

REQUEST FOR COMMENT

US States and Territories: Proposed Methodology Update

Table of Contents:

SUMMARY	1
IMPACT ON RATINGS	3
HOW TO SUBMIT COMMENTS	3
PROPOSED METHODOLOGY	4
MOODY'S RELATED PUBLICATIONS	52

Analyst Contacts:

NEW YORK +1.212.553.1653

Matthew Butler +1.212.553.7108
Vice President-Senior Credit Officer
matthew.butler@moodys.com

Emily Raimes +1.212.553.7203
Vice President-Senior Credit Officer/Manager
emily.raimes@moodys.com

» contacts continued on the (second to) last page

CLIENT SERVICES:

Americas: +1.212.553.1653
Asia Pacific: +852.3551.3077
Japan: +81.3.5408.4100
EMEA: +44.20.7772.5454

Summary

In this Request for Comment, we propose a number of changes to the [US States and Territories](#) methodology published in April 2018.

The key proposals to the current methodology involve revisions to scorecard sub-factors, a proposal to assign issuer ratings to US states and territories that reflect their fundamental credit quality, and a change in our analytical approach to rating certain long-term debt instruments associated with states and territories. The proposed change in approach would enable a more comprehensive assessment under a single methodology of certain types of securities that are anchored around a US state's or territory's issuer rating.

The key proposed revisions are as follows:

- » **Increase the weight of the Economy factor and revise the sub-factor metrics:** Under our proposal, we would increase the weight of the Economy factor to 30% from 25% to reflect its importance to the credit strength of states and territories. In addition, we would use per capita income (PCI) adjusted for regional differences in the cost of living, which provides a more comparable view of income differences among states and territories and their ability to pay debt than our existing use of non-adjusted PCI relative to US PCI. Also under our proposal, we would use the difference between a state's or territory's five-year compound annual growth rate (CAGR) in real gross domestic product (GDP) and the five-year CAGR of US real GDP. We consider this metric to be a more descriptive measure of a state's or territory's relative economic strength than our current approach of using nominal GDP.
- » **Decrease the weight of the Finances factor, rename it Financial Performance and revise the sub-factor metrics:** Under our proposal, the fixed costs ratio sub-factor would move into the Leverage factor and the resulting Financial Performance factor weight would decrease to 20% from 30%. In addition, we would provide a more detailed description of how we assess fund balance, liquidity and structural balance qualitatively under the Financial Performance factor.
- » **Provide more comprehensive information in our qualitative assessment of a state's or territory's institutional strength:** Under our proposal, the Governance/Constitutional Framework factor would be renamed Institutional Framework/Governance, and we would provide more detail on how we assess financial planning and policies, and revenue and expenditure flexibility.

- » **Increase the weight of the factor for leverage and change the factor name to Leverage from Debt and Pensions:** The proposed weight change reflects the shift of the 10% fixed costs ratio sub-factor from Finances and a 5% reduction in the weight of the long-term debt and pensions liability ratio. Also, we would use a more comprehensive view of leverage, which includes debt, pensions, other post-employment benefits and other liabilities reported on state and territory balance sheets. In addition, we would compare a state's or territory's liabilities to its revenue, which provides a more direct assessment of current leverage affordability than our existing approach of comparing liabilities to state or territory GDP. As part of the proposal to shift the fixed costs ratio sub-factor, we also would adjust the calculation of fixed costs for a more standardized view of non-discretionary spending than in our current approach. Our proposal would foster greater comparability of annual debt and liability carrying costs across issuers.
- » **Reduce the number of notching factors to one from six, retaining one notching factor for very limited and concentrated economies:** The current notching factor, Economic or Revenue Concentration or Volatility, would be broadened and renamed Very Limited or Concentrated Economy, and it would have a downward adjustment of up to two notches. Under the notching factor, we would assess states and territories that are highly exposed to budgetary volatility resulting from economic shocks. We propose to incorporate the analytic considerations in the current methodology's remaining notching factors into the proposed scorecard factors and as Other Considerations.
- » **Assign issuer ratings to US states and territories that reflect their fundamental credit quality:** Under our proposed approach, we would assign issuer ratings to US states and territories based on their ability to repay debt and debt-like obligations without consideration of any specific pledge, security or structural features. The proposed approach is supported by our observations that in US municipal defaults, the primary driver of credit distress is general operational and financial weakness rather than weakness of a particular security pledge. Our current approach contemplates a full faith and credit obligation of the borrower. Our proposed approach contemplates credit strength without consideration of any pledge.
- » **Introduce guidance for assigning instrument ratings relative to a US state's or territory's issuer rating:** The proposed guidance would apply in the assignment of certain instrument-level ratings in relation to the state's or territory's issuer rating. Where applicable, we would assign individual debt-instrument ratings at the same level, or higher or lower than the issuer rating, to reflect our assessment of differences in expected loss related to an instrument's priority of claim as well as the specific pledge included in the instrument's terms. The proposal would update our guidance for assigning ratings to general obligation (GO) debt of US states and territories.
- » **Rate certain securities issued by US states and territories under this methodology:** Securities issued by US states and territories that are currently rated under the *Lease, Appropriation, Moral Obligation and Comparable Debt of US State and Local Governments Methodology* would be rated under this methodology.¹ These securities include non-contingent pledges, such as general promises to pay, and contingent obligations, including appropriation and abatement leases, non-lease appropriation obligations and moral obligations. We would continue to rate state and territory special tax debt under the existing *US Public Finance Special Tax Methodology*.²
- » **Move the "US State Lottery Prize Receivables" appendix into this methodology:** We propose to make the "US State Lottery Prize Receivables" section an appendix to this methodology and remove the appendix from the *Lease, Appropriation, Moral Obligation and Comparable Debt of US State and Local Governments Methodology*. The analytic guidance in the appendix would reference the state issuer rating instead of its GO rating. A state's or territory's issuer rating would be the starting point for the lottery prize receivable analysis. We propose no further changes to the lottery prize receivables appendix.

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.

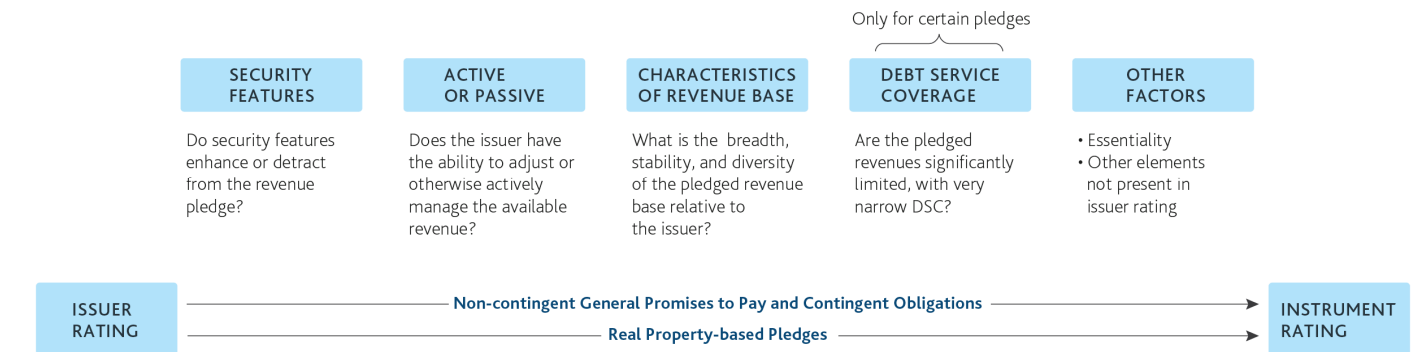
¹ A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

² A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

The exhibit below illustrates how instrument-level ratings would be assigned relative to the issuer rating.

EXHIBIT 1

General Approach for Assigning Instrument Ratings



Note: DSC stands for debt service coverage.

Source: Moody's Investors Service

We also propose to make some editorial changes to enhance readability.

Impact on Ratings

If this methodology is updated as proposed, we expect that no outstanding general obligation and issuer ratings for US states and territories will change. We also expect that some instrument ratings will change, for fewer than 10 of the issuers in the sector. These instruments represent fewer than 2% of the total instruments that would be rated under the proposed methodology. Almost 90% of the rating changes would be upgrades and the remainder would be downgrades. The vast majority of rating changes would be by one notch.

This expected rating impact only reflects the methodological changes noted above and does not incorporate potential impact from other factors, including prevailing market conditions or factors specific to a particular issuer or transaction, such as financial metrics or qualitative considerations, that may be relevant to the rating analysis.

How to Submit Comments

In this Request for Comment, we are seeking feedback on our proposed revisions to the methodology titled *US States and Territories*. The text of the proposed methodology follows. Prior to publication of the methodology, we may also consider other changes to the methodology as a result of the consultation process and our internal review.

We invite market participants to comment on the Request for Comment by January 10, 2022, no later than 11:59 p.m. US Eastern time, by submitting comments on the Request for Comment page at www.moodys.com. Upon appropriate consideration of received comments, we will adopt and publish the *US States and Territories Methodology*.

Proposed Methodology

US States and Territories Methodology

Introduction

In this rating methodology, we explain our general approach to assessing credit risk of US states and US territories.

We discuss the scorecard used for this sector. The scorecard³ is a relatively simple reference tool that can be used in most cases to approximate credit profiles in this sector and to explain, in summary form, many of the factors that are generally most important in assigning issuer-level ratings to issuers in this sector. The scorecard factors may be evaluated using historical or forward-looking data or both.

We also discuss other considerations, which are factors that are assessed outside the scorecard, usually because the factor's credit importance varies widely among the issuers in the sector or because the factor may be important only under certain circumstances or for a subset of issuers. In addition, some of the methodological considerations described in one or more cross-sector rating methodologies may be relevant to ratings in this sector.⁴ Furthermore, since ratings are forward-looking, we often incorporate directional views of risks and mitigants in a qualitative way.

As a result, the scorecard-indicated outcome is not expected to match the actual rating for each issuer.

Our presentation of this rating methodology proceeds with (i) the scope of this methodology; (ii) a sector overview; (iii) the scorecard framework; (iv) a discussion of the scorecard factors; (v) other considerations not reflected in the scorecard; (vi) the assignment of issuer-level and instrument-level ratings; (vii) methodology assumptions; and (viii) limitations. In Appendix A, we describe how we use the scorecard to arrive at a scorecard-indicated outcome. Appendix B shows the full view of the scorecard factors, sub-factors, weights and thresholds. Appendix C describes our approach for assigning instrument ratings for US states and territories. Appendix D describes our approach for assigning ratings to US State Lottery Prize Receivables.

³ In our methodologies and research, the terms "scorecard" and "grid" are used interchangeably.

⁴ A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

Scope of This Methodology

This methodology applies to US states and territories, including debt issuances that are backed by a state's or territory's general obligation pledge, general promise to pay, and lease, appropriation, moral obligation and comparable debt obligations.

US state or territory short-term debt is rated under a separate methodology. Also rated under separate methodologies are state aid intercept programs and special tax debt. States and territories outside of the US are rated under a separate methodology for regional and local governments.⁵

Sector Overview

US states are sovereign entities, each with its own government and constitution, that delegate certain powers to the US government under the US Constitution. US territories are administrative units that may have their own governments and constitutions, but are fully under the jurisdiction of the US government. US territories also lack voting representation in the US Congress.

States⁶ have tended to exhibit high credit quality, reflecting broad powers to control their financial positions and service their debt. Territories have tended to be rated significantly lower than states, reflecting their typically narrower powers, smaller and less diversified economies and weaker financial management.

States and territories derive revenue from sources including personal income taxes, corporate income taxes, sales and other special taxes, user fees, federal aid, federal grants and property taxes. The mix of revenue varies by state and territory. States' sovereign powers allow them to raise or lower tax rates and to implement new taxes and fees, but they have limited discretion over the amount of federal revenue they receive. States have significant discretion over much of their budgetary spending. States also have the ability to push certain responsibilities and their associated costs down to lower levels of government.

US territories have been granted relatively broad taxing powers by Congress and benefit from an exemption from most forms of federal taxation. But their ability to raise revenue is often constrained by the small size and volatility of their economies. Some territories are responsible for the services provided by both states and local governments, so they lack the ability to control expenditures by pushing responsibilities down to lower levels of government.

⁵ A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

⁶ In this section and those that follow, where we refer to states, we mean US states, and where we refer to territories, we mean US territories.

Scorecard Framework

The scorecard in this rating methodology is composed of four factors. Some of the four factors comprise a number of sub-factors. The scorecard also includes one notching factor, which may result in a downward adjustment of half-notch or whole-notch increments to the preliminary outcome.

EXHIBIT 2

US States and Territories Scorecard Overview

Factor	Factor Weighting	Sub-factor	Sub-factor Weighting
Economy	30%	Resident Income (RPP-Adjusted Per Capita Income / US Per Capita Income)	15%
		Economic Growth (Difference Between Five-Year Compound Annual Growth in Real GDP and Five-Year CAGR in Real US GDP)	15%
Financial Performance	20%	--*	20%
Institutional Framework / Governance	20%	--*	20%
Leverage	30%	Long-term Liabilities Ratio (Debt + ANPL + Adjusted Net OPEB + Other Long-term Liabilities) / Own-Source Revenue)	20%
		Fixed-Costs Ratio (Adjusted Fixed Costs / Own-Source Revenue)	10%
Total	100%		100%
Preliminary Outcome			
Notching Factor			Notching Range
Very Limited or Concentrated Economy			-2 to 0
Scorecard-Indicated Outcome			

*This factor has no sub-factors.

Source: Moody's Investors Service

Please see Appendix A for general information about how we use the scorecard and for a discussion of scorecard mechanics. The scorecard does not include or address every factor that a rating committee may consider in assigning ratings in this sector. Please see the "Other Considerations" and "Limitations" sections.

Discussion of the Scorecard Factors

In this section, we explain our general approach for scoring each scorecard factor or sub-factor, and we describe why they are meaningful as credit indicators.

Factor: Economy (30% Weight)

Why It Matters

A state's or territory's economy is critical to its ability to generate tax revenue, which supports the government's budgetary goals and allows it to pay its debt, pension and other obligations. Taxes on retail sales and income are a primary source of states' revenue, and higher per capita income, in addition to indicating residents' ability to pay taxes, is closely associated with economic strength. The growth rate of

the state's economy is also an important indicator of economic strength. Robust and growing economies are capable of producing more tax revenue than small, poor or concentrated ones, and a growing economy makes it easier for a state to keep taxes affordable.

This factor comprises two quantitative sub-factors:

Resident Income: Per Capita Income (PCI) Adjusted for Regional Price Parity (RPP) / US PCI

The resident income levels in a state or territory relative to those in the US provide important indications of a state's or territory's ability to raise own-source revenue.⁷ Income is a proxy for the revenue-generating potential of a state's economy, because states whose taxpayers have higher income are generally able to generate more tax revenue than states with lower-income taxpayers.

Using PCI adjusted for regional price parity (RPP) provides for greater comparability across the US, because RPP adjusts for regional differences in the cost of living. Where two states have the same PCI and state-level tax rates but one state has a higher cost of living, tax revenue represents a higher percentage of disposable income in that state.

Where PCI data is unavailable, which is typically the case with territories, nominal gross domestic product (GDP) per capita is another useful proxy for the revenue-generating potential of the economy. We then compare a territory's per capita GDP to that of the US for the same time period.

Economic Growth: Difference Between Five-Year Compound Annual Growth Rate (CAGR) in Real Gross Domestic Product (GDP) and Five-Year CAGR in US Real GDP

Economic growth is an important indicator of a state's or territory's ability to continue generating the revenue necessary for the programs and services it provides, because states where the economy shows solid growth are more likely to attract additional residents and businesses who will pay taxes. In general, a state or territory with a more productive tax base over a multi-year period is better able to generate adequate own-source revenue on an ongoing basis. States and territories with robust, sustained GDP growth are typically better able to meet or exceed budgetary goals, manage their debt burdens and build reserves against economic shocks. Comparing a state's or territory's GDP growth to US GDP growth provides an important indication into state or territory economic strength above or below national economic fluctuations.

