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Credit Analysis

City of El Paso, Texas

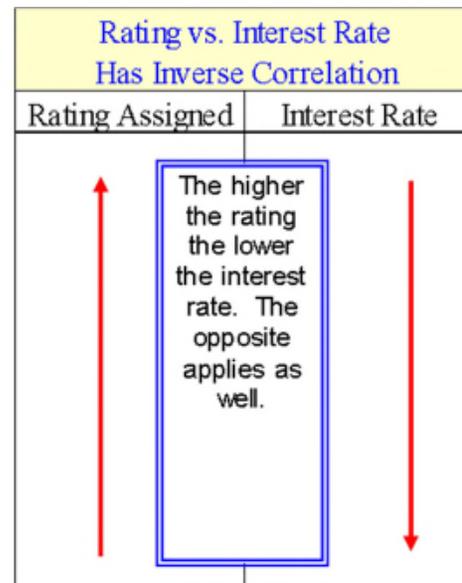
October 27, 2014



Introduction

- FirstSouthwest has prepared an in-depth analysis of the City’s existing credit rating in an effort to assist staff in formulating a plan to develop debt management policies and to address concerns from Council members.
- Standard & Poor’s and Fitch have rated the City’s Tax Supported Debt as “AA”

	Fitch Investors Service	Standard & Poor’s Rating Service
	AAA	AAA
	AA+	AA+
	AA	AA
	AA-	AA-
	A+	A+
	A	A
	A-	A-
	BBB+	BBB+
	BBB	BBB
	BBB-	BBB-





Why Standard & Poor's Rates City of El Paso "AA"

Standard & Poor's Reports – July 24, 2014

Strengths

- Adequate economy
 - El Paso is the nation's largest border city. The City benefits from international trade due to its border location, near Ciudad Juarez.
 - It serves as a regional economic center with several large institutions including Fort Bliss, the University of Texas at El Paso, University Medical Center of El Paso and other governmental agencies.
 - Although the City has below average income and wealth, it has experienced healthy economic growth in recent years. The taxable assessed value has risen 9% since fiscal year 2010 and tax collections have and are expected continue to grow.
- Very strong budgetary flexibility
 - Despite recent fund balance reductions, the City has strong budgetary flexibility due to the fiscal policies and willingness to increase tax rates.
- Adequate budgetary performance
- Very strong liquidity
 - The City has exceptional access to external liquidity. Fiscal 2013 total unrestricted government cash and equivalents were 24% of total government fund expenditures and more than 150% of total governmental funds annual debt service.
- Very strong management practices
 - City management is well embedded in the government's daily operations and practices. It provides a monthly financial update to the City Counsel that is also posted online. They also update the three year financial forecast annually. The City has a conservative investment policy that requires quarterly updates.

Challenges

- Very weak debt and contingent liabilities profile
 - The City has a large amount of direct debt outstanding. Net direct debt is high as a % of governmental funds revenue for FYE 2013, and total governmental funds debt service was 15.8% of total governmental funds expenditures.
 - El Paso currently projects long-term debt issuance for the next 15 years and it issues GO debt and certificates of obligation annually to fund capital projects.
- Funding of pension and OPEB obligations
 - The City contributes to two single-employer, defined-benefit plans that include the El Paso Employees Pension Fund (CEPF) and the El Paso Firemen & Policemen's Pension Fund (FPPF). As of the latest actuarial valuations, the CEPF was 74% funded with an unfunded \$206.5 million liability, the firemen's FPPF was 81% funded with unfunded \$114.7 million liability, and the police FPPF division was 78% funded with an unfunded \$194.9 million accrued liability is unfunded.
 - El Paso also contributes other postemployment benefits (OPEB) via a single-employer, defined benefit health care plan that it funds through pay-as-you-go financing. Due to this form of financing, the entire \$194.9 million accrued liability is unfunded.

Why Fitch Rates City El Paso “AA”

Fitch Report – July 28, 2014



Strengths

- A large and diverse regional economy
 - El Paso is the sixth-largest city in Texas. There has been an average annual increase in population growth of 1.5% since the 2000 Census. Although median household income is below average, they continue to grow at a faster rate than state and national levels.
 - The City’s economic activity stems from their position as a key NAFTA trade corridor as well as the presence of Fort Bliss Army base. The medical sector and Texas University Health Sciences Center also add to the diversity of the economy.
 - The City has had growth in TAV annually, averaging a rate of 2.4% from 2009-2014.
- Satisfactory Financial Profile
 - The City’s reserves are expected to remain adequate despite projections of a modest draw on reserves at fiscal year-end 2014.
 - Although the City has had concerns with modest revenue contraction and ongoing growth-related operating and capital reserves, the City has been able to make timely adjustments to balance operations. They have been able to balance an increasing debt load with tax base growth and capital needs.

