16 APR 2021

Fitch Rates Vermont's $151MM GOs 'AA+'; Outlook Stable

Fitch Ratings - New York - 16 Apr 2021: Fitch Ratings has assigned a 'AA+' rating to the following State of Vermont general obligation (GO)

bonds:

--$80.26 million GO bonds, 2021 series A (competitive);

--$31.86 million GO refunding bonds, 2021 series B (competitive);

--$39.315 million GO refunding bonds, 2021 series C (Vermont Citizens Bonds) (negotiated).

In addition, Fitch has affirmed the following ratings for the state of Vermont:

--Issuer Default Rating (IDR) at 'AA+';

--Outstanding GO bonds at 'AA+';

The Rating Outlook is Stable.

The bonds are expected to sell the week of April 26, 2021; the series A and B bonds will sell through competitive bid and the series C bonds through negotiated bid. Par amounts are subject to change based on market conditions.

SECURITY

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

ANALYTICAL CONCLUSION

The 'AA+' IDR and GO rating reflect conservative financial management, positioning the state well to absorb budgetary implications of the coronavirus pandemic. Fitch anticipates the moderate long-term liability burden will remain relatively stable.

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. The state's population is older than most states, and growth has been relatively limited. Leading into the pandemic, Vermont's labor force had been flat to declining over the prior decade. As with several other New England states, high educational attainment levels provide some potential for economic gains, but Vermont has not fully benefited from that potential to date.

Revenue Framework: 'aa'

Fitch anticipates Vermont's revenues used for state operations will grow at a modest pace, consistent with our long-term 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 and are adjusted annually based on multiple factors including decisions of voters in those school districts. The state has complete legal control over its revenues.

Expenditure Framework: 'aaa'

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'

Vermont's long-term liabilities burden is above the median for U.S. states but remains moderate. Positively, the state's leadership team maintains close oversight and management of debt issuance, and engages in ongoing efforts to adjust policies to improve retirement liabilities sustainability over time.

Operating Performance: 'aaa'

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 took steps during the pre-pandemic expansion to expand its fiscal flexibility.

RATING SENSITIVITIES

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

--Material and sustained improvement in the state's demographic profile, such as through consistent population and labor force gains, could support stronger revenue growth prospects and a more robust revenue framework assessment.

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

--Inability to prudently manage the long-term liability burden, in the context of modest growth expectations for the economic base available to support repayment.

Best/Worst Case Rating Scenario

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

CURRENT DEVELOPMENTS

Federal Relief Provides Critical Support

Federal aid measures enacted in 2020 provided direct fiscal support and boosted economic activity in Vermont and throughout the country. The American Rescue Plan Act (ARPA) could prove even more directly beneficial for the state. Direct fiscal aid authorized last year included a 6.2 percentage point (pp) increase in the Federal Medical Assistance Percentage (FMAP) for Medicaid and $1.25 billion from the Coronavirus Relief Fund (CRF) included in the Coronavirus Aid, Relief and Economic Security (CARES) Act. Vermont directed its allocation primarily to economic relief for businesses and individuals, with more than three-fourths of CRF expenditures in the form of grants.

The Committee for a Responsible Federal Budget (CRFB) estimates that Vermont's residents, business, and healthcare providers received approximately $4.8 billion in additional federal funding from the multiple stimulus and relief bills enacted by Congress since the pandemic's onset in March 2020, with the majority coming in the form of various federal loan programs such as the Paycheck Protection Program. This significant influx of federal funding played a key role in supporting a rebound in economic activity.

Under the ARPA, Vermont's state government is also in line to receive just over $1 billion in direct aid from the Coronavirus State and Local Fiscal Recovery Fund, with the first installment arriving within 60 days of the ARPA's enactment on March 11. The statute allows the U.S. Treasury Department to withhold up to 50% of any state's allocation for up to 12 months, based on the Treasury Secretary's evaluation of the state's unemployment rate. Fitch anticipates details on that evaluation and on allowable uses of the direct aid will be forthcoming from the Treasury Department. Vermont will also receive $113 million from the Coronavirus Capital Projects Fund established by ARPA.