How We Assess It for the Scorecard

Scoring for this factor is based on two quantitative sub-factors: Resident Income - PCI Adjusted for RPP / US PCI; and Economic Growth - Five-Year Change in Real GDP Compared to Five-Year Change in US Real GDP

RESIDENT INCOME - PCI ADJUSTED FOR RPP / US PCI:

For states, the numerator is the PCI, adjusted for the RPP of the state, and the denominator is US PCI. For territories where PCI data is unavailable, the numerator is GDP per capita, which is typically reported by the World Bank, and the denominator is US GDP per capita.

ECONOMIC GROWTH – DIFFERENCE BETWEEN FIVE-YEAR CAGR IN REAL GDP AND FIVE-YEAR CAGR IN US REAL GDP:

For states and territories, we use the difference between the five-year CAGR in real GDP and the five-year CAGR of US real GDP.

⁷ Own-source revenue is the total revenue, typically reported in the governmental funds section of the audited financial statements, minus revenue received from the federal government. Federal funding may include revenue under different categories, such as earmarked grants, annual disbursements and one-time payments.

FACTOR

Economy (30%)

Sub-Factor	Sub-Factor Weight	Aaa	Aa	A	Baa	Ba	B	Caa	Ca
Resident Income (RPP-Adjusted Per Capita Income / US Per Capita Income) ^{*1}	15%	≥ 100%	85 - 100%	70 - 85%	60 - 70%	50 - 60%	40 - 50%	30 - 40%	< 30%
Economic Growth (Difference Between Five-Year Compound Annual Growth in Real GDP and Five-Year CAGR in Real US GDP) ^{*2}	15%	≥ 0%	(1) - 0%	(2) - (1)%	(3) - (2)%	(4) - (3)%	(5) - (4)%	(6) - (5)%	< (6)%

*1 For the linear scoring scale described in Appendix A, the Aaa endpoint value is 120%. A value of 120% or better equates to a numeric score of 0.5. The Ca endpoint value is 20%. A value of 20% or worse equates to a numeric score of 24.5.

*2 For the linear scoring scale, the Aaa endpoint value is 2%. A value of 2% or better equates to a numeric score of 0.5. The Ca endpoint value is (7)%. A value of (7)% or worse equates to a numeric score of 24.5.

Source: Moody's Investors Service

Factor: Financial Performance (20% Weight)**Why It Matters**

The strength of a state's or territory's financial performance is important because fund balances and liquid reserves represent the resources available to fund the budget in the event of unforeseen contingencies such as revenue shortfalls and spending overruns. A state's or territory's finances also provide a base from which to balance current budgetary priorities and future obligations. States or territories that fail to maintain structurally balanced budgets over a prolonged period risk accumulating unaffordable liabilities, depleting their liquid reserves or encountering a budget emergency, forcing them to prioritize some outlays over others.

Fund balance provides an important indication of whether a state or territory has a financial cushion against unexpected events. The fund balance typically includes cash as well as receivables, payables and other current assets and liabilities that are likely to become cash inflows or outflows in the short term. Comparing fund balance to own-source revenue, provides insights into the strength of resources relative to the scale of the state's or territory's recurring revenue.

Liquidity is important to help states or territories bridge temporary budgetary imbalances. Larger liquid reserves provide states and territories more time to manage their cash flows and address deficits, which are at greater risk of becoming long-term liabilities if they coincide with low liquidity.

Liquidity provides an important perspective in conjunction with a state's or territory's fund balance. While these indicators are related, they may diverge because the fund balance reflects accruals that are not incorporated into liquidity. For example, a large receivable for a federal grant could lead to a high fund balance, but the state or territory could have limited liquidity because the state has not yet received the grant; in such cases, its liquidity may provide a better indicator of immediate financial flexibility than the fund balance. Alternatively, a state or territory could have strong liquidity because it has deferred certain expenditures into the next fiscal year. In this case, the lower fund balance, which reflects the associated payable, provides a more accurate picture of finances because the expenditure will eventually reduce liquidity.

Structural balance is an important indicator of the ongoing relationship between funding inflows and outflows. A lack of balance entails a greater risk that deficits will be converted into long-term liabilities and will make a return to a budgetary balance more difficult. State and territory inflows are comprised mostly of taxes and federal aid and are driven by tax policy, the economy and the federal government's funding for Medicaid (the program that provides health care for low-income residents) and transportation

infrastructure. State and territory outflows largely consist of outlays for health care, public education, prisons, highways, debt service and pension contributions.

States and territories have substantial discretion over their inflows and outflows. Those that remain in structural balance either match inflows to outflows or manage their budgets to keep revenue higher than expenditures. Governments generally have the authority to set policy and enact new taxes, increase tax rates in order to raise revenue, or to cut tax rates. The size of a state's or territory's budget is essentially a policy decision, and cutting spending on programs such as aid to localities, Medicaid recipients or public schools can be politically difficult. Nonetheless, some states and territories may spend more than they collect in revenue through practices such as depleting liquid reserves or converting deficits into long-term liabilities by underfunding pensions, deferring payments to vendors or underinvesting in infrastructure. These practices represent a structural imbalance and can pose long-term risks to a state's or territory's credit profile.

How We Assess It for the Scorecard

In our qualitative assessment of this factor, we consider the overall robustness of a state's or territory's fund balance, liquidity and structural balance.

As part of our assessment, we compare fund balance to the state's or territory's own-source revenue. In this comparison, we consider the sum of all amounts in funds that are classified as unassigned, assigned or committed in the total governmental funds section of a state's or territory's audited financial statements. We exclude any fund balance that is categorized as non-spendable in the total governmental funds section, and exclude amounts in restricted funds in that section except in certain circumstances. For example, if the financial statements identify the restricted fund balance as being restricted for budget stabilization or budget reserves, we consider that amount part of available fund balance. We also include in fund balance the net current assets of the internal services fund, from which a state or territory typically accounts for services provided to various departments on a cost-reimbursement basis. These net current assets are unrestricted current assets in the internal services fund minus current liabilities, excluding the current portion of long-term debt from current liabilities.

In assessing financial performance, we consider the proportion of revenue states and territories derive from economically sensitive sources, such as taxes on oil production or gaming, which tend to be more volatile than taxes on retail sales or personal income. Where such economically sensitive revenue comprises a principal source of total state or territory revenue, we typically consider that a higher fund balance or liquidity level than described in the scorecard is necessary to achieve a given score for this factor. In addition, our assessment is typically informed by the state's or territory's past fund balance amounts and by our view of likely fund balance levels in the future, based on the fiscal climate, economic trends and the track record of financial management.

We make an overall qualitative assessment of the strength of a state's or territory's liquidity. We assess unrestricted cash in the total governmental funds section of a state's or territory's financial statements. Considerations typically include an analysis of sources and uses of cash, the breadth and depth of a state's or territory's market access, and the ability of a state or territory to meet its near-term obligations in a scenario of a temporary inability to access capital markets due, for example, to market dislocation. Our assessment is typically also informed by a comparison of the amount of unrestricted cash in total governmental funds and unrestricted cash from the internal services fund to own-source revenue. We exclude from unrestricted cash any short-term debt in those funds that we consider to be debt issued for operations and maturing within one year, such as cash flow notes or tax anticipation notes.

Our assessment of structural balance is qualitative and forward-looking and is informed by the state's or territory's track record of matching revenue to expenditures. We consider the size of any imbalance in the

budget, and how quickly a state or territory is likely to attain balance. Our assessment typically centers on a state's or territory's recurring revenue and recurring expenditures, and the levels that would be necessary to maintain structural balance in the current year and over the longer term. In assessing structural balance, we also consider the difference between a state's actual pension contribution and the amount necessary to prevent reported unfunded pension liabilities from growing if all actuarial assumptions are met.⁸

Generally, we do not expect a given state's or territory's qualitative factor score to match exactly each of the attributes listed for a given scoring category. For example, a state or territory with consistent structural balance may temporarily have a lower ratio of fund balance to own-source revenue. As another example, a state or territory may currently demonstrate strong liquidity that we think would be eroded over time due to a persistent weaknesses in its structural balance. We typically assign the factor score to the alpha category for which the state or territory has the greatest number of characteristics. However, there may be cases where one characteristic is sufficiently important to the state's or territory's credit profile that it has a large influence on the factor score.

⁸ For more information, see our cross-sector methodology that describes our adjustments to pension and OPEB data reported by GASB issuers. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

FACTOR
Financial Performance (20%)

Factor	Factor Weight	Aaa	Aa	A	Baa	Ba	B	Caa	Ca
Financial Performance	20%	Fund balance approximates or exceeds 15% of own-source revenue and liquidity is very strong; revenue and expenditures are expected to remain in structural balance.	Fund balance approximates or exceeds 10% of own-source revenue and liquidity is strong, or fund balance is below 10% of own-source revenue and liquidity is very strong; revenue and expenditures face a modest structural imbalance, with an expected return to balance.	Fund balance approximates or exceeds 5% of own-source revenue and liquidity is adequate, or fund balance is below 5% of own-source revenue and liquidity is strong; revenue and expenditures face a noteworthy structural imbalance, with an expected return to balance.	Fund balance approximates or exceeds 0% of own-source revenue and liquidity is somewhat weak, or fund balance is below 0% of own-source revenue and liquidity is adequate; revenue and expenditures face a significant structural imbalance, with a potential return to balance.	Fund balance is between 0% and minus 5% of own-source revenue and liquidity is weak, or fund balance is below minus 5% of own-source revenue and liquidity is somewhat weak; revenue and expenditures face significant structural imbalance, with a limited path toward balance.	Fund balance is between minus 5% and minus 10% of own-source revenue and liquidity is very weak, or fund balance is below minus 10% of own-source revenue and liquidity is weak; revenue and expenditures face significant structural imbalance that undermines the delivery of core government services.	Heightened likelihood of default due to fund balance that is below minus 10% of own-source revenue, extremely weak liquidity or overwhelming structural imbalance of revenue and expenditures.	Heightened likelihood of default with significant impairment to creditors due to fund balance that is below minus 10% of own-source revenue, extremely weak liquidity or overwhelming structural imbalance of revenue and expenditures.

Source: Moody's Investors Service

Factor: Institutional Framework/Governance (20% Weight)

Why It Matters

The institutional framework governing a state or territory provides important indications of whether it will balance its budget, take on liabilities that are affordable and maintain adequate liquidity. A state's or territory's constitutional and legal framework, under which the government creates a budget and manages its finances, influences its ability to provide services to citizens and pay debt obligations.

Core aspects of a state's or territory's institutional framework and governance are its fiscal track record and planning, and financial flexibility, including operational management, budget monitoring, debt management, and the ability to generate revenue and control expenditures.

A state's or territory's track record of adhering to stated fiscal policies, plans and commitments provides insight into its elected officials' and appointed executives' likely future performance, including in stressed situations. A state's or territory's operational management, financial projections, long-term planning and close monitoring of inflows and outflows of funds are key to better fiscal performance over the long term.

A state's or territory's ability to manage its budget is also typically associated with stable or decreasing debt levels relative to its economy. Lower debt levels over time typically allow greater flexibility for a state or territory to withstand economic shocks. We typically take a broad view of all of a state's or territory's obligations to assess overall debt management. These obligations may include legally non-recourse debt, which typically is not a general or full faith and credit obligation and can be issued by the state or territory directly or indirectly through an affiliated entity. Non-recourse debt instruments do not carry a promise of broader support from the state or territory, but may have implications for the broader credit standing.

States have significant flexibility over their revenue and expenditures, and almost always have the legal and political means provided by the institutional framework to maintain strong credit profiles. Past use of these means can be a strong indicator of likely future performance. Territories also have tools to balance their budgets, but they face greater credit challenges than states due to their narrower legal powers.

How We Assess It for the Scorecard

INSTITUTIONAL FRAMEWORK/GOVERNANCE:

In assessing institutional framework and governance, we consider a state's or territory's fiscal track record and planning, and financial flexibility. Our qualitative assessment of fiscal planning and operational management typically incorporates the strength of the state's or territory's multi-year fiscal projections, its established policies and practices, consensus revenue forecasts,⁹ and how conservative the budgetary assumptions are. We consider whether the state or territory regularly sets and meets annual and multi-year budget targets, the extent to which it monitors inflows and outflows within the fiscal year, and whether its operational management incorporates mid-year corrections when budgetary targets are not being met. We also consider the state's or territory's debt and liability management, including whether it has a track record of underfunding pension plans or increasing non-pension liabilities more rapidly than assets.

We also consider the state's or territory's financial flexibility, including its revenue-generating ability and expenditure flexibility. In our assessment, we consider the existing legal and constitutional framework, as well as any meaningful practical or political constraints. Our assessment of revenue-generating ability incorporates a review of restrictions such as tax limits or a super-majority legislative requirement to raise taxes. We also consider any constitutional or legal spending requirements or structural hurdles, such as

⁹ Consensus revenue forecasting involves estimates from several executive and legislative agencies.

statutory pension contribution requirements. We view other laws that enhance financial flexibility, such as rainy day fund requirements or executive authority to make midyear budget adjustments, as a positive.

We view a lack of sovereign powers or US congressional representation as a weakness that constrains financial flexibility for a territory and typically leads to an Institutional Framework/Governance factor score of no higher than Baa.

Some states and territories have the flexibility to change their legal frameworks with regard to fiscal management, in which case we consider the magnitude and type of change, and how it affects the strength of the institutional framework and governance.

FACTOR

Institutional Framework/Governance (20%)

Factor	Factor Weight	Aaa	Aa	A	Baa	Ba	B	Caa	Ca
Institutional Framework/Governance	20%	Extremely strong fiscal planning and operational management, with financial projections that are typically conservative; and consistent long-term planning and in-year monitoring; and extremely conservative debt and liability management; strong revenue-generating flexibility and strong expenditure flexibility.	Strong fiscal planning and operational management, with financial projections that are typically conservative; and consistent long-term planning and in-year monitoring; and conservative debt management; strong revenue-generating flexibility and moderate expenditure flexibility, or strong expenditure flexibility and moderate revenue-generating flexibility.	Adequate fiscal planning and operational management, with financial projections that are somewhat conservative; inconsistent long-term planning and in-year monitoring; somewhat conservative debt and liability management; moderate revenue-generating flexibility and moderate expenditure flexibility.	Moderately weak fiscal planning and operational management, with somewhat optimistic financial projections; inconsistent long-term planning and in-year monitoring; some debt and liability management weaknesses; moderate revenue-generating flexibility and weak expenditure flexibility, or moderate expenditure flexibility and weak revenue-generating flexibility.	Weak fiscal planning and operational management, with meaningfully optimistic financial projections; long-term planning or monitoring are rarely used; weak debt and liability management; or weak revenue-generating flexibility and weak expenditure flexibility.	Very weak fiscal planning and operational management, with extremely optimistic financial projections; or no long-term planning or monitoring; or very weak debt and liability management; or very weak revenue-generating flexibility and very weak expenditure flexibility.	Extremely weak fiscal planning or operational management heighten likelihood of default; or has not demonstrated ability or willingness to generate any revenue increases.	Extremely weak or essentially non-existent planning or operational management heighten likelihood of default with significant impairment for creditors; or revenue-raising ability is fundamentally constrained, with little prospect of improvement.

Source: Moody's Investors Service

Factor: Leverage (30% Weight)

Why It Matters

Leverage metrics provide important indications of a state's or territory's capacity to invest in capital assets and pay annual fixed costs, including debt service, while providing core services.

Debt, unfunded pension liabilities, unfunded other post-employment benefit (OPEB) liabilities and other long-term liabilities can curtail a state's or territory's budgetary flexibility. Large long-term liabilities can translate into large outlays to meet fixed or rising debt service and pension costs, which can crowd out other budgetary priorities and force states or territories to raise taxes or cut other spending. In addition, other types of long-term liabilities such as compensated absences and claims and judgments can also negatively affect credit strength where material. As a state's or territory's financial capacity to deliver on its core services declines, the risk rises that it will default and seek to restructure its debt.

The factor comprises two quantitative sub-factors:

Long-Term Liabilities Ratio: (Total Net Tax-Supported Debt + Adjusted Net Pension Liabilities + Adjusted Net OPEB Liabilities + Other Long-Term Liabilities) / Own-Source Revenue

The ratio of total net tax-supported debt, adjusted net pension liabilities (ANPL), adjusted net OPEB liabilities and other long-term liabilities to own-source revenue is an important indicator of leverage.

