

MOODY'S

INVESTORS SERVICE

New Issue: Moody's assigns Aa3 to \$61.1 million State of Connecticut G.O. Refunding Notes (Economic Recovery Notes)

Global Credit Research - 03 Dec 2014

Outlook is stable

CONNECTICUT (STATE OF)
State Governments (including Puerto Rico and US Territories)
CT

Moody's Rating

ISSUE	RATING
General Obligation Refunding Notes (Economic Recovery Notes, 2014 Series A)	Aa3
Sale Amount	\$61,100,000
Expected Sale Date	12/08/14
Rating Description	General Obligation

Moody's Outlook STA

Opinion

NEW YORK, December 03, 2014 --Moody's Investors Service has assigned Aa3 ratings to the State of Connecticut \$61.1 million General Obligation Refunding Notes (Economic Recovery Notes, 2014 Series A) SIFMA Index. Proceeds of the economic recovery notes (ERNs) will be used to restructure the state's outstanding ERNs by extending a portion of the debt service payment by one to three years. The state expects to price the notes on or about December 8.

SUMMARY RATING RATIONALE

The Aa3 state rating incorporates Connecticut's high combined fixed costs for debt service, pension, and post employment benefits relative to the state's budget; pension funded ratios that are among the lowest in the country and likely to remain well below average; and minimal reserve levels. The slow pace of the state's economic recovery led to revenue underperformance and persistent budget gaps though the state has recently worked to increase reserves and bring the state budget into fiscal balance.

STRENGTHS:

- Legislated support for application of operating surpluses to the Budget Reserve Fund (BRF)
- Commitment to eliminate GAAP negative fund balance
- Wealthiest state in the nation with per capita personal income levels well above national levels

CHALLENGES:

- Fixed costs for debt, pension, and other post employment benefits (OPEB) relative to budget are among the highest in the nation
- Very low funding ratios for pension systems
- Vulnerability to financial market fluctuations due to effect on capital gains for very high wealth residents and employment in the financial services sector
- General Fund balance sheet will remain negative over near term and rainy day fund modest due to state's slow

recovery from the recession

DETAILED CREDIT DISCUSSION

ADOPTED 2014-2015 BIENNIAL BUDGET ADDRESSED PROJECTED GAPS, INCORPORATES ONE-TIME SOLUTIONS

On a current services basis, Connecticut faced large projected budget gaps relative to most other states. The final 2014 -2015 adopted budget featured a combination of revenue enhancements, but no new taxes; reduced transfers for municipal aid as well as to the special transportation fund; and spending cuts, largely due to programmatic changes in Medicaid costs. In addition, the state reduced its General Fund current services budget by changing how the state funds its Medicaid expenditures. First, beginning in fiscal 2014, the Affordable Care Act Medicaid expansion program is being funded off budget, since it is funded entirely by the federal government. Second, only the state's share of Medicaid expenditures in the Department of Social Services is appropriated. The net effect of these changes was a reduction of appropriations by \$2.8 billion in fiscal 2014 and by \$3.2 billion in fiscal 2015, with corresponding offsets on the revenue side. The state made modest adjustments to the adopted fiscal 2015 on May 7, mainly due to the revised revenue projections and policy changes. The revised budget is approximately \$26 million under the state's expenditure cap.

After adopting a structurally balanced budget for the 2012-2013 biennium, Connecticut returned to the use of one-time solutions to balance its budget for the current 2014-2015 biennium. One-time resources are lower than they were during the recession, representing about 4% (\$728 million) of fiscal 2014 revenues and 2.8% (\$491 million) of revised fiscal 2015 revenues. The largest non-recurring solutions included the use of \$221 million of the fiscal 2013 year end surplus; restructuring the 2009 economic recovery notes by extending the maturity two years to save \$196 million fiscal 2014 and \$61 million in fiscal 2015 (reduced from a planned \$196 million); and various fund transfers totaling almost \$250 million over the biennium. The state expects this trend of using non-recurring resources to balance the budget to reverse again in fiscal 2016.

As of December 1, the state is projecting a small budget deficit for fiscal year 2015 of approximately \$45 million, or 0.3% of the fiscal 2015 budget. This amount is after corrective measures to address larger projected shortfalls. These measures included expenditure cuts, a hiring freeze and a cap on overtime wages. The budget shortfall is mainly due to higher than expected spending and a reduction in federal grants.

