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Connecticut Special Tax Obligation Bonds

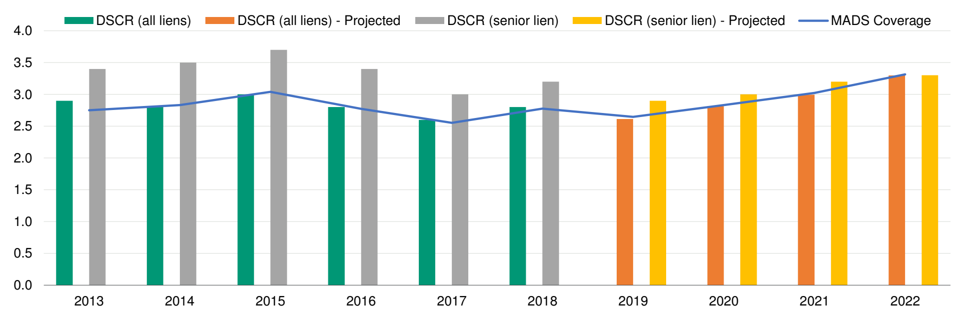
Update to credit analysis

Summary

Connecticut's (A1 stable) Special Tax Obligation (STO) Bonds benefit from strong legal covenants, including a two times additional bonds test and a combined senior and second lien debt service reserve funded at maximum aggregate annual debt service; the diversified stream of pledged revenues with some sensitivity to economic fluctuations; and satisfactory debt service coverage. The credit profile also includes challenges resulting from the state's lagging economic and demographic trajectory, which we expect to continue to dampen revenue growth and limit the ambitions of the state's transportation plans.

The STO bonds have been used to finance infrastructure improvements across the state, including some of the state's major transportation-related capital projects. As of October 25, 2018 there are $6.16 billion of special tax obligation bonds outstanding. The bonds are rated A1 with a stable outlook. The close relationship to the state's broader economic and fiscal condition results in the rating and outlook being linked to the state's.

Exhibit 1
Debt service coverage will remain stable



Coverage ratios incorporate all outstanding bonds up to and including 2018 Series B and C.
Source: State of Connecticut

Credit strengths

- Diversified stream of dedicated transportation-related and retail sales tax revenues
- Effective management of Connecticut's Special Transportation Fund (STF)
- Legal rate covenant to provide pledged revenues in each fiscal year equal to two times aggregate principal and interest requirements on senior lien and second lien bonds
- Proposed constitutional structural enhancements to the STF that ensure the resources of the STF will be expended solely for transportation purposes, and that the resources will remain in the STF

Credit challenges

- Some revenue sensitivity to economic fluctuations
- Sizeable future borrowing plans at $1.95 billion through fiscal 2022

Rating outlook

The bonds carry the stable outlook of Connecticut's GO rating, which reflects the state's strong provisions to promote fiscal discipline, which pair redressing elements of its high leverage position and requiring GAAP-based budgeting.

Factor that could lead to an upgrade

- Stronger debt service coverage

Factors that could lead to a downgrade

- Revenue declines resulting in lower debt service coverage
- Weakened legal covenants

Key indicators

Exhibit 2

Connecticut Special Tax Obligation Transportation Infrastructure Purpose					
Credit Background					
Pledged Revenues	Motor fuels tax, oil companies tax, sales and use taxes, motor vehicle receipts, licenses, permits and fees, DMV sales tax, federal payments				
Legal Structure					
Additional Bonds Test	2.0x aggregate annual debt service				
Open or Closed Lien	Open				
Debt Service Reserve Requirement	Maximum aggregate annual debt service				
Coverage					
2018 MADS coverage (aggregate)	2.57x				
Trend Analysis					
	2014	**2015**	**2016**	**2017**	**2018**
Debt Outstanding ($mil)	2,910	3,755	4,520	5,414	6,155
Pledged Revenue ($mil)	1,271	1,376	1,353	1,394	1,630
Pledged Revenue % Change	1.9%	8.3%	-1.7%	3.1%	16.9%
Annual Debt Service Coverage (aggregate)	2.8x	3.0x	2.8x	2.6x	2.8x

MADS takes place in 2020. MADS coverage is calculated using fiscal 2018 pledged revenues and outstanding debt across all liens, up to and including 2018 Series B and C.
Debt outstanding in 2018 is as of October 25, 2018, from the official statement of the 2018 Series B and C bonds.
Source: State of Connecticut; Moody's Investors Service

Profile

The State of Connecticut has a population of 3.59 million people located in the coastal northeastern US, bordered by Rhode Island (Aa2 stable), Massachusetts (Aa1 stable) and New York (Aa1 stable), with 618 miles of shoreline, according to the NOAA. The state has a large and diverse economy with a gross state product of $261 billion in 2017. It is the wealthiest state in the country with per capita income of 139% of the US average.

