak management may materially impact the overall credit quality of the tax increment debt.

Linkage to related distressed overlapping taxing entity: As discussed earlier in the methodology, we may factor into the TIF rating the credit weakness of the primary, related overlapping taxing entity. For example, if a city's credit profile is deteriorating, we may notch down the rating on the TIF issuer's bonds if we believe the city and TIF issuer are closely enough linked where the city's problems could pose threats to the TIF debt.

Litigation: We will factor in legal disputes with overlapping taxing entities or residents and the potential impact on revenues. Redevelopment agencies may face lawsuits from overlapping taxing entities relating to the legality of the loss of their property tax revenues upon the creation of a TIF district. These disputes may be resolved by tax sharing agreements between the issuer of tax increment debt and affected local government. Residents also may contest eminent domain proceedings, potentially derailing development plans.

Outlier Discussion

Under the proposed methodology, approximately one-half of California tax allocation bonds would be outliers, defined as having a grid-indicated rating more than two notches away from the actual rating. Our prior downgrades were not only due to the restructuring of cash flows under legislation enacted in 2011 and 2012 but also due to uncertainty and challenges surrounding the administrative implementation of the new laws. As we have observed the administrative processes related to the payment of debt service on TABs has generally gone smoothly, the California TAB sector will go on review for upgrade with the publication of the methodology. We expect that upon completion of the review, the numbers of outliers will decline significantly.

For non-California tax increment debt, two out of 23 credits are outliers and may be placed on review upon publication of the methodology. One of the credits has significant tax base deterioration, the other has an unusual structural feature that relates to distribution of property taxes.

Case Study #1: Debt Service Payment Defaults by Victor Valley Economic Development Authority

The defaults by Victor Valley Economic Development Authority underscore the risks inherent in the TIF sector. In December 2011, the Authority defaulted on \$51 million Southern California Logistics Airport Authority's (SCLA) Subordinate Tax Allocation Revenue Bonds (Southern California Logistics Airport Project), Series 2007 and Series 2008 (rated B3).

The Victor Valley Redevelopment Project Area (VVEDA Project Area) encompasses more than 85,000 acres. The project area was created by Victor Valley Economic Development Authority (VVEDA) to stimulate economic development in and around Victorville and the Southern California Logistics Airport (SCLA). VVEDA is a Joint Exercise of Powers Authority that adopted its original Redevelopment Plan to include the Southern California Logistics Airport and 44,813 acres of adjacent properties within the original territorial jurisdictions of the VVEDA members. Those include the County of San Bernardino, the City of Victorville, the Town of Apple Valley, and the City of Hesperia.

The initial default on the subordinate bonds occurred on December 1, 2011 with a failure to pay \$535,000 of principal. Exacerbating the situation, the debt service reserve fund could only be accessed for the interest payment because of a document drafting error. The default was cured with tax increment revenues received in March 2012. The Authority defaulted again in subsequent years. According to the Authority's bond counsel, defaulted obligations would remain lawful obligations of the issuer. When excess increment is available, the Authority will use the funds to cure prior defaults. We expect that the majority, if not all of the currently outstanding debt service, will be paid over the life of the bonds.

The underlying reason for the credit deterioration of the TABs and the eventual payment default was a contraction of the tax base due to a steep drop in real estate values. The total AV of the project areas declined by 30%, however as the tax revenues are solely based off of the incremental AV, the decline was amplified with the AV increment shrinking by almost 50% from 2009 to 2013. The ratio of incremental AV to total AV ratio is approximately 55.8% in 2014, well below the California TAB sector median of 81%. The tax base, like many TIF districts, is also concentrated with the top-ten taxpayers representing 22.4% of the AV increment. Furthermore, with the top-two taxpayers representing 6.1% and 4.7% of the incremental AV, respectively, material diminishment of tax revenues could occur with the loss of a small number of taxpayers or successful appeals from a limited number of property owners. The weak socioeconomic profile of the project areas and high unemployment levels also contribute to the overall weak credit profile of the debt. Lastly, the legal structure of the Authority's debt portfolio also plays a role in the diminished credit quality of the defaulted bonds. The subordinated position of the defaulted bonds leaves it second in line after the senior housing and non-housing bonds, both of which continue to be paid.

