

Research

Vermont; General Obligation

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Credit Profile

US\$50.0 mil GO bnds ser 2014 B due 08/15/2034		
<i>Long Term Rating</i>	AA+/Stable	New
US\$36.055 mil GO rfdg bnds ser 2014 C due 08/15/2027		
<i>Long Term Rating</i>	AA+/Stable	New
US\$25.0 mil GO bnds (Citizen Bnds) ser 2014 A due 08/15/2024		
<i>Long Term Rating</i>	AA+/Stable	New
Vermont GO		
<i>Long Term Rating</i>	AA+/Stable	Outlook Revised

Rationale

Standard & Poor's Ratings Services revised the outlook on Vermont's general obligation (GO) bonds to stable from positive, and affirmed its 'AA+' rating on the bonds. At the same time, Standard & Poor's assigned its 'AA+' rating, with a stable outlook, to Vermont's series 2014 A, B, and C GO bonds.

The outlook revision reflects Vermont's slower-than-average economic recovery, which continues to pressure the budget, in our view.

The ratings reflect our opinion of the state's:

- Diversifying economic base that is characterized by above-average income levels and low unemployment rates but a slower-than-average pace of growth by most measures recently;
- Strong financial and budget management policies that have contributed to consistent reserve and liquidity levels over time;
- 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 GO bonds are secured by Vermont's full faith and credit pledge. The bond proceeds will be used for various capital projects and refunding of certain outstanding debt for interest cost savings.

Demographic trends for Vermont have been weak relative to the region and national trends. The estimated population of 627,000 in 2013 is only 0.1% above 2010 levels. Despite this weaker demographic pattern, income levels have expanded at a healthy pace and per capita personal income has been above the U.S. for the past three years. Vermont's pace of economic recovery has been uneven and more recently, growth has lagged the U.S.; we expect this to continue.

The state has actively managed its budget over time, which is a credit strength, and has consistently maintained financial reserves, providing flexibility to address midyear budget imbalance. Unaudited budgetary basis results for

fiscal 2014 indicate a \$14 million operating surplus in the general fund before transfers. After transfers, the state projects a slight decline in the total general fund reserve balance to \$71.2 million (5.1% of general fund expenditures) from \$74.4 million. For the general fund, the budget stabilization reserve increased to \$66.2 million and an additional \$5 million was available in the reserve for general fund surplus/revenue shortfall reserve. This additional reserve was established by the legislature in 2012. This reserve can be funded with budget surpluses after the existing budget stabilization fund and other statutory requirements are funded, up to a level of 5% of prior-year appropriations. The education and transportation fund reserves were also maintained at their statutory maximum of 5% at year-end. General fund tax revenues for fiscal 2014 of 3.6% were above fiscal 2013's. Growth in fiscal 2013 was 8%, which we consider strong, due to federal tax policy changes during that year.

The revenue projection for the fiscal 2015 general fund budget is now \$1.37 billion following a downward adjustment in July of this year of \$28.8 million, or about 2%. The most significant adjustment was corporate income tax revenue, which was adjusted down by 1%. There were also slight revisions in the education and transportation fund revenues. Despite these revisions, the budgets for the general, education, and transportation funds project ending balances at statutory maximums at the end of fiscal 2015. The state immediately implemented a rescission plan that reduces certain appropriations and adjusts certain revenue items. We believe this swift action should ensure balance at year-end; however, year-to-date tax revenue collections are below the revised estimate, which we think could lead to additional revisions.

Officials indicate that through the first four months of fiscal 2015, general fund tax revenues are about 2.7% below forecast, with the primary negative variance in personal income tax collections. The transportation and education fund revenues are performing in line with revised estimates.

The state has expanded Medicaid under the Affordable Care Act (ACA) and has established a health benefits exchange. Vermont currently enrolls individuals who earn up to 350% of the poverty line in state health programs so the ACA eligibility expansion has resulted in some recurring federal revenue to the state as well as federal funds for other elements of implementation including grants to develop its health benefits exchange. The state has had some technical and security issues with the exchange but officials indicate they have been able to continue enrollment. We believe that ACA implementation and general caseload activity could pressure the state's budget in the future. Vermont currently plans to implement universal health care coverage for all residents by calendar year 2017 but it will need a federal waiver to implement and other triggers must be met before implementation occurs.

Vermont's debt burden is moderate overall and all tax-supported debt issuance is governed by a comprehensive capital and debt affordability process. Pension liabilities have grown considerably during the past several years and funded ratios steadily deteriorated through fiscal 2013. The state has increased pension funding toward annual required contribution (ARC) levels, and contributions in fiscal years 2012-2014 were significantly above the actuarially determined annual pension costs of the two pension systems. We expect that these higher contributions should improve funding levels in future years. The updated pension valuations for fiscal 2014 indicate that funding levels improved under the new GASB 67 reporting requirements with assets reported on a market value basis. Despite this improvement, funded ratios have been below those of state peers. OPEB liabilities also remain high, with limited asset accumulation despite the creation of a trust fund.

Based on the analytical factors we evaluate for states, on a scale of '1' (strongest) to '4' (weakest), we have assigned Vermont a composite score of '1.7'.

