FitchRatings

Fitch Rates Delaware's $299MM GO Bonds 'AAA'; Outlook Stable Ratings

08 Oct 2010 4:31 PM (EDT)

Fitch Ratings-New York-08 October 2010: Fitch Ratings assigns an 'AAA' rating to the following general obligation (GO) bonds of the State of Delaware:

--$123.47 million GO bonds, series 2010B;
--$115.775 million GO bonds, series 2010C (federally taxable - Build America Bonds);
--$59.590 million GO bonds, series 2010D (federally taxable - Qualified School Construction Bonds).

In addition, Fitch affirms the following ratings:

--$1.5 billion in outstanding go bonds at 'AAA'.

The Rating Outlook is stable.

The bonds are expected to sell via negotiation the week of Oct. 18.

RATING RATIONALE:
--Delaware is a wealthy state with considerable economic and financial resources.
--Financial practices are solid and longstanding constitutional protections are designed to ensure surplus operations.
--The state employees' pension system is fully funded, and the state has taken steps to begin funding its other post-employment benefits (OPEB) liability.
--Although the state debt burden is above average, it reflects centralization of many local government functions and is mitigated by extremely rapid amortization.

KEY RATING DRIVER:
--Continuation of sound financial practices, including proactive response to economic and fiscal challenges.

SECURITY:
General Obligation, full faith and credit of the State of Delaware

CREDIT SUMMARY:
Delaware's premier credit standing centers on its considerable economic and financial resources, supported by institutionalized protections designed to ensure surplus operations. The state's economy, diversified through deliberate policies that created a climate attractive to banking and related business services, and pharmaceuticals, is showing the effects of the deep recession like much of the nation. There is no state sales tax, aiding in the state's comparative cost advantage. An above-average debt burden is tempered by a rapid rate of amortization, with 74% of GO bonds due in 10 years.

Delaware is a wealthy state, illustrated by personal income per capita that ranks 19th of the states at 101% of the nation, although recent personal income performance has lagged the U.S. Unemployment levels are typically well below the U.S. average (87% of the U.S. rate at 8.1% in 2009); although, like the nation, the rate remains relatively high as the economic recovery is slow to take hold. The August unemployment rate was 8.4% versus the U.S. rate of 9.6%. The pace of employment growth, which had slowed as compared to the U.S. beginning in 2006, began to decline midway through 2008 and declined 1% in 2008 compared to a .4% drop for the U.S. Employment declined 3.9% in 2009 comparing favorably to a 4.5% decline for the nation. Job losses began to abate early in calendar 2010 and modest growth resumed in July. August year-over-year job growth of .9% exceeded the U.S. rate of .2%. The state's September forecast projects a slow recovery in employment, with growth delayed until FY 2012 after a flat year in FY 2011 and 3.6% decline for fiscal 2010.

The state addressed revenue shortfalls during FY 2009 totaling $215 million as the forecast was repeatedly lowered over the course of the year. To match spending to the lowered revenues, the governor instituted a statewide hiring freeze and announced midyear budget reductions of 7% for all state agencies, excluding schools and higher education. Other expenditure reduction measures included deauthorizing cash-funded capital projects and shifting Medicaid payments by one day into FY 2010. The state was able to close the budgetary gap without using its budget reserve fund, which remained fully funded at $186.4 million (5%) of prior year appropriations.

Faced with an $800 million budget gap in FY 2010, the state used a combination of budget reductions, revenue enhancement including increases in corporate franchise, personal income and cigarette taxes, and federal stimulus funds to achieve balance. Revenue performance improved slightly over the course of the fiscal year, with total revenues 2.9% higher than estimated at the beginning of the fiscal year. Total revenue increased 2.8% year-over-year and expenditures were reduced 6.6% resulting in a positive operating balance and a $157 million increase in the unencumbered cash balance to $165.8 million from just $8.4 million at the end of FY 2009. The state ended fiscal year 2010 with its budget reserve fund intact.

Revenues are expected to rebound in fiscal 2011, with total revenue estimated to increase 4%, led by a 12% increase in personal income tax receipts. The enacted budget increases appropriations 6.9% with reductions in the base budget offset by continued federal stimulus supported spending. The 2.5% pay reduction implemented in fiscal 2010 is restored to employees in fiscal 2011. Operations will benefit from the receipt of additional federal stimulus funds that had not been assumed in the budget, including $47.3 million of enhanced federal matching funds for Medicaid (FMAP) and $27.4 million in education jobs funding.

Lottery revenues (8.5% of FY 2010 general fund revenues) have been negatively affected by the start of video lottery operations in Pennsylvania. Consistent with prior practice, the state has enacted legislation to enhance its competitive position; however, the November 2008 voter approval of gaming in Maryland is expected to significantly reduce lottery revenues starting in fiscal 2011. Abandoned property typically accounts for 10% to 12% of general fund revenues though collections were a high 15% in fiscal 2010; this variable revenue stream has been negatively affected by the downturn in financial markets but the state's decision to shorten the dormancy period on held securities is resulting in an increase in these collections.

The Delaware Economic and Financial Advisory Council (DEFAC) reviews revenue forecasts at least six times each fiscal year. The most recent forecast, from September 2010, raised modestly the general fund revenue estimate for fiscal 2011 (by $63 million), reflecting expected increases in corporate and franchise taxes. Personal income tax revenue declined 9.6% in FY 2009 and a further 6.3% in FY 2010, despite tax increases included in the budget. However, the tax increase is evident in the estimate for FY 2011 when personal income tax revenue is expected to increase 12%.

As a small state with a minimal number of local governments, Delaware's service functions are highly centralized, leading to an upper moderate debt burden. Net tax-supported debt as of June 30, 2010, equals about $2.6 billion, or 7.3% of personal income, with about 46% of debt issued through the transportation authority. This ratio remains well below the double-digit levels experienced in the state's very weak fiscal period of the mid-1970s, reflecting steps taken by the state to reduce its bonding for capital. The state employees' pension system was overfunded until 2009 when investment losses resulted in the development of a small unfunded liability.

Contact:

Primary Analyst
Karen Krop
Senior Director
+1-212-908-0661
Fitch, Inc.
One State Street Plaza
New York, NY 10004

Secondary Analyst
Laura Porter
Managing Director
+1-212-908-0575

Committee Chairperson
Kenneth Weinstein
Senior Director
+1-212-908-0571

Media Relations: Cindy Stoller, New York, Tel: +1 212 908 0526, Email: cindy.stoller@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.

In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from IHS Global Insight.

Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria', dated Aug. 16, 2010;
--'U.S. State Government Tax-Supported Rating Criteria', dated Oct. 8, 2010.

For information on Build America Bonds, visit 'www.fitchratings.com/BABs'.

Applicable Criteria and Related Research:
U.S. State Government Tax-Supported Rating Criteria
Tax-Supported Rating Criteria