

CREDIT OPINION

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 Rate this Research

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Connecticut (State of)

Update to credit analysis of special tax obligation bonds

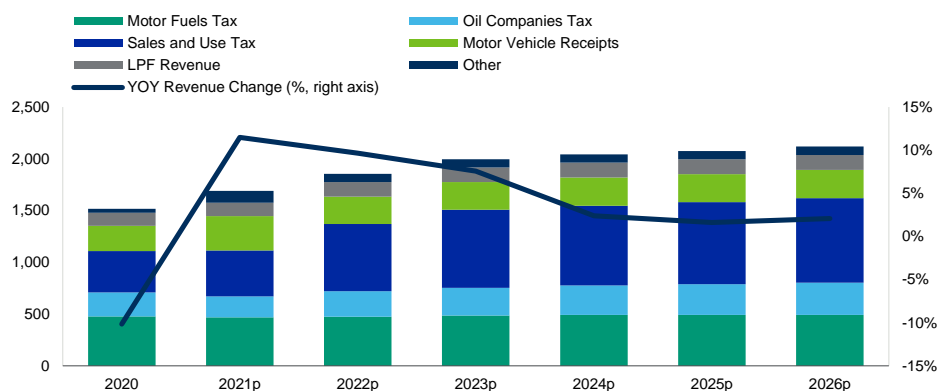
Summary

Connecticut's (Aa3 stable) Special Tax Obligation (STO) Bonds have been used to finance infrastructure improvements across the state, including some of the state's major transportation-related capital projects. The bonds benefit from strong legal covenants, a diversified stream of pledged revenue 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, exacerbated by the recession triggered by the coronavirus crisis. Our view incorporates the impact of COVID-19 to date, but the pandemic and its long-term credit implications remain fluid. If our view of the credit quality of rated debt changes, we will update the rating or outlook at that time. We regard the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety.

As of May 1 2021, there will be approximately \$6.085 billion of special tax obligation bonds outstanding. The state plans continued issuances while also adding revenue sources. The close relationship to the state's broader economic and fiscal condition results in the rating and outlook being linked to the state's. On March 31, Moody's upgraded the STO bond rating to Aa3 stable when it upgraded the state's GO rating.

Exhibit 1

Sales tax will become more prominent in diverse pledged revenue stream



Source: Connecticut Office of Policy and Management

Credit strengths

- » Diversified stream of dedicated transportation-related and retail sales tax revenues
- » Effective management of Connecticut's Special Transportation Fund (STF)
- » Strong legal protections including a two times coverage covenant and constitutional protection of the STF
- » Cash funded debt service reserve fund

Credit challenges

- » Some revenue sensitivity to economic fluctuations
- » The need to find new pledged revenue sources to support future borrowing plans while maintaining policy of sustaining coverage levels above 2 times

Rating outlook

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

Factors that could lead to an upgrade

- » State rating upgrade

Factors that could lead to a downgrade

- » Revenue declines resulting in debt service coverage falling below covenanted level
- » Weakened legal covenants
- » State rating downgrade

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

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

2020 MADS coverage (x) 2.3

Trend Analysis

	2016	2017	2018	2019	2020
Debt Outstanding (\$mil)	5,139	4,831	6,064	5,706	6,161
Pledged Revenue (\$mil)	1,353	1,394	1,630	1,688	1,516
Pledged Revenue % Change	-17.0%	3.1%	16.9%	3.6%	-10.2%
Annual Agg. Debt Service Coverage	2.8x	2.6x	2.8x	2.6x	2.3x

Maximum annual debt service occurs in 2023. Debt outstanding and debt service coverage include senior and subordinate lien. As of 2020, no subordinate lien debt is outstanding.

Source: State of Connecticut; Moody's Investors Service

Profile

The State of Connecticut has a population of 3.57 million people located in the coastal northeastern US, bordered by [Rhode Island](#) (Aa2 stable), [Massachusetts](#) (Aa1 stable) and [New York](#) (Aa2 stable) with 618 miles of shoreline, according to the National Oceanic and Atmospheric Administration (NOAA). The state has a large and diverse economy with a gross state product of \$286 billion in 2019. It is the wealthiest state in the country with per capita income of nearly 140% 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. The state has from time to time adjusted the allocations of revenue streams to the STF. In fiscal 2015, the legislature enacted law depositing a portion of state general sales tax revenue directly into the STF and depositing of oil companies tax revenue directly to the STF beginning in fiscal 2016. Oil companies revenue had previously been transferred from the general fund. The law provided that deposits to the STF of sales and use tax on motor vehicles would be phased in over 5 years. Although the phase-in schedule has been adjusted, it is currently scheduled to be completed in fiscal 2023. The diversity of the revenue stream is a credit strength.

The addition of sales tax to the revenue stream has helped buffer the impacts on the STF of long term stagnation and decline in driving and fuel usage. Following the addition of sales taxes, the dependence of the STF on motor fuels tax has fallen from 40% in fiscal 2014 to less than 28% in fiscal 2021 (projected) and will decline more as the sales tax on motor vehicles phase-in is completed. The sales tax has also softened the effects of declining crude oil prices on oil company taxes: the share of oil company tax revenue of total STF revenue has fallen by half since 2014, to less than 16% of the total in fiscal 2021 (please refer to Exhibit 1 on front page of this report).

