FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Connecticut's $500MM STO Bonds 'AA-'; Outlook Stable

Fri 29 Oct, 2021 - 12:51 PM ET

Fitch Ratings - San Francisco - 29 Oct 2021: Fitch Ratings has assigned a 'AA-' rating to the State of Connecticut's $500MM special tax obligation (STO) bonds, transportation infrastructure purposes, 2021 series D.

The STO bonds will be offered by negotiated sale the week of Nov. 8, 2021.

In addition, Fitch has affirmed the state's outstanding STO bonds at 'AA-'.

The Rating Outlook is Stable.

SECURITY

The STO bonds are secured by a gross lien on pledged revenues and other receipts deposited to the special transportation fund (STF) prior to any other uses.

ANALYTICAL CONCLUSION

The 'AA-' ratings and Stable Outlook on Connecticut's STO bonds reflect very strong resiliency of the financing structure and solid debt service coverage. The rating also considers the state's active management of STF revenues, as underlying growth prospects for revenues over time are otherwise slow, similar to other states.

The rating on the STO bonds remains capped at the state's 'AA-' IDR, given its ability to statutorily adjust the rates of pledged taxes and fees and their distribution. The new bonds and all outstanding bonds have been issued under a senior lien, with no second lien bonds outstanding or contemplated.

KEY RATING DRIVERS

Growth Prospects Steady: Underlying growth prospects for transportation-related revenues pledged to the bonds are likely to be flat over time, similar to other states and reflective of an 'a' assessment. The pledge of portions of statewide sales taxes adds diversity to the pledge beyond transportation receipts and supports steadier growth over time. Revenue trends are affected by active state management to augment resources for transportation capital and operating needs.

Leverage Limits and High Resiliency: Receipts are economically sensitive, but pledged revenues can absorb a significant decline and still provide sufficient coverage of debt service based on current revenue expectations. A 2x maximum annual debt service (MADS) additional bonds tests provides a strong cushion for bondholders in the event of cyclical declines. The state's demonstrated capability to statutorily redirect pledged revenues constrain the resilience assessment to 'aa'.

Rating Capped by State IDR: The credit is exposed to the operating performance of the state of Connecticut given the state's ability and demonstrated willingness to alter the flow of pledged revenues to the transportation fund. This interdependence caps the STO rating at the state's 'AA-' IDR.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--An upgrade of Connecticut's IDR, given that the rating on the STO bonds is capped at the state's IDR;

--Sustained improvement in revenue growth prospects to a level exceeding national inflation;

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--A material and sustained erosion in pledged receipts that reduces resilience of the structure, or state actions that shift pledged revenues away from the STF or otherwise narrow the resilience of the structure;

--A downgrade of Connecticut's IDR, given that the rating on the STO bonds is capped by the state's IDR.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

ECONOMIC RESOURCE BASE

Connecticut's economy is anchored by a sophisticated, defense-related manufacturing sector, important finance and insurance sectors in Fairfield County and Hartford, respectively, health and education institutions, and tourism linked in part to Native American gaming in the southeast. Population growth in Connecticut, like much of the northeast, has been well below the U.S. average in recent decades. Initial 2020 census data points to a modest, 0.9% uptick since the 2010 census, stronger than recent annual estimates although below neighboring states and national trends.

DEDICATED TAX CREDIT PROFILE

The 'AA-' rating reflects the underlying credit quality of the bonds' structure, with both growth prospects and resilience dependent on state policy actions. The credit is exposed to the operations of the state of Connecticut by virtue of the state's ability to statutorily adjust both the rates of pledged taxes and fees and their distribution among the state's funds. Although voters approved a constitutional dedication of revenues in the STF for transportation purposes in 2018, the legislature retains discretion to adjust rates and/or allocations of pledged revenues prior to deposit of revenues into the STF.

Some of these adjustments constrain resilience, while some enhance resilience. This has been demonstrated in the fiscal 2020-2021 biennium, when the scheduled phase-in of expanded sales tax deposits to the STF was modified to support the general fund, and in the fiscal 2022-2023 biennium, with the passage of a highway use fee on truck traffic as of Jan. 1, 2023.

The state actively manages capital, debt issuance, revenues and expenditures in the STF to identify and address cumulative deficits in the STF over the state's longer-term transportation planning window.

For additional information on Connecticut's IDR, please see Fitch's May 2021 press release "Fitch Upgrades Connecticut's IDR to 'AA-'; Rates $1 Billion GO Bonds 'AA-'; Outlook Stable," at www.fitchratings.com.

STO bonds issued under Connecticut's longstanding transportation borrowing program are supported by a first claim on pledged revenues and other receipts deposited to the STF, consisting primarily of transportation-related taxes and fees. Monthly deposits for debt service are made on a one-sixth, one-twelfth basis, and a debt service reserve is cash-funded at MADS. All outstanding bonds are on a senior lien, with remaining issuance under a second lien having fully amortized in April 2020.

After issuance of the bonds, approximately $7.2 billion will be outstanding under the senior lien, all of which has been issued at fixed rates and a 20-year maximum amortization. Leverage of pledged resources is limited by minimum required coverage of 2x maximum annual debt service (MADS) in any 12 consecutive months of revenues in the 18 months prior to issuance of additional bonds. The bonds also carry a 2x annual coverage requirement.

