S&P Global Ratings

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# Vermont; General Obligation; Multifamily Whole Loan

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## Rationale

S&P Global Ratings has assigned its 'AA+' long-term rating to the State of Vermont's 2019 series A general obligation (GO) bonds and 2019 series B GO refunding bonds (Vermont Citizens Bonds). 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;
- Employment composition reflective of the U.S. economy that is characterized by average income levels and low unemployment rates, although economic growth has been slow in recent years and demographic challenges persist;
- 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.

We believe Vermont's credit profile benefits from a history of proactive budget management and well-embedded strong financial policies and practices. The state's process for identifying and remediating budget shortfalls early in the fiscal year allows for flexibility of resolution, in our view. In addition to demonstrating budgetary strength, Vermont has reduced its authorizations for debt in recent years, which we expect will noticeably lower its debt burden. We believe these strengths will remain crucial to credit quality given mounting credit pressures stemming from the state's slowing economy and retirement liabilities. Relatively weak demographic trends will persist, in our view, and continue to dampen the state's economic growth potential, but the state is actively addressing these challenges. Vermont's unfunded retirement liabilities are significant, in our view, and continue to increase despite excess contributions in recent years. The state has demonstrated an ability to pass and implement retirement reforms that we believe better positions it compared with many states that cannot do so. However, continued slow economic growth could make it more difficult to address these liabilities as contribution requirements escalate.

The state's enacted general fund budget for fiscal 2020 totals $1.64 billion, representing a moderate 3.0% increase over the previous year's enacted budget, in our view. The general fund budget increases funding for clean water ($50 million), childcare ($6 million) and higher education ($3 million), while meeting funding recommendations for pension and OPEB liabilities. On the revenue side, the budget includes several minor tax increases that result in a net general fund increase of $2.14 million (0.1% of enacted general fund revenues). Changes include adjustments to the capital gains exclusion ($2.21 million) and adjustments to the meals-and-room tax for online travel agencies ($2.78 million) that are partially offset by the creation of a new medical-expense deduction within the personal income tax ($2.08 million), and adjustments to the land-gains tax ($0.78 million). The enacted budget includes stabilization reserves in the general fund, transportation fund, and education fund that are fully funded at their maximum statutory levels of 5% of the previous year's budgetary appropriations.

Several key changes were made to existing state revenue and expenditure distributions effective in fiscal year 2019, as passed in Act 11 in 2018. The most significant changes were the shift of the entirety of the sales-and-use tax and 25% of the meals-and-rooms tax from the general fund to the education fund. At the same time, the act eliminated a lump-sum annual transfer of general fund dollars to the education fund. Officials report the law was intended to remove the need for this interfund transfer. In our opinion, this shift puts additional spotlight on the education fund as one of the state's core operating funds.

Preliminary unaudited results for fiscal 2019 are not yet available, but officials report that general fund revenues are above target by 4.4% and education fund revenue are below target by 0.7% as of June 30, 2019. As of May 2019, fiscal year-to-date revenue were up 4.3% in the general fund as the result of higher-than-forecasted personal income receipts. Education fund revenue declined 0.6% due mostly to underperformance in the sales-and-use tax.

Vermont's reserve profile has grown following consistent deposits in recent years. The general fund budget stabilization reserve and general fund balance reserve totaled $77.00 million and $12.49 million, respectively, at the close of fiscal 2019, and represent a good 5.7% of expenditures, in our view. This is nearly 18% higher than levels recorded in fiscal 2015. The education fund had $34.64 million in its budget stabilization reserve at the close of fiscal 2018. Adding this amount to the general fund reserves brings the state's main operating reserves to $124.13 million or 3.9% of annual expenditures in the general and education funds. Officials expect this percentage to rise to well over 4.0% after allocating fiscal 2019 surplus.

