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MUNI MARKET UPDATE

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INSIDE THIS ISSUE:

HARRISBURG: THE INCINERATOR THAT BURNED A CITY

By Larry Levitz

Municipal bonds are relatively safe investments, as evidenced by the modest default rates experienced historically. Those bonds that do default are usually project-type financings where for any number of reasons – including construction problems, operational issues, and overoptimistic demand projections – the projects failed to perform as expected. Recent defaults of this nature include the Las Vegas Monorail deal; Jefferson County, Alabama Sewer bonds; and hundreds of land-secured bonds in Florida. (See "Diamonds in the Rough" by Larry Levitz for an update on land-secured bonds and to obtain resources for performing meaningful due diligence of these transactions.)

General Obligation ("GO") bond defaults, on the other hand, are historically as rare as a Cubs World Series championship. GO issuers have the ability to raise taxes, control expenses, and muster all available revenues to pay debt service.

The default of the City of Harrisburg, Pennsylvania on its GO guarantee of the Harrisburg Authority ("Authority") Resource Recovery Facility ("RRF")

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MARKET UPDATE

Momentum slowed for manufacturers around the world in June, with data from the U.S., China and the Euro Zone adding to worries that global economies are poised for slower growth ahead.

U.S. Treasury yields plummeted as investors fled risk for the safe haven of Government bonds. Buying was heaviest last Thursday morning as 10-year Treasury notes touched 2.878% while 30-year bond's yield hit 3.824%.

The turbulence that's battered financial markets in recent weeks reduced the new issue volume of municipals sold in June to the lowest level that month has seen in 10 years. Issuers floated only $30.5 billion of debt overall last month which represents a 30.4% decline from the $43.9 billion issued in June 2009, according to preliminary data from Thomson Reuters. A combination of increased uncertainty in the municipal market, volatility relating to the European sovereign debt crisis and low nominal yields were to blame for the light supply.

Tax exempt bonds underperformed U.S. Treasuries in the first half of 2010 as municipal headline credit risk combined with the flight-to-quality trade to drive ratios to the highest levels in over a year.

Retail secondary flows remain muted as municipal investors struggled with both low nominal yields and the sharp downturn in the equity markets. ♣

THIS WEEK'S CALENDAR

E.D.T.	Amount	Ratings	Issuer	State	Structure
Tuesday, July 6					
11:30AM	6,137M	UR/UR	Alfred-Almond CSD	NY	2011-2025 BQ
Wednesday, July 7					
11:00AM	21,096M	UR/UR	T/O Bedford	MA	2011-2030 BQ
11:00AM	2,675M	UR/UR	T/O Easton	CT	2011-2025 BQ
11:00AM	15,300M	UR/AAA	T/O Huntington	NY	2011-2025 BQ
11:00AM	84,715M	A3/BBB+	Monroe Co	NY	2011-2030
11:30AM	19,900M	UR/AA	Fairport CSD	NY	2011-2030 BQ
11:30AM	4,788M	UR/UR	Southwestern CSD	NY	2011-2025 BQ
Thurday, July 8					
10:30AM	178,750M	UR/UR	Montgomery Co	MD	
11:00AM	3,395M	UR/UR	Old Tappan Boro	NJ	
			2,120M Gen'l Impt		2011-2022 BQ
			1,275M Rfdg		2011-2019 BQ
11:00AM	122,550M	UR/UR	Montgomery Co	MD	
11:00AM	23,700M	UR/UR	Montgomery Co - TAXABLE - RZED	MD	
11:00AM	37,245M	UR/UR	S/O West Virginia	WV	2013-2023
11:15AM	7,300M	UR/UR	Warren Co (College Bonds)	NJ	2011-2025 BQ
11:30AM	16.925M	UR/UR	Albany Co	NY	2010-2018 BQ
11:30AM	4,583M	UR/UR	Mt Morris CSD	NY	2011-2025 BQ
11:45AM	4,280M	UR/UR	Warren Co (Open Space) - Rfdg	NJ	2011-2018 BQ

Click here for calendar updates.

VISIBLE SUPPLY

The 30-day visible supply of municipal bonds totaled $5.535 billion, down $314.0 million from the previous session, according to The Bond Buyer.

That comprises $1.173 billion of competitive bonds, which is down $36.4 million and $4.633 billion of negotiated bonds, which is down $277.6 million.

Week of July 5, 2010

Total supply: $2.5B

Taxable/BABs: $0.77B

Tax-Exempt: $1.74B

The 30-day visible supply is calculated by The Bond Buyer and reflects the total dollar volume of bonds to be offered at competitive bidding and through negotiation over the next 30 days.

Source: Thomson Reuters. 7/2/2010.

ECONOMIC CALENDAR

HARRISBURG: THE INCINERATOR THAT BURNED A CITY (CONT'D)

bonds stands out as an example of an otherwise creditworthy city unwisely attaching its GO pledge to a risky project financing. The city's GO pledge was required as credit support so the Authority could sell its bonds. City officials, particularly the then-mayor, believed that the plant could sell the steam and electricity it produced for a profit. As a result, they let project costs to spiral out of control.