The state House enacted a plan to allocate about $650 million of the ARPA direct aid, primarily on infrastructure measures. The governor recently put forward his own plan for utilization of ARPA receipts, focused primarily on one-time infrastructure investments including for broadband, affordable housing and water/sewer infrastructure. The combination of direct aid and a significant amount of economic stimulus should have a positive near-term effect on state revenues. Fitch does not expect the stimulus aid to alter Vermont's long-term credit fundamentals, but should help bridge near-term fiscal gaps.

Vermont Economic and Budgetary Update

Vermont's economic performance has improved since the pandemic's onset but slightly trails national trends. Following a steep decline in April 2020 of more than 20% from the prior month, Vermont's non-farm payrolls had recovered 56.5% through February. This compares to a national decline of just under 14.7% in April and a slightly more robust recovery of 57.6% increase through February (U.S. States Labor Markets Tracker, published April 2021 - https://www.fitchratings.com/research/us-public-finance/us-states-labor-markets-tracker-employment-recovery-remained-muted-through-february-pickup-expected-in-march-15-04-2021). Vermont's employment growth tailed off beginning in October 2020 but should benefit from accelerating vaccinations. As of April 15, Vermont ranks seventh amongst states with 29.1% of its total population fully vaccinated, compared to approximately 23.6% nationally, according to the Centers for Disease Control and Prevention.

State revenue performance has out-performed expectations and, in some cases, even exceeds pre-pandemic forecasts. The state reports revenues over three primary operating funds, the general, education and transportation funds. Collectively, the state's January 2021 revenue forecasting body (Emergency Board or E-Board) anticipates revenues in the three funds will be largely unchanged in the current fiscal year relative to both fiscal 2020 and fiscal 2019, at $2.4 billion. This is a $254.3 million (11.6%) improvement compared to the last E-Board forecast in August 2020.

Versus the last pre-pandemic forecast from January 2020, the January 2021 forecast for three funds combined is essentially flat. The education fund forecast (predominantly sales tax) is 2.7% ahead of the pre-pandemic outlook; while the general fund and transportation fund forecasts still slightly lag pre-pandemic expectations.

Through February, the state reports revenue collections are running 2.5% ahead of the January 2021 forecast at $1.8 billion across the three primary operating funds. Administrative issues, including the delay in the start of federal tax filing season and the individual income tax filing deadline extension into May, imply there may be a slower pace of growth over the rest of fiscal 2021 in income tax collections. The individual income tax, nearly half of total revenues in the three funds, is more than 5% ahead of target through February. Sales tax revenues, one-fifth of total revenues, were essentially in line with the January 2021 forecast.

Based on the January 2021 E-Board revenue forecast and appropriations as revised under a March 2021 Budget Adjustment Act, the state anticipates a strong $225 million general fund operating surplus in fiscal 2021 on $1.7 billion in spending. Vermont anticipates modest surpluses in the education and transportation funds as well. This follows small operating surpluses in 2020 for the general and education funds, and a minor deficit in the transportation fund. The likely strong fiscal 2021 operating results position Vermont well for fiscal 2022.

The state did not draw on its operating reserves last year and has no plans to draw on them in 2021 or 2022. All three funds maintain budget stabilization reserves (BSR) at their statutory maximum levels of 5% of prior year appropriations. For the general fund, the BSR equals $80 million and the state also maintains several additional general fund reserves totaling another nearly $150 million.

