S&P Global Ratings

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State of Connecticut; Gas Tax

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Credit Profile		
US$500.0 mil spl tax oblig bnds, transp infrastructure purposes ser 2021D due 11/01/2041		
Long Term Rating	AA-/Stable	New

Rating Action

S&P Global Ratings assigned its 'AA-' long-term rating to the State of Connecticut's $500 million senior-lien special tax obligation (STO) bonds, 2021 series D, while also affirming its 'AA-' long-term rating on the state's senior-lien STO bonds outstanding. The outlook is stable.

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. 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.

In accordance with the enabling act and bond provisions, pledged revenues are appropriated and do not require further legislative approval.

Proceeds from the 2021 series D bonds will finance various projects of the state's transportation infrastructure program. As of Nov. 1, 2021, the state will have $6.71 billion of senior-lien STO bonds outstanding.

Credit overview

As pandemic-induced mobility restrictions eased and the transitory public health and safety effects on Connecticut's economy faded further into the background, estimated pledged revenues recovered swiftly and exceeded pre-pandemic levels in fiscal 2021, supporting our expectation that the 2021 series D bonds and the state's outstanding senior-lien STO bonds will maintain strong debt service coverage (DSC) and near-term credit stability. In addition, the broad, diversified, and historically stable composition of pledged revenues, in conjunction with the state's maintenance of a 2.0x rate covenant remain key features that further underpin our view of overall low volatility and are stabilizing credit factors. The stable outlook also reflects the state's very strong economic fundamentals, supported by a large statewide taxing base from which pledge revenues are collected.

Although pandemic pressures materially reduced pledged revenues in fiscal 2020, the state's DSC remained relatively stable at 2.3x during that period, which we view as strong. Net of pledged Build America Bond (BAB) interest subsidies and interest earnings, pledged revenues deposited into the STF declined by approximately $281 million (or 10.2%).

Nevertheless, unaudited year-end results for fiscal 2021 have surpassed pre-pandemic levels, with net pledged revenues deposited into the STF of approximately $1.77 billion, or a 7.6% increase above fiscal 2019 receipts, which we believe will support maximum annual debt service (MADS) coverage of 2.4x. This quick recovery was aided by robust growth in general retail sales tax and motor vehicle receipts. Over the fiscal biennium, Connecticut's May 2021 consensus revenue forecast projects a 4.5% increase in motor fuel tax receipts in fiscal 2022, followed by a negative 0.7% decline in fiscal 2023. Concurrently, general retail sales and use tax revenue are projects a negative 0.8% growth rate in fiscal 2022, followed by 2.2% growth in fiscal 2023. The current fiscal biennium projects pledged revenues in the STF to increase to nearly $1.9 billion in fiscal 2022 and $2.07 billion in fiscal 2023. We anticipate the state will support its prospective transportation capital program needs by leveraging against this lien over the next biennium, and on a pro forma basis, the state expects to sustain coverage levels to remain above 2.0x MADS.

While the motor fuel tax has historically been the primary revenue source of the STF, sales and use tax surpassed motor fuel taxes in fiscal 2021 as the state continues to phase in this transfer of revenue until 2023. Increasingly restrictive federal fuel-efficiency standards and the potential future loss of revenue due shifting consumer preferences toward electric vehicles and other alternative technologies could have a proportionate negative effect on statewide motor fuel tax receipts over time. 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 when the state has endured periods of fiscal stress. Upon full phase-in of the sales and use tax beginning in fiscal 2023, the state will not be able to modify the sales and use tax transfer without violation of the constitutional lockbox provisions approved in 2018, limiting the potential for future modifications.

In general, the state has demonstrated active management of the STF, both through the sizing of its transportation capital program and periodically increasing revenues to the STF. 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 to 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.

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

- A very strong statewide diverse economic base of nearly 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 and its approval of new revenue streams dedicated to the STF, as well as establishment of a 2.0x 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 MADS coverage of 2.4x on $914.1 million estimated debt service, occurring in fiscal 2024 following this issuance based on unaudited fiscal 2021 revenue estimates. We expect MADS coverage will 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 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. For more information on the general obligation (GO) ratings on Connecticut, refer to the most recent state analysis, published May 13, 2021, on RatingsDirect.

The 'AA-' rating is based on the application of our priority-lien tax revenue debt criteria, published Nov. 20, 2019, which factors in both the strength and stability of the pledged revenues, as well as the general creditworthiness of the state as the issuing obligor. The priority-lien rating on the STO bonds is limited to one notch above our view of Connecticut's creditworthiness (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.

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.

