

**New Issue: Moody's assigns Aa3 to \$980 million State of Connecticut G.O. bonds**

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Global Credit Research - 05 May 2015

**Outlook is stable**

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

**Moody's Rating**

<b>ISSUE</b>	<b>RATING</b>
General Obligation Bonds (2015 Series B)	Aa3
<b>Sale Amount</b>	\$500,000,000
<b>Expected Sale Date</b>	05/12/15
<b>Rating Description</b>	General Obligation
General Obligation Bonds (2015 Series C) - SIFMA Index	Aa3
<b>Sale Amount</b>	\$200,000,000
<b>Expected Sale Date</b>	05/20/15
<b>Rating Description</b>	General Obligation
General Obligation Refunding Bonds (2015 Series D) - SIFMA Index	Aa3
<b>Sale Amount</b>	\$280,000,000
<b>Expected Sale Date</b>	05/20/15
<b>Rating Description</b>	General Obligation

**Moody's Outlook** STA

NEW YORK, May 05, 2015 --Moody's Investors Service has assigned Aa3 ratings to the State of Connecticut \$500 million General Obligation Bonds (2015 Series B), \$200 million General Obligation Bonds (2015 Series C) - SIFMA Index and \$280 million General Obligation Refunding Bonds (2015 Series D) - SIFMA Index. The Series B bonds are expected to price May 12 and the Series C and D bonds are expected to price May 20.

**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.

**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

#### 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

#### RECENT DEVELOPMENTS

As of March 31, the state is projecting a small budget deficit for fiscal year 2015 of approximately \$121 million, or 0.6% of the fiscal 2015 budget. This amount is after corrective measures to address larger projected shortfalls. These measures included expenditure cuts and hiring and purchasing restrictions. The budget shortfall is mainly due to reduced collections of oil companies taxes and a reduction in anticipated federal grants revenue. Other recent developments at the state are incorporated into the detailed credit discussion below.

#### DETAILED RATING RATIONALE

##### ECONOMY: ECONOMIC RECOVERY SLOWLY TAKING HOLD

Connecticut's economy is recovering more slowly than the rest of the country, though both job growth and personal income growth improved in the last quarter of 2014. Much of the rebound in income growth is due to a more stable manufacturing sector. The state has recovered about 94% of the private sector jobs it lost during the recession, though some key sectors continue to show negative employment trends from a year ago, including information and financial activities. Connecticut's unemployment rate was 6.4% in March 2015, above the national rate of 5.5% the same month. Moody's Analytics expects that Connecticut's employment growth will remain steady in 2015, after a burst of hiring in retail and hospitality. Single-family housing starts were below the US average due to a large backlog of foreclosures, but will see some spurts of construction this year, along with

commercial construction, aiding the recovery. Longer term, the state faces some headwinds from high energy living costs.

## FINANCIAL OPERATIONS

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

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.

### 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.

## LIQUIDITY

Connecticut's liquidity has improved and remains satisfactory. The state did not have to borrow for cash flow purposes in fiscal 2014 and does not anticipate cash flow borrowing in fiscal 2015. Cash balances averaged \$2.0 billion in fiscal 2014 and are currently about \$1.5 billion (as of May 2). 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.

## DEBT AND PENSIONS

### Debt Structure

### 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.

#### Debt Related Derivatives

#### 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. Only \$56.6 million of the state's variable rate debt is swapped to fixed, based on 60% of LIBOR or a percentage point above CPI, after a \$280 million swap was terminated at par on March 1. 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.

#### Pensions and OPEB

#### CONNECTICUT'S PENSION LIABILITY AMONG THE HIGHEST IN THE COUNTRY

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.

#### GOVERNANCE

The state has a constitutional balanced budget requirement, strong, binding consensus revenue process supported by nonpartisan and objective economic analysis that is conducted at least quarterly or can be scheduled more frequently during times of revenue shortfalls or economic distress. There is a constitutional cap on spending and a statutory limit on debt payable from the General Fund. The state is not subject to mandated initiatives or voter referenda. The Governor has executive authority--though limited--to cut expenses by up to 5% of an individual appropriation, not to exceed 3% of any fund, without legislative approval, and if a deficit exceeds 1% of the General Fund, there are requirements for a timely deficit mitigation plan to be developed. A super-majority is not required for tax increases or legislatively enacted budget adjustments. There is monthly budget reporting by both the Governor's budget office and the State Comptroller and budget adoption has been timely. The state does not conduct a debt affordability analysis however both the Governor's budget office and the Office of Fiscal Analysis prepare Fiscal Accounting reports that include multiple-year financial planning including projections of debt issuance, debt levels and debt cost. The state has frequently maintained a rainy day fund over the years, and

there are statutory requirements that all budget surplus funds be deposited to the rainy day fund at year-end.

#### KEY STATISTICS

Per capita income relative to U.S. average: 137.1%

Industrial diversity (1=most diverse): 0.76

Employment volatility (U.S.=100): 92

Available balances as % of operating revenue (5-yr. avg.): -8.8%

NTSD/total governmental revenue: 80.1%

3-year average adjusted net pension liability/total governmental revenue: 213.5%

#### OBLIGOR PROFILE

The State of Connecticut has a population of almost 3.6 million people. The state, located in the northeastern US, has a large and diverse economy with a gross state product of \$249.2 billion. It is the wealthiest state in the country with per capita income of 137.1% of the US average.

#### LEGAL SECURITY

The bonds will be secured by the full faith and credit of the State of Connecticut.

#### USE OF PROCEEDS

Proceeds of the bonds will be used to refund certain prior obligations for debt service savings, various capital projects and for other state purposes.

#### 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.moodys.com](http://www.moodys.com) for a copy of this methodology.

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