Challenges

- Resolution of budget imbalance
 - Budget balance has been somewhat dependent on temporary solutions. Fitch cautions that further erosion of the City’s reserves may apply downward pressure to the rating.
- A high debt burden and large capital plan
 - Growth related capital pressures have led to a high overall debt burden. The below average socioeconomic characteristics and slow tax base growth could challenge the City’s ability to balance capital needs.
- Funding of pension and OPEB obligations
 - The City has been able to contribute 97% to 99% of its annual pension cost over the past three years to its City Employee Pensions Fund but has made significantly lower contributions to the Fire and Police Pension Fund.
 - The underfunding of the pension cost is a credit concern and continuation of the practice would be inconsistent with the City’s current rating.

CITY OF EL PASO, TEXAS



New Rating Methodology

- In an effort to make the rating process more transparent, the rating agencies have been introducing new “scorecard” methodology in various sectors, including local government G.O.s
 - The scorecards show the percentage weighting assigned to major credit factors
 - FirstSouthwest has provided responses to proposed criteria changes during comment periods that have influenced final outcomes
- Standard & Poor’s released its updated G.O. rating criteria on September 12, 2013
- We have models to predict the estimated or “indicated” Moody’s and S&P G.O. ratings for its clients
 - We can use these models to identify circumstances warranting consideration of upgrades of El Paso’s ratings, as well as potential credit concerns
- Fitch has not introduced rating scorecards, but may do so in the future
 - We are fluent in its criteria and will continue to monitor rating drivers with respect to the City’s G.O. debt



S&P Rating Scorecard

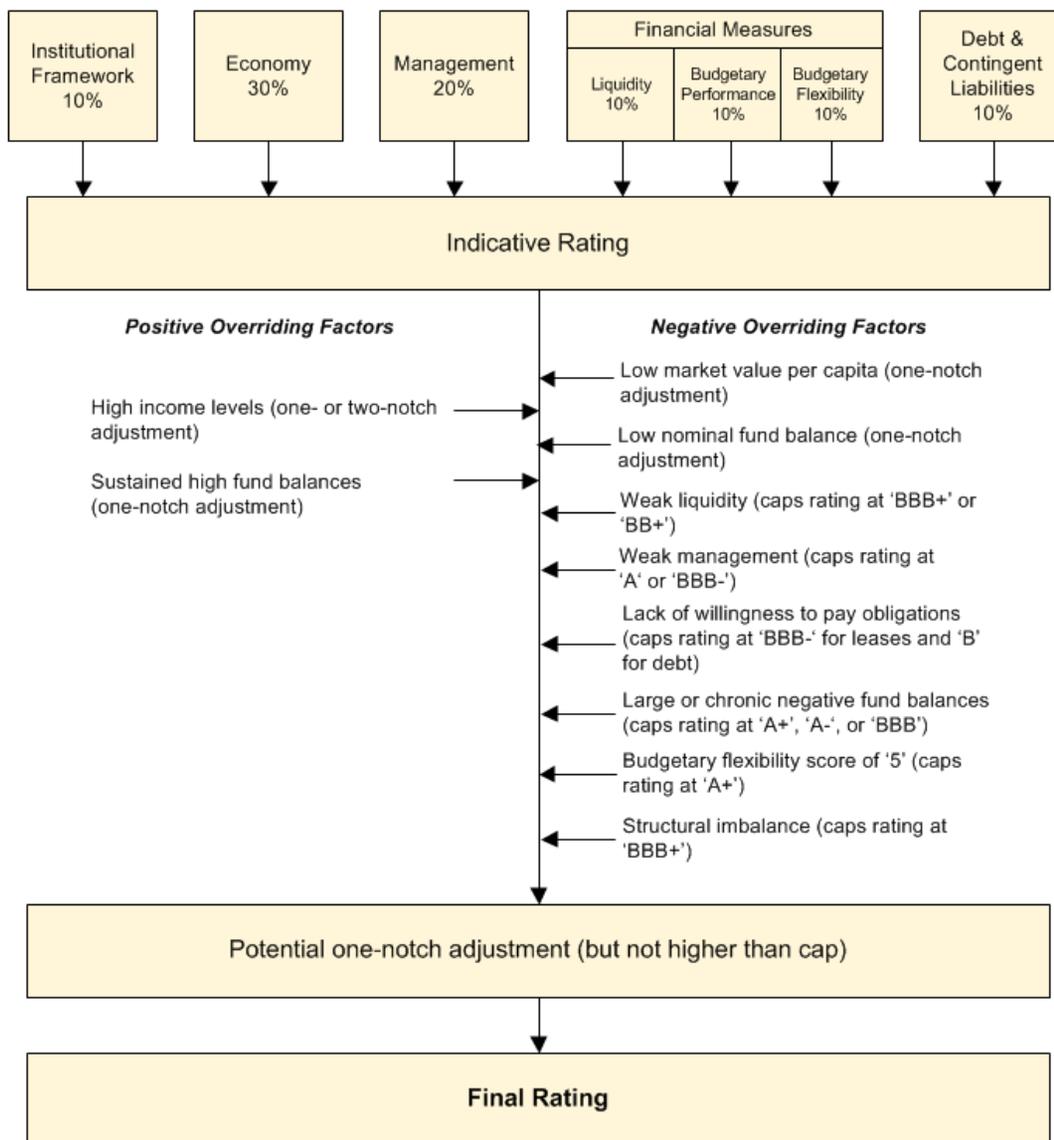
S&P GO Rating Scorecard	
Rating Factor	Weighting
Institutional Framework	10%
Uniform score for all of the same type of governments in same state	
Economy	30%
Total Market Value Per Capita and Projected Per Capita Effective Buying Income as a % of US Projected Per Capita EBI	
Management	20%
Issuer's Financial Management Assessment Score considered with other certain qualitative factors	
Financial Measures	30%
Liquidity (10%) – Total Government Available Cash as % of Total Governmental Funds Debt Service and % of Total Governmental Funds Expenditures	
Budgetary Performance (10%) – Total Governmental Funds Net Result (%) and General Fund Net Result (%)	
Budgetary Flexibility (10%) – Available Fund Balance as a % of Expenditures	
Debt and Contingent Liabilities	10%
Net Direct Debt as % of Total Governmental Funds Revenue and Total Governmental Funds Debt Service as % of Total Governmental Funds Expenditures	

