29 SEP 2023

# Fitch Rates Connecticut's $1.2 Billion STO Bonds 'AA-'; Outlook Stable

Fitch Ratings - San Francisco - 29 Sep 2023: Fitch Ratings has assigned a 'AA-' rating to the State of Connecticut's $1.215 billion special tax obligation (STO) bonds, consisting of:

--$875 million special tax obligation bonds transportation infrastructure purposes 2023 series A;

--$340 million special tax obligation refunding bonds transportation infrastructure purposes 2023 series B.

The STO bonds will be offered by negotiated sale the week of Oct. 16, 2023. Par amounts are subject to change pending final sale.

In addition, Fitch has affirmed the rating on Connecticut's outstanding STO bonds at 'AA-'.

The Rating Outlook is Stable.

## SECURITY

STO bonds are secured by a gross lien on transportation-related pledged revenues and other receipts deposited to the special transportation fund (STF) prior to any other uses. The largest pledged revenue sources are a portion of statewide motor vehicle and general retail sales and use taxes, a motor fuels tax, a tax on gross earnings of oil companies, and motor vehicle registration receipts.

## ANALYTICAL CONCLUSION

The 'AA-' ratings and Stable Outlook on Connecticut's STO bonds reflect superior resiliency of the financing structure, the state's active management of STF revenues, and otherwise slow underlying growth prospects for transportation revenues, similar to other states.

The rating on the STO bonds remains capped at the state's 'AA-' IDR, given the state's ability to statutorily adjust the rates of pledged taxes and fees and their distribution. All outstanding STO bonds have been issued under a senior lien, with no second lien bonds outstanding or contemplated.

## KEY RATING DRIVERS

Growth Prospects Slow: Slow underlying growth prospects for transportation-related revenues pledged to the bonds are similar to other states and reflective of an 'a' assessment. The pledge of portions of statewide sales taxes adds diversity to the pledge beyond transportation receipts and supports expectations for steadier growth over time. Revenue trends are affected by active state management to augment resources for transportation capital and operating needs.

Leverage Limits and High Resiliency: Receipts are economically sensitive and subject to legislative adjustments, but pledged revenues can absorb a sizeable decline and still provide sufficient coverage of debt service supporting an 'aaa' assessment for resilience. A 2x maximum annual debt service (MADS) additional bonds tests provides a strong cushion for bondholders in the event of cyclical declines.

Rating Capped by State IDR: The credit is exposed to the operating performance of the state of Connecticut given the state's ability and demonstrated willingness to alter the flow of revenues to the transportation fund. This interdependence caps the STO rating at the state's 'AA-' IDR.

## RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--An upgrade of Connecticut's IDR and maintenance of resilience and revenue growth prospects, absent state actions, at least in line with recent trends.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--A material and sustained erosion in pledged receipts that reduces resilience of the structure, or state actions that reduce pledged revenues to the STF or otherwise narrow the resilience of the structure;

--A downgrade of Connecticut's IDR, given that the rating on STO bonds is capped by the state's IDR.

## ECONOMIC RESOURCE BASE

Connecticut's economy is anchored by a sophisticated, defense-related manufacturing sector, important finance and insurance sectors in Fairfield County and Hartford, respectively, health and education institutions, and tourism linked in part to Native American gaming in the southeast. Population growth in Connecticut, like much of the northeast, is well below the U.S. average in recent decades. 2022 census data points to modest 1.5% uptick since the 2010 census, stronger than recent annual estimates although below neighboring states and national trends.

## DEDICATED TAX CREDIT PROFILE

The 'AA-' rating reflects the underlying credit quality of the bonds' structure and its linkage to the state's overall credit quality, reflected in the state's 'AA-' IDR. The credit is exposed to the operations of the state of Connecticut by virtue of the state's ability to statutorily adjust the rates of pledged taxes and fees.

Voters approved a constitutional dedication of revenues held in the STF for transportation purposes in 2018, though the legislature retains discretion to adjust rates of pledged revenues prior to deposit into the STF. There is otherwise no annual appropriation requirement. Some of these adjustments constrain resilience, while some enhance resilience. This was demonstrated in the fiscal 2020-2021 biennium, when the scheduled phase-in of expanded sales tax deposits to the STF was modified to support the general fund, and in the fiscal 2022-2023 biennium, with the passage of a highway use fee on truck traffic as of Jan. 1, 2023.

