Moody's Investors Service

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New Issue: Delaware (State of)

MOODY'S ASSIGNS Aaa RATING TO STATE OF DELAWARE'S $172 MLN OF SERIES 2006 GENERAL OBLIGATION BONDS

OUTLOOK STABLE; STATE HAS $1 BLN OF GENERAL OBLIGATION BONDS OUTSTANDING

State
DE

Moody's Rating

ISSUE	**RATING**
General Obligation Bonds, Series 2006	Aaa

Sale Amount	$172,000,000
Expected Sale Date	07/13/06
Rating Description	General Obligation

Opinion

NEW YORK, Jun 28, 2006 -- Moody's Investors Service has assigned a rating of Aaa and a stable outlook to the State of Delaware's approximately $172 million of General Obligation Bonds - Series 2006, which are expected to be priced for institutional investors on July 13. The highest rating assigned to the state's general obligation debt is based on strong financial management characteristics and a history of maintaining ample budgetary reserves throughout recent economic cycles. Proceeds of the bonds will be used to finance various capital projects.

Strengths:

o Financial management practices that are expected to maintain strong reserve levels

o Revenues exceeding forecast in current fiscal year

o Strong economy, characterized by above-average employment and population growth

o Fully funded pension, although funding for post-employment health benefits is in its early stages

Challenges:

o Large debt burden relative to population and income o Exposure to consolidation or downsizing, respectively, in the financial services and domestic automobile manufacturing industries

HIGHEST RATING REFLECTS FINANCIAL MANAGEMENT STRENGTHS

The highest rating level assigned to Delaware's general obligation bonds is based in large part on legal provisions that Moody's believes will lead the state to maintain a strong financial profile over a long period. Delaware's constitution requires the state to budget expenditures at 98% of available resources, which helps maintain budgetary balance. There is also a constitutional mandate that unencumbered budgetary general fund resources, as much as 5% of general fund revenue in any fiscal year, be transferred to a budget reserve. This funding may be accessed only by a three-fifths vote of the members of each house and may be used only to close a general fund deficit or to provide funds needed as a result of the enactment of legislation reducing revenue. Revenue estimates are made by a 31-member panel appointed by the governor, known as the Delaware Economic and Financial Advisory Council (DEFAC). This panel, which includes officials from the public and private sectors, issues revenue and expenditure forecasts that are used by both the executive and legislative branches of government during the budget process. These provisions for consensus forecasts, well-managed expenditure growth, and the limit on appropriations have led to year-end cash surpluses and contribute to the state's long-term prospects for sustained financial strength. The state's otherwise strong management profile is tempered by a constitutional requirement that tax increases be approved by a three-fifths majority in the legislature.

REVENUE GROWING AT FASTER-THAN-ANTICIPATED PACE

Delaware's personal income, franchise and other tax revenues have grown significantly faster than the forecast rate in fiscal 2006. The June 2006 DEFAC revenue projection called for net receipts of $3.2 billion, a 10.3% increase compared with the 2005 total. Adjusted for various tax and accounting changes, fiscal 2006 revenue growth is estimated at 9.9%, compared with 6.3% when the fiscal year began. Growth estimated at 15% in personal income tax collections and at 45% for corporate income taxes has supported this strong overall performance in fiscal 2006. The state's forecasts for fiscal 2007 are conservative, calling for overall revenue growth to slow to 3.7%, with increases of 4.7% and 2.3 % in personal and corporate income taxes, respectively.

NEIGHBORING STATES' VIDEO LOTTERY PLANS POSE REVENUE RISKS

Pennsylvania has passed legislation that will allow video lottery machines at race tracks and other venues, pending required licensing. As a result, Delaware's fiscal 2007 revenue forecast reflects a $5 million reduction in lottery revenue (which includes traditional lottery and video lottery), and the fiscal 2008 forecast reflects a $32 million reduction, representing the potential loss of all of Delaware's Pennsylvania patrons. The licensing process has been delayed, and as long as the delay continues, Delaware will push its anticipated revenue loss out further into the future. Maryland also has proposed similar legislation. If that legislation passes, Delaware will adjust its revenue forecast accordingly. Competition from Maryland could have a greater effect on Delaware's revenue than Pennsylvania's video lottery plans will.

FISCAL 2007 BUDGET TO CONTAIN INCREASED MEDICAID FUNDING

In January 2006 the governor proposed a fiscal 2007 budget that would increase spending by 5.7%, to $3 billion. The budget would increase spending on health and social services by 10%; on children, youth and families by 4%; on public education by 4.5%, and on higher education by 3%. Natural resources funding would be cut by almost 2%. The increased funding for social services includes Medicaid, a program that remains a source of significant fiscal pressure for state governments. Delaware, one of the few states that has not taken steps to reduce Medicaid program benefits or enrollment, projects that its Medicaid costs will rise about 13% in fiscal 2007. The relatively high pace of growth in the state's Medicaid costs in recent years reflects growth in the numbers of citizens eligible for coverage, as well as the depletion of funds received through an enhanced Federal Medical Assistance Percentage provided under 2003 federal legislation. The state's Medicaid cost-control measures to date have included establishing a preferred drug list, revising prescription-drug reimbursement rates, and requiring prior authorization for prescriptions.

