STANDARD
&POOR'S

Global Credit Portal®
RatingsDirect®

October 26, 2011

# Delaware; General Obligation

**Primary Credit Analyst:**
Robin Prunty, New York (1) 212-438-2081; robin_prunty@standardandpoors.com

**Secondary Contact:**
Danielle Leonardis, New York (1) 212-438-2053; danielle_leonardis@standardandpoors.com

## Table Of Contents

# Delaware; General Obligation

| Credit Profile | | |
|---|---|---|
| US$275.0 mil GO bnds ser 2011A&B due 07/01/2031 | | |
| *Long Term Rating* | AAA/Stable | New |
| **Delaware GO** | | |
| *Long Term Rating* | AAA/Stable | Affirmed |

## Rationale

Standard & Poor's Ratings Services assigned its 'AAA' rating, and stable outlook, to Delaware's series 2011A and B general obligation (GO) bonds. At the same time, Standard & Poor's affirmed its 'AAA' rating, with a stable outlook, on Delaware's GO debt outstanding.

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

- Diversified economy, which is recovering in line with national trends after recessionary declines related to the financial service and manufacturing sectors;
- Strong financial and budget management;
- 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--other postemployment benefit (OPEB) liabilities are what we regard as significant, but the state has been actively managing the liability.

Delaware's budgetary performance and liquidity remain strong despite the recent recession and slow pace of economic recovery. The state ended fiscal 2011 with a cumulative general fund cash balance of $797.8 million or 24.4% of general fund expenditures. This includes a fully funded budget reserve account of $186.4 million. The budget reserve account is established by constitution and is funded at 5% of estimated budgetary general fund revenues. We believe this provides significant flexibility to respond to a deteriorating macroeconomic outlook and the potential for federal funding reductions in the future. The strong operating performance in fiscal 2011 was due largely to stronger-than-forecasted revenue performance and federal stimulus funds above the budgeted amount. The surplus and healthy reserve position eased the state's transition to fiscal 2012 and the elimination of federal stimulus funds.

The fiscal 2012 budget was balanced with no revenue increase and focused on spending reductions and targeted tax rate reductions. The general fund operating budget totals $3.5 billion or 6.1% above the fiscal 2011 budget, within the 98% of revenue limitation. The Delaware Economic and Financial Advisory Council (DEFAC) updates the revenue forecast six times in the fiscal year. The most recent forecast update in September reflects a deteriorating national and state economic outlook, and revenues were adjusted downward slightly by $43 million or what we consider a modest 1.2% in fiscal 2012 and $55 million in fiscal 2013. Total revenues were adjusted down by $234.1 million to include certain legislative changes included in the enacted budget. The forecast update does not assume a double dip recession but does factor in a weaker recovery. Based on the enacted budget, the state's budget reserve account will remain intact at year-end as it has since 1980. The unencumbered cash balance is projected to decline following the planned use for capital, economic development initiatives, and other nonrecurring items.

Standard & Poor's 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, multiyear revenue forecasting, a formal general fund reserve policy, and formal statutory debt affordability issuance guidelines.

Delaware's economy is relatively diverse following several decades of active economic development at the state level. Performance over time has been stable, in our view, with unemployment consistently below the nation's rate for the past 20 years. The current rate of 8.1% through September of 2011 compares favorably with the national rate of 9.1%. Development initiatives have encouraged financial sector, business services, pharmaceutical, and biotech expansion and have reduced the state's reliance on manufacturing. Although Delaware lost several large manufacturing firms through the recession, many of the sites have been acquired and are undergoing redevelopment. State income levels remain in line with the national average.

The state has implemented various debt management policies over time to decrease its debt burden and limit bond issuance. These measures have been successful in reducing Delaware's debt level despite the broad role the state maintains in funding capital requirements for education and corrections.

Most of Delaware's debt limitations are imbedded in statute, and the state has adhered to these limitations over time. Compared with Delaware's state peers, current tax-supported debt levels are, in our opinion, moderately high at $2,612 per capita and 6.6% of personal income. Total GO debt is $1.8 billion following this issuance, of which $591 million is supported by local school districts. Transportation trust fund revenue bonds are supported by various state gas tax and motor vehicle fees. Debt service carrying charges are projected to be a moderate 6.2% of general fund appropriations in fiscal 2012. Debt amortization is rapid, in our opinion, with about 74% of principal scheduled to retire in the next 10 years. The state's pension plan had a funded ratio of 94% and an unfunded accrued liability of $456.1 million as of June 30, 2011. Delaware has historically contributed its annual required contribution (ARC). Its OPEB liability is sizable at $6.3 billion, although the state has worked on managing this liability through various funding and reform initiatives and Standard & Poor's expects this to continue.

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 '1.5' to Delaware.

## Outlook

The stable outlook reflects what we view as the state's healthy reserve and liquidity position, which remained strong despite the recent recession and slow pace of economic recovery. Proactive budget management has been a key to Delaware's credit stability over time and we believe that this will be an important consideration over our two-year outlook horizon given the deteriorating economic outlook and the uncertainty surrounding federal funding. Standard & Poor's will continue to monitor the federal consolidation efforts stemming from the Budget Control Act and, once these are identified, will evaluate their effect on the state's finances and officials' response to these revenue reductions.

