STANDARD & POOR'S

PUBLIC FINANCE

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RatingsDirect Publication Date
Jan. 24, 2006

Credit Profile

UPGRADED	***To***	***From***
Indiana ICR	AA+	AA
OUTLOOK: REVISED	TO	FROM
Status	STABLE	POSITIVE

Rationale

Standard & Poor's Ratings Services raised its rating on Indiana's issuer credit rating to 'AA+' from 'AA', reflecting the state's continued improved financial position, which exceeds budgeted expectations, driven both by management's fiscal action and revenue growth. The outlook is now stable.

Management has continued to demonstrate a commitment to building reserves and reimbursing the delayed payments. The state formulated its first, balanced biennium budget in 10 years, and has now closed the deficit that was projected in the first year, and has been able to maintain expenditure growth within budgeted parameters. The state implemented a tax amnesty program and received $192 million above budgeted expectations, of which $156 million has already been set aside for the reimbursement of the school payment delays, reducing that liability in half.

The 'AA+' rating also reflects the state's:

- Improving economic environment that is translating into tax revenue growth;
- Biennium budget that will add to fund balance by the end of the biennium; and
- Low overall debt levels.

These strengths are offset by a significant unfunded pension liability and a $572 million obligation to local units of government, due to payment delays (reduced from $728 million, due to the tax amnesty program and the cutting of the school liability mentioned above).

Economic conditions indicate that a modest recovery is starting to take hold, albeit at a slower pace than previously predicted, contributing to improved tax revenue collections, which are above budgeted levels. Although the state is still heavily manufacturing based, it is outperforming its neighbors, and its performance is more in line with national economic trends. The reasons for the state's performance is due, in part, to a fairly diverse makeup within the manufacturing sector, which has become less auto-related (and what is auto-related is primarily foreign owned), and the strides that have been made in the service-related sector, particularly in life sciences.

Although still the most manufacturing-dominant state in the country, Indiana is less manufacturing dependent than it was at the onset of the previous recession: down to 19.5% in 2005 from 23.4% in 1995. Furthermore, the manufacturing sector is only 20% auto-related, and of that amount foreign-owned companies account for four times the amount of employment than U.S.-owned firms. The declines in manufacturing have been offset by growth in the health service and transportation sectors. Central Indiana's $13.6 billion global life science hub supports a range of life science jobs including protein analysis, evidence-based medicine, and cancer research.

In terms of the state's financial position, Governor Daniels and the legislature agreed upon a biennium budget for fiscals 2006 and 2007 that is the first budget in 10 years to add to the fund balance at the time of adoption. As a result, the biennium budget will not be dependent on positive budget variances to reach structural balance, as has been the case in the past decade. The fiscal 2006 budget had a $132 million budget deficit whereas the fiscal 2007 budget has an estimated $227 million surplus at the time of passage.

In terms of fiscal 2006, expenditure growth was limited to 2.6%; Medicaid was held at a 5% growth rate in both years versus a 7% average annual historical rate. In terms of revenues, the state projected that revenues will continue to grow at a 4.5% rate in fiscal. As a result of the revenue growth, the limits on expenditure growth, and the cost cutting measures, the state expects to have a positive budget variance for fiscal 2006 and no use of reserves.

In addition, the state implemented a tax amnesty program after paying expenses, $156 million of the tax amnesty revenue will be used pay down the school payment delays, thus reducing that liability in half and reducing total payment delays from $728 million to $572 million. The state has indicated that it will continue to pay down the payment delays. As well, the state has structured the State Teacher's Retirement Fund such that funding the unfunded liability will not impact the general fund by more than 6% annually. The state was able to accomplish this by using the Pension Stabilization Fund as initially set up by the legislature in 1997.

In September 2005, the Governor released a $10.6 billion, 10-year transportation plan, with the possibility for a public private partnership for the toll roads. The state announced today that they accepted a bid for $3.85 billion from a private investor, the legislature still needs to accept the proposal. According to the state, any proceeds from the proposed concession sale of the Indiana Toll Road would be used in a structurally balanced manner.

Debt levels remain among the lowest in the nation at less than $379 on a per capita basis and just above 1% of personal income, serving as a credit strength and providing the state with some flexibility. The state is in an asset divestiture mode, and thus little construction is expected in fiscal 2006 beyond a $60 million for the forensics laboratory. The state entered into interest-rate swap agreements concurrent with the stadium and convention center bonds sold in September 2005. The state will continue to issue debt for the convention center and stadium project through 2009.