Case Study #2: Tax Increment Revenue Limits Pose Risks to TIF Credit Quality

Tax increment revenue limits can be a key determinant of the credit quality of tax increment debt and occasionally have played a role in credit downgrades in California. The limits detail the maximum permitted amount of tax increment revenues that may be collected over the life of a TIF district. These limits introduce the possibility that debt might be outstanding after a limit is reached and result in a below investment grade rating. For instance, we downgraded tax allocation bonds issued by the Walnut Creek Redevelopment Agency, CA (now Successor Agency to Walnut Creek RDA) to Ba3 from Ba1 in September 2013. The bonds are secured from tax increment revenue from a merged project area consisting of two sub-areas, Mount Diablo and South Broadway. The Mount Diablo project area reached its \$25.5 million tax increment revenue cap in fiscal 2011 and the bonds are now solely supported by the much weaker South Broadway project area. The South Broadway project area is very small (28.6 acres), dominated by a shopping center, retail stores, and office buildings, and its incremental assessed valuation has demonstrated high volatility in the past few years with declines in fiscal 2011 (-2%) and fiscal 2012 (-9%), followed by gains in fiscal 2013 (+16%).

The loss of the Mount Diablo project area caused a loss of \$2.5 million in tax increment revenue and a sharp decline in debt service coverage. A longer term risk is the \$28.6 million tax increment cap for South Broadway project area that the City of Walnut Creek predicts will be reached in 2019.

However, there is a lack of clarity on the applicability of these limits after the dissolution of the California redevelopment agencies. Under the state's current legislation, even if the remaining permitted revenues under the applicable cap is sufficient to pay debt service, TABs are still at a risk of a debt service shortfall. The risk arises because excess revenues, after payment of pass-throughs and debt service, are to be shared with other local governments rather than retained or escrowed for future debt service. Typically, bond indentures include an annual revenue sufficiency test and a requirement that a portion of the revenues be escrowed if the revenue limit might be reached before the final maturity, at current tax base growth rates. But an agency's ability to reserve monies for this escrowing is untested.

However, we note that the intent of the RDA dissolution statutes is to allow the successor agencies to abide by all of their covenants and preserve the fundamental security of the bonds. In many other cases, the tax increment receipt limit is so large as not to be a practical limit at all.

Case Study #3: Bunker Hill Project Area – Real Estate Market Declines Puts TABs in Peril

In the mid-1990's, the Los Angeles Redevelopment Authority's Bunker Hill project area (currently rated Baa3/NOO) was downgraded to Ba2 from Baa1 due to pressures from large tax appeals and a collapse in real estate prices in Southern California. These challenges highlight the risks that real estate boom and bust cycle and tax appeals and presents to tax increment financing districts.

The Bunker Hill project area encompasses a geographically small 133 acres in downtown Los Angeles. High commercial presence (64% in 1998) and substantial taxpayer concentration (65% in 1998) left the project area exposed to potential real estate volatility. Although the district had a high 98.9% ratio of increment to total AV, tax appeals and large assessed valuation declines precipitated a significant 44% deterioration in the project area's incremental valuation, which fell to \$1.75 billion from \$3.1 billion between 1994 and 1998. As a result, debt service coverage on the agency's senior lien bonds fell to less than one times, necessitating the agency to use non-pledged revenues including interest earnings and cash-on-hand to make debt service payment in 1996 and 1997.

Ultimately, the agency did not default on its senior lien obligations and a refinancing in December 1997 bought it enough time for economic conditions to improve. In December 1997, the agency sold subordinate lien TABs to refund a prior series of bonds for debt service savings and to fund a Supplemental Debt Service Fund, which could be used to pay debt service on the First Lien Bonds to the extent that pledged revenues were not sufficient. The Supplemental Debt Service Fund was structured to provide sufficient revenues to meet debt service payments through December 2009.

