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11 August 2017

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New Jersey (State of)

State lottery transfer to pensions sets contribution floor, is slightly credit positive

This report was included in MuniMonitor: October 2017.

The State of New Jersey (A3 stable) has transferred ownership of its lottery enterprise to three of its pension funds, a transaction that will shift roughly $1 billion of annual net lottery revenues from the general fund to pensions for the next 30 years.[1] Positively, the transaction sets a minimum level of pension contributions going forward that is equivalent to annual net lottery revenues and not subject to appropriation. In addition, the transaction adds $5.7 billion of aggregate contributions to the state's pension funding plan for fiscal years 2023 and beyond. It also reflects the state's continued commitment to supporting its pension funds within the realities of its budget constraints. However, the majority of future pension contributions remain subject to appropriation, which continues to be a key risk to the state's funding plan. In addition, annual pension contributions will not increase significantly with this transaction, because the lottery revenues will mostly replace planned contributions that would have otherwise come from the state's general fund. The move has minimal budget impact on the state's general fund, and does not alter the burden of pensions on the state's credit profile.

» **New Jersey's weak and steeply rising pension contribution schedule continues to drive general fund budget pressure.** Net lottery revenues will replace a portion of state general fund pension contributions, but the incremental cost to the general fund of rising contributions remains the same because net lottery revenues previously funded other general fund expenditures. Planned contributions slightly above projected ARC requirements for 2023 and beyond will ultimately depend largely on future state budget appropriations, as they did before the lottery transaction.

» **The state's lottery transfer to restructure the sources of its ongoing pension funding is the latest example of an emerging strategy by some governments.** Several issuers have altered the timing, amount, and/or source of pension contributions by dedicating certain governmental revenue streams for pension funding. Unlike the City of Jacksonville, FL's (Aa2 stable) future sales tax dedication, however, New Jersey has transferred ownership of a business enterprise, and favorably, does not intend to reduce its previously scheduled contributions for near-term budget relief. However, the lottery transaction is not accompanied by any pension benefit reforms that reduce accrued liabilities or slow the rate of future benefit accruals.

New Jersey's weak and steeply rising pension contribution schedule continues to drive general fund budget pressure

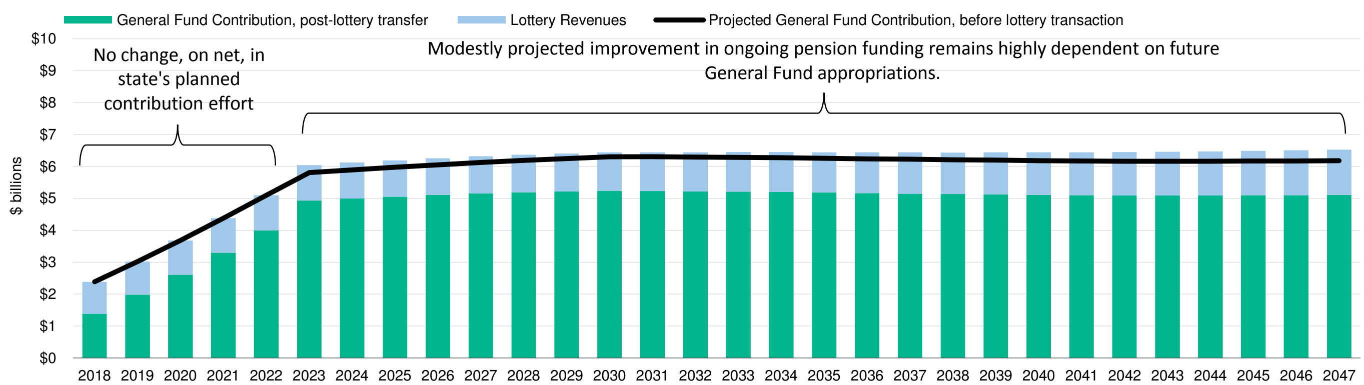
New Jersey's lottery enterprise transfer reflects the state's continued commitment to supporting its pension funds within the realities of its budget constraints. In addition to the lottery transfer, New Jersey adopted legislation in December 2016 to shift to quarterly pension contributions throughout the fiscal year from an annual contribution at the end of the year. Together, these two actions reduce the risk of a late-year pension contribution cut as a means to balance the state's budget. Historically, many of the state's pension contribution cuts were enacted during the fiscal year.

