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# State Of Connecticut; Gas Tax

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## Credit Highlights

- S&P Global Ratings assigned its 'AA-' long-term rating to the State of Connecticut's $830 million senior-lien special tax obligation (STO) bonds, 2022 series A, and approximately $312 million STO refunding bonds, 2022 series B.
- At the same time, S&P Global Ratings affirmed its 'AA-' long-term rating on the state's senior-lien STO bonds outstanding.
- The outlook is positive.

### Security

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. In accordance with the enabling act and bond provisions, pledged revenues are appropriated and do not require further legislative approval. Pledged revenues credited to and deposited in the STF are derived from the statewide collection of:

- Motor fuels tax (including gasoline, special fuels, and motor carrier road taxes);
- Oil companies tax;
- Specific portions of the general retail sales and use tax, motor vehicle receipts (registration fees for motor vehicles, license, permit, and fee revenue [e.g., fee for license to sell or repair motor vehicles]); and
- Other receipts, funds, and moneys credited to the STF.

Proceeds from the 2022 series A bonds will finance various projects of the state's transportation infrastructure program and proceeds from the 2022 series B refunding bonds will be used to refund the state's 2012 series A and 2012 series B bonds. As of Oct. 1, 2021, the state had approximately $6.83 billion of senior-lien STO bonds outstanding.

### Credit overview

The long-term rating incorporates our view of Connecticut's very strong economic fundamentals, anchored by a large statewide taxing base from which pledge revenues are collected, as well as diverse composition of pledged revenues deposited into the STF that have historically exhibited low-to-very low volatility across economic cycles. We view the STO bonds as exhibiting a close linkage to the Connecticut GO rating, and the positive outlook on the bonds reflects that of the State of Connecticut. In our view, any rating action on the state's general creditworthiness would also have a corresponding effect on the rating of the state's STO bonds.

Pledged revenues recovered swiftly and exceeded pre-pandemic levels in fiscal years 2021 and 2022, supporting our expectation that state's senior-lien STO bonds will maintain strong to very strong debt service coverage (DSC). Unaudited year-end results for fiscal 2022 surpassed collections during the previous fiscal year, with net pledged revenues deposited into the STF of $2.0 billion, or a 13.1% increase above fiscal 2021 receipts, which supports maximum annual debt service (MADS) coverage of 2.5x. Connecticut currently forecasts total pledged revenue growth will increase by 4.2% in fiscal 2023 and 8.8% in fiscal 2024, before flattening in fiscal years 2025 and 2026, which we view as reasonable given current economic conditions and expected adjustments to pledged revenues over the forecast period. Over the same period, the state projects cumulative fiscal year-end surplus balances in the STF will rise to $1.13 billion in 2026 from $457.6 million at the end of fiscal 2022. In addition, we anticipate the state will support its prospective transportation capital program needs by leveraging against this lien over the next biennium, while on a pro forma basis, we expect Connecticut will sustain coverage levels above 2.0x MADS.

In general, Connecticut has demonstrated active management of the STF, both through the sizing of its large transportation capital program and periodically expanding revenues deposited to the STF to provide stability. Illustrative of this point is the state's enactment of revenue enhancements for transportation-related purposes during the 2021 legislative session. Pursuant to state law, Connecticut will implement a highway use fee (effective Jan. 1, 2023) on certain heavy, multi-unit motor vehicles that will be based on the weight and number of miles driven on public roads in the state. These carriers will be required to obtain Highway Use Fee permits from the Connecticut Department of Revenue Services (DRS), and they must file returns and remit the fee to the state's DRS monthly. The state estimates highway use fees will generate approximately $45 million in 2023 and increase to $90 million upon the first full year of implementation in 2024, with a projected annual growth rate to be a more modest 4.5% in both 2025 and 2026. Highway use fees collected will flow to the STF and they can be used for the payment of debt service. However, a key credit consideration will be the state's ability to identify alternative and sustainable revenue sources and raise revenue when necessary to fund the state's transportation infrastructure program.

