

PENNSYLVANIA DEBT OVERVIEW

JANNEY FIXED INCOME RESEARCH

APRIL 6, 2011



General obligation bonds as well as several major revenue programs offer a variety of investment grade alternatives.

GENERAL OBLIGATION

AA1/AA/AA+

TURNPIKE TOLL REVENUE

SR - AA3/AA/AA
SUB - A3/A-/NR

TURNPIKE OIL FRANCHISE

SR - AA3/AA/NR
SUB - A2/A+/NR

SINGLE FAMILY HOUSING PROGRAM

AA2/AA+/NR

COMMONWEALTH FINANCING AUTHORITY

AA3/AA-/AA

ALAN SCHANKEL
Managing Director
215 665 6088
aschankel@janney.com

See page 5 for important information and disclaimers.

JANNEY MONTGOMERY SCOTT
www.janney.com
© 2011 Janney Montgomery Scott LLC
Member: NYSE, FINRA, SIPC

SUMMARY

- Pennsylvania has a diversified economy, with about average wealth levels and unemployment below the national rate.
- Following declines during the recession, state income is recovering, with revenues from sales taxes as well as corporate and personal income taxes growing.
- In addition to general obligation debt, issues include turnpike revenue bonds secured by four different revenue streams as well as a strong single family mortgage program.
- A state "intercept" program for K-12 schools and community college bonds offers bond holders enhanced security on school bonds.

INTRODUCTION

Pennsylvania is a frequent issuer of municipal bonds with \$9.9 billion in general obligation debt outstanding and \$23 billion of revenue issues, primarily for the Turnpike Commission and the Housing Finance Agency. The state enters budget season with a \$4 billion deficit for the coming fiscal year (July 2011-June 2012). The new governor's proposal closes that gap with cuts including a 52% reduction in state spending on higher education and elimination of 1,500 state jobs, for total spending of about \$27.3 billion. Although Gov. Corbett's budget proposal included no tax increases or new taxes, a potential new revenue source is taxes or fees related to drilling and extraction of gas in the Marcellus Shale formation, a promising new source for natural gas.

GENERAL OBLIGATION ISSUES

Pennsylvania has almost \$10 billion of general obligation debt outstanding, backed by the full faith, credit and taxing power of the state. The following considerations reflect directly on GO debt, but are also factors for most of the state's issues.

- Ratings are Aa1/AA/AA+. Both Moody's and Fitch have a negative outlook on the rating.
- Per capita personal income of \$40,161 (2009) is just above the national average ranking, ranking Pennsylvania 18th among states.
- The state unemployment rate is 8.0%, compared to the 8.9% national rate (Feb 2011).
- The state has moderate debt and liabilities. A recent Moody's report comparing debt and unfunded pension liabilities as a percent of state GDP ranked Pennsylvania at 39th among the states. Pension funding is at about 80% of liabilities, a funding level generally considered to be adequate.
- Undesignated general fund balance was negative \$1.4 billion as of 6-30-10, an improvement over negative \$2.5 billion at the close of FY2009.
- State revenues, primarily from sales and personal income tax, are recovering with YoY increase of 5.4% through Sep 2010, compared to 4.4% national average.
- Pennsylvania's economy is diversified with a significant manufacturing sector and a growing service sector.

The table contains information on Pennsylvania's many bond issuers, followed by further data and explanation on the larger programs.