The state has additional reserve accounts that are restricted as to use including $12.5 million in the 27/53 reserve (to meet liabilities during years with a 27th biweekly payroll and a 53rd week of Medicaid payments) and $22 million in the human services caseload reserve (for caseload-related needs of several human services agencies), as of June 30, 2018. Management notes the balance of the human services caseload reserve will grow to more than $100 million in fiscal 2019 following a net-transfer of $79.9 million from the global commitment fund that will first transfer to the general fund and then be reserved in the human services caseload reserve and in the 27/53 reserve.

We anticipate that the relatively weak demographic trends in recent years will persist as Vermont's economy continues to expand at a slower pace than the nation. Following three years of decline from 2014-2016, Vermont recorded population growth of 0.14% in 2017, and 0.28% in 2018, according to the U.S. Census Bureau. The state reports population growth is due to international migration, as U.S. residents migrate outside of Vermont's borders. Foreign in-migration has proved steady the past two years, as domestic migration decreased to nearly net-neutral in 2018. IHS Markit projects that weak in-migration trends as well as an aging workforce will limit Vermont's ability to attract and retain businesses. Vermont has strategized its workforce development initiatives in order to address its demographic issues. We believe that while the state is taking proactive steps, the effectiveness will not be clear in the near term.

Per capita personal incomes in Vermont have declined relative to the U.S. for the first time since 2008, decreasing to 99.8% of the U.S. in 2018. IHS expects the state's real income levels to remain below the U.S. through 2024. The state reports there has been upward pressure on wages given the state's extremely low unemployment rate of 2.1%--the lowest in the nation as of May 2019.

A comprehensive capital-and-debt-affordability process governs Vermont's tax-supported debt issuance. Officials report the state has decreased its appetite for debt issuance and we believe decreasing authorizations for debt in recent years support this claim. Specifically, authorization for $123.2 million of debt in the fiscal 2020-2021 biennium is 23% less than the authorization for $159.9 million of debt in the fiscal 2014-2015 biennium. Overall, we view Vermont's current debt burden as moderate. We calculate fiscal year-end 2018 tax-backed debt per capita at only $1,073, while debt amortization is rapid, with nearly 71% of tax-backed debt maturing within 10 years.

The governor signed a Budget Adjustment Act for fiscal 2019 that directed additional funds to the state's pension and OPEB plans. Specifically, $22.2 million was provided to extinguish an interfund loan to the Retired Teachers Health and Medical Benefit Fund, and an additional $3.3 million above the actuarially determined contribution (ADC) was contributed to the Vermont State Teachers Retirement Fund. The bill also calls for 50% of general fund surpluses going forward to be transferred to the Vermont State Employees Retirement System OPEB plan.

Vermont's pension profile is weak, in our view, with what we consider a relatively low three-year-average funded ratio of 62% 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 based on ADC, but contribution levels lag actuarial valuation by two years. Vermont has historically funded its pension liabilities at ADC levels, and has recently contributed above the ADC. Despite these excess contributions, unfunded pension liabilities have grown. We calculate that total annual plan contributions in fiscal years 2016-2018 did not cover a level equal to service cost and interest cost plus some amortization of the unfunded liability, which we believe could weaken the state's pension liability profile over time.

In our opinion, OPEB liabilities also remain high with an unfunded liability of $2.17 billion or $3,469 per capita according to our calculations. On a per capita basis, Vermont's unfunded OPEB liability is nearly as large as its unfunded pension liability. 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. The state has paid down a loan for VSTRS (of which $28.3 million remained at the close of fiscal 2018) and will now generate dollars for prefunding going forward--starting with an expected end of fiscal year 2020 fund balance of $2.4 million. 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.

Based on the analytical factors we evaluate for states, on a scale of '1.0' (strongest) to '4.0' (weakest), we have assigned a '1.8' composite score to Vermont, which reflects an indicative rating of 'AA+'.

## Outlook

The stable outlook reflects our view that Vermont's strong framework for budgetary and financial management will support its credit profile in the near term as it faces challenges related to its economy and retirement liabilities. In addition, decreasing debt levels and constrained health care costs stemming from fee-for-value based policies are expected to provide the state some budgetary relief. We anticipate that slower-than-average economic growth and weak demographic trends will continue and pressure the state's budget during our two-year outlook horizon. Vermont's unfunded pension and OPEB liabilities remain high relative to state peers and have grown despite excess contributions and reforms.

