City of Tucson Independent Audit and Performance Commission

May 13, 2014

Subject: Report to Mayor and Council: Commission Comments on City of Tucson's Comprehensive Annual Financial Report (CAFR) for Fiscal Year Ending June 30, 2013

Honorable Mayor and Council:

During the past several months, the City's Independent Audit and Performance Commission (IAPC) reviewed the City's Comprehensive Annual Financial Report (CAFR) for Fiscal Year Ending June 30, 2013. In addition to the IAPC member's individual reviews of the CAFR, the City's external audit firm, CliftonLarsonAllen, presented an overview of the CAFR at the February IAPC meeting, and Finance Department staff responded to the Commission's CAFR questions at the March and April IAPC meetings. Those questions and staff responses are attached.

The City's CAFR contains both a *Management's Discussion and Analysis* and *Notes to Basic Financial Statements* sections. These sections provide significant discussion and details on the City's finances and challenges.

<u>Comments</u>

The Commission would like to highlight the following:

1. The City's General Fund assigned/unassigned fund balances (portion of Fund Balance available for spending) declined 25% from the prior year:

	Balance at June 30, 2012	Balance at June 30, 2013
Stabilization Fund	$ 22.8 million	$ 22.8 million
Assigned Fund Balance	18.1 million	1.7 million
Unassigned/Unreserved	8.7 million	12.8 million
Total	$ 49.6 million	$ 37.3 million

2. The General Fund's cash balance at June 30, 2013 (CAFR page 20) was under $700,000. For year-end statement purposes, the General Fund must cover the negative cash balances in the other funds. At June 30, 2013 the General Fund covered over $25.5 million in deficits in other funds (see question/response # 5 - IAPC *2013 CAFR Questions,* attached).

3. The CAFRs two year comparison of the City's bond ratings (see the *Management's Discussion and Analysis*, CAFR page 15) showed that two of three bond rating companies, Standard and Poor's and Fitch, assigned the same bond ratings during FY's 2012 and 2013. The third company, Moody's, downgraded the City's General Obligation and Street and Highway bonds by one level.

According to Moody's *Summary Rating Rationale,* the downgrade "reflects a still relatively weak financial position compared to Aa-rated cities nationally featuring chronically low general fund cash and reserve levels and above average levels of debt."

It was also noted that Moody's "outlook on the City's long-term ratings has been revised to stable from negative." This positive change reflects Moody's view that "the City will continue its efforts to improve cash and reserve levels albeit at a slow pace."

4. The funded ratio for the Tucson Supplemental Retirement System decreased slightly from 63.5% at June 30, 2012 to 63.3% at June 30, 2013. Funding ratios for the Police and Fire retirement systems decreased from 51.6% and 50.2%, to 49.5% and 47.3%, respectively. Employer contributions rates, based on actuarial analysis, for all three retirement systems were increased for the current fiscal year. Additional increases for FY 2015 have been adopted by the City's Pension Board and included in recommended budgets for FY 2015.

Recommendation

The City's *Comprehensive Financial Policies*[1], adopted by Mayor and Council, do not clearly layout the decision process for increasing the General Fund's Stabilization Fund or the Unassigned Fund Balance accounts when year-end funds are available (see question/response # 7 - *IAPC 2013 CAFR Questions,* attached). Since the *Financial Policies* define how the various fund balance elements may be used, and in some cases restored, it is recommended that City Staff and Mayor and Council have an annual discussion related to year-end allocations to fund balance components.

Additional Comment

During its review of the 2011 CAFR, the IAPC made the following recommendation:

> *The IAPC recommends that the General Fund formally record the coverage of Golf's cash deficits as a long term loan. The Commission recognizes that formalizing the loan will reduce the General Fund's Unassigned Fund Balance and increase its Nonspendable or Committed Fund Balance's, both by the loan amount. It is, however an accurate reflection of the unavailability of those funds to meet other General Fund needs pending repayment of the loan. This recommendation is made with the following considerations in mind:*
>
> - *Transparency: The extent of the General Fund cash support of the Golf Fund, and contingent exposure to loss, should be clearly evident in financial statements.*
> - *Conservative Presentation and Risk: As the amount of Golf's cash deficit increases, the probability of repayment within the next several years is significantly reduced. Repayment, when it occurs, is likely to be many years in the future.*

The IAPC notes that the 2013 CAFR reflects the implementation of this recommendation.

The Commission would like to acknowledge Mike Mason, Accounting Administrator, for

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[1] *http://finance.tucsonaz.gov/files/finance/res21977.pdf* pages 9 and 10.

presenting information on the CAFR and coordinating responses to the Commission questions.

