FitchRatings

FITCH RATES CONNECTICUT'S $800MM SPECIAL TAX OBLIG. BONDS 'A+'; OUTLOOK STABLE

Fitch Ratings-New York-16 January 2018: Fitch Ratings has assigned an 'A+' rating to the following state of Connecticut special tax obligation (STO) bonds:

--$800 million in STO bonds, transportation infrastructure purposes, 2018 series A.

Proceeds from the sale of the 2018 series A bonds will fund various transportation capital projects. The bonds are scheduled to be offered via negotiated sale on Jan. 23 and 24, 2018.

In addition, Fitch has affirmed the 'A+' ratings on $4.6 billion senior lien and $186.5 million second lien outstanding STO bonds.

The Rating Outlook is Stable.

SECURITY

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

KEY RATING DRIVERS

Growth Prospects Steady: Most of the transportation-related revenues pledged to the bonds, including motor fuels taxes and motor vehicle receipts, are generally stable over time but have limited growth potential, while the oil company tax is more volatile. The addition of portions of the statewide sales tax has diversified pledged receipts beyond transportation-related activity. The addition of new motor vehicle sales taxes, to be phased-in over five years beginning in fiscal 2021, will further diversify pledged revenues.

Established and Stable Program: The STO bond program is a well-established part of a comprehensive and legislatively authorized long-term transportation infrastructure program. Management strengths include active revenue monitoring, multi-year forecasting, and the ability to curtail capital spending in the event of revenue weakness.

Leverage Limits and High Resiliency: 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. Pledged revenues can absorb a significant decline and still provide coverage of debt service under the current structure.

Linkages with General Fund: 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 or for other purposes. Interdependence with general fund operations has led to periodic revenue and cost shifts, capping the STO rating to that of the state of Connecticut's 'A+' Issuer Default Rating (IDR).

RATING SENSITIVITIES

Link to State Credit Quality: The rating is sensitive to changes in Connecticut's 'A+' IDR, by which it is capped.

Consistently Solid Coverage: The rating is also sensitive to consistently solid coverage by pledged revenues and to ongoing careful management of the transportation fund.

CREDIT PROFILE

The 'A+' rating on both the senior and second lien bonds reflects steady growth prospects for pledged revenues, secure legal provisions and the ability of the revenue stream to withstand a significant decline and still provide coverage of debt service. Although pledged revenues supporting the STO bonds would warrant a higher rating, the credit quality of the bonds is limited by the exposure of the STF to general state operations.

The STO bonds are secured by pledged revenues deposited to the STF and both senior and second liens carry an additional bonds test (ABT) requiring 2x coverage of aggregate principal and interest. Moreover, the state covenants under the second lien that any senior issuance must meet all second lien requirements; both senior and second lien bonds are subject to an annual 2x debt service coverage test. The bonds are also backed by an aggregate debt service reserve funded at maximum annual debt service (MADS).

Pledged revenues are available first for senior lien debt service and reserves, followed by second lien debt service and reserves; outstanding second lien bonds are scheduled to mature in fiscal 2022. Thereafter, pledged revenues are available for transportation-related state general obligation bond debt service and operating expenses of the STF including for the departments of transportation and motor vehicles.

EXPANSION OF PLEDGED RESOURCES

Pledged revenues include taxes and fees on motor vehicle fuel, casual vehicle sales and licenses. The legislature expanded pledged revenues in its 2015 session to accelerate transportation capital spending; however, revenue changes were partly delayed as the state sought to shore up projected weak general fund performance, highlighting the historical linkage between the STF and the state's general operations.

Under the 2015 expansion of pledged resources, all taxes on oil companies' gross earnings and a designated portion of the statewide sales tax are now deposited directly to the STF and pledged to bondholders; the sales tax deposit has been phased in through fiscal 2018. The inclusion of sales taxes in pledged revenues broadened the base of economic activity from which collections derive beyond transportation while tying future trends more closely to underlying state economic performance. Oil company tax collections are correlated to broader energy market trends, which exposes the STF to more heightened cyclicality, in Fitch's view.

The legislature enacted several adjustments to the STF in its June 2017 special session, the most extensive of which is the five-year phase-in, beginning in fiscal 2021, of new motor vehicle sales taxes deposited to the STF. The state estimates a beginning net $59.5 million addition to the STF in fiscal 2021, escalating over the phase-in period. In 2017, the legislature also referred a constitutional amendment for voter consideration in November 2018 that would ensure that all monies once deposited to the STF are solely applied to transportation purposes, including debt repayment. The legislature would retain the ability to adjust rates and revenue allocations prior to pledged revenues deposit to the STF.

