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Ratings

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Summary:

Orange Township, New Jersey; General Obligation; Non-School State Programs

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Credit Profile		
Orange Twp GO (BAM)		
Unenhanced Rating	BBB+(SPUR)/Stable	Downgraded
Underlying Rating for Credit Program	BBB+/Negative	Downgraded
Orange Twp (AGM)		
Unenhanced Rating	BBB+(SPUR)/Stable	Downgraded
Underlying Rating for Credit Program	BBB+/Negative	Downgraded

Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings lowered its long-term underlying ratings to 'BBB+' from 'A-' on Orange Township, N.J.'s general obligation (GO) bonds outstanding. The outlook is negative.

The downgrade reflects our view of Orange's sustained structural imbalance, stemming from limited flexibility under tax levy and appropriations caps, and contributing to misaligned revenue and expenditures over the past three fiscal years, including expenditures outpacing revenues (which for our consideration do not include appropriated fund balance) by $4.1 million in 2017 and a likely further reserve drawdown in 2018. The downgrade also reflects our view that the deterioration of available reserves to 3.9% in 2017 from 10.8% in 2015 (and an additional but still uncertain deterioration in 2018) limits the township's ability to absorb rising costs related to salaries and retirement benefits. Given material changes in these credit factors over several years, we believe Orange's weakened budgetary performance and flexibility are unlikely to return to levels that support a higher rating in the near term. Although a new management team reports it is taking steps to align revenues and expenditures, has reduced the amount of emergency borrowing each year, and may seek waivers from appropriations caps in 2019, we believe Orange remains vulnerable to adverse economic conditions or changing circumstances.

The negative outlook represents the possibility that there is a one-in-three chance that we could lower the rating during the two-year outlook period absent an improvement in financial performance. The budgetary constraints from appropriations and tax levy caps have encouraged budgets constructed using relatively large fund balance appropriations and emergency borrowing, and it is uncertain if economic development in the township will translate into improved budgetary performance. Resolution of the outlook will also require indication that future budgets are constructed with flexibility to absorb unexpected changes.

A pledge of the township's full faith and credit and resources and an agreement to levy ad valorem property taxes without limitation secure the bonds. The bonds are additionally secured by Municipal Qualified Bond Act [QBA], P.L. 1976. The state enhancement program under the QBA is intended to facilitate distressed municipal issuers' access to the capital markets. The QBA instructs the state treasurer to withhold qualifying state aid from an issuer municipality and instead direct that aid to a paying agent to service debt on bonds issued pursuant to the QBA. To qualify for this program, the issuer municipality--in this case Orange Township--must receive state approval for the bonds and the scheduled debt service. We rate the program 'BBB+' with a stable outlook, reflecting the rating and outlook on the State of New Jersey.

The rating reflects our opinion of the township's:

- Weak budgetary performance, with the township not regenerating all appropriated fund balance used in the current fund in fiscal 2017;
- Very weak budgetary flexibility, with an available fund balance in fiscal 2017 of 3.9% of operating expenditures, as well as limited capacity to reduce expenditures;
- Weak economy, with market value per capita of $52,445 and projected per capita effective buying income (EBI) at 62.4%, but that benefits from access to a broad and diverse metropolitan statistical area (MSA);
- Weak management, arising from our view of the township's vulnerable financial policies and practices as determined under our Financial Management Assessment (FMA) methodology;
- Very strong liquidity, with total government available cash at 24.5% of current fund expenditures and 8.1x governmental debt service, and access to external liquidity we consider strong;
- Adequate debt and contingent liability position, with debt service carrying charges at 3.0% of expenditures and net direct debt that is 53.8% of current fund revenue, as well as rapid amortization, with 76.8% of debt scheduled to be retired in 10 years, but a large pension and other postemployment benefit (OPEB) obligation and the lack of a plan to sufficiently address it; and
- Strong institutional framework score.

Weak budgetary performance

Orange's budgetary performance is weak, in our opinion. The township had expenditures outpace revenues, excluding appropriated fund balance, in the current fund by 6.4% of expenditures in fiscal 2017.