Connecticut was also one of a handful of states implementing a gas tax holiday, which spanned portions of fiscal 2022 and 2023. The gas tax holiday is estimated to have reduced STF revenues around $90 million in fiscal 2022 and $200 million in fiscal 2023. There are no current plans for another gas tax holiday.

For additional information on Connecticut's IDR, please see Fitch's May 2023 press release "Fitch Rates Connecticut's $700 Million GO Bonds 'AA-'; Outlook Stable," at www.fitchratings.com.

STO bonds issued under Connecticut's longstanding transportation borrowing program are supported by a first claim on pledged revenues and other receipts deposited to the STF, consisting primarily of transportation-related taxes and fees. Monthly deposits for debt service are made on a one-sixth, one-twelfth basis, and a debt service reserve is cash-funded at MADS. All outstanding bonds are on a senior lien, with remaining issuance under a second lien having fully amortized in April 2020.

After issuance of the bonds, approximately $8.1 billion will be outstanding under the senior lien, all of which has been issued at fixed rates and a 20-year maximum amortization. Leverage of pledged resources is limited by minimum required coverage of 2x maximum annual debt service (MADS) in any 12 consecutive months of revenues in the 18 months prior to issuance of additional bonds. The bonds also carry a rate covenant requiring 2x annual coverage.

Fiscal 2022 pledged revenues of $2.0 billion were a 12.6% increase over fiscal 2021, as statutory increases to the share of state sales taxes pledged to bondholders and increased receipts from taxes on oil companies more than offset sizeable decreases to motor fuels tax charged on gasoline, diesel largely due to gas tax holidays.

Fiscal 2022 pledged revenues consisted of a fixed portion of the statewide general sales tax ($703 million, 35% of the total); a motor fuels tax charged on gasoline, diesel and other fuels sold by distributors ($390 million, 19%); an oil companies tax on gross earnings from the sale of petroleum products containing oil derivatives ($387 million, 19%); various motor vehicle registration, inspection and user fees ($282 million, 14%); vehicle license, permit and fee revenues ($126 million, 6%); and a rising share of the sales tax levied on motor vehicles ($122 million, 6%).

The motor fuels tax has traditionally been the largest component, although the phase in of vehicle sales tax made the sales tax the largest component of STF revenue beginning in fiscal 2021. In fiscal 2022, 75% of vehicle sales tax were deposited to STF, up from 25%. Beginning fiscal 2023, 100% of the vehicle sales tax was shifted to the STF, bringing in a preliminary $703 million, or 40% of the $2.1 billion in total pledged revenues.

The STF also benefits from the fiscal 2023 implementation of a highway use fee on truck traffic in the state. The highway use fee generated a preliminary $30 million in fiscal 2023, and is projected to rise to $90 million in fiscal 2024.

Fiscal 2024 will also be the first full year of motor fuels tax levies since fiscal 2021. The state projects fiscal 2024 motor fuels tax revenues to increase 88% to $496 million. Motor fuels tax are forecast to regain their place as the STF's second-largest revenue stream, with 21% of fiscal 2024 revenues. The oil company tax is forecast to shrink slightly in fiscal 2024, as petroleum prices fall to somewhat lower than recently high levels. Increases in national gas price forecasts will likely positively affect oil company tax prospects.

STF revenues are closely monitored, with monthly updates by the state budget office and comptroller, and updates of a multiyear outlook at each state consensus forecast. After payment of debt service, receipts support the state's broad transportation needs, including expenses of the departments of transportation and motor vehicles and pay-go capital. The forecast of cumulative surpluses or deficits over time is regularly updated to reflect underlying economic and revenue trends, planned changes to taxes, fees and their distributions, operating and capital spending and state debt issuance plans.

Multi-year STF forecasts have typically shown narrowing surpluses or deficits later in the state's planning period. To ensure the STF retains a cumulative surplus, including as a cushion against revenue shocks such as what was experienced during the pandemic, the state has a longstanding practice of actively adjusting planned capital spending, debt issuance, revenues and expenses across a multiyear planning period. State projections anticipate small surpluses in the fiscal 2024-2025 biennium as the new revenue streams increase flow into the STF.

LIMITED TRANSPORTATION RECEIPTS GROWTH PROSPECTS

Fitch views growth prospects for the diverse mix of transportation and general receipts securing the STO bonds to be relatively flat over time, although the recent addition of new sales tax inflows and future collections from highway use fees could over time result in stronger growth to offset expected declines in fuels-based revenues. The dedicated revenue stream had a ten-year CAGR of 4.3% through fiscal 2022, but this CAGR reflects substantial rate changes and other state actions that increase receipts flowing to the STF, such as the deposit of vehicle-related sales taxes.

