

U.S. LOCAL GOVERNMENT SECTOR

Pennsylvania State Aid Intercept Program for School Districts—A Summary

- The Pennsylvania State Aid Intercept statutes provide the legal ability to divert (or intercept) funds the commonwealth is paying to school districts.
- If a school district fails to pay debt service, state aid payments can be intercepted and used to pay debt service due to bondholders.
- Security for the intercept mechanisms is primarily based on Pennsylvania’s ability to appropriate school district funding.
- The principal Pennsylvania State Aid Intercept mechanism is the post-default PA Act 150 Intercept. It covers all Pennsylvania school districts unless they participate in or have structured one of the pre-default intercepts.
- There are two pre-default intercepts: the State Public School Building Authority Lease Intercept (SPSBAL) and the School District Fiscal Agent Agreement Intercept (Sect 633).
- The enhanced ratings for the Pennsylvania School District Intercept Program have slipped because of state-level credit deterioration.
- State aid was intercepted to pay debt service on Penn Hills School District bonds before an April 1, 2015, default could occur, although the intercept provisions of Pennsylvania law, in most instances, do not actually take effect until after a debt service payment is missed.
- We have found that the Pennsylvania intercept has been used a total of three times. Two times prior to 2015, then for Penn Hills School District at the beginning of 2015.
- Moody’s treatment of the enhanced intercept ratings has changed recently and Standard & Poor’s (S&P) placed the Pennsylvania intercept enhancement programs on “CreditWatch with negative implications.”

Tom Kozlik

215-585-1083

thomas.kozlik@pnc.com

Ratings Summary

Program	Type	Enhanced Rating	
		Moody's	S&P
SPSBAL	Pre	A1	A+ *
Section 633	Pre	Varies	A+ *
PA Act 150	Post	Varies	A *

*CreditWatch negative

Source: Moody’s, Standard & Poor’s, and PNC Municipal Strategy

The Commonwealth of Pennsylvania has not pledged its general obligation to the state aid intercept program.

The Pennsylvania School District Intercept

Pennsylvania state aid was 11-79% of school district revenues (43% average) in 2014.

State revenues can be “intercepted” if needed.



PRE-DEFAULT STATE PUBLIC SCHOOL BUILDING AUTHORITY

The DoE intercepts needed funds and sends them to the paying agent if a debt service payment is not funded prior to the scheduled payment date.

PRE-DEFAULT FISCAL AGENT OPTION (Section 633)

An agreement between the DoE and the school district allows state aid to be intercepted and paid to the paying agent bank for the benefit of bondholders if a debt service payment is not funded prior to the scheduled payment date.

POST-DEFAULT

If a school district does not make a debt service payment, the DoE intercepts state revenues and sends the funds to the paying agent for the benefit of bondholders.



Paying Agent Bank

Recent Pennsylvania Intercept Developments

There are a variety of enhancement and intercept programs used by local governments throughout the United States. Most of these programs provide an added benefit to bondholders. In the following commentary we review certain details about the Pennsylvania State Aid Intercept for School Districts. In addition, some important events have materialized in recent months relating directly to the Pennsylvania intercept mechanisms. We touch on those, too.

In early 2015 investors witnessed the intercept in action. State aid was intercepted to pay debt service on Penn Hills School District bonds before an April 1 default could occur. It is important investors note the intercept provisions of Pennsylvania law do not actually take effect, in most instances, until after a debt service payment is missed. We would like to highlight that even though the Penn Hills bonds did not possess pre-default mechanism enhancements, notice was given before the debt service payment date, and a default was avoided.

Another development is related to the state's structural imbalance. The Commonwealth of Pennsylvania's credit quality has declined and rating downgrades have followed. This affects the enhanced ratings and the intercepts' credit quality. The ongoing budget negotiations in Pennsylvania (please see our report "What Does Pennsylvania's Delayed Budget Mean for Municipal Credit" dated August 12) could help or hurt the credit quality of state and state-related debt, including school districts.

Intercept Program Basics

Which Funds Are Intercepted?

