

RESEARCH

Delaware; General Obligation

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Credit Profile

US\$172. mil GO bnds ser 2006 dtd 08/01/2006 due 08/01/2026 AAA
 Sale date: 13-JUL-2006

AFFIRMED

\$1.026,947 bil. Delaware AAA

OUTLOOK:

STABLE

Rationale

The 'AAA' rating on Delaware's GO bonds series 2006 and previously issued GO debt reflects the state's:

- Excellent financial management,
- Consistently strong general fund reserve levels and liquidity,
- Resilient local economy centered on financial services, and
- Moderate overall debt burden.

Delaware's full faith and credit GO pledge secures the bonds. Bond proceeds will be used to finance various capital projects.

Delaware's financial position continues to be strong and is greatly enhanced by the Delaware Economic and Financial Advisory Council (DEFAC), which provides the state with objective and frequently updated financial and economic projections. Comparisons of historical revenue estimates illustrate DEFAC's conservative forecasting nature, as actual year-ending revenues typically exceed projections. In addition, Delaware maintains an array of prudent fiscal and debt policies in order to ensure sustained healthy financial performance.

On a GAAP basis, fiscal 2005 closed with a \$97.9 million general fund operating surplus, and the total general fund balance was \$1.31 billion (40.2% of expenditures), up from \$1.22 billion (39.8%) in fiscal 2004. The fiscal 2005 unreserved fund balance also increased to \$999 million, or 30.5% of expenditures, up from \$929 million (also 30.5%) in fiscal 2004. General fund liquidity is robust, as unrestricted cash and investments-to-current liabilities measures 5.4x in fiscal 2005, up from 5.1x in fiscal 2004. On a GASB 34 basis, the state's primary government net assets increased by \$221.2 million to \$5.2 billion in fiscal 2005 from approximately \$5.0 billion in fiscal 2004. Since fiscal 2003, Delaware's general fund has closed each year with an operating surplus--strong revenue performance, particularly personal income taxes, is a primary factor behind the recent positive performance.

Fiscal 2006 revenues through the June 2006 DEFAC meeting are coming in ahead of fiscal 2005 actual collections and previous 2006 projections. DEFAC recognizes an additional \$13.8 million in projected revenues for fiscal 2006 over the May 2006 DEFAC estimate, bringing fiscal 2006's total anticipated revenues to \$3.17 billion, or 10.3% higher than fiscal 2005. On a cumulative cash balance basis, fiscal 2006 is projected to end close to a break-even position. Fiscal 2007's estimated general fund revenues total \$3.29 billion, or a modest 3.7% increase over fiscal 2006. Delaware's management practices are considered strong under Standard & Poor's Ratings Services Financial Management Assessment (FMA). 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 reports, multiyear revenue forecasting, a formal general fund reserve policy, and three debt issuance guidelines.

Delaware's annual unemployment rate has been below that of the nation for more than 20 years. For 2005, the unemployment rate was 4.2%, up slightly from the 2004 unemployment average of 4.0%. As of April 2006, Delaware's seasonally adjusted unemployment rate was 3.7% according to the U.S. Department of Labor-Bureau of Labor Statistics. The state's aggregate employment and labor force have posted positive gains in recent years. Delaware's income levels remain above the national average.

Compared with other states, facets of Delaware's overall debt burden (through fiscal 2005) are above average, as estimated debt per capita is \$2,276, translating to 5.3% of per capita personal income. However, debt service carrying charges are low at 4.2% of fiscal 2005 general and local school district fund expenditures. Moreover, amortization is very rapid, with 79% of forthcoming and existing GO debt retired over 10 years and 100% over 20 years. Delaware remains well within its three-part debt-affordability guidelines.

Outlook

The stable outlook reflects Delaware's excellent financial management, robust general fund reserves and liquidity, healthy economy, and moderate overall debt position. The stable outlook also signifies Standard & Poor's expectation that the state's prudent fiscal and debt management practices will lead to sustained sound financial operations. Despite the potential near-term economic issues surrounding the Bank of America-MBNA merger, Delaware's long-term economic outlook remains moderately positive for job growth and output.