Pennsylvania Debt as of June 30, 2010

Bond Program	Amount (\$)	Security	Ratings
Direct Debt			
General Obligation	9,924,575,000	Full faith credit and taxing power. Negative outlook Moody's and Fitch	Aa1/AA/AA+
Revenue Bonds			
Pa Turnpike Comm - Toll Revenue	5,173,393,000	Revenue from tolls - senior and subordinated	Aa3/A+/A+ A3/A-/NR
Pa Turnpike Comm - Oil Company Franchise Tax	814,558,000	Tax on fuel at wholesale level - senior and subordinated	Aa3/AA/NR A2/A+/NR
Pa Turnpike Comm - Reg Fee	442,020,000	Fixed allocation of MV registration fees	Aa3/A/AA
Pa Turnpike Comm - Motor License Fund	293,115,584	Third lien on toll revenue plus support from retail fuel tax and registration fees	Aa3/NR/AA
Pa Housing Finance Agcy - Single Family Hsg	4,590,193,000	Mortgage loans and HFA GO	Aa2/AA+/NR
Pa Housing Fin Agcy - Multi Family Hsg	223,193,000	Various projects to finance low and moderate income rental housing	Various
Commonwealth Financing Auth (CFA)	1,313,455,000	Programs to stimulate economic activity, alternative energy and clean water subject to legislative appropriations	Aa3/AA-/AA
Pennsylvania Industrial Development Auth (PIDA)	363,395,000	Revolving pool which makes loans to companies to stimulate industrial development in state	A1/A-/A+
Philadelphia Regional Port Auth	39,220,000	Lease payments from state subject to legislative appropriation	Aa2/AA-/NR
Pennsylvania Infrastructure Investment Auth	23,120,000	Pennvest - pooled loan program to finance low interest loans to communities to improve water and sewer systems	Aaa/AAA/AAA
Pennsylvania Higher Ed Assist Agcy	9,751,917,000	Student loan financing. Most debt is variable or auction rate.	Various
Conduit Issuers			
Pennsylvania Public School Building Auth	2,354,242,025	Conduit issuer for school districts and community colleges	Various
Pennsylvania Higher Education Facilities Auth	6,100,000,000	Conduit issuer for colleges and universities	Various
Pennsylvania Econ Dev Fin Auth	1,858,000,000	Conduit issuer for financing of industrial, commercial and other projects	Various

Outstanding bond amounts are as of 6-30-10 except most turnpike which are 5-31-10. Turnpike Motor License Enhanced bond amounts are as of 3-31-11. Certain issues and maturities may be insured.

Source: PA CAFR and other financials, Moody's, S&P, Fitch and Janney FIS

COMMONWEALTH FINANCING AUTHORITY (CFA)

- The ratings are Aa3/AA-/AA.
- CFA finances loans, guarantees and grants to both public and private sector entities across the state. Specific programs include Business in Our Sites, which provides financing of site preparation for future development, H2O PA, which provides grants for water, sewer and related projects as well as funds to support alternative energy projects.
- Bonds are secured by payments under a service agreement with the PA Department of Community and Economic Development. These payments are subject to annual legislative appropriation.
- Although ratings are based on the state's creditworthiness, the state does not have a legal obligation to appropriate funds, so ratings are one (S&P, Fitch) or two (Moody's) notches below state's GO rating.

Debt service of Commonwealth Financing Authority issues is secured by a service agreement with PA Department of Community Affairs, subject to legislative appropriation.

PA Turnpike bonds are secured by a variety of revenue sources, with toll revenue and oil franchise tax bonds having senior and subordinate lien structures.

PENNSYLVANIA TURNPIKE COMMISSION (PTC)

- Turnpike Revenue bonds are secured by toll revenues from the 500 mile highway system, with senior (Aa3/A+/A+) and subordinate (A3/A-/NR) structures. The debt service coverage (DSC) estimates for 2011 are 2.9x and 1.6x respectively (S&P). Moody's has a negative outlook on its A3 rating of the subs.
- Oil Franchise Tax secured senior (Aa3/A+/A+) and subordinate (A2/A+/NR) bonds are supported by revenues from taxes levied on gasoline and diesel fuel at the wholesale level. DSC for 2010 is 2.1x for seniors and 1.15x for subs (S&P).
- Registration Fee bonds (Aa3/A+/A+) are secured by an allocation from total motor vehicle registration fees. PTC receives the first \$2.33 million collected each month (\$28 million annually) of the approximately \$200 million collected each year. This amount is equal to the annual debt service requirement.
- Motor License Fund Enhanced bonds (Aa3/NR/AA) are secured by a third lien on toll revenues, but if this revenue stream is insufficient they are further supported by the state's Motor License Fund, into which flows fuel consumption taxes and car and truck registration fees.
- PTC is a primary and essential east-west traffic route connecting the NJ and Ohio turnpikes. The turnpike's northeast extension, a north-south road in the eastern part of the state, ends at I-81, about 45 miles from New York border.
- Toll rates increased by about 5% Jan 2011 with continued annual increases anticipated. Future increases could lower traffic. I-80, which runs across the state about 75 miles north of the turnpike, is toll free.
- Most revenue sources supporting the various turnpike bonds including tolls and fuel taxes, are susceptible to volatility during economic downturns or from elevated energy prices.