Investors have not suffered any losses from Harrisburg's financial crisis because municipal bond insurer Assured Guaranty has insured all of the RRF bonds. While Harrisburg's travails certainly underscore the value of bond insurance, they also point to the need for investors to do their credit homework.

Ultimately, it will be the citizens of Harrisburg who will suffer the most from this debacle, in the form of increased taxes and fees, reduced services, and higher borrowing costs.

Beginnings

Harrisburg is city of approximately 47,000 located along the eastern shore of the Susquehanna River in south-central Pennsylvania. It is the State capital and the county seat of Dauphin County.

The incinerator was built in the late 1960s to serve the city and its neighboring jurisdictions. From the first, the plant was beset with problems, frequent breakdowns and ongoing repairs which limited production. During the early 1980s, city officials, with the help of outside experts, made significant repairs and improved operations. Operating stability enabled the plant to turn a profit for the remainder of the decade.

In 1993, the city transferred the plant to the Harrisburg Authority, formerly the Harrisburg Water and Sewer Authority, for $55 million. To finance a portion of the sale price, the Authority issued $41 million of Authority RRF bonds payable first from net revenues of plant operations and backed up by the city's guaranty to pay any shortfalls in net revenues for debt service. This guaranty represented a full faith and credit obligation of the city. The city guaranty was applied to all subsequent RRF issues as well.

Crisis

Until the 1990s, the city's commitment to the plant was at manageable levels. However, when regulatory changes required extensive refurbishment of the plant, the city's stake in the project rose dramatically.

The issuance of more stringent federal air quality standards during the 1990s led to Harrisburg's financial collapse. By this time, the public had developed an increased awareness of the air pollution risks posed by incinerators. Hundreds of incinerator projects were either cancelled or put on hold.

Authority and city officials were under growing pressure from the Environmental Protection Agency ("EPA") to bring the plant into compliance with the new standards. Already, EPA had identified the Harrisburg plant as the largest emitter of dioxin in the nation and a substantial grass roots movement had formed to shut down the plant.

In 2000, EPA ordered the plant to be shut down due to continuing air pollution violations. The shutdown lasted about a year, followed by a negotiated agreement allowing it to reopen.

The arrangement called for the plant to burn trash at a reduced rate, temporarily resulting in its reclassification as a "small" waste incinerator and the ability evade the stricter large incinerator requirements. The Agreement terminated on June 13, 2003.

To bring the plant into compliance, Harrisburg 'doubled down' its bet on the incinerator in 2003 with a $125 million bond issue to retrofit the plant. These bonds, backed by the city's guaranty, added to the Authority's existing $100 million debt load. Approximately $110 million of the issue also carried a second guaranty from Dauphin County, which would become operative only if the city failed to pay on its first guaranty. A portion of the bonds also had swaps associated with them, with payments to the swap provider also guaranteed by the city and county.

To manage the project, the Authority chose a relatively inexperienced firm, Barlow Projects, Inc., who had undercut the bids of more established competitors by $40 million. Barlow had developed an improved technology and had indicated that it could complete the project for $47 million. However, the company had never worked on a project anywhere near the size of the Harrisburg retrofit.

Delays, shoddy construction, design flaws and cost overruns plagued the work. By 2007, the estimated cost of the retrofit

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HARRISBURG: THE INCINERATOR THAT BURNED A CITY (CONT'D)

had risen to $90 million and was a year behind schedule. Barlow was forced off the project and the Authority filed a lawsuit against it. Barlow then filed for bankruptcy.

The situation was not helped by the fact that Barlow had never posted a performance bond for its work. A performance bond, required on most construction projects, is an insurance payment to the owner to complete a project if the original contractor leaves the work unfinished. In many government construction contracts, the performance bond would cover the full cost of the original contract.

Tellingly, Barlow's inexperience had disqualified it for a performance bond, but the Authority had moved ahead with Barlow anyway. Now, the Authority was forced to come up with more funds from other sources.

The Authority brought in Covanta Energy to finish the work. The project was not completed until 2008 and the plant continued to experience equipment failures.

As a result, the Authority was forced to issue additional financing notes and take out loans to finish the job. Authority debt, all of it guaranteed by the city, now exceeded $300 million and the plant was still losing about $1 million per month.

In 2008, the Authority was desperate for more revenues and sought to impose a $100 per ton rate increase for county trash, which accounted for two thirds of plant volume. Based on a 2003 agreement, the county was able to block any increase in tipping rates at the plant. Because of this provision, there was a huge disparity in rates with city users charged $200 per ton versus the county waste charge of $50 per ton. When the county vetoed the rate hike, the dispute went into arbitration. The result was a paltry increase of $1.58 per ton for county trash. Authority operations continued to lose money.

By 2009, the Authority was using city and county guarantee payments, debt service reserve funds and borrowing $3.2 million from its Sewer Fund to pay scheduled debt service on the bonds.

