S&P Global
Ratings

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Summary:

Connecticut; Appropriations; General Obligation; General Obligation Equivalent Security; Moral Obligation

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Summary:

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Credit Profile		
US$300.0 mil GO bnds ser 2016C due 05/15/2034		
Long Term Rating	AA-/A-1/Stable	New
Connecticut		
Long Term Rating	AA-/Stable	Downgraded
Connecticut GO		
Long Term Rating	AA-/Stable	Downgraded
Connecticut Innovations Incorporated, Connecticut		
Connecticut		
Connecticut Innovations Incorporated (Connecticut) gen fd oblig bnds		
Long Term Rating	AA-/Stable	Downgraded

Rationale

S&P Global Ratings has assigned its 'AA-/A-1' ratings to the State of Connecticut's $300 million general obligation (GO) bonds, 2016 series C (variable-rate demand bonds). At the same time, S&P Global Ratings affirmed its 'AA-' rating on Connecticut's GO debt outstanding, its 'A+' rating on the state's appropriation-secured debt, and 'A-' moral obligation debt rating. The outlook is stable.

The 2016C bonds are being issued as variable-rate demand obligations. The rating's 'AA-' long-term component reflects our view of the state's GO pledge. The 'A-1' short-term component reflects the short-term rating on Bank of America N.A. (A/Watch Pos/A-1), which is providing an enhancement for the bonds in the form of a standby bond purchase agreement (SBPA). The SBPA will cover the purchase price, consisting of the principal and interest coverage at the maximum interest rate of 9% for 34 days per year, for bonds that are not successfully remarketed. The SBPA is due to expire on June 13, 2019, unless extended or terminated beforehand.

The SBPA provider's obligation to purchase unremarketed tendered bonds while the bonds bear interest in the weekly rate mode (the covered mode), which is the initial interest rate mode, will terminate without notice to bondholders should various events, as outlined in the SBPA, occur. These events, which we consider to be consistent with our published criteria include, but are not limited to, lowering of the long term component of the rating on the bonds or any related parity debt below 'BBB-'.

The GO rating on Connecticut reflects our view of the following factors:

- High wealth and income levels;

- A diverse economy, whose performance has been cyclical;
- Ongoing revenue and expenditures that remain near structural alignment;
- Active monitoring of revenues and expenditures to identify and correct mid-fiscal year budget gaps, as exemplified by midyear budget adjustments made for fiscal years 2015, 2016, and 2017; and
- Adequate operating liquidity, which has improved following the state's move to budgeting based on generally accepted accounting principles (GAAP), and issuance of GAAP conversion bonds in 2014 to provide liquidity to assist in the transition.

Offsetting factors, in our opinion, include:

- Above-average debt, high unfunded pension liabilities, and large unfunded OPEB liabilities, all of which create what we believe are significant fixed cost pressures that restrain the state's budgetary flexibility;
- A history of cyclical budget performance, with weak financial reserves available to cushion against the next economic downturn. We expect revenue growth to remain slow for the next several years, the result of economic weakness in Connecticut's high-paying financial sector.

S&P Global Ratings understands that the series 2016C bonds will fund various capital purposes.

We view the state's high income level as a key credit strength, with per capita income at 140% of the nation in 2015. However, Connecticut has been slow in regaining its highest-paying jobs, which we believe has been affecting state revenues. The state estimates that it has only recovered 8,200 of the 54,100 jobs lost during the financial crisis that paid wages of more than $80,000, while adding 61,500 jobs paying wages under $50,000, compared with 39,900 jobs lost in that category during the recession. Connecticut has one of the highest concentration of financial services employment in the country, at 7.8% of total jobs in 2015. According to IHS Global Insight Inc., this sector has had consecutive years of job losses since 2008, and forecasts average Connecticut financial sector job losses of 1.2% per year through 2020. Nevertheless, IHS estimates that Connecticut experienced slow 0.7% total employment growth in 2015, compared with 2.0% for the nation. IHS projects 1.1% state employment growth in 2016, and 0.8% in 2017, led by the services industries, although it projects continued slower state employment growth than that of the nation. Connecticut's unemployment rate remains slightly elevated compared with that of the U.S., but has improved since the recession, dropping to 5.6% in 2015 (compared with 5.3% for the nation) from 9.3% in 2010, according to the federal Bureau of Labor Statistics.