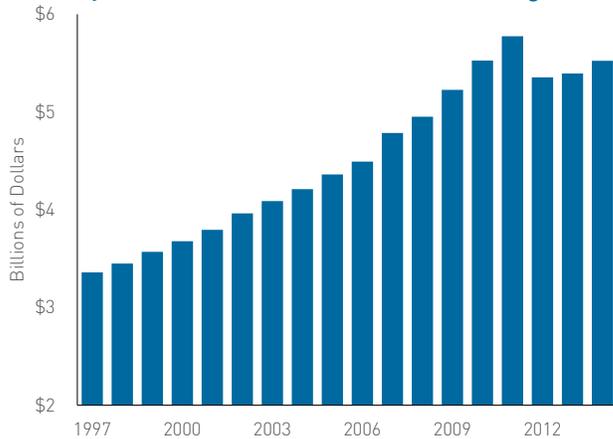
Intercepted funds are aid payments scheduled to be paid to school districts by the commonwealth. Pennsylvania school districts receive varying amounts of state aid in the form of basic education funding and various other sources. Total state aid amounted to between 11% and 79% of individual Pennsylvania school districts' annual revenues for the 2014 school year, according to the Pennsylvania Department of Education. Much of a school district's state aid, including the basic education funding is determined during the annual budget process, is subject to annual appropriation, and is paid to school districts monthly. The ultimate security for the intercept program is based on Pennsylvania's ability to appropriate this state aid to school districts.

While the ability to intercept state aid is a plus, we should note that from a credit perspective we always strongly consider the underlying security of individual school districts in addition to any type of state-level enhancement, such as the intercept. It is also important to reinforce that there is not a general obligation guarantee from the Commonwealth of Pennsylvania associated with the state aid intercept. In all, we have found that the Pennsylvania intercepts have been used a total of three times. Two times prior to 2015, then for Penn Hills school district at the beginning of 2015.

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Pennsylvania Basic Education Funding



Source: Pennsylvania Department of Education and PNC Municipal Strategy

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Selected Pennsylvania School Districts by State Revenue

School District	County	Portion of District Budget from State Revenue	Percentage of Total State Revenue
Upper Merion Area SD	Montgomery	\$10,560,387	11%
Lower Merion SD	Montgomery	\$25,957,351	12%
Quaker Valley SD	Allegheny	\$5,343,201	13%
Radnor Township SD	Delaware	\$10,783,306	13%
North Allegheny SD	Allegheny	\$25,832,382	13%
New Hope-Solebury SD	Bucks	\$4,751,877	13%
Great Valley SD	Chester	\$10,655,513	13%
Tredyffrin-Easttown SD	Chester	\$16,160,260	14%
Wyomissing Area SD	Berks	\$4,503,322	14%
Colonial SD	Montgomery	\$14,697,584	14%
Pittsburgh SD	Allegheny	\$250,865,711	40%
Philadelphia City SD	Philadelphia	\$1,366,594,971	51%
Union SD	Clarion	\$7,665,438	74%
Midland Borough SD	Beaver	\$4,023,132	75%
Otto-Eldred SD	McKean	\$7,812,417	75%
Windber Area SD	Somerset	\$11,404,518	75%
Redbank Valley SD	Clarion	\$11,988,020	75%
Portage Area SD	Cambria	\$9,007,869	75%
Union City Area SD	Erie	\$12,575,434	75%
Northern Cambria SD	Cambria	\$12,171,619	75%
Blacklick Valley SD	Cambria	\$6,881,080	77%
Duquesne City SD	Allegheny	\$16,267,102	79%

Source: Pennsylvania Department of Education, Moody's, Standard & Poor's, and PNC Municipal Strategy

Uncovering the Mechanics of the Intercept Program

The intercept provisions of the Commonwealth of Pennsylvania's School Code establish the process by which school district bond debt service payments may be paid by the intercept. The school code explains that upon notice the Pennsylvania Secretary of Education or the Department of Education will withhold state aid payments if a school district fails to make a debt service payment. This is how state aid is intercepted if necessary, sent to the paying agent, and paid to bondholders. There are three forms of the intercept mechanism for school districts in Pennsylvania.

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Pennsylvania State Aid Intercept for School Districts: Programs and Enhanced Ratings

PA Intercept Program	Pre- or Post Default	Moody's		S&P	
		State GO Rating	Intercept Program Rating	State GO Rating	Intercept Program Rating
State Public School Building Authority Lease Intercept Program	Pre-Default	Aa3 (Stable)	A1 (Stable)	AA- (Stable)	A+ (Watch Negative)*
School District Fiscal Agent Agreement Intercept Program (Sect 633)	Pre-Default	Aa3 (Stable)	Varies	AA- (Stable)	A+ (Watch Negative)*
PA Act 150 School District Intercept Program	Post-Default	Aa3 (Stable)	Varies	AA- (Stable)	A (Watch Negative)*

*S&P put all Pennsylvania intercept program ratings on CreditWatch with negative implications.

Source: Moody's, Standard & Poor's, and PNC Municipal Strategy

State Public School Building Authority Lease Intercept: PRE-DEFAULT

The State Public School Building Authority Lease Intercept is a direct-pay program that is used by a very limited number of Pennsylvania school district bond issuers. We have seen the Philadelphia School District and Chester Upland School District issue debt with this program. The Pennsylvania Department of Education (DoE) will intercept state aid dollars and send them directly to the paying agent bank for the benefit of the bondholders. This is a direct pay program, so notification of a potential default is not needed by the paying agent bank. A default will be avoided as long as state aid payments are appropriated and available.