Outlook

The stable outlook reflects Vermont's slower-than-average economic recovery, which continues to pressure the budget, in our view. In addition, pension and OPEB liabilities remain high relative to those of state peers. We believe that the state has a very strong budget management framework and should this lead to improved reserve levels in the future, a higher rating could be warranted. In addition, we believe that there has been progress in increasing pension contributions and the state has taken certain actions to begin to address OPEB liability. Improved liability position could also translate to a higher rating. Although we do not envision it at this time, given Vermont's history of proactively managing its budget and recent actions to address retirement liabilities, substantial deterioration of budget reserves or a deteriorating liability position could negatively pressure the current 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 the state's revenue sources as diverse. Voter initiatives cannot affect the state. 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.

Vermont'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' (strongest) to '4' (weakest), we have assigned a '1.6' to Vermont's government framework.

Financial Management

Financial Management Assessment: 'Strong'

Standard & Poor's considers Vermont's financial management practices "strong" under its FMA 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 provide their 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 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 state also forecasts Medicaid revenues and spending.

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 between 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%, but instead, the legislature added a second general fund reserve fund with a separate cap of 5% of expenditures.

On a scale of '1' (strongest) to '4' (weakest), we have assigned a '1.0' to Vermont's financial management.

Economy

Vermont's population has grown more slowly than the nation as a whole; for 2000-2010, its population grew by only 0.26% compared with the nation's 0.9%. The state's age dependency ratio in 2013 grew to 56.7%, which is still 3.1% below the U.S. level, although the difference has narrowed from previous years. Although the state's per capita personal income in 2013 was slightly above the nation's, at 103% of the national level, its nominal gross state product (GSP) was only 89% of the U.S. level. Still, real GSP growth was in line with the U.S. through 2013, growing at about

0.34% on average per year since 2010. Vermont's unemployment rate has historically remained well below the nation's, including 4.4% in 2013 compared with 7.4% nationally. In September 2014, the state's unemployment rate remained at 4.4% compared with 5.9% for the nation.

The state reports it has recovered more than 76% of the jobs lost during the recession and we expect it will reach its pre-recession peak in mid-2015, based on IHS Global Insight forecasts. Health care employment, in particular, will be a driver of growth; however, IHS Global Insight forecasts very slow total employment growth of 0.6% in 2014 and an average annual growth rate of 0.64% between 2015 and 2017, 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 3.5%, as labor force growth will be stagnant. It projects real GSP and personal income growth to average 2% and 4.5%, respectively, during the 2015 to 2017 period. Although housing starts in the state declined in the first quarter of 2014 due to difficult winter weather, we expect slow growth in home construction and recovery of home prices in the near term similar to trends in the New England region (see "U.S. State And Local Government Credit Conditions Forecast," Oct. 15, 2014.). 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 employment diversity by sector is generally in line with the nation's, in our view, and has not demonstrated more cyclicity than the U.S. However, IBM, the second-largest private-sector employer in the state, accounts for a large portion of the state's manufacturing employment and exports. IBM employed about 4,000 at its Essex Junction plant, which manufactures semiconductors for consumer electronic products, including chips for cell phones and other devices. According to IHS Global Insight, a large portion of the state's manufacturing exports includes computers and electronics products from the IBM facility. In October 2014, GlobalFoundries announced it acquired IBM's semiconductor manufacturing operations, including the Vermont facility. We understand GlobalFoundries has indicated it intends to keep the site open and has no current plans for layoffs. The Vermont Yankee nuclear power plant is expected to cease power production by the end of 2014, although state officials indicated that this closure is not expected to immediately affect employment -- as the transition to site restoration will take multiple years -- or power prices, given that Vermont power companies do not purchase power from this plant.

On a scale of '1' (strongest) to '4' (weakest), we have assigned a '1.8' to Vermont's economy

Budgetary Performance

Vermont ended fiscal 2013 -- 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. Total general fund balance decreased by \$19.2 million to \$159.2 million.

The state 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' (strongest) to '4' (weakest), we have assigned a '1.4' to Vermont's budgetary performance.

Debt And Liability Profile

Debt

Including this issue, Vermont's total tax-supported debt was about \$1,004 per capita, or 2.2% of personal income and 2.1% of GSP. The fiscal 2014 tax-supported debt service was about 2.3% of general governmental expenditures. Vermont's debt portfolio consists of only fixed-rate debt, without any exposure to interest rate swaps. We consider the debt amortization to be rapid, with officials retiring more than 67.9% of GO 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 fiscal year, and while the committee's recommendations are not binding, Vermont has consistently adhered to them. The recommendation for fiscal 2016 and 2017 has not been finalized but based on preliminary information, debt issuance could be lower in both years based on current revenues estimates. Debt service can be paid without a budget, but there is no other priority for the payment of debt before other general state expenditures.

