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# Connecticut; General Obligation

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# Connecticut; General Obligation

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| US$650.0 mil GO rfdg bnds ser 2014 C due 12/15/2025 | | |
| *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 to Connecticut's $650 million general obligation (GO) refunding bonds 2014 series C. 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 reflects what we view as Connecticut's:

- Diverse economic base, which 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 principle (GAAP) conversion bond issue.

In our view, despite these strong fundamentals, the state has a history of budget performance we consider cyclical, 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 plans to sell the bonds to refund existing debt with debt service savings taken in level annual amounts over the life of the bonds. Debt maturities are not expected to be extended as a result of the refunding.

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) remain limited in our view. 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. Connecticut has one of the highest concentrations of financial services employment in the country, at about 8% of total jobs, according to IHS Global Insight. Although these jobs are generally high paying, they suffered losses in 2012 and 2013. Nevertheless, Global Insight estimates the state experienced modest nonfarm employment growth of 0.9% in 2013, and projects 0.5% growth in 2014, and 1.3% in 2015, led by the services industries. The unemployment rate remains slightly elevated compared to that of the U.S. but has improved, dropping to 7.8% in 2013 (compared with 7.4% for the nation) from 9.3% in 2010. It was 6.3% in

April 2014 on a preliminary basis compared with 6.9% for the nation.

Although weak economic growth has limited revenue expansion, the current state consensus revenue forecast for fiscal 2014 is for a small, $43 million operating surplus -- better than the $4 million already budgeted -- but this is down substantially from a $504 million surplus projected in February. The state attributes the change to recently lowered income tax projections, primarily due to a greater-than-anticipated effect from federal tax changes regarding capital gains taxes, which accelerated capital gains into earlier fiscal years, offset to some degree by allowing $118 million of appropriations to lapse. The $43 million surplus is expected to be added to the state's budget stabilization fund, bringing the balance up to $314 million, which we view as modest at 1.8% of fiscal 2014 expenditures on a budgetary basis.

The state's most recent revenue projection, updating the enacted fiscal 2015 budget, projects slow, 1.8% general fund revenue growth in fiscal 2015, to $17.46 billion, and only a modest $400,000 operating surplus at the end of the fiscal year, slightly worse than the enacted budget's $3.1 million projected operating surplus. The state estimates that one-time revenues in its enacted 2015 budget total about $294.9 million, or about 1.7% of budgeted revenues. A positive inclusion in both the fiscal 2014 and 2015 budgets is full funding of the annual actuarially required state retirement system pension contribution, which will help ameliorate what we view as currently low retirement systems funded levels, which we calculate at 49% on a combined basis.

On a GAAP basis, the most recent audited fiscal year, 2013, ended with a $588.6 million negative general fund balance position, improved by $323.7 million from the year before and equal to negative 1.7% of general fund GAAP expenditures. In our view, state finances have been cyclical, with a budget reserve fund balance in fiscal 2009 of almost $1.4 billion, which was fully depleted in the subsequent recession before being built back up to $270.7 million at fiscal year-end 2013 on a GAAP basis. In October 2013, the state issued $560.4 million of GO bonds specifically to partially fund its negative GAAP general fund balance; the state anticipates future budgets will maintain a positive GAAP balance.

We consider the state's $18.9 billion of tax-backed debt to be at high levels, which we calculate as $5,137 per capita or 8.6% of personal income, including an upcoming new money sale of $200 million of state GO bonds expected in several weeks. Our calculation of tax-backed debt service to total governmental fund expenditures is 9.7%. We also consider combined unfunded pension liabilities as high, at $24.6 billion, although now that the state is funding the pension annual required contribution (ARC) for its employee retirement system, this will likely begin to decrease. In addition, we consider other postretirement benefits (OPEB) as high at $19.5 billion. Connecticut law considers OPEB a contractual right of current workers. Until recently, the state funded OPEB on a pay-as-you go basis. However, the state recently implemented an employee contribution of 3% of salaries towards OPEB, over and above current health costs, which the state will match at the 3% rate beginning in fiscal 2017 for additional OPEB prefunding.

Based on the analytic factors we evaluate for states, on a scale of '1.0' (strongest) to '4.0' (weakest), we have assigned a composite score of '1.9' to Connecticut.

## 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 still-modest expected budget reserves, despite a small projected deposit to the stabilization fund at the end of fiscal 2014, limit financial flexibility. In our view, 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 and slow economic growth. However, the state is projecting that it will perform slightly better than originally budgeted in fiscal 2014 and has enacted a balanced budget for fiscal 2015, albeit with what we view as a modest level of one-time budget items and no budgeted increase to reserves.

The rating could come under pressure if structural gaps emerge that are not addressed in a timely manner with recurring solutions or if additional deficit bonds are issued.