60% of the score is driven by factors directly within the City's control.

Source: "Standard & Poor's U.S. Local Governments General Obligation Ratings: Methodology and Assumptions," September 12, 2013



S&P's Analytical Framework for Local GO Ratings



Indicative Rating Outcomes Resulting From the Weighted Average of Seven Factors	
Factor Score Weighted Average	Indicative Rating
1.00 to 1.64	AAA
1.65 to 1.94	AA+
1.95 to 2.34	AA
2.35 to 2.84	AA-
2.85 to 3.24	A+
3.25 to 3.64	A
3.65 to 3.94	A-
3.95 to 4.24	BBB+
4.25 to 4.54	BBB
4.55 to 4.74	BBB-
4.75 to 4.94	BB Category
4.95 to 5.00	B Category

CITY OF EL PASO, TEXAS

Source: "Standard & Poor's U.S. Local Governments General Obligation Ratings: Methodology and Assumptions," September 12, 2013



Understanding S&P's Rating Factors and Scores for the City

- **Institutional Framework (10%)** – All Texas Cities and Counties are currently rated in the “Strong” category.
- **Economy (30%)** – This Economy factor assesses both the health of the asset base relied upon to provide both current and future locally derived revenues as well as the likelihood of additional service demands resulting from economic deterioration. At first glance, the City has a low market value per capita score as compared to others in the United States. However, the initial score is adjusted to account for the City’s large and diversified economy and the presence of stabilizing institutional employers such as Fort Bliss, UTEP, etc.
 - Factors that could have a positive impact: The City already has been adjusted favorably to account for a diverse economy and stable institutional employers. An increase in the projected per capita income and market value per capita.
 - Factors that could have a negative impact: Negative budget impact from demographic profile, employment concentration within an individual sector, and top 10 tax payers represent more than 35% of tax base.



Understanding S&P's Rating Factors and Scores for the City (continued)

- **Management (20%)** – Managerial decisions, policies and practices apply directly to the government's financial position and operations, debt burden, and other key credit factors. Management score assesses the impact of management conditions on the likelihood of repayment. The City currently has the highest score available and considered "Very Strong."
 - Factors that could have a positive impact: The City already has the highest score for this category. Management will have to be consistent in balancing operations.
 - Factors that could have a negative impact: Frequent management turnover inhibiting a current understanding of the government's financial position and its ability to adjust, or political gridlock, or instability that brings the same results.

- **Financial Measures (Liquidity, Budgetary Performance, and Budgetary Flexibility) (30%)** – The budgetary flexibility score measures the degree to which the government can look to additional financial flexibility in times of stress. The City currently has adequate fund balance as a percentage of expenditures. However, for the past two years the City has used General Fund Balance to pay for certain expenses. This practice is seen as a possible negative qualitative factor of budgetary inflexibility.