For fiscal 2022, the E-Board anticipates strong 5.4% growth in revenues, attributable to an anticipated acceleration in economic recovery through the year. Notably, the E-Board completed this forecast before passage of the ARPA which Fitch anticipates will provide a significant boost to national economic activity (Global Economic Outlook - March 2021 - https://www.fitchratings.com/research/sovereigns/global-economic-outlook-march-2021-17-03-2021). The governor's executive budget for fiscal 2022 was built on the January 2021 E-Board forecast, leaving budgetary upside for lawmakers to consider as they settle on a final budget. Prudently, the governor's proposal uses the roughly $200 million anticipated fiscal 2021 operating surplus for one-time needs, mainly capital, in fiscal 2022 rather than building it into the base budget.

The executive budget includes full actuarial contributions for the state's pension systems, consistent with prior years. The fiscal 2022 contributions are materially higher than current year levels based on the recent updates to actuarial assumptions, including a decrease in the investment return assumption. The House passed its version of the budget in late March and the Senate is now deliberating.

CREDIT PROFILE

Fitch considers the state's economic growth trajectory modest and in the middle relative to its New England peers. Vermont's population has been largely unchanged since 2010, falling below the national trend of slow and steady growth. Pre-pandemic, the state's unemployment rate was the lowest in New England and amongst the lowest nationally, labor force weakness had been a primary factor. Vermont's government remains focused on addressing its demographic challenges with multiple policy efforts to enhance the state's attractiveness for new residents and businesses including a grant program for remote workers relocating to Vermont.

Given Vermont's small population of 623,347 as of July 2020 (second lowest amongst the states), even minor shifts in migration trends could lead to notable population and workforce changes. Early data, including rapid growth in housing prices and unanticipated spikes property transfer tax receipts imply at least a short-term boost in migration into the state during the coronavirus pandemic. The sustainability of these recent gains could be an important consideration in determining the longer-term economic and credit implications for the state.

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 limited growth in Vermont's revenues over the long term, relatively in line with inflation, given the state's modest economic growth prospects. Vermont's historical total tax revenue growth, adjusted for policy changes, has been essentially flat on a real basis over the past decade. The limited growth reflects the state's ongoing constraints on economic and revenue growth.

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

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, and 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 fundamental programmatic and financial structure does not appear to be a near-term priority of the current federal administration or Congressional leadership. As with all federal initiatives, Medicaid remains subject to regulatory changes that could affect various aspects of the program.

Vermont has been particularly aggressive in addressing the long-term national trend of steadily rising healthcare costs (including Medicaid), including a recent shift towards outcome-based care under an 'all-payer' system, rather than the traditional fee-for-service model. Under terms of agreements with the federal government for the all-payer system, Vermont is transitioning 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. The state began an initial all-payer pilot program with Medicaid patients in January 2017 and has since expanded the program to cover the vast majority of Vermont's Medicaid members.

MEDICAID SPENDING GROWTH REMAINGS MODEST

Leading into the coronavirus pandemic, healthcare spending in recent years had leveled off with the state reporting that Medicaid spending growth slowing considerably since fiscal 2016. The state also reported that Medicaid enrollment declined sharply in this period (by 21% between fiscals 2016 and 2019), a trend seen by many other states as well given the then-expanding economy, and a key factor in slower Medicaid spending growth.

During the coronavirus pandemic, despite the deep job losses noted above, Vermont's Medicaid spending increased only modestly. The state's Agency for Health Services notes enrollment growth since the pandemic's onset has been offset by a decline in utilization, partially due to the pandemic's limiting effects on public interactions. Fiscal 2020 spending (combined state and federal) was flat year over year (YOY) at 0.2%, while the state currently projects fiscal 2021 spending will be up 2.1% and fiscal 2022 up 1.6%. Both levels actually trail the pre-pandemic five-year average Medicaid spending growth through 2019 of 2.6%. Medicaid spending growth during the pandemic-driven downturn also trailed the more than 12% growth in fiscal 2009 at the peak of the Great Recession.

