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Ratings

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Vermont; General Obligation

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Credit Profile		
US$66.88 mil GO bnds ser 2017B due 08/15/2037		
Long Term Rating	AA+/Stable	New
US$33.465 mil GO bnds (Vermont Citizen Bnds) ser 2017A due 08/15/2037		
Long Term Rating	AA+/Stable	New
Vermont GO		
Long Term Rating	AA+/Stable	Affirmed

Rationale

S&P Global Ratings has assigned its 'AA+' rating and stable outlook to the State of Vermont's general obligation (GO) bonds, 2017 series A (Vermont Citizen Bonds) and 2017 series B. At the same time, S&P Global Ratings affirmed its 'AA+' rating on the state's GO debt outstanding and it's 'A+' rating on the state's moral obligation bonds. The outlook on all ratings is stable.

The ratings reflect our opinion of the state's:

- Strong financial and budget management policies that have contributed to consistent reserve and liquidity levels over time;
- Employment composition reflective of the U.S. economy that is characterized by average income levels and low unemployment rates, but a recent slower-than-average pace of growth by most measures and population declines in the past three calendar years;
- Well-defined debt affordability and capital planning processes, in our view, that have limited leverage and contributed to a modest tax-supported debt burden with rapid amortization of tax-supported debt; and
- Significant pension and other postemployment benefits (OPEB), which remain sizable relative to those of state peers despite some recent reform efforts.

The state's full faith and credit pledge secures the series 2017A and series 2017B bonds. Issuance proceeds will finance various capital projects within the state.

In our opinion, Vermont has a history of actively managing its budget over time, which we view as a positive credit factor. State statute requires Vermont to conduct revenue forecasts twice a year, in July and January. The budget is created off of estimates in January and updated after the July forecast. Most recently, the state's $1.6 billion fiscal 2018 budget was signed into law on June 28, 2017. The July 2017 forecast revised estimates downward slightly to peg a shortfall of $28.8 million or 1.8% of expenditures, which we consider minor. The state reports that the majority of the shortfall, 57%, stems from $16.3 million of corporate tax refunds that will be paid out in fiscal 2018. In addition, a large portion, 39%, of the gap is created from an $11.2 million downswing in personal income tax revenues. To address the shortfall, the state has created a rescission plan that includes using surplus from fiscal 2017 operations to close the gap. We believe the state's process for identifying, remediating, and monitoring budget shortfalls early in the fiscal year allows for flexibility of resolution.

Vermont also implemented a rescission plan for fiscal 2017 that closed a $21.04 million gap through several measures including underspending in Medicaid and a reduction in appropriations for fiscal 2017, which did not have 53rd pay week as did fiscal 2016. Preliminary unaudited results indicate the state ended fiscal 2017 with general fund revenues of $1.456 billion creating an operating gain of $34.3 million, which was offset by $5.8 million net transfers out to other funds and transfers to reserves of $28.5 million.

The general fund budget stabilization reserve has grown in recent years. In fiscal 2017, reserves increased 4.0% to $74.1 million from $71.25 million in fiscal 2016 and $69.31 million in 2015. The account's $74.1 million balance represents 4.8% of fiscal 2017 expenditures, which we consider good. In addition, the general fund balance reserve sat at $17.18 million at the close of fiscal 2017. The stabilization reserves for the general, transportation, and education funds ended the year at their statutory maximums of 5% of expenditures.

We anticipate that the relatively weak demographic trends in recent years will persist and continue to dampen the state's economic growth potential. Vermont's population of 624,594 has declined at an increasing rate in the past three years: by 0.02% in 2014, 0.14% in 2015, and 0.24% in 2016. The population grew slightly, by 0.11%, in 2013 after a 0.05% decline in 2012. Despite this weaker demographic pattern, income levels have expanded at a healthy pace and per capita personal income has been at or above that of the U.S. for the past eight years. However, Vermont's pace of economic recovery has been uneven and more recently, growth has lagged that of the U.S., a trend we expect to continue.