Substantial revenue shortfalls over the past year have left the state with what we believe are low reserves and an increasing share of the budget devoted to fixed costs. In our opinion, Connecticut may be poorly positioned should there be a national economic downturn in the next several years. The state is not budgeting to restore reserves in fiscal 2017, and projected out-year budget gaps in 2018 and beyond could prove troublesome in view of Connecticut's historically cyclical finances. Rising debt service, pension, and other postemployment benefit (OPEB) costs have pushed fixed costs to what we see as a significant portion of the overall budget and could hamper the state's ability to make further budget cuts should new revenue shortfalls develop. At the same time, tax increases in the two most recent biennia have constrained revenue-raising ability, in our view.

Despite multiple midbiennium budget adjustments, budget reserves have been falling since fiscal 2014. Connecticut's April revised consensus revenue forecast projects a fiscal 2016 general fund operating deficit of $259.1 million, which we calculate will draw down reserves to $146.9 million, or only 0.8% of 2016 net general fund appropriations. The legislature recently passed fiscal 2017 budget cuts of $824.7 million, and additional revenue measures of $136.3 million, which are projected to produce just a $200,000 general fund operating surplus in fiscal 2017. The governor signed this bill, but exercised his line-item veto authority for amounts totaling $22.5 million in appropriations to offset projected savings expected from proposed legislation the general assembly did not pass. At the same time, the state legislative Office of Fiscal Analysis (OFA) projects a $1.3 billion out-year fiscal 2018 budget gap (6.6% of projected 2018 appropriations) based on maintenance of current service levels, a gap which will need to be addressed in next year's biennium budget. As a result, we expect state reserves will remain low for the foreseeable future. A law recently passed by the state that prohibits the previous routine publication of OFA's out-year service gap projection also increases uncertainty, in our opinion, as to the direction of future credit quality.

Budget cuts have had the unintended impact of raising the proportion of the budget composed of fixed costs and constraining future budget-cutting flexibility. The state estimates that if Gov. Daniel Malloy signs the legislature's recently passed fiscal 2017 budget revisions, combined debt service, pension, and OPEB costs will constitute 28% of fiscal 2017 general fund appropriations, up from a previously estimated 26% in 2016. Connecticut has recently reduced net bond authorizations by $642 million, a process required by law when debt reaches 90% of the state's statutory debt limit, which could help stabilize debt service costs.

Based on current state budget projections, we calculate fiscal 2016 general fund revenues have fallen 3.6% below the original budget estimates, and fiscal 2017 revenues will fall 5.1% below, not including enacted revenue enhancement measures. The state attributes much of the revenue shortfall against budget to volatile capital gains taxes, based on a recent study of the 50 largest state taxpayers.

We believe Connecticut has taken timely midyear corrective action following successive downward revisions in projected fiscal years 2016 and 2017 state income tax. However, because the recent April downward revision in forecast revenue does not allow enough time to make significant adjustments before the June 30 year-end of fiscal 2016, the state will dip into its budget stabilization fund (BSF) for the new $259.1 million estimated 2016 operating deficit. Recent 2017 budget revisions passed by the legislature, but not yet signed by the governor, consist largely of ongoing structural measures, in our opinion. The state estimates only about 2% of 2017 budget items are of a one-time nature, including a $50 million deferral of municipal revenue sharing that we believe could be continued into following years, if necessary.

However, we also believe that the $961 million of midbiennium budget adjustments for fiscal 2017 leave Connecticut with constrained flexibility to solve future revenue shortfalls, particularly because we believe pension and OPEB costs are likely to increase faster than revenues. In 2015, the governor briefly proposed funding less than the actuarial annual required contribution (ARC) for legacy pension plans due to potentially rising pension costs, and we feel the state's large pension liability and potentially weak current investment returns could boost ARC payments. At the same time, an increased matching contribution for annual employee OPEB costs is scheduled to go into effect in fiscal 2018.

Underlying recent revenue shortfalls is continued weakness in income tax, underpinned by the lack of a bounce back in high wage jobs since the last recession. After two rounds of well-publicized tax rate increases in recent biennia, and the high profile move of General Electric's headquarters to Boston, we believe raising taxes further at this point would be politically difficult.