Pensions

Vermont maintains three statutory pension plans: the Vermont State Teachers' Retirement System (VSTRS), with about 9,950 active members; the Vermont State Retirement System (VSRS), which includes general state employees and state police and has about 8,300 active members; and the municipal employees' retirement system (6,664 members). The state appropriates funding for the first two systems; the municipal system is supported entirely by municipal employers and employees. The pension systems' funded ratio for the combined VSTRS and VSRS systems is below average, in our view, at 67.6% as of June 30, 2014, and has declined from 72.7% as of June 30, 2010. The valuation uses a "select and ultimate" method for developing interest rate assumptions, which results in an effective expected rate of return of 8.1% for VSRS and 7.9% for VSTRS, which is somewhat high relative to state peers. The combined unfunded actuarial accrued liability (UAAL) at June 30, 2014 was \$1.5 billion, or \$2,426 per capita, which we also view as below average; however, the state estimates that the combined pension UAAL is lower at \$1.3 billion as of June 30, 2014, and about \$2,100 per capita under GASB 67 standards, reflecting higher actuarial value of assets based on market value and an assumed 8.2% expected rate of return.

The state budgets for pension contributions based on percentage rates of each member's annual earnable compensation and the actuarial valuations from the prior fiscal year. It budgets for the VSTRS ARC appropriation at the beginning of the year. The VSRS ARC accrues as a percentage of salary expenses throughout the year and the state adjusts subsequent appropriations to reconcile variations in actual payroll from year to year in order to meet the projected ARC. Since fiscal 2012, actual annual contributions to the systems have exceeded the respective ARCs, which state officials attribute to conservative budgeting. In fiscal 2014, actual contributions of \$56.5 million to VSRS represented 132% of the pension ARC. The actual contribution to the VSTRS system in fiscal 2014 represented 106%

of the ARC, which included amounts to be used toward the payment of retiree health care expenses.

OPEB

The state's unfunded OPEB liability is relatively high, in our view, at \$2,937 per capita, although the state has recently made plan adjustments to manage the liability. Vermont offers postemployment medical insurance, dental insurance, and life insurance benefits to retirees of the single-employer VSRS and the multiemployer VSTRS. The VSTRS plan's OPEB UAAL improved to \$713 million as of June 30, 2013, from \$827 million in June 2012, primarily reflecting a change to a Medicare Part D Employer Group Waiver Plan (EGWP) for prescription drug benefits from a retiree drug subsidy (RDS) program. As of June 30, 2014, however, the VSTRS OPEB UAAL increased to almost \$767 million, reflecting recent demographic experience and other refinements of estimated savings related to the EGWP implementation. The fiscal 2015 OPEB cost is almost \$45 million compared with \$42.8 million in fiscal 2014. The VSTRS contributes to the liability on a pay-as-you-go basis, but Vermont did not historically break out the actual employer contribution, including it, instead, through the pension contribution without an explicit appropriation. In 2014, Vermont passed legislation to establish a separate retired teachers benefit fund to fund current-year health care expenses, which will receive funding from general fund appropriations, EGWP subsidies, and a future health care fee for new hires.

The state has established an OPEB trust fund for the VSRS, but as of June 30, 2014, it contained only \$18.9 million of assets, for a 1% actuarial asset funded ratio. The actuarial annual OPEB cost in fiscal 2014 was \$67 million for the VSRS, of which Vermont paid almost 36% under pay-as-you-go funding. We understand the VSRS will also offer Medicare prescription drug benefits through an EGWP beginning Jan. 1, 2015. Before this change, the VSRS actuarial valuation had assumed the system contributed Medicare Part D refunds from the RDS program into the irrevocable trust fund. Assuming no future contributions to the trust after implementation of EGWP, the June 30, 2014 OPEB valuation assumed a lower 4% discount rate (from 4.25%) which, along with rising assumed per capita costs and demographic experience -- and despite the savings from the EGWP implementation -- increased the estimated OPEB UAAL to about \$1 billion from \$932 million as of June 30, 2013. 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' (strongest) to '4' (weakest), we have assigned a '2.6' to Vermont's debt and liability profile.

Related Criteria And Research

Related Criteria

- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- Ratings Above The Sovereign: Corporate And Government Ratings—Methodology And Assumptions, Nov. 19, 2013
- USPF Criteria: Financial Management Assessment, June 27, 2006

Related Research

- U.S. State And Local Government Credit Conditions Forecast, Oct. 15, 2014
- State And Local Government Ratings Are Not Directly Constrained By That Of The U.S. Sovereign, Aug. 8, 2011

Ratings Detail (As Of November 10, 2014)

Ratings Detail (As Of November 10, 2014) (cont.)

Vermont GO bnds		
<i>Long Term Rating</i>	AA+/Stable	Outlook Revised
Vermont GO bnds (Citizen bnds)		
<i>Long Term Rating</i>	AA+/Stable	Outlook Revised
Vermont GO bnds (Vermont Citizen Bnds)		
<i>Long Term Rating</i>	AA+/Stable	Outlook Revised
Vermont GO bnds (Vt Citizen Bnds)		
<i>Long Term Rating</i>	AA+/Stable	Outlook Revised
Vermont GO bnds (Vt Citizen Bnds)		
<i>Long Term Rating</i>	AA+/Stable	Outlook Revised

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