Commission members appreciate the opportunity to provide the Council with review of relevant issues. Please contact your appointee to the Commission, or the City Manager, should you have topics you would like the Commission to review.

Respectively Submitted,

Kevin Oberg
IAPC Chair

Attachment: *IAPC 2013 CAFR Questions* and Staff Responses

c: Richard Miranda, City Manager
Kelly Gottschalk, Assistant City Manager/CFO
Albert Elias, Assistant City Manager
Martha Durkin, Assistant City Manager
Silvia Amparano, Finance Director

IAPC 2013 CAFR QUESTIONS and STAFF RESPONSES

(1) ***Page vii:***
"Tucson's gross metropolitan product or output accelerated throughout the year, which led the Region and the nation." What is the source of this statement?

The source of this information is from the Brookings Mountain Monitor, which provides economic data for various geographic areas of the United States. The City of Tucson is included in the Intermountain West Metropolitan region, which includes Albuquerque, NM, Boise, ID, Colorado Springs, CO, Las Vegas, NV, Ogden, UT, Phoenix, and Provo, UT. I use this information to provide comparisons of economic data.

The June 2013 Brookings report compared the first quarter of 2013 to the first quarter of 2012, not the full year. Per the report, Phoenix's quarter to quarter growth exceeded Tucson's. Per the report *"Phoenix and Tucson led the region and the nation with output growth of 1.2 percent and 1.1 percent, respectively, over the first quarter. "*

http://www.unlv.edu/brookingsmtnwest/mountain-monitor.
The June 2013 edition provides some information, although not the exact words.

(2) ***Page viii:***
"....current 5-year projections show strong potential for the imbalance to continue..." What are the yearly projected imbalances?

See attached.

(3) ***Page 10:***
"Water commodities (expense) decreased primarily because of adjustments to decrease inventory..." How does a decrease in inventory reduce expense in an enterprise fund?

About $500,000 in General Fund inventory issues were erroneously charged (as expenses) to the Water Utility fund during the year. These expenses were corrected and recorded late in the fiscal year thus reducing the Utility's expenses.

(4) ***Page 15:***
What reasons did Moody's give for the bond rating changes for GO, and Street and Highway bonds?

See attached Moody's Investors Service report.

(5) ***Page 20:***
The General Fund's Pooled Cash and Investments at June 30 was $681,357. Is this a typical day-to-day level for the fund?

No, this balance represents imprest cash accounts. The General Fund will normally average about $30 million on a monthly basis. *At year end, the General Fund must cover* *the negative cash balances in the other funds.* The coverage of the negative cash balances are recorded as interfund receivables in the General Funds and interfund payables in the borrowing fund. For FY 2013 this amounted to $25.5 million distributed as follows:

Mass Transit	$5,185,525
ParkWise	77,258
Community Development Block Grant	132,751
Miscellaneous Housing Grant	948,585
HOME Affordable Housing	598,395
Other Federal Grants	2,644,685
Non-Federal Grants	407,478
GO Bond and interest	59,088
Capital Projects	5,072,657
RTA	10,421,111

The amounts for Mass Transit and Other Federal Grants - are these cash deficits the result of expenditures awaiting federal reimbursement?

That is correct.

The amount for Capital Projects – are cash deficits the result of expenditures awaiting bond sale proceeds?

No, this is similar to the federal reimbursements, except the reimbursement is coming from other agencies such as Pima County.

(6) Page 39:
What makes up the $1.7 million in Assigned Fund Balance?

The $1.7 million represents a management assignment of $657,000 for the ERP project, $478,000 for the IBM licensing project, and $198,340 from the M&C budget surplus to use in FY 2014. The remaining $347,560 is the imprest cash.

How is the $4.3 million restricted for Public Safety to be used?

The $4.3 million represents various accounts that include ant-racketeering funds and City Court programs that are restricted for specific use by State Statute.

(7) Page 39:
The Stabilization Fund remained constant from June 30, 2012 to June 30, 2013, while the Unassigned Fund Balance increased from $8,668,230 to $12,765,747. How is the allocation to these two portions of Fund Balance determined/calculated?

The Stabilization Fund was established by M&C. Our financial policies require that this amount represent 10% of the General Fund revenues (currently 5.2%). With our current budget challenges, this balance has not been increased. For the unassigned fund balance category, the goal is 7% of General Fund revenues (currently 3%).

The unassigned balance represents discretionary resources available for expenditure. This balance will increase or decrease based on how the other categories increase or decrease. Based on management decisions, funds can be moved into the assigned category to meet the next fiscal year budget requirements.