## Government Framework

In our opinion, Delaware has a strong government framework. Due to well-established policies, the state has been able to maintain what we view as its solid financial position, especially during recessionary periods, including the recent recession. The Delaware Constitution requires that the governor submit a balanced budget to the general assembly annually. While there is no legal requirement to maintain a balanced budget during the year, the DEFAC's frequent revenue and expenditures updates allow for timely adjustments. State statute provides the executive branch with the authority to make necessary adjustments after providing for the payment of principal and interest on the state's bonds, notes, or revenue notes. The state cannot carry forward operating deficits from one year into the subsequent year.

A constitutionally required annual operating appropriation limit of 98% of estimated budgetary general fund revenues and the previous year's unencumbered budgetary general fund balance support the government framework. The state has what we regard as considerable revenue-raising ability; it can increase income tax and license fees as well as implement the imposition or the levy of new taxes or license fees with the concurrence of three-fifths of all members of each house. Public and higher education, and health and social services are the state's leading expenditures, accounting for 40% and 26%, respectively, in fiscal 2011. Delaware pays between 60% and 80% of public school capital improvements on approval by the state board of education with the school district paying the difference.

As debt service becomes due, the school districts are required to pay debt service into the state's budgetary general fund from their tax receipts; then the state pays the total debt service from its budgetary general fund appropriations. If Delaware fails to make sufficient provisions to pay principal and interest on any of the bonds outstanding, or if at the time such an amount is payable sufficient funds are unavailable, state law requires the state treasurer to set apart a sum to pay principal and interest from the first revenues thereafter received by the state. Delaware does not permit for initiatives or referendums at the state or local level, and it is the only state that does not require popular approval of constitutional amendments.

On a four-point scale, where '1.0' is the strongest and '4.0' is the weakest, Standard & Poor's has assigned an overall score of '1.4' to Delaware's governmental framework.

## Financial Management

Delaware's constitution, statutes, and internally developed policies guide its overall financial and budget management. Policy improvements have been made continuously over time and the state's track record of adhering to policies has been strong.

### Financial Management Assessment: 'Strong'

Standard & Poor's considers Delaware's management practices "strong" under its Financial Management Assessment (FMA) methodology. An FMA of strong indicates practices are strong, well embedded, and likely sustainable.

Key policies include:

- The 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 revenues 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 revenues to provide flexibility against any unexpected revenue declines;
- A cash management policy board that sets formal state investment policies and regularly monitors investments;
- Well-established debt management policies including a three-part statutory debt affordability limit; and
- Multiyear revenue forecasts updated throughout the fiscal year with a less formal process for general operating expenditures.

Delaware, however, does not maintain a traditional multiyear capital improvement program. The state fully outlines its annual capital requirements in the annual capital budget, but officials make internal cost estimates for capital projects expected to span multiple years.

The three-part statutory debt affordability limit includes the following:

- 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 (MADS) on debt outstanding exceeds 15% of estimated budgetary general fund revenues and transportation trust fund revenues 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 MADS on GO debt outstanding exceeds the estimated cash balances, including all reserves, for the fiscal year subsequent to the fiscal year in which the debt is issued.

**Budget management framework**

An executive order mandates DEFAC to submit budgetary general fund and transportation trust fund revenue forecasts to the governor and the general assembly six times a fiscal year in September, December, March, April, May, and June for the current fiscal year and the succeeding two fiscal years. Delaware uses these forecasts in the state budget process to ensure compliance with constitutional spending limits and statutory debt limitations.

The state has a strong track record of implementing adjustments as needed.

On a four-point scale, where '1' is the strongest and '4' is the weakest, Standard & Poor's has assigned an overall score of '1' to Delaware's financial management.

## Economy: Recovery Under Way But Pace Is Slow

Delaware's economic recovery has been modest to date after a period of decline through the recent recession. Although many sectors experienced decline through the recession, it was most pronounced in the manufacturing, financial services, and construction sectors. The state's economy has diversified over time with contributions from government (15.4%), wholesale and retail trade (15.0%), health services (13.9%), and financial services (9.0%), according to the Delaware Department of Labor in 2010. The financial services sector remains well anchored despite the financial crisis and recession, with more than 70 bank and trust companies operating in the state, and remains a steady focus of economic development at the state level with significant legislation and tax policy directed at it. Some of the more significant manufacturing downsizing has been offset to some degree by reinvestment, which has minimized the affect on the overall economy.