A default will be avoided as long as state aid payments are appropriated and available.

School District Fiscal Agent Agreement Intercept (Section 633): PRE-DEFAULT

The use of the School District Fiscal Agent Agreement (Section 633) pre-default program has increased in recent years as more school districts have discovered it is available. Issuers and their financing and legal teams make arrangements for the DoE to be notified, through an agent, which provides for state aid to be paid directly to the paying agent before bond principal and interest is due. This pre-default mechanism typically receives the same ratings as the State Public School Building Authority version. There has been one exception so far.

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Selected Fiscal Agreement Intercept (Sect. 633) Issues

Issuer	Moody's	
	Underlying	Enhanced
Bellefonte ASD	A1	A1
Bristol Twp SD	A3	A1
Clearfield ASD	A1	A1
Coatesville ASD	Baa2	A1
Duquesne DS	None	A1
Panther Valley SD	A2	A1
Penn Hills SD	B3	Baa1*
Philadelphia SD	Ba3	A1
Pocono Mountain SD	Baa2	A1
Pottstown ASD	A1	A1
Reading SD	Baa2	A1
South Fayette Township SD	A1	A1
Steelton Highspire SD	None	A1
Warren Cty SD	A2	A1

*Due to the speculative characteristics of underlying credit and delayed Pennsylvania budget

Source: Moody's and PNC Municipal Strategy

Pennsylvania Act 150 School District Intercept: POST-DEFAULT

The Act 150 intercept program applies to all Pennsylvania school districts. There are specific rating agency criteria and debt service coverage requirements that apply when the rating agencies assign enhanced ratings for this program and the methodology differs by rating firm. The structure of the Act 150 program is not set-up to make sure debt service payments are made prior to a default. However, if the DoE is made aware of an upcoming deficiency, it is possible to avoid a default, as it was in the case of the Penn Hills School District in early 2015.

The Act 150 intercept program applies to all Pennsylvania school districts.

Recent Selected Pennsylvania Act 150 School District Intercept Pricings

Issuer	Moody's		S&P	
	Underlying	Enhanced	Underlying	Enhanced
Dallas SD	A1	A2	A+	A
Forest City RSD	A1	A2	None	None
Neshaminy SD	Aa2	A2	NR	NR
Phoenixville ASD	Aa2	A2	AA	A
Warren County SD	A2	A2	NR	NR
Waynesboro ASD	A1	A2	None	None
Ambridge ASD	None	None	A	A
McKeesport ASD	Ba1	Baa2	A	A
Monessen SD	None	None	A-	A
Penn Cambria SD	None	None	A	A
Red Lion ASD	Aa3	A2	AA-	A

Source: Moody's, Standard & Poor's, and PNC Municipal Strategy

What Is the Intercept Enhancement Worth Now?

The level of security provided by the Pennsylvania State Aid Intercept Program for School Districts has slipped in recent years because of the credit deterioration at the state level. The commonwealth has been grappling with a structural imbalance, and remedies have eluded political actors so far. Moody's downgraded Pennsylvania's general obligation rating to Aa3 from

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Aa2 in July 2014, then S&P downgraded Pennsylvania in Sept 2014 to AA- from AA. Enhanced ratings for the Pennsylvania intercept program also have been downgraded. In addition, issuers are requesting that rating agencies not mention the enhancement program ratings in their rating agency reports on a more regular basis. This could be because in an increasing number of cases the school district underlying ratings are now higher than the intercept enhancement ratings.

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Rating Agency Treatment

Moody's View of and Criteria for Rating the Pennsylvania Intercept

Moody's changed the criteria it uses to rate PA Act 150 post-default Pennsylvania intercept issues in the fall of 2013. Before this change, enhanced ratings were two notches below the state rating, creating, in effect, a floor for the enhanced rating. But after the criteria change, Moody's started to use a bottom-up approach. Now the enhanced rating also considers the underlying credit fundamentals of the individual school district. A history of state support for school districts and the mechanics of the intercept are also considered in applying the rating.

An underlying rating is required by Moody's for a school district before it assigns an enhanced post-default rating. Only if a school district has an underlying is it eligible for a Post-Default Act enhanced rating.