The state received approval to extend its Global Commitment to Health Medicaid waiver from the Centers for Medicare and Medicaid Services in October 2016. The approval granted is effective for a five-year term beginning Jan. 1, 2017, and ending Dec. 31, 2021. The state contends that updates to the terms of the waiver, including moving to a "per member per month" model from an aggregate budget neutrality agreement for consistency across the federal landscape, are minor and without major effect to operations. Given the uncertainty around health care in the federal landscape, the state reports that the potential impact from changes in federal law is indeterminate at this time.

In our view, Vermont's debt burden is moderate. We calculate fiscal year-end 2016 tax-backed debt per capita at only $1,069, while debt amortization is rapid, with most tax-backed debt maturing within 10 years. All of Vermont's tax-supported debt issuance is governed by a comprehensive capital and debt affordability process.

Vermont's pension liabilities are weak, in our view, with what we consider a relatively low three-year-average funded ratio of 66% across the two pension plans for which the state has a reported liability. Furthermore, we consider the funding discipline of Vermont's pension plans to be average. State contributions to Vermont's pension plans are expressed as a percent of payroll; however, the contribution amounts are based on actuarial determination. Vermont has historically funded its pension liabilities at actuarially determined levels. However, pension liabilities have grown considerably in the past several years and funded ratios steadily deteriorated through fiscal 2016 and are below those of state peers. Total annual plan contributions in fiscal years 2014 through 2016 did not cover a level equal to service cost and interest cost plus some amortization of the unfunded liability, according to our calculations, which we believe could weaken the strength of the state's pension liability profile over time.

In our opinion, OPEB liabilities also remain high with an unfunded liability of $1.82 billion or $2,917 per capita according to our calculations. The state created an irrevocable trust for the Vermont State Employees' Retirement System (VSRS) OPEB plan in fiscal 2007; however, there is limited asset accumulation in the fund. Before fiscal 2014, health care expenses related to The State Teachers Retirement System (STRS) were not explicitly budgeted or funded but were treated as an amortized actuarial loss. In fiscal 2014, the legislature created the Retired Teachers' Health and Medical Benefits Fund to separate health care expenses from the pension fund. The state reports that it is not currently making pre-funding contributions to either trust fund.

Based on the analytical factors we evaluate for states, on a scale of '1.0' (strongest) to '4.0' (weakest), we have revised our composite score for Vermont to a '1.8' from a '1.7' reflecting the state's weak pension liability profile.

Outlook

The stable outlook reflects our view that although Vermont has a very strong budgetary management framework, the state's slower-than-average economic growth will continue to pressure the budget during our two-year outlook horizon. In addition, pension and OPEB liabilities remain high relative to those of state peers. While we believe the state has implemented reform efforts to reduce its long-term retirement liabilities, including increasing pension contributions in excess of actuarially determined levels, we note that the funded ratio across plans has steadily decreased in recent years as the liability has rapidly grown. A demonstrated improvement in the economic metrics or the pension and OPEB liability position could translate into a higher rating. Although we do not envision it at this time, given Vermont's history of proactively managing the state budget and recent actions to address retirement liabilities, substantial deterioration of budget reserves or a deteriorating liability position could negatively pressure the rating.

Government Framework

Vermont does not have a constitutional or statutory requirement to enact or maintain a balanced budget, but it has consistently maintained sound finances. In our view, the state has significant flexibility to increase the rate and base of its major tax revenues, which include income taxes, sales taxes, and a statewide property tax that funds the state's support of local education. We view Vermont's revenue sources as diverse. The state does not allow voter initiatives. Vermont maintains the ability to adjust disbursements in order to maintain sufficient liquidity. Debt service can be paid without a budget, but there is no other legal priority for debt.

The state's tax structure is broad, and its revenue sources are diverse across several operating funds. The general fund relies primarily on unrestricted revenues from personal and corporate income, sales and use, and meal taxes.

The education fund relies primarily on a statewide property tax, and an appropriation from the general fund. The education stabilization reserve ended the year at the statutory maximum of 5% of expenditures. The transportation fund relies primarily on federal-match grant revenues, a motor vehicle license fee, and a motor fuel tax.