LARGE DECLINE IN APRIL REVENUES REDUCED PROJECTED FISCAL 2014 SURPLUS

Changes in the federal capital gains tax rate in 2012 impacted several states significantly, including Connecticut, as investors recognized larger than usual investment gains in 2012 to avoid higher tax rates in 2013. As a result, April income tax revenue was approximately \$390 million below projections. Connecticut, however, fared better than some states due to a previously projected \$504 million surplus for fiscal 2014. General fund revenues of \$17.20 billion for fiscal 2014 resulted in surplus of \$248.5 million for the year, which will be deposited into the state's rainy day fund. Connecticut's rainy day fund balance of \$519.2 million after the fiscal 2014 deposit will remain modest at 3.0% of general fund revenues. The surprise decline in April revenues also caused the state to revise income tax revenue projections down by \$246 million for fiscal 2015, after revising them \$213 million and \$114 million upward in January for fiscal 2014 and 2015, respectively.

BOND PROCEEDS USED TO REDUCE NEGATIVE GAAP BALANCE

In fiscal 2013 the state implemented a plan to begin addressing Connecticut's sizeable \$1.2 billion cumulative GAAP deficit. The state issued \$560 million of general obligation bonds, which generated \$598.5 million in proceeds, (of the \$750 million total authorized by the legislature), amortizing the bonds over 15 years and reducing the accumulated GAAP deficit to \$618.5 million. The remaining portion of the deficit will be amortized over 13 years starting in fiscal 2016, resulting in an annual payment of about \$47.5 million. These amounts will be "deemed appropriated", meaning no further legislative action is needed to make the payments.

The GAAP bond proceeds are not counted as General Fund revenues, and the proceeds cannot be used for any current or future budget appropriations. While the funding strategy enabled the state to begin addressing its longstanding sizeable GAAP deficit and injects discipline into the plan, the additional debt adds to the state's already high debt levels and fixed costs. Even with the plan, the unassigned General Fund balance will remain negative over the near term.

CONNECTICUT'S PENSION LIABILITY AMONG THE HIGHEST IN THE COUNTRY; FIXED COSTS ARE HIGH RELATIVE TO BUDGET

Based on Connecticut's fiscal 2012 pension data, we have calculated that the SERS adjusted net pension liability (ANPL) was 121% of revenues. Moody's adjusted net pension liability applies a bond index rate to determine the present value of plan liabilities, incorporates the market (rather than actuarial) value of plan assets and makes certain other changes to improve comparability of reported pension liabilities. The state reported a preliminary funded ratio for SERS of 41.5% as of June 30, 2014. The actuarial valuation for TRS showed a funded ratio of 59% as of June 30, 2014, up from 55% as of June 30, 2012. SERS revised downward the assumed rate of return, to 8% from 8.25% beginning in fiscal 2014, along with other adjustments to price and wage inflation rates. The assumed rate of return for TRS is 8.5%. For these two plans, the state's combined ANPL for fiscal 2012 was 236% of revenues. This amount is notably higher than that of Kentucky, the state with the third largest pension burden, at 193.2% of revenues, but is well below Illinois at 268.3%. The 50-state median ANPL to revenues is 60.3%, based on 2013 data. Other pension ratios such as ANPL to personal income, GDP, and population are similarly very high for Connecticut.

Full SERS and TRS ARC payments are reflected in the current budget, and the state is required to maintain full funding of the ARC going forward pursuant to a labor agreement for SERS and a bond covenant for the TRS 2008 pension obligation bonds (POB). Some pension and healthcare reforms were achieved in the round of union negotiations prior to the adoption of the fiscal 2012-2013 biennial budget.

Connecticut's unfunded liability for other post employment benefits (OPEB) declined (from \$26.6 billion to \$19.5 billion) due to changes in assumptions and 2011 plan reforms. Still, Connecticut's combined fixed costs for debt service, pension, and OPEB are high and, absent significant further reforms, will continue to consume an increasingly larger portion of the state's budget.