During the period that both the Stabilization Fund and Unassigned Fund Balance are being grown towards policy levels, who determines, assuming funds are available, by how much and when each are increased? Is this a judgment call by M&C, City Manager, and Finance Director?

The City Manager would make the recommendation to M & C based on discussions with the CFO and the Finance and Budget Directors.

(8) ***Page 50:***
What makes up the $25.5 million in General Fund interfund receivables?

See question 5.

(9) ***Page 61:***
Please explain the Funding Policy table.

The purpose of the table is to disclose the actuarially computed Annual Required Contribution (ARC) and whether or not the employer is making the associated contributions. If not made, then a liability must be recorded. Three years of data is required.

(10) ***Page 61/62:***
The ARC amount for OPEB varies slightly between the tables on these pages. Intentional?

Unintentional.

***Which $$ amount is correct*?**

The figure on page 62 for the ARC should be $17,005,336 (the amount on page 61 is also incorrect). The figure on page 62, $17,041,069, is actually the total OPEB cost. The difference between the Employer Contributions and the OPEB cost for the year would represent the increase in the liability. The liability of $8,575,266 is correct.

(11) ***Page 68:***
Restatements affected Unrestricted amounts. Please briefly explain the new Pronouncements impact on Unrestricted accounts?

The new pronouncement now requires that bond issue costs be expensed instead of amortized over the period on the bond issue. This required that the remaining unamortized costs be expensed and treated as an adjustment to unrestricted net position. The impact on the Water Utility fund was $4.4 million reduction and a $7.8 reduction for Governmental Activities.

(12) ***Page 89:***
Golf received $3.6 million in Special Items (assumption of Golf COPs debt by the General Fund). At the October 23, 2012 meeting, Mayor and Council decided to transfer a portion of the Houghton Road Golf property (Civano) to the General Fund in exchange for the General Fund's assumption of the COPs debt. How was this land transfer recorded/reported in the CAFR?

The transfer of land from the Golf Enterprise Fund to the Governmental Activities was at net book value of $709,141.

Is a summary of the appraisal report available (showing that the value of land transferred equals the COPs debt being paid by the General Fund?

Please see attached appraisal report dated May 8, 2013 by AXIA Real Estate Appraisers. The purpose of this report was to assess the market value of approximately 70.54 acres located in the southwest portion of the Civano property owned by the City's general government (APN 141-01-007B). This property is adjacent to the 242.55 acres transferred from Golf to the General Fund during Fiscal Year 2013 in exchange for the assumption of the COPs debt. In the appraisal report's conclusion (pg. 45), the market value is approximately $15,000 per acre. Assuming this acreage serves as a comp for the adjacent Golf property, the estimated market value of the land transferred is $3.6 million dollars (i.e. $15,000 per acre times the 242.55 acres). However, per governmental accounting standards (GASB 48), the 2013 CAFR transferred the land at book value of $709,141, as noted in the financial statements located on page 89, "Transfers In".

(13) ***Page 91:***
What makes up the $29.5 million in Self Insurance Fund Other Assets?

This represents the bond that the Industrial Commission requires the City to purchase to keep our ability to self-insurance.