On a scale of '1.0' (strongest) to '4.0' (weakest), we have assigned a '1.6' to Vermont's government framework.

Financial Management Assessment: 'Strong'

S&P Global Ratings considers Vermont's financial management practices strong under its financial management assessment methodology, indicating financial practices are strong, well embedded, and likely sustainable.

Much of Vermont's debt and financial management practices are embedded in state statute. These, along with internally developed policies, guide the state's long-term budget and capital planning, debt management, and investing practices. The state has a well-established consensus revenue-estimating process. According to statute, the joint fiscal office and administration provides its respective revenue estimates for the general, transportation, and federal funds for the current and next succeeding fiscal year to the Vermont Emergency Board.

Vermont law also requires a long-term capital plan. The governor submits a capital budget annually to the General Assembly based on debt management provisions outlined by the state's capital debt affordability advisory committee. The committee's estimate is nonbinding, but the state legislature has never authorized new long-term GO debt in excess of the committee's estimated amount. The state has formal debt management policies, including a statutory debt affordability analysis developed by the capital debt affordability advisory committee that Vermont integrates into the operating budget development process and updates at least annually. Vermont has not entered into any interest rate swaps and thus does not have an adopted swap management policy. Statutory restrictions and adopted administrative policies govern investment management, and the office of the state treasurer monitors compliance.

Budget management framework

The state has multiple tools to assist financial management. Vermont monitors revenues and publishes results monthly; and the emergency board meets at least twice annually, in July and January, to evaluate the revenue forecast and make adjustments, if necessary. The state forecasts also include Medicaid revenues and spending. These consensus forecasting meetings can be convened more frequently, and were held quarterly during fiscal years 2008 through 2010, due to the recession and the potential impact on revenues and expenditures. The emergency board includes the governor and the legislative chairs of the house and senate fiscal appropriations committees. The forecasting process includes traditional economic and revenue forecasting, which Vermont performs with the assistance of outside economists, for the current and next succeeding fiscal year, as well as a less detailed forecast for the next eight years.

The governor has statutory authorization to adjust the budget within certain revenue and expenditure change limits when the Vermont Legislature is not in session. Vermont maintains stabilization reserve funds at statutory levels to reduce their effect on annual revenue variations. In 1993, the state created separate budget stabilization reserves within the general and transportation funds. The amount in each of these reserves is not to exceed 5% of previous-year appropriations. In fiscal 1999, the state created an education fund budget stabilization reserve, which is to fund in a range of 3.5%-5.0% of expenditures. Vermont statute requires annual funding of such reserves. The governor included a proposal in the fiscal 2013 executive budget to increase the general fund stabilization fund to 5.25% from 5.00%, but instead, the legislature added a general fund balance reserve fund with a separate cap of 5.00% of expenditures.

On a scale of '1' (strongest) to '4' (weakest), we have assigned a '1' to Vermont's financial management.

Economy

According to our report, "For U.S. State and Local Governments, The Resilient But Shallow Expansion Complicated Budget Management," published July, 24, 2017, on RatingsDirect, we expect the New England economy to continue to expand at the same pace we've seen over the past five years. Forecasts for GDP growth in 2018 are slightly above the region's forecast in 2017 and actual results recorded in 2016, with growth driven in large part by demand in the housing market. However, we expect most of this growth will be concentrated in Connecticut and Massachusetts. Other states in the region, including Vermont, are expected to see a decline in new housing construction as pent-up demand from the recession has largely been met.

Vermont's economy is driven by tourism, higher education, electronics, consumer-goods manufacturing, and agriculture. Exports continue to be an important part of the state's economy at 16% of gross state product (GSP), with a substantial portion going to Canada according to IHS Global Insight Inc. Exports in 2016 were primarily made up of computer and electronic products (63.6%) followed by food manufactures (6.8%), and machinery (4.84%). In 2016, Vermont's exports totaled $2.9 billion of which 39.7% was with Canada. Recent data from the International Trade Administration show that Vermont's export performance has deteriorated for six years, with total exports shrinking by 6% from 2015. The state's value of total exports in real terms has not been as low as it is currently since 2003, according to IHS Markit.

