S&P Global Ratings

RatingsDirect®

Summary:

State of Delaware; Appropriations; General Obligation

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Table Of Contents

Rationale

Outlook

Summary:

State of Delaware; Appropriations; General Obligation

Credit Profile		
US$107.2 mil GO rfdg bnds ser 2019A due 10/01/2029		
Long Term Rating	AAA/Stable	New
Delaware GO		
Long Term Rating	AAA/Stable	Affirmed

Rationale

S&P Global Ratings has assigned its 'AAA' rating, and stable outlook, to the State of Delaware's series 2019 general obligation (GO) refunding bonds. At the same time, S&P Global Ratings affirmed its 'AAA' rating, with a stable outlook, on Delaware's GO debt outstanding and its 'AA+' long-term rating, and stable outlook, on the state's appropriation debt outstanding.

The series 2019 bonds are secured by the general obligation of the state to which the full faith and credit of Delaware is pledged.

The 'AAA' rating on the state reflects what we view as Delaware's:

- Strong financial and budget management;
- Relatively diverse economy, which continues to expand at a modest pace and in line with national trends;
- Consistently strong general fund reserves and liquidity even during recessionary periods;
- Moderate overall debt burden, with what we consider strong debt management policies in place; and
- Well-funded pension system and implementation of reforms in past years in addressing other postemployment benefits (OPEB) liabilities, which are significant.

We believe Delaware's credit profile benefits from a history of proactive fiscal management and well-embedded strong financial policies and practices. In years past, the state has made difficult decisions to restore budget balance when necessary while managing surpluses to retain structural budget balance. Most recently, its fiscal 2018 enacted operating budget closed a $386 million shortfall (9.2% of expenditures) through a majority of recurring measures. In addition, the state has managed a stable reserve profile over multiple economic cycles. We expect these strengths to persist and believe they will remain crucial to credit quality given credit pressure stemming from the state's unfunded OPEB liabilities, which we consider significant. The state's unfunded OPEB liabilities are larger than the state's unfunded pension liabilities and economic growth trends projected to lag the nation could make it more difficult to address these significant liabilities as contribution requirements escalate. We believe the state's ability to pass and implement retirement reforms positions Delaware well compared with many other states without such flexibility. However, implementation of new reforms for OPEBs last occurred in 2013. Recently, the governor signed Executive Order 32 to reestablish a committee to study OPEBs in Delaware and identify options available to the state. The committee shall hold its first meeting on or before Sept. 15, 2019 and reports its findings at Delaware Economic and Financial Advisory Council's (DEFAC) March 2020 meeting.

Delaware's fiscal 2020 enacted budget totals $4.4 billion and represents 4.2% growth over fiscal 2019. Officials report that more than half of this expenditure growth is directed to education initiatives including salary increases for teachers, the hiring of new teachers, funding for low-income students, and related transportation costs. Operating growth is above the 3.7% targeted forecast in relation to Executive Order 21 that requires the DEFAC to calculate an advisory benchmark for appropriation growth based on three years of personal income and population growth within the state. We view efforts in recent years to implement spending controls positively. However, in our opinion, 4.2% expenditure growth is somewhat high given that it outpaces projected growth in net general fund receipts of 0.7% ($33.2 million) from fiscal 2019 according to the latest DEFAC projections from June 2019. In addition, S&P Global Ratings expects the pace of economic growth for the states sector to decelerate in 2019. For more information, please see "U.S. State Sector 2019 Outlook: Caution - Slower Speeds Ahead," published Jan. 8, 2019, on RatingsDirect. The budget fully funds the rainy-day fund at $240.4 million, or a good 5.2% of general fund operating expenditures. Management reports the budget sets aside more than $126 million of reserves after projected cash to bond bill and grant in aid.

The DEFAC's estimates as of June 2019 made minor adjustments to projected revenues compared with the council's previous forecast in May 2019. The latest projections show slightly increased revenues in fiscal 2019 at 0.4%. The forecasts for fiscal 2020 and fiscal 2021 were reduced slightly by 0.04% and 0.2%, respectively.

