FITCH RATES CONNECTICUT'S $1B SPECIAL TAX OB. BONDS 'AA-'; DOWNGRADES OUTSTANDING ON CRITERIA CHANGE

Fitch Ratings-New York-02 September 2016: Fitch Ratings has assigned 'AA-' ratings to the following State of Connecticut special tax obligation (STO) bonds:

--$800 million in STO bonds, transportation infrastructure purposes, 2016 series A;
--$200 million in STO refunding bonds, transportation infrastructure purposes, 2016 series B.

The bonds are scheduled to be offered via negotiated sale on Sept. 13, 2016.

In addition, Fitch has downgraded the ratings on outstanding STO bonds as follows:

--$4.2 billion in outstanding STO senior lien bonds to 'AA-' from 'AA';
--$257 million in outstanding STO second lien bonds to 'AA-' from 'AA'.

The Rating Outlook remains Stable.

SECURITY

The bonds are secured by a gross lien on pledged revenues and other receipts deposited to the state's special transportation fund prior to any other uses.

KEY RATING DRIVERS

The downgrade reflects the application of Fitch's revised U.S. Tax-Supported Rating Criteria, published on April 18, 2016.
Underlying credit factors since the time of Fitch's last review of the STO bonds are stable; however, the structure does not meet the requirements for rating a dedicated tax bond higher than the state IDR under the revised criteria.

Although pledged revenues supporting the STO bonds would warrant a higher rating, the credit quality of the STO bonds is limited by the exposure of the special transportation fund (STF) to general state operations, and hence limited by the 'AA-' Issuer Default Rating (IDR) of the state. The Stable Outlook on the STO bonds' rating reflects Fitch's Stable Outlook on Connecticut's IDR.

Growth Prospects Steady: Most of the transportation-related revenues pledged to the bonds, including motor fuels taxes and motor vehicle receipts, are generally stable over time but have limited growth potential, while the oil companies' tax is more volatile. Expansion of pledged revenues to include a portion of the statewide sales tax diversifies pledged receipts beyond those linked to transportation-related activity.

Established & Stable Program: The STO bond program is a well-established part of a comprehensive and legislatively authorized long-term transportation infrastructure program. Management strengths include active revenue monitoring, multi-year forecasting, and the ability to curtail capital spending in the event of revenue weakness.

Leverage Limits: A 2.0x maximum annual debt service (MADS) test for additional bonds limits leverage of pledged resources. The bonds also carry a 2.0 times (x) annual coverage requirement.

Linkages with General Fund: Interdependence with general fund operations has led to periodic revenue and cost shifts, which Fitch expects will continue in the future.

RATING SENSITIVITIES

Link to State Credit Quality: The rating is sensitive to changes in the State of Connecticut's 'AA-' IDR, by which it is capped.

Consistently Solid Coverage: The rating is also sensitive to consistently solid coverage by pledged revenues and to ongoing careful management of the transportation fund.

CREDIT PROFILE

The downgrade of Connecticut's STO bonds, to 'AA-' from 'AA', reflects the application of Fitch's Tax-Supported Rating Criteria, published in April 2016. The program's strengths include a solid 2x ABT and a 2x annual coverage requirement, and the state carefully manages the condition of the special transportation fund (STF). However, given frequent statutory changes that shift pledged revenues or costs between the STF and the state's general fund based on general fund budgetary needs, Fitch views the credit quality of STO bonds as being linked to the state's general operations, and hence capped by the state's 'AA-' IDR.

ESTABLISHED & STABLE PROGRAM

The STO bonds are issued under a senior and second lien, and are secured by pledged revenues deposited to the STF. Both senior and second liens carry an additional bonds test requiring 2x coverage of aggregate principal and interest. Moreover, the state covenants under the second lien that any senior issuance must meet all second lien requirements, both senior and second lien bonds are subject to an annual 2x debt service coverage test. The bonds are also backed by an aggregate debt service reserve funded at maximum annual debt service (MADS).

Pledged revenues include taxes and fees on motor vehicle fuel, casual vehicle sales and licenses. The legislature expanded pledged revenues in its 2015 session as part of a broader initiative, called 'Let's Go CT!' to accelerate transportation capital spending. Revenue changes were partly delayed during fiscal 2016 as the state sought to shore up projected weak general fund performance in fiscal 2016 and 2017.

Under the 2015 expansion of pledged resources, all taxes on oil companies' gross earnings and a designated portion of the statewide sales tax are being deposited directly to the STF and pledged to bondholders; the sales tax deposit is being phased in through fiscal 2018. The inclusion of sales taxes in pledged revenues broadens the base of economic activity from which collections derive beyond transportation and tying future trends more closely to underlying state economic performance. Oil companies' tax collections are correlated to broader energy market trends, which exposes the STF to more heightened cyclicality, in Fitch's view.