HIGH DEBT RATIOS REFLECT HEAVY DEBT LOAD

Connecticut is a frequent borrower and the state's debt per capita and debt-to-personal income ranked first and second, respectively, among the 50 states for Moody's 2014 debt medians. Net tax-supported debt equaled \$5,457 per capita and 9.2% of total state personal income, well above the 50-state medians of \$1,054 in debt per capita and 2.6% for debt-to-personal income. These high debt ratios are partly due to substantial capital financing for K-12 school building construction that is carried out at the local level in many other states. However, with the \$2 billion POBs and the sale of \$560 million in GAAP Conversion bonds to address a portion of the state's sizeable cumulative GAAP deficit, on top of the state's normal sizeable annual debt issuances, Connecticut's debt ratios will likely remain among the highest in the country. Connecticut adheres to a 20-year level principal repayment schedule for its general obligation debt, with a declining debt service schedule that provides some flexibility.

State debt includes financing for certain municipal projects (mostly schools) that are funded at the local level in most states. As a result, the state's resources are more leveraged than other states. This results in higher state fixed costs for debt service, even though Connecticut's combined debt loads (state plus local obligations) are more moderate relative to its significant taxable base.

Connecticut's liquidity has improved and remains satisfactory. The state has not had to borrow for cash flow purposes. A standby line of credit for \$300 million for potential cash flow needs in fiscal 2013 was not tapped and expired in December 2013. Cash balances averaged \$2.0 billion in fiscal 2014 and are currently about \$1.1 billion (as of November 15). Cash margins would likely be tighter if the state decreased its use of debt, as the state uses bond proceeds as an occasional and temporary source of cash.

MODEST AMOUNT OF VARIABLE RATE DEBT AND MINIMAL SWAP EXPOSURE

The state has \$1.6 billion in variable rate debt, most of which is indexed to either SIFMA or CPI, or approximately 11% of the state's total G.O. debt. A total notional amount of \$336 million variable rate debt is swapped to fixed based on 60% of LIBOR or a percentage point above CPI. Termination payments could be triggered in the unlikely event that the state's rating is downgraded below Baa2, or by the state if the counterparty rating falls below A3. There are collateral posting requirements on the part of the counterparties but not for the state. According to the most recent valuation (September 30, 2014), if all of the state's general obligation swaps were terminated, the state would owe approximately \$ 7.3 million to the counterparties. This amount is manageable given the state's current resources and likely ability to issue bonds for the amount if necessary. In accordance with its swap guidelines, the state generally negotiates provisions that permit funding a required termination payment over a period of time to allow time for a refunding. Accordingly, the state would have 270 days to fund a termination payment for its general obligation swaps.

SLOW ECONOMIC RECOVERY

Connecticut's economy is recovering more slowly than the rest of the country, though the state's GDP growth has recently improved to 3.5% in the first quarter of fiscal 2015 down from 4.6% in the last quarter of fiscal 2014. Job growth was strong in September and income growth has also started to improve. Much of the rebound in income growth is due to a more stable manufacturing sector, though overall manufacturing employment is still down. Other key sectors also continue to show negative employment trends from a year ago, including information and financial activities. The state has recovered about 71% of the non-farm jobs it lost during the recession. Connecticut's unemployment rate was 6.4% in September 2014, above the national rate of 5.9% the same month. Moody's Analytics expects that Connecticut's employment growth will lag the nation over the forecast horizon. Single-family housing starts are also below the US average and remain hindered by a large backlog of foreclosures.

OUTLOOK

The outlook for Connecticut is stable reflecting the positive steps the state has taken to address its long-standing balance sheet weakness and reduce its fixed post employment benefit costs through pension reforms, as well as the adoption of a budget that largely relies on recurring solutions. We expect that Connecticut's revenue trends should improve as its recovery picks up steam. We also expect that the state will maintain its new commitment to replenishing its rainy day fund over time and addressing its remaining negative GAAP basis unassigned General Fund balance. The slow pace of economic recovery will continue to challenge the state's financial position over the near term.

What could make the rating go up

- Achievement and maintenance of higher GAAP-basis combined available reserve levels
- Established trend of structural budget balance
- Evidence of sustained stronger economic performance
- Reduced debt ratios relative to Moody's 50-state median and lower fixed annual costs.
- Significantly improved funding of pension and post-retirement liabilities

What could make the rating go down

- Lack of improvement in available reserve levels
- Reversion to significant one-time budget solutions, including deficit financings
- Revenue weakness driven by delayed economic recovery
- Cash flow strain stemming from reduced liquidity
- Significant increase in fixed costs as percent of budget

RATING METHODOLOGY

The principal methodology used in this rating was US States Rating Methodology published in April 2013. Please see the Credit Policy page on www.moody.com for a copy of this methodology.

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