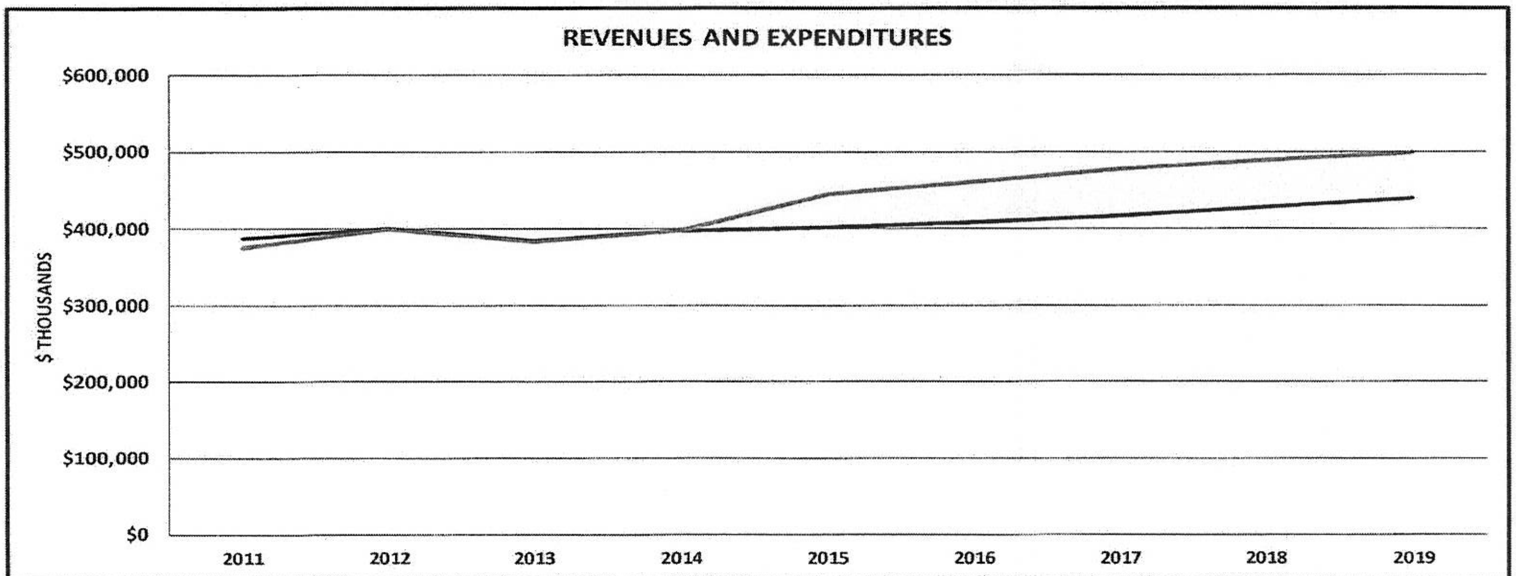
(14) ***Page 138:***
The per capita personal income seem extremely high for Tucson ($69,447 for 2013, although all years seem high. Please verify.

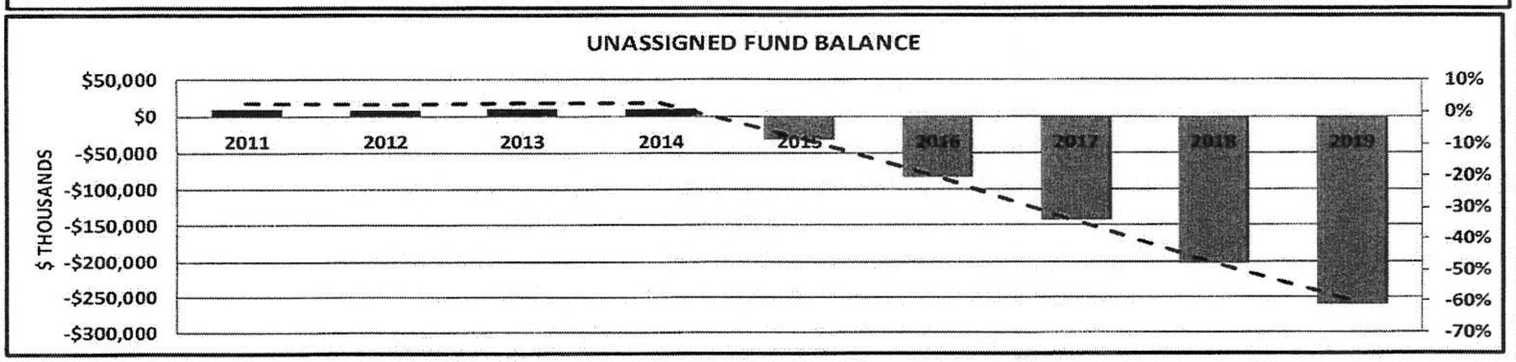
The personal income is for the Tucson metropolitan area (Pima County) so the population (996,700) should represent the entire area and not just Tucson. This would reduce the per capita personal income to about $37,153. The table will be corrected for the FY 2014 CAFR.

Attachment for Question #2

tucsonaz.gov

Five Year Financial Model: General Fund





MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns A1 rating to the City of Tucson, Arizona's Senior Lien Street and Highway User Revenue Bonds, 2013

Global Credit Research - 29 May 2013

Outstanding Senior Lien Street and Highway User Revenue Bonds downgraded to A1 from Aa3; rating carries a stable outlook

TUCSON (CITY OF) AZ
Cities (Including Towns, Villages and Townships)
AZ

Moody's Rating

ISSUE		RATING
Senior Lien Street and Highway User Revenue Refunding Bonds, Tax-Exempt Series 2013A		A1
Sale Amount	$34,250,000	
Expected Sale Date	06/11/13	
Rating Description	Special Tax: Transportation-Related	
Senior Lien Street and Highway User Revenue Refunding Bonds, Federally Taxable Series 2013B		A1
Sale Amount	$23,220,000	
Expected Sale Date	06/11/13	
Rating Description	Special Tax: Transportation-Related	