Fixed-Costs Ratio: (Adjusted Fixed Costs / Own-Source Revenue)

The ratio of fixed costs to a state's or territory's own-source revenue is an important indicator of the financial burden of a state's or territory's debt service, pension and OPEB obligations, and other long-term liabilities relative to its own-source revenue. The ratio is also a proxy for the percentage of own-source revenue that remains for core services after fixed costs are paid. A state or territory with high fixed costs faces a greater challenge adjusting expenditures with revenue than one with low fixed costs.

How We Assess It for the Scorecard

Scoring for this factor is based on two quantitative sub-factors: the Long-term Liabilities Ratio; and the Fixed-Costs Ratio.

LONG-TERM LIABILITIES RATIO - (TOTAL NET TAX-SUPPORTED DEBT + ANPL + ADJUSTED NET OPEB LIABILITY + OTHER LONG-TERM LIABILITIES) / OWN-SOURCE REVENUE:

The numerator is the sum of the state's or territory's total net tax-supported debt, adjusted net pension liability (ANPL), adjusted net OPEB liability and other long-term obligations. By incorporating these four elements into the numerator, we typically include all long-term liabilities of a state or territory reported in the governmental activities entry of the audited financial statements. The denominator is own-source revenue.

Total net tax-supported debt (NTSD) is debt secured by statewide taxes and other general resources, net of obligations that are self-supporting from pledged sources other than state taxes or resources such as utility or local government revenue. Total NTSD typically includes public-private partnership (P3 or PPP) agreements that include contractual obligations of the government to make scheduled payments. We typically incorporate debt the state or territory is supporting from its taxes or general resources even if that debt is not reported in the state's or territory's financial statements. Obligations of non-governmental activities that are fully and reliably supported by other pledged funding sources, such as revenue of higher education systems, utilities and enterprises, typically are not included in total NTSD.

For a description of how we calculate or estimate ANPL and adjusted net OPEB liabilities, please see our cross-sector methodology that describes our adjustments to pension and OPEB data reported by Governmental Accounting Standards Board (GASB) issuers.¹⁰

Other long-term liabilities are typically composed of the total amount of liabilities reported under the governmental activities entry in a state's or territory's financial statements for obligations such as claims and judgments, compensated absences and environmental remediation. We may also include long-term liabilities that are reported in other activities in other sections of the financial statement where they reflect similar obligations, such as claims and judgments and environmental remediation, in order to improve comparability across states and territories.

FIXED-COSTS RATIO - ADJUSTED FIXED COSTS / OWN-SOURCE REVENUE:

The numerator is adjusted fixed costs, which is the sum of a state's or territory's implied debt service, its pension tread water indicator, and its OPEB contributions. The denominator is own-source revenue. The three components of the numerator are described below.

Implied Debt Service

A state's or territory's implied debt service represents the annual cost to amortize its long-term liabilities, excluding those related to pensions and OPEB, over 20 years with level payments. The metric incorporates an assumed debt service cost and assumed carrying cost of other long-term liabilities. We use a 20-year amortization period to reflect the typical composite useful life of capital assets financed by states and territories, which range from assets with long expected useful lives, such as government buildings, to assets with typically short useful lives, such as technology. The 20-year amortization period also represents a general composite of the weighted average maturity of a state's or territory's long-term liabilities outstanding.

We use the government's implied debt service rather than its actual debt service as an input to the fixed-costs ratio for two key reasons. First, implied debt service provides a comparable measure of annual debt carrying costs across states and territories. Using actual debt service in the ratio could have the effect of rewarding the backloading of debt amortization — in such cases, the current year ratio would understate the state's or territory's growing fixed cost burden. Using actual debt service could also penalize more rapid debt amortization, because the current fixed-costs ratio would appear relatively weak. Second, implied debt service avoids potentially misleading volatility in actual debt service payments that can be caused by refunding (i.e., debt refinancing) activity.

As part of our implied debt service measure, we incorporate an amortized, estimated current cost to the state or territory of paying down its other long-term liabilities (e.g., compensated absences), which provides a comparable annual carrying cost of those liabilities. Carrying costs for pensions and OPEBs are excluded from our implied debt service measure.

We calculate or estimate implied debt service in several steps (see the exhibit below):

- » **Step 1:** We assign a common implied interest rate to all states and territories, approximately annually. We base the implied interest rate each year upon a 10-year rolling average of a high-grade municipal bond index, such as the Bond Buyer 20-bond GO index or a comparable index, as of the end of the prior calendar year (see line A).
- » **Step 2:** A level-dollar amortization divisor is calculated, using a 20-year period and the implied interest rate calculated in Step 1 (see line B).

¹⁰ A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

- » **Step 3:** The sum of the state's or territory's debt and other long-term liabilities outstanding at the beginning of the fiscal year (i.e., its outstanding debt at the end of the prior year) is divided by the amortization divisor calculated in Step 2. The result is the implied debt service (see lines C and D).

EXHIBIT 3

Example Calculation of Implied Debt Service

Line item	Example State Information	Value	Typical Source
A	Implied interest rate (10-year rolling average as of end of prior calendar year)	3.70%	Bond Buyer 20-bond GO or comparable index
B	Amortization divisor	13.964	$=\{1 - [1 / (1 + A)^{20}]\} / A$
C	Debt and other long-term liabilities outstanding, end of prior fiscal year	\$1,000,000	Audited financial statements
D	Implied debt service	\$71,613	$= C / B$

Source: Moody's Investors Service

Pension Tread Water Indicator

The pension tread water indicator represents our estimate of the pension contribution necessary to prevent reported unfunded pension liabilities from growing, year over year, in nominal dollars, if all actuarial assumptions are met.¹¹ The pension tread water indicator is the sum of two components: the employer portion of the service cost and the implied interest on the net pension liability at the beginning of the plan's fiscal year.

OPEB Contributions

The input to the fixed-costs ratio for OPEBs is a state's or territory's actual contribution in a given period, typically the fiscal year. In the event a state or territory issues pension or OPEB funding bonds, the deposit of the proceeds into a retirement system or trust is not considered a contribution in our analysis of fixed costs, nor in our analysis of pension contributions relative to the pension tread water indicator.

FACTOR

Leverage (30%)

Sub-factor	Sub-factor Weight	Aaa	Aa	A	Baa	Ba	B	Caa	Ca
Long-term Liabilities Ratio (Debt + ANPL + Adjusted Net OPEB + Other Long-term Liabilities) / Own-Source Revenue) ^{*1}	20%	≤ 100%	100 - 200%	200 - 350%	350 - 500%	500 - 700%	700 - 900%	900 - 1,100%	> 1,100%
Fixed-Costs Ratio (Adjusted Fixed Costs / Own-Source Revenue) ^{*2}	10%	≤ 10%	10 - 15%	15 - 20%	20 - 25%	25 - 35%	35 - 45%	45 - 55%	> 55%

*1. For the linear scoring scale described in Appendix A, the Aaa endpoint value is 0%. A value of 0% or better equates to a numeric score of 0.5. The Ca endpoint value is 1,300%. A value of 1,300% or worse equates to a numeric score of 24.5.

*2. For the linear scoring scale described in Appendix A, the Aaa endpoint value is 0%. A value of 0% or better equates to a numeric score of 0.5. The Ca endpoint value is 65%. A value of 65% or worse equates to a numeric score of 24.5.

Source: Moody's Investors Service

¹¹ For more information about our adjustments, see our cross-sector methodology that describes our adjustments to pension and OPEB data reported by GASB issuers. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

Notching Factors

The scorecard includes one notching factor. Our assessment of the notching factor may result in downward adjustments to the preliminary outcome that results from the four weighted scorecard factors. Adjustments may be made in half-notch or whole-notch increments based on the notching factors listed in the table below.

In aggregate, the notching factors can result in a total of up to two downward notches from the preliminary outcome to arrive at the scorecard-indicated outcome. In cases where we consider that the credit weakness represented by a notching factor is greater than the scorecard range, we incorporate this view into the state's or territory's rating, which may be different from the scorecard-indicated outcome.

Very Limited or Concentrated Economy

Why It Matters

A state or territory with very limited economy activity is more exposed to budgetary volatility resulting from economic shocks. In addition, large exposure to one industry (e.g., tourism) or one revenue source (e.g., oil and gas excise taxes) can result in outsize economic and budgetary volatility driven by changes in that industry or revenue source. A larger or more diverse economy benefits from greater economies of scale.

How We Assess It for the Scorecard

We consider the size of a state's or territory's GDP and the proportion of the GDP or revenue base contributed by the largest industries or sectors. This notching factor may result in a downward adjustment of up to two notches, in half-notch increments, for states or territories whose GDP is less than \$10 billion and where the state's or territory's economy demonstrates unusual concentration or volatility. We may use scenario analysis in assessing the potential credit impact on the economy from a downturn or structural change in the relevant industry.

Other Considerations

Ratings may reflect consideration of additional factors that are not in the scorecard, usually because the factor's credit importance varies widely among the issuers in the sector or because the factor may be important only under certain circumstances or for a subset of issuers. Such factors include financial controls and the quality of financial reporting; the quality and experience of management; assessments of governance as well as environmental and social considerations; and possible interference from other levels of government. Regulatory, litigation, liquidity, technology and reputational risk as well as changes in demographic and macroeconomic trends also affect ratings.

Following are some examples of additional considerations that may be reflected in our ratings and that may cause ratings to be different from scorecard-indicated outcomes.

Environmental, Social and Governance Considerations

Environmental, social and governance (ESG) considerations may affect the ratings of US states and territories. For information about our approach to assessing ESG issues, please see our methodology that describes our general principles for assessing these risks.¹²

States and territories may be directly exposed to extreme weather events due to climate change, such as floods, and this may affect credit quality. State facilities or investments in physical assets could be affected by physical risks and by other sources of environmental risk. Territories, in particular, are highly exposed to numerous environmental risks. Environmental hazards, such as hurricanes, can result in an immediate adverse impact on economic activity and result in revenue disruption, while longer-term environmental trends, such as rising sea levels, can cause more prolonged pressure on budgeting and spending priorities. Social considerations for states and territories include adverse trends in demographics, labor and income, and housing affordability. For example, where housing affordability is low, such risks can influence population and business retention, dampen property tax revenue and increase the cost of social services. They may lead to a declining tax base, diminished economic growth, higher social spending and less political influence at the federal level over time.

Some governance considerations are reflected in the qualitative Institutional Framework/Governance sub-factor, including revenue-raising flexibility, debt management, multi-year fiscal planning and timely disclosure of information. Weak or opaque governance can negatively affect a state's or territory's performance, which can reduce taxpayer willingness to support the state's or territory's revenue needs and can constrain capital market access. Conversely, very strong governance can lead to outcomes that foster economic growth or to measures that effectively mitigate certain kinds of credit-negative ESG exposures.

External support, such as federal government funds for natural disaster relief, can help to mitigate the credit impact of ESG exposures.

ESG considerations are not always negative, and they can be a source of credit strength in some instances. For example, robust demographic growth, strong labor and income indices, high educational attainment and relatively good housing affordability can all drive strong tax revenue trends and foster economic growth.

Likelihood of Providing Extraordinary or Ongoing Support

A key credit strength of US states is the ability to push obligations to downstream entities, such as school districts or public universities, at will. It is generally a strength of states that the decision to cut funding or alter respective shares of pension contributions is purely at the state's discretion. While many states use this

¹² A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

discretion to protect their own operating funds at the expense of their local governments, others have shown a willingness to take on some local governments' problems as their own.

A state's or territory's willingness to extend extraordinary support is often related to its commitment to a particular policy (e.g., education) and may also be specific to the situation of the component unit (e.g., university system), business-type activity (e.g., highway authority) or the municipality or school district that is undergoing financial or operational stress. In some cases, a state or territory may provide meaningful financial or managerial support to a related public entity undergoing stress, thereby bolstering the entity's weak fundamental credit profile. This support, if material in relation to the state's or territory's finances, can weaken the credit strength of the state or territory.

States may extend support through an explicit guarantee. A guarantee to pay the debt or manage the operations of an entity outside the state's or territory's primary activities sometimes reduces credit strength. For example, where a state begins paying debt service for a state university, the action could impact the state's credit strength. We typically would consider the amount and structure of the entity's debt and any material legal, policy or political issues that could limit the financial flexibility of the state or territory in the event its guarantee was invoked or we believe it is about to be invoked.

States may extend support without an explicit guarantee, including support for debt that may be non-recourse to the state's or territory's general credit. There are cases where we consider it likely that a state or territory will support a related entity,¹³ whether contractually required to or not. Where this occurs, we may use scenario analysis to quantify the potential credit impact on the state or territory. Examples include a state's or territory's decision to provide financial or other operational support to transportation, economic development or public utility enterprises that are outside the state's or territory's primary governmental operations. Our assessment of the likelihood of support is informed by, among other things, the liquidity of the state's or territory's non-governmental operations as well as the long-term liability burdens those operations carry. Our analysis also considers the amount of support that the state-related entity is likely to need, and the impact of extending the support on the state's or territory's financial flexibility and leverage metrics. We may also assess the impact qualitatively, for example, where the range of support scenarios is very wide.

There are also instances where a state or territory may be able to provide extraordinary or ongoing support to a state- or territory-related entity without a negative effect on the credit strength of the state or territory. For example, providing a temporary infusion of state funds to provide aid to localities after a hurricane or to bolster an economic development agency's financial performance in the short term may not, as a one-time event, be material relative to a state's or territory's budget and may be sufficient to stabilize the agency. Also, many component units of states and territories operate without receiving material financial support from the parent government. We typically assess the type, magnitude and likely recurrence of the support. We also typically consider the potential benefit to the state's or territory's credit profile if we expect support that is currently being extended to end.

Likelihood of Receiving Extraordinary or Ongoing Support

States typically receive annual funding from the federal government for programs such as healthcare and transportation. This type of federal funding is often earmarked, and we do not consider it to be extraordinary support. Due in part to the constitutional framework of the US, including the enumerated separation of powers across levels of government, we do not typically expect states would receive extraordinary support from the federal government, e.g., support that would help them avoid a default on debt obligations. However, we would consider any extraordinary federal support that we believe is reliable and meaningful.

¹³ State-related entities are backed solely by a pledge of that particular entity or its revenue and not backed by the general credit of the state.

Unusual Risk or Benefit Posed by Long-Term Liabilities

We may conclude that a state's or territory's adjusted net pension or adjusted net OPEB liability is likely to grow due to pension funding law or policy, resulting in insufficient contributions, overly optimistic assumptions for the return on pension plan assets or other factors. In addition, a state or territory may need to support a public pension plan unrelated to its direct employees, for example, an underfunded teacher pension plan whose unfunded liabilities are not currently incorporated in the state's long-term liabilities ratio. Conversely, we may conclude that a state's or territory's adjusted net pension or adjusted net OPEB liability is likely to diminish in light of pension benefit changes or larger contributions. We may also incorporate a qualitative assessment of the trajectory of net pension and net OPEB liabilities over the medium- to long-term.

In addition, most states and territories issue fixed-rate debt that amortizes over a multi-year period. States and territories that have variable-rate debt, debt with bullet maturities or capital appreciation bonds, derivatives such as interest rate swaps or other forms of debt that are subject to remarketing risk may be more exposed to liquidity demands or may require market access for refinancing, which can place downward pressure on credit quality. Liquidity and market access risks can also arise with variable-rate demand obligations and bonds that contain provisions that allow debtholders to put bonds back to the issuer. The potential adverse credit effects of variable-rate demand obligations are assessed in the context of the overall credit profile and circumstances of each issuer. In addition, a large amount of short-term notes without sufficient offsetting liquidity can expose a state or territory to market access risks.

A state or territory that is rapidly paying off debt or other long-term liabilities with recurring revenue typically has greater financial flexibility, which may result from a conservative financial policy and may indicate strengthening credit. Conversely, if a state's or territory's current debt service costs are very high and are causing financial stress that is not fully captured in implied debt service input to the Fixed Costs Ratio in the scorecard, the issuer rating may be lower than the scorecard-indicated outcome.