LAKE CHAMPLAIN CLEANUP COSTS

Following a June 2016 agreement between the EPA and the state to address pollution issues in Lake Champlain, Vermont's legislature enacted legislation (Act 76 of 2019) in an effort to address a federal requirement to establish an ongoing source of funding for cleanup efforts. Act 76 dedicates 6% of the meals and room tax (MRT) collections to a clean water fund. The state estimates the MRT dedication, along with other allocated state revenues, will yield approximately $20 million annually for cleanup costs. The EPA indicated last April the state's recent statutory dedication of revenues put it on track to meet its obligations under the June 2016 agreement. Sharp declines in the MRT over the past year will decrease dedicated revenues; should MRT receipts fail to recover within the next several years, the EPA may require the state to supplement its annual contributions.

Fitch anticipates Vermont's low fixed carrying cost burden (5.8% of governmental expenditures in fiscal 2020) will increase modestly based on the most recent actuarial valuation reports, given the state's commitment to at least full actuarial contributions to its pension systems. The state has regularly contributed in excess of actuarially determined amounts for pensions in an effort to manage and reduce the net pension liabilities. Overall, the state retains ample flexibility to adjust its main expenditure items.

NEW PENSION VALUATIONS WILL TRIGGER HIGHER CONTRIBUTIONS

In October, the state's primary pension systems released new actuarial valuations based on the most recent experience study (completed in September 2020), reporting sizable growth in unfunded liabilities and actuarially determined employer contributions. Contributions to the Vermont State Employer Retirement System (VSERS) and Vermont Teachers Retirement System combined will increase 44% in fiscal 2022. This approximately $96 million increase is not a material concern in the context of the state's fiscal 2020 governmental funds expenditures of $6.2 billion.

On a combined basis, Vermont's debt and net pension liabilities as of Fitch's 2020 State Liability Report (dated October 2020) totaled 11.5% of 2019 personal income, compared with a U.S. states median of 5%. Based on the state's fiscal 2020 audited financial statements, Fitch calculates a long-term liability burden of 11.9% of 2020 personal income. This ratio includes special obligation transportation infrastructure bonds (TIBs) supported by a dedicated share of Vermont's gasoline and diesel taxes, and Vermont Housing Finance Agency bonds paid from the state's real property transfer tax. Vermont considers the TIBs self-supporting from the dedicated tax revenues as part of its legal and policy calculations for tax-supported debt.

Debt levels remain modest at approximately 2% of personal income 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 with Fitch-adjusted net pension liabilities representing approximately 10% of personal income. The pension liability calculations include essentially 100% of the liability in the Vermont State Employees Retirement System (VSERS) and the State Teachers' Retirement System (VSTRS), 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.

STATE LOOKS TO ADDRESS GROWTH IN PENSION AND OPEB LIABILITIES

The October valuations noted earlier will lead to an approximately 25% increase in the reported actuarial unfunded liability for VSERS and STRS, although Fitch anticipates Vermont's long-term liability burden will remain consistent with a 'aa' assessment over the long term. An analysis from the Treasurer's office attributed the growth to a change in the discount rate assumption to 7% from 7.5%, and various demographic changes based on the experience study findings.

Earlier this year, the legislature considered a bill to revise pension benefits and increase both employer and employee contributions in an effort to reduce the projected growth in liabilities. The state treasurer had presented a January 2021 report to the legislature with a series of recommendations. Instead of enacting legislation, the legislature elected to create a task force to study the issue and propose new legislation for the next session in 2022.

OPEB liabilities are also significant with the reported 2020 net OPEB liability equal to 7.3% of the state's personal income, up from 6.6% the prior year. The Treasurer's office notes the increase is due entirely to interest rate changes; given the lack of full actuarially determined contributions, the state (following guidelines from the Governmental Accounting Standards Board) reports its OPEB liability using a 20-year AA municipal bond rate to calculate the present value of its benefit obligation. The prescribed rate declined last year, lowering the discount rate used for the OPEB liability calculation and increasing the liability.