Connecticut's suspension of the 25-cent per gallon gas tax to provide taxpayer relief, effective April 1, 2022, and extended through Nov. 30, 2022, is credit neutral, in our view. Budget projections indicate that growth in STF pledged revenues above originally budgeted fiscal 2022 and 2023 levels will more than compensate for the estimated $90 million and $150 million losses, respectively, of pledged highway user-tax revenue. Even with the approximately $240 million loss in motor fuel taxes, Connecticut projects that overall growth across all revenue sources deposited in the STF will increase to $2.08 billion for fiscal 2023, or 4.2% above fiscal 2022 year-end (unaudited) pledged revenues. We will continue to monitor any potential effects on the transportation budget if the state chooses to extend the gasoline tax suspension beyond Nov. 30, 2022.

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

- A very strong and diverse statewide economic base of nearly 3.56 million people generating the pledged revenues, and the state's stable economic profile, which contributed to growth in overall pledged revenues following a pandemic-induced decline;
- Low-to-very low volatility of pledged STF revenues, including a history of the state increasing motor fuel tax rates,

fees, and allocations of pledged revenues and its approval of new revenue streams dedicated to the STF;

- Strong to very strong coverage and liquidity, including senior-lien MADS coverage of 2.5x on $812.7 million estimated debt service following these bond issuances, occurring in fiscal 2024,based on unaudited fiscal 2022 revenue estimates (net of federal payments and interest income). Although sizable transportation debt issuance is expected within the state's capital improvement plan (CIP), we expect MADS coverage will remain strong to very strong.
- Good bond provisions and Connecticut's strong commitment to its transportation program, including a 2.0x additional bonds test (ABT) for both first- and second-lien bonds, a fully funded debt service reserve (DSR), as well as establishment of a 2.0x rate covenant, which are likely to support maintenance of strong to very strong DSC.

### Environmental, social, and governance

We consider Connecticut's environmental and governance risks to have a neutral influence within our credit rating analysis and are consistent with similar obligations secured by sales, motor fuels, and other related taxes. Connecticut's strong management helps to mitigate exposure to physical risks--including severe weather events, coastal, and inland flooding--and the state's long-term capital and agency planning incorporate hardening of transportation assets and other infrastructure with potential exposure to physical risk from severe weather events and the long-term effects of rising sea levels. In addition, we consider the state's social risks to have neutral influence in our credit rating analysis for Connecticut, although we recognize demographic trends--including aging and slow population growth--could present long-term social capital considerations to Connecticut's economic and budgetary performance. However, we believe the broad taxing base and diversity of pledged revenue, coupled with proactive measures to forecast the effects of potential long-term revenue pressures and adjusting revenue to insulate the STF from volatility helps in managing these risks.

## Outlook

The positive outlook reflects our view that there is a one-in-three or greater chance we could raise the rating over the next two years. In our view, any rating action on the state's general creditworthiness would also have a corresponding effect on the rating of the state's STO bonds.

### Downside scenario

As we view the STO bonds to exhibit a close linkage to the Connecticut GO rating, if we were to revise the state's GO rating outlook to stable or downgrade the rating, it would likely result in a corresponding rating action on the STO rating. Alternatively, significant deterioration of the underlying credit characteristics of the STO bonds or a sustained material weakening of pledged revenues that reduces DSC, could result in a lowering of the rating.

### Upside scenario

The application of our priority-lien tax revenue debt criteria limits the STO bonds to no more than one notch above Connecticut's general creditworthiness. Therefore, raising the STO rating would correspond with the raising of the state GO rating.

For more information regarding the state's long-term credit fundamentals, see our analysis on Connecticut, published May 23, 2022, on RatingsDirect.

## Credit Opinion

### Revenue volatility: Low-to-very low

We believe pledged revenue will continue to exhibit low-to-very low volatility based on a broad-and-well-diversified mix of pledged transportation-related revenue, supplemented by increased allocations of state sales tax from Connecticut's general fund. 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, Connecticut established a 2.0x rate covenant under the senior trust indenture and levied pledged revenue and other receipts to meet this requirement, if necessary, which we view as a stabilizing credit factor.

Estimated actual (unaudited) fiscal 2022 STF revenue was composed of what we view as a diverse mix of general fund sales tax allocations (35.3% of fiscal 2021 pledged revenues), motor fuels taxes (24.2%), motor vehicle receipts (primarily vehicle registration fees; 18.1%), oil companies' tax payments (14.3%), licenses, permits, and fees (8.1%). 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.