History or Likelihood of Impaired Liquidity or Market Access or Missed Debt Service Payments

While liquidity is specifically considered in the scorecard, when it is very weak, near-term default risk may be elevated and the impact liquidity has on ratings may be much greater than the standard scorecard weight would imply. In our forward view of liquidity, we typically consider the state's or territory's own sources of liquidity as well as its market access. In our assessment, we may use scenario analysis, including a scenario where market access is lost.

Most states and many territories access the capital markets. While the majority of states and territories borrow for long-term capital projects, sometimes their borrowings are for cash flow or deficit financing, which could indicate an unbalanced budget or financial stress. For distressed states or territories, access to financing from public markets or banks could be a stopgap to defer a liquidity crisis. The loss of such market access could be a prelude to debt restructuring and possibly a default.

Also, a past default, whether on rated or unrated obligations, often indicates a heightened risk of failure to meet financial obligations, especially if the credit drivers of the default have not been cured. In addition, a history of default can indicate weak or wavering willingness to take necessary steps to avoid a future default. We include in this category missed or materially late payments on any of a state's or territory's long-term bonds or short-term notes, reflecting an inability or unwillingness to pay, and we typically include defaults on contingent obligations. We place less emphasis on this consideration in cases where a state or territory has demonstrated an ability and willingness to address the credit drivers behind a default.

Financial Controls

We rely on the accuracy of audited financial statements to assign and monitor ratings in this sector. The quality of financial statements may be influenced by internal controls, including the proper tone at the top, centralized oversight of operations, and consistency in accounting policies and procedures. Auditors' reports on the effectiveness of internal controls, auditors' comments in financial reports and unusual restatements of financial statements or delays in regulatory filings may indicate weaknesses in internal controls. A lack of timeliness or transparency of information disclosure may indicate a material credit weakness.

Expected Decline or Improvement in Instrument-Level Credit Quality

Expectations of a marked decline in credit quality (e.g., debt service coverage) on any debt pledge of a state or territory could indicate weakening credit quality of the state or territory that is not yet reflected in the scorecard. Conversely, an expected material improvement in instrument-level credit quality may indicate improving credit quality of the state or territory. Overall, a change in the credit quality of any instrument of a state or territory could indicate shifts in the credit quality of the state or territory itself, e.g., through financial or governance ties between the instrument and general government operations.

Additional Metrics

The metrics included in the scorecard are those that are generally most important in assigning ratings to issuers in this sector; however, we may use additional metrics to inform our analysis in specific cases. These additional metrics may be important to our forward view of metrics that are in the scorecard or other rating factors.

Event Risk

We also recognize the possibility that an unexpected event could cause a sudden and sharp decline in a state's or territory's fundamental creditworthiness, which may cause actual ratings to be lower than the scorecard-indicated outcome. Event risks — which are varied and can include natural disasters, material litigation, pandemics or cybercrime events — can have a material credit impact on even a stable state or territory.

Assigning Issuer-Level and Instrument-Level Ratings

After considering the scorecard-indicated outcome, other considerations and relevant cross-sector methodologies, we typically assign an issuer rating to the US state or territory.

Individual debt instrument ratings for general promises to pay, contingent obligations, annual appropriation obligations, general obligation unlimited tax, general obligation limited tax may be assigned at the same level or higher or lower than the issuer rating to reflect our assessment of differences in expected loss related to an instrument's priority of claim as well as the specific pledge included in the instrument's terms. Broad guidance for decisions on assigning instrument ratings relative to the issuer rating can be found in Appendix C. Guidance for rating state and territory short-term debt is provided in our methodologies for short-term obligations, and guidance for the ratings of state and territory long-term debt instruments not discussed in Appendix C is provided in the relevant security-specific methodologies.¹⁴

Key Rating Assumptions

For information about key rating assumptions that apply to methodologies generally, please see *Rating Symbols and Definitions*.¹⁵

¹⁴ A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

¹⁵ A link to *Rating Symbols and Definitions* can be found in the "Moody's Related Publications" section.

Limitations

In the preceding sections, we have discussed the scorecard factors and many of the other considerations that may be important in assigning ratings. In this section, we discuss limitations that pertain to the scorecard and to the overall rating methodology.

Limitations of the Scorecard

There are various reasons why scorecard-indicated outcomes may not map closely to actual ratings.

The scorecard in this rating methodology is a relatively simple tool focused on indicators for relative credit strength. Credit loss and recovery considerations, which are typically more important as an issuer gets closer to default, may not be fully captured in the scorecard. The scorecard is also limited by its upper and lower bounds, causing scorecard-indicated outcomes to be less likely to align with ratings for issuers at the upper and lower ends of the rating scale.

The weights for each factor and sub-factor in the scorecard represent an approximation of their importance for rating decisions across the sector, but the actual importance of a particular factor may vary substantially based on an individual issuer's circumstances.

Factors that are outside the scorecard, including those discussed above in the "Other Considerations" section, may be important for ratings, and their relative importance may also vary from issuer to issuer or from instrument to instrument. In addition, certain broad methodological considerations described in one or more cross-sector rating methodologies may be relevant to ratings in this sector.¹⁶ Examples of such considerations include the following: how sovereign credit quality affects non-sovereign issuers and the assignment of short-term ratings.

We may use the scorecard over various historical or forward-looking time periods. Furthermore, in our ratings we often incorporate directional views of risks and mitigants in a qualitative way.

General Limitations of the Methodology

This methodology document does not include an exhaustive description of all factors that we may consider in assigning ratings in this sector. US states and territories may face new risks or new combinations of risks, and they may develop new strategies to mitigate risk. We seek to incorporate all material credit considerations in ratings and to take the most forward-looking perspective that visibility into these risks and mitigants permits.

Ratings reflect our expectations for an issuer's future performance; however, as the forward horizon lengthens, uncertainty increases and the utility of precise estimates, as scorecard inputs or in other considerations, typically diminishes. Our forward-looking opinions are based on assumptions that may prove, in hindsight, to have been incorrect. Reasons for this could include unanticipated changes in any of the following: the macroeconomic environment, general financial market conditions, disruptive technology, or regulatory and legal actions. In any case, predicting the future is subject to substantial uncertainty.

¹⁶ A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

Appendix A: Using the Scorecard to Arrive at a Scorecard-Indicated Outcome

1. Measurement or Estimation of Factors in the Scorecard

In the "Discussion of the Scorecard Factors" section, we explain our analytical approach for scoring each scorecard factor or sub-factor,¹⁷ and we describe why they are meaningful as credit indicators.

The information used in assessing the sub-factors is generally found in or calculated from information in the state's or territory's financial statements or disclosures, regulatory filings, derived from other observations or estimated by Moody's analysts. We may also incorporate non-public information.

Our ratings are forward-looking and reflect our expectations for future financial and operating performance. However, historical results are helpful in understanding patterns and trends of a state's or territory's performance as well as for peer comparisons. Financial ratios, unless otherwise indicated, are typically calculated based on an annual or 12-month period. However, the factors in the scorecard can be assessed using various time periods. For example, rating committees may find it analytically useful to examine both historical and expected future performance for periods of several years or more.

Metrics that relate to pension and OPEB obligations are calculated based on our cross-sector methodology that describes our adjustments to pension and OPEB data reported by GASB issuers.¹⁸ Financial metrics may incorporate analytical adjustments that are specific to a particular state or territory.

We may also make other analytical adjustments that are specific to a particular state or territory.

2. Mapping Scorecard Factors to a Numeric Score

After estimating or calculating each factor or sub-factor, each outcome is mapped to a broad Moody's rating category (Aaa, Aa, A, Baa, Ba, B, Caa or Ca, also called alpha categories) and to a numeric score.

Quantitative factors are scored on a linear continuum. For each metric, the scorecard shows the range by alpha category. We use the scale below and linear interpolation to convert the metric, based on its placement within the scorecard range, to a numeric score, which may be a fraction. As a purely theoretical example, if there were a ratio of revenue to interest for which the Baa range was 50x to 100x, then the numeric score for an issuer with revenue/interest of 99x, relatively strong within this range, would score closer to 9.5, and an issuer with revenue/interest of 51x, relatively weak within this range, would score closer to 12.5. In the text or table footnotes, we define the endpoints of the line (i.e., the value of the metric that constitutes the lowest possible numeric score and the value that constitutes the highest possible numeric score).

For numeric scoring of the weighted factors and sub-factors, each alpha category has an equal width of three, based on the scale below.

Aaa	Aa	A	Baa	Ba	B	Caa	Ca
0.5-3.5	3.5-6.5	6.5-9.5	9.5-12.5	12.5-15.5	15.5-18.5	18.5-21.5	21.5-24.5

Source: Moody's Investors Service

¹⁷ When a factor comprises sub-factors, we score at the sub-factor level. Some factors do not have sub-factors, in which case we score at the factor level.

¹⁸ A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

Qualitative factors and sub-factors are scored based on the description by broad rating category in the scorecard. The numeric value of each alpha score is based on the scale below, which is based on the midpoints of the scale above.

Aaa	Aa	A	Baa	Ba	B	Caa	Ca
2	5	8	11	14	17	20	23

Source: Moody's Investors Service

3. Determining the Overall Scorecard-Indicated Outcome¹⁹

The numeric score for each sub-factor (or each factor, when the factor has no sub-factors) is multiplied by the weight for that sub-factor (or factor).

The numeric score for each sub-factor or each factor, when the factor has no sub-factors, is multiplied by the weight for that sub-factor (or factor), with the results then summed to produce an aggregate numeric score before notching factors (the preliminary outcome). We then consider whether the preliminary outcome that results from the weighted factors should be notched downward²⁰ in order to arrive at an aggregate numeric score after the notching factor on very limited or concentrated economy. The notching factor can result in a total of up to two downward notches from the preliminary outcome to arrive at the scorecard-indicated outcome.

How We Convert the Aggregate Numeric Score to a Preliminary Score

As described above, we use a scale for weighted-factor scoring whereby each rating category, including Aaa and Ca, has an equal width of three.

Before notching, we narrow the scoring bands for Aaa and Ca to a width of one and leave the widths of the other alpha categories at three. We do this because, unlike the other alpha categories, each of which has three alphanumeric ratings, the Aaa and Ca categories have only one rating. This conversion allows for numeric whole and half-notches to have an impact throughout the rating scale that matches the meaning of whole and half-notches described above.

To accomplish the conversion, any aggregate numeric score lower than 2.5 is increased to 2.5, and any aggregate numeric score greater than 22.5 is reduced to 22.5. The resultant score then falls along a scale ranging from 2.5 to 22.5. Next, for ease of use and to make the midpoint of the Aaa scoring band equal to the number 1, we subtract 2 from the resultant score to arrive at a preliminary score (before notching factors), which falls along a scale ranging from 0.5 to 20.5.

We then apply the notching factor. After applying any downward notching adjustments to the preliminary score, we arrive at the overall numeric score, which can range from 0.5 to 21.5.²¹ This overall numeric score is then mapped back to our alphanumeric scale using the exhibit below to arrive at the scorecard-indicated outcome.

For example, if the preliminary score were 11.7, corresponding to Ba2 in the exhibit below, and the result of the notching factor were 1.5 downward notches, the overall numeric score would be 13.2, which would correspond to a scorecard-indicated outcome of Ba3.

¹⁹ In general, the scorecard-indicated outcome is oriented to the general obligation or issuer rating of the state.

²⁰ Numerically, a downward notch adds 1 to the score, and an upward notch subtracts 1 from the score.

²¹ For Aaa, 0.5 is the upper endpoint. For C, the lower endpoint is 21.5.

EXHIBIT 4

Scorecard-Indicated Outcome

Scorecard-Indicated Outcome	Overall Numeric Score
Aaa	$x \leq 1.5$
Aa1	$1.5 < x \leq 2.5$
Aa2	$2.5 < x \leq 3.5$
Aa3	$3.5 < x \leq 4.5$
A1	$4.5 < x \leq 5.5$
A2	$5.5 < x \leq 6.5$
A3	$6.5 < x \leq 7.5$
Baa1	$7.5 < x \leq 8.5$
Baa2	$8.5 < x \leq 9.5$
Baa3	$9.5 < x \leq 10.5$
Ba1	$10.5 < x \leq 11.5$
Ba2	$11.5 < x \leq 12.5$
Ba3	$12.5 < x \leq 13.5$
B1	$13.5 < x \leq 14.5$
B2	$14.5 < x \leq 15.5$
B3	$15.5 < x \leq 16.5$
Caa1	$16.5 < x \leq 17.5$
Caa2	$17.5 < x \leq 18.5$
Caa3	$18.5 < x \leq 19.5$
Ca	$19.5 < x \leq 20.5$
C	$x > 20.5$

Source: Moody's Investors Service

In general, the scorecard-indicated outcome is oriented to the issuer rating.

Appendix B: US States and Territories Scorecard

	Factor or Sub-factor Weight	Aaa	Aa	A	Baa	Ba	B	Caa	Ca
Factor: Economy (30%)									
Resident Income (RPP-Adjusted Per Capita Income / US Per Capita Income) ¹¹	15%	≥ 100%	85 – 100%	70 – 85%	60 – 70%	50 – 60%	40 – 50%	30 – 40%	< 30%
Economic Growth (Difference Between Five-Year Compound Annual Growth in Real GDP and Five-Year CAGR in Real US GDP) ¹²	15%	≥ 0%	(1) - 0%	(2) – (1)%	(3) - (2)%	(4) – (3)%	(5) – (4)%	(6) - (5)%	< (6)%
Factor: Financial Performance (20%)									
Financial Performance	20%	Fund balance approximates or exceeds 15% of own-source revenue and liquidity is very strong; revenue and expenditures are expected to remain in structural balance.	Fund balance approximates or exceeds 10% of own-source revenue and liquidity is strong, or fund balance is below 10% of own-source revenue and liquidity is very strong; revenue and expenditures face a modest structural imbalance, with an expected return to balance.	Fund balance approximates or exceeds 5% of own-source revenue and liquidity is adequate, or fund balance is below 5% of own-source revenue and liquidity is strong; revenue and expenditures face a noteworthy structural imbalance, with an expected return to balance.	Fund balance approximates or exceeds 0% of own-source revenue and liquidity is somewhat weak, or fund balance is below 0% of own-source revenue and liquidity is adequate; revenue and expenditures face a significant structural imbalance, with a potential return to balance.	Fund balance is between 0% and minus 5% of own-source revenue and liquidity is weak, or fund balance is below minus 5% of own-source revenue and liquidity is somewhat weak; revenue and expenditures face significant structural imbalance, with a limited path toward balance.	Fund balance is between minus 5% and minus 10% of own-source revenue and liquidity is very weak, or fund balance is below minus 10% of own-source revenue and liquidity is weak; revenue and expenditures face significant structural imbalance that undermines the delivery of core government services.	Heightened likelihood of default due to fund balance that is below minus 10% of own-source revenue, extremely weak liquidity or overwhelming structural imbalance of revenue and expenditures.	Heightened likelihood of default with significant impairment to creditors due to fund balance that is below minus 10% of own-source revenue, extremely weak liquidity or overwhelming structural imbalance of revenue and expenditures.

	Factor or Sub-factor Weight	Aaa	Aa	A	Baa	Ba	B	Caa	Ca
Factor: Institutional Framework / Governance (20%)									
Institutional Framework / Governance	20%	Extremely strong fiscal planning and operational management, with financial projections that are routinely conservative; and consistent long-term planning and in-year monitoring; and extremely conservative debt and liability management; strong revenue-generating flexibility and strong expenditure flexibility.	Strong fiscal planning and operational management, with financial projections that are typically conservative; and consistent long-term planning and in-year monitoring; and conservative debt and liability management; strong revenue-generating flexibility and moderate expenditure flexibility, or strong expenditure flexibility and moderate revenue-generating flexibility.	Adequate fiscal planning and operational management, with financial projections that are somewhat conservative; somewhat inconsistent long-term planning and in-year monitoring; somewhat conservative debt and liability management; moderate revenue-generating flexibility and moderate expenditure flexibility.	Moderately weak fiscal planning and operational management, with somewhat optimistic financial projections; inconsistent long-term planning and in-year monitoring; some debt and liability management weaknesses; moderate revenue-generating flexibility and weak expenditure flexibility, or moderate expenditure flexibility and weak revenue-generating flexibility.	Weak fiscal planning and operational management, with meaningfully optimistic financial projections; long-term planning or monitoring are rarely used; weak debt and liability management; or weak revenue-generating flexibility and weak expenditure flexibility.	Very weak fiscal planning and operational management, with extremely optimistic financial projections; or no long-term planning or monitoring; or very weak debt and liability management; or very weak revenue-generating flexibility and very weak expenditure flexibility.	Extremely weak fiscal planning or operational management heighten likelihood of default; or has not demonstrated ability or willingness to generate any revenue increases.	Extremely weak or essentially non-existent planning or operational management heighten likelihood of default with significant impairment for creditors; or revenue-raising ability is fundamentally constrained, with little prospect of improvement.