We consider Connecticut's level of approximately $22 billion in tax-backed GO and transportation debt, after this sale to be high and rising slowly. At fiscal year-end 2015, we calculate the state had $5,716 of tax-backed debt per capita. Combined GO, capital lease, and transportation special tax bonds outstanding have risen about $1.4 billion since fiscal year-end 2014. We estimate tax-backed debt per capita at about $6,023 after this sale. Fiscal year-end 2015 tax-backed debt to income was 8.5%. Our calculation of tax-backed debt service, less federal revenues and restricted grant funds during fiscal 2015, is what we view as high at 12.3% of total governmental fund expenditures. The governor has proposed a substantial increase in annual transportation capital spending to make up for perceived past underfunding of transportation infrastructure, with up to $6.6 billion of state bonding over five years, consisting mostly of transportation fund secured bonds. The potential exists for substantially more bonding after the initial five-year period under the contemplated program--the governor has proposed up to $100 billion of transportation-related bonds over 30 years. However, we expect additional transportation-related bonds to be contingent on additional transportation-related tax revenue being made available, and the Connecticut senate has passed cancellation of $642 million of net bond authorizations as the state approaches 90% of its statutory debt cap. We expect the house to pass the bill in the coming days.

We consider combined unfunded pension liabilities as high, at $26.6 billion at fiscal year-end 2015. Since fiscal 2012, Connecticut has been fully funding its retirement system ARC, a bond covenant requirement of its previous pension bonds issuance, which helps ameliorate what we view as currently low retirement systems' funded levels. The state funds the ARC using the credit actuarial cost methodology, which differs from the entry age normal actuarial methodology used in GAAP-based audits, but which we believe will eventually lead to a fully funded system if continued. We view the fiscal 2015 pension funds' combined funded ratio as a relatively low 50% on a combined actuarial basis. The state employees' retirement fund (SERF) alone has a funded ratio using the Governmental Accounting Standards Board (GASB) 67 GAAP basis methodology of what we regard as a low 39.54% (compared with 43.3% using state actuarial assumptions), while the teacher retirement funded ratio on a GASB basis was 61.51%.

In addition, we consider OPEB high at $22 billion, including both the SERF's and the state teachers' retirement system. Connecticut law considers state employee OPEB a contractual right of current workers, and state payment of teachers' OPEB a state statutory obligation. Connecticut recently implemented a state employee contribution of 3% of salary toward OPEB, over and above current health costs, which it will match at the 3% rate beginning in fiscal 2018. Combined with small state OPEB trust fund contributions in 2008 and 2011, this will help ameliorate this still-sizable unfunded liability.

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 '2.0' to Connecticut. A score of '2.0' is indicative of a 'AA' rating. However, we have reduced our rating one notch, as permitted under our state rating criteria, to reflect what we believe will be continuing minimal reserve levels and high fixed costs.

(For more information on Connecticut's GO debt, see the analysis published May 19, 2016, on RatingsDirect).

Outlook

The stable outlook reflects our assumption that low fund balances and high fixed costs will continue to constrain state budget-cutting and revenue-raising flexibility, but that Connecticut can achieve near structural budget balance during periods of economic expansion. The current rating reflects our expectation that the state could fall out of structural budget alignment during economic downturns, and will likely maintain what we would characterize as low reserve levels over our two-year outlook horizon, despite national economic growth. Connecticut previously issued debt to cover operating deficits during the recession, some of which remains outstanding.

Upside scenario

Should Connecticut restore material budgetary flexibility either through the build-up of material ongoing reserve levels, or if fixed costs fall as a percent of budget, we could raise our rating on the state.

Downside scenario

Should unfunded pension or OPEB liabilities rise significantly, or large revenue shortfalls reoccur without additional offsetting budget adjustments, we could lower our rating.

Related Criteria And Research

Related Criteria

- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- USPF Criteria: Financial Management Assessment, June 27, 2006
- USPF Criteria: Debt Statement Analysis, Aug. 22, 2006
- USPF Criteria: Appropriation-Backed Obligations, June 13, 2007
- USPF Criteria: Moral Obligation Bonds, June 27, 2006
- USPF Criteria: Bank Liquidity Facilities, June 22, 2007
- USPF Criteria: Standby Bond Purchase Agreement Automatic Termination Events, April 11, 2008
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

Ratings Detail (As Of June 6, 2016)		
Connecticut GO		
Long Term Rating	AA-/Stable	Downgraded
Connecticut Hlth & Ed Fac Auth		
Long Term Rating	AA-/Stable	Downgraded
Connecticut approp		
Long Term Rating	A+/Stable	Downgraded
Connecticut GO		
Long Term Rating	AA-/Stable	Downgraded
Connecticut GO		
Long Term Rating	AA-/Stable	Downgraded

