PFM

Maintaining Financial Stability and Improving Infrastructure in an Unprecedented Economic Environment

Presidential Transition Team Meeting

December 16, 2008

The PFM Group

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Introduction

- Today's Meeting Participants
- Economic and Financial Market Conditions
- Confronting the Challenges
- Perspectives from State & Local Governments
- Conclusions

Today's Meeting Participants

The PFM Group

- John White, *Chief Executive Officer*
- Robert Rich, *Managing Director*
- JoAnne Carter, *Managing Director*
- Robert Bobb, *Director*
- John Cape, *Director*
- Scott Trommer, *Senior Managing Consultant*
- Chris Pencikowski, *Consultant*

Municipal Market Participants

- Jerry Bridges, Executive Director, *Virginia Port Authority*
- Ron Carlee, County Manager *Arlington County , VA*
- Kena Cofield, Project Manager, *Hardie Industries, Inc.*
- Jane Garvey, Infrastructure Advisory Group, *J.P. Morgan Securities, Inc.*
- Jerry Johnson, General Manager, *District of Columbia Water and Sewer Authority*
- Reginald Zeno, Finance Director, *City of New Orleans*

Economic and Financial Conditions

- An unprecedented financial environment
  - Global credit crunch and financial system stress
  - Deepening/severe recession

- By law, state and local government budgets must be balanced
  - Projected deficits total in the hundreds of billions of dollars
  - Severely impacted states like California, Nevada and New York face shortfalls of about 20% of general fund receipts
  - In addition to revenue losses, local governments contending with cuts in state aid

Economic and Financial Conditions

- Governments have only limited tools to deal with fiscal problems to balance their budgets
  - Cut jobs. Worsening unemployment
  - Cut services. At a time when more people need more services
  - Raise taxes. Creating further economic problems
  - Borrow. Facing higher debt service costs and constrained market access
- At the same time governments are facing
  - Counter-cyclical expense growth as demands on the social safety net increases—Medicaid, unemployment claims, welfare, use of public health clinics, etc.
  - Increasing employee pension and other benefit obligations while investments to fund those commitments have declined

Economic and Financial Conditions

- Non-profits and public power providers facing severe constraints impacting their ability to provide health care, education and energy

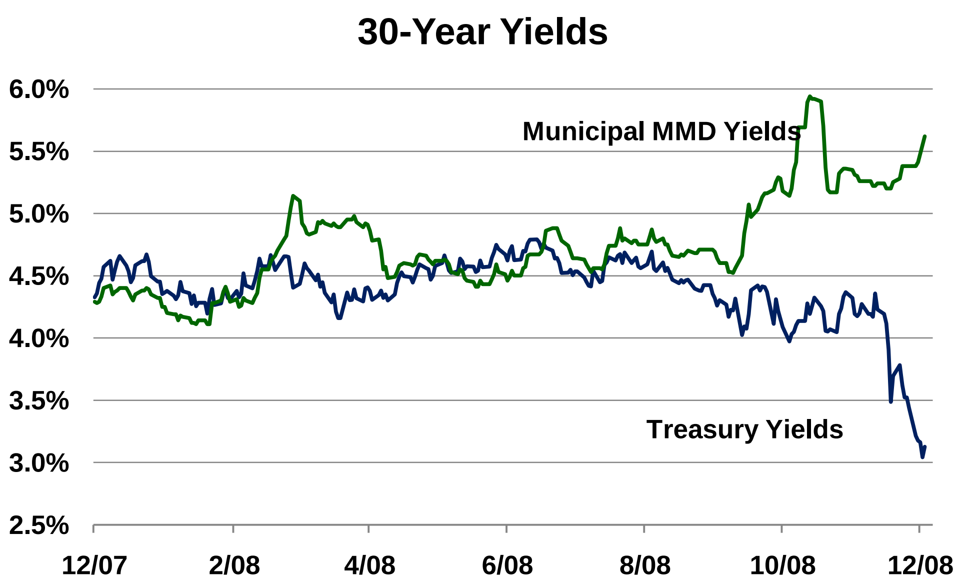
Public Power	Health Care	Higher Education
• Capital needs for new generation alternatives • Constraints on traditional energy generating sources • New alternatives require capital intensive transmission investments	• With rising costs/reduced resources, hospitals facing program cuts • Impacting underserved urban and rural communities • As major employers, layoffs further worsen the economy	• Increasing obligations • Lack of student loan availability • Declining endowments