State officials continue to focus on economic development initiatives centered on biotechnology, life sciences, and pharmaceuticals, which have been growth areas. The U.S. Department of Defense's Base Realignment and Closure Commission list keeps Dover Air Force Base, the Kirkwood U.S. Army Reserve Center, and New Castle County Airport Air Guard Station viable. Federal government employment accounts for less than Dover Air Force Base, which accounts for less than 2% of total employment. Federal spending as a share of state gross domestic product is the lowest among all states at 13.5% (see "State And Local Governments Face Fiscal Challenges Under Federal Debt Deal," published Aug. 18, 2011, on RatingsDirect on the Global Credit Portal). Delaware's current population is 898,000 according to the U.S. Census and growth rates have been relatively strong since 2005 compared with the U.S. and the mid-Atlantic region, with 1.4% average annual growth. Personal income has grown at a slower pace, however, and represents 99% of the U.S. average compared with 104% in 2005.

According to the September 2011 DEFAC report, projections for state employment growth are 0.9%, 1.8%, and 1.5% for fiscal years 2012, 2013, and 2014, respectively. The state expects personal income to increase by 3.8%, 4.0%, and 4.0%, respectively, from fiscal years 2012-2014. Population is forecast to rise by 1.4% annually in the same period. These forecasted growth rates are closely aligned the DEFAC forecast for the U.S.

On a four-point scale, where '1.0' is the strongest and '4.0' is the weakest, Standard & Poor's has assigned an overall score of '1.6' to Delaware's economic factors.

## Budgetary Performance

Delaware's tax and revenue structure is broad, in our opinion. The general fund relies on tax revenues from personal income and corporate income, as well as a corporate franchise tax; business and occupational gross receipts; a bank franchise tax; realty transfers; and cigarette taxes, among others. Additional significant general revenue streams include abandoned property and lottery receipts. Delaware does not levy ad valorem taxes on real or personal property and does not impose a general sales or use tax. The budget reserve account has been a stabilizing factor to the state's overall financial profile and liquidity. The budget reserve account, or rainy-day fund, is funded at 5% of estimated budgetary general fund revenues. Officials can appropriate this money only with the approval of a three-fifths vote of the members of each house of the general assembly, and they can only use the money to fund an unexpected budgetary deficit or to provide funds required due to the enactment of legislation reducing revenue. Officials have not withdrawn any funds from the budgetary reserve account since its inception in 1980.

### Fiscal 2010

On a generally accepted accounting principles basis, business taxes accounted for almost 53% of general fund revenues in fiscal 2010, followed by personal income tax at 22%. At the close of fiscal 2010, Delaware's unreserved general fund balance was $843.6 million while its reserved general fund balance, which includes the budgetary reserve account, was $353.0 million. On a combined basis, these reserves totaled almost 32% of expenditures. On a budgetary basis, the fiscal 2010 cumulative cash balance was $537.1 million, less the budgetary reserve account, which remains funded in full at 5%, for a total unencumbered cash balance of $165.8 million, much improved from $8.4 million in fiscal 2009.

On a four-point scale, where '1.0' is the strongest and '4.0' is the weakest, Standard & Poor's has assigned an overall score of '1.3' to Delaware's budgetary performance.

## Debt And Liability Profile

The state has focused its attention on reducing debt over time with clearly defined debt affordability parameters and a commitment to cash-funding capital projects funding, especially when the economy is performing well. The fiscal 2012 bond and capital improvement act totals $663.9 million: $432.4 million for state projects and $220 million for transportation. The plan includes GO debt issuance of $171 million.

Delaware does not have any variable-rate debt outstanding, and it has not entered into any interest rate swap agreements or related derivative transactions. The state issues debt for political subdivisions. It 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 Delaware Transportation Authority. Transportation authority debt consists of revenue bonds supported primarily by motor fuel taxes, motor vehicle fees, and turnpike tolls.

## Pensions And Other Postemployment Benefits

Compared with other state pension systems, Delaware has funded its pension system well, in our opinion. 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 2011, the State Employees' Pension Plan had a strong funded ratio of 94%. Fiscal 2011 saw a 24.3% return on investments. The state's fiscal 2011 contribution to this plan totaled $141.6 million, or 4.3% of general fund expenditures. One of DPERS' nine pension funds, the Closed State Police Pension Plan, has a 0.5% funded ratio since the state funds this plan through pay-as-you-go financing. Other than the Closed State Police Pension Plan, Delaware has funded its remaining pension plans well. The state lowered its investment return assumption to 7.5% from 8.0%.

As of July 1, 2011, Delaware's actuarially accrued liability for OPEB is what we consider a sizable $6.3 billion, using a discount rate of 5%. The ARC is estimated at $496 million in fiscal 2011, which would represent 15% of general fund expenditures. The state has actively managed this liability, in our view, and we expect these efforts to continue. Through legislation effective July 1, 2007, Delaware created an OPEB trust fund, of which it had $130 million of assets accumulated as of Aug. 31, 2011. Recent legislation was passed, making modifications to employee health and pension plans that are expected to moderate costs over time. The legislation centered on increasing contributions, increasing vesting and other reforms for new hires, and other cost-saving measures for current employees.

On a four-point scale, where '1.0' is the strongest and '4.0' is the weakest, Standard & Poor's has assigned an overall score of '2.1' to Delaware's debt and liabilities profile.

## Related Criteria And Research

- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- State And Local Government Ratings Are Not Directly Constrained By That Of The U.S. Sovereign, Aug. 8, 2011