Environmental, social, and governance (ESG) factors

We consider Connecticut to have elevated social risks compared with the sector given its older population and higher cost of living relative to other states, which could slow the growth of certain pledged revenues. These demographic trends could present long-term credit risks to the state's economic and budgetary performance, although we believe the broad taxing base and diversity of pledged revenue, coupled with other measures by the state to adjust revenues somewhat insulate potentially volatility of STO bonds help to manage these risks. Environmental risks are considered above those of other states due to its 618 miles of coastline along Long Island Sound. However, we believe Connecticut's historically strong management helped 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 at risk from rising sea levels. Generally, 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

As we view the STO bonds to exhibit a close linkage to the Connecticut GO rating, a downgrade of the state GO rating would result in a commensurate downgrade on the STO rating. Should we calculate that Connecticut's debt ratios have increased to previous levels or total pension funded ratios fall below 40% without a plan to improve funding, we could lower the GO rating if there is no reasonable plan to improve these liability metrics. Alternatively, significant deterioration of the underlying credit characteristics of the STO bonds or a material weakening of pledged revenues that substantially reduces debt service coverage, we could lower the rating.

Upside scenario

The application of our priority-lien 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. A positive rating action would be predicated on Connecticut's maintenance of near-term structural balance and strong reserve levels, while the state's economic profile significantly improves, and its long-term debt burden substantially moderates.

Credit Opinion

Revenue volatility: Low

We believe pledged revenue will continue to exhibit 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 has established a 2.0x rate covenant under the senior trust indenture and to levy pledged revenue and other receipts to meet this requirement, if necessary, which we view as a stabilizing credit factor.

Estimated actual (unaudited) fiscal 2021 STF revenue--not including pledged BAB interest subsidy or interest earnings--was composed of what we view as a diverse mix of general fund sales tax allocations (27.4% of fiscal 2021 pledged revenues), motor fuels taxes (26.9%), motor vehicle receipts (primarily vehicle registration fees; 18.2%), oil companies' tax payments (13%), licenses, permits, and fees (7.4%), and sales tax from sales between individuals (6.6%), 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 and use tax allocations surpassed motor fuels taxes as the leading STO-pledged revenue source, and it 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% decline in total pledged revenue in fiscal 2016 primarily due to lower oil company tax revenue. However, we note that following voter approval of the 2018 constitutional referendum, the state can 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 $914.1 million, occurring in fiscal 2024 after this sale, to be a still-strong 2.3x, but improve to 2.4x based on unaudited STO-pledged revenue for fiscal 2021, reflecting a revenue increase of 19% based on year-end 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 $716 million as of Oct. 14, 2021.

The state projects annual DSC will remain at levels we view as strong through 2026, incorporating downward revenue projections and factoring in available authorizations of $4.48 billion of new-money STO bonds subject to approval by the state's Bond Commission. The state plans to issue an average of $950 million annually in new STO bonds amortized over 20 years between 2021 and 2026 including the 2021D 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 2.2x 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 recent 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.

Very strong wealth and income levels remain a hallmark of the state's economic profile. In 2020, Connecticut's per capita personal income was $78,609, or approximately 132% 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 has also lagged the nation the past five years with a real gross state product (GSP) CAGR of negative 0.6% compared with 1.1% for the nation. Connecticut experienced a greater decline in GSP than national GDP during the Great 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 recover slower than of the national trend.

While the near-term health of the U.S. economy remains strong, S&P Global Economics revised its economic forecasts for real GDP growth for 2021 and 2022 to 5.7% and 4.1%, respectively, from 6.7% and 3.7% in its June report. With a stimulus-driven surge in demand outpacing supply chain productivity and a recent surge in inflation, some pressures could be sticky through 2022. With the labor market still 5.3 million jobs short of its pre-pandemic peak, recovery could also take a while. Despite these potential downside risks to growth and employment recovery, and ongoing debates on infrastructure, the federal budget, and the U.S. debt ceiling, S&P Global Economics believes the U.S economy remains resilient and both business and consumer confidence remain well into expansion territory. For more information see "Economic Outlook U.S. Q4 2021: The Rocket Is Leveling Off", published Sept. 23, 2021).

A long-term challenge for economic growth reflects the state's population characteristics. Over the past five years, Connecticut's population 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).

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. 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 issuer'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 October 28, 2021)		
Connecticut GASTAX		
Long Term Rating	AA-/Stable	Affirmed
Connecticut spl tax (BAM) (SEC MKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
Connecticut GASTAX		
Long Term Rating	AA-/Stable	Affirmed
Connecticut GASTAX		
Long Term Rating	AA-/Stable	Affirmed
Connecticut GASTAX (BAM)		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
Connecticut GASTAX (BAM)		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed

Ratings Detail (As Of October 28, 2021) (cont.)		
Connecticut GASTAX (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
Connecticut GASTAX (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
State of Connecticut gas tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.