Between 1999 and 2004, the project area demonstrated strong annualized growth of 5% and improved maximum annual debt service coverage to 1.13 times by 2004 (1.37x current DSC), which contributed to a 2004 upgrade to Baa3.

Appendix A: Tax Increment Debt Scorecard

Standard Approach (National- Non-California)

Subfactor	Measure	Weight	Aaa	Aa	A	Baa	Ba	B
<i>Numerical score</i>			0.5 to 1.5	1.5 to 2.5	2.5 to 3.5	3.5 to 4.5	4.5 to 5.5	5.5 to 6.5
Socioeconomic Context (10%)								
Socioeconomic Context	MFI as % of US	10%	> 150% of US level	150% to 90% of US level	90% to 75% of US level	75% to 50% of US level	50% to 40% of US level	< 40% of US level
Project Area Characteristics / Tax Base (35%)								
Size	Incremental AV	10%	> \$12B	\$12B \geq n > \$1.4B	\$1.4B \geq n > \$240M	\$240M \geq n > \$120M	\$120M \geq n \geq \$60M	< \$60M
Economic Diversity	Taxpayer Concentration (Top Ten Taxpayers' AV as % of Incremental AV)	15%	< 2%	2% \geq n > 5%	5% \geq n > 10%	10% \geq n > 20%	20% \geq n \geq 35%	> 35%
Tax Base Volatility	Ratio of Incremental AV to Total AV	10%	> 95%	95% \geq n > 90%	90% \geq n > 85%	85% \geq n > 80%	80% \geq n \geq 60%	< 60%
Financial Strength (25%)								
Debt Service Coverage	MADS Coverage	20%	> 4.5x	4.5x \geq n > 3.5x	3.5x \geq n > 2.0x	2.0x \geq n > 1.3x	1.3x \geq n \geq 1.0x	< 1.0x
Revenue Trend	3-year Compound Average Growth Rate of Tax Increment Revenue	5%	> 10%	10% \geq n > 5%	5% \geq n > 0%	0% \geq n > -2%	-2% \geq n \geq -5%	< -5%
Debt/Legal Structure (30%)								
Additional Bonds Test	Additional Bonds Test	20%	> 3.0x OR a closed lien	3.0x to 1.76x	1.75x to 1.26x	1.25x to 1.0x	No Limit	
Debt Service Reserve Fund	Debt Service Reserve Fund	10%	1-year MADS Cash funded or with high rated surety provider (A rated or higher)	Standard 3-prong test Cash funded or with high rated surety provider (A rated or higher)	Less than 3-prong test Cash funded or with high rated surety provider (A rated or higher)	Any DSRF with Baa rated surety provider	Any DSRF with Ba rated surety provider	No DSRF or B rated or lower or unrated surety provider