At the same time, the lottery transfer does not change the state's weak, albeit steeply rising, pension contribution schedule. Despite shifting the responsibility for a portion of the contributions to the lottery enterprise, the post-lottery transfer aggregate contribution will match the planned pre-transfer contributions, assuming net lottery revenues meet the state's projections. [2] Therefore the transfer's projected net effect on the general fund budget and on total pension contributions will be neutral for the first five years. [3] As a result, there remains considerable risk that the state will be unable to afford rapidly growing pension contributions without implementing structural revenue or spending changes, and such changes could prove very difficult to implement.

In the first five years of the lottery transfer, the state plans to maintain its phased pension contribution schedule. Even though the phased schedule is well below the ARC payment calculated by the pension systems' actuaries, its rapidly rising nature will nonetheless continue to drive general fund budget pressures. The state will contribute $2.4 billion to its three largest pension funds in fiscal year 2018, inclusive of lottery revenues, and projects that it will have to contribute a total of roughly $6 billion by fiscal 2023, the first year it expects to contribute its full ARC (see Exhibit 1).[4]

Exhibit 1

New Jersey's lottery transaction shifts annual pension funding sources, but its overall pension contributions will change very little



Source: State of New Jersey

Given that the state's aggregate pension contributions are not expected to change significantly in the next 5 to 10 years compared to the prior plan, the most notable long-term effect of the transaction is the creation of an effective minimum, or "floor," on future pension contributions. General fund contributions will still require annual appropriation, but the annual contribution from lottery revenues will be automatic.

The creation of a funding floor is slightly positive for the state's credit profile because it all but removes the prospect of a complete pension contribution holiday going forward. The state's very weak pension contribution history, including years with no pension contributions whatsoever, is a major driver of its current pension cost and unfunded liability challenge. However, the lottery floor only covers 25% of the state's pension ARC.

The consequences of not appropriating the full contribution remain substantial because of the very low funded status of New Jersey's pension funds. Further contribution holidays would greatly diminish the assets available to pay pension benefits, and put the state at risk of having to pay pension benefits directly from its general fund.

Another potentially positive element of the transaction is a statutory update to the state's contribution formula. The new formula is expected to generate $5.7 billion of additional contributions in 2023 and later that target a 90% funded ratio by 2047 (under the plans' actuarial assumptions, such as a 7.65% discount rate). The 90% funded ratio represents an increase from the 80% target established in 2012 pension reform legislation. Success in achieving the target funded ratio will depend on full appropriation of general fund pension contributions. Although the lottery transfer will lower the general fund portion of pension contributions, the need to backfill state expenses previously paid from lottery revenues is somewhat greater, causing a slightly negative net impact on the general fund (averaging 0.5% of General Fund revenues) starting in fiscal 2023.[5]

Although established by statute, which can be revised, the transaction was purposely designed to be very politically and financially difficult to unwind in the future. For example, any future attempt to undo the enterprise transfer would likely revoke the pension funds' tax-exempt qualified status, making all past and future contributions taxable.

The state's lottery transfer to restructure ongoing pension funding is the latest example of an emerging strategy by some governments

From an actuarial and statutory perspective, New Jersey will consider the lottery enterprise as a pension asset. The state currently values the enterprise at $13.5 billion, based on a consultant's analysis of the lottery as an independent business that will generate future net cash flows, similar to the valuation of many private businesses.

We intend to recognize the annual net lottery revenues as part of the state's annual contribution in our key credit metrics related to New Jersey's pensions, as opposed to excluding those future net revenues from contributions but including their present value as pension assets. The state's lottery enterprise has not fundamentally changed with this transaction; it remains essentially part of the state, and is not a private or independent entity. It cannot legally be sold by the state or its pension funds. The lottery enterprise has and will retain strong governance linkages to the state because it is overseen by a commission appointed by New Jersey's governor.

Regardless of the valuation approach chosen, however, both perspectives represent the same economic reality:

» From an accounting perspective, the state has given up an enterprise that carried a positive net position of $11 million in its fiscal 2016 financial statements and shifted it to its pension funds. The projected 30 years of future net revenues used to determine the present value of the lottery enterprise on a statutory basis were not reflected in the state's financial reporting because they fall outside the accounting recognition period.