We could lower the rating if we believe the state's economic measures were no longer commensurate with the rating level or reserves deteriorate in an effort to resolve budgetary stress. The state's large unfunded pension and OPEB liability could also pressure the rating. A higher rating could result from sustainable improvement to the state's economic metrics (e.g. incomes, gross state product [GSP] growth) or pension and OPEB profile. However, this is unlikely to occur during our outlook horizon.

## 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. It 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. 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 years 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, therefore, 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 revenue and spending. These consensus forecasting meetings can be convened more frequently, and were held quarterly during fiscal years 2008-2010 due to the recession and the potential effect on revenue 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 years, 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 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 four-point scale, with '1' being the strongest score, we have assigned a '1' to Vermont's financial management.

## Economy

According to our report, "Summer Should Be Smooth Sailing For U.S. State And Local Governments, But There Could Be Waves Ahead" (published April 30, 2019, on RatingsDirect), we expect the New England regional economy's real GDP growth will continue to slow over the next several years, generally lagging national levels. We expect Vermont to trail national growth along with Connecticut, Maine, and Rhode Island. In our view, New England will be somewhat insulated from trade policy, as many of the region's top exports are for secondary goods that can pass additional costs to the end consumer.

Vermont's quality of life and well-educated workforce provide economic development opportunities, however, it ranks low among the states in its business-tax-and-regulatory environment, and its slow workforce expansion could stifle future economic growth prospects. Vermont's population has increased more slowly than the nation as a whole; from 2014-2018, the state's population remained flat compared with the nation's 0.7% growth. Furthermore, the state's aging population--34.2% over 55 and 18.7% over 65, compared with 28.5% and 15.6%, respectively, for the nation, will continue to be a drag on the state's growth potential in our view.

We anticipate that the relatively weak demographic trends in recent years will persist as Vermont's economy expands slower than the nation. Vermont reports it has strategized its workforce-development initiatives in order to address its demographic issues. Broadly, the state has coordinated efforts with the U.S. Department of Labor, kindergarten through grade 12 (K-12) education, and higher education. Specific initiatives include work-opportunity tax credits and a program to attract remote workers. We believe that while the state is taking proactive steps, the effectiveness will not be clear in the near term.

Vermont's economy is driven by tourism, higher education, electronics, consumer-goods manufacturing, and agriculture. Exports are an important part of the state's economy, with a substantial portion going to Canada according to IHS Markit. Exports in 2018 primarily consisted of computer and electronic products (65.3%), followed by machinery (5.2%). In 2018, Vermont's exports totaled more than $2.9 billion, of which 43.5% was with Canada.

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--the third-largest private-sector employer in the state, which accounts for a large portion of the state's manufacturing employment and exports. Global Foundries employs about 2,500 at its Essex Junction plant, which manufactures semiconductors for consumer electronic products, including chips for cell phones and other devices. According to IHS, a large portion of the state's manufacturing exports includes computers and electronics products from the facility. The Vermont Yankee nuclear power plant ceased production at the end of 2014 and it will be demolished by 2030.

Vermont was the second state in New England to complete its labor market recovery from the most recent recession, following Massachusetts. Health care employment, in particular, will be a growth driver, however, IHS forecasts very slow total employment growth of 0.7% in 2019, and an average annual growth rate of 0.5% from 2019-2022, which is well below forecast national employment growth rates.

State income levels are average, in our opinion. State per capita income of $53,598 in 2018 was 99.8% of that of the

U.S. GDP per capita of $53,849 in 2018 and has historically remained at about this level.

On a four-point scale, with '1' being the strongest, we have revised our score on Vermont's economy to '2.4' from '2.1'.

