

HARRISBURG UPDATE

JANNEY FIXED INCOME STRATEGY

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Harrisburg filed for bankruptcy. The question remains as to whether bankruptcy status will remain after court review.

- City Council votes 4-3 to file for bankruptcy. It's unclear whether the filing is legal.
- Legislative action likely next week, as state moves to enact a bill allowing state takeover of the city's finances.
- Pennsylvania's proactive approach, through Act 47, is a credit positive for Pennsylvania municipalities.

Focus now shifts to the state, which passed legislation in June prohibiting cities of Harrisburg's size from filing for bankruptcy, under penalty of losing state aid.

On October 11, Harrisburg city council voted 4-3 to file for bankruptcy under Chapter 9 of the Federal Bankruptcy Code. Officials ranging from the city attorney to Pennsylvania Governor Corbett question the legality of the filing, but once the filing was faxed to the court, the city was officially in bankruptcy. The question ahead is whether it will stand. The case has been assigned to Mary France, the chief bankruptcy judge for the Middle District of Pennsylvania. Her courtroom is in Harrisburg.

THE ACT 47 PLAN

The filing comes as disputes over a state-sponsored recovery plan rage on. Already financially strapped, Pennsylvania's capital ran into severe difficulties when a city-sponsored incinerator project failed to produce enough revenue to support debt service on the nearly \$300 million in bonds and loans issued to finance the project. The bonds were guaranteed by the city, with Dauphin County (NR/AA) backing about half of the bonds as a secondary guarantor, and Assured Guaranty (Aa3/AA+) insuring the bonds. Harrisburg stopped making payments required under its guarantee, forcing the county and insurer to pay debt service. The city applied for inclusion in the state's program for distressed municipalities, known as Act 47, and was accepted in January 2011. In June 2011, as part of the Act 47 process, a consulting team, engaged by the state and led by the Novak Consulting Group, submitted a 400-page recovery plan for city consideration. Although the plan had many moving parts, the primary components were sale of the incinerator as well as execution of a long-term lease of parking authority assets such as garages, lots and meters, to a private entity.

In addition to asset sales as noted, the plan would have left the city with about \$30 million in debt. Also the city would have lost revenue now received each year from the parking authority. The four council members who voted for bankruptcy oppose the plan, having voted three times against acceptance. They believe that Assured Guaranty, the insurer on about \$225 million in debt, should put \$100 million towards the plan. They also want Dauphin County and the state to approve a 1% countywide sales tax to benefit Harrisburg.

FOCUS ON THE STATE

Focus now shifts to the state, which passed legislation in June prohibiting cities of Harrisburg's size from filing for bankruptcy, under penalty of losing state aid. A new law is working through the legislature that would allow the governor to declare a fiscal emergency for cities such as Harrisburg, essentially taking over finances through a receiver, who would presumably implement the Act 47 plan. Senate action on this bill is expected next week, and the governor has said he will sign it into law.

When the parties make appearance in bankruptcy court, expect the state, Dauphin County and Assured Guaranty (among others) to contest the filing. We believe the state is likely to eventually prevail, with the recovery plan imposed either as it stands, or with modifications. If, on the other hand, the case proceeds through the bankruptcy process, the outcome is less certain, although it

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could end up looking much like the recovery plan, with asset sales generating money to pay off bonds and pay back the insurers and Dauphin County.

The travails of Jefferson County, AL, have certainly played a part in Harrisburg's city council's decision to file. Jefferson County commissioners have been negotiating with bondholders and other stake holders on \$3 billion in debt, with bankruptcy threatened at several points. A settlement to avert what would be the largest municipal bankruptcy in history was reached, including about \$1 billion in concessions from bondholders. Harrisburg may be playing the bankruptcy card to extract further concessions from various stakeholders. Alabama state legislators are balking at approving the Jefferson County plan, so bankruptcy is still a possibility. By comparison, Pennsylvania has been much more proactive in seeking resolution of the city's financial problems.

THE BONDS

Resource Recovery Debt

Many of the outstanding bonds issued to build the incinerator through the Harrisburg Authority are guaranteed by Dauphin County, and all are insured by Assured Guaranty. As we note in our recent reports titled Bond Insurance (October 11 and 12), Assured Guaranty is a strong insurer, with sufficient capital and claims paying resources to meet its present and future obligations. Recent trading activity for these bonds have shown little concession to the market, with yield levels the same or slightly higher compared to other Assured Guaranty backed debt.

General Obligation Bonds

The few Harrisburg GO bonds outstanding are zero coupon bonds with Ambac insurance. They mature each March and September. The state advanced funds to Harrisburg in September 2010 to help make the payment, and a loan from the city's parking authority provided funds for last month's \$3 million maturity. Although no claims related to Harrisburg have been presented to Ambac, the insurer has been paying claims on other debt. Ambac is paying claims when presented, which we believe is likely to continue near term, but the longer term outlook for this insurer, which was rated Caa2 by Moody's before the rating was withdrawn earlier this year, is less certain. Depending on maturity, recent trades (pre filing) have ranged widely around a 10% yield.

Parking Authority Bonds

With about \$100 million outstanding, these bonds were issued under five different liens. They all carry insurance, but the quality of insurers range from Assured Guaranty (Aa3/AA+) to Syncora (defunct) with MBIA/National (Baa1/BBB) and Ambac (NR/NR) in the middle. The parking system has operated profitably, and in past years has contributed millions of dollars to the city's general fund. The recovery plan anticipates sale of parking authority assets, which would probably require defeasance or redemption of all or part of outstanding parking debt. Pre filing trade prices have ranged widely, depending on the insurer.

Water Revenue Bonds

With about \$150 million outstanding, these bonds were issued through the same Harrisburg Authority which issued the incinerator issues. About half of the outstanding bonds are insured by Assured Guaranty, but the most recent, 2008 issue, has no insurance, and was recently rated A1. Moody's dropped its rating in January 2011 to Ba1, due to city's problems. Recently Moody's placed the water bonds on watch for further downgrade due to lack of timely financial information. Like the parking authority, the water system has operated positively generating money in prior years for the city's general fund. Recent trading levels (pre-filing) for the uninsured bonds have ranged widely around 6.5%.

School Bonds

Bonds issued for the Harrisburg School District have not been significantly impacted by the city's woes. Pennsylvania's educational funding system includes an intercept mechanism which protects bondholders by intercepting state aid for the benefit of bondholders. (See Janney Report on Pa School Intercept -Aug 31, 2011).

When all is done it seems likely that some version of the Act 47 recovery plan will be implemented, including asset sales.

CONCLUSION

Harrisburg's bankruptcy filing has generated national attention. It's uncertain how or if the process will proceed. Harrisburg's financial difficulties are not reflective of systemic problems for municipal issuers, but are rather related to the enterprise risk associated with its ill-fated incinerator project and financing. The magnitude of the problem is outsized compared to financial issues faced by other Pennsylvania and national municipalities. The state's Act 47 process has blazed some new paths, and while ultimate resolution is clouded by the bankruptcy filing, the state's proactive approach to supporting its communities, through Act 47, is a credit positive for Pennsylvania municipal issuers.

To date bondholders have been paid on time, either directly, or through insurance. Bankruptcy filing clouds the future for uninsured bonds or bonds backed by insurers of low quality. We believe the bankruptcy filing is ultimately a step in the negotiation dance between the city on the one hand and Assured Guaranty, the state, the county and other stakeholders on the other, with resolution likely to favor bondholders, although the path may be long and uncertain. When all is done it seems likely that some version of the Act 47 recovery plan will be implemented, including asset sales.

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