	Factor or Sub-factor Weight	Aaa	Aa	A	Baa	Ba	B	Caa	Ca
Factor: Leverage (30%)									
Long-term Liabilities Ratio ((Debt + ANPL + Adjusted Net OPEB + Other Long-term Liabilities) / Own-Source Revenue) ^{*3}	20%	≤ 100%	100 – 200%	200 – 350%	350 – 500%	500 – 700%	700 – 900%	900 – 1,100%	> 1,100%
Fixed-Costs Ratio (Adjusted Fixed Costs / Own-Source Revenue) ^{*4}	10%	≤ 10%	10 - 15%	15 - 20%	20 - 25%	25 - 35%	35 – 45%	45 - 55%	> 55%
Notching Factor									
Very Limited or Concentrated Economy (0 to -2)									

*1 For the linear scoring scale described in Appendix A, the Aaa endpoint value is 120%. A value of 120% or better equates to a numeric score of 0.5. The Ca endpoint value is 20%. A value of 20% or worse equates to a numeric score of 24.5.

*2 For the linear scoring scale, the Aaa endpoint value is 2%. A value of 2% or better equates to a numeric score of 0.5. The Ca endpoint value is (7)%. A value of (7)% or worse equates to a numeric score of 24.5.

*3 For the linear scoring scale described in Appendix A, the Aaa endpoint value is 0%. A value of 0% or better equates to a numeric score of 0.5. The Ca endpoint value is 1,300%. A value of 1,300% or worse equates to a numeric score of 24.5.

*4 For the linear scoring scale described in Appendix A, the Aaa endpoint value is 0%. A value of 0% or better equates to a numeric score of 0.5. The Ca endpoint value is 65%. A value of 65% or worse equates to a numeric score of 24.5.

Source: Moody's Investors Service

Appendix C: Assigning Instrument Ratings for US States and Territories

In this appendix, we describe our general principles for assessing how an instrument's particular characteristics affect its credit risk, more specifically, the instrument's probability of default and loss upon an event of default. Credit risk of individual debt instruments of US states and territories may be different from what is reflected in the issuer rating.

We also provide guidance for assigning individual debt instrument ratings relative to the issuer rating based on these considerations.²² These differences may arise from the specific pledge included in the instrument's terms, the instrument's priority of claim and the nature of the instrument (i.e., whether it is a contingent or a non-contingent obligation). As a result, instrument considerations may lead to the application of upward or downward notches from the issuer rating.

General Approach for Assigning Instrument Ratings

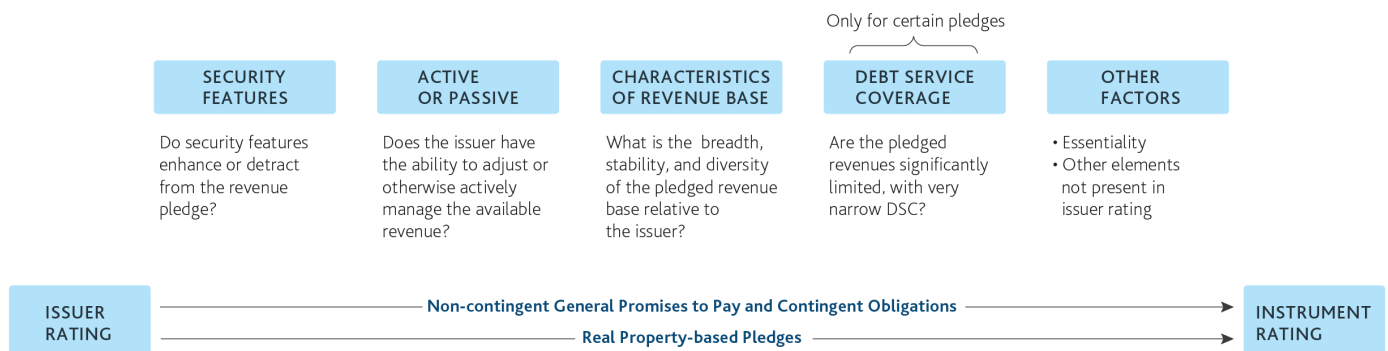
In this section, we describe some of the analytic elements of the typical structural features of debt instruments for US states and territories, and why they are important. Individual instruments may include permutations of these analytic elements. We divide US states' and territories' instruments into two groups of pledges that are typical in the sector: (i) non-contingent general promises to pay and contingent obligations, which in aggregate typically comprise most state and territory debt; and (ii) real property-based pledges.

For each instrument type, we evaluate the instrument's security features, including whether the debt obligation is contingent or non-contingent. We also consider whether the pledge, if any, is active or passive. Based on these characteristics, we may also assess the characteristics of the revenue base available to pay debt service on the debt instrument, debt service coverage and other factors. We consider the aggregate (typically cumulative)²³ effect of these structural analytic elements to arrive at the assigned instrument rating.

The exhibit below illustrates how these instrument-level ratings may be assigned relative to the issuer rating.

EXHIBIT 5

General Approach for Assigning Instrument Ratings



Note: DSC stands for debt service coverage.

Source: Moody's Investors Service

²² For clarity, the guidance for assigning instrument ratings also refers to situations where we assign a debt instrument rating at the same level as the issuer rating.

²³ In most cases, notching for the various analytic elements is cumulative; however, there may be circumstances where one analytic element mitigates or exacerbates the credit effect of another analytic element.

Security Features

Why It Matters

Security features set the framework for our overall debt instrument analysis because these features may enhance or weaken the instrument's credit risk relative to the credit risk indicated by the issuer rating. Security features include the specific revenue pledge, if any, that a state or territory grants to bondholders.

A fundamental security consideration is whether the pledge is contingent or non-contingent. Contingent obligations are typically weaker than a non-contingent general promise to pay (as described below) for states and territories. Contingent debt is an obligation where the bondholder has no long-term claim and the stated promise to pay depends on additional action, typically an annual appropriation, or the availability of the asset. A typical contingency requires a state or territory to appropriate funds to pay debt service annually; each appropriation renews the pledge for another year. There are other types of contingencies, such as a requirement for a leased asset to remain available for a use or occupancy in order for the state or territory to remain obligated to make lease payments.²⁴ It is important to look through the nominal debt type to the underlying characteristics of the pledge to understand whether it is contingent or non-contingent.

Where present, the physical and legal separation of pledged revenue from a state's or territory's control is an important security feature. With physical separation, the issuer does not have custody of the money. With legal separation, the legal structure insulates the money.

Physical separation can be accomplished through the federal government or a trustee collecting or holding the revenue and transferring it directly to the payment of debt service, e.g., where funds from certain intergovernmental transfers are transferred directly from a third-party tax collector or grantor, often the federal government, to the trustee for the bonds. This feature can lessen the likelihood of default because it creates a separation between the revenue dedicated to debt service from the issuer's operations and other funds. We do not consider this effective where the separation is among funds that remain under the issuer's control, i.e., funds held by the issuer in a segregated account.

Legal separation, which has historically been used infrequently, can be accomplished through the constitutional dedication of the pledged revenue stream to the debt.

Overall, physical and legal separation of pledged revenue from the issuer's control is rare for states or territories. Where separation exists, it can enhance recovery prospects in the event of default, compared with other debt.

Active or Passive Pledges

Why It Matters

The active or passive nature of a pledge²⁵ is important because it can differentiate whether the state or territory has promised or has the ability to raise revenue to pay debt service or otherwise needs additional approvals to do so. We consider a pledge to be active if the issuer can increase the revenue stream (e.g., by raising tax rates or fees) without meaningful limitation or additional approvals from voters or the federal government. We consider most pledges from a state active because of the broad powers of states, including their ability to raise revenue, and the long history of states raising revenue to pay their obligations. We

²⁴ Typically, from a statutory perspective, contingent obligations are not considered debt, which is often a reason why these instruments are employed; they also do not typically require voter approval. Please see *Rating Symbols and Definitions* for more information on what we consider to be a default.

²⁵ In this context, a pledge means the revenues that are effectively designated as being available to pay debt service on the instrument in the transaction documents. This designation may be explicit, such as a pledge of real estate tax revenue, or implicit, such as a general promise to pay from revenues that are not otherwise pledged.

consider pledges to be passive if the issuer can increase the revenue stream only after securing voter approval or other external approvals, or if there are specific legal or practical limitations on the pledged or available revenue stream, e.g., tax rate limitations. In these cases, revenue to pay debt service typically depends on the performance of the revenue base, e.g., economic growth, and thus is more vulnerable to economic decline than the issuer's total revenue.

Characteristics of the Revenue Base

Why It Matters

The promise to pay and the revenue pledge, if any, embedded in the instrument delineate the relationship between the issuer's total revenue and economic base, which are considered in its issuer rating, and the revenue base that is available to pay debt service of a specific instrument.

The breadth, stability and diversity of the revenue base for payment of debt service relative to the issuer's revenue base provide important indications of the relative strength or weakness of the obligation. If the revenue base from which debt service will be paid is materially more limited or less stable than the broad revenue base that is reflected in the issuer rating, a bondholder may face more risk than is indicated in the issuer rating.

Where the pledged revenue base is narrow, bondholders may have limited recourse if the specific pledged revenue is insufficient to meet debt service on the related obligations. However, in some cases, a nominally narrower pledge can still be robust.

Debt Service Coverage

Why It Matters

For some instrument types, debt service coverage is an important indicator of the sufficiency of the available revenue to meet debt service payments, e.g., where the dedicated revenue stream is limited or passive. If there is material excess revenue, the relevant bonds have lower exposure to potential variations in the revenue stream.

Other Factors

Why It Matters

Additional factors, some of which vary by pledge or security type, may also affect the risk of a given debt instrument relative to the credit strength of the issuer. Following are some examples:

- » For contingent obligations, where there is one or more leased or financed asset or function, its essentiality is important because it can indicate the likelihood that an issuer will choose to appropriate funds to pay the lease. For an abatement lease, the more important the pledged asset or function is to the borrower, the more likely it is that the borrower will ensure that it is repaired in an abatement circumstance.
- » Where a pledge type is subject to unanticipated legal challenges, an individual debt instrument may be vulnerable to non-payment even if the issuer is not undergoing stress.
- » Where a state or territory has put in place an exceptionally strong incentive to appropriate, such as statutory provisions that limit the use of funds for operations until an appropriation for debt service has been made, the strong incentive to appropriate may result in uplift.
- » Where a state's or territory's debt includes a significant amount of derivatives such as interest rate swaps that are exposed to liquidity demands or may require market access for refinancing, this may result in meaningful additional risk to the holders of the instrument.

Guidance for Assigning Individual Debt Instrument Ratings

In assigning instrument ratings, we consider all of the analytic elements relevant to the specific debt issuance and their impact. In this section, we provide guidance on the typical range of notching for common security types. For each major security type, the guidance for assigning a rating is described by analytic element and is typically cumulative. However, actual ratings may be different from the guidance where there is unusual strength or weakness in the legal structure or revenue base, in the terms of the debt instruments, or in the relation of an issuer to the obligation, e.g., where the issuer or instrument is in financial distress.

Other issuer-specific or instrument-specific considerations may also be relevant.

The exhibit below illustrates the typical rating range seen between a state's or territory's issuer rating and its instrument ratings.

EXHIBIT 6

Illustrative Example: Relative Ratings for Typical US State and Territory Instruments

	NON-CONTINGENT DEBT General promise to pay, full faith and credit, or real property-based pledge	CONTINGENT DEBT No long-term pledge; contingent upon annual action of issuer or subject to abatement
Issuer Rating +1 Notch	Debt with legal and physical separation	
ISSUER RATING	General promise to pay; general obligation; GOLT (with headroom)	
Issuer Rating -1 Notch	General promise to pay (with carve-out); GOLT (without headroom)	More essential leases/COPs
Issuer Rating -2 Notches		Less essential leases/COPs/ some moral obligations
Issuer Rating -3 Notches		Moral obligations/less essential leases/COPs

Note: GOULT stands for general obligation unlimited tax, GOLT for general obligation limited tax and COPs for certificates of participation.

Source: Moody's Investors Service

Where a US state or territory is undergoing financial distress, we may widen or narrow the rating differentials between the issuer rating and the rating of any specific obligations, based on our view of the relative probabilities of default and relative loss rates upon default. In these instances, the anticipated recovery rate for an obligation would be a more important rating consideration than our general principles for assigning instrument-level ratings. Our views of relative expected loss would generally be informed by

state or federal case law within the relevant jurisdiction and other meaningful issuer-specific risk factors that may indicate the state's or territory's relative willingness and ability to pay various types of obligations.

The guidance below for assigning instrument-level ratings is divided into two groups of pledges that are typical in the sector: (i) non-contingent general promises to pay and contingent obligations; and (ii) real property-based pledges.

Non-contingent General Promises to Pay and Contingent Obligations

This grouping includes general promises to pay, where broad revenue is available for the payment of debt service, but the issuer has typically not pledged a specific, material revenue stream. This grouping also includes contingent obligations, which often are paid from the issuer's broad revenue as well. Most state and territory debt belongs to this grouping.

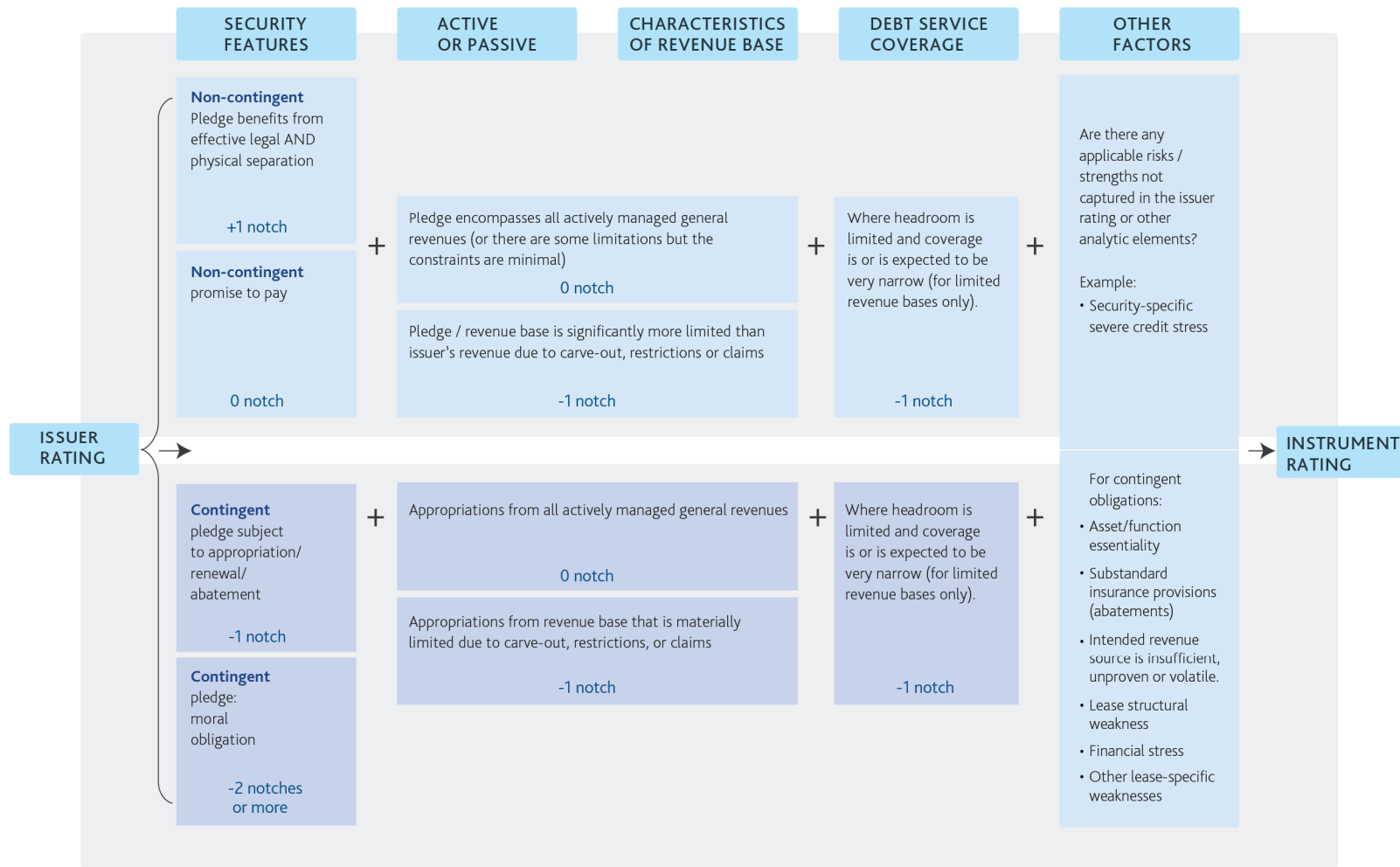
Non-contingent General Promises to Pay

Many obligations represent a non-contingent general promise to pay, for which the state's or territory's revenue²⁶ is available as a source of repayment. Often, these instruments are called "general obligations," but the instrument does not include a property-tax pledge. In other cases, pledges specifically exclude taxation. Many obligations in this group contain broad language describing the promise (e.g., "full faith and credit" or similar wording) but do not include a specific pledge of a property tax or other particular revenue. Because these promises to pay are non-contingent and states have broad powers to raise revenue, we typically consider them to be very strong pledges. In other cases, material carve-outs of revenue that is pledged to other debt effectively limit the breadth of the general promise to pay. As there is wide variation in the language used, we assess the substance of the issuer's obligation.