## Budgetary Performance

Audited results indicate the state ended fiscal 2018 with combined general fund and education fund revenue of $2.82 billion, creating an operating gain of $272.0 million, which was offset by $191.0 million of net transfers out to other funds. Vermont ended fiscal 2018 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 most recent recession.

S&P Global Ratings considers the state's combined general fund and education fund revenue to be diverse, with statewide education taxes, personal income taxes and sales taxes constituting 37.6%, 29.4%, and 14.1% of fiscal 2018 revenue collections, respectively.

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 previous-year budgetary appropriations. The three stabilization funds have been at their statutory maximums since fiscal 2007. Vermont pools the cash reserves for these major funds, which result in sufficient liquidity for operations during the fiscal year. Officials indicate that the state has not externally borrowed for liquidity since fiscal 2004.

We have assigned a '1.4' to Vermont's budgetary performance.

## Debt And Liability Profile

### Debt

Vermont's total tax-supported debt is moderate, in our opinion, at $1,073 per capita or 2.0% of personal income. Compared with general governmental expenditures and GSP, the fiscal 2018 tax-supported debt service was low, in our view, at about 1.9% and 2.0%, respectively. 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 nearly 71% 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 2020 and 2021 totals $123.2 million, which is down 7.0% from the previous biennium recommendation of $132.5 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 8,530 active members. The STRS and Vermont Municipal Employees' Retirement System (MERS) are multiple-employer, cost-sharing plans with approximately 9,892 and 7,452 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 pension plans to be relatively low at 62%. The state's pension-funded ratio as of June 30, 2018, is also considered relatively low at 62%, which is nearly unchanged from 62% in fiscal 2017 and slightly lower than 62.1% in fiscal 2016.

Vermont's proportionate share of the plans' net pension liability reflects what we view as a high $3,616 per capita and moderate 6.8% of personal income.

Vermont lowered its long-term investment return assumptions for the VSRS and STRS plans in July 2017 to 7.50% from 7.95%. 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 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 two years prior. 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 year-to-year variations in actual payroll 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 the 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 $64.6 million in fiscal 2018 represented 124% of the pension ADC. For STRS, actual contributions (from employers and nonemployers) of $114.6 million in fiscal 2018 represented 129.6% 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.

Overall, we believe that 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 22 years remain as of fiscal 2018. However, the plans use the level percentage of pay method, which assumes rising future payroll and results in escalating absolute pension contributions over time. Projected salary increases range from 3.75%-9.46% for VSTRS and from 3.5%-7.04% for VSRS. The VSRS plan reported a return of 6.73% in 2018, and the STRS plan reported a return of 6.99% in the fiscal 2018 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, 2018. We believe this report's underlying assumptions are realistic. The state has recently updated its mortality assumptions. The STRS plan's ratio of active members to beneficiaries equals 1.07, which is significantly below the median national ratio of 1.50. The VSRS plan's ratio is slightly higher at 1.22. We believe the plans incorporate experience trends and industry standards in their experience studies conducted at least every five years.

### 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 high, in our view, at $3,469 per capita, the state 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, partially 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 billion 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. The net OPEB liability increased to $932.3 million in fiscal 2017 and $954.3 million in fiscal 2018. State contributions under pay-as-you go financing were $29.8 million in fiscal 2018. Before fiscal 2015, health care expenses for the plan's retirees were paid through a subfund 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, 2018, it contained only $21.8 million of assets, for a 1.8% actuarial asset funded ratio. The plan has a net OPEB liability of $1.2 billion as of June 30, 2018, which is nearly 17% lower compared with 2017 partially due to per capita claims experience and plan changes. Vermont paid almost $33 million under pay-as-you-go funding in fiscal 2018.

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 four-point scale, with '1.0' being the strongest, we have assigned a '2.8' to Vermont's debt and liability profile.

| Ratings Detail (As Of July 11, 2019) | | |
|---|---|---|
| Vermont GO | | |
| *Long Term Rating* | AA+/Stable | Affirmed |
| Vermont GO | | |
| *Long Term Rating* | AA+/Stable | Affirmed |
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