California TABs Approach

Subfactor	Measure	Weight	Aaa	Aa	A	Baa	Ba	B	Caa
<i>Numerical score</i>			0.5 to 1.5	1.5 to 2.5	2.5 to 3.5	3.5 to 4.5	4.5 to 5.5	5.5 to 6.5	6.5 to 7.5
Socioeconomic Context (5%)									
Socioeconomic Context	MFI as % of US	5%	> 150% of US level	150% to 90% of US level	90% to 75% of US level	75% to 50% of US level	50% to 40% of US level	< 40% of US level	
Project Area Characteristics / Tax Base (30%)									
Size	Incremental AV	10%	> \$12B	\$12B ≥ n > \$1.4B	\$1.4B ≥ n > \$240M	\$240M ≥ n > \$120M	\$120M ≥ n ≥ \$60M	< \$60M	
Economic Diversity	Taxpayer Concentration (Top Ten Taxpayers' AV as % of Incremental AV)	10%	<2%	2% ≥ n > 5%	5% ≥ n > 10%	10% ≥ n > 20%	20% ≥ n ≥ 35%	> 35%	
Tax Base Volatility	Ratio of Incremental AV to Total AV	10%	> 95%	95% ≥ n > 90%	90% ≥ n > 85%	85% ≥ n > 80%	80% ≥ n ≥ 60%	< 60%	
Financial Strength (25%)									
Debt Service Coverage	MADS Coverage	20%	> 6.5x	6.5x ≥ n > 4.5x	4.5x ≥ n > 3.5x	3.5x ≥ n > 2.0x	2.0x ≥ n > 1.3x	1.3x ≥ n ≥ 1.0x	< 1.0x
Revenue Trend	3-year Compound Average Growth Rate of Tax Increment Revenue	5%	> 10%	10% ≥ n > 5%	5% ≥ n > 0%	0% ≥ n > -2%	-2% ≥ n ≥ -5%	< -5%	
Debt/Legal Structure (40%)									
Additional Bonds Test	Additional Bonds Test	5%	> 3.0x OR a closed lien	3.0x to 1.76x	1.75x to 1.26x	1.25x to 1.0x	No Limit		
Debt Service Reserve Fund	Debt Service Reserve Fund	10%	1-year MADS Cash funded or with high rated surety provider (A rated or higher)	Standard 3-prong test Cash funded or with high rated surety provider (A rated or higher)	Less than 3-prong test Cash funded or with high rated surety provider (A rated or higher)	Any DSRF with Baa rated surety provider	Any DSRF with Ba rated surety provider	No DSRF or B Rated or lower or unrated surety provider	
CA TABs Flow of Funds Structure		25%					Weak post-RDA dissolution flow of funds		

Other Credit Considerations

Factor 1: Socioeconomic Context

Additional local economy strength or weakness not captured in the grid (including other wealth/income indicators and labor and housing market metrics)

Other analyst adjustment to Socioeconomic Context factor (Specify)

Factor 2: Project Area Characteristics / Tax Base

Level and potential for development

Geographical size

Characteristics of largest taxpayers (sector concentration / credit quality)

Land use composition and tax status

Institutional presence

Historical incremental and total tax base value trends

Inflationary base AV

Other analyst adjustment to Project Area Characteristics / Tax base factor (Specify)

Factor 3: Financial Strength

Tax increment revenue limit caps

Property tax appeals

Changes in tax rates impacting revenues

Reserves

Semiannual debt service coverage (CA TABs Approach only)

Other analyst adjustment to Financial Strength factor (Specify)

Factor 4: Debt/Legal Structure

Debt issuance limitations

Exposure to variable rate debt and/or swaps, or other unusual debt structure

Other analyst adjustment to Debt/Legal Structure factor (Specify)

Other

Governance / TIF legislative framework

Management

Linkage to related distressed overlapping taxing entity

Litigation

Credit event / trend not yet reflected in existing data set

Indicated Rating	Overall Weighted Score
Aaa	0.5 to 1.50
Aa1	1.50 to 1.83
Aa2	1.83 to 2.17
Aa3	2.17 to 2.50
A1	2.50 to 2.83
A2	2.83 to 3.17
A3	3.17 to 3.50
Baa1	3.50 to 3.83
Baa2	3.83 to 4.17
Baa3	4.17 to 4.50
Ba1	4.50 to 4.83
Ba2	4.83 to 5.17
Ba3	5.17 to 5.50
B1	5.50 to 5.83
B2	5.83 to 6.17
B3	6.17 to 6.50
Caa1	6.50 to 6.83
Caa2	6.83 to 7.17
Caa3	7.17 to 7.50

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- » [Continued Reviews of California Tax Allocation Bonds Will Incorporate New Information Requirements, February 2013 \(149887\)](#)
- » [Cash Flow Risks Drive Downgrades of California Tax Allocation Bonds, June 2012 \(143256\)](#)
- » [Dissolution of California Redevelopment Agencies Increases Near-Term Cash Flow Risk; Long-Term Challenges Persist, February 2012 \(139434\)](#)
- » [California Tax Allocation Bonds May Face Substantially Increased Credit Risk Due to Recent Legislation and Pending State Supreme Court Action, September 2011 \(135506\)](#)

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