Outlook

The stable outlook reflects the state's improving financial position and management's commitment to returning the state's budget to structural balance. The outlook also reflects the expectation that the state will continue to pay down the delayed payments and continue its progress towards funding the substantial unfunded liability in the State Teacher's Retirement Fund. As well, the stable outlook reflects Standard & Poor's expectation that any proceeds from the proposed concession sale of the Indiana Toll Road would be used in a structurally balanced manner. The stable outlook also reflects the state's economic position. Although it continues to make progress and diversify away from manufacturing, the state is still the most heavily manufacturing-based economy in the country, thus limiting the rating.

Economy

Today, the state is less manufacturing dependent than it was at the onset of the last recession. Manufacturing concentration has decreased from 23.4% to 19.5% of the state's employment base between 1995 and 2005. Further, automotive manufacturing, although still a major component of the state economy, has diversified beyond the Big Three automakers to include foreign-owned companies, adding a degree of stability to the state's economy. Foreign-owned auto manufacturing is now four times larger than U.S.-owned auto manufacturing in the state. However, the recently announced closing of DaimlerChrysler Corp.'s Indianapolis foundry and Delphi's bankruptcy, which may lead to plant consolidations and closings, are likely to lead to slower performance of the state's manufacturing sector. In terms of other manufacturing, the state's steel sector, which had performed extremely well in 2004, has also experienced slowing growth due to weak demand from the U.S. auto industry.

In terms of other manufacturing, the state is experiencing growth in nonauto-related manufacturing. Cook Pharmacia, a biotechnology manufacturer, just opened a new plant in Bloomington; Nemcomed, a medical instruments and orthopedic products manufacturer, announced plans to build a plant in Fort Wayne. It is expected that growth in these fields will reduce some of the exposure to steel and motor vehicles, although this change will be gradual. The state is also becoming a national leader in the production and distribution of bio-fuel, with three new plants to begin construction sometime this year, and a number of additional plants under development.

The service and transportation sectors are growing, offsetting the overall declines in the manufacturing sector. The service sector is primarily made up of health services, business services, and hospitals. Clarian Health Partners leads the way with an $875 million expansion in new development comprising both research and practice of medicine and life sciences. Higher education, which is also a large employer, with Purdue University (12,810 employees) and Indiana University, is supporting the creation of the biotechnology sector through technology and research. There are currently $200 million in life science academic commitments and more than 10,000 life science college graduates each year. Central Indiana's $13.6 billion global life science hub supports a range of life science jobs including protein analysis, evidence-based medicine, and cancer research. During 2005, there were $214 million of investments in life science companies creating 2,200 jobs.

During 2005, Indiana has attracted more than $3.8 billion in new capital investments in a wide range of industries, with job creation commitments for 18,500 new jobs and the retention of 47,000 jobs. Moreover, although Indianapolis continues to perform as the state's economic engine, many of these projects are spread throughout the state. Major investments include: Summitt Logistics with a $67 million investment adding 302 jobs; Wal-Mart Stores, with a $60 million investment adding 600 jobs; and American General Financial, with a $36 million investment adding 150 jobs.

The federal government is the largest employer in the state; the weapons station in southern Indiana is expected to lose 500 of its 5,000 jobs due to the BRAC closing. However, the state is expected to have a net gain of 2,200 jobs due to BRAC, with 2,700 jobs added in Indianapolis.

Major private employers in the state include:

- Wal-Mart Stores (31,820 employees);
- The Kroger Co. (18,025);
- Indiana University (15,100);
- Eli Lilly & Co. (14,900); and
- Marsh Supermarkets Inc. (14,822).

Indiana's 12-month average unemployment rate as of October 2005 has decreased to 5.32%, and still remains below the regional rate of 5.9%. Employment has measured a positive 0.4% since 2000 as Indiana has fared better than many of its Midwest peers. Indiana has benefited from modest economic diversification and both positive population growth (up 3.1%) and net migration from 2000 to 2005.

The state continues to be a leader in income growth. Median household incomes were $37,917 (99.6% of the national average) in 2003, up from $25,982 (93.4%) in 1990, as the state has added middle- and high-income jobs in the past eight years. As well, per capita income was $17,761 (95.9% of the U.S. level) in 2003, up from $12,273 (89.8% of U.S. level) in 1990. Despite the strides that Indiana has made in terms of income growth, the state is the 11th worst in the country for nonbusiness bankruptcy filings, and this continues to pressure consumer spending and economic growth.

