Does Fiscal Emergency Always Lead to Bankruptcy?

By Betsy Shelton, Director of Research/Senior Portfolio Manager

Late in the afternoon of January 29, 2015, Kern County declared a fiscal emergency, citing a significant anticipated shortfall in revenues due to the decline in oil prices. There was a time when such an announcement would have sent the markets into a tailspin. This time, however, the County's announcement flashed on the newswires and then life went on as before. Perhaps the markets, and investors as well, have become desensitized as a result of the more dire action of bankruptcy taken by Stockton and San Bernardino. Suffice it to say, the words "fiscal emergency" appear to have lost the shock value they once carried.

This month's **Credit Corner** focuses on what constitutes a fiscal emergency and how it impacts both the municipality itself and investors.

What is a "fiscal emergency"? Who can declare it and when can it happen? Governments have inherent power to do whatever is necessary for the general good of the public even if this includes impairment of contacts. Often unanticipated events or prolonged imbalances between resources and spending can result in the need to declare a fiscal emergency in order to maintain the essential services provided by the governmental entity.

While a fiscal emergency allows for the temporary suspension or modification of certain contractual obligations, this tactic should be considered a means to an end, rather than an end in and of itself. Furthermore, certain criteria must be met in order for the declaration of a fiscal emergency to be valid. These include the actual existence of an emergency (which may have just occurred but more often than not has been brewing for some time), and documentation of steps taken to address the financial issues, such as drawing down reserves, proof of other actions taken to date that have been specifically tailored to the situation at hand, and the evaluation and elimination of other alternatives. (Continued on page 2)

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Our Mission

CFI is dedicated to the task of securing for each individual account the best possible after-tax performance net of fees. We accomplish this by actively managing tailored portfolios in strict adherence to the strategic objectives of each client. It is our responsibility to employ the most suitable fixed income assets and strategies in a manner most effective for every account. It is our duty to devote the resources, intensity and vigilance necessary to insure all clients consistent superior results.

Drumroll Please!!! We are pleased to announce the release of our newly designed website. Questions and comments are *always* welcome. Email susan@charlesfishinvestments.com

> "A little caution outflanks a large cavalry."
> Otto von Bismarck, Prussian Statesman

What was the basis for Kern County's declaration of a fiscal emergency?

Specifically, the recent fall in oil prices has resulted in a forecasted sizable decline in assessed valuation. Known as the "Oil Capital of California", Kern County is responsible for over 2/3 of California's oil production. Roughly 30% to 35% of the assessed valuation associated with the County's oil-producing properties is attributable to oil prices. Given that the County had based its most recent budget on oil being at $99 per barrel, the significant drop in oil to its current $55 per barrel is at the root of the County's revenue drop and resulting call to action. According to the County, the recent drop in oil prices is expected to create a loss of $61 as the basis for Kern County's declaration of a fiscal emergency? (Continued on page 3)

Acronym of the month: "ADA" stands for average daily attendance. Following the passage of Proposition 13 in 1978, ADA was the basis on which school districts received state aid. ADA was not the same as student enrollment, which takes into account all pupils regardless of the number of days they attend school. In 2014 the State changed its formula for compensating schools. It now uses the Local Control Funding Formula ("LCFF"), which was designed to better reflect a district's demographics and give the district more flexibility in the use of its funds.

FISH SCALES

		Scales for California names only					
NATIONAL AA RATED*	DEC	AA G.O.	A-rated COPs	Pre-Refunded	1915 Act (1x7)**	USTN	AA Txbl Muni
0.15	2016	0.23	0.47	0.18	0.59	0.19	+31
0.49	2017	0.49	0.81	0.46	0.92	0.63	+39
0.86	2018	0.82	1.14	0.81	1.32	1.00	+40
1.08	2019	1.04	1.38	0.99	1.65	1.33	+45
1.30	**2020**	**1.24**	**1.62**	**1.19**	**1.94**	**1.50**	**+53**
1.53	2021	1.47	1.85		2.20	1.68	+63
1.79	2022	1.74	2.12		2.47	1.81	+70
1.97	2023	1.95	2.32		2.69	1.87	+85
2.13	2024	2.14	2.50		2.89	1.94	+93
2.26	**2025**	**2.29**	**2.64**		**3.04**	**1.98**	**+102**
2.39	2026	2.48	2.80		3.18		
2.52	2027	2.63	3.00		3.33		
2.62	2028	2.80	3.12		3.43		
2.69	2029	2.87	3.25		3.53		
2.75	**2030**	**2.92**	**3.28**		**3.61**	**2.27**	**+120**
2.96	**2035**	**3.15**	**3.47**		**3.79**	**2.38**	**+130**
3.05	**2040**	**3.20**	**3.60**		**3.96**	**2.55**	**+135**
3.10	**2045**	**3.32**	**3.65**		**4.02**	**2.62**	**+140**

February 27, 2015

AS OF DATE

NOTE: The scales represent CFI's opinion of approximate bond values (offered side) at the close of business for the date shown and should be used as a general reference only. They are based on data from sources we believe to be reliable. CFI does not guarantee the above information for accuracy or changes due to shifting market conditions and other unforeseen reasons.

Specifically, the recent fall in oil prices has resulted in a forecasted sizable decline in assessed valuation. Known as the "Oil Capital of California", Kern County is responsible for over 2/3 of California's oil production. Roughly 30% to 35% of the assessed valuation associated with the County's oil-producing properties is attributable to oil prices. Given that the County had based its most recent budget on oil being at $99 per barrel, the significant drop in oil to its current $55 per barrel is at the root of the County's revenue drop and resulting call to action. According to the County, the recent drop in oil prices is expected to create a loss of $61 million in property tax revenues, which would constitute nearly 18% of the County's $346 million discretionary budget. When coupled with the effects of California's ongoing drought, escalating pension costs, and a $20.5 million bill for the upcoming opening of a new jail, the County clearly has a serious imbalance between revenues and spending requirements. Having declared a fiscal emergency the County is now able to (1) tap into $40 million of reserves, (2) make temporary wage cuts and freeze hiring, (3) renegotiate union contracts, and (4) put relief tax measures on the ballot.

What is the impact on other municipalities within the County? It is important to remember that counties, unlike cities and other local governments, are much more dependent upon property taxes as their primary source of funds. In some cases the oil producing properties are outside of the boundaries of other taxing entities in the county. Furthermore, many of these other entities are likely to have alternative revenue sources such as ADA funding for school districts (see "acronym of the month" and our September 2014 newsletter for more information on ADA funding) and sales tax revenues for cities. These additional sources of revenue should help to buffer any reduction in county funding support. At greatest risk are county leases and entities dependent upon the County for support, such as county health care services. However, even temporary cutbacks in funding to such entities are likely to be managed without impairment of debt and other significant obligations.

What can investors expect going forward? Investors should keep in mind that local governments may declare a fiscal emergency for reasons other than to signal insolvency. Kern County is just one of a growing number of stressed cities and counties throughout the nation, and even the world, that have declared a fiscal emergency without filing for bankruptcy (i.e. La Mirada, Fairfield, Culver City, Stanton, Adelanto, and El Monte, to name a few). However, declaring a fiscal emergency is a sign of financial challenges and potential fiscal distress that should not be ignored. The County is being proactive in anticipating the potential impact of lower property values and we commend them for taking action in advance. Only time will tell just how and to what extent this action will enable the County to weather the various forces pressing on its finances.

For more information on this or any other credit topic, please contact our research department at 949-296-3972.

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