PENNSYLVANIA HOUSING FINANCE AGENCY (PHFA) – SINGLE FAMILY MORTGAGE PROGRAM

- The ratings are Aa2/AA+/NR.
- PA HFA makes mortgage loans, primarily to first time homebuyers. There are 48,314 loans outstanding (6-30-10), totaling \$3.6 billion.
- Most mortgages are insured or guaranteed by FHA, VA or Rural Development (former Farmers Home Adm).
- Proceeds of mortgage prepayments may be used to redeem outstanding issues, with focus usually on highest coupon maturities.

The state's single family housing program is one of strongest in the nation.

Most Loans in PA HFA Portfolio are Guaranteed or Insured by a Federal Agency

Mortgage Insurance (6-30-10)	Number of Loans	Amt. Out. (\$1,000)
FHA, VA, Rural Hsg (US Agencies)	28,456	2,168,814
Private Mortgage Ins	9,083	711,339
No insurance (LTV<80%)	8,275	552,086
HFA Risk Retention Program	2,500	199,264
Totals	48,314	3,631,503

Source: PA HFA Financials, Official Statements and Janney FIS

The asset liability ratio for PIDA's revolving loan program is 1.7x.

PENNSYLVANIA INDUSTRIAL DEVELOPMENT AUTHORITY (PIDA)

- Ratings are A1/A-/A+.
- PIDA is structured as a revolving fund, making low interest loans (3.28% average FY 2010) to businesses, targeting areas of high unemployment. As loans are paid, monies are re-deployed as new loans.
- Net assets are \$257 million (6-30-10). \$438 million of loans and \$201 million of mainly short term investments compare favorably to bonds outstanding of \$376 million for an asset/liability ratio of 1.7x.
- PIDA's portfolio includes 853 individual loans with delinquency rate equal to 3.98% of loan balances.
- The state has appropriated seed money over the years since inception (\$617 million) but has also transferred excess monies from PIDA to the state (\$661 million).
- Under bond indenture PIDA can't make new loans unless DSC is 1.5x and can't transfer funds to state unless DSC is 2.0x

CONDUIT ISSUERS

- Pennsylvania Higher Education Facilities Authority (PHEFA) – issues debt on behalf of colleges and universities in Pennsylvania. Although the state provides some funding for public universities which issue through PHEFA, each school issues under its individual credit rating. The state does not guarantee or provide direct support for these issues.
- Pennsylvania State Public School Building Authority (PSPSBA) – issues debt on behalf of K-12 schools, community colleges and similar borrowers. The state does not guarantee or provide direct support to these bond issues, but most are covered under the state's school aid intercept program (see below).

Pennsylvania's school aid intercept program adds a layer of bondholder security.

SCHOOL AID INTERCEPT PROGRAM

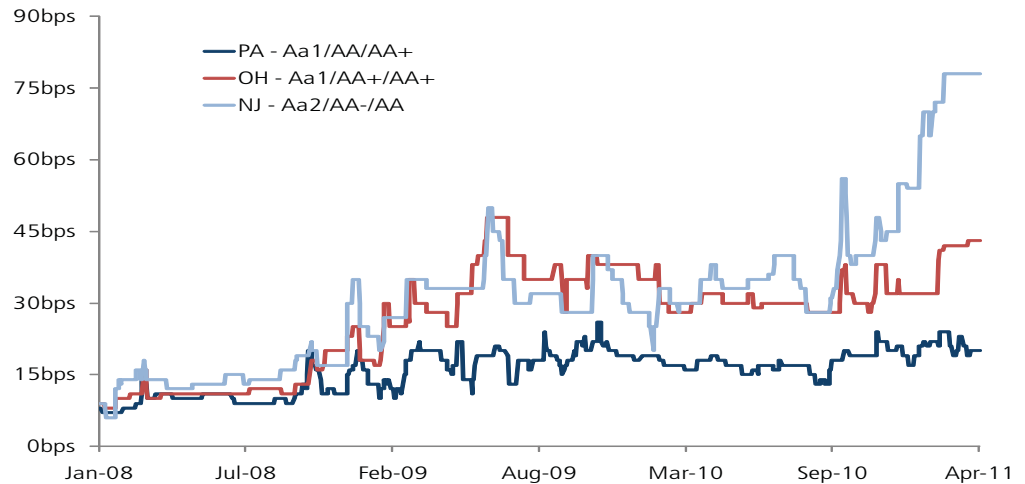
- Like many states, Pennsylvania supports school district and community college borrowing with a program to enhance bondholder security, which enables many districts to save on interest expense.
- Under provisions of Act 150, the Secretary of Education automatically withholds state aid from a school district or community college that fails to make a debt service payment. These funds are then transferred to the bond trustee.
- Most schools are covered under a post default program which generates an Aa3/A/NR rating.
- Four school districts, including Philadelphia, are covered under an enhanced, pre-default program which generates ratings of Aa2/A+/AA.