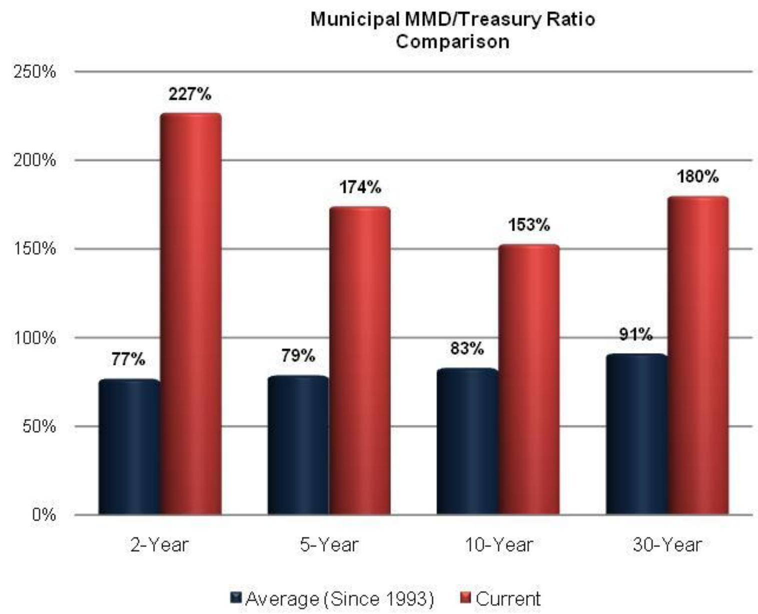
Financial Market Challenges

- Municipal borrowers adversely impacted this year by:
  - Downgrade, diminished value and elimination of bond insurers which helped to lower borrowing costs and provide liquidity
  - Collapse of the auction rate securities market
  - Downgrades, bankruptcies and retrenchment of banks which underwrite bonds and provided financial products to facilitate liquidity and cost effective market access
  - Loss of major investors now facing diminished available capital and/or investing in Treasury securities in a "flight to quality"

Financial Market Challenges

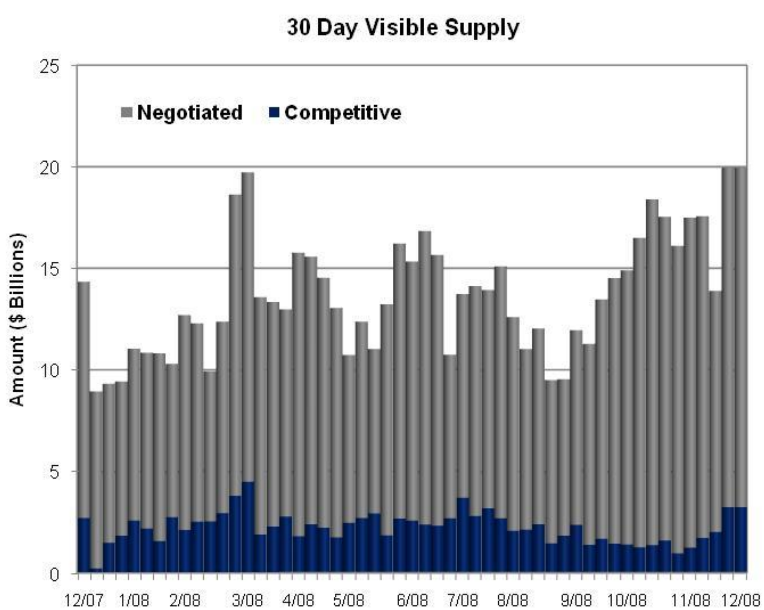
- Creating severe illiquidity in the tax exempt capital markets—limited investors, limited banks and limited options
- Longer dated debt interest rates have increased by about 50-100 basis points
- Municipal demand has not been sufficient to meet the needs of issuers

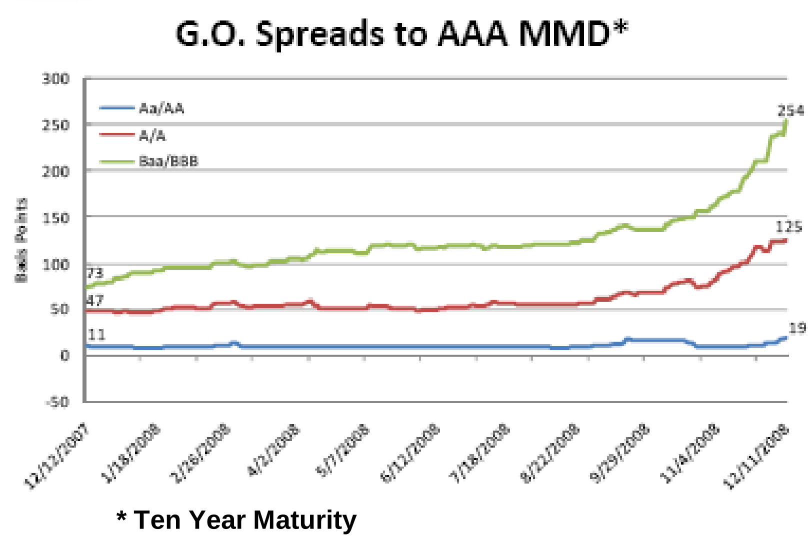




Financial Market Challenges

- Growing backlog of borrowing needs. Retail/individuals are most significant buyers, but have limited capacity
- While higher rated credits in the 'AA'-'AAA' categories are paying more, lower rated issuers facing limited/no market access and no insurance
- Limited synthetic fixed rate alternatives to diversify investor demand





