FITCH AFFIRMS CONNECTICUT'S SPECIAL TAX OBLIGATION BONDS AT 'A+'; OUTLOOK STABLE

Fitch Ratings-New York-22 November 2019: Fitch Ratings has affirmed the following ratings for the state of Connecticut:

--Approximately $6 billion in senior lien special tax obligation (STO) bonds at 'A+';
--Approximately $120 million in subordinate lien STO bonds at 'A+'.

The Rating Outlook is Stable.

SECURITY
Senior and subordinate lien 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. The modest amount of subordinate lien debt service is paid after the senior lien.

ANALYTICAL CONCLUSION
The 'A+' ratings and Stable Rating Outlook on Connecticut's senior and subordinate lien special tax obligation bonds reflects ample resiliency of the financing structure and strong debt service coverage, and considers the support provided by state tax policy actions as growth prospects for revenues are otherwise slow. Dedicated revenues are expected to remain economically sensitive and allocation of portions of statewide sales tax to the STF is likely to benefit the fund, providing firmer future growth prospects than would be provided if the STF were funded solely by transportation-related receipts. The state projects strong net revenue growth in the STF from all revenue sources through fiscal 2023, inclusive of the additional sales tax revenue allocations, with slower growth beginning in fiscal 2024.

The security is exposed to the state's ability to statutorily adjust both the rates of pledged taxes and fees and their distribution among the state's funds, placing a cap on the STO rating at the state of Connecticut's 'A+' Issuer Default Rating (IDR). A constitutional amendment in 2018 now requires revenue, once deposited in the STF, to be spent only on transportation purposes.

KEY RATING DRIVERS
Growth Prospects Steady: Considered in sum, transportation-related revenues pledged to the bonds have been generally stable over time, although motor fuels taxes have fluctuated in recent years and the oil company tax has been volatile. The addition of portions of the statewide sales tax beginning in fiscal 2016 diversified pledged receipts beyond transportation-related activity. The additional deposit of the motor vehicle sales tax on automobile purchases at dealerships will also further diversify pledged revenues, although an earlier approved acceleration of these deposits was modified in the 2020-2021 biennial budget to provide additional revenue to the state's General Fund. The full deposit of this tax remains scheduled for fiscal 2023.

Leverage Limits and High Resiliency: Pledged revenues can absorb a significant decline and still provide solid coverage of debt service under the current structure. A minimum of 2x maximum annual debt service (MADS) is required for additional bonds, limiting leverage of pledged resources. The bonds also carry a 2x annual coverage requirement.

Linkages with State: The credit is exposed to 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. This interaction caps the STO rating at Connecticut's 'A+' IDR. A 2018 constitutional amendment now requires revenue once deposited in the STF to be spent solely on transportation purposes.

RATING SENSITIVITIES
SOLID COVERAGE BY PLEDGED REVENUE: The rating is sensitive to anticipated growth in the dedicated revenue stream that will maintain solid coverage of debt service requirements.

RESILIENCY OF THE FINANCING STRUCTURE: The rating is sensitive to the ongoing, careful management of the transportation fund and its corresponding capital program, which ensures sound resiliency of the financing structure is maintained.

LINK TO STATE CREDIT QUALITY: The rating is sensitive to changes in Connecticut's 'A+' IDR, by which it is capped. The state's IDR is sensitive to its ability to balance financial operations in response to economic and revenue growth expectations, maintenance of its recently improved financial resilience, shifts in its elevated liability burden, and ability to manage its expenditures given a comparatively high fixed cost burden.

CURRENT DEVELOPMENTS
The expected insufficiency of future STF resources to fund planned and sought after transportation capital projects in the state has been much discussed in recent years. This concern does not affect capital projects already under way, future maintenance projects, nor the STO bonds issued to support them. The governor recently proposed a transportation infrastructure plan titled 'CT2030' that proposes $21 billion in capital projects over 10 years for roads, bridges, and public transit, with funding derived from federal grants, state general obligation (GO) and STO bonds, tolling on the state's highways and bridges, and cash funding. The legislature is currently considering this proposal. Fitch expects the state to effect a well thought-out transportation infrastructure program while continuing to actively manage STF resources, ensuring that the annual coverage covenant and a requirement to balance the STF budget are met.

ECONOMIC RESOURCE BASE
Connecticut has a diverse, mature and wealthy economic base, with flat to modestly declining population trends and an aging demographic profile. In contrast to past economic expansions, the state's performance in the current expansion has been unusually slow and has weighed on the natural pace of revenue growth. The state projects positive economic growth over the medium term but at rates below the nation.

Employment gains through much of the recovery have been well below national averages and slower than past recoveries. September 2019 three-month moving average employment growth averaged 0.6% as compared to 1.5% for the nation while labor force growth over this same span was 0.3% compared to 1.1% for the nation. Rates of recovery have varied across the state's larger metropolitan regions, ranging from robust gains in the New Haven region to only modest gains in areas like New London and Waterbury. The finance sector, with important banking and investment activity in the southwestern part of the state and insurance activity in Hartford, saw sizable employment losses through the Great Recession and well into the recovery. Employment in these areas remains below the post-recession peak.

The state's large and sophisticated manufacturing sector has seen relatively flat employment growth since steep recessionary losses ended, although important defense-related manufacturing anchors the sector and may bring future gains. Tourism has grown in importance over time, but prospects for the state's gaming resorts are more uncertain given rising competition in neighboring states. The state's unemployment rate has historically run below the U.S. rate but has exceeded the nation since 2012; the unemployment rate was 4.1% in 2018 compared to 3.9% for the U.S. and 3.4% was recorded for September compared to 3.3% for the nation. Personal income per capita ranks the highest among the states, at 140% of the national level, and growth was above the national average in 2018 following subpar performance since 2010.

