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Summary:
Connecticut; Gas Tax

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Summary:

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Credit Profile		
US$850.0 mil spl tax oblig bnds transp infrastructure purp ser 2020A due 05/01/2040		
Long Term Rating	A+/Stable	New
Connecticut GASTAX		
Long Term Rating	A+/Stable	Affirmed

Rating Action

S&P Global Ratings has assigned its 'A+' rating to State of Connecticut's series 2020A first-lien special tax obligation (STO) bonds and affirmed 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. Should we raise the state GO rating, we could potentially raise the rating on the STO bonds.

The state is issuing approximately $850 million of first-lien STO bonds to finance various projects of its transportation infrastructure program. As of May 1, 2020, there were $5.6 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

The state issued its consensus revenue forecast update at the end of April reflecting initial effects of the COVID-19 pandemic and a $164.4 million decline (negative 9.5%) in net pledged revenues for fiscal year 2020. Over the outyear forecast, it projects growth in overall pledged revenues, primarily due to the continued phase-in of car dealers' sales tax revenues, but continued shortfalls in the STF. In our opinion, the state's forecast may prove somewhat optimistic depending on the depth and duration of the recession and any long-term changes to people's consumption patterns.

While motor fuel tax remains the primary revenue source, sales and use tax is expected to surpass this in fiscal 2022. 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 may likely remain so as the state enters a period of fiscal stress.

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. Additional stress caused by COVID-19 will likely result in the state using available surplus in the transportation fund to close budget gaps over the biennium estimated at $151.7 million in 2020 and $139.5 million in 2021. The state has a balanced budget requirement and will need to make adjustments in subsequent fiscal years to keep the STF in balance. Efforts to balance the fund may require new revenue sources or a reduction in planned capital projects.

We view the strength and stability of the pledged revenues deposited to the STF as strong. Even with projected declines in pledged revenues, we expect coverage to remain strong. 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 2.48x on $659.8 million estimated debt service, occurring in fiscal 2023 after this sale based on 2019 revenues. We expect coverage to remain strong as revenue used for MADS calculation declines in fiscal 2020 by 5.2% to 2.35x coverage. While the bonds have a gross revenue pledge, we calculate coverage based on total net revenues less federal payments and interest income.

Environmental, social, and governance factors

Our rating incorporates our view regarding the health and safety risks posed by the COVID-19 pandemic. S&P Global Ratings considers health and safety a social risk under our view of environmental, social, and governance (ESG) factors. Absent the social risks of COVID-19, 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

The outlook on the bonds reflects that of the state of Connecticut. Generally, our rating outlook timeframe is up to two years. Given the current uncertainty around the pandemic, our view of the credit risks to Connecticut and its obligations centers on the more immediate budget effects in 2020 and are subject to change.

Downside scenario

Should a significant structural gap emerge and the state no longer continues making required pension contributions, use significant one-time budgetary maneuvers (including deficit bonds), or sees reserves deteriorate to low levels as they were before bond covenants were imposed, we may lower the rating. We also note that the state's three-year average pension funding ratio is close our threshold of 40% and may result in further downward rating action if pension funding levels deteriorate. We recognize that state governments across the nation will face unprecedented challenges in the near term. The duration and severity of recent events affecting the state's fiscal profile may result in faster deterioration of its credit quality as economic conditions change.

Upside scenario

If the state is able to weather the economic recession, maintaining good reserve balances and demonstrating a moderating debt burden, we may consider a higher rating. We currently estimate that the majority of our debt ratios will 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 2019 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 (30% of fiscal 2019 pledged revenues); general fund sales tax allocations (21%); oil companies' tax payments (18%); motor vehicle receipts (primarily vehicle registration fees; 15%); licenses, permits, and fees (9%); 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 debt service coverage (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 additionally 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 41% 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 unaudited actual pledged revenues collected by the state comptroller for the fiscal year ended June 30, 2019--not including pledged BAB interest subsidy or interest earnings--covered proposed future senior-lien MADS of $659.8 million, occurring in fiscal 2023 after this sale, by 2.48x, and declining to a still-strong 2.35x in 2020, reflecting a revenue decline of 5.2% 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.

While the economic effects of COVID-19 continually change, including its effects on state revenue collections, in our opinion, coverage on the STO bonds will likely remain strong. We estimate that total revenue collections would have to fall 61%, an extreme scenario, for coverage to reach 1.00x, and 21% for it to reach 2.00x. The obligations are also secured by a DSR that had a balance of $599.9 million as of May 1, 2020.

The state projects annual DSC will remain at levels we view as strong through 2024, 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. On average, the state issues about $750 million a year in new STO bonds amortized over 20 years. The maintenance of strong coverage projected by the state is in part due to a rapid amortization schedule, with 63% 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.

The state expects that any substantial expansion of current bonding plans would be met with additional pledged revenue not currently in statute. The governor proposed re-instating tolling within the state this year, but that ultimately failed to achieve sufficient support in the legislature.

Connecticut has historically 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, but 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 2.3x on senior-lien debt, absent new revenue based on gross revenues. The state does not have plans to issue additional debt under its subordinate lien.

Economic fundamentals: Very strong

In our opinion, Connecticut's economic profile makes it highly exposed to the 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 $79,087 and 140% 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 to 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 economy is expected to contract this year based on S&P Global Economics forecast (see "An Already Historic U.S. Downturn Now Looks Even Worse," published on April 16, 2020). The COVID-19-induced recession will have a material negative effect on the state's economy and finances.

A future challenge for economic recovery reflects the state's population characteristics. Over the past five years, its population has experienced modest annual declines to an estimated 3.57 million residents in 2019. 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, please refer to the most recent Connecticut GO summary analysis, published May 15, 2020, on RatingsDirect.

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.

Ratings Detail (As Of May 15, 2020)		
Connecticut GASTAX		
Long Term Rating	A+/Stable	Affirmed
Connecticut GASTAX		
Long Term Rating	A+/Stable	Affirmed

Ratings Detail (As Of May 15, 2020) (cont.)		
Connecticut GASTAX (BAM)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed
Connecticut GASTAX (BAM)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed
Connecticut GASTAX (BAM) (SECMKT)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed
Connecticut GASTAX (BAM) (SECMKT)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed
Many issues are enhanced by bond insurance.		

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.