²⁶ A portion of revenue could be subject to prior claims.

EXHIBIT 7

Non-contingent General Promises to Pay and Contingent Obligations: Illustrative Notching



Source: Moody's Investors Service

How We Assess It

SECURITY FEATURES:

There is typically no notching for this analytic element, because general promises to pay are non-specific as to revenue, by definition. However, we assess the security features of each transaction in order to determine if they provide material benefit to creditors.

ACTIVE OR PASSIVE PLEDGE AND CHARACTERISTICS OF THE REVENUE BASE:

We consider these two analytic elements together.

Where the pledge or general promise to pay encompasses all actively managed revenue or where the relevant revenue is subject to some limitations but the constraints are minimal, there is no notching for these analytic elements.

Where the relevant revenue base is significantly more limited than the issuer's revenue base (e.g., it is limited by the exclusion of certain significant revenue streams, by meaningful tax limitations, by a materially smaller size or by pledges of specific revenue to other obligations), there is typically one downward notch for these analytic elements, although there may be more than one downward notch if the revenue base is exceptionally limited. Where this more limited base is still robust, however, there may be no downward notching for this analytic element because the credit strength of the pledge is not materially weaker than that of the issuer rating.

DEBT SERVICE COVERAGE:

For non-contingent pledges, there is no upward notching for this analytic element. Where the pledge is substantially reduced by carve-outs or other competing claims that render the pledged revenue significantly more limited than the state's or territory's revenue, we typically assess debt service coverage on a current and forward-looking basis. One downward notch is typical for this analytic element where there are material revenue carve-outs and debt service coverage is expected to be near or below 1.1x. More than one downward notch is likely to be applied where there are material revenue carve-outs and debt service coverage is expected to be below 1.0x, in the absence of other mitigants.

OTHER FACTORS:

We also consider strengths or risks in the structural features of the pledge that are not already reflected in the issuer rating or other analytic elements. If the strengths are material, they may offset downward notching related to other analytic elements. If the risks are material, cumulative notching may reflect one or more additional downward notches, depending on the severity of the risks. For example, security-specific severe credit stress or a legal structure or security type with a poor track record in default could lead to downward notching for this analytic element. In addition, a serious legal challenge to the validity of a non-contingent general promise to pay could lead to downward notching for this analytic element.

Contingent Obligations

Examples of contingent obligations include appropriation lease-backed obligations, abatement lease-backed obligations, non-lease annual appropriation obligations and moral obligations.²⁷ In the municipal market, appropriation-backed instruments are often issued as certificates of participation.

For states and territories, the most common type of contingent obligations issued are non-lease annual appropriation obligations. These obligations are typically backed solely by the issuing government's covenant to take certain administrative steps to consider appropriating for debt service in each budget cycle. The appropriations are typically made through the government's annual budget process. Once the

²⁷ Not all leases are contingent obligations. Non-contingent leases are rated based on the long-term pledge, e.g., general obligation. Special tax obligations with annual appropriation features are addressed in our methodology on special tax bonds issued in the US public sector.

appropriation is made, it is absolute and unconditional for the time period to which the appropriation applies (typically one year). After one year, the annual option to not appropriate renews. Annual appropriation obligations do not include recourse to an asset among the remedies in case of a default.

States and territories also issue an appropriation lease-backed instruments. The state or territory usually does not pledge any specific revenue to the lease and instead annually appropriates funds to pay debt service. The state or territory obligates itself to make lease payments pursuant to a capital lease between itself (as lessee) and, usually, a special purpose entity lessor created and controlled by the lessee. This lease payment revenue is used to pay debt service on the lease-backed instrument.

In the case of an appropriation lease, the state or territory has a legal right to choose not to appropriate the funds, thereby not renewing the lease. The state or territory generally covenants to take proactive steps to make the annual lease payment and lease renewal, although with the explicit recognition that it is legally entitled to choose not to appropriate funds for the lease payment, or renew the lease.

A less common type of contingent obligation that states and territories issue is an abatement lease, where the lease payment is contingent upon the continued availability of the leased asset for use or occupancy. If the use of the asset is compromised (e.g., a state office building is partially destroyed by an earthquake), the lessee may be required to abate or reduce the lease payment in proportion to the reduction in use.

A fourth type of contingent obligation is a moral obligation. An example of a moral obligation structure would be where a state or territory promises to consider supporting a contingent obligation, under certain circumstances, by appropriating funds for the replenishment of a debt service reserve. Some states pledge their moral obligation on behalf of the state's housing finance authority, bond bank or other state-associated entity; these moral obligation pledges are typically a promise to consider paying or supporting payment of the outstanding debt of the entity. A moral obligation pledge is neither a guarantee to pay debt service nor a promise to replenish a debt service reserve nor a legally enforceable obligation to pay. Rather, it is a declaration that the state or territory intends to support the debt and will consider making appropriations and providing funding under certain circumstances.

Contingent obligations are typically weaker from a legal perspective than debt secured by a general obligation or full faith and credit pledge, due to the contingent nature of appropriation and abatement features and the more limited creditor recourse in the event of default.

In all cases, contingent debt includes a legal out, either through failure to appropriate or abatement, and therefore lacks a firm pledge of revenue over the life of the debt. Even in cases where an issuer plans to use certain revenue flows for contingent lease payments or debt service, unless they are pledged for the life of the instrument, this intention does not improve credit quality.²⁸ However, where the issuer signals an intention to use limited revenue to pay the contingent obligation, this may indicate additional risk for the obligations. An example is where the issuer intends to pay from expected project revenue (e.g., an economic development project that involves market risk), as opposed to its own-source revenue.

We typically notch down from the issuer rating for a state's or territory's contingent obligations. The number of downward notches for appropriation and abatement obligation bonds is usually limited to one or two, depending on our assessment of the essentiality of the pledged asset or financed project to the state's or territory's operations. In most cases, there is a fundamental connection between the financed asset and the fundamental operations of the state or territory, providing a strong incentive for the state or territory to

²⁸ An exception to this would be a case where a state or territory has put in place an exceptionally strong incentive to appropriate, such as statutory provisions that limit the use of funds for operations until an appropriation for debt service has been made.

appropriate funds for debt service payments. For moral obligation pledges, the typical notching is two or more, depending on the legal structure and assets involved.

How We Assess It

SECURITY FEATURES:

A contingent pledge is notched downward for security features.

A contingent pledge subject to appropriation, renewal or abatement typically leads to one downward notch for this analytic element. An exception is if an instrument also carries a backup pledge (full faith and credit, general obligation pledge or other non-contingent pledge), in which case we rate the instrument based on the stronger of the two pledges.

Where the contingent pledge is a moral obligation, there are typically two downward notches for this analytic element, and there may be more than two downward notches where the legal structure is unusually weak. In a typical moral obligation structure, a parent government undertakes to consider appropriating for the replenishment of a debt service reserve under certain circumstances. An unusually weak moral obligation structure might include numerous conditions that must be met for the government to consider appropriating, or the timing of debt service payments may not align well with the timing during which the state or territory could appropriate funds for payment of debt or replenishment of a debt service reserve. The greater notching for moral obligations, relative to leases and appropriation obligations, reflects several characteristics of moral obligations, including that they are typically contingent upon legislative approval and are only called upon if the underlying revenue streams are insufficient.

ACTIVE OR PASSIVE PLEDGE AND CHARACTERISTICS OF THE REVENUE BASE:

We consider these two analytic elements together.

Where all actively managed revenue is available for annual appropriation, including cases where the revenue is subject to some limitations but those constraints are minimal, there is typically no downward notching for these analytic elements.

However, there would typically be one downward notch for these analytic elements where the available revenue is materially limited, such as by the exclusion of certain significant revenue streams, meaningful tax limitations on revenue or other priority claims on material revenue.

DEBT SERVICE COVERAGE:

For contingent pledges, there is no upward notching for this analytic element. Where the available revenue for debt service is significantly more limited than the state's or territory's revenue, we typically assess debt service coverage on a current and forward-looking basis. One downward notch is typical for this analytic element where debt service coverage is assessed and expected to be near or below 1.1x. More than one downward notch will likely be applied where debt service coverage is assessed and expected to be below 1.0x, in the absence of other mitigants.

OTHER FACTORS:

We also consider risks in the structural features of the obligation that are not already reflected in the issuer rating or other analytic elements. If the risks are material, cumulative notching may reflect one or more additional downward notches, depending on the severity of the risks.

The largest share of contingent obligations issued by states is non-lease annual appropriation obligations. These obligations do not include recourse to an asset among the remedies in case of a default and are typically backed solely by the issuing government's covenant to take certain administrative steps to consider appropriating for debt service in each budget cycle. Creditor recourse is often very limited in the event of

non-payment. We typically look at the programs or functions being funded with the contingent obligation and assess their essentiality. The exhibit below shows the typical notching between the state's or territory's issuer rating and non-contingent lease-backed obligations, contingent obligations and moral obligations inclusive of the essentiality consideration, which is explained in greater detail below.

EXHIBIT 8

Typical Downward Notching from the Issuer Rating

For non-contingent lease-backed obligations, contingent obligations and moral obligations

Security Type	Non-Contingent Lease-Backed Obligations	Contingent Lease-Backed and Annual Appropriation Obligations		Moral Obligations	
Essentiality	N/A	More	Less	More*	Less
Notches from Issuer Rating:					
Zero	X				
One		X			
Two			X	X	
Three or more				X	X

*For moral obligations, we may apply two or three downward notches from the issuer rating for more essential assets, depending on the legal structure.

Source: Moody's Investors Service

Essentiality

For contingent obligations, the essentiality of the underlying assets, financed project or function to the state's or territory's core operations is a major consideration. We consider essentiality to be a strong indicator of a state's or territory's incentive to appropriate funds for these contingent payments.

While essentiality falls on a continuum, we typically classify it in two categories. We generally consider an asset or project that is critical to state or territory core operations or administration as more essential (e.g., public infrastructure such as courthouses). In these cases, the asset or project also cannot be separated from the core operations or administration of the state or territory (it is not severable) and has no commercial or enterprise risk. With more essential assets, there is no notching for the essentiality consideration.

Less essential assets or projects are those that are not critical to state or territory core operations or administration, are severable, or have commercial or enterprise risk, e.g., an economic development project or a project that depends on vendor performance. In these cases, a future administration may no longer choose to support the project, appropriate funds for debt service, or repair the asset following an abatement event. In these cases, there are typically one or more downward notches for the essentiality consideration.

The exhibit below provides a summary of typical notching for the essentiality consideration. Actual notching is based on our view of the circumstances of the state or territory, the terms and conditions of the obligation and the state's or territory's incentives or disincentives to honor the obligation.²⁹ If there is a mix of more and less essential assets associated with an individual instrument or master lease structure, we generally characterize the essentiality of the entire asset pool by the single most essential asset. In the case

²⁹ For example, a change in law that weakens a state's or territory's incentive to provide a given social service could diminish the essentiality of a lease tied to that service's operations.

of a large statewide master lease program, we may characterize the entire asset pool as more essential even if the individual assets would be considered less essential, because the all-or-nothing payment requirement of a master lease reduces the risk of non-appropriation.

EXHIBIT 9

Typical Notching for Essentiality

More Essential	Less Essential
Asset/function is critical to a state's or territory's core operations or administration, not severable, and has no commercial or enterprise risk.	Asset/function is not critical to a state's or territory's core operations or administration, is severable, or has commercial or enterprise risk.
Examples (Illustrative; categorization could vary based on specific circumstances)	
<ul style="list-style-type: none"> » Public safety facilities/functions (courthouses, prisons, etc.) » Administrative, educational or health facility/function » Public infrastructure (roads, water/sewer facilities, etc.) » Improvements, equipment or technology not severable from core operations or essential facilities (parking garages, HVAC, etc.) 	<ul style="list-style-type: none"> » Facilities, improvements or purpose for economic development, tourism, recreation, or other less essential services (hotels, convention centers, golf courses, sports stadiums, etc.) » Projects that incorporate commercial/vendor performance³⁰ » Improvements, equipment or technology severable from core operations or supporting less essential services
Typical Notching for Essentiality	
No notching	One or more downward notches

Source: Moody's Investors Service

Insurance and Asset Substitution

For abatement leases, the leased asset's availability for a state's or territory's use or occupancy is a precondition for lease payment. We typically consider sufficient property insurance procured by the lessee or the ability to substitute a new asset for a compromised asset to be an important structural feature. In the absence of both the ability to substitute an asset and standard insurance provisions, such as title insurance and renters' interruption insurance, there may be downward notching for this consideration.

Intended Revenue Source

In some cases, states or territories may have an intended source of revenue to support contingent obligations. There are instances where a state or territory has constitutional or statutory protections or mechanisms related to the use of intended revenue that are strong enough to warrant an upward notch for this analytic element; this strength may offset all or part of downward notching related to the contingent nature of the obligation. This could apply, for example, where a state cannot appropriate substantial funds for operations until sufficient funds for debt service have been set aside. Often, where these strong protections exist, they mitigate the impact of any downward notching related to essentiality.

On the other hand, the mere intention to use a specified revenue source without constitutional or statutory protections does not offset the contingent nature of the obligation, regardless of how stable the revenue source is. In these cases, there is typically no upward notching for this analytic element. In addition, where the intended revenue source is unproven or volatile, the state or territory may not expect or be prepared to pay debt service from other sources. In these cases, we may apply one or more downward notches for this analytic element.

³⁰ Vendors are not the lessors or owners of projects, but their performance could cause costs (lease payments) to increase on a state's or territory's budget. Typically, a state's or territory's payment obligation is not explicitly conditioned on vendor performance.

Structural Weakness

For any contingent pledge, where there is a material structural weakness, such as lack of clarity in the legal documents on the pledge and its mechanics, cumulative notching may reflect one or more additional downward notches, depending on the severity of the risks. Also, unusual complexity in the financing structure, such as inclusion of a non-governmental third party in the transaction, or a serious legal challenge to the validity of a contingent pledge could lead to downward notching for this analytic element.

Real Property-based Pledges

In a real property-based pledge, the issuer pledges taxes that are levied on real property or other real property-related revenue. These pledges can be active or passive but are, by definition, non-contingent.