## Highlights Of The Fiscal 2015 Enacted Budget

After an increase in state income tax rates last year, the enacted fiscal 2015 budget has relatively modest changes, in our opinion. The state now projects ending fiscal 2014 with a $43 million operating surplus, which we view as small and was slightly above what the state projected in the originally enacted 2014 budget. During mid-fiscal 2014, the state revised revenue projections sharply upward, then later lowered projected capital gains tax receipts. The net effect, after the lapse of $118 million in appropriations, was that the operating surplus was slightly better than originally budgeted. The fiscal 2014, $43 million surplus will go into the state's budget stabilization fund, which is estimated to rise to $314.1 million, or a modest 1.8% of 2014 expenditures.

The fiscal 2015 budget continues the state's new practice of budgeting on a GAAP basis (implemented when the state sold GAAP funding bonds in October 2013). State general fund revenue projections for fiscal 2015, based on revisions subsequent to budget adoption, project only 1.8% revenue growth in fiscal 2015, to $17.458 billion, with nearly matching 2.0% expenditure growth, leaving a projected operating surplus of only $400,000. This compares with a $3.1 million operating surplus projected at the time the 2015 budget was enacted. The state projects 3.1% economic growth in 2015 but also recognizes slower growth in personal income tax following recent weakness in capital gains tax receipts as the result of federal tax law changes. Fiscal 2015 general fund expenditures fund the full ARC for the state employee pension fund. Actions taken to close the fiscal 2015 budget compared to the governor's executive budget proposal include delaying the phase-in of tax exemptions for teachers' pension income, other delays or eliminations of tax exemptions, a cut in capital funds for the state board of regents, certain funds transfers, and a lower estimate of debt service due to lower debt than forecast and low interest rates. New spending initiatives include a partial phase-in of tax breaks for retired teacher pension income, increased municipal aid, the commencement of programs to broaden access to pre-kindergarten schooling, transportation infrastructure investments, funding to keep elderly residents in their homes, long-term unemployment assistance, mental health initiatives, and school security.

We view the level of one-time budget items the state has identified as modest at $294.9 million, or 1.7% of general fund expenditures. These include an assumed $75 million from a state tax amnesty, $74 million from maintaining a current corporation tax surcharge, $30 million from the use of a prior 2013 surplus, $27 million from maintaining an insurance company tax, and various fund transfers.

The state's revised Special Transportation Fund revenue growth projection for fiscal 2015 is 6.2%, to $1.3 billion total revenue, and for a $6.8 million fund operating surplus, up from $400,000 in the original 2015 budget.

## 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.

Key features of Connecticut's governmental framework include a balanced budget requirement. A voter-approved amendment to the state constitution 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. At Dec. 15, 2013, authorized unissued GO debt stood at $2.2 billion while the state legislature in its recent session has authorized an additional $779.6 million of GO debt. 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 it has 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 of 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 and structural solutions.

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

The state intends to sell an additional $200 million of new money GO bonds in a few weeks for capital purposes, the debt of which has been included in our debt ratios.

Connecticut's approximately $15.0 billion in GO and tax-supported debt (including the upcoming GO sale) and $3.5 billion of special obligation debt put the state's total tax-supported debt per capita at $5,137, which is high compared with that of state peers. Compared with income, debt ratios are also high, in our opinion, at 8.6% of personal income. Debt service represents 9.7% 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 in 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 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 in 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 this 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 by 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 retirement 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 ARC and to smooth future payments, which could translate into gradually improving funded ratios.

Connecticut's 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 in 2013. In fiscal 2014 the state budgeted $548.7 million for retiree health care compared to an OPEB ARC of $1.6 billion.

The 2013 OPEB valuation followed an interim 2013 report that showed a lower UAAL of $16.2 billion. Despite the increase in the UAAL, the liability is much lower than it had been before 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 the discount rate to 5.7% from 4.5% 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

- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- USPF Criteria: Financial Management Assessment, June 27, 2006

### Related Research

U.S. State And Local Government Credit Conditions Forecast, April 7, 2014

| Ratings Detail (As Of May 19, 2014) | | |
|---|---|---|
| Connecticut | | |
| *Long Term Rating* | AA/Stable | Affirmed |
| Connecticut GO | | |
| *Long Term Rating* | AA/NR/Stable | Affirmed |
| Connecticut GO | | |
| *Long Term Rating* | AA/Stable | Affirmed |
| *Unenhanced Rating* | NR(SPUR) | |
| Connecticut GO | | |
| *Long Term Rating* | AA/Stable | Affirmed |
| Connecticut GO bnds ser 2014 A due 03/01/2034 | | |
| *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 |

| Ratings Detail (As Of May 19, 2014) (cont.) | | |
|---|---|---|
| **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 |

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