MULTI-YEAR PLANNING

The state actively manages the STF through a five-year forecast period to maintain ample resources for projected debt service, capital program needs and operating expenses. The STO bond program is very well established, with a 20-year maturity for each series and flexibility to slow capital projects as necessary. Offsetting these strengths are forecast debt service that generally rises faster than pledged revenues and large planned spending for transportation capital which the state indicates would rely on the identification of additional funding sources.

Connecticut announced a major expansion of transportation capital spending in 2015 under the "Let's Go CT!" initiative, intended as a multi-decade effort to address longstanding transportation needs beyond those already funded through the existing capital program. Fitch believes continued enhanced funding of the capital program will remain dependent on the sufficiency of available STF resources.

GENERAL FUND SHIFTS

Interdependence with the state general fund has led to revenue or cost shifts during periods of general fund fiscal stress, most recently in fiscal 2016. Although the Let's Go CT! initiative included the statutory designation of the STF as a perpetual fund, limiting the use of resources to only transportation, the new designation did not prevent the state from delaying the originally planned sales tax allocation phase-in to address general fund revenue underperformance. Comparable state action on dedicated revenues following an affirmative result on the November 2018 constitutional ballot question remains a possibility, in Fitch's view.

As of fiscal 2017, the major revenues in the STF consist of motor fuels tax (35%), motor vehicle receipts (17%), oil company tax (17%), license, permit and fee revenues (10%), and a portion of statewide sales tax (13%). The latter reflects the second year of the sales tax phase-in through fiscal 2018, when it is forecast to constitute 21% of STF revenues.

UNDERLYING GROWTH PROSPECTS STEADY

Underlying performance of most of the transportation-related receipts deposited to the STF is economically sensitive and not fast-growing, and Fitch expects growth prospects going forward to generally match historical trends.

Motor fuels taxes fell by 3.8% in fiscal 2017, largely reflecting a decline in the diesel fuels tax component as gasoline taxes modestly increased. Going forward, the state forecasts relatively flat to declining collections through fiscal 2022. Motor vehicle receipts also fell, by 3.4%, in fiscal 2017 and the state has forecast essentially flat performance over the forecast period.

The oil company tax is more volatile, as it reflects broader crude oil price trends. The tax has fallen for three consecutive years, from fiscal 2015 through 2017, although it is expected to grow rapidly in fiscal 2018 and beyond with forecast gains in oil prices. The portion of the general statewide sales tax deposited to the STF is currently forecast to grow to $323 million in fiscal 2018, up from $109 million in fiscal 2016. The allocation of new motor vehicle sales taxes to the STF beginning in fiscal 2021 will serve to further boost this revenue source. The state's forecast for fiscal 2022 projects sales tax revenue as a close equal component of the STF ($501 million) compared to the motor fuels tax ($498 million).

Fiscal 2017 STF revenues increased 3.1% overall due to the sales tax deposit, more than offsetting declines in the majority of revenue sources. Fiscal 2017 ended with a cumulative fund surplus of $97.6 million, or about 7% of net revenues. Pledged revenues covered combined outstanding fiscal 2017 senior and second lien debt service by 2.6x. Including the current sale, Fitch calculates that fiscal 2017 pledged revenues cover projected MADS in fiscal 2019 by 2.4x.

The state's multi-year forecast assumes annual bond issuance through fiscal 2022. Based on these assumptions and the increasing deposits of sales tax revenue, annual coverage of outstanding senior and second lien bonds would equal 2.4x in fiscal 2022. Over the forecast period through fiscal 2022, pledged revenues would grow at an average pace of 5.7% annually given the phase-in of newly pledged revenues.

HIGH RESILIENCY IN DOWNTURN SCENARIO

To evaluate the sensitivity of the dedicated revenue stream to cyclical decline, Fitch considers the results of the Fitch Analytical Sensitivity Tool (FAST), using 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. Based on a 16-year pledged revenue history, FAST generates a 4% scenario decline in pledged revenues. Pledged revenues could withstand a decline equal to 15x the scenario output and still meet MADS. Assuming full leveraging to the ABT, pledged revenues could withstand a decline equal to almost 13x the scenario output - a high level of resiliency. The largest consecutive revenue decrease occurred in fiscal 2003 when revenue declined by 7.8%.

For additional information on the state of Connecticut see "Fitch Rates Connecticut GO Bonds 'A+' and CHESLA Bonds 'A'; Outlook Stable" dated Dec. 6, 2017 and available at www.fitchratings.com.

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Applicable Criteria
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