The outlook for 2010 is dire. About $68 million of RRF bonds and loans come due, greater than the city's $65 million budget for 2010. The city did not include debt service payments on its guaranteed bonds in its 2010 budget. This year, the city has already missed debt service payments on its guaranteed bonds as well as a payment on a $20 million dollar loan to Covanta.

The county is suing Harrisburg for compensation for payments made under its second guaranty of RRF bonds as well as associated swaps.

In February, Moody's downgraded the city's GO rating to B2, which puts the city's credit firmly into junk status.

The city continues to pay its direct GO bond debt service on time. The RRF Bonds themselves are highly rated because of insurance. City officials are discussing bankruptcy as a realistic alternative.

Options

The city has no good options available. City officials are in the process of negotiating a forbearance agreement with the bond insurer, Dauphin County, the Authority and other parties. Forbearance would relieve the city of its debt obligations for a three-month period while it comes up with a strategy to pay its debts.

The city commissioned a study from Management Partners, a consulting firm, to develop a plan to navigate the crisis. Management Partner's report recommended the sale or lease of city assets as the best approach to raise money quickly.

Potential assets include the plant itself, the city's parking garages, and City Island, a patch of land in the middle of the Susquehanna River, which serves as a city park. Proceeds from the sales or leases would be used to pay down city debt.

Other suggestions involve the city revisiting its labor agreements, cutting expenditures, and possible increases in fees.

Chapter 9 municipal bankruptcy offers insolvent municipal issuers protection from creditors, allowing them to develop workable plans to reorganize their debts and obligations. However, Chapter 9 bankruptcy is a long and costly process and the stigma attached to a bankruptcy filing can affect the issuer's access to the capital markets for years.

The extreme nature of such a filing (only 600+ filings since inception in 1934), has led most states to prohibit localities from filing on their own. Pennsylvania law requires that Harrisburg resolve its debt issues through the State's Act 47 program for distressed municipalities be-

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fore it can file for bankruptcy. Act 47 provides assistance and oversight to municipalities as they work out a plan to restore their financial viability. The state can make small grants and loans as part of the Act 47 process, but Governor Rendell has already indicated that a state bailout of Harrisburg is not feasible.

Clearly, the city is in a bind. The Mayor and City Council President have both stated that bankruptcy is not an option.

The best outcome would be for the City to sell the plant for an amount that would cover most of its associated debt. Such a rosy scenario seems unlikely because of its problem-riddled history.

Perhaps a combination of measures, debt restructuring, sale of some City assets, an agreement with the County to equalize tipping fees and some tax and spending initiatives could bring debt service down to manageable levels. Much of this can be done through a comprehensive forbearance agreement with all interested parties, enabling the City to avoid state and federal oversight. City officials have a long road ahead of them.

The Bond Buyer reported on July 1st that the City may select qualified financial advisers to participate in a request for proposal process to deal with the issue.

The Harrisburg crisis was caused not by the economic recession but by a series of bad decisions made over the last decade by city officials. For investors, the Harrisburg case demonstrates that management does count, that even a state capital can be brought down by bad governance. Fundamental credit research can help investors avoid situations like these. For the city, there are few precedents to provide guidance. As the Authority bond counsel told the City Council at a meeting

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Chapter 9 Municipality Bankruptcy

Chapter 9 is the chapter of the Bankruptcy Code providing for reorganization of municipalities (which includes cities and towns, as well as villages, counties, taxing districts, municipal utilities, and school districts).

The purpose of Chapter 9 is to provide a financially-distressed municipality protection from its creditors while it develops and negotiates a plan for adjusting its debts. Reorganization of the debts of a municipality is typically accomplished either by extending debt maturities, reducing the amount of principal or interest, or refinancing the debt by obtaining a new loan.

Although similar to other chapters in some respects, Chapter 9 is significantly different in that there is no provision in the law for liquidation of the assets of the municipality and distribution of the proceeds to creditors. Such a liquidation or dissolution would undoubtedly violate the Tenth Amendment to the Constitution and the reservation to the states of sovereignty over their internal affairs. Indeed, due to the severe limitations placed upon the power of the bankruptcy court in chapter 9 cases (required by the Tenth Amendment and the Supreme Court's decisions in cases upholding municipal bankruptcy legislation), the bankruptcy court generally is not as active in managing a municipal bankruptcy case as it is in corporate reorganizations under Chapter 11.

The functions of the bankruptcy court in Chapter 9 cases are generally limited to approving the petition (if the debtor is eligible), confirming a plan of debt adjustment, and ensuring implementation of the plan. As a practical matter, however, the municipality may consent to have the court exercise jurisdiction in many of the traditional areas of court oversight in bankruptcy, in order to obtain the protection of court orders and eliminate the need for multiple forums to decide issues.

Source: United States Courts. www.uscourts.gov

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in December, "There has never been a default like this in Pennsylvania municipal finance history. This is all new territory." ♣