FITCH RATES VERMONT'S $100MM GOS 'AAA'; OUTLOOK STABLE

Fitch Ratings-New York-11 August 2017: Fitch Ratings has assigned a 'AAA' rating to the following state of Vermont general obligation (GO) bonds:

--$33.465 million GO bonds, 2017 series A (Vermont Citizen Bonds) (negotiated);
--$66.88 million GO bonds, 2017 series B (competitive).

The bonds are expected to sell the week of Aug. 21, 2017; the series A bonds through negotiation and the series B bonds through competitive bid.

In addition, Fitch affirms the state's 'AAA' Issuer Default Rating (IDR) and the 'AAA' rating on the state's outstanding $577.06 million GO bonds.

The Rating Outlook is Stable.

SECURITY
The bonds are general obligations of the state of Vermont backed by the state's full faith and credit.

KEY RATING DRIVERS

Vermont's 'AAA' IDR primarily reflects conservative financial management, including prompt action to address projected budget gaps as they emerge, and maintenance of sound reserves. Vermont's economic growth has been steady but below national rates. The moderate long-term liability burden, measured as a percentage of personal income, is above the states' median but should remain relatively stable given state changes to improve pension sustainability over time.

Economic Resource Base
Vermont's small and modestly growing economy has a larger-than-average reliance on health and educational services, manufacturing, and tourism and remains exposed to several key large employers. During the recession, Vermont's peak-to-trough monthly employment loss of 4.8% (seasonally adjusted levels) was less severe than the national 6.3% decline. The state's jobs recovery has been on par with the national trend. Vermont's population is older than most states' and domestic out-migration continues to pose a challenge. The state's labor force has been flat to declining over the past decade, in contrast to slow growth at the national level. As with several other New England states, high educational attainment levels provide some potential for more accelerated economic gains, but the state has not fully benefited from that potential to date.

Revenue Framework: 'aaa' factor assessment
Fitch anticipates Vermont's revenues used for direct state operations will grow at a moderate pace, reflecting our expectations for the state's economy. Property taxes represent the largest component of state revenues and have grown at a robust rate, but these revenues do not drive the state's overall revenue framework. Property tax revenues are essentially passed through to school districts, rather than used for state operations, and are adjusted annually based on multiple factors include decisions of voters in local school districts. The state has complete legal control over its revenues.

Expenditure Framework: 'aaa' factor assessment

The state maintains ample expenditure flexibility with a low burden of carrying costs for liabilities and the broad expense-cutting ability common to most U.S. states. Vermont has been particularly focused on addressing healthcare spending, including Medicaid, which is a key expense driver.

Long-Term Liability Burden: 'aa' factor assessment
Vermont's long-term liabilities burden is moderate and above the median for U.S. states.

Operating Performance: 'aaa' factor assessment
Fitch anticipates Vermont will utilize its broad gap-closing capacity to manage through economic downturns while maintaining a high level of fundamental financial flexibility. The state has taken steps during the expansion to expand its flexibility and position itself well for the next downturn.

RATING SENSITIVITIES
The rating is sensitive to changes in the state's fundamental credit characteristics. Weakened fiscal discipline or material deterioration in economic growth prospects could negatively affect the rating.

CREDIT PROFILE

Revenue Framework
The state's revenues used for direct state operations consist primarily of personal and corporate income taxes, sales and use taxes, and a meals and rooms tax meant to export a share of the tax burden to visiting tourists. Vermont also levies a state property tax for education, an unusual feature for state governments, which is the largest source of total state revenues. Since Vermont essentially passes through property tax collections to local school districts, Fitch discounts the importance of this stream in the revenue framework assessment. There are no legal limitations on the state's ability to raise revenues.

Fitch anticipates steady growth in Vermont's revenues, just ahead of inflation, given the state's moderate economic growth prospects. Vermont's historical total tax revenue growth, adjusted for policy changes, has been slightly positive on a real basis.

Vermont has no legal limitations on its ability to raise revenues through base broadenings, rate increases, or the assessment of new taxes or fees.

Expenditure Framework
Education is the state's largest expenditure from own-source revenues, driven by the unique funding system in Vermont with the state covering the full cost for locally administered K-12 schools primarily through the property tax, a general fund appropriation, and a share of the sales and use tax. Health and human services, primarily Medicaid, is the second-largest expenditure area.

Spending growth, absent policy actions, will likely be slightly ahead of revenue growth, driven primarily by Medicaid, requiring regular budget measures to ensure ongoing balance. The fiscal challenge of Medicaid is common to all U.S. states, and the nature of the program as well as federal government rules limit the states' options in managing the pace of spending growth.

Federal action to revise Medicaid's programmatic and financial structure remains a possibility given recent federal legislative and administrative efforts. Most proposals to date include a basic restructuring of federal Medicaid funding to a capped amount. Whether a change in federal Medicaid funding has consequences for Fitch's assessment of a state's credit quality would depend on the state's fiscal response to those changes. Responses that create long-term structural deficits or increase liability burdens could negatively affect both the expenditure framework assessment and the IDR.

Vermont has been particularly aggressive in addressing the long-term national trend of steadily rising healthcare costs (including Medicaid), with the most recent effort being a shift towards outcome-based care under an 'all-payer' system, rather than the traditional fee-for-service model. This January, Vermont started an initial all-payer pilot program with Medicaid patients. Under terms of agreements with the federal government for the all-payer system, Vermont will transition Medicare and Medicaid to an outcome-based accountable care organization model, with the goal of getting participation from private insurers and providers as well over the program's initial five-year period.