Unaudited pledged revenues of $1.8 billion in fiscal 2021 were a 17.2% increase over fiscal 2020, as statutory increases to the share of state sales taxes pledged to bondholders and increased receipts from vehicle purchasing offset continued decreases to motor fuels tax charged on gasoline, diesel and taxes to oil companies.

Fiscal 2021 pledged revenues consisted of a fixed portion of the statewide general sales tax ($482.9 million, 26.9% of the total); a motor fuels tax charged on gasoline, diesel and other fuels sold by distributors ($475.2 million, 26.4%); various motor vehicle registration, inspection and user fees ($321.4 million, 17.9%); a tax on gross earnings from the sale of petroleum products containing oil derivatives ($229.1 million, 12.8%); vehicle license, permit and fee revenues ($130.7 million, 7.3%); and a rising share of the sales tax levied on the private sale of motor vehicles ($117.2 million, 6.5%).

The motor fuels tax has traditionally been the largest component, although the phased shift of vehicle sales tax made the sales tax the largest component of STF revenue beginning in fiscal 2021. As of fiscal 2022, 75% of vehicle sales tax will be deposited to the STF, up from 25%; 100% of the vehicle sales tax will shift to the STF as of fiscal 2023 which the state estimates will yield $370 million of the projected $2.1 billion in pledged revenues. Fiscal 2023 revenues will also benefit from implementation of a highway use fee on truck traffic in the state, which will generate $45 million, rising to $90 million in fiscal 2024.

STF revenues are closely monitored, with monthly updates by the state budget office and comptroller, and updates of a multiyear outlook at each state consensus forecast. After payment of debt service, receipts support the state's broad transportation needs, including expenses of the departments of transportation and motor vehicles and pay-go capital. The forecast of cumulative surpluses or deficits over time is regularly updated to reflect underlying economic and revenue trends, planned changes to taxes, fees and their distributions, operating and capital spending and state debt issuance plans.

RECENT PERFORMANCE

The STF was not spared from budgetary effects of the pandemic, but the rebound has already begun. STF net revenues fell 10.2% in fiscal 2020, to $1.5 billion. An annual deficit of $152 million was absorbed by the STF's cumulative excess (fund balance), which fell to $168 million in fiscal 2020, from $320 million in fiscal 2019. Unaudited fiscal 2021 results see the balance increasing by $73 million to $241 million. State projections anticipate surpluses totaling over $400 million in the fiscal 2022-2023 biennium as the economic recovery continues and the new revenue streams flow to the STF.

Multi-year STF forecasts have typically shown narrowing surpluses or deficits later in the state's planning period. To ensure the STF retains a cumulative surplus, including as a cushion against revenue shocks such as what was experienced during the pandemic, the state has a longstanding practice of actively adjusting planned capital spending, debt issuance, revenues and expenses across a multiyear planning period.

LIMITED TRANSPORTATION RECEIPTS GROWTH PROSPECTS

Fitch views growth prospects for the diverse mix of transportation and general receipts securing the STO bonds to be relatively flat over time despite the recent addition of new sales tax inflows and future collections from highway use fees. The dedicated revenue stream through fiscal 2020 had a 10-year CAGR of 3.1%, but this CAGR reflects substantial rate changes and other state actions that increase receipts flowing to the STF, such as the deposit of vehicle-related sales taxes. Fitch expects transportation-related collections in Connecticut, similarly to other states, to be a flat to declining source of revenue in the absence of rate changes, particularly given factors such as rising fuel efficiency and the transition to alternative fuels.

VERY STRONG RESILIENCE OF PLEDGED RECEIPTS

To assess the resilience of the bond structure to potential cyclicality, Fitch considers how much cushion the structure could still provide under stress scenarios that assume full issuance to the ABT. The assessment relies on historical pledged revenue performance for these scenarios, which include stressing current revenues based on the largest actual historical decline and based on a moderate recession as provided by the Fitch Analytical Stress Test (FAST), a model which relates historical pledged revenue over time to GDP.

Based on fiscal 2020 net revenues of $1.5 billion and assuming full issuance to the 2x ABT, collections could fall 53% while maintaining sum-sufficient coverage of debt service. This level of cushion is about 5x the largest historical decline in pledged revenues (-10.2%, in fiscal 2020). Using the FAST model and revenue data through fiscal 2020, a separate scenario assuming Fitch's standard moderate GDP decline of 1.0% produces an expected revenue decline of 3.7%. This constitutes a very strong level of resilience, with the structure's cushion at more than 13x the scenario revenue decline, an assessment that could further strengthen as additional sales taxes are added to the fund.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR

ENTITY/DEBT	RATING			PRIOR
Connecticut, State of (CT) [General Government]				
• Connecticut, State of (CT) /Special Tax Oblig Trans Infr/1 LT	LT	AA- Rating Outlook Stable	Affirmed	AA- Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

U.S. Public Finance Tax-Supported Rating Criteria (pub. 04 May 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

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