Transportation-related collections in Connecticut, similar to other states, are expected to be a flat-to-declining source of revenue in the absence of rate changes, particularly given factors such as rising fuel efficiency and the transition to alternative fuels.

SUPERIOR RESILIENCE OF PLEDGED RECEIPTS

To assess the resilience of the bond structure to potential cyclicality, Fitch considers how much cushion the structure could still provide under stress scenarios that assume full issuance to the ABT. The assessment relies on historical pledged revenue performance for these scenarios, which include stressing current revenues based on the largest actual historical decline and based on a moderate recession as provided by the Fitch Analytical Stress Test (FAST), a model which relates historical pledged revenue over time to GDP.

The state's demonstrated capability to statutorily redirect pledged revenues is offset by the ample cushion created by the current set of pledged revenues to move the resilience assessment to 'aaa'.

Based on fiscal 2022 net revenues of $2.0 billion and assuming full issuance to the 2x ABT, collections could fall 50% while maintaining sum-sufficient coverage of debt service. This level of cushion is a sizeable 5x the largest historical decline in pledged revenues (-10.2%, in fiscal 2020). Using the FAST model and revenue data through fiscal 2021, a separate scenario assuming Fitch's standard moderate GDP decline of 1.0% produces an expected revenue decline of 4.2%. This constitutes a superior level of resilience, with the structure's cushion at just under 12x the scenario revenue decline.

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

### REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

## Fitch Ratings Analysts

**Bryan Quevedo**
Director
Primary Rating Analyst
+1 415 732 7576
Fitch Ratings, Inc. One Post Street Suite 900 San Francisco, CA 94104

**Douglas Offerman**
Senior Director
Secondary Rating Analyst
+1 212 908 0889

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

## Media Contacts

**Sandro Scenga**
New York
+1 212 908 0278
sandro.scenga@thefitchgroup.com

## Rating Actions

| ENTITY/DEBT | RATING | RECOVERY | PRIOR |
|---|---|---|---|
| Connecticut, | | | |

| ENTITY/DEBT | RATING | | | RECOVERY | PRIOR |
|---|---|---|---|---|---|
| State of (CT) [General Government] | | | | | |
| • Connecticut, State of (CT) /Special Tax Oblig Trans Infr/ 1 LT | LT | AA- | Affirmed | | AA- |

| RATINGS KEY | OUTLOOK | WATCH |
|---|---|---|
| POSITIVE | | |
| NEGATIVE | | |
| EVOLVING | | |
| STABLE | | |

## Applicable Criteria

U.S. Public Finance Tax-Supported Rating Criteria (pub.04 May 2021) (including rating assumption sensitivity)

## Applicable Models

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

## Additional Disclosures

Solicitation Status

## Endorsement Status

| | |
|---|---|
| Connecticut, State of (CT) | EU Endorsed, UK Endorsed |

## DISCLAIMER & DISCLOSURES

All Fitch Ratings (Fitch) credit ratings are subject to certain limitations and disclaimers. Please read these limitations and disclaimers by following this link: https://www.fitchratings.com/understandingcreditratings. In addition, the following https://www.fitchratings.com/rating-definitions-document details Fitch's rating definitions for each rating scale and rating categories, including definitions relating to default. ESMA and the FCA are required to publish historical default rates in a central repository in accordance with Articles 11(2) of Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 and The Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019 respectively.

Published ratings, criteria, and methodologies are available from this site at all times. Fitch's code of conduct, confidentiality, conflicts of interest, affiliate firewall, compliance, and other relevant policies and procedures are also available from the Code of Conduct section of this site. Directors and shareholders' relevant interests are available at https://www.fitchratings.com/site/regulatory. Fitch may have provided another permissible or ancillary service to the rated entity or its related third parties. Details of permissible or ancillary service(s) for which the lead analyst is based in an ESMA- or FCA-registered Fitch Ratings company (or branch of such a company) can be found on the entity summary page for this issuer on the Fitch Ratings website.

In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third- party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that

## Endorsement policy

Fitch’s international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch’s approach to endorsement in the EU and the UK can be found on Fitch’s Regulatory Affairs page on Fitch’s website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.