Moody's Outlook STA

Opinion

NEW YORK, May 29, 2013 --Moody's Investors Service has assigned an A1 rating to the City of Tucson, Arizona's Senior Lien Street and Highway User Revenue Refunding Bonds Tax-Exempt Series 2013A and Senior Lien Street and Highway User Revenue Refunding Bonds Federally Taxable/State of Arizona Tax-Exempt Series 2013B. At this time, Moody's downgrades to A1 from Aa3 the rating on the city's parity senior lien bonds, outstanding in the amount of $32.97 million, not being refunded with the current issuance. Moody's also downgrades to A2 from A1 the city's $20.7 million of junior lien street and highway user revenue bonds. Moody's also revises the outlook to stable from negative on the long term ratings. The current offering is secured by a pledge of the city's highway user revenues, including fuel taxes, registration fees, and license taxes that are collected by the state and returned to municipalities by formula that considers population and point of sale. Bond proceeds will be used to refund certain maturities of the city's outstanding senior lien bonds for upfront savings.

RATINGS RATIONALE

The downgrade to A1 reflects a recent and prolonged trend of declining passive, pledged revenues, a broad revenue pledge, and sound but weakened coverage levels, as well as relatively weak bondholder protections. The stable outlook reflects estimates of improved pledged revenues in the current fiscal year (2013) will likely continue to improve over the near-term horizon resulting in a slightly improved coverage of maximum annual debt service.

STRENGTHS

- Broad nature of the pledge

- Adequate coverage levels

CHALLENGES

- Ability of the state to adjust revenue distributions to local municipalities

- Consecutive years of declining, passive pledged revenues

- Weak legal structure that lacks a debt service reserve or structural enhancements

DETAILED CREDIT DISCUSSION

DECLINING PASSIVE PLEDGED REVENUES HAVE LED TO LOWER, BUT STILL SOUND COVERAGE LEVELS

Pledged revenues are derived from the city's share of state collected highway user revenues, including fuel taxes, registration fees, and license taxes. Of the revenue collected by the state, 27.5% is allocated to incorporated cities and towns, and incorporated cities with a population of 300,000 or more (such as Tucson) get an additional 3% apportioned by population. Of the 27.5% distribution to cities and towns, half is distributed based on population, and the remaining half is apportioned by point of sale of motor fuels. Attributable to both the weak economy and diversions at the state level, pledged revenues declined sharply during the recession, falling from $50.6 million in 2006 to $37.2 million in 2012, with the largest declines coming in 2009 (-6.3%) and 2011 (-8.0%). As a result, coverage of maximum annual debt service (MADS, estimated to be in 2017) fell to a still-sound 2.13 times in 2012. Coverage of combined junior and senior lien debt MADS was a similar 2.12 times. City officials are projecting a solid increase in 2013 pledged revenues to $40.8 million (9.8%), which would raise MADS coverage slightly on both liens. Pledged revenues not used for debt service are restricted to highway-related capital projects.

SOMEWHAT WEAK LEGAL COVENANTS

The legal covenants for the current bond issue are somewhat weak, lacking both a debt service reserve or any structural enhancements such as monthly segregation of funds. The additional bonds test is 1.5 times maximum annual debt service (MADS), plus a statutory requirement that if pledged revenues do not equal 2.0 times MADS, the bonds must be rated "A" or higher by a nationally recognized credit rating service, inclusive of any credit enhancements. The city does not anticipate issuing additional street and highway revenue bonds anytime in the near future.

LOCAL ECONOMY APPEARS TO IMPROVING

The city is the second largest in the state after Phoenix (GO rated Aa1 with stable outlook), covering 230 square miles and serving a population of 523,471 (2013). The city is seeing noticeable economic improvement; unemployment as of March 2013 was just 7.3%, down from the recession high of 9.9% (seasonally unadjusted figures from the Bureau of Labor Statistics), although some of this improvement may be attributable to individuals dropping out of the workforce. Wealth measures remain below average and primarily due to the large university presence; per capita income and median family income levels were 74.1% and 75.2% of the U.S. according to the American Community Survey. Significant development related to student housing, expansion in retail as well as in the leisure/hospitality and healthcare sectors will likely help the city's recovery.

WHAT COULD MOVE THE RATING-UP

- Sustained increases in pledged revenues leading to higher coverage levels

- Strengthening of legal covenants

WHAT COULD MOVE THE RATING-DOWN

- Adjustments at the state level that would result in lower pledged revenue receipts

- Declines in pledged revenues

KEY STATISTICS

Estimated population: 523,471

2010 per capita income: 74.1% of U.S.