In our view, recurring misalignment of Orange's revenue and expenditures have demonstrated structural imbalance over the past two audited fiscal years, and year-end projections show the township is unlikely to regenerate the full amount of appropriated fund balance in fiscal 2018, indicating budgetary performance will likely remain weak in the near term. Although management notes it is consistently able to regenerate some portion of fund balance appropriated, this has not stopped the large decrease in the township's available fund balance.

In calculating budgetary performance, we have included the $1.8 million in deferred charges for costs incurred in fiscal 2017 but that will be paid in future years, as well as charges deferred in previous years that were paid in fiscal 2017. These include costs associated with Emergency and Special Emergency items. Initial results indicate the township will have deferred charges of $1.1 million related to $750,000 in legal fees and $310,000 for settling an outstanding billing discrepancy.

In 2016, the township resolved many outstanding contracts dating back to 2010. As a result of these settlements (including retroactive raises for civilians and new hires), total salaries increased by approximately $5.0 million in 2017, of which $1.2 million was subject to the appropriations cap. Because of these payments, officials allocated $4.76 million in surplus. Of this, the township only regenerated $628,000 during the year. The fund balance appropriation for fiscal year 2018 is only marginally lower at $4.75 million. In November 2017, officials indicated they expected balanced budgetary performance in 2018, although now, they do not expect to regenerate all appropriated fund balance.

Orange's budgets are pressured due to the limitations on both its revenue-raising capabilities and appropriations increases imposed by the state of New Jersey. The township's 2017 budget was $481,000 less than the state-imposed appropriations cap, which limits year-over-year budget growth of appropriations subject to the cap of 3.5% in Orange's case, as the township passed an ordinance allowing the budget to increase an additional 3%. On the revenue-raising side, Orange is limited by the state's 2% levy cap, with exceptions for health benefits, pensions, and debt service. We consider much of the pressure to be the result of the township's historical use of cost and maintenance deferrals that a new management team is now seeking to address. The township's 2017 budget increased its tax levy to the legal maximum and used cap exclusions for pensions and permitted deferred charges. It does not have any banked levy capacity. The township's 2018 budget was $2,937 less than the appropriations cap and $1,344 less than the levy cap. Given continued over-expenditures and Orange's emergency borrowing in 2014, 2016, 2017, and 2018, we believe that these amounts are indicative of the underlying pressure the township is experiencing because of expenditures outpacing its legal ability to raise its primary revenue source--property taxes.

More than 70% of township revenues derive from property taxes. Collections, however, have been below average, with only 93% collected historically. The township hired a new tax collector in 2017. Officials report that tax collection rates appear to have bottomed in fiscal year 2016 at just under 93.0%, before creeping back to 93.3% in 2017. Officials estimate the percentage collection is around 94.4% in 2018. As of 2017, delinquent taxes and tax title liens accounted for 10.26% of the tax levy.

During our outlook horizon, we expect budgetary performance to remain weak. We note that a new management team has taken several steps to align revenues and expenditures. The township hired a new tax assessor, new tax collector, budget consultants, and finance advisors; implemented new controls in budgets and finance departments; hired new police officers to reduce overtime payouts; identified revenue-underperforming properties; and reduced—although did not eliminate—new emergency borrowing in 2018. Reducing sick time and personal time off carry-over, and eliminating terminal leave have been initiatives from the new administration to reduce variable costs. Looking forward, we understand the management team has developed plans to reduce staffing to provide additional flexibility in the large salary and benefits section of the budget. Even so, we believe finances will remain pressured by historically deferred charges, prior hiring decisions and collective bargaining agreements, limited flexibility under state caps, and rising retirement costs. While the township has not adopted a 2019 budget, which is common among New Jersey municipalities, we understand management may seek an appropriations cap waiver to provide additional spending room under the cap.

Very weak budgetary flexibility

Orange's budgetary flexibility is very weak, in our view, with an available fund balance in fiscal 2017 of 3.9% of operating expenditures, or $2.5 million. Impairing budgetary flexibility, in our view, is limited capacity to reduce expenditures.

