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Connecticut; General Obligation

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Connecticut; General Obligation

Credit Profile		
US$300.0 mil GO bnds ser 2014 A due 03/01/2034		
Long Term Rating	AA/Stable	New
US$100.0 mil GO bnds (Sifma Index Bnds) ser 2014 B due 03/01/2024		
Long Term Rating	AA/Stable	New
Connecticut GO		
Long Term Rating	AA/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services assigned its 'AA' long-term rating and stable outlook to the State of Connecticut's $400 million general obligation (GO) bonds as follows:

- $300 million GO bonds (2014 series A); and
- $100 million GO bonds (2014 series B) – SIFMA Index bonds.

At the same time, Standard & Poor's affirmed its 'AA' rating on the state's $13.7 billion parity debt outstanding. The outlook is stable.

The 'AA' rating reflect what we view as Connecticut's:

- Diverse economic base that has experienced cyclical performance over time;
- High wealth and income levels;
- Capacity to adjust revenues and expenditures, which we believe has provided it with flexibility to manage budget volatility;
- Active monitoring of revenues and expenditures to identify gaps; and
- Adequate operating liquidity, which has improved due to stronger revenue performance and the recent generally accepted accounting principles (GAAP) conversion bond issue.

In our view, despite these strong fundamentals, the state has a history of what we consider cyclical budget performance, which has led to its issuance of debt to cover operating deficits in recessionary periods. Connecticut's above-average debt levels and high unfunded postretirement liabilities represent a significant fixed cost pressure and we expect this to accelerate based on new bond authorizations in recent years for operating and capital purposes.

The state's economic recovery continues at a muted pace and we expect that this will continue in the near term as growth prospects in key sectors (financial services, government, and manufacturing) are limited in our view. Greater certainty regarding the federal budget situation could contribute to stronger underlying growth. The unemployment rate remains elevated relative to that of the U.S., but has improved, dropping to 7.4% through December 2013.

Employment growth remains limited overall and the state has recovered approximately half of the jobs lost through the Great Recession. Real gross state product growth for Connecticut was slightly negative in 2011 and 2012 (0.1% decline each year), ranking it last among the 50 states for 2012.

While weak economic growth has limited revenue expansion, the current revenue forecast for fiscal 2014 has proved to be conservative based on actual results to date. Connecticut is now forecasting a significant surplus for fiscal 2014. Nearly all revenue sources are projected to be above forecast, with significant positive variance in personal income taxes ($213.1 million), sales and use tax ($88.2 million) and corporation tax ($91.9 million). Expenditures are forecast to be $80.5 million below forecast due largely to budget lapses. The aggregate surplus is now estimated at a significant $504.4 million. The governor released midyear budget recommendations that propose using the surplus for three key areas, which include one-time tax refunds for sales and gas tax in fiscal 2015 ($155 million), a $100 million contribution to the state retirement system, and a $242.6 million deposit to the budget reserve fund. In addition, the $30 million of fiscal 2013 used to fund fiscal 2015 budget requirements will be redirected to fiscal 2014 for deposit into the reserve. These recommended changes would not build recurring spending into the base in our view and would enhance the state's reserve position, which increases flexibility to mitigate future budget challenges. If approved, the budget reserve fund would increase to $543 million or 3.1% of the budget, which is more than double the current level. Minor revenue and tax reductions are recommended for fiscal 2015 as part of the midterm budget adjustments, amounting to $228 million but $155 million would be funded by the fiscal 2014 surplus so the recurring effect of additional changes is modest in our view. The total spending now proposed for fiscal 2015 is $19 billion or 2.7% above fiscal 2014, with some modest program increases in education and other program areas. The year-end surplus is now estimated to be $22.3 million for fiscal 2015. The biennial budget originally included spending reductions and minor revenue enhancements to achieve balance. There was also a reliance on nonrecurring measures including restructuring of economic recovery notes outstanding, which to lower debt service payments for the biennium and extend the maturity by two years. Connecticut was one of the early states to announce Medicaid expansion under the Affordable Care Act and implementation was included the enacted budget. A positive inclusion in the current budget is full funding of the pension costs on an actuarial basis.

Outlook

The stable outlook reflects Standard & Poor's expectation that Connecticut will retain structural budget alignment over the two-year outlook horizon. Slow revenue growth, the state's significant fixed cost pressures and diminished budget reserves limits financial flexibility. We note that recent efforts to increase the budget reserve will enhance flexibility to respond to future budget gaps. Connecticut has historically managed budget pressures, and above-average leverage and revenue volatility have been factors at the current rating level over time. We believe that the state is currently more vulnerable than other states to adverse trends in the economy given the fiscal strain of the past several years. The rating could come under pressure if structural gaps emerge and are not addressed in a timely manner with recurring solutions or additional deficit bonds are issued.