2010 median family income: 75.2% of U.S.

2012 highway user revenues: $37.16 million

Senior Lien Maximum annual debt service (estimated): $17.4 million (2017)

Senior Lien Maximum annual debt service coverage (2012 pledged revenues): 2.13 times

Junior Lien Maximum annual debt service (estimated): $17.5 million (2015)

Junior Lien Maximum annual debt service coverage (2012 pledged revenues): 2.12 times

The principal methodology used in this rating was US Public Finance Special Tax Methodology published in March 2012. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns Aa3 rating to City of Tucson, Arizona's General Obligation Bonds, 2013

Global Credit Research - 29 May 2013

Outstanding G.O. Bonds downgraded to Aa3 from Aa2; outlook revised to stable from negative

TUCSON (CITY OF) AZ
Cities (including Towns, Villages and Townships)
AZ

Moody's Rating

ISSUE		**RATING**
General Obligation Refunding Bonds Taxable /State of Arizona Tax-Exempt Series 2013-B		Aa3
Sale Amount	$26,670,000	
Expected Sale Date	06/15/13	
Rating Description	General Obligation	
General Obligation Bonds Tax-Exempt Series 2012-A (2013)		Aa3
Sale Amount	$20,000,000	
Expected Sale Date	06/15/13	
Rating Description	General Obligation	

Moody's Outlook STA

Opinion

NEW YORK, May 29, 2013 --Moody's Investors Service has assigned a Aa3 rating to the City of Tucson, Arizona's, General Obligation Bonds Tax-Exempt Series 2012-A (2013) and General Obligation Refunding Bonds Federally Taxable/State of Arizona Tax-Exempt Series 2013-B. At this time, Moody's downgrades to Aa3 the rating on the city's $185.3 million in outstanding parity General Obligation Bonds. Moody's also downgrades to A1 from Aa3 the city's Certificates of Participation outstanding in the amount of $252.8 million.

Moody's has also downgraded to A1 from Aa3 the Rio Nuevo Multipurpose Facilities District Certificates, Series 2009 ($12.56 million outstanding) and the Civano Phase 1, Neighborhood 1, District Special Assessment Improvement Bonds ($1.12 million outstanding) to A1 from Aa3.

Proceeds from the current issuance will be used to fund various street and road improvement projects and to refund certain maturities of previously issued general obligation bonds. The current offerings are secured by the City's unlimited property tax pledge.

The outlook on the city's long-term ratings has been revised to stable from negative.

SUMMARY RATING RATIONALE

The downgrade to Aa3 reflects a still relatively weak financial position compared to Aa-rated cities nationally featuring chronically low general fund cash and reserve levels and above average levels of debt. The Aa3 rating also takes into account the city's large and diverse economy that is in the beginning stages of recovery. The revision of the outlook to stable from negative reflects our view the City will continue its efforts to improve cash and reserve levels albeit at a slow pace. The outlook also takes into account that the city will continue to be challenged to improve its overall financial position given a trend of growing pension and OPEB costs and increased mass transit subsidies.

STRENGTHS

-Long-term economic growth prospects aided by a highly educated workforce, affordable cost of living and low business costs

-State and local consumer-related revenues continue to improve, albeit slowly

-Stabilizing university presence

CHALLENGES

-Relatively low reserve levels combined with a high exposure to economically-sensitive revenues

-Trend of increased mass transit subsidies and costs associated with employee benefits

DETAILED CREDIT DISCUSSION

ECONOMIC RECOVERY FOR STATE'S SECOND LARGEST CITY CONTINUES DESPITE GAINING LITTLE GROUND IN 2013

Tucson's economic recovery remains intact despite gaining little ground through the beginning of calendar year 2013. Moody's Economy.com projects employment growth of 1.5% for the Tucson metropolitan area for 2013 followed by a gradual increase in employment between 2% and 4% through 2017. As of March 2013, the city's unemployment rate improved to 7.3% (from a high of 9.9% in 2010), which was lower than both state (7.8%) and national (7.6%) levels.

Traditionally, steady but somewhat slow population growth has been an advantage for the metro area and recent census data indicate this trend continues. Between 2000 and 2010, the city's population increased only 6.9%, followed by a trend of still slower increases through 2012 to an estimated 523,471 residents. Going forward, the rate of in-migration is expected to increase supported by affordable housing which should support ongoing demand, while low business costs and a highly educated workforce are expected to support investment and diversification in the local economy as well as continued hiring in leisure/hospitality, construction and healthcare. We also note there remains a degree of uncertainty surrounding sequestration defense procurement cuts and how lower federal spending will impact the city's large defense and aerospace employers. Lastly, the presence of the University of Arizona's large college population does provide significant economic stability to the region but does depress Tucson's wealth indices to some degree which are less than favorable compared to similarly-rated cities.