Vermont's employment diversity by sector is generally in line with the nation's, in our view, and has not demonstrated more cyclicality than when the U.S. Global Foundries completed its acquisition of IBM, which is the second-largest private-sector employer in the state and accounts for a large portion of the state's manufacturing employment and exports. Global Foundries employs about 2,600 at its Essex Junction plant, which manufactures semiconductors for consumer electronic products, including chips for cell phones and other devices. According to IHS Markit, a large portion of the state's manufacturing exports includes computers and electronics products from the facility. The Vermont Yankee nuclear power plant ceased power production at the end of 2014 and the facility is in the process of placing spent fuel into dry cast storage. Employment levels in 2015 reflected that development. The transition to site restoration will take multiple years, and state officials indicate that this close is not expected to immediately affect power prices, given that Vermont power companies do not purchase power from this plant.

The state reports it was the second state in New England to complete its labor market recovery from the last recession, following the State of Massachusetts. Health care employment, in particular, will be a growth driver; however, IHS Markit forecasts very slow total employment growth of 0.5% in 2017 and an average annual growth rate of 0.5% between 2017 and 2020, which is well below forecast national employment growth rates. Despite the slow forecast employment growth, IHS projects unemployment rates to remain low in the next few years at about 3.1%, as labor force growth will be stagnant. As of June 2017, the state's unemployment rate is 3.2%, which is below the U.S. rate of 4.4% for the same time period.

State income levels are strong in our opinion. State per capita income of $50,321 in 2016 was 102% of that of the U.S. However, GDP per capita of $49,780 in 2016 is only 87% of that of the nation and has historically remained at about this level. In 2016 and 2017, real state GDP rose 0.79% and 0.92%, respectively, compared with 1.54% and 2.58% for the nation.

Vermont's quality of life and well-educated workforce provide economic development opportunities; however, the state ranks low among the states in its business tax and regulatory environment and its slow labor force growth could stifle future economic growth prospects. Vermont's population has grown more slowly than the nation as a whole; for 2010-2016, its population decreased by 0.2% compared with the nation's growth of 4.7%. Furthermore, the state's aging population--34% over 55 and 18% over 65, compared with 28% and 15%, respectively, for the nation, will continue to be a drag on the state's growth potential in our view.

On a scale of '1' (strongest) to '4' (weakest), we have assigned a '2.1' to Vermont's economy.

Budgetary Performance

The fiscal 2018 general fund consensus revenue forecast was $1.51 billion for the fiscal 2018 budget. Appropriations total $1.561 billion and the budget projected a budget stabilization reserve of $77 million. The general fund consensus revenue forecast in July 2017 decreased the general fund revenue estimate for fiscal 2018 creating a shortfall of $28.8 million between revenues and appropriations. This decrease, according to the state, is due to a one-time event of increased corporate tax refunds and a decrease in the personal income tax forecast.

Preliminary unaudited results indicate the state ended fiscal 2017 with general fund revenues of $1.456 billion creating an operating gain of $34.3 million, which was offset by $5.8 million of net transfers out to other funds and transfers to reserves of $28.5 million. Vermont ended fiscal 2016--the last audited year--with the budget stabilization reserves in the general fund, transportation fund, and education fund fully funded at their maximum statutory levels of 5% of the previous year's budgetary appropriations, along with some additional reserves in the general fund. These three funds' stabilization reserves remained funded at their statutory maximums through the recent recession.

S&P Global Ratings considers the state's general fund revenues to be diverse, with personal income tax constituting 52% of fiscal 2016 revenue collections, while sales tax makes up 17% of revenues.

Vermont maintains separate budget stabilization funds in its general, transportation, and education funds that are available to offset undesignated fund deficits. The statutory maximum for the three stabilization reserves is 5% of the prior-year budgetary appropriations, and the education stabilization fund also has a statutory minimum of 3.5% of the prior-year appropriation. The three stabilization funds have been at their statutory maximums since fiscal 2007. Vermont pools the cash reserves for these major funds, which results in sufficient liquidity for operations during the fiscal year. Officials indicated that the state has not externally borrowed for liquidity since fiscal 2004.