Source: "Standard & Poor's U.S. Local Governments General Obligation Ratings: Methodology and Assumptions," September 12, 2013



Understanding S&P's Rating Factors and Scores for the City (continued)

▪ **Financial Measures (Liquidity, Budgetary Performance, and Budgetary Flexibility) (30%) – Continued:**

- Factors that could have a positive impact:
 - Projections for the current year and the following year suggest improvement.
 - Ability to avoid financial imbalances with demonstrated capacity and willingness to cut operational spending (by more than 2%), resulting from flexible cost structure, flexible legislation, and/or widespread political support.
 - Demonstrated ability and willingness to raise taxes when needed (and voter support is usually obtained when such approval is required).
 - Maintenance of general fund balance exceeding 30% of general fund expenditures for the most recently reported year, the current year, and next year.
- Factors that could have a negative impact: Negative budget impact from demographic profile, employment concentration within an individual sector, and top 10 tax payers represent more than 35% of tax base.
 - Projections for the current year worsen.
 - High level of questionable receivables or amounts due from other funds with deficit balances.
 - Limited capacity to cut expenditures due to infrastructure or operational needs or political resistance.
 - Limited capacity to raise revenues due to consistent and ongoing political resistance

*Future credit quality is dependent on current and future performance.

Source: "Standard & Poor's U.S. Local Governments General Obligation Ratings: Methodology and Assumptions," September 12, 2013



Understanding S&P's Rating Factors and Scores for the City (continued)

- **Debt and Contingent Liabilities (20%)** – This factor assesses the amount of the total governmental funds debt service as a percentage of total governmental funds expenditures and net direct debt as a percentage of total governmental funds revenue. The City currently has a high percentage of overall net debt as a % of market value.
 - Factors that could have a positive impact: Overall net debt as a percentage of market value below 3% and overall rapid annual debt amortization (more than 65% coming due in 10 years).
 - Factors that could have a negative impact:
 - Significant medium-term debt plans that could produce a higher score.
 - Exposure to interest-rate risk or instrument provisions that could increase annual payment requirements by at least 20%.
 - Overall Net debt as a percentage of market value exceeding 10%.
 - Unaddressed exposure to large unfunded pension or OPEB obligations leading to acceleration payment obligations over the medium term that represent significant budget pressure.
 - Speculative contingent liabilities or those otherwise likely to be funded on an ongoing basis by the government representing more than 10% of revenues.

Source: "Standard & Poor's U.S. Local Governments General Obligation Ratings: Methodology and Assumptions," September 12, 2013

Our Analysis Points to a Final Issuer Credit Rating of “AA” for the City

FirstSouthwest’s Analysis of the City’s S&P Issuer Credit Rating



- For the City, the Factor Score Weighted Average of “2.25” is equivalent to an Indicative Rating of “AA”. Because the Indicative Rating was not changed by Overriding Factors, the Final Issuer Credit Rating is estimated at “AA”.

Indicative Rating Outcomes Resulting From the Weighted Average of Seven Factors		
Score Range		Indicative Rating
1.00	1.64	AAA
1.65	1.94	AA+
1.95	2.34	AA
2.35	2.84	AA-
2.85	3.24	A+
3.25	3.64	A
3.65	3.94	A-
3.95	4.24	BBB+
4.25	4.54	BBB
4.55	4.74	BBB-
4.75	4.94	BB Category
4.95	5.00	B Category

CITY OF EL PASO, TEXAS



Upward Rating Potential?

- Fitch and S&P have “Stable” outlooks on the City’s debt, indicating that no rating changes—upward or downward—are anticipated within the next two years
- In its July 28, 2014 report, Fitch mentions that El Paso’s rating is contingent upon the following factors:

Rating Sensitivities:

- Continued underfunding of the city’s pension programs – particularly the public safety plan – will increase the liability of the city and would not be consistent with the current rating
- Further reduction in the city’s reserves, or use of nonrecurring means to achieve budget balance, also could apply downward pressure to the rating.

- In its July 24, 2014 report, S&P state’s the following as its rationale for its “AA” rating and “Stable” outlook on the City’s debt:

Outlook

“ The stable outlook reflects our view that El Paso will likely remain a large regional economic center, but that income and wealth will likely stay below the national average. The outlook also reflects our expectation that, despite a growing budget, El Paso will likely maintain or grow general fund reserves beyond fiscal year-end 2014 by raising revenue or cutting expenditures as needed. Finally, the outlook reflects our opinion that El Paso’s weak debt and contingent liabilities profile will likely remain the key rating constraint. While we do not expect it to occur within the two-year outlook period, we could lower the rating if El Paso experiences any budgetary imbalance due to it’s inability to raise revenue or cut expenditures, or if general fund reserves as a percentage of expenditures continue to decrease. ”



Conclusion

- **Questions & Answers**