Real estate values have increased steadily since 2012 but remain well below peak levels. Additionally, although lagging assessed valuations are still declining, the city's property tax revenues are expected to remain stable over the near- to medium-term. Moody's notes that the city's debt service levy (the secondary levy) is unlimited as to rate or amount and, by statute, the operating levy (the primary levy) is limited and may grow by only 2% annually, plus new construction and accepted torts, regardless of underlying changes in assessed value. After peaking in fiscal 2010, the full cash value of property declined by nearly 19% over the subsequent three years to $25.3 billion (2013) and just below the 2008 full cash value. Preliminary estimates from the county assessor indicate another decline, albeit smaller in 2014 before resuming growth in 2015. Although significant, Moody's notes recent declines were relatively mild compared to other areas in Arizona, particularly in Maricopa County. Full value per capita is amongst the lowest for its peer rating group at $48,288.

Importantly, in an effort to revitalize the city's downtown, the city is working collaboratively on significant projects to develop student housing in the downtown area. In addition, the recent openings of several big box retailer in the last year, a new auto dealership in early 2014, as well as new hotels opening later in 2013 are also signs of positive private development activity. Another potential key driver to furthering public and private development downtown is the construction of a 3.9 mile streetcar connecting the University of Arizona campus to the city's 4th Avenue business district, the Arizona Health Sciences Center, and downtown Tucson. The streetcar project recently received significant funding from federal grants and due to recent delays is now projected to be operational in 2014.

Though near-term economic growth will continue to be restrained, Tucson's economic recovery will slowly match the pace of Arizona's over the next two years supported in large part by expansion in the leisure/hospitality and healthcare sectors. Longer term, favorable demographics and established defense and aerospace industries will support above-average growth in the metro area.

IMPROVEMENT IN RESERVE LEVELS CHALLENGED BY MASS TRANSIT PROGRAM AND HEALTH AND

PENSION COSTS; 2013 AND 2014 RESERVE LEVELS WIL DECLINE SLIGHTLY

Although reserves improved slightly in fiscal 2012, financial operations still reflected the use of one-time sources (primarily debt restructuring) to offset expenditures. Going into fiscal 2012 the city closed a smaller budget gap relative to prior years through actions including reducing department budgets with a continued hiring freeze, eliminating over 400 general fund FTEs primarily through attrition and retirement, reducing various services and implementing nine furlough days. Positively, numerous revenue sources did see improvement in 2012, although overall general fund revenue performance was slightly lower than the prior year. State-shared revenues (21% of general fund revenues) consisting of sales and income taxes declined a combined 5% from the prior year and largely due to lower state-shared income collections; state-shared income distributions are based on state collections in 2010. The city's largest operating revenues source, local sales taxes (42%), increased 4.5% over the prior year continuing a trend of increased collections that began in fiscal 2011. The fiscal 2012 general fund balance increased slightly to 14.9% of general fund revenues ($62.4 million) which is just below the median for large Aa3-rated cities nationally . In addition, although management notes liquidity is available on a pooled basis, Moody's notes general fund cash remains low and was only 4.1% of general fund revenues ($17.2 million).

For the current fiscal year (2013), the city closed a comparatively small general fund budget gap primarily through savings and use of unassigned fund balance along with modest budget and position reductions. Estimates for fiscal 2013 indicate a majority of the city's primary operating revenues will end above budgeted expectations. Local sales taxes are estimated to have increased 4.5% over the prior year while both state-shared sales and state-shared income taxes are estimated to increase 4.5% and 16.9%, respectively. Notably, as a result of the city's continued reductions in staff, the city's workforce is nearly equal to levels seen in 1995 (9.6 employees per 1,000 residents). Still, despite improvement in operating revenues and controlled expenditures estimates for fiscal 2013, indicate still structurally imbalanced operations. The city anticipates a partial use of the city's assigned general fund balance rather than relying on debt restructuring and after taking into account a partial employee compensation restoration (1%) and pension cost increases. The general fund balance is estimated to decline to between 9 - 10% of general fund revenues.

