

RatingsDirect®

Summary:

State of Connecticut; Gas Tax

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Credit Profile

US\$875.0 mil spl tax oblig bnds transp infrastructure purposes ser 2021A due 05/01/2041		
<i>Long Term Rating</i>	A+/Stable	New
US\$145.23 mil spl tax oblig rfdg bnds transp infrastructure purposes ser 2021C due 01/01/2032		
<i>Long Term Rating</i>	A+/Stable	New
US\$11.61 mil spl tax oblig rfdg bnds transp infrastructure purposes ser 2021B due 12/01/2030		
<i>Long Term Rating</i>	A+/Stable	New
Connecticut GASTAX		
<i>Long Term Rating</i>	A+/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'A+' rating to Connecticut's pro forma \$875 million series 2021A first-lien special tax obligation (STO) bonds, \$11.6 million series 2021B STO refunding bonds, and \$145.2 million series 2021C STO refunding bonds while also affirming its 'A+' rating on the state's first-lien STO bonds outstanding. The outlook is stable.

The rating is based on the application of our priority-lien tax revenue debt criteria (published Oct. 22, 2018 on RatingsDirect), which factors in both the strength and stability of the pledged revenues, as well as the general creditworthiness of the state as issuing obligor. The priority-lien rating on the STO bonds is limited to one notch above our view of Connecticut's creditworthiness (general obligation [GO] rating: A/Stable) and is constrained from going higher unless there is an improvement in the state GO rating. In our view, the STO bonds do not benefit from limited scope of operations or extraordinary expenditure flexibility of the obligated entity, despite strong revenue coverage of debt service, while we believe pledged revenues could have exposure to operating risk of the state in the event of a distress situation.

The 2021A bonds are being issued to finance various projects of the state's transportation infrastructure program, the 2021B bonds are being issued to current refund the series 2009A and 2010C STO bonds for interest savings, and the 2021C are being issued to forward refund the series 2011A and 2011B STO bonds for interest savings with an expected delivery in October 2021. As of May 1, 2021, there will be approximately \$6.1 billion of senior-lien STO bonds outstanding.

The senior STO bonds are secured by a first-lien pledge of revenues deposited into the state transportation fund (STF) before payment of operating expenditures. According to bond counsel, the funds are considered appropriated at time of issuance and no further legislative approval is required. Revenues deposited to the STF include a portion of the state sales tax; motor fuel taxes; oil companies tax; licenses, permits, and fees; and motor vehicle receipts.

On Nov. 6, 2018, Connecticut voters approved a state constitutional amendment that continues directing any funding

sources to the STF, including motor fuels, oil company, and sales tax revenues, as long as the law authorizing the state to collect or receive them remains in existence. While the amendment adds a legal restriction against potential diversion of a portion of the pledged revenue stream, we believe it does not sufficiently mitigate the exposure of the STO rating from the operating risk of the state, as collector of the pledged taxes, to go beyond our one-notch upward limitation from the state rating.

Credit overview

Despite the effects of the pandemic, pledged revenues continue to demonstrate stability and generate strong debt service coverage (DSC). However, the STF is currently projected by the state to run a deficit this year that may be balanced with use of reserves available in the fund. An additional deficit is projected in 2022 (\$24 million) and in other outyears but must be balanced based on the state's balanced budget requirement. Efforts to balance the fund could require new revenue sources or a reduction in planned capital projects.

Finding revenue to fund the state's transportation infrastructure program continues to present a challenge. Despite the governor's proposal to reinstate tolls in the state, this did not achieve sufficient legislative support during the last biennium budget. In the current 2022-2023 biennium budget proposal, the governor is seeking a new highway use fee, a sales and use tax on cannabis sales, and a convenience fee on credit card transactions. In total, the measures are estimated to add \$50 million to the STF in fiscal 2023 and about \$100 million annually fiscal 2024 to fiscal 2026.

While the motor fuel tax remains the primary revenue source of the STF, sales and use tax is expected to surpass this in fiscal 2022 as the state continues to phase in this transfer of revenue until 2023. In our view, sales taxes, particularly derived from auto sales, have the potential to show more variation over the economic cycle than per-gallon fuel taxes or motor vehicle license fees, but they are also likely to grow faster over time. However, the direction of sales tax revenue to the STF has been adjusted over time and might remain so should the state enter periods of fiscal stress.

Despite these risks, the state has a demonstrated record of increasing revenues to the STF and sizing its capital program appropriately. Even with projected declines in pledged revenues in 2021, we expect coverage to remain strong and recover in subsequent years.

Key considerations in our assessment of the credit quality of the pledged STF revenues include:

- A very strong statewide diverse economic base of 3.6 million people generating the pledged revenues;
- Low volatility of pledged STF revenues, including a history of the state increasing motor fuel tax rates, fees, and allocations of pledged revenues, as well as establishment of a 2x rate covenant;
- Strong coverage and liquidity, despite sizable state debt issuance plans, and a strong 2.0x additional bonds test (ABT) for both first- and second-lien bonds, coupled with a fully funded debt service reserve (DSR) and a 2x rate covenant; and
- Strong senior-lien maximum annual debt service (MADS) coverage of 2.1x on \$718.6 million estimated debt service, occurring in fiscal 2023 after this sale based on 2020 revenues, which reflects a material decline in revenues as a result of COVID-19 and its economic impact. However, we expect MADS coverage to remain strong as revenues recover from their pandemic lows observed in 2020. While the bonds have a gross revenue pledge, we calculate coverage based on total net revenues less federal payments and interest income.