In our calculation of budgetary flexibility, we exclude roughly $2.7 million in accumulated deferred charges that will be paid in subsequent budgets and not out of fund balances, as permitted under New Jersey accounting. We expect reserve levels will continue to deteriorate in 2018, although it is still unclear by how much. Furthermore, Orange's budgetary flexibility is limited by its proximity to the state-imposed appropriations and tax levy caps, resulting in deferred expenses and special emergency note issuances. Even after adjusting for deferred charges, we still expect available fund balance will be positive at the end of fiscal year 2018.

In the long term, officials are looking to increase the fund balance through improved cost controls and additional revenue from new developments. However, we expect the budgetary flexibility to remain challenged due to cap limitations and historical budgetary decisions and agreements. To the extent the current administration's efforts to seek cap waivers or substantially increase expenditure flexibility are successful, we would view these as positive developments.

Weak economy

We consider Orange's economy weak. The township, with an estimated population of 29,753, is in Essex County in the New York-Newark-Jersey City MSA, which we consider to be broad and diverse. It has a projected per capita EBI of 62.4% of the national level and per capita market value (MV) of $52,445. Overall, market value grew by 7.5% over the past year to $1.6 billion in 2017. The county unemployment rate was 5.7% in 2017.

Following the recession, Orange experienced years of declines to its assessed values (AVs) and MVs. The township is still working to resolve more than 200 tax appeals from the years 2011 through 2017, which could cost as much as $1 million. It completed a reassessment in 2013, but has seen AVs continue to fall, declining 1.8% since 2014. MVs seem to be recovering, growing 7.5% in 2017.

As mentioned, management has focused on increasing revenue over the past two years. The township plans to redraft the master plan for the city to include redevelopment areas, and was recently awarded four designated Opportunity Zone areas under the Tax Cuts and Jobs Act. In recent months, Orange has experienced a surge in interest among developers looking to construct large-scale housing developments. According to officials, new construction includes a 208-unit residential project, with a planned additional 108 units at a second site; several additional smaller residential developments; several minor commercial developments; and two initiatives to develop previously tax-exempt property for mixed-use buildings.

Most of the proposed developments are market rate, near mass transit, and weighted heavily toward one-bedroom and studio units. Therefore, officials are not expecting a significant draw on services. Although the increase in development and proximity to Manhattan lend strength to Orange's economy, we expect the township to remain challenged by weak income indicators and below-average wealth levels.

Weak management

We view the township's management as weak, reflecting our view of the township's vulnerable financial policies and practices under our FMA methodology, which indicates the government lacks policies in many of the areas we believe are most critical to supporting credit quality.

Our assessment accounts for the fact that budgetary assumptions have neglected likely shortfalls and expenditure pressures, and that management has historically tended to defer costs and issue debt instead of addressing potential budgetary imbalance. Furthermore, township officials have, in the past, not made appropriate adjustments throughout the year to ensure long-term budgetary alignment, perhaps in part due to the township's limited flexibility we note above. We believe the structural budgetary imbalance illustrates these tendencies.

The township lacks debt management and reserve policies. Furthermore, there is no long-term financial plan. However, management regularly reports on budget-to-actuals and investments, with monthly reports sent to the governing body. Orange has a basic capital improvement plan covering six years that it updates annually during the budget process. However, funding and sources are not identified in all years. The township regularly reports on cash balances, and maintains a cash management plan that governs investments, which is required by state mandate.

We note that in previous reports, we discussed ongoing litigation between the administration and council, as well as a Federal Bureau of Investigation (FBI) inquiry into library and city hall staff. We understand that the litigation between the council and the administration has largely been resolved and should not have material financial effects on the township. Similarly, the FBI investigation, although still ongoing, is not expected to have budget ramifications. We understand the investigation is nearing resolution and many of the individuals involved are no longer with the township.

We also note that the new management team has made efforts to implement new controls and financial reforms. To the extent the effect of these changes becomes apparent through positive developments in financial results, we would view them favorably and potentially reconsider our management assessment.

Very strong liquidity

In our opinion, Orange's liquidity is very strong, with total government available cash at 24.5% of current fund expenditures and 8.1x governmental debt service in 2017. In our view, the township has strong access to external liquidity if necessary.