Management

Under Governor Daniels, a new management team and management structure has been brought into place to focus on improving the state's management systems. The governor created a new position of Director of the Office of Management and Budget (OMB) to oversee all departments. The OMB Director will act as the Chief Financial Officer of the state and report to the Governor. The director has the ability to allocate less funds than appropriated in the budget, which allows the state to control the budget through expenditure reductions if needed. All departments are now accountable to OMB.

The state also created a new Indiana Finance Authority (IFA) to coordinate the operations of Indiana Development Finance Authority, Indiana Transportation Finance Authority, Indiana Recreational Development Commission, State Office Building Commission, and the State Revolving Fund. IFA is expected to increase efficiency of the various entities and provide oversight.

As well, an office of Government Efficiency and Financial Planning (GEFP) was created within OMB. GEFP was created to identify inefficiencies and further cost saving opportunities, and to initiate the state's first long-range financing plan. As of Aug. 2005, GEFP identified inefficiencies that, once eliminated, will save more than $150 million. The savings will be through various cost cutting measures including: the closure of 12 out of the 170 Bureau of Motor Vehicle locations for a $1 million saving; within the next year, the state is planning to sell 2,000 of its 12,000 vehicles, lowering what is now one vehicle for every three employees; the state reached an agreement on outdated correctional facility food contracts to reduce the cost per meal at an annual savings of $12 million; GEFP found 3,000 paintings owned by the state that will be sold, among other cost cutting initiatives.

The Governor also created an Indiana Economic Development Corp. to accelerate economic expansion and increase the state's tax base. The state's focus is on fostering local entrepreneurship.

In September 2005, the Governor released a $10.6 billion, 10-year transportation plan, with the possibility for a public private partnership for the toll roads. The state is already a distribution center and under the plan the state would continue to invest in its infrastructure while adding a significant amount of construction jobs. The state has sent out a request for proposals, and accepted a bid for $3.85 billion from a private investor.

Finances

The 2006-2007 biennium budget

Governor Daniels and the legislature have agreed upon a biennium budget for fiscals 2006 and 2007 that is the first budget in 10 years to be balanced without any use of fund balances. The budget will also add to the rainy day fund, contribute to the State Teacher Retirement Fund, and cease the growth of payment delays to local units of government. Although the Governor proposed a 1% increase on income tax for the top marginal tax rate for a one-year period, the budget was adopted without any revenue enhancements. The budget will be balanced through reductions in expenditure growth to 2.6% and 1.4% in fiscals 2006 and 2007, respectively. In the past, average annual expenditure growth had been slightly higher than 5.7%. Medicaid will be held at a 5% growth rate in both years versus a 7% average annual historical rate.

Other positive aspects of the budget include contributions to the pension stabilization fund to address the State Teacher's Retirement Fund unfunded pension liability. Payment delays to schools, higher education, and local units of government, which reached $728 million in fiscal 2005, will no longer be allowed in the fiscal 2006 and 2007 budgets, and the budget agency will start to pay back these obligations as the funds become available. The fiscal 2006 budget had a $132 million budget deficit; the fiscal 2007 budget had an estimated $227 million surplus at the time of passage.

Fiscal 2006

State sales taxes and individual income taxes make up about 80% of the state's revenue for the general fund and property tax replacement fund. As of Dec. 14, 2005, the revenue forecast showed sales tax growth of 5% and a very slight (-0.1%) decline in individual income tax from fiscal 2005 levels. Overall, revenues are up by $179 million, or 3.3%, from fiscal 2005 revenues, and $52.9 million above budgeted revenues for fiscal 2006. As well, through cost cutting initiatives the state was able to save about $150 million in fiscal 2006. As a result of the revenue growth, the limits on expenditure growth, and the cost cutting measure, the state expects to have a positive budget variance for fiscal 2006 and no use of reserves.

In addition, the state implemented a tax amnesty program and budgeted revenues of $65 million from the program. The actual results were $257 million in revenue. After paying expenses, $156 million of the tax amnesty revenue will be used pay down the school payment delays, thus reducing that liability in half and reducing total payment delays from $728 million to $572 million. The state has indicated that it will continue to pay down the payment delays.

Fiscal 2005

Fiscal 2005 (June 30) ended with a $96.6 million general-fund operating surplus. The ending fund balance was $1.24 billion, or a strong 14.7% of operating expenditures. The unreserved general fund balance was $836 million, or a strong 10% of operations. At time of budget passage, the state had expected a deficit of $237 million. The positive budget variance is due to revenue growth of a projected 6.3% from fiscal 2004 revenues

for both the general fund and Property Tax Relief Fun. At the same time, expenditures have been held at a 3% growth level from fiscal 2004, except for Medicaid, which is up by 12% from fiscal 2004.