Economy

Delaware has the highest concentration of finance employment in the nation, with more than 60 banks and trust companies based in the state. According to Global Insight, 10.5% of Delaware's nonagricultural jobs were in financial services, compared with 6.1% for the nation. Delaware has passed a number of laws to make the state more favorable for banking, credit card, and other financial firms to locate there, beginning with the 1981 Financial Center Development Act. MBNA America Bank (now Bank of America), the largest credit card lender in the world and one of the leading employers in the state (roughly 10,000 employees), anchors Delaware's credit card industry. Bank of America purchased MBNA in 2005, and although it had been speculated that 4,000 jobs would be cut, the state forecasts only 2,000 job losses resulting from the merger. More importantly, the Delaware-based credit card operation will remain intact. Keeping in line with its conservative nature, the state has incorporated the potential impacts from the merger into its revenue forecasts. DEFAC forecasts finance/insurance/real estate sector employment to decline by 0.5% in fiscal 2007 and 1.1% in fiscal 2008. Other major employers in the financial services industry in Delaware include J. P. Morgan Chase & Co. (5,200), Wilmington Trust Co. (2,100), Citicorp (1,400), and Discover Card Bank (1,200).

E.I. du Pont de Nemours and Co. (DuPont), long the state's leading employer, is now second to Bank of America, with roughly 8,900 employees, which is down from a high of 22,500 in 1992. As DuPont continues to position itself to become a global leader in the life sciences, it will attempt to achieve greater economies of scale and contain costs. Growth industries such as biotechnology, life sciences, and pharmaceuticals are expected to offset losses in the state's chemical manufacturing industry over the long term. To this end, the announcement of investment in R&D operations--\$80 million by Dupont, \$15 million by Hercules Inc., \$30 million by Air Liquide, and continued investment by AstraZeneca Inc. --is significant.

The state's manufacturing sector includes two major automobile plants: DaimlerChrysler Corp. and General Motors Corp. (GM). DaimlerChrysler's Newark, Del. plant, where the newly redesigned Durango sports utility vehicle is assembled, employs 2,100. According to Global Insight, GM recently recalled 550 workers to its plant in Newport due to increased demand for the Pontiac Solstice and the Saturn Sky. Overall, GM employs approximately 1,800 people and despite the company's current troubles, there are no near-term concerns over the Delaware facility.

The U.S. Department of Defense's Base Realignment and Closure (BRAC) commission list includes the augmentation of Dover Air Force Base by roughly 250 direct positions, while the Kirkwood U.S. Army Reserve Center and New Castle County Airport Air Guard Station will experience very slight direct job losses.

Delaware's current population totals 843,524, according to the U.S. Census Bureau, and signifies a 7.6% increase over the 2000 U.S. Census estimate. Average annual population growth between 2000 and 2005 was about 1.2%, which exceeded both the mid-Atlantic region and the nation as a whole. The state's median household effective buying income is 110% of the national average, while per capita effective buying income is 107% of the national average.

As of the June 2006 DEFAC meeting, Delaware employment growth is forecast at 1.6%, 1.0%, and 1.3% for fiscals 2006, 2007, and 2008, respectively. Delaware's projected employment growth is generally slower compared with the nation. Personal income growth is forecast at 6.7%, 6.2%, and 5.3% for fiscals 2006, 2007, and 2008, respectively. Annual population growth is forecast at 1.2%, 1.2%, and 1.3% for fiscals 2006, 2007, and 2008, respectively. Both personal income and population growth forecasts are generally favorable when compared with national estimates.

Finances

Delaware's tax and revenue structure is fairly broad. The general fund relies on tax revenues from personal income and corporate income, as well as a corporate franchise, business/occupational gross receipts, bank franchise, realty transfer, and cigarette taxes, among others. Additional significant general revenue streams include abandoned property and lottery receipts. On a budgetary basis, the personal income tax accounted for about 31% of total general fund revenues in fiscal 2005, with the corporate franchise tax (18%), abandoned property (9%), lottery (8%), and the business/occupational gross receipts tax (6%) accounting for other major revenue sources. Delaware does not levy a consumer sales tax.