Detailed credit considerations

Tax base and nature of pledge

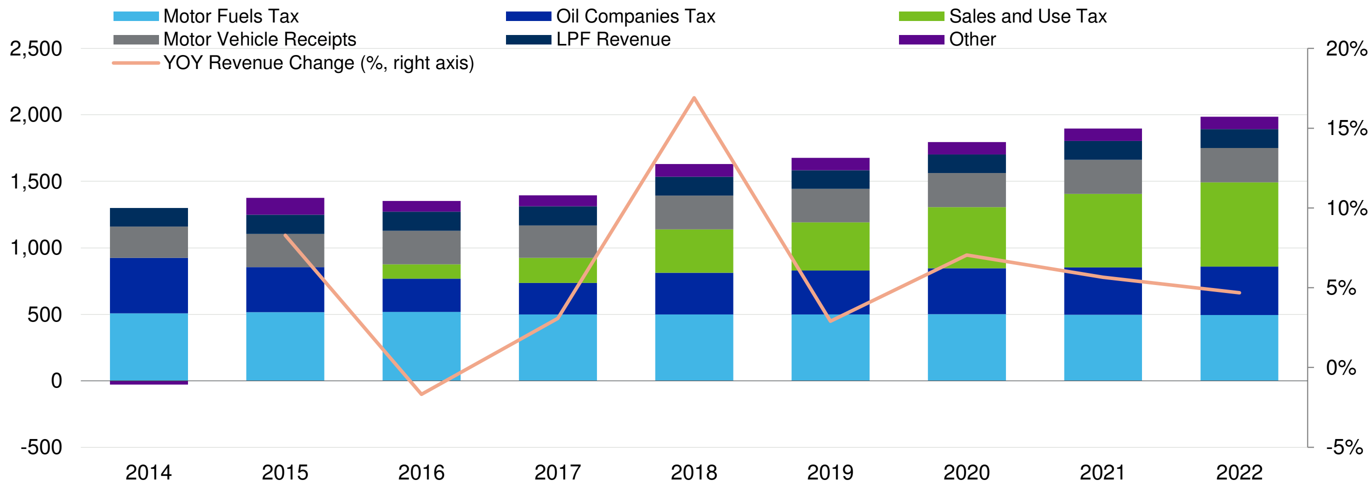
Connecticut's special tax obligation bonds are payable from multiple pledged revenue streams credited to the special transportation fund (STF). These revenues include motor fuels tax, oil companies tax, general retail sales taxes, motor vehicle receipts, licenses, permits and fees, and DMV sales taxes. In the past, the majority of pledged revenues have been derived from motor fuel taxes, which totaled approximately 38% in fiscal 2015 revenues. However, in fiscal 2015 the state enacted new laws that provided for a specific portion of state general sales tax revenues be deposited directly into the STF. In addition, oil companies tax revenues, previously transferred from the general fund, were deposited directly to the STF beginning in fiscal 2016, and general fund transfers were eliminated. Moreover, a sales and use tax on motor vehicles will be phased into the STF over 5 years, beginning with 8% in fiscal 2019, 33% in fiscal 2020, 56% in fiscal 2021, 75% in fiscal 2022, and 100% in fiscal 2023.

Following the addition of sales taxes, the dependence on motor fuels tax has fallen. Sales taxes were phased in, beginning Oct. 1, 2015, of 0.3%, increasing to 0.4% on Oct 1, 2016, and to 0.5% beginning July 1, 2017. Following this phase in, motor fuels taxes fell from 38% of revenues in fiscal 2016 to an estimated 28% in fiscal 2020. Additionally, sales taxes grew from 8% of revenues in fiscal 2016 to 20% in fiscal 2018.

Among the various revenue streams, oil companies taxes have been most volatile due to the fluctuating price of crude. In fiscal 2018, oil companies taxes fell to 19% of revenues from 33% of revenues in fiscal 2014. However, the increasing share of sales taxes as a proportion of revenues helps to offset the volatility of oil companies taxes, paving the way for more steadily increasing total revenues.

Exhibit 3

Revenue growth settles into an upward trend;
Sales and use tax helps offset oil companies tax volatility



2018 data is unaudited. 2019-2022 data is estimated.
Source: State of Connecticut

The addition of the sales tax has helped stabilize the STF's finances, while the state has also scaled back its capital program in recent years. Proposals to add significant resources to the transportation fund through tolling and other measures have so far not gained traction with the legislature.