At present, $4.2 billion in senior lien bonds and $257 million in second lien bonds are outstanding. Senior lien bonds have been issued periodically under a 1984 indenture, with second lien bonds issued since 1990 for new money and refunding purposes. Pledged revenues are available first for senior lien debt service and reserves, followed by second lien debt service and reserves. Thereafter, pledged revenues are available for transportation-related state general obligation bond debt service and operating expenses of the departments of transportation and motor vehicles.

MULTI-YEAR PLANNING

The state actively manages the STF through a five-year forecast period to maintain ample resources for projected debt service, capital program needs and operating expenses. The STO bond program is very well established, with a 20-year maturity for each series and flexibility to slow capital projects as necessary. Offsetting these strengths are forecast debt service that generally rises faster than pledged revenues and large planned spending for transportation capital.

Connecticut announced a major expansion of transportation capital spending in 2015 under the 'Let's Go CT!' initiative, intended as a multi-decade effort to address longstanding transportation needs beyond those already funded through the existing capital program. The initiative applies the expanded revenues to support additional STO borrowing, beginning with $275 million in fiscal 2016 and rising to $706 million by fiscal 2020. Even with new authorization, the state has actively managed the pace of borrowing in the past to conform to available STF resources, including reducing issuance during periods of revenue weakness.

GENERAL FUND SHIFTS

Interdependence with the state general fund has led to revenue or cost shifts during periods of general fund fiscal stress, most recently in fiscal 2016. Although the 'Let's Go CT!' initiative included the statutory designation of the STF as a perpetual fund, limiting the use of resources only for transportation, new designation did not prevent the state from delaying the originally planned sales tax allocation phase-in to address general fund revenue underperformance.

As of fiscal 2016, revenues in the STF consist of motor fuels tax (38%), motor vehicle receipts (18%), oil companies' tax (18%), license, permit and fee revenues (11%), and a portion of statewide sales tax (8%). The latter reflects the first year of the sales tax phase-in through fiscal 2018, when it is forecast to constitute 21% of STF revenues.

UNDERLYING GROWTH PROSPECTS STEADY

Underlying performance of most of the transportation-related receipts deposited to the STF has been steady, although not fast-growing, and Fitch expects growth prospects going forward to generally match historical trends.

Motor fuels taxes rose only 0.3% in fiscal 2016, slower than in recent years. Going forward, the state forecasts lower motor fuel tax receipts in fiscal 2017, with very slow gains in the forecast period through fiscal 2020. Motor vehicle receipts rose only 0.8% in fiscal 2016, with the state forecasting slightly faster gains during the forecast period.

Oil companies' tax, by contrast, has been more volatile reflecting broader oil price trends. The tax fell 26% in fiscal 2016, although is expected to grow rapidly in fiscal 2017 and beyond with forecast gains in oil prices. The general statewide sale tax deposited to the STF is currently forecast to grow to $373 million in fiscal 2020, from $109 million in fiscal 2016.

Estimated FY 2016 STF revenues fell 0.5% from FY 2015, reflecting the impact of lower oil prices on the oil companies' tax and the delayed phase-in of the sales tax deposit, as well as generally flat motor fuels and motor vehicle receipts. Fiscal 2016 is estimated to have ended with a cumulative fund surplus of $150.4 million, or about 11.1% of net revenues. Pledged revenues covered combined outstanding FY 2016 senior and second lien debt service by 2.8x. Including the current sale, Fitch calculates that FY 2016 pledged revenues cover projected MADS in FY 2018 by 2.5x.

The state's multi-year forecast assumes annual bond issuance rising to approximately $900 million in FY 2020. Based on these assumptions, annual coverage of outstanding senior and second lien bonds would drop to 2.3x in FY 2020. Over the forecast period through FY 2020, pledged revenues would grow at an average pace of 6.6% annually given the phase-in of newly-pledged revenues.

HIGH RESILIENCY IN DOWNTURN SCENARIO

To evaluate the sensitivity of the dedicated revenue stream to cyclical decline, Fitch considers the results of the Fitch Analytical Sensitivity Tool (FAST), using a 1% decline in national GDP scenario, as well as assessing the largest decline in revenues over the period covered by the revenue sensitivity analysis. Based on a 15-year pledged revenue history, FAST generates a 3% scenario decline in pledged revenues. Pledged revenues could withstand a nearly 17% decline, assuming full leveraging to the ABT, or almost 6x the scenario output, a high level of resiliency.

Contact:

Primary Analyst
Douglas Offerman
Senior Director
+1-212-908-0889
Fitch Ratings, Inc.
33 Whitehall Street
New York, NY 10004

Secondary Analyst
Marcy Block
Senior Director
+1-212-908-0239

Committee Chairperson
Karen Krop
Senior Director
+1-212-908-0661

Media Relations: Hannah James, New York, Tel: + 1 646 582 4947, Email: hannah.james@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.

Applicable Criteria
U.S. Tax-Supported Rating Criteria (pub. 18 Apr 2016)
https://www.fitchratings.com/site/re/879478