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 and use tax allocations surpassed motor fuels taxes as the leading STO-pledged revenue source, and they are projected to be about 38% of pledged revenues in fiscal 2023 when fully phased in. In our view, sales taxes, particularly derived from auto sales, could exhibit somewhat higher volatility 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, we note that following voter approval of the 2018 constitutional referendum, the state can no longer reallocate motor fuels tax and other pledged revenues for state budget relief.

### Coverage and liquidity: Strong-to-very strong

We calculate audited actual pledged revenues for the fiscal year ended June 30, 2021--excluding pledged BAB interest subsidy or interest earnings for our DSC calculations--covered proposed future senior-lien MADS of $812.7 million, occurring in fiscal 2024, to be a strong to very strong 2.5x. MADS coverage is estimated to improve to nearly 2.6x based on unaudited STO-pledged revenue for fiscal 2022, reflecting a revenue increase of 13.1% based on year-end estimates. The obligations are also secured by a DSR that had a balance of $753 million as of Sept. 20, 2022.

The state projects annual DSC will remain at levels that we view as strong to very strong through 2026, incorporating a modest growth in revenue projections and factoring in available authorizations of $3.9 billion of new-money STO bonds subject to approval by the state's Bond Commission. The state plans to issue an average of $982 million annually in new STO bonds amortized over 20 years between fiscal years 2023 and 2026, including the 2022 series A and B bonds. The maintenance coverage projected by the state is partially due to a rapid amortization schedule, with nearly 68% of existing STO principal retired within the next 10 years, a declining debt service schedule after 2024, and the increase of sales tax, registration fees for electric vehicles, and highway use fees as pledged revenue.

Connecticut maintained annual DSC well above the 2.0x ABT requirement. However, under current projections, allocated revenues, and anticipated additional debt issuance, the state projects annual DSC will decline to 2.2x on senior-lien debt, absent new revenue. The state has no current plan to issue additional debt under its subordinate lien.

### Economic fundamentals: Very strong

Very strong wealth and income levels remain a hallmark of the state's economic profile, although lagging economic and population growth compared with the nation and comparatively higher employment concentration in financial services expose the state to potential effects of recessions. In 2021, Connecticut's per capita personal income was $82,082, or approximately 129% of the nation. However, growth in state personal income slowed substantially following the Great Recession to a compounded annual growth rate (CAGR) of 2.4% (2010-2020). Economic output also lagged the nation the past five years, with a real gross state product (GSP) CAGR of 0.2% compared with 1.9% for the nation. S&P Market Intelligence projects the state's GSP growth (3.7% increase) could continue on a slower path over the next four years compared with the national trend (5.8% increase) over the same period.

The U.S. economy's remarkably favorable economic conditions have given way to stiffening headwinds that could change the economic landscape for U.S. states, yet again. U.S. GDP unexpectedly fell by an annualized rate of 1.6% and 0.9% in the first and second quarters of 2022, respectively--after expanding at an average of 5.7% in 2021. S&P Global Economics lowered its recent baseline forecast for U.S. GDP growth to 1.6% for 2022 and 0.2% for 2023 (down from 1.8% and 1.6%, respectively, in the August 2022 forecast). The downward U.S. GDP revision comes amid sharply higher and persistent inflationary price pressures on energy and commodities, renewed consumer caution that could reduce household spending, and both direct and indirect pressures from geopolitical conflicts. Against the backdrop of higher inflation, the U.S. Federal Reserve has undertaken more aggressive monetary policy tightening. In September 2022, the Federal Reserve increased the benchmark federal funds rate by 75 basis points, the fifth of what we expect could be six rate hikes in 2022, with rates reaching more than 4% by 2023. We recognize that risks have increased, and S&P Global Economics now expects the U.S. economy will fall into a shallow recession in the first half of 2023. (see "Economic Outlook U.S. Q4 2022: Teeter Totter," published Sept. 26, 2022).

### 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 with the state GO rating, we factored into our analysis our view that Connecticut provides critical public services. In 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 added state constitutional restrictions on the use of pledged transportation revenue deposited to the STF in accordance with state statute 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. In addition, 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 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022