The stable outlook on the bonds reflects that on Connecticut. Any rating action on the state would also affect these bonds, in tandem.

Environmental, social, and governance (ESG) factors

We consider Connecticut to have elevated social risks compared to the sector given its older population and higher cost of living. These demographic trends could present long-term credit risks to the state's economic and budgetary performance. However, we believe Connecticut's historically strong management and policy framework will help manage this risk. Environmental risks are considered above those of other states due to its 618 miles of coastline along Long Island Sound. Connecticut's shoreline roads and communities are at risk from rising sea levels. However, we view the state's governance risks as being in line with the sector as a whole and it has historically maintained a strong management and policy framework to respond to developing risks.

Stable Outlook

Downside scenario

A downgrade on the state GO rating would result in a downgrade on the STO rating. If the state relies on significant one-time measures to address its structural gap or if reserves deteriorate to low levels, as they were before the volatility transfer was implemented, we might lower the rating. We also note that the state's three-year average pension funding ratio is close to our threshold of 40%, and may result in further downward rating action if pension funding levels deteriorate. Alternatively, significant deterioration of the underlying credit characteristics of pledged revenues may also affect this rating.

Upside scenario

An upgrade on the STO rating would require an upgrade on the state GO rating. We could raise the rating if the state maintains near-term structural balance and strong reserve levels while continuing to reduce its long-term debt burden. We currently estimate that the majority of our debt ratios could remain at least one-third higher than the threshold triggering our one-notch lower rating over our outlook horizon. This threshold was first triggered at the end of fiscal 2017.

Credit Opinion

Revenue volatility: Low

We believe pledged revenue have will have low volatility based on a diverse mix of pledged transportation-related revenue, supplemented by increased allocations of state sales tax. Connecticut has made changes in its allocation of pledged revenue to the STF in recent years that, in general, have increased the overall amount of STO-pledged revenue and supported expansions of its transportation capital plan. In addition, a 2x rate covenant requires the state to increase pledged revenue if necessary.

Actual audited fiscal 2020 STF revenue--not including pledged Build America Bond (BAB) interest subsidy or interest earnings--was composed of what we view as a diverse mix of motor fuels taxes (31% of fiscal 2020 pledged revenues); general fund sales tax allocations (26%); motor vehicle receipts (primarily vehicle registration fees; 16%); oil

companies' tax payments (15%); licenses, permits, and fees (8%); and sales tax from sales between individuals (5%), with these percentages not including the effects of legislative net fund transfers and refunds. The proportion of pledged revenue derived from sales tax increased when a new car sales tax allocation began to be phased in starting in fiscal 2019. Pledged revenues also include BAB federal interest subsidy payments and fund interest income, which we do not include in our DSC calculations.

Beginning in fiscal 2016, Connecticut made a statutory dedication of a 0.5% statewide general sales tax to the STF to be fully phased in during fiscal 2018, while the 2017 legislative session added dedicated sales and use taxes collected on the sale of new and used motor vehicles, to be phased in originally over five years beginning in fiscal 2021; this was accelerated into 2019 in the 2018 legislative session. Sales tax is projected to be about 40% of pledged revenues in 2023 when fully phased in.

In our view, sales taxes, particularly derived from auto sales, have the potential to show more variation over the economic cycle than per-gallon fuel taxes or motor vehicle license fees, but they are also likely to grow faster over time. While we expect revenues overall to increase with the additional allocation of sales tax, the STF experienced a small 0.6% dip in total pledged revenue in fiscal 2016 primarily due to lower oil company tax revenue. In fiscal 2016, there was a two-month \$35.2 million delay in the allocation of sales tax to the STF to provide general fund budget relief, and a further \$50 million budgeted reduction in sales tax allocated to the STF for fiscal 2017, also for budget relief. We believe that the state could make additional reductions in sales tax flowing into the STF in future years in the event of state budget stress, but following the Nov. 6 constitutional referendum, it could no longer reallocate motor fuels tax and other transportation-related revenues for state budget relief.

Coverage and liquidity: Strong

We calculate audited actual pledged revenues collected by the state comptroller for the fiscal year ended June 30, 2020--not including pledged BAB interest subsidy or interest earnings--covered proposed future senior-lien MADS of \$718.6 million, occurring in fiscal 2023 after this sale, to be a still-strong 2.1x, but improving to 2.3x in 2021, reflecting a revenue increase of 7.5% based on updated estimates. While the bonds have a gross revenue pledge, we calculate coverage based on total net revenues less federal payments and interest income. The obligations are also secured by a DSR that had a balance of \$654.1 million as of April 1, 2021.