The city has tentatively budgeted another slightly smaller draw down of reserves in fiscal 2014. As a result, reserve levels will be below the city's minimum reserve policy (committed general fund balance equal to 10% of prior year revenues) and a key factor in the current rating action. Going forward, we believe that the city will benefit from a continued trend of improving economic indicators locally and regionally which will likely generate revenues above budgeted expectations and therefore reduce the city's reliance on reserves over the medium term. However, despite the improvements, we view the city's return to reserve levels that approximate similarly-rated peers and its own policy will take several years as the city is also challenged to improve reserves or cash due in part to increasing long-term pension costs and unique to the city, increased subsidies to the mass transit program.

In fiscal 2011 the city increased the annual transfer amount from the general fund to the mass transit fund to $42.0 million (10% of general fund expenditures) due to reduced fare box revenues and less assistance from the Regional Transportation Authority of Pima County combined with increased costs for health and pension, fuel, and liability insurance reserves. Since then, and including preliminary 2014 budget documents, transfer amounts will average about $42.0 million annually. The transfer amount will fluctuate depending on fare box performance and savings generated from delayed vehicle replacements.

DEBT LEVELS ABOVE NATIONAL MEDIANS

The city's debt levels exceed national medians for similarly rated cities with an overall debt burden of 3.7%. Much of this debt is attributed to the city which has a direct debt burden of 2.0%. Positively, payout of all debt is above average at 87% in ten years. The new money portion of the current sale will be used for road and street improvements while the refunding will be used to debt service savings. The city recently received voter-approval to issue $100 million in G.O. bonds for road and street projects throughout the city. After the current sale, the city will have $80 million in remaining authorization.

Moody's notes that under the city charter, as long as the city levies a local sales tax, the city's total ad valorem property tax rate cannot exceed $1.75 per $100 assessed valuation, effectively restricting the city's ability to levy property taxes for operations or debt beyond those imposed by state statute. The city's current total tax rate is $1.26, well below the tax rate cap and management's informal target of $1.50. Despite declines in assessed value and given the existing taxing margin between the current rate and cap, the city will be able to increase property tax revenues up to 2% annually per state law; management will determine the operating and debt tax rate composition.

ABOVE AVERAGE ESTIMATED PENSION LIABILITIES RELATIVE TO RATING CATEGORY

Tucson has an above average employee pension burden, based on unfunded liabilities for a single-employer plan and for its share of a multiple-employer plan administered by the state. Moody's has allocated liabilities of state cost-sharing in proportion to its contributions to the plan for analytic purposes. Reported unfunded pension liabilities consist primarily of $327.6 million for Tucson's Police and Fire Retirement Plans and an estimated $303.9 million for Tucson's single-employer supplemental retirement system (TSRS) as of December 31, 2011. Together, these reported liabilities amount to $631.5 million, or about 1.5 times Tucson's 2011 general fund revenues. Budgetary pressures for providing these benefits are growing . The actuarially determined annual contribution requirement (or ARC) for all three plans rose 5.6% in 2011 to $66.3 million, or nearly 16% of general fund revenues. The city has historically paid 100% of the ARC.

Moody's adjusted net pension liability (ANPL) for Tucson, under our methodology for adjusting reported pension data, is $1.3 billion, or a high 3.1 times general fund revenues. The ANPL for the Police and Fire Retirement Plan is $723.3 million, and the ANPL for the TSRS is $571.3 million. Moody's ANPL reflects certain adjustments we make to improve comparability of reported pension liabilities. The adjustments are not intended to replace Tucson's reported liability information, but to improve comparability with other rated entities.

WHAT COULD MAKE THE RATING GO UP

-Sustained long-term economic growth and diversification

-Long-term improvement in wealth measures

-A formal commitment to higher reserve and cash levels given exposure to economically-sensitive revenues

WHAT COULD MAKE THE RATING GO DOWN

-Weakened financial performance below budgeted expectations

-Ongoing budget imbalances, with no plan for a return to structural balance

-Long-term sustained deterioration of tax base

OUTLOOK

The stable rating outlook primarily reflects Moody's expectation that the city's economic recovery will continue, and eventually match that of the state, which will support both an improved revenue trend and stabilize financial operations.

KEY STATISTICS:

2013 Estimated population: 523,471

2013 Full market value: $25.28 billion

Full value per capita: $48,288

Average annual growth in full value, 2008 to 2013:-0.7%

Direct debt burden: 2.0%

Overall debt burden: 3.7%

Payout of principal on all debt (10 years): 86.9%

FY12 General fund balance: $62.4 million (14.9% of revenues)

FY12 Unrestricted, spendable fund balance: $54.7 million (13.1% of revenues)

The principal methodology used in this rating the general obligation bonds was General Obligation Bonds Issued by US Local Governments published in April 2013. The principal methodology used in this rating the certificate of participation was The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in December 2011. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

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