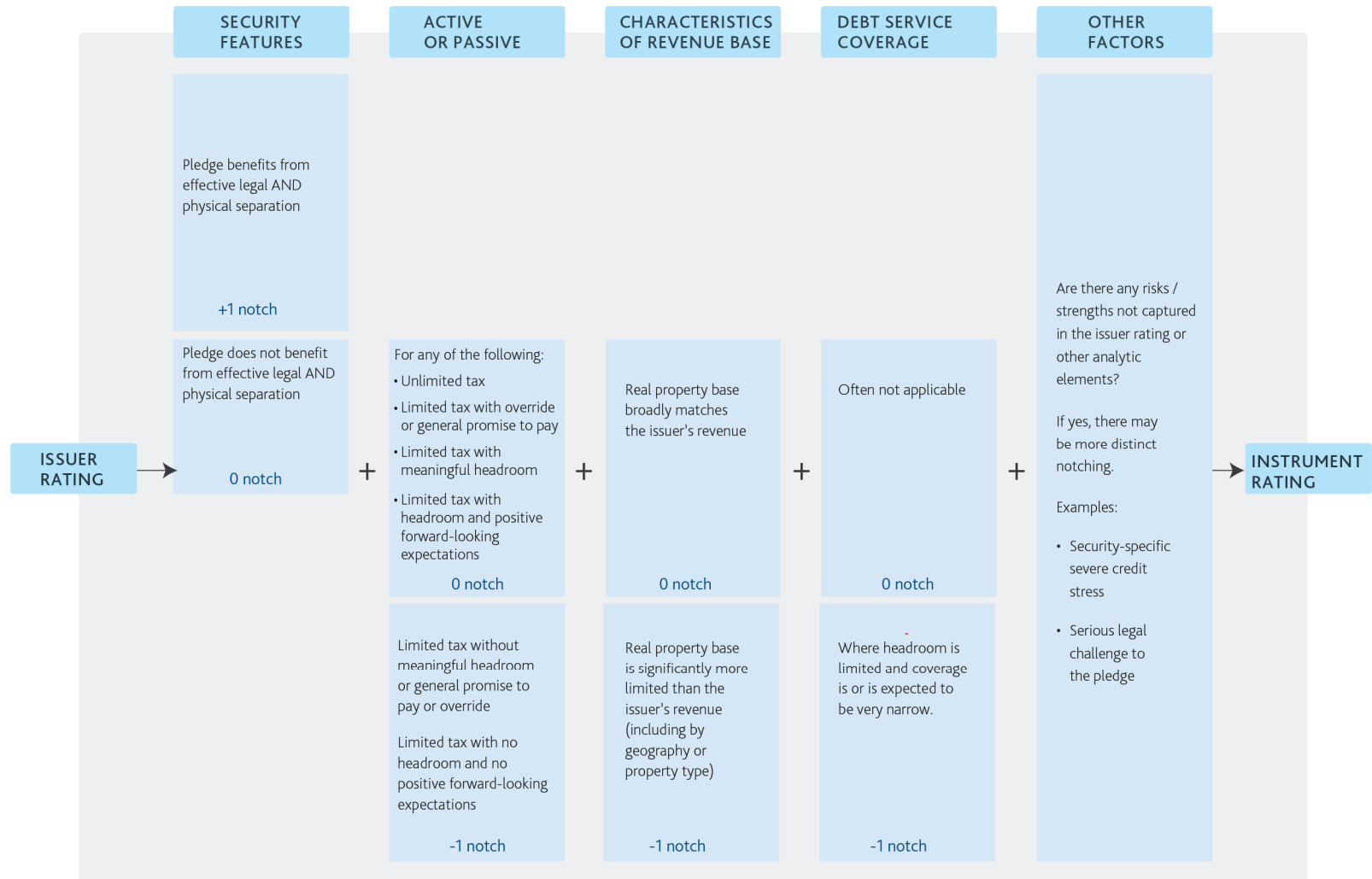
While rare, some states and territories issue debt secured by an unlimited tax on real property, and less frequently, some states issue debt with a limited tax on real property.³¹ In most cases, state and territory debt with a real property-based pledge is also secured by a full faith and credit pledge.

Overall, a major consideration for all securities within the real property-based pledge grouping is whether the state or territory has promised to adjust without limit the tax rate that generates the pledged revenue and, where it exists, how meaningful the limitation is. Where we consider the limitation to be material, the instrument rating is typically one notch below the issuer rating.

³¹ Typically, a state's or territory's tax base includes property that is categorized in many sub-groupings, including real, personal, tangible and mineral property.

EXHIBIT 10

Real Property-based Pledges: Illustrative Notching



Source: Moody's Investors Service

Ad Valorem (General Obligation) Tax Pledges

While many states pledge a general promise of the issuer to pay the obligation (the specific language may vary; an example is a full faith and credit pledge), some also secure debt with an explicit general obligation (GO) pledge to levy ad valorem taxes.³² These ad valorem bonds are often without limit as to rate or amount, sufficient to make timely payment of debt service. Because of the breadth and strength of the pledge, most unlimited tax ad valorem instrument ratings are at the same level as the issuer rating.

States and territories less frequently issue a general obligation debt instrument with a limited rather than an unlimited real property tax pledge. The nature of the limit varies. It can be imposed on the tax rate or on the levy amount that is available to pay the related debt service. Although some of these limitations result in materially weaker credit strength, in many other cases, the tax limit does not materially constrain a state's or territory's ability to pay debt service and therefore does not result in a material difference in the credit risk of the instrument relative to the issuer rating.

There are various structural features that can reduce or eliminate the difference in credit risk between unlimited and limited ad valorem pledges. For example, a state or territory may be able to override the stated limit, or it may issue limited tax debt that is also secured by a broad revenue pledge. In addition, some state or territory limited ad valorem pledges have headroom within the limit that we consider would be sufficient to cover projected growth in debt service. If there are no sufficient mitigants, a limited tax ad valorem instrument is typically rated one notch below the issuer rating.

How We Assess It

SECURITY FEATURES:

Where a state or territory ad valorem pledge provides effective physical and legal separation of the pledged revenue for debt service, there is typically one upward notch for this analytic element. Effective separation typically would include a constitutional dedication of the pledged revenue stream to the debt and physical separation such as the federal government's or a trustee's collecting or holding the revenue and transferring it directly to the payment of debt service.

We may not consider these security features to be effective where we think the physical or legal separation does not materially strengthen the instrument's credit strength compared to the issuer rating, or where there have been successful legal challenges to the separation.

ACTIVE OR PASSIVE PLEDGE:

Unlimited general obligation pledges are, by definition, active pledges. There is no notching for this analytic element. For limited general obligation pledges, where a state or territory has an ability to raise taxes within the stated limit that is meaningful relative to the maximum annual debt service of the obligation (i.e., meaningful headroom) or can override the limit, or where an additional pledge (e.g., a general promise to pay) mitigates the limit, we consider the pledge to be active. In these cases, there is no downward notching for this analytic element. The absence of meaningful headroom typically leads to one downward notch for this analytic element.

CHARACTERISTICS OF THE REVENUE BASE:

Where a general obligation pledge encompasses all or substantially all of the issuer's tax base, there is no notching for this analytic element. Where we consider that the revenue pertaining to the specific general obligation pledge is significantly more limited than the issuer's revenue base (e.g., from a more limited geographic base or property type), there may be one downward notch for this analytic element, although

³² Ad valorem taxes are based on the value of real property.

there may be more than one downward notch if the revenue base is exceptionally limited. Where this more limited tax base is still robust, however, there may be no downward notching for this analytic element.

DEBT SERVICE COVERAGE:

This analytic element is not applicable for unlimited general obligation pledges. For limited general obligation pledges, where headroom is limited, we typically assess debt service coverage on a current and forward-looking basis. In cases where the debt service coverage of the pledge is materially lower than the issuer's general ability to meet all of its obligations, we may notch the instrument rating down to reflect this risk to the extent it is not already captured in the issuer rating or other analytic elements.

For clarity, the guidance for this analytic element does not apply where there is an additional pledge (e.g., a general promise to pay).

OTHER FACTORS:

We also consider risks in the structural features of the pledge that are not already reflected in the issuer rating or other analytic elements. If the risks are material, cumulative notching may reflect one or more additional downward notches, depending on the severity of the risks.

For example, a serious legal challenge to the validity of the general obligation pledge (unlimited or limited) could lead to downward notching for this analytic element.

Appendix D: US State Lottery Prize Receivables

This appendix provides an overview of our general approach to assessing credit risk of US state lottery prize receivables (LPRs).³³ LPRs are contractual obligations of a state lottery to make payments over time to a prizewinner who chooses an annuity rather than a lump sum payment, or to a third-party investor that has purchased a lottery prize annuity from a lottery winner. This analytic approach does not apply where the state has assigned its obligation to fund lottery prizes to a third party.³⁴

Our approach to these instruments is similar to our approach to assessing credit risk of rated lease, appropriation and moral obligation debt of US state and local governments, in that the issuer rating of the state is the starting point for our analysis.

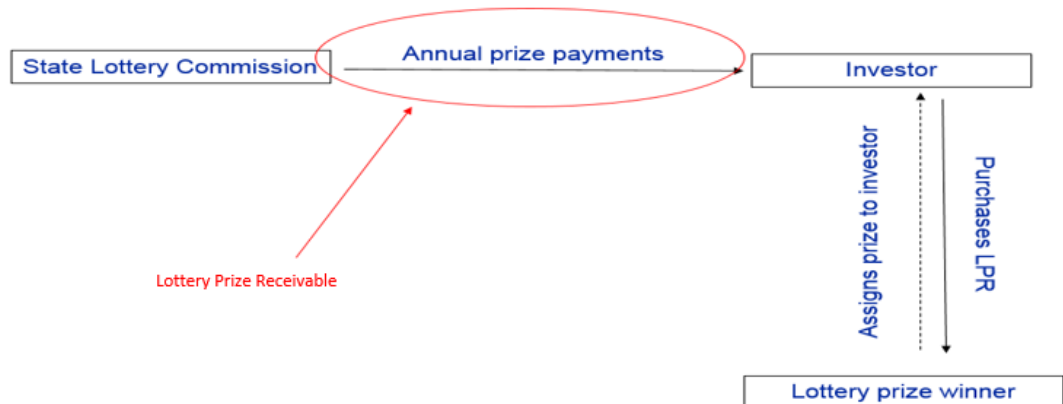
Mechanics of Lottery Prize Receivables

Most US state lotteries offer winners the choice of receiving a lottery prize payment as a lump sum at the time the winner claims the prize, or as an annuity paid annually over a fixed time frame, usually 20 years. If the winner opts to receive the prize as an annuity, the winner does not typically have the right to alter the terms at a later date and receive the remainder of the payout from the state as a lump sum.

However, a winner can convert the annual prize payments into a lump sum at a later date by transferring the right to the remaining annuities to a third-party investor in exchange for a single cash payment. This generally requires, by state law, a court order assigning the prize annuity, or the LPR, to the investor.

EXHIBIT 11

The Mechanics of Lottery Prize Receivables Assigned to an Investor



Source: Moody's Investors Service

LPR ratings reflect the credit quality of the stream of payments that are due to the investor or prizewinner. Lotteries are enterprises of the state, so risk to that state's general credit quality implies some risk to the state lottery as well. Holders of LPRs typically have no security interest in the lottery enterprise or the prize fund, nor are prizes typically backed by an obligation of the state beyond the lottery enterprise's obligation to pay. These weaknesses in security are generally mitigated by the importance of the state lottery as an

³³ We use the term "states" to refer to states and territories in this appendix, unless otherwise indicated.

³⁴ For example, some states pay a third-party annuity provider to assume the lottery prize payable and disclaim any further obligation. In these cases, the lottery prize receivable rating is based on the credit profile of the annuity provider and the strength of its obligation to pay the lottery prize. If the strength of the obligation is sufficiently strong, we use our methodology that discusses rating obligations based on credit substitution.

ongoing source of revenue for the state and by certain protections, typically embedded in state statutes (or sometimes in the state's constitution), including one or more of the following:

- » A mandated flow of a minimum percentage of lottery ticket sales to pay prizes;
- » Required pre-funding of all prize liabilities, including annuitized prizes;
- » Maintenance of a prize fund that is statutorily separate from all other state finances;
- » A prohibition on the state from borrowing from funds set aside for lottery prize payments.

Due to the lack of a security interest and the ability of the state to change its statutes or even its constitution, the strength of the lottery enterprise and its contribution to state financial operations is the primary source of an LPR's credit strength. States have a financial incentive to maintain strong, well-funded lottery enterprises because the purchase of lottery tickets is voluntary, and the enterprise's revenue potential is highly influenced by public confidence in the state's ability to pay prizes. State lotteries pursue different strategies to generate a robust level of excess revenue, including the way that games are marketed and the percentage of revenue dedicated to payouts; however, ensuring confidence in the lottery is common to all of these strategies. States generally use excess lottery enterprise revenue (the amount in excess of the lottery's prize payouts and costs) for essential public services, such as education.

Another credit strength to the LPR is the pre-funding of all prize liabilities. States generally require, by law, that all lottery prizes be pre-funded, resulting in annuitized prize liabilities that are generally at least 100% funded over the life of the annuity and greatly overfunded for near-term payments. States generally calculate the prize liability based on the present value of the stream of annuity payments. In determining the present value, states often use a discount rate reflecting the interest rates earned by the investments held in the lottery prize fund, which typically consist of high-quality fixed-rate bonds or annuities purchased from a third party that match the cash flows of the corresponding annual prize payouts. For that reason, we typically use the state's valuation of the fund relative to the prize liability. However, if we believe the state's reporting is overly optimistic based on the types of securities in the prize fund or the discount rate used for the present value of the liability, we may adjust the state's valuation in our analysis.

Factor: Position of the State Lottery Prize Receivables in the State Hierarchy of Debt and Spending Priorities

Why It Matters

The LPR rating has a direct relationship to the state's fundamental credit quality, given that state lotteries are governed by US state governments, which have the authority to make statutory changes that could affect the functioning of lottery enterprises and their pre-funding requirements. State lotteries generally do not require ad hoc financial support from the state, and many states do not provide any specific financial backing to the lottery commission. Should the lottery commission encounter financial difficulties, however (resulting, for example, from unexpected losses on investments), the state has a strong incentive to support an enterprise that is likely to continue to generate excess revenues, because these revenues are usually valuable to state operations. While the need for support is generally unlikely, the position of LPRs in the hierarchy of a given state's debt and spending priorities is an important credit consideration. If a lottery enterprise encountered financial difficulties, the willingness of a state to use non-lottery resources to make payments to winners would compete with a state's other debt obligations, operating expenditures and funding priorities.

How We Assess It

We typically assess the state's commitment to its lottery prize obligations relative to the issuer rating and its commitment to its general obligation (GO), appropriation and moral obligation debt, as well as other spending priorities.

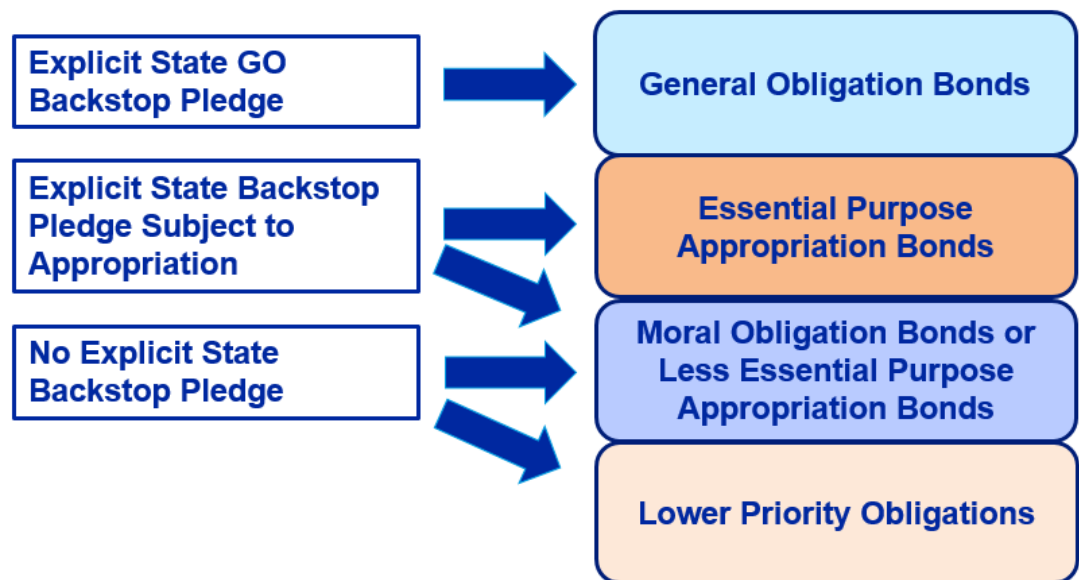
If the state has provided an explicit backstop pledge to the payment of lottery prizes, that pledge typically serves as a floor for the LPR rating. For example, if a state has pledged its general obligation to backstop lottery prize payments, the state's GO rating typically serves as the floor for the LPR rating. If the state has made a backstop pledge to make payments, but the payments are subject to appropriation, the rating on the state's appropriation bonds for essential purposes (or the rating that would apply to such appropriation bonds, in accordance with this methodology) typically serves as the floor for the LPR rating, as long as the excess revenue generated by the lottery is used for essential state services, such as education.