In terms of GASB34, which was first implemented in fiscal 2002, fiscal 2005 ended with a net change in assets of a negative $253 million, bringing the net asset position to $13.26 billion. The 1.8% decrease from fiscal 2004 was due to expenditures outpacing revenues; however, the structural imbalance is slowing, demonstrated by the fact that total revenues increased by 2.4% from 2004 while expenditures increased by just 2.3%. In terms of the state's business activities, the state revolving fund had surplus operations, but the unemployment compensation fund's expenditures came in above revenues.

The state cut its full-time work force during calendar 2005 by 7.1% to 36,708 employees by December 2005. This was somewhat offset by an increase of 866 National Guard employees due to the Iraq War.

Fiscal 2004

The state's financial position at year-end fiscal 2004 (June 30) showed a general fund deficit of $115 million, bringing the ending fund balance to $1.24 billion, or a still strong 15.3% of operations. However, this reserve level is well below the $3.4 billion general fund balance (a very strong 40% of operations) that the state maintained in the general fund prior to fiscal 2001. The state began to utilize significant levels of reserves during fiscals 2001 and 2002, using $1 billion and $720 million, respectively, of the general fund balance. The state did have a surplus in operations in fiscal 2003 when it added $178 million to fund balance, but still the fund balance remained much lower than in previous fiscal years. As well, the property tax stabilization fund ended with a $1 billion negative fund balance at fiscal year end 2004.

In terms of GASB34, fiscal 2004 ended with a net change in assets of a negative $716 million, bringing the net asset position to $13.97 billion. The 4.9% decrease from fiscal 2003 was due to expenses rising faster than revenue growth. Total revenues increased by 7.5% from 2003 while expenditures increased by 12.8%. In terms of the state's business activities, toll roads and the state lottery had surplus operations, but the unemployment compensation fund's expenditures came in above revenues.

Pensions

The State Teachers Retirement Fund's unfunded liability is still a significant issue for the state; however, due to measures taken in 1996 when the plan was closed and new hires were moved to actuarially sounds plans, the fund is not getting any worse. As of June 30, 2005, the Indiana State Teachers Retirement Fund's unfunded actuarial liability was $8.4 billion. The value of the closed plan assets relative to its computed actuarial accrued liability was a weak 44.77% (funded ratios for most state plans are usually in excess of 80%) at fiscal year-end 2004.

As part of the state's plan to address the significant unfunded liability, the state also adopted a 40-year amortization schedule and established a pension stabilization fund, which is expected to limit the annual growth rate of general appropriations for the State Teachers Retirement Fund to less than historical general revenue growth rates. The pension stabilization fund is a dedicated fund in the Teachers Retirement Fund, which is designed to accumulate a balance during a 12-year period. The pension stabilization fund is allowed to smooth out yearly general fund contributions to less than 6%; the original statute allowed this use of the fund to start in 2007.

During the previous biennium (2004-2005), the state put in place a new statute that allowed the use of the pension stabilization fund prior to fiscal 2007. The state transferred $380 million from the pension stabilization fund in fiscal 2004 and fiscal 2005 to help fund current pension obligations and provide general fund operating

relief. As well, the state did not make a $30 million transfer in either year from the lottery and gaming revenues as it had done previously. The fiscal 2006-2007-biennium budget showed a renewed commitment to funding the pension stabilization fund with the lottery and gaming revenues. The biennium budget currently only projects using $5.4 million from the stabilization fund in fiscal 2007 for pension obligations, which is in line with the original statute that allowed the use of the stabilization fund for contributions that were more than the 6% growth level.

State law has, since 1997, permitted retirement funds to be invested in equities, potentially increasing long-term earnings. Currently, 43% of plan assets are invested in actively managed equity investments. The new plan, which is the responsibility of local governments, includes transferred teachers from the state plan, and is actuarially funded now at 9% of payroll, up from 8.5%. The increase was in response to the plan actuary's recommendation to increase funding, given a high level of senior, highly paid transfers from the closed to the open plan.

The state's Public Employee Retirement Fund is the state's largest plan and continues to have more than 100% funding. In terms of other post employment benefits, the state is undertaking an actuarial study in 2006 to estimate its liability. Retired state employees can join the state's health plans but they must pay the entire cost. Therefore, the state has no liability in that area. However, there are three plans under which the state does pay part or the entire amount of the premiums for retirees, legislators, state police, and conservation officers.