For education, state spending growth pressure is somewhat offset by the funding structure as school districts' property tax rates (collected by localities on behalf of the state) increase when voter-approved school district budgets increase. Revenue growth does not fully mitigate spending increases though, exposing the state to a level of ongoing expenditure growth as reflected in the steadily growing annual state general fund appropriation to the education fund.

Vermont's fixed carrying cost burden is low and Fitch anticipates it remaining stable given the state's commitment to full actuarial contributions to its pension systems and careful management of debt issuance. Overall, the state retains ample flexibility to adjust main expenditure items.

Long-Term Liability Burden
Vermont's combined burden of debt and unfunded pension liabilities is a moderate 11.3% of personal income, based on the most recently available data and Fitch's revised 6% investment return assumption for pension plans. Debt levels remain modest at just 2% and are closely monitored through the state's Capital Debt Affordability Advisory Committee (CDAAC). The governor and legislature consistently stay within CDAAC's recommendations for annual bond issuance.

Net pension liabilities are more significant. The pension liability calculations include essentially 100% of the liability in the Vermont State Retirement System and the State Teachers' Retirement System, for which the state makes the full actuarial contribution. Market losses during the last two recessions contributed to recent growth in net liabilities for both systems. Since the Great Recession the state has negotiated with employee groups and implemented multiple changes including to benefits, contributions, and actuarial methods to improve pension sustainability over time. Given recent shifts to somewhat more conservative actuarial assumptions, including a decrease in the investment return assumption to 7.5% from 7.95%, Fitch anticipates Vermont's long-term liability burden will remain consistent with a 'aa' assessment over the long term.

Operating Performance
Vermont's exceptionally strong gap-closing capacity derives from institutional and statutory mechanisms, and a demonstrated ability to prudently manage through economic downturns. Official revenue forecasts are updated at minimum twice a year through the Emergency Board, a consensus process involving the administration and legislature. During the Great Recession, the state moved to quarterly updates to enhance its ability to respond to rapidly changing fiscal circumstances. The governor can implement a spending reduction plan unilaterally (if a revenue forecast downgrades revenues less than one percent from the prior forecast) or with legislative cooperation. During the Great Recession, and again in a more recent shortfall, the governor, legislature, and other key stakeholders including employee unions, worked quickly and cooperatively to develop spending rescission plans to address emerging deficits. The state's recent trend has been to focus on expenditure cuts, such as negotiated wage reductions or programmatic cuts, rather than revenue increases.

The state maintains multiple budget reserves including fully-funded budget stabilization reserves (5% of revenues) in each of its three primary operating funds (general, education and transportation), and separate, fund-specific reserves or unreserved balances of lesser amounts. At fiscal year-end 2017, the various general fund reserves totaled just over $100 million, representing approximately 7% of general fund spending. Education fund reserves were approximately 5% of education fund spending. On a combined basis, total general and education fund reserves at the end of fiscal 2017 covered approximately 6% of general and education fund spending.

The state's budgeting practices tend to be conservative in forecasting and proactive through the fiscal year, with most fiscal years ending with a general fund budget surplus despite the lack of a statutory or constitutional balanced budget requirement. Through the economic expansion Vermont has maintained its primary budget reserves. Recently the state has taken steps to build in additional fiscal capacity through additional reserves including the general fund balance reserve (balance of $17.2 million at fiscal year-end 2017, or 1.2% of general fund revenues), a human services caseload reserve (newly established with $10 million at fiscal year-end 2017), and a 27/53 reserve that will set aside funds for the infrequent years with a 27th biweekly payroll or 53rd weekly Medicaid payment cycle ($5.3 million at fiscal year-end 2017). Based on the enacted budgets for fiscal 2018, and an anticipated general fund rescission plan (discussed further below), Fitch anticipates reserves will decline modestly in fiscal 2018 primarily to address one-time issues.

CURRENT DEVELOPMENTS

Fiscal 2017 general fund revenues were up slightly from the prior year (1.1%) and essentially in line with the January forecast. Slow personal income and sales tax revenue growth was offset by stronger than anticipated corporate income tax collections - the corporate income tax over-performance was attributable mainly to the processing of a series of anticipated refunds extending beyond the fiscal year-end. This $16.3 million in budgeted refunds was a key driver of a downward revenue revision for fiscal 2018 that the state's emergency board adopted at its July 2017 meeting.

Based on that new revenue forecast, the state entered the current fiscal year with a projected general fund revenue shortfall of $28.9 million, or approximately 2% of projected general fund revenues. The administration anticipates releasing its full rescission plan at an August 17 meeting of the joint fiscal committee and it will include a mix of recurring and one-time solutions. The one-time solutions, including use of the fiscal 2017 general fund surplus and a draw on the general fund balance reserve, are intended to address what the state considers a one-time bump in corporate tax refunds due mainly to recent mergers and acquisitions involving local companies.

For the education fund, the enacted fiscal 2018 budget includes draws on unallocated balances from prior years as well as on the budget stabilization reserve to fund a shift in the teachers' pension normal cost to the education fund from the general fund. The budget stabilization reserve balance is budgeted to decline to approximately $25 million, or 3.6% of revenues. In fiscal 2019, the state will allocate an additional cent of the sales tax (to 36% from 35%) to the education fund to offset the shift of the pension normal cost going forward. The governor also intends to recommend in his fiscal 2019 executive budget that the education fund budget stabilization reserve be restored to its 5% statutory maximum.

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

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Applicable Criteria
U.S. Public Finance Tax-Supported Rating Criteria (pub. 31 May 2017)
https://www.fitchratings.com/site/re/898466