Overall economic performance has been historically stable, in our view. However, economic growth is forecast to be somewhat limited in the next four years as GDP growth is forecast below national levels according to IHS Markit. From 2019 to 2022, average real gross state product growth is expected to be 1.7% for the state, which is under the 1.9% for the U.S. For the same time period, the state's average employment is also expected to grow at levels just below the nation at 0.7% for Delaware and 0.9% for the U.S. The state's labor force returned to its pre-recessionary peak at the end of 2014, ahead of IHS Markit's projections, primarily due to strong growth in professional and financial activities jobs. The state is somewhat concentrated in financial services jobs with 4.8% more jobs in this sector compared to the national average, which we believe exposes Delaware to some risk. However, we understand there has been diversification within this sector. The state's unemployment rate has been consistently below the nation's rate for the past 20 years although it rose slightly above the national average for 2017 (4.6% for the state compared to 4.4% for the nation). As of June 2019, the state's unemployment rate is below that of the U.S. (3.2% for the state compared to 3.7% for the nation).

Beyond the near term, the state faces a significant OPEB liability that has grown despite past reform efforts. As it stands, Delaware's net OPEB liability (NOL) as of the June 30, 2018, under Governmental Accounting Standards Board (GASB) Statement No. 74 reporting, is $7.2 billion, which we consider significant. This amount is 4.5x higher than the $1.6 billion state share of the aggregate net pension liability of Delaware's pension plans (which are well funded in our opinion). On a per-capita basis, we estimate the unfunded liability to be $7,460 and rank it among the highest in the nation. Applying the 90.4% proportionate share disclosed for fiscal 2017 (in the state's fiscal 2018 comprehensive annual financial report) to the fiscal 2018 collective NOL shows that the state is directly responsible for approximately $6.5 billion of this liability, an amount that we still consider high. Reform efforts included pre-funding the obligation in 2002 and 2003 with lump sum payments and establishing an OPEB trust in 2007--the funded ratio for this trust is currently very low, in our opinion, at 5.0% under GASB Statement No. 74 reporting. Additional reforms to curb the state's liability included plan modifications in 2011 and shifting the costs of retiree pharmacy benefits to the Centers for Medicare and Medicaid Services in 2013.

Although we understand there are no immediate plans to implement additional OPEB reforms, we believe it is possible the state could begin to take additional action to address this liability. The state's retirement benefit study committee is expected to present its findings and recommendations at DEFAC's March 2020 meeting, in accordance with Executive Order 32.

We anticipate that the state will continue to address its OPEB liabilities, which have grown at a rapid pace in recent years, in an effort to curb the long-term liability. Delaware has reported year-over-year growth in excess of 15% in two out of the past four years: 16% in 2017 and 19% in 2016. While the liability decreased from fiscal 2017 to fiscal 2018, we note this was primarily due to an increase in the Bond Buyer GO 20-Bond Municipal Bond Index--the discount rate used under GASB 74. In our view, inaction in addressing this liability over our two-year outlook horizon could affect the state's credit quality.

The state successfully implemented reform and made various changes to benefits in previous years to actively manage the estimated liability. In our view, OPEB plans that operate on a pay-as-you-go basis (such as Delaware's) effectively defer contributions until the moment benefits are due. As unfunded OPEB liabilities grow, contributions in the future can be expected to escalate. We believe the state's ability to effectively manage its OPEB liability will be an important credit factor over time.

Delaware's pension liabilities are average, in our view, with what we consider a good three-year average funded ratio of 83.0% across the five pension plans for which the state reports liability. In addition, the state's unfunded liability compared with income and population is moderate in our view. We consider the funding discipline of Delaware's pension plans to be adequate. State contributions to four of its five pension plans are determined on an actuarial basis with contributions historically meeting 100%, which we view as positive. The closed state police plan is funded on a pay-as-you-go basis given the only minimal plan assets, although actual contributions met actuarially determined levels in fiscal 2016. We also note that aggregate annual plan contributions for the pension system were under our calculation of 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. We believe this could also weaken the strength of the state's pension liability profile over time.