Government Framework

The government framework, including fiscal policy and intergovernmental funding, within which each state taxes, spends, and issues debt, influences its ability to manage through economic cycles.

Following are the key features of Connecticut's governmental framework:

- The requirement to approve a balanced budget. Voters approved an amendment that provides that the amount of general budget expenditures authorized in any fiscal year shall not exceed the estimated amount of revenue for that fiscal year.
- In developing its budget, the state operates under a statutory expenditure cap that limits spending growth to the greater of personal income growth or the inflation rate. The cap excludes debt service and certain other expenditures.
- There is no statutory or constitutional prohibition against borrowing for operating purposes. Connecticut is authorized to issue GO debt, special tax obligation debt, and special obligation and revenue debt. Debt outstanding, authorized, and payable from the general fund is limited by statute to 1.6x total general fund tax receipts ($2.9 billion of excess capacity estimated by the state).
- There are no constitutional or statutory provisions providing for, or precluding, a priority of payment for GO debt service over other claims of the state. Funds for debt service are "deemed to be appropriated" and, as part of the contract between bondholders and Connecticut, the state must appropriate all amounts necessary for the punctual payment of principal and interest.
- Connecticut, which is not a voter-initiative state, has the autonomy to raise taxes and has adjusted its tax structure over time.
- Connecticut has relatively broad service responsibilities with about 27% of its budget tied to education funding and other resources shared with local government units. Although there is legal flexibility to adjust funding to local governments, Connecticut has avoided sharp midyear reductions in these areas in recent years. Court cases over the years regarding education funding have generally contributed to increased spending over time in our view.

On a scale from '1.0' (strongest) to '4.0' (weakest), Standard & Poor's assigned a '1.5' score to Connecticut's governmental framework.

Financial Management

State statutes and internally developed policies guide budget management, long-term financial planning, capital planning, debt management, and investing.

Financial management assessment: 'strong'

We consider Connecticut's management practices "strong" under our financial management assessment (FMA) methodology. An FMA of strong indicates that, in our opinion, practices are robust, well embedded, and likely sustainable.

Beginning Oct. 15, 2009, the Office of Policy and Management (OPM) and the legislature's Office of Fiscal Analysis have been required by statute to issue consensus revenue estimates each year. An update to the estimate is required by Jan. 15 and April 30 of each year, and it must cover a five-year period. In addition to its internal resources, Connecticut bases its revenue estimates for budget forecasting on a number of outside data sources and economic forecasting firms. The state's long-term financial planning includes a three-year forecast for the legislature in addition to the biennial budget. The financial plan is updated annually and submitted to the legislature by Nov. 15.

The state also produces a five-year capital improvement plan as part of the November update. State statutes require monthly revenue and expenditure forecasts measured against the budget. The OPM and the Office of the Comptroller generate monthly reports projecting year-end surpluses or deficits. State statutes also prescribe investment of state funds. Dedicated staff monitors investments and generates monthly reports. Connecticut also holds quarterly meetings with the investment advisory commission. The state has a swap management policy and other debt policies that guide amortization and issuance. Connecticut statute authorizes a budgetary reserve fund at a maximum of 10% of general fund appropriations. The statute prescribes that the state must transfer all unappropriated general fund surpluses into the budget reserve fund, and that the fund can only be drawn on to fund operating deficits.

Budget management framework

Connecticut maintains a formal schedule for updating revenues and expenditures on a monthly basis, and this is done by both OPM and the comptroller. If the comptroller reports a projected general fund deficit greater than 1%, the governor is required to file a deficit mitigation plan. While the governor may reduce appropriations, this is limited to 5% of total appropriations and 3% of any fund, with any additional reductions requiring legislative approval. Legislative deliberation relating to interim budget adjustments has contributed to a delay in addressing budget gaps at times. The state is allowed to end the year in a deficit, which has periodically been addressed with deficit bonds. However, statutory provisions provide that any new budget deficit after fiscal 2013 must be funded in the ensuing fiscal year budget. Gap-closing solutions in the most recent biennium relied on significant nonrecurring measures as well as structural solutions.

On a scale from '1.0' (strongest) to '4.0' (weakest), Standard & Poor's assigned a '1.5' score to Connecticut's financial management.

Debt And Liabilities

In our opinion, Connecticut's debt burden is high by all measures when compared with that of state peers, in part reflecting debt issued for education and other programs that may be handled at the local level of government in other states. It also includes debt issued for pension liabilities, which is not done by all states.

Connecticut's approximately $16 billion in GO and tax-supported debt (including this issuance) and $3.8 billion of special obligation debt put the state's total tax-supported debt per capita at $5,525, which is high compared with that of state peers. Compared with income, debt ratios are also high, in our opinion, at 9.3% of personal income. Debt service represents 9.5% of general fund expenditures in fiscal 2013, which we again consider high. The debt service burden has been stable over time, but recent bond issuance including the GAAP conversion bonds and additional authorizations could increase this fixed-cost burden. On a positive note, the amortization of debt outstanding remains rapid at 65% in 10 years. The state's debt profile is largely fixed-rate obligations.