Debt service coverage and revenue metrics

Pledged revenues are volatile because of fundamental trends in the tax base and changes in state allocations to the STF. The average growth rate (CAGR) of pledged revenue was 3% from fiscal 2014 to fiscal 2020, including the impact of the coronavirus on fiscal 2020 revenue, which declined 10.2%.

Debt issuance has outpaced revenue growth, resulting in current coverage of debt service drifting down from 3.0x in fiscal 2015 to a projected 2.5x in fiscal 2021. With planned additional bond issuances of about \$4.4 billion through 2026, coverage is projected to continue to decline and approach the 2 times coverage covenant by fiscal 2026. However, the state has historically managed coverage by either reducing issuance or adding sources of pledged revenue. Governor Lamont's recommended budget for fiscal 2022 includes a weight-based highway user fee and other smaller initiatives that the budget office projects would add \$100 million annually to pledged revenue by fiscal 2026.

Based on current estimates, maximum annual debt service (MADS) of about \$719 million will occur in fiscal 2023 after planned issuances and refundings in calendar 2021. Projected 2021 revenue would provide 2.4x coverage of MADS.

LIQUIDITY

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

Debt and legal covenants

Connecticut funds its portion of the state's transportation infrastructure program primarily with debt, which is supplemented with federal funds to invest in highway, transit and aviation projects. The state projects that on a current services basis it will issue \$875 million in STO bonds per year through 2026. The Governor's recommended budget calls for an escalating annual issuance schedule that would bring issuance to \$1.1 billion in fiscal 2026.

The STO bonds benefit from strong legal covenants and legislative changes ensure the resources of the STF will be expended solely for transportation purposes. The state covenants to provide pledged revenue 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 of maximum annual aggregate debt service to be held by the trustee. The reserve is fully funded with cash.

In fiscal 2015, Connecticut enacted significant legislative changes that enhanced the STO program including a new sales tax pledge and new statutory lockbox. The lockbox established 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 2018, voters approved the incorporation of these protections into the state constitution.

DEBT STRUCTURE

After fiscal year 2021 bond issuance is completed, there will be \$6.959 billion of senior lien special tax obligation bonds outstanding. While allowed by the indenture, there is no longer any subordinated lien debt outstanding; however the second lien is not closed. All of the debt is fixed rate and approximately 60% of STO principal will amortize over the next 10 years.

DEBT-RELATED DERIVATIVES

There is no derivative exposure.

PENSIONS AND OPEB

Pensions and OPEB are not credit factors in our special tax methodology. However, Connecticut's pension and OPEB liabilities are among the highest of the states. Funding these liabilities puts pressure on the state's budget and tax base, constraining resources available for other purposes, including transportation spending. Please see our most recent State of Connecticut [credit opinion](#) for a discussion of these liabilities.

ESG considerations

Environmental Considerations

The US states sector overall has low credit exposure to [environmental risks](#) because of states' large and diverse economies, revenue raising ability and [federal government support](#) for disaster recovery costs. However, because of its coastline along the Long Island Sound, Connecticut is more exposed than most states to climate risks.

According to data from Moody's affiliate Four Twenty Seven, Connecticut counties' average projected rate of change in five climate risk factors, when weighted by county GDP, is among the highest in the nation. Hartford and Fairfield counties, which combined account

for over 60% of the state's GDP, project to have high water stress and cyclone risk according to Four Twenty Seven's assessment scale. Fairfield county also has high sea level rise risk, due to its large border on the coastline.

With its southern counties situated along the shore of the Long Island Sound, the state is vulnerable to sea level rise and coastal storms, although the storm risk is mitigated by the protective barrier formed by Long Island to the south. The state is working to develop a systematic climate resiliency plan. The state's utilities regulatory authority has authorized funding for substation mitigation and other storm-hardening initiatives and the state is developing plans to reduce statewide greenhouse gas emissions.

Social considerations

Social issues, such as demographics, labor force, income and education, are [key influencers](#) of Connecticut's economy, governance stability and financial and leverage trends. We regard the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety. The coronavirus crisis will intensify social challenges, such as access to healthcare and demands on the social safety net.

Connecticut is wealthy but losing population and lagging the nation in most demographic indicators. The workforce is highly educated, with almost 40% of the population aged 25 or more possessing a bachelor's degree or higher compared to the nationwide rate of just less than 33%.

Governance

Governance is a [material consideration](#) for the entire state sector. Connecticut'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 multiyear 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 adoption of 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 exceeding 1% of the general fund is projected by the comptroller in that office's monthly financial statement, the governor is required to submit and implement a deficit mitigation plan. Historically, some of the state's financial provisions were not highly effective, as the state has accumulated high debt levels and did not make a constitutional spending cap operative until 2018. See the Summary section for further details on the state's governance improvements.

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, in recent years the state legislature enacted a number of measures designed to curtail 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 and constitutional amendments. While the required practices strengthens the state's long term credit profile, covenanting to follow them reduces budgetary flexibility

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