S&P Global Ratings considers Delaware's debt ratios moderate. State-supported GO debt was approximately $1.5 billion as of June 30, 2018, excluding $501 million, which is supported by the local school districts. Total tax-supported debt in fiscal 2018, including GO, transportation, and appropriation obligations, is moderately high relative to that of state peers, at $2,513 per capita and 5.1% of personal income. We estimate total tax-supported debt service carrying charges, after excluding the local school district support, were a moderate 5.7% of governmental spending in fiscal 2018. Debt amortization is rapid, in our opinion, with about 67% of state-supported debt scheduled to retire in the next 10 years. Delaware has focused its attention on reducing debt over time with clearly defined debt affordability parameters and a commitment to cash-funding capital projects, especially when the economy is performing well. We believe that this and rapid amortization of principal outstanding will contribute to a stable debt profile.

In recent years, Delaware has faced several lawsuits in regard to its claim to certain abandoned properties. The state is currently litigating claims involving 30 states that allege Delaware improperly accepted certain abandoned property that should have been escheated to those other states. In an attempt to avoid multiple, duplicative complaints, the state filed a Bill of Complaint in the U.S. Supreme Court on May 27, 2016. The complaint seeks to resolve the open district court matters and avoid future, similar litigation from other states. However, on June 9, 2016, 21 states filed suit against Delaware in the U.S. Supreme Court for the very same issue, with an estimated $162 million asserted against Delaware. The state reports that any resolution is likely to be at least a year away. As of Nov. 29, 2018, the state's potential aggregate litigation exposure (across multiple claims) could exceed $203.9 million. In addition, there is ongoing litigation related to the state's abandoned property in the U.S. District Court; however, officials report it creates no financial exposure to the state. In our opinion, abandoned property revenues are a significant revenue source for the state--in fiscal 2019 they are Delaware's third-largest revenue source (behind personal income taxes and franchise taxes). Estimated net abandoned property revenues of $444 million in fiscal 2019 represent 9.7% of total general fund revenues. The state reports that the fiscal 2017 operating budget rewrote Delaware's unclaimed property laws to align them with other states.

In terms of other litigation, an ongoing lawsuit filed in January 2018 alleges, among other claims, that Delaware has failed to provide appropriate funding for certain categories of students with an adequate education, violating the state's constitution. Currently, the state allocates its share of public education funding to school districts, based on a formula dependent mostly on enrollment. Officials report it is unknown how the ruling could affect the state's funding for public education. Education initiatives included in the state's fiscal 2020 enacted budget direct $75 million of funding over three years for low-income students, English learners, and mental health support. The budget also includes $26 million for block grants for early education, along with various other initiatives.

S&P Global Ratings considers Delaware's management practices strong under its Financial Management Assessment (FMA) methodology. An FMA of strong indicates that practices are strong, well-embedded, and likely sustainable. The state's financial management highlights include regular general fund revenue and expenditure reports, multi-year revenue forecasting, a formal general fund reserve policy, and formal statutory debt affordability issuance guidelines. Delaware has implemented various debt management policies to decrease its debt burden and limit bond issuance. These measures have reduced the state's debt level despite the broad role it maintains in funding capital requirements for education, transportation, and corrections.

Delaware's bonds are eligible to be rated above the sovereign because we believe the state can maintain better credit characteristics than the U.S. in a stress scenario. Under our criteria "Ratings Above The Sovereign: Corporate And Government Ratings—Methodology And Assumptions" (published Nov. 19, 2013), U.S. states are considered to have moderate sensitivity to country risk. State-derived revenues are the sole source of security on the bonds, and the institutional framework in the U.S. is predictable with significant state autonomy and flexibility.