Ratings Detail (As Of June 6, 2016) (cont.)		
Connecticut GO		
Long Term Rating	AA-/Stable	Downgraded
Connecticut GO bnds ser 2012 B dtd 04/26/2012 due 04/15/2021-2032		
Unenhanced Rating	AA-(SPUR)/Stable	Downgraded
Connecticut GO (AGM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Downgraded
Connecticut GO (AGM) (SEC MKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Downgraded
Connecticut GO (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Downgraded
Connecticut GO (BAM) (SEC MKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Downgraded
Connecticut GO (BAM) (SEC MKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Downgraded
Connecticut GO (FGIC)		
Unenhanced Rating	AA-(SPUR)/Stable	Downgraded
Connecticut GO		
Long Term Rating	AA-/Stable	Downgraded
Connecticut GO		
Long Term Rating	AA-/Stable	Downgraded
Connecticut GO		
Long Term Rating	AA-/Stable	Downgraded
Connecticut GO		
Long Term Rating	AA-/Stable	Downgraded
Connecticut GO		
Unenhanced Rating	AA-(SPUR)/Stable	Downgraded
Capital City Economic Dev Auth, Connecticut		
Connecticut		
Capital City Economic Dev Auth (Connecticut) GOEQUIV		
Long Term Rating	AA-/Stable	Downgraded
Capital City Economic Dev Auth (Connecticut) GOEQUIV		
Long Term Rating	AA-/A-1/Stable	Downgraded
Capital City Economic Dev Auth (Connecticut) pkg & energy fee rev		
Unenhanced Rating	AA-(SPUR)/Stable	Downgraded
Connecticut Hlth & Educl Facs Auth, Connecticut		
Connecticut		
Connecticut Hlth & Educl Facs Auth (Connecticut) rev bnds (Child Care Facs Prog) (ASSURED GTY)		
Unenhanced Rating	A-(SPUR)/Stable	Downgraded
Connecticut Hlth & Educl Facs Auth (Connecticut) state supported rev bnds		
Long Term Rating	A+/Stable	Downgraded

Ratings Detail (As Of June 6, 2016) (cont.)		
Connecticut Hlth & Educl Facs Auth (Connecticut) APPROP		
Long Term Rating	A+/Stable	Downgraded
Connecticut Hlth & Educl Facs Auth (Connecticut) GOEQUIV		
Long Term Rating	AA-/Stable	Downgraded
Connecticut Hlth & Ed Fac Auth nsg home prog		
Long Term Rating	AA-/Stable	Downgraded
Connecticut Hlth & Ed Fac Auth (Connecticut) nsg home prog taxable		
Long Term Rating	AA-/Stable	Downgraded
Connecticut Hlth & Ed Fac Auth (Connecticut) st univ sys issue		
Long Term Rating	AA-/Stable	Downgraded
Connecticut Hlth & Educl Facs Auth (Connecticut) ser G&H		
Unenhanced Rating	AA-(SPUR)/Stable	Downgraded
Connecticut Hlth & Ed Fac Auth rev bnds (Connecticut State Univ Sys Issue) ser D-2 dtd 03/15/2002 due 11/01/2020-2022		
Unenhanced Rating	AA-(SPUR)/Stable	Downgraded
Connecticut Hlth & Ed Fac Auth (Connecticut) univ issue		
Unenhanced Rating	AA-(SPUR)/Stable	Downgraded
Connecticut Hsg Fin Auth, Connecticut		
Connecticut		
Connecticut Hsg Fin Auth (Connecticut) state supported spl oblig bnds		
Long Term Rating	AA-/Stable	Downgraded
Connecticut Hsg Fin Auth spl needs hsg mtg fin prog		
Unenhanced Rating	AA-(SPUR)/Stable	Downgraded
Connecticut Innovations Incorporated, Connecticut		
Connecticut		
Connecticut Dev Auth (Connecticut) GO		
Unenhanced Rating	AA-(SPUR)/Stable	Downgraded
Waterbury, Connecticut		
Connecticut		
Waterbury (Connecticut) GO spl cap reserve fd		
Unenhanced Rating	AA-(SPUR)/Stable	Downgraded

Many issues are enhanced by bond insurance.

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.globalcreditportal.com. All ratings affected by this rating action can be found on the S&P Global Ratings public website at www.standardandpoors.com. Use the Ratings search box located in the left column.