Debt service coverage and revenue metrics

Pledged revenues have grown since 2016, bolstered by the addition of the sales and use tax. Fiscal 2017 and 2018 saw revenue increases at 3.1% and 16.9%, respectively. This increase in revenue has helped maintain debt service coverage above 2.5 times for all liens, despite volatility in tax collections.

In fiscal 2018, debt service coverage across all liens stood at 2.8 times, with senior lien coverage at 3.2 times. Debt service coverage is projected to decrease in 2019 to 2.6 times for all liens and 2.9 times for the senior lien, as debt service growth outpaces pledged revenue growth. Projections may change, though, if revenue estimates prove to be conservative or the state makes revenue allocation adjustments in future budgets.

LIQUIDITY

Unlike most transportation programs, Connecticut's special tax obligation bond indenture also requires a combined debt service reserve account equal to maximum annual debt service. The reserve is currently cash funded.

Debt and legal covenants

The bonds benefit from strong legal covenants and recent legislative changes ensure the resources of the STF will be expended solely for transportation purposes. The state covenants to provide pledged revenues in each fiscal year equal to at least two times aggregate principal and interest requirements on senior lien and second lien bonds. In addition, there is an additional bonds test of 2.0x aggregate senior lien debt service coverage for current and all succeeding years on outstanding and additional bonds. The indenture contains a reserve requirement whereby maximum annual aggregate debt service is fully funded with cash and held with a trustee.

In fiscal 2015, Connecticut enacted significant legislative changes that enhanced the STO program including a new sales tax pledge and new statutory lockbox. The new statutory lockbox establishes the STF as a perpetual fund, the resources of which shall be expended solely for transportation purposes, which include the payment of debt service on obligations of the state incurred for transportation purposes. In the upcoming November 2018 general election, voters will decide whether these provisions should be included in the Constitution of the state.

DEBT STRUCTURE

As of October 25, 2018 there are $6.16 billion of special tax obligation bonds outstanding, of which $6.03 billion are senior lien and $124 million are second lien. All of the debt is fixed rate and approximately 55% of STO principal will amortize over the next ten years.

DEBT-RELATED DERIVATIVES

There is no derivative exposure.

PENSIONS AND OPEB

Connecticut's adjusted net pension liability (ANPL), our measure of the government's pension burden, is significantly above the 50-state median. As of the state's 2017 financial statements, ANPL was 360% of own-source governmental revenue, and 27.3% of state gross domestic product, the second highest among the states. The state participates in 3 pension systems, of which the most significant are the State Employees Retirement System (SERS) and the Teachers Retirement System (TRS). Connecticut is among the handful of states that take responsibility for directly funding teacher pensions. Moody's ANPL reflects certain adjustments made to improve comparability of reported pension liabilities. The state contributes the full amount of its actuarially determined contributions, about $2.55 billion in fiscal 2017.

Connecticut also has a very high OPEB liability. As reported in the fiscal 2017 financial statements, the net OPEB liability is $20.86 billion, including a $3.5 billion Teachers' OPEB liability as of the June 30 2017 valuation date. Employees have been required to make contributions to prefund OPEB benefits since 2011, and the state is now making matching contributions, which total about $120 million in both fiscal 2018 and fiscal 2019.

Pensions and OPEB are not factors in the special tax methodology.

Governance

The state's financial management is characterized by strong practices that include timely budget adoption and binding consensus revenue forecasting conducted at least three times a year. Annual multi-year Fiscal Accountability reports are produced by both the governor's budget office and the legislative office of fiscal analysis, and the state releases monthly budgetary updates. The state constitution requires a balanced budget, given greater force by the state's recent move to GAAP-basis budgeting. In addition, the state is not constrained by supermajority requirements to enact tax increases, mandated initiatives or voter referenda.

The governor's executive authority to cut expenses mid-year without legislative approval is limited to 5% of an individual appropriation, not to exceed 3% of any fund providing only moderate flexibility. We consider strong executive flexibility to make mid-year spending adjustments a plus. If a deficit exceeds 1% of the general fund, a timely deficit mitigation plan is required to be developed by law. Some of the state's financial provisions are not highly effective, as the state has accumulated high debt levels and did not until this year make a constitutional spending cap operative.

The state has taken action to address some of its most pressing long-run financial challenges in recent years by implementing pension and OPEB reforms and committing to moving pension contributions to a more adequate level, although the state's long-term obligations remain formidable. In addition, the state legislature recently passed a number of measures designed to contain spending and debt growth, rebuild the state's rainy day fund, and more frequently assess the condition of its pension funds. Following some of these provisions will now be required by bond covenants until mid-2023. While the required practices would strengthen the state's long term credit profile, covenanting to follow them reduces budgetary flexibility.

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