» From a future cash flow valuation perspective, the state has given its pension funds ownership of a projected annual net revenue stream of over $1 billion for the next 30 years. The state can no longer use that revenue stream to finance other expenditures, so it has given up future financial resources that it values $13.5 billion in order to increase pension assets by the same amount. In fiscal 2016, the state used $987 million of net lottery proceeds to finance state education and institutions in the general fund.

The transfer of New Jersey's lottery enterprise is somewhat distinct from other recent revenue dedications to pensions, but is nonetheless consistent with an emerging trend to alter the timing, amount and/or source of pension contributions to address accumulated unfunded liabilities from an actuarial and statutory perspective.

For example, the City of Pittsburgh, PA (A1 stable) legally dedicated parking revenues to improve its statutory funding levels and prevent a state takeover of its pension funds. Jacksonville earlier this year obtained voter approval for a dedicated sales tax extension, likely beginning around 2030. Jacksonville concurrently closed its defined benefit plans for all new employees going forward. The City of Portland, OR (Aaa stable) funds a largely unfunded pension plan that it supports on a pay-as-you-go basis with a dedicated property tax. Portland's plan is also closed to new employees.

New Jersey is not implementing any benefit reforms as part of its lottery enterprise transfer, nor is it altering its total planned pension contributions for at least five years. Similar to Pittsburgh and Jacksonville, however, the state will increase its plans' funded status on a statutory basis and from the perspective of its actuarial funding strategy, and the new asset will represent a significant portion of total pension assets from that perspective (see Exhibit 2).

Exhibit 2
Transfer of enterprises and dedicated future revenue streams now comprise a significant portion of several governments' pension assets on a statutory and actuarial funding basis
$ billions

Issuer	Jacksonville, FL	Pittsburgh, PA	State of New Jersey
Dedicated Funding Source	Half-cent sales tax, beginning around 2030	Parking revenues from 2011 through 2041.	Legal transfer of lottery enterprise
Plan(s)	Police Pension Fund	Municipal Pension Trust Fund (includes Fire, Police and Municipal)	PERS, TPAF & PFRS
Date	10/1/2016	12/31/2016	7/1/2016
Valuation / Statutory Basis			
Reported Liability	$3.5	$1.3	$85.0
Reported Assets, including future revenues	$2.3	$0.7	$50.1
Unfunded Liability	$1.2	$0.6	$34.8
Portion of Valuation Assets from Dedicated Future Revenues	$0.8	$0.3	$12.6
% of Assets from Dedicated Future Revenues	33%	42%	25%
GASB Basis			
Assets	Not yet available	$0.4	Not yet available
GASB assets include future revenues?	Not yet available	No	Not yet available

Data reflect Jacksonville's police pension fund only. New Jersey's lottery revenues valued at $12.6 billion rather than $13.5 billion due to discounting to July 1, 2016 valuation snapshot.
Sources: Government and plan CAFRs, actuarial valuations and presentations

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Endnotes

1 The state's plans affected by the lottery transaction are the Teachers Pension and Annuity Fund (TPAF), the Public Employees Retirement System (PERS) and the Police & Fire Retirement System (PFRS).

2 This projection assumes net lottery revenue growth will average 2.3% in the first five years after the transfer.

3 The statute authorizing the lottery enterprise transfer reduces the general fund's share of the pension contribution to give credit for the lottery revenues. In the first five years, the "credit" is in fixed amounts ranging from $1 billion to $1.1 billion. In the remaining years, the credit is a 25-year amortization of the lottery enterprise asset, as valued by the state. The lottery asset will be revalued at least every five years to adjust for actual revenue performance, and the credit against the general fund contribution will be revised down, accordingly. If lottery revenues exceed expectations, the additional revenue will remain in the pension fund without increasing the credit against the general fund contribution.

4 New Jersey's stated plan is to increase annual pension contributions by one tenth of the ARC annually until it reaches a full ARC payment in fiscal 2023. The state has budgeted a fiscal 2018 pension contribution that is 50% of the ARC.

5 This assumes that net lottery revenue growth meets the state's projected 1% from fiscal 2024 to fiscal 2047.

REPORT NUMBER 1085720

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