The state projects annual DSC will remain at levels we view as strong through 2026, incorporating downward revenue projections and despite available authorizations of \$4.1 billion of new-money STO bonds subject to approval by the state's Bond Commission. The state plans to issue approximately \$875 million annually in new STO bonds amortized over 20 years between 2021 and 2026 including the 2021A bonds. The maintenance of strong coverage projected by the state is in part due to a rapid amortization schedule, with 57% of outstanding STO principal retired within the next 10 years, a declining debt service schedule, and the phase-in of additional sales tax as pledged revenue.

Connecticut has maintained annual DSC well above the 2.0x ABT requirement--ranging from above 3.0x for senior-lien bonds and 2.6x for combined senior- and second-lien bonds--since fiscal 2009. However, under current projections, allocated revenues, and anticipated additional debt issuance, the state projects annual DSC to decline to what we view as a still-strong 2.1x on senior-lien debt, absent new revenue, based on gross revenues. The state does not plan to issue additional debt under its subordinate lien.

Economic fundamentals: Very strong

In our opinion, Connecticut's economic profile makes it highly exposed to potential effects of the recession. Elements that exacerbate its exposure include 10 years of economic growth that lagged the nation, a high concentration in financial services employment, and a weak demographic profile.

Despite increased recessionary risks, very strong wealth and income levels remain a hallmark of the state's economic profile. In 2019, its per capita personal income was \$77,289 and 137% of the nation. However, its growth in personal income significantly slowed following the Great Recession to a compounded annual growth rate (CAGR) of 2.5% (2009-2018). Economic output has also lagged the nation the past five years with a real gross state product (GSP) CAGR of 0.91% compared with 2.43% for the nation. Connecticut experienced a greater decline in GSP than national GDP during the last recession, although annual growth was stronger than that of the U.S. in 2007 and in 2006 before the recession.

In our opinion, the state's economic performance in 2021 is expected to mirror that of the national trend. An improving vaccination outlook, a faster reopening schedule, and the \$1.9 trillion stimulus provided by the American Rescue Plan (ARP), which, along with a \$900 billion package approved in December under Coronavirus Response and Relief Supplemental Appropriations Act, all point to a seismic positive shift in the U.S. economic outlook relative to where it stood in December 2020. Our forecasts of real GDP growth for 2021 and 2022 are 6.5% and 3.1%, respectively, up from 4.2% and 3.0% in our December report, with our 2021 GDP forecast targeting the highest reading since 1984. As a result, with both business and consumer confidence well into expansion territory, we believe the U.S. economy is on the mend and now view the risk for recession over the next 12 months at 10%-15%, down sharply from the 20%-25% range in January, and around the U.S. economy's long-term unconditional recession risk average of 13%. (For more information see "Economic Outlook U.S. Q2 2021: Let The Good Times Roll," March 24, 2021).

A long-term challenge for economic growth reflects the state's population characteristics. Over the past five years, its population has experienced modest annual declines to an estimated 3.56 million residents in 2020. Like most of New England, it is aging faster than the rest of the country as prime working-age adults seek opportunities elsewhere, contributing to slower economic growth (see "Increasing Generational Dependency Poses Long-Term Social Risks To U.S. States' Fiscal And Economic Stability," published Feb. 24, 2020).

For more information on the state and its economy, refer to the most recent Connecticut GO article, published Dec. 7, 2020.

Linkage to state general creditworthiness

Because the state collects the pledged revenues, we view the rating on the transportation revenue bonds as linked to Connecticut's creditworthiness. In our establishment of a one-notch upward limitation on the transportation revenue bond rating compared to the state GO rating, we factored into our analysis our view that Connecticut provides critical public services. However, due to state constitutional restrictions on the use of pledged transportation revenue to the pledged STF, we believe revenue collection and allocation under state constitutional restrictions and the flow of funds are sufficiently removed from the entity's control so as to substantially mitigate operating risk and lead to a one-notch uplift from the state GO rating. Nevertheless, Connecticut does not, in our view, benefit from limited scope of operations or extraordinary expenditure flexibility, which we believe still exposes it to some operating risk in the

collection and distribution of pledge revenues.

Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

Ratings Detail (As Of April 12, 2021)		
Connecticut spl tax (BAM) (SEC MKT)		
<i>Unenhanced Rating</i>	A+(SPUR)/Stable	Affirmed
Connecticut GASTAX		
<i>Long Term Rating</i>	A+/Stable	Affirmed
Connecticut GASTAX		
<i>Long Term Rating</i>	A+/Stable	Affirmed
Connecticut GASTAX (BAM)		
<i>Unenhanced Rating</i>	A+(SPUR)/Stable	Affirmed
Connecticut GASTAX (BAM)		
<i>Unenhanced Rating</i>	A+(SPUR)/Stable	Affirmed
Connecticut GASTAX (BAM) (SECMKT)		
<i>Unenhanced Rating</i>	A+(SPUR)/Stable	Affirmed
Connecticut GASTAX (BAM) (SECMKT)		
<i>Unenhanced Rating</i>	A+(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

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