Delaware's major general government expenditures consist of public education (roughly 32% of fiscal 2005 expenditures); health/social service, which includes Medicaid (25%); higher education (8%); and corrections (7%). Delaware's Medicaid costs increased at an estimated average annual rate of about 9% between fiscals 2001 and 2005. The state's share of the cost of its Medicaid program totaled nearly \$400 million in fiscal 2005. The state's approach to Medicaid is to control cost growth and manage efficiently while not reducing program benefits.

Through the June 2006 DEFAC meeting, fiscal 2006 revenues are coming in ahead of fiscal 2005 actual collections and previous 2006 projections: fiscal 2006's anticipated revenues total \$3.17 billion, or 10.3% higher than fiscal 2005 actual collections. Personal income taxes are forecast to be \$1.01 billion, or 15% higher than fiscal 2005, while corporate franchise taxes are forecast at \$514 million (a 5% increase). On a cash balance basis, fiscal 2006 is projected to close essentially on a break-even position. The ending cumulative cash balance, on a budgetary basis, is projected to be \$692 million, which includes \$337 million of continuing appropriations and the statutory 5% budgetary reserve, funded at \$161 million.

Gov. Ruth Ann Minner's fiscal 2007 recommended net operating budget totaled \$3 billion in appropriations. Since the recommended budget's introduction, DEFAC raised the fiscal 2007 general fund revenue forecast to \$3.29 billion, or 3.7% higher than fiscal 2006. Consequently, the new 98% spending limit for fiscal 2007 now totals \$3.41 billion (this is inclusive of \$194 million in unencumbered cash). Fiscal 2007 personal income and corporate franchise tax receipts are forecast to grow by 4.7% and 5.1%, respectively. Conversely, business/occupational gross receipt tax receipts are forecast to decline by \$16 million (9%) due to a recent rate reduction. Medicaid spending is budgeted to increase by roughly \$60 million (13%), while appropriations for public education are estimated to increase by about 5%. Although the operating budget is now being finalized, the state indicates that fiscal 2007's ultimate operating budget growth will be slightly less than 8%.

Delaware Economic and Financial Advisory Council

Created in 1977 in response to the fiscal challenges of the mid-1970s, DEFAC meets at least six times a year to forecast government revenues. DEFAC is a 31-member council appointed by the governor; historically, however, it has been bipartisan and has had representation from all branches of government, various business community representatives, and state academics. Mandated by executive order, DEFAC must submit annual budgetary general fund and transportation fund revenue forecasts to the governor and state Legislature in September, December, March, April, May, and June for the current fiscal year and succeeding two years. In times of economic uncertainty, DEFAC can meet more frequently. A five-year revenue forecast is to be generated once a year around September. Corresponding expenditure forecasts are required in December, March, April, May, and June. The DEFAC process is open to the public.

Regular DEFAC forecasting has allowed Delaware to take early action in recent years as revenues tightened during the recession. Moreover, DEFAC revenue forecasts enable the state to ensure compliance with constitutional limits on annual appropriations and debt. With the current makeup being bipartisan and representative, the branches of government can then take action on resolving any revenue shortfall or expenditure excess without the common debate over the size of the problem. With nearly 30 years of history, the DEFAC process has become part of the prudent and conservative culture of Delaware's financial management.

Financial Management Assessment

Delaware's management practices are considered strong under Standard & Poor's Financial Management Assessment (FMA). An FMA of strong indicates that practices are strong, well embedded, and likely sustainable. Among the highlight of the state's management techniques are:

- Regularly updated DEFAC general revenue and budget forecasts for current and future fiscal years, along with an annual DEFAC report that outlines current and subsequent fiscal year performance and estimates;
- A constitutionally required annual operating appropriation limit of 98% of estimated budgetary general fund revenue and the previous year's unencumbered budgetary general fund balance;
- A constitutionally required general fund budget reserve account funded at 5% of budgetary general fund revenue in order to provide flexibility against any unanticipated revenue declines;
- A cash management policy board that sets formal state investment policies and regularly monitors investments; and
- Three debt affordability guidelines.

The debt affordability guidelines are:

- New tax-supported debt authorizations in any one fiscal year cannot exceed 5% of estimated net budgetary general fund revenue for that fiscal year;
- No new tax-supported debt and no transportation authority debt can be issued if the aggregate maximum annual debt service on outstanding debt exceeds 15% of estimated budgetary general fund revenue and transportation trust fund revenue for the fiscal year succeeding the fiscal year in which such debt is issued; and
- No new state GO debt can be issued if, in any fiscal year, the maximum annual debt service on outstanding GO debt exceeds the estimated cash balances (including all reserves) for the fiscal year subsequent to the fiscal year in which the debt is issued.