PENNSYLVANIA GENERAL OBLIGATION TRADING LEVELS

The graph on following page compares the spreads of Pennsylvania, Ohio and New Jersey, all rated in the AA range. Spread is the basis point differential between the yield of a given security and a benchmark AAA yield, in this case for ten year maturities. Pennsylvania spreads have been consistently narrower than spreads of comparable states. All three states have seen spreads widen over the past several years, but Pennsylvania spreads have shown more stability.

Pennsylvania bonds have traded closer to AAA benchmark levels than the bonds of two neighboring states.

Ten Year Maturity PA and Comparable State Yield Spreads



Source: Thomson MMD, Janney FIS

CONCLUSION

Pennsylvania, like many states, is challenged by budget deficits in the aftermath of the Great Recession. The state's negative fund balance needs to be addressed. Relatively low levels of liabilities, including adequately funded pension obligations, give the state more financial flexibility than many. The governor's proposed budget for FY 2012 shows a willingness to cut expenditures, but the legislature needs to weigh in, and all is subject to change. Although there is no tax proposal in the governor's plan, expected drilling and extraction of natural gas from the Marcellus Shale offers a potential future revenue source if needed. Sale of the state's liquor store system is also under consideration.

ANALYST CERTIFICATION

I, Alan Schankel, the Primarily Responsible Analyst for this report, hereby certify that all of the views expressed in this report accurately reflect my personal views about any and all of the subject sectors, industries, securities, and issuers. No part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

Disclaimer

This Firm, its officers, directors, employees, or members of their families may have positions in the securities mentioned and may make purchases or sales of such securities from time to time in the open market or otherwise and may sell to or buy from customers such securities on a principal basis.

Janney managed or co-managed public offerings of securities for Pennsylvania Turnpike Commission and Pennsylvania Housing Finance Agency in the past twelve months and may seek compensation for investment banking services for issuers mentioned in this report in the next three months.

Unless otherwise noted, market data is from Bloomberg, Barclays, and Janney Fixed Income Strategy & Research (Janney FIS). This report is the intellectual property of Janney Montgomery Scott LLC (Janney) and may not be reproduced, distributed, or published by any person for any purpose without Janney's express prior written consent. This report has been prepared by Janney and is to be used for informational purposes only. In no event should it be construed as a solicitation or offer to purchase or sell a security. The information presented herein is taken from sources believed to be reliable, but is not guaranteed by Janney as to accuracy or completeness. Any issue named or rates mentioned are used for illustrative purposes only, and may not represent the specific features or securities available at a given time. Preliminary Official Statements, Final Official Statements, or Prospectuses for any new issues mentioned herein are available upon request. The value of and income from investments may vary because of changes in interest rates, foreign exchange rates, securities prices, market indexes, as well as operational or financial conditions of issuers or other factors. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized. We have no obligation to tell you when opinions or information contained in Janney FIS publications change. Janney Fixed Income Strategy does not provide individually tailored investment advice and this document has been prepared without regard to the circumstances and objectives of those who receive it. The appropriateness of an investment or strategy will depend on an investor's circumstances and objectives. For investment advice specific to your individual situation, or for additional information on this or other topics, please contact your Janney Financial Advisor and/or your tax or legal advisor.