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Moody's does not require an underlying assessment for a pre-default enhancement program rating. In assigning the enhanced pre-default ratings Moody's considers current-year debt service coverage and competing claims from charter schools and pensions. There is not a set number of notches for a Moody's pre-default rating from the state's general obligation rating. For example, Penn Hills School District was recently assigned a B3 underlying and a Baa1 pre-default enhanced rating. The rating agency explained that Penn Hill's pre-default enhanced rating was below the typical A1 enhanced ratings because of the underlying credit quality and uncertainty of funding based on Pennsylvania's delayed budget.

S&P's View of and Criteria for Rating the Pennsylvania Intercept

The pre-default ratings from Standard and Poor's are currently one notch below the state rating and the post-default ratings are two notches below the state rating. S&P has indicated that these enhanced ratings will not necessarily move simultaneously with the state rating, but they could. A school district's annual state aid must be at least equal to future maximum annual debt service for a school district to be eligible for an S&P Post-Default Act 150 enhanced rating.

PA Intercept Enhancement Programs on CreditWatch with Negative Implications

On September 4, 2015, S&P published a statement notifying investors that it has placed the Pennsylvania intercept enhancement programs on "CreditWatch with negative implications" due to the commonwealth's late budget. In a brief report the rating agency's analysts wrote:

The CreditWatch placement is due to the current impasse on the fiscal 2016 budget, which creates uncertainty, in our view, that state aid for school districts will be sufficient to cover any debt service payments if there was a notification to the state regarding a debt service deficiency as outlined in the statute that authorizes the program.

In the note, S&P indicated that it expects to resolve its CreditWatch designation within 90 days. In other words, it is possible that without a Commonwealth of Pennsylvania budget, S&P may downgrade its Pennsylvania intercept enhancement program ratings by December.

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PNC Capital Markets Pennsylvania School District Financings through August 28, 2015

Sale Date	Description	Amount (millions \$)	Moody's		S&P		Intercept Mechanism	Bid Type
			Underlying	Enhanced	Underlying	Enhanced		
1/12/2015	Abington Heights SD	6.86	Withdrawn	None	AA	A	Act 150	Negotiated
2/9/2015	Conneaut SD	9.69	None	None	A+	A	Act 150	Negotiated
2/16/2015	Titusville Area SD	3.57	None	None	A+	A	Act 150	Negotiated
2/19/2015	Northwest ASD	4.93	None	None	A	A	Act 150	Negotiated
3/23/2015	Philadelphia SD	91.30	Ba3	A1	None	A+	Fiscal Agent	Negotiated
4/20/2015	Tulpehocken ASD	8.80	None	A2	A+	A	Act 150	Negotiated
4/27/2015	Avonworth SD	9.93	None	None	AA-	A	Act 150	Negotiated
5/4/2015	Penn-Trafford SD	4.45	A1	A2	None	None	Act 150	Negotiated
5/18/2015	Hermitage SD	4.73	None	A2	A+	A	Act 150	Negotiated
5/18/2015	Huntingdon Area SD	10.00	None	None	A	A	Act 150	Negotiated
5/18/2015	South Park SD	10.00	None	A2	A	A	Act 150	Negotiated
5/25/2015	Pine Richland SD	9.52	None	A2	AA-	A	Act 150	Negotiated
6/22/2015	Bedford ASD	8.30	Aa3	A2	None	None	Act 150	Negotiated
6/22/2015	Montrose ASD	5.18	None	None	A+	A	Act 150	Negotiated
7/20/2015	Greater Nanticoke ASD	8.10	None	None	A+	A	Act 150	Negotiated
7/27/2015	Girard SD	7.60	None	None	A+	A	Act 150	Negotiated
7/28/2015	Dallas SD	5.98	A1	A2	None	None	Act 150	Negotiated
8/17/2015	North Allegheny SD	34.70	None	None	AA	AA	Fiscal Agent	Negotiated
2/2/2015	South Middleton SD	10.00	None	None	AA	A	Act 150	Competitive
3/24/2015	Central Fulton SD	9.65	None	None	A+	A	Act 150	Competitive
4/13/2015	Whitehall Coplay SD	9.17	None	A2	A+	A	Act 150	Competitive
5/7/2015	Greencastle Antrim SD	9.88	A1	A2	AA	A	Act 150	Competitive
5/11/2015	Conewago Valley SD	8.94	Aa3	Not Requested	None	None	Act 150	Competitive
6/11/2015	Shikellamy SD	7.04	None	None	A+	A	Act 150	Competitive
6/15/2015	Curwensville ASD	9.90	None	None	A	A	Act 150	Competitive
8/11/2015	Waynesboro ASD	9.90	A1	A2	Suspended	AA	Act 150	Competitive
8/24/2015	Phoenixville ASD	7.70	Aa2	A2	None	None	Act 150	Competitive

Source: Bloomberg L.P., Moody's, Standard & Poor's, and PNC Municipal Strategy

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