However, Delaware does not maintain a traditional multiyear capital improvement program (CIP). The state's annual capital requirements are fully outlined in its annual capital budget, though internal cost estimates are made for capital projects expected to span multiple years. Finally, despite the fact that DEFAC provides intricate multiyear revenue forecasts, the state does not formally project multiyear general operating expenditures.

Debt

Compared with other states, facets of Delaware's overall debt burden (through fiscal 2005) are above average, as estimated debt per capita is \$2,276, translating to 5.3% of per capita personal income. When \$862 million in gas tax-supported Delaware Transportation Authority revenue bond debt is excluded, Delaware's debt burden drops to \$1,237 per capita and 2.9% of per capita personal income, based on \$1.03 billion in outstanding GO debt through fiscal 2005. These debt burden ratios exclude the state's operating lease obligations, which totaled \$112.1 million through fiscal 2005.

Delaware's debt service carrying charges are low at 4.2% of fiscal 2005 general and local school district fund expenditures, which is up from 3.9% in fiscal 2004. Amortization is very rapid, with 79% of forthcoming and existing GO debt retired over 10 years and 100% over 20 years. Delaware does not have any variable-rate debt outstanding, nor has the state entered into any interest rate swap agreement or related derivative transaction.

Delaware issues debt for political subdivisions. The state pays between 60% and 80% of the cost of capital improvements for public school districts upon approval of such costs; the school districts pay the remaining

portions. Delaware's other major bonding program is associated with the Delaware Transportation Authority. Transportation authority debt consists of revenue bonds supported primarily by motor fuel taxes, motor vehicle fees, and turnpike tolls.

The state has committed significant pay-as-you-go resources to fund capital over the past couple of years--\$236 million in fiscal 2005 and \$282 million in fiscal 2006. The recommended fiscal 2007 bond and capital budget totals \$402 million. Of this, roughly \$286 million is allocated for statewide nontransportation projects and \$117 million for transportation authority projects. Within the \$286 million statewide capital budget, \$118 million is funded by general fund revenue and \$158 million by GO bonds. However, since the recommended budget was submitted, the capital budget's numbers have increased: the current fiscal 2007 capital budget totals \$465 million, including \$165 million in GO bonds. The state will finalize the capital budget after the fiscal 2007 operating budget is enacted. Future debt plans include new transportation authority and solid waste authority debt later in 2006, and another GO issuance in early 2007.

Pensions and other postemployment benefits

Compared with other state pension systems, Delaware's pension system is well funded. The Delaware Public Employees' Retirement System (DPERS) consists of nine separate pension funds, with the State Employees' Pension Plan representing the largest plan by assets. As of fiscal 2005, the State Employees' Pension Plan's funded ratio was 101.6%, which is slightly down from 103.0% in fiscal 2004. The state's fiscal 2005 contribution to this plan totaled \$105 million, or 3% of general fund expenditures. One of DPERS's nine pension funds, the Closed State Police Pension Plan, has a 0.3% funded ratio as the state funds this plan on a pay-as-you-go basis. Other than the Closed State Police Pension Plan, the remaining pension plans are well funded.

Pursuant to Executive Order Number 67, the state conducted a comprehensive study of the potential effects of GASB 45 other postemployment benefits (OPEB) accounting disclosure. An actuarial valuation was conducted that projected a total unfunded OPEB liability of approximately \$4 billion. According to the study, the estimated annual required contribution in fiscal 2008 is \$286 million, or in excess of \$180 million more than the projected pay-as-you-go amount. The state's pay-as-you-go OPEB appropriation totaled about \$85 million (3% of general fund expenditures) in fiscal 2005. The state study also included a detailed array of potential options in addressing OPEB. At this point, the state plans to deposit 0.3% of payroll (equal to about \$5 million) in fiscal 2007 into an OPEB trust fund that was originally established in 2000. To date, about \$24 million has been accumulated in this OPEB trust fund. Delaware will continue to examine its various options in terms of addressing OPEB.

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