Based on the analytic factors we evaluate for states, on a scale of '1.0' (strongest) to '4.0' (weakest), we have assigned a composite score of '1.6' to Delaware. We have notched up to 'AAA' as allowed as per our state rating methodology criteria reflecting our view of the state's strong fiscal management including timely budget adjustments informed by frequent revenue forecasts (conducted six times per year) and Delaware's history of structural solutions when faced with a shortfall. In addition, the state has managed a stable reserve profile over multiple economic cycles; no funds have been withdrawn from the budget reserve account since its inception in 1980. It also reflects the state's position and income generation from Delaware's business-friendly legal system; the state is home to more than half of all publicly traded firms in the U.S. We believe Delaware's credit profile remains in line with comparable 'AAA' rated peers.

(For more information on the state's general credit characteristics, please see the most recent full analysis on Delaware's GO debt, published Jan. 31, 2019.)

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Based on the analytic factors we evaluate for states, on a scale of '1.0' (strongest) to '4.0' (weakest), we have assigned a composite score of '1.6' to Delaware. We have notched up to 'AAA' as allowed as per our state rating methodology criteria reflecting our view of the state's strong fiscal management including timely budget adjustments informed by frequent revenue forecasts (conducted six times per year) and Delaware's history of structural solutions when faced with a shortfall. In addition, the state has managed a stable reserve profile over multiple economic cycles; no funds have been withdrawn from the budget reserve account since its inception in 1980. It also reflects the state's position and income generation from Delaware's business-friendly legal system; the state is home to more than half of all publicly traded firms in the U.S. We believe Delaware's credit profile remains in line with comparable 'AAA' rated peers.

(For more information on the state's general credit characteristics, please see the most recent full analysis on Delaware's GO debt, published Jan. 31, 2019.)

Outlook

The stable outlook reflects what we view as Delaware's strong fiscal management that has allowed the state to proactively manage its budgets and has been key to the state's credit stability. We believe this will be an important consideration over our two-year outlook horizon. In addition, strong management will be essential to control the state's OPEB liabilities, which are significant in our opinion. The outlook also reflects the state's healthy reserve and liquidity position, which has been relatively stable over a range of economic cycles. We believe Delaware's strong reserve position adds cushion to the state's budgetary position and note that no funds have been withdrawn from the budget reserve account since its inception in 1980, which we believe is evidence of strong fiscal management.

Downward pressure to the rating could arise from inaction in addressing the state's elevated OPEB liabilities over our two-year outlook horizon, which, absent meaningful reform, we expect will continue to grow requiring increasing pay-as-you-go contributions. In our view, the governor's recently established retirement benefit study committee could lead to the implementation of additional OPEB reforms aimed at reducing the state's net OPEB liability. However, it is currently unclear what, if any, action will occur based on the study's findings or recommendations. We could also lower the rating if the state's budget were to become significantly pressured or structurally imbalanced--stemming from elevated retiree healthcare liabilities, soft revenues, or other factors--to a degree we feel is not commensurate with the rating level. In addition, we could take a rating action if we believe weakened long-term economic trends expose the state to challenges uncharacteristic of the rating level or if the state's reserve position were to decline precipitously due to revenue softening or the outcome of current litigation surrounding the abandoned property program--which is a large revenue source for Delaware.

Ratings Detail (As Of August 1, 2019)		
Delaware GO		
Long Term Rating	AAA/Stable	Affirmed
Delaware GO		
Long Term Rating	AAA/Stable	Affirmed

Ratings Detail (As Of August 1, 2019) (cont.)		
Sustainable Energy Util, Inc., Delaware		
State of Delaware, Delaware		
Sustainable Energy Utility, Inc. (Delaware) APPROP		
Long Term Rating	AA+/Stable	Affirmed
Sustainable Energy Util, Inc. (State of Delaware) energy efficiency rev bnds (Delaware) ser 2018 dtd 10/15/2018 due 10/01/2039		
Long Term Rating	AA+/Stable	Affirmed

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.