Orange has demonstrated its strong external liquidity by issuing GO debt and bond anticipation notes (BANs) within the past 20 years. Currently, it does not have any variable-rate or direct-purchase debt, nor does it have any contingent-liquidity risks from financial instruments with payment provisions that change on the occurrence of certain events. At present, the majority of the township's cash is held in bank accounts. Therefore, we believe the liquidity profile will likely remain very strong over the next two fiscal years.

We note that cash-flow indicators are still relatively strong. While accounts payable increased to $427,000 in 2017 from $214,000 in 2016, officials indicated average time to pay an invoice decreased in 2018.

Adequate debt and contingent liability profile

In our view, Orange's debt and contingent liability profile is adequate. Debt service is 3.0% of current fund expenditures, and net direct debt is 53.8% of current fund revenue. Approximately 76.8% of the direct debt is scheduled to be repaid within 10 years, which is, in our view, a positive credit factor.

We calculate total direct debt outstanding to be $35.9 million, which includes emergency notes. Management plans to obtain a $10 million New Jersey Infrastructure Bank loan over the next two years, only 50% of which would require interest payments.

In our opinion, a credit weakness is Orange's large pension and OPEB obligation, without a plan in place that we think will sufficiently address it. Orange's combined required pension and actual OPEB contributions totaled 12.7% of current fund expenditures in 2017. Of that amount, 6.4% represented required contributions to pension obligations, and 6.3% represented OPEB payments. The township made its full annual required pension contribution in 2017. The funded ratio of the largest pension plan is 54.5% and we do not see material improvement in the near future. While Orange is paying its full required portion of the actuarially determined contribution in 2017, we believe it has limited ability to control future growth of contributions and, with regard to OPEB obligations, has no mechanism for prefunding its share of the liabilities. We believe the budgetary pressure from these obligations is likely to increase, and that this pressure constrains the township's flexibility to address unforeseen challenges, which could have a negative long-term effect on credit quality.

The township participates in the cost-sharing multiple-employer Police and Firemen's Retirement System (PFRS) and Public Employees' Retirement System (PERS) pension plans. The reported plan fiduciary net position as a percentage of the total pension liability was 54.52% for PFRS and 36.78% for PERS as of June 30, 2017. The township's proportionate share of the net pension liability as of June 30, 2017, was $92.6 million for PFRS and $41.3 million for PERS. While funding policies somewhat mitigate the risks for local governments of escalating contributions due to low plan funded ratios, Orange could face escalating pension costs should the state not follow its current schedule of increasing pension contributions. For more details and information on these risks, see our report, "New Jersey Pension Funding: State Actions Reverberate At The Local Level" (published Dec. 12, 2018, on RatingsDirect).

The township also provides OPEBs to eligible retirees through the State Health Benefits Program, a cost-sharing, multiple-employer defined-benefit postemployment health care plan administered by the state. These benefits are funded on a pay-as-you-go basis with no mechanism in place that allows for prefunding, limiting the township's ability to plan for these rapidly escalating costs. In 2017, the township contributed $4.1 million toward its OPEB obligations, which we expect will grow in the future.

Outlook

The outlook on the program rating is stable, reflecting the outlook on the State of New Jersey.

The negative outlook on the township's long-term underlying rating reflects our opinion there is at least a one-in-three chance that we could lower the rating over our two-year outlook period. This is based on our expectation that weak budgetary performance for Orange will persist in the near future. We believe the township's budget is pressured by an inability to reduce costs, coupled with state limitations on revenue-raising capabilities.

Although the relatively new management team reports it is taking steps to align revenues and expenditures, we believe Orange remains vulnerable to adverse economic conditions or changing circumstances. Therefore, if draws on reserves are larger than expected in 2018, or if they continue, we could lower the rating.

We could revise the outlook to stable if management is able to consistently manage operations (without deferring costs or issuing emergency notes) by reducing expenditures. We believe expenditure reduction would provide more budgetary flexibility and the ability to plan for and absorb potential budgetary stresses such as unexpected payouts from settlements, tax appeals, payouts, or small emergency capital needs.

Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Incorporating GASB 67 And 68: Evaluating Pension/OPEB Obligations Under Standard & Poor's U.S. Local Government GO Criteria, Sept. 2, 2015
- Local Government Pension And Other Postemployment Benefits Analysis: A Closer Look, Nov.8, 2017

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.