Financial Market Challenges

- In response municipal issuers have
  - Reduced the size of their transactions
  - Issued debt with shorter maturities
  - Actively marketed to retail investors
- Example: Commonwealth of Pennsylvania
  - Rated Aa2/AA/AA
  - Downsized planned $600 million transaction to $300 million
  - Competitive transaction with 5.05% interest rate; compared to 4.02% interest rate for a $405 million transaction in May

Growing Infrastructure Needs

- Financial challenges manifested while public agencies are confronting growing infrastructure needs
- American Society of Civil Engineers identifies $1.6 trillion of needs over the next five years to bring assets to a state of good repair
  - Encompasses transportation, energy, water, solid waste, parks and schools
  - Current infrastructure condition rated "poor"

Confronting the Challenge

- State and local governments have a well-established framework for delivering services, improving infrastructure and, consequently, stimulating the economy
- Direct injections of cash including FMAP, CDBG, block grants and other direct aid measures would help to provide fiscal relief
- This fiscal relief is critical. The liquidity issues we are here to discuss are **not** a substitute for direct assistance
- But direct aid alone will not solve the problem—Federal measures are needed to provide a catalyst for the return of a fully functioning municipal market

Perspectives: State & National

- John Cape, former Budget Director - State of New York, Director of Strategic Consulting - PFM
  - States spend $1.5 trillion annually
  - More than 40 states are now reporting current year deficits
  - Most states will face fiscal stress in their 2009-10 Fiscal years, ranging from catastrophic in states like California, Nevada and New York, to mild in natural resource-rich like the Dakotas, Wyoming, etc.
  - Without FMAP and direct cash block grants, many states will see drastic tax hikes and/or service reductions
  - States need liquidity to generate the non-Federal share of direct assistance and to facilitate and finance infrastructure programs

- Jane Garvey, *Member PTT – Transportation, Infrastructure Advisory Group, J.P. Morgan Securities, Inc., past Administrator, FAA*

Perspective: Major Local Governments

- Jerry Bridges, Executive Director,
  Virginia Port Authority
- Ron Carlee, County Manager,
  Arlington County , VA
- Jerry Johnson, General Manager,
  District of Columbia Water and Sewer Authority
- Reginald Zeno, Finance Director,
  City of New Orleans

Measures to Provide Market Liquidity

Facilitate Market Access

- Federal reinsurance of bond insurers, limited to municipal portfolios
- *Utilizes insurers' existing credit processing infrastructure to provide credit enhancement*
- *Promotes bond insurance availability*
- *Greatly enhances liquidity for institutional investors to purchase and trade bonds, providing improved market access*
- Encourage FHLB and FHA innovation to provide market access for hospitals and higher education institutions
- Federal liquidity back stop for variable rate bonds

Broaden Investor Base

- Eliminate or increase $10 million limit for bank qualified bonds
- *H.R. 6333 raises limit to $30 million and adjusts it annually based on inflationary index*
- *Repeal small issuer aggregation rules*
- Allow financial institutions to hold up to 2% of assets in tax exempt securities without affecting interest expense deduction

Allow Additional Advance Refunding

- Current law limits municipal issuers to one advance refunding
- Issuers of bonds subject to AMT cannot advance refund bonds
- Providing for an additional advance refunding allows municipal issuers to refinance debt at lower interest costs as market conditions warrant

Measures to Facilitate Infrastructure Investments

Expand AMT Exemption

- Extended to all public purpose infrastructure—airports, ports, highways, etc. and to student loans
- Lowers borrowing costs
- Sparks private sector investments utilizing PABs
- Exemption for airports provides dual benefit to public airport operators and airlines

Increase Federal Loan Programs

- Increase TIFIA funding to expand lending capacity
- *Increase allowable percent of project costs financed by TIFIA from 33% to 50%*
- *Provide additional TIFIA refinancing flexibility—loans can be used as part of a refinancing to facilitate a future infrastructure investment*
- Expansion of DOE loan guarantee programs for power projects
- Provide additional capitalization for clean water/drinking water SRFs

Additional Measures

- Provide issuers flexibility to leverage federal grants similar to GARVEE program
- Allow public agencies to sell an equity stake in assets up to a certain percent (i.e., 49%) of capitalization without losing ability to issue tax exempt bonds for those assets

Conclusions

- State and local governments are confronting the dual impacts of a severe recession and significantly constrained municipal market
- Hampering government's ability to deliver services and improve infrastructure when the public needs it most
- Governments have a well-established framework for meeting its constituents needs and serving as a catalyst for the economy—no new agencies needed
- To overcome financial market challenges, measures can be taken by the Federal government under new and existing programs, to restore liquidity, lower borrowing costs and stimulate economic activity

Thank You.