It is more common for states to provide no explicit pledge to backstop the lottery prize obligations. In these cases, the rating on the state's moral obligation debt (or the rating that would apply to such moral obligation bonds representing a similar commitment as the state's commitment to the lottery) usually serves as the rating floor, as long as either the value of the lottery enterprise to the state is high or the profitability of the lottery enterprise is strong (see "Factor: Value and Profitability of the State Lottery Enterprise").

The actual rating floor may be lower than the state's moral obligation rating. Please see the "Other Considerations for LPR Ratings" section below.

EXHIBIT 12

Hierarchy of State Debt and Spending Priorities



Source: Moody's Investors Service

Factor: Value and Profitability of the State Lottery Enterprise

Why It Matters

The value of the lottery enterprise to the state provides an important counterbalance to the holder's lack of a security interest in the lottery enterprise or the prize fund. The annual transfer to the state of excess lottery revenue gives the state an incentive to maintain strong lottery enterprise operations and meet its lottery prize obligations.

The profitability of the lottery enterprise is also a source of credit strength for the LPR because the state is more likely to maintain strong lottery operations, including payment of all prize obligations, when the lottery enterprise produces high margins.

How We Assess It

There are separate thresholds for the value of the state lottery enterprise and its profitability, and we distinguish between lottery enterprises that meet at least one of these thresholds and lottery enterprises that meet neither of these thresholds.³⁵

VALUE OF THE STATE LOTTERY ENTERPRISE:

We assess the value of the lottery enterprise to the state based on the amount of excess revenue the state lottery enterprise transfers to the state annually. If the lottery transfers \$100 million or more to the state each year, the threshold is met and we score the value of the enterprise as high. If the lottery transfers less than \$100 million to the state each year, the threshold for high enterprise value is not met.

PROFITABILITY OF THE STATE LOTTERY ENTERPRISE:

We assess the profitability of the lottery enterprise based on the coverage of annual prize payments from annual revenue. If annual lottery prize revenue (net of payment of all non-prize administrative expenses) cover annual prize payments by at least 125%, the threshold is met and we consider the profitability of the enterprise to be strong. If coverage is less than 125%, the threshold for strong profitability is not met.

If either threshold is met, i.e., the value of the lottery enterprise is high or the profitability is strong, we typically set the floor for the LPR rating at the state's moral obligation rating, or assumed moral obligation rating.

If the lottery enterprise value is not high, the profitability is not strong and there is no explicit pledge from the state or that pledge is weak, we may set the floor of the LPR at a level below the state's moral obligation rating (i.e., more than two notches below the state issuer rating). In such cases, the LPR rating is primarily based on our overall view of the strength or weakness of the state's commitment to the lottery relative to its other priorities and the strategy and prospects of the lottery enterprise. In addition, the pre-funding level of the lottery prize fund, described in the following section, typically does not provide uplift to the rating.

Factor: Pre-funding Level and Investment Credit Quality of the Lottery Prize Fund

Why It Matters

This factor provides important indications of a state lottery commission's ability to meet its future prize obligations. The pre-funding of lottery prize obligations in a separate lottery prize fund can provide further support to the LPR's credit strength in cases where the value of the lottery enterprise is high or the profitability is strong.

³⁵ For the purposes of this rating factor, meeting one of the tests is equivalent to meeting both of the tests.

A lottery prize fund that covers most or all outstanding prize liabilities and that invests in high-quality assets provides a strong indication of the state's commitment to a healthy lottery enterprise. A fund that is invested in assets that are not related to the state's economy and finances (e.g., US Treasury bonds) helps to insulate the LPR from the state's own credit risk and the future operations of the lottery enterprise. When the fund does not cover the full amount of the LPR, the lottery commission must cover those liabilities with future lottery revenue or with support from the state. A poorly funded LPR may indicate that the state's dependence on lottery revenue transfers is growing to an unsustainable level, or it may indicate that there are problems with the fund's investments, which is of particular concern in cases where there is no explicit pledge from the state, or where the pledge is weak.

If an LPR is supported by a well-funded, high-quality lottery prize fund, it may have higher credit quality than suggested by the rating floor, and may even have higher credit quality than the state's issuer rating. However, the holder's lack of a security interest in the lottery prize fund, the strong linkages between the state and its lottery commission, and the state's ability to change the statutes that govern the lottery commission limit the additional credit strength provided by the fund and its investments.

How We Assess It

Once the rating floor has been set (see "Factor: Position of the State Lottery Prize Receivables in the State Hierarchy of Debt and Spending Priorities" and the "Other Considerations for LPR Ratings" section) and we have determined that the LPR is eligible for ratings uplift based on the value or profitability of the lottery enterprise (see "Factor: Value and Profitability of the State Lottery Enterprise"), we assess the additional credit strength provided by rated, fixed-income investments in the lottery prize fund. Depending on the level of these investments relative to the net present value of the lottery's payment obligations to prize holders, the LPR rating may receive uplift above the floor. The uplift is expressed in relation to the state's issuer rating. The credit quality of the investments in the fund acts as a cap on any uplift assigned under this factor.

PRE-FUNDING LEVEL:

In calculating the pre-funding level, we exclude any securities that are obligations of the state or its localities.

If rated lottery prize fund assets provide coverage of at least 110% of the net present value of all outstanding lottery prize obligations, we typically assign the LPR rating two notches above the state issuer rating, subject to the investment credit quality cap on uplift.

If rated lottery prize fund assets provide coverage of 95% or greater, but less than 110%, of the net present value of all outstanding lottery prize obligations, we typically assign the LPR rating one notch above the state issuer rating, subject to the investment credit quality cap on uplift.

If rated lottery prize fund assets provide coverage of 75% or greater, but less than 95%, of the net present value of all outstanding lottery prize obligations, we typically rate the LPR the same as the state issuer rating, subject to the investment credit quality cap on uplift.

If lottery prize fund assets provide coverage of 65% or greater, but less than 75%, of the net present value of all outstanding lottery prize obligations, we typically assign the LPR rating one notch below the state issuer rating, subject to the investment credit quality cap on uplift and subject to the floor, as described above.

If lottery prize fund assets provide less than 65% coverage of the net present value of all outstanding lottery prize obligations, the LPR rating is not eligible for any uplift relative to the floor.

Our assessment of an LPR's eligibility for rating uplift relative to the floor is based on our forward view of the sustainable level of pre-funding. Our forward view may be informed by the historical pre-funding level, by the lottery commission's investment and funding strategy, by our expectations of future actions that the lottery commission may take, for example to increase or reduce fund assets, and by fixed-income market dynamics.

EXHIBIT 13

Potential Uplift to the Lottery Prize Receivable Rating Based on Level of Pre-funding



Source: Moody's Investors Service

INVESTMENT CREDIT QUALITY OF THE LOTTERY PRIZE FUND:

The LPR rating uplift is subject to a cap based on the credit quality of the rated, fixed-income investments in the lottery prize fund.³⁶

In cases where the lottery prize fund provides more than 110% coverage of the net present value of lottery prize obligations, we rank order the fund's investments by rating and exclude the lowest-rated securities in the fund until the remaining assets are equal to 110% of net present value of the lottery prize obligations. This adjustment allows for more consistent comparisons of credit quality for lottery prize funds that have different coverage levels.

We assess the credit quality of the lottery prize fund by calculating or estimating the weighted average rating of the investments, based on the reported value of the investment and the 10-year idealized expected loss associated with the rating of that investment. Any uplift to the rating based on the pre-funding level is generally capped at the weighted average rating of the fund's fixed-income investments. Unrated investments are excluded from the calculation of the weighted average rating.

³⁶ For example, if we consider that the applicable rating floor for the LPR is equivalent to the state's moral obligation bonds, and those bonds are rated Aa3, the state's issuer rating is Aa1, the funding level for the lottery prize fund is 110% and the credit quality of the lottery's investment portfolio is Aa2, the rating of the LPR would typically be Aa2.

Other Considerations for LPR Ratings

We may assign LPR ratings below the normal rating floor if there is a weak or weakening state commitment to the lottery enterprise.

Signs of weakening commitment may include:

- » An ongoing or expected material deterioration of the value or profitability of the lottery enterprise to the state;
- » The borrowing of lottery funds by the state for non-lottery purposes;
- » A meaningful change in the percentage of lottery revenue dedicated to paying prizes, especially where the change is rapid or indicative of increased state reliance on transfers from the lottery fund;
- » A rapid deterioration of the credit quality of the fund's investments, especially if the credit quality of the investments is materially lower than the state's issuer rating;
- » Indications that the lottery is less attractive to the public, such as a deterioration in state lottery revenue, especially where the revenue deterioration is not related to changes in state GDP.

Moody's Related Publications

Credit ratings are primarily determined through the application of sector credit rating methodologies. Certain broad methodological considerations (described in one or more cross-sector rating methodologies) may also be relevant to the determination of credit ratings of issuers and instruments. A list of sector and cross-sector credit rating methodologies can be found [here](#).

For data summarizing the historical robustness and predictive power of credit ratings, please click [here](#).

For further information, please refer to *Rating Symbols and Definitions*, which is available [here](#).

» contacts continued from page 1

Analyst Contacts:

NEW YORK +1.212.553.1653

Timothy Blake +1.212.553.4524
Managing Director-Public Finance
timothy.blake@moodys.com

Alfred Medioli +1.212.553.4173
Senior Vice President /
Manager - Ratings and Process Oversight
alfred.medioli@moodys.com

Naomi Richman +1.212.553.0014
Senior Vice President / Public Finance
naomi.richman@moodys.com

DALLAS +1.214.220.4350

Sarah Jensen +1.214.979.6846
Assistant Vice President – Analyst /
Ratings and Process Oversight
sarah.jensen@moodys.com

Tom Aaron +1.214.979.6886
Vice President – Senior Credit Officer / Public
Finance
thomas.aaron@moodys.com

Author
Julie Beglin

Report Number: 1299300

CLIENT SERVICES:

Americas:	+1.212.553.1653
Asia Pacific:	+852.3551.3077
Japan:	+81.3.5408.4100
EMEA:	+44.20.7772.5454

© 2021 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S CREDIT RATINGS AFFILIATES ARE THEIR CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND MATERIALS, PRODUCTS, SERVICES AND INFORMATION PUBLISHED BY MOODY'S (COLLECTIVELY, "PUBLICATIONS") MAY INCLUDE SUCH CURRENT OPINIONS. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT OR IMPAIRMENT. SEE APPLICABLE MOODY'S RATING SYMBOLS AND DEFINITIONS PUBLICATION FOR INFORMATION ON THE TYPES OF CONTRACTUAL FINANCIAL OBLIGATIONS ADDRESSED BY MOODY'S CREDIT RATINGS. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS, NON-CREDIT ASSESSMENTS ("ASSESSMENTS"), AND OTHER OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. MOODY'S PUBLICATIONS MAY ALSO INCLUDE QUANTITATIVE MODEL-BASED ESTIMATES OF CREDIT RISK AND RELATED OPINIONS OR COMMENTARY PUBLISHED BY MOODY'S ANALYTICS, INC. AND/OR ITS AFFILIATES. MOODY'S CREDIT RATINGS, ASSESSMENTS, OTHER OPINIONS AND PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND MOODY'S CREDIT RATINGS, ASSESSMENTS, OTHER OPINIONS AND PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. MOODY'S CREDIT RATINGS, ASSESSMENTS, OTHER OPINIONS AND PUBLICATIONS DO NOT COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS, ASSESSMENTS AND OTHER OPINIONS AND PUBLISHES ITS PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL, WITH DUE CARE, MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

MOODY'S CREDIT RATINGS, ASSESSMENTS, OTHER OPINIONS, AND PUBLICATIONS ARE NOT INTENDED FOR USE BY RETAIL INVESTORS AND IT WOULD BE RECKLESS AND INAPPROPRIATE FOR RETAIL INVESTORS TO USE MOODY'S CREDIT RATINGS, ASSESSMENTS, OTHER OPINIONS OR PUBLICATIONS WHEN MAKING AN INVESTMENT DECISION. IF IN DOUBT YOU SHOULD CONTACT YOUR FINANCIAL OR OTHER PROFESSIONAL ADVISER.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

MOODY'S CREDIT RATINGS, ASSESSMENTS, OTHER OPINIONS AND PUBLICATIONS ARE NOT INTENDED FOR USE BY ANY PERSON AS A BENCHMARK AS THAT TERM IS DEFINED FOR REGULATORY PURPOSES AND MUST NOT BE USED IN ANY WAY THAT COULD RESULT IN THEM BEING CONSIDERED A BENCHMARK.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process or in preparing its Publications.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability to any person or entity for any indirect, special, consequential, or incidental losses or damages whatsoever arising from or in connection with the information contained herein or the use of or inability to use any such information, even if MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers is advised in advance of the possibility of such losses or damages, including but not limited to: (a) any loss of present or prospective profits or (b) any loss or damage arising where the relevant financial instrument is not the subject of a particular credit rating assigned by MOODY'S.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability for any direct or compensatory losses or damages caused to any person or entity, including but not limited to by any negligence (but excluding fraud, willful misconduct or any other type of liability that, for the avoidance of doubt, by law cannot be excluded) on the part of, or any contingency within or beyond the control of, MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers, arising from or in connection with the information contained herein or the use of or inability to use any such information.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY CREDIT RATING, ASSESSMENT, OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

Moody's Investors Service, Inc., a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by Moody's Investors Service, Inc. have, prior to assignment of any credit rating, agreed to pay to Moody's Investors Service, Inc. for credit ratings opinions and services rendered by it fees ranging from \$1,000 to approximately \$5,000,000. MCO and Moody's Investors Service also maintain policies and procedures to address the independence of Moody's Investors Service credit ratings and credit rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold credit ratings from Moody's Investors Service and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at www.moody.com under the heading "Investor Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

Additional terms for Australia only: Any publication into Australia of this document is pursuant to the Australian Financial Services License of MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657AFSL 336969 and/or Moody's Analytics Australia Pty Ltd ABN 94 105 136 972 AFSL 383569 (as applicable). This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001. MOODY'S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail investors.

Additional terms for Japan only: Moody's Japan K.K. ("MJJK") is a wholly-owned credit rating agency subsidiary of Moody's Group Japan G.K., which is wholly-owned by Moody's Overseas Holdings Inc., a wholly-owned subsidiary of MCO. Moody's SF Japan K.K. ("MSFJ") is a wholly-owned credit rating agency subsidiary of MJJK. MSFJ is not a Nationally Recognized Statistical Rating Organization ("NRSRO"). Therefore, credit ratings assigned by MSFJ are Non-NRSRO Credit Ratings. Non-NRSRO Credit Ratings are assigned by an entity that is not a NRSRO and, consequently, the rated obligation will not qualify for certain types of treatment under U.S. laws. MJJK and MSFJ are credit rating agencies registered with the Japan Financial Services Agency and their registration numbers are FSA Commissioner (Ratings) No. 2 and 3 respectively.

MJJK or MSFJ (as applicable) hereby disclose that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MJJK or MSFJ (as applicable) have, prior to assignment of any credit rating, agreed to pay to MJJK or MSFJ (as applicable) for credit ratings opinions and services rendered by it fees ranging from JPY125,000 to approximately JPY550,000,000.

MJJK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.