On a scale of '1.0' (strongest) to '4.0' (weakest), we have assigned a '1.4' to Vermont's budgetary performance.

Debt And Liability Profile

Debt

Vermont's total tax-supported debt is moderate about $1,069 per capita, or 2.1% of personal income and 2.1% of GSP.

The fiscal 2016 tax-supported debt service was low, in our view, at about 2.1% of general governmental expenditures. Vermont's debt portfolio consists of only fixed-rate debt, without any exposure to interest rate swaps. The state also does not have any direct placement debt. We consider the debt amortization to be rapid, with officials retiring more than 68% of tax-supported debt over the next 10 years.

The state has a debt affordability committee that annually recommends a maximum amount of debt issuance for the next two fiscal years, and while the committee's recommendations are not binding, Vermont has consistently adhered to them. The authorization for fiscal years 2018 and 2019 totals $132.5 million, which is down 8.01% from the previous biennium recommendation of $144 million. Debt service can be paid without a budget, but there is no other priority for the payment of debt before other general state expenditures.

State pension liability

Vermont maintains three statutory defined benefit pension plans. The VSRS is a single-employer plan with about 8,436 active members. The STRS and Vermont Municipal Employees' Retirement System (MERS) are multiple-employer, cost-sharing plans with approximately 9,919 and 6,966 active members, respectively. The state appropriates funding for the first two systems; the municipal system is supported entirely by municipal employers and employees.

The state's unfunded pension liability represents Vermont's proportionate share of the VSRS and STRS plans. We consider Vermont's three-year-average, pension-funded ratio across the five pension plans to be relatively low at 66%. The state's pension-funded ratio as of June 30, 2016, is also considered relatively low at 62%, which is down from 65% in fiscal 2015 and 72% in fiscal 2014.

Vermont lowered its long-term investment return assumptions for the VSRS and STRS plans to 7.50% in July 2017 from the 7.95% rate agreed on in fiscal 2015. Through 2014, actuarial valuations used a "select and ultimate" method for developing interest rate assumptions where return assumptions varied by period ranging from 6.25% in year one to 9.0% in years 17 and later. The lower assumed discount rate is expected to increase required employer contribution rates in future fiscal years.

State contributions for VSRS and STRS are actuarially based and funding has been at least 100% of the actuarially determined contribution (ADC) historically, which we view positively. Vermont budgets for pension contributions based on percentage rates of each member's annual earnable compensation and the actuarial valuations from the previous fiscal year. It budgets for the STRS ADC appropriation at the beginning of the year. The VSRS ADC accrues as a percent of salary expenses throughout the year and the state adjusts subsequent appropriations to reconcile variations in actual payroll from year to year to meet the projected ADC. Each plan's actuary recommends a contribution amount and each plan's retirement board reviews the actuary's recommendations annually before submitting their recommendation to the governor and both houses of the legislature for inclusion in Vermont's annual budget. The legislature is not required to follow the recommendations of the actuaries or governor.

Since fiscal 2012, actual annual contributions to the systems have exceeded the respective ADCs, which state officials attribute to conservative budgeting. For VSRS, actual contributions of $54.3 million in fiscal 2016 represented 118% of the pension ADC. For STRS, actual contributions (from employers and non-employers) of $76.948 in fiscal 2016 represented 106.3% of the ADC. We note that aggregate annual plan contributions across the two plans were under amounts necessary for the plans to cover a portion of the amortization in unfunded liability as well as certain cost drivers of the annual change in the liability, according to our calculations, which we believe could weaken the strength of the state's pension liability profile over time.