The State Employees Retirement Fund (SERF) recorded a significant unfunded liability of $13.9 billion as of June 30, 2013, and the funded ratio declined to 41.2% from 42.3% in fiscal 2012. The funded ratio is based on an interim valuation that updated on certain assumptions. The earnings assumption was lowered to 8.00% from 8.25% (following a September 2012 experience study). While still higher than the 7.4% average return in the past 20 years, it is a better alignment with performance. The negative investment returns experienced due to financial market declines 2008 and 2009 are now fully reflected in the state's actuarial reports, which should point to improved funded ratios as more positive returns are phased in but will depend on investment performance and actuarial assumptions. The SERF currently uses the projected unit credit actuarial cost method, which is not aligned with the new Governmental

Accounting Standard Board standard that requires use of the entry age normal cost method. A conversion to this method would require legislative approval, as well as approval of the State Employees Bargaining Agent Coalition (SEBAC), and is expected to increase liabilities, lower funded ratios, and increase contributions, which would add to overall cost pressures.

The Teachers' Retirement Fund had an unfunded liability of $11.1 billion, despite a deposit of $2 billion in bond proceeds. The funded ratio declined to 55.24% in 2012 from 61.4% in 2010 and 70.1% in 2008. The current earnings assumption is 8.5%, which is higher than the 7.56% average return in the past 20 years.

Both of the state's major funds are below the average funded ratio for state public pension plans according to Standard & Poor's recent state pension report ("A Bumpy Road Lies Ahead For U.S. Public Pension Funded Levels," published July 16, 2013, on RatingsDirect). Pension reforms to eliminate a bullet payment planned in 2031 and to improve funded ratios have been implemented. Certain contract provisions have been amended to increase the annual required contribution (ARC) and to smooth future payments, which could translate into gradually improving funded ratios.

Connecticut's other postemployment benefit (OPEB) liability is significant, but recent actions to lower the liability have substantially lowered the growth trajectory. The state received an updated OPEB valuation for fiscal 2013 that shows the unfunded actuarial accrued liability (UAAL) increasing to $19.5 billion. Connecticut still funds OPEB on a pay-as-you-go basis, and there are limited resources in the trust at this time ($143.8 million as of June 30, 2013). Pay-as-you-go costs for funding retiree health costs were $587.4 million in fiscal 2013, which was in contrast to the sizable ARC of $1.2 billion. This most recent report follows an interim report released in 2013 that showed a UAAL of $16.2 billion. Despite the increase in the UAAL, the liability is much lower than it had been before to the cost-containment measures. The unfunded OPEB liability had been $26.6 billion at June 30, 2008. The lower trend in liabilities is attributable to a change in discount rate from 4.5%-5.7% due to the creation of a trust fund, lower liabilities resulting from changes in plan design negotiated with the SEBAC, and various health care cost-containment initiatives. Before the plan changes and updated actuarial report, OPEB costs had been forecast to rise sharply, reaching approximately $45 billion by fiscal 2017.

Related Criteria And Research

Related Criteria

- U.S. State And Local Government Credit Conditions Forecast, Dec. 17, 2013
- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- USPF Criteria: Financial Management Assessment, June 27, 2006

Ratings Detail (As Of March 5, 2014)		
Connecticut		
Long Term Rating	AA/Stable	Affirmed
Connecticut GO		
Long Term Rating	AA/NR/Stable	Affirmed
Connecticut GO		
Long Term Rating	AA/NR/Stable	Affirmed

Ratings Detail (As Of March 5, 2014) (cont.)		
Connecticut GO		
Long Term Rating	AA/Stable	Affirmed
Unenhanced Rating	NR(SPUR)	
Connecticut GO		
Long Term Rating	AA/Stable	Affirmed
Connecticut GO rfdg nts var rate (Economic Recovery Nts) ser 2013 A due 01/01/2018		
Long Term Rating	AA/Stable	Affirmed
Connecticut GO (AGM) (SEC MKT)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Connecticut GO (AGM) (SEC MKT)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Connecticut GO (FGIC)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Connecticut GO		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Connecticut Innovations Incorporated, Connecticut		
Connecticut		
Connecticut Dev Auth (Connecticut) GO		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
University of Connecticut, Connecticut		
Connecticut		
University of Connecticut (Connecticut)		
Long Term Rating	AA/Stable	Affirmed
University of Connecticut (Connecticut) GO rfdg bnds		
Long Term Rating	AA/Stable	Affirmed
Waterbury, Connecticut		
Connecticut		
Waterbury (Connecticut) GO spl cap reserve fd		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.