The state has taken modest steps towards pre-funding OPEB liabilities and has also made some progress in reducing liabilities through collective bargaining with unions. Fitch anticipates Vermont will continue to seek additional ways reduce OPEB costs and long-term liabilities. The Treasurer's January 2021 report to the legislature also included recommendations regarding OPEB.

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 a minimum twice a year through the E-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. At the pandemic's onset last spring, the state implemented more frequent "revenue risk assessment analyses."

The governor can implement a spending reduction plan unilaterally (if a revenue forecast lowers revenues less than one percent from the prior forecast), or with approval of the legislature's Joint Fiscal Committee (a bipartisan and bicameral committee of legislative fiscal leaders) for larger forecast revenue shortfalls. As noted earlier, the state has been able to engage key stakeholders, including labor, to develop spending reduction plans during economic and fiscal downturns. The state's recent trend has been to focus on expenditure cuts, such as negotiated wage reductions or programmatic cuts, rather than revenue increases.

Last year, the state legislature and governor implemented two budget adjustment acts for fiscal 2020, including one in May expressly in response to the pandemic. The state focused on reducing spending primarily by holding back on planned expenses and freezing hiring, rather than deep programmatic cuts or widespread layoffs.

Vermont's multiple budget reserves also support the state's robust financial resilience. These include fully-funded budget stabilization reserves (5% of prior year appropriations) in each of its three primary operating funds (general, education and transportation), and separate, fund-specific reserves or unreserved balances of lesser amounts. The state estimates the various general fund reserves will total $228.1 million at the end of fiscal 2021, representing approximately 15% of forecast general fund uses. Combined reserves across the three primary operating funds total 13% of revenues, net of the statewide property tax.

FAST Scenario Analysis for Vermont

The Fitch Analytical Stress Test (FAST) scenario analysis tool relates historical tax revenue volatility to

GDP to support the assessment of operating performance under Fitch's criteria. FAST is not a forecast, but it represents Fitch's estimate of possible revenue behavior in a downturn based on historical revenue performance. Hence, actual revenue declines will vary from FAST results. FAST does provide a relative sense of the risk exposure of a particular state compared to other states.

Vermont has robust financial resilience that should allow it to absorb the budgetary effects of the ongoing pandemic. Fitch's standard FAST scenario of a 1% decline in GDP in year 1 results in a 1% decline in Vermont's revenue compared to an approximately 3% states' median decline. The state appears to be less vulnerable to cyclical revenue declines tied to economic downturns than most other states.

Prudent Management Prepares the State for Downturns

The state's budgeting practices tend to be conservative in forecasting and proactive through the fiscal year, with most fiscal years ending with at least a modest general fund budget surplus despite the lack of a statutory or constitutional balanced budget requirement. In the years leading into the pandemic, the state took steps to build in additional fiscal resilience through additional reserves including the general fund balance reserve (established in 2012 to replace the revenue shortfall reserve), a human services caseload reserve (established in 2017 and primarily for Medicaid), and a 27/53 reserve (established in 2016 to address years with a 27th biweekly payroll or a 53rd week of Medicaid disbursements).

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

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

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

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
Vermont, State of (VT) [General Government]	LT IDR	AA+	Affirmed		AA+
• Vermont, State of (VT) /General Obligation - Unlimited Tax/1 LT	LT	AA+	Affirmed		AA+

RATINGS KEY	OUTLOOK	WATCH
POSITIVE	⊕	⬘
NEGATIVE	⊖	⬙
EVOLVING	◎	◆
STABLE	◯	

Applicable Criteria

U.S. Public Finance Tax-Supported Rating Criteria (pub.27 Mar 2020) (including rating assumption sensitivity)

Applicable Models

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

FAST Econometric API - Fitch Analytical Stress Test Model, v2.4.0 (1)

Additional Disclosures

Solicitation Status

Endorsement Status

Vermont, State of (VT)	EU Endorsed, UK Endorsed

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