The proposed fiscal 2007 budget is based on 3% revenue growth, as forecast by the December 2005 DEFAC meeting. The Transportation Trust Fund suffered shortfalls last year, due to increasing operating costs, rising demand for transportation, and stagnant revenues. An executive order of the governor will implement financial controls for transportation and mandate annual reporting of transportation revenue and expenditures. The governor also established an oversight committee of private-sector experts to review and monitor transportation expenditures and revenues. In the meantime, some of the trust fund's costs are being shifted to the general fund.

The legislature's Joint Finance Committee completed work on the fiscal 2007 operating budget last week, and the proposed budget is expected to be voted on by House and Senate members shortly.

ECONOMY SHOWED RESILIENCY AFTER 2001 RECESSION

Delaware recovered more quickly from the 2001 recession than many other states. When the national economy returned to a job-creation mode in 2004, Delaware's non-farm employment growth rate was significantly faster, at 2.2%, versus a 1.1% national pace. The rebound was enough for Delaware to surpass its pre-recession peak total non-farm employment level. The state has enjoyed a lower unemployment rate than the nation in recent years (4.2% versus the nation's 5.1% in 2005), and wealth trends also have been positive. The state's personal income per capita improved to 108% of the national level in 2004 from 103% in 2000. Delaware's manufacturing employment declined for a sixth consecutive year in 2005, leaving the sector's loss at 25% since 1999. The pace of manufacturing job loss is slowing, and the state is now somewhat less dependent on the sector for employment than the nation as a whole. Delaware's employment growth has been realized primarily in construction and the service industries in recent months.

Delaware's increasing population reflects the state's healthy employment trends. Delaware's population growth in the 1990s exceeded that of both the mid-Atlantic region and the nation. Between 2001 and 2005, Delaware's population expanded 6.2%, compared with 1.7% for the region and 4% for the nation.

WEAKNESSES INCLUDE EXPOSURE TO CONSOLIDATING INDUSTRIES

Sources of potential economic weakness include the state's exposure to the declining domestic auto industry, to the consolidating financial services industry, and to the cyclical chemical manufacturing industry. The state is home to two auto manufacturing facilities, one operated by DaimlerChrysler AG's Chrysler Group and the other operated by General Motors Corp. It is also home to the former MBNA Corp., a credit card-issuing bank that has been acquired by Bank of America Corp. In the chemicals industry, Delaware is home to DuPont. The most immediate area of concern is MBNA, a Delaware-based company whose operations in the state were expected to be significantly reduced as a result of the company's acquisition. Even with Bank of America's decision to base its merged credit-card operations in Delaware, job losses have totaled approximately 2,000. There is no immediate threat of job reductions at the state's auto plants.

DEBT BURDEN HAS GROWN AT PACE BELOW 50-STATE MEDIAN

Delaware's debt burden has increased at a slower pace than the 50 states overall in recent years. Its net tax-supported debt totaled $1,845 on a per-capita basis in Moody's 2006 State Debt Medians report, compared with $1,616 five years earlier. The 14% increase compared with 39% growth in the median level for all states' debt per capita. Delaware's debt amounts to about 5.3% of the state's personal income, based on the 2006 debt medians report. The slight decline in this measure (from the 5.5% reported in 2001) is notable in view of the national median figure's increase (to 2.5% from 2.1%) during the period. Delaware's relatively high debt burden reflects the state's role in financing facilities, such as schools and prisons, that in other states would receive capital through local entities. A 1991 state law imposes several constraints on Delaware's debt, including a requirement that in any fiscal year the state can only authorize new debt equal to as much as 5% of budgetary general fund revenue projected for the year. Although these limits are fairly generous, the state's debt burden has decreased since they were enacted.

MAIN PENSION PLAN IS WELL-FUNDED

It is also worth noting that Delaware benefits from a well-funded pension. The Delaware Public Employees' Retirement System had a funded ratio of about 102% as of June 30, 2005, meaning that the value of pension plan assets ($5.66 billion) exceeded the plan's actuarial liability. Like other states, Delaware will have to comply with new accounting standards on other post-employment benefits (or OPEB) in coming years. Delaware has performed an initial actuarial valuation that puts size of these unfunded liabilities (primarily for health insurance) at about $4 billion. The state has also taken various steps, such as the creation of a dedicated trust to receive OPEB-related payments, to begin to address this liability.

Outlook

The outlook for Delaware is stable. The state's relatively high debt burden must be balanced against strong financial management practices grounded in the state constitution, as well as the state's above-average economic and fiscal growth and its financial flexibility.

What could move the rating down:

o Significant increase in debt levels relative to the economy

o Significant economic contraction

o Erosion of trend of strong financial management

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