DEDICATED TAX CREDIT PROFILE

Senior and subordinate lien STO bonds are secured by a gross lien on pledged revenues and other receipts deposited to the STF prior to any other uses. Pledged revenues consist of a motor fuels tax charged on gasoline, diesel and other fuels sold by distributors; vehicle license, permit and fee revenue; a tax on gross earnings from the sale of petroleum products containing oil derivatives; portions of the general statewide sales tax and the sales tax levied on new and pre-owned automobile purchases; various motor vehicle registration, inspection and user fees; and a department of motor vehicle (DMV) sales tax levied on the casual sale of non-commercial motor vehicles, aircraft, vessels and snowmobiles.

DIVERSE MIX OF PLEDGED REVENUE SOURCES

The tax and fee revenue that secures the STO bonds is derived primarily from economically-sensitive transportation-related activity, although recently boosted allocations of statewide sales tax revenue have added diversity and reduced exposure to transportation-related activity. The mix of dedicated revenue sources compensates for expected slow growth in transportation-related revenue sources. In the absence of additional state sources allocated to the STF, Fitch expects growth prospects going forward to remain slow but sound.

Motor fuels taxes increased 2% YOY in fiscal 2019 as a $0.026 increase in the diesel fuel tax rate, to $0.465 per gallon, boosted receipts. Going forward, the state forecasts relatively flat to declining collections through fiscal 2024. Motor vehicle-related (MV) receipts, along with license, permit and fee revenues (LPF), demonstrate the variability associated with annual customer transactions. MV receipts declined by 1.1% in fiscal 2019 while LPF was up by 5.8%. This historical variability is expected to remain a feature of future collections.

Volatility in oil company tax collections reflects broader crude oil price trends. The tax fell for three consecutive years, from fiscal 2015 through 2017, but grew rapidly in fiscal 2018 with gains in oil prices and was flat in fiscal 2019. General statewide sales tax deposited to the STF was approximately $371 million in fiscal 2019 and is currently forecast to grow to $765 million in fiscal 2024 due to the car sales tax phase-in through fiscal 2023, inflation, and economic growth. On a per penny basis, sales tax revenue is expected to grow slightly above the rate of inflation. Sales tax revenue is expected to become the largest component of the STF at 32% in fiscal 2022.

Total fiscal 2019 net revenues grew 3.6% in fiscal 2019 and solid future growth is anticipated, largely from the additional sales tax revenue. The state's November 2019 consensus revenue forecast projects 2.1% growth in available net revenue in fiscal 2020, inclusive of the state's revenue cap that limits appropriations beginning in fiscal 2020. The appropriations limit begins at 99.5% of expected revenue in fiscal 2020 and phases-in to 98% in fiscal 2026 and thereafter. Looking ahead to fiscal 2024, following the full fiscal 2023 allocation of automobile sales tax to the STF and incorporating 98.5% of expected revenue, the state projects only 1% growth in available net revenues; very modest revenue growth absent additional tax policy action.

ONGOING TAX POLICY ACTION

STF performance is actively managed, with an annual coverage requirement and a balanced budget requirement, ongoing revenue monitoring and frequent forecast updates that allow the state to quickly identify weakness as STF resources in aggregate are economically sensitive. This active management together with legislative action on a one-time or multi-year basis has resulted in tax rates changes, taxable base adjustments, as well as statutory diversions. These factors somewhat subdue the otherwise robust resiliency outcome generated by Fitch's Analytical Stress Test (FAST) results as revenue performance does not exclude tax policy changes.

To evaluate the sensitivity of the dedicated revenue stream to cyclical decline, Fitch considers the FAST results which use a 1% decline in national GDP scenario, as well as assessing the largest decline in revenues over the period covered by the revenue sensitivity analysis. For STF net revenues overall, which include the impact of tax policy changes, the FAST output indicates a 4% drop in a moderate recession scenario; the maximum decline was 7.8%. For motor fuel tax deposits, the FAST output indicates a slightly larger drop in a moderate recession scenario while for the statewide sales tax, the FAST output indicates a smaller drop. Pledged revenues could withstand a 50% decline, assuming full leveraging to the ABT, or 12.5x the scenario output, a strong level of resiliency. Considering the largest consecutive decline, resiliency remains strong at 6.4x the scenario output.

Debt service coverage of both senior and subordinate lien bond debt service in fiscal 2019 is estimated at 2.6x and absent additional, planned borrowing, is expected to grow over time. However, state projections include continual borrowing to address significant transportation needs, and when combined with expected slow growth in current revenue sources, is forecast to result in a narrowing of coverage over the forecast period.

EXPOSURE TO ISSUER OPERATIONS
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 or for other purposes. Typically, adjustments to STF revenues to address general fund budget needs have generally been matched with reductions in planned spending. Notwithstanding voter approval of the constitutional dedication of the STF for transportation purposes only in 2018, the legislature retains its discretion to adjust rates and/or allocations of pledged revenues prior to deposit of revenues into the STF.

Contact:

Primary Analyst
Marcy Block
Senior Director
+1-212-908-0239
Fitch Ratings, Inc.
Hearst Tower
300 W 57th Street
New York, NY 10019

Secondary Analyst
Douglas Offerman
Senior Director
+1-212-908-0889

Committee Chairperson
Karen Krop
Senior Director
+1-212-908-0661

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

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3 - 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.

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email: sandro.scenga@thefitchgroup.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018)
https://www.fitchratings.com/site/re/10024656