We believe, on the whole, management factors and actuarial inputs do not significantly encumber or improve our view of the state's overall pension funding discipline. VSRS and STRS assume a closed amortization schedule of which 21 years remain; however, the plans use the level percentage of pay method, which assumes rising future payroll and results in escalating absolute pension contributions over time. The VSRS plan reported a return of 1.69% in 2016 and the STRS plan reported a return of 1.44% in the fiscal 2016 comprehensive annual financial report. Neither plan projects an asset depletion date under the most recently available Governmental Accounting Standards Board reporting as of June 30, 2016, which includes projected fiduciary net position cash flows based off of the state's since retired select-and-ultimate interest rate assumption method (ranging from 6.25 to 9.00%) due to lags in reporting. We believe the underlying assumptions under this reporting including the interest rate method and mortality assumptions are unrealistic. Officials note that the select-and-ultimate method was discontinued for reporting effective fiscal 2015 when the interest rate assumption changed to 7.95% and reporting in fiscal 2017 will include an interest rate assumption of 7.5%. In addition, officials note that mortality assumptions have been tested for reasonability against more recently published tables and will be updated for fiscal 2017.We note that the state has hired a new actuary firm that is currently completing reviews of certain assumptions. We believe changes in assumptions could change liability projections in the future. The STRS plan's ratio of active members to beneficiaries equals 1.05, which is significantly below the median national ratio of 1.50. The VSRS plan's ratio is slightly higher at 1.28. We believe the plans incorporate experience trends and industry standards in their experience studies conducted at least every five years.

Vermont's proportionate share of the plans' net pension liability translates into what we view as a moderate $3,131 per capita and 6.4% of personal income.

Other postemployment benefits

Vermont offers postemployment medical insurance, dental insurance, and life insurance benefits to retirees of the multiemployer STRS and the single-employer VSRS. While the state's unfunded OPEB liability is relatively high, in our view, at $2,917 per capita, Vermont has made plan adjustments to manage the liability.

The VSTRS plan enrolled its retirees in a Medicare Part D Employer Group Waiver Plan (EGWP) from a retiree drug subsidy program as of Jan. 1, 2014, in part to achieve cost savings. As of June 30, 2014, however, the VSTRS OPEB unfunded actuarial accrued liability (UAAL) increased 7.6% to almost $767 million, reflecting demographic experience and other refinements of estimated savings related to the EGWP implementation. The unfunded liability rose again in fiscal 2015 to $1.003 million or by 31% primarily due to updates to the methodology used in setting cost assumptions based on revisions to actuarial standards. The plan's cost-setting assumptions were updated again in fiscal 2016 using actual claims information for the plan's population and resulted in a decrease of the plan's UAAL by $325.2 million or 32.4% as of June 30, 2016. ADCs were approximately $52 million in fiscal 2016 and $45 million in fiscal 2015. State contributions under pay-as-you go financing of $31.6 million in fiscal 2016 and $25 million in fiscal 2015 represented 52% and 56% of actuarially determined levels, respectively. Before fiscal 2015, health care expenses for the plan's retirees were paid through a sub-fund of the defined benefit pension trust fund and no state contribution was explicitly budgeted or funded.

Vermont's VSRS plan enrolled in Medicare's EGWP a year after STRS and was effective as of Jan. 1, 2015. The state has also established an OPEB trust fund for the VSRS, but as of June 30, 2016, it contained only $21.4 million of assets, for a 1.8% actuarial asset funded ratio. The plan has an unfunded liability of $1.1 billion as of June 30, 2016, which is 4.7% higher compared with 2015. The actuarial annual OPEB cost in fiscal 2014 was $76.2 million for the plan, of which Vermont paid almost 45% under pay-as-you-go funding. .

The separate multiemployer Vermont Municipal Employees Health Benefit Fund for local government is administered by the state, but has no liability to the state, and is not included in our OPEB calculations.

On a scale of '1.0' (strongest) to '4.0' (weakest), we have assigned a '2.7' to Vermont's debt and liability profile.

Ratings Detail (As Of August 11, 2017)		
Vermont GO		
Long Term Rating	AA+/Stable	Affirmed
Vermont GO		
Long Term Rating	AA+/Stable	Affirmed
Vermont GO bnds		
Long Term Rating	AA+/Stable	Affirmed