

RatingsDirect®

Delaware; General Obligation

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Delaware; General Obligation

Credit Profile		
US\$225.0 mil GO bnds ser 2013B due 08/01/2026		
<i>Long Term Rating</i>	AAA/Stable	New
US\$115.01 mil GO bnds ser 2013A due 08/01/2026		
<i>Long Term Rating</i>	AAA/Stable	New
Delaware GO		
<i>Long Term Rating</i>	AAA/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services assigned its 'AAA' rating, and stable outlook, to Delaware's series 2013A 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. We understand that the series 2013A bonds will be used to refund certain bonds outstanding for interest cost savings and the series 2013B bonds to fund various authorized capital projects.

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

- Relatively diverse economy, which is recovering in line with national trends;
- Strong financial and budget management;
- Consistently strong general fund reserves and liquidity even during recessionary periods;
- Moderately high overall debt burden, with what we consider strong debt management policies in place; and
- Well-funded pension system and progress in addressing other postemployment benefits (OPEB) liabilities, which we consider sizable. Reform efforts should help to mitigate future cost pressures for the state.

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 6.9% through December 2012 compares favorably with the national rate of 8.1% and the mid-Atlantic region's rate of 8.3%. Economic development initiatives have included targeted statutory and tax policy changes to encourage financial sector, business services, pharmaceutical, and biotech expansion, and have reduced the state's reliance on traditional manufacturing. We expect that this investment will continue the trend of diversification and allow Delaware to benefit from other developments in the region. Although Delaware lost several large manufacturing firms through the last 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 a long history of prudent fiscal management. This includes making difficult budget decisions to restore fiscal balance when necessary, as well as managing surpluses when they occur, to retain structural budget balance. Delaware's enacted fiscal 2013 budget was focused on spending restraint, in our view, and was balanced with no revenue enhancement. The general fund operating budget was \$3.6 billion, a 2.2% growth over fiscal 2012, within the

98% of revenue limitation. Of the \$78 million in additional spending, \$38.5 million was tied to education, \$21 million to fund caseload and inflationary growth in Medicaid, \$14.1 million to fund a 1% pay increase for state employees and public education, and \$10 million will be contributed to the state's OPEB trust fund. Delaware also indicates it's moving forward with federal health care reform. The Delaware Economic and Financial Advisory Council (DEFAC) updates the revenue forecast six times per fiscal year and the most recent adjustment in December forecasts that revenues will be 11.2% higher than last year and are performing in line with estimates. Based on the enacted budget, Delaware's budget reserve account (5% of budgetary revenue) will remain intact at year-end as it has since 1980 and an unencumbered \$167 million is forecast.

At the December DEFAC meeting, the revenue forecast for fiscal years 2014 and 2015 was also updated. While modest economic recovery is forecast, revenues are projected to decline by 2% in fiscal 2014 (\$3.66 billion) and 0.7% in fiscal 2015 (\$3.64 billion) due to the sunset of various tax increases. Due to this revenue decline, Delaware was forecasting a preliminary budget gap of \$56 million, growing to \$266.4 million in fiscal 2015 (assuming 3.3% appropriation growth). Under the governor's proposed budget, about half of the gap is closed with revenue measures and half with spending reductions. Significantly, in our view, the recommendations included in the fiscal 2014 budget are also aimed at resolving the projected budget gap for fiscal 2015. The recommended 6.6% personal income tax rate is projected to yield \$24.7 million in fiscal 2014 and \$61.5 million in fiscal 2015. The other significant measure is the extension of the corporate franchise tax, which is expected to yield \$80 million in fiscal 2015. Total appropriations in the recommended budget are \$3.8 billion, or 3.3% above fiscal 2013 estimated appropriations. We expect that continued economic growth should moderate social service caseload growth, which will ease some budgetary pressure in the next two years. The state will be expanding Medicaid as part of federal health care reform implementation and has made steady progress on implementing requirements associated with reform in our view.

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, transportation, and corrections.

Most of Delaware's debt limitations are imbedded in statute, and the state has adhered to these limitations over time. Total GO debt is \$1.7 billion following this issuance, of which \$545 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 were a moderate 6.3% of general fund appropriations in fiscal 2013. Debt amortization is rapid, in our opinion, with about 70% of principal scheduled to retire in the next 10 years. The state's primary pension plan had a funded ratio of 91.5% and an unfunded accrued liability of \$679 million as of June 30, 2012. Delaware has historically contributed its annual required contribution (ARC) to this plan. In 2011, it lowered its investment earnings assumption to 7.5% from 8.5%, which is reflected in the 2012 report. Legislation was approved in 2011 that instituted various reforms to the state's pension and OPEB. The legislation establishes a fixed cost share in Delaware's health insurance programs for both active employees and retirees and increases the time to vest for retiree health care benefits. The liability was also lowered by shifting the cost of retiree pharmacy benefits to the Centers for Medicare and Medicaid Services (effective Jan. 1, 2013). As a result, the OPEB liability declined to \$5.8 billion as of June 30, 2012, compared with \$6.8 billion in 2011. While the liability remains substantial, we believe the state has been actively managing it over the past several years.

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.

Outlook

The stable outlook reflects what we view as the state's healthy reserve and liquidity position, which we believe positions the state well to manage future economic volatility. 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 slow pace of economic recovery, uncertainty surrounding federal funding, and federal health care reform implementation.

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 next.

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. Delaware 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, each accounting for 31% 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 Delaware'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 Assessment: 'Strong'

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.

Standard & Poor's considers Delaware's management practices "strong" under its 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 '1.0' is the strongest and '4.0' is the weakest, Standard & Poor's has assigned an overall score of '1.0' to Delaware's financial management.

Economy: Recovery Continues

Delaware's economic recovery has been modest to date. 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 (15.1%), wholesale and retail trade (14.9%), health services (14.6%), and financial services (9.1%), according to the Delaware Department of Labor in 2012. The financial services sector remains well anchored with more than 70 bank and trust companies operating in the state with more than 25,000 employees, and remains a steady focus of economic development at the state level with regular statutory and tax policy changes focused on creating economic incentives. The other important segment of the economy and state tax base are the volume of business entities registered in Delaware, which now number 995,000, with 143,000 added in 2012 alone according to the state.

Other economic development initiatives have centered on biotechnology, life sciences, and pharmaceuticals, which have been growth areas. Delaware's targeted investment in these industries and their proximity to aligned industry clusters in Maryland and New Jersey should position the state well for expansion. Some of the more significant manufacturing downsizing has been offset to some degree by reinvestment, which has minimized the effect on the overall economy.

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 is limited and accounts for less than 2% of total employment according to the state. 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 917,000 according to the U.S. Census, and growth rates have been relatively strong in the past five years compared with the U.S. and the mid-Atlantic region, with more than 1% average annual growth. Personal income has grown at a slower pace, however, and represents 100% of the U.S. average compared with 104% in 2005.

Delaware's forecast of growth for the next three years is reasonable based on current performance. According to the December 2012 DEFAC report, projections for state employment growth are 1.5%, 1.9%, and 1.7% for fiscal years 2013, 2014, and 2015, respectively. The state expects personal income to increase by 2.9%, 3.7%, and 4.2%, respectively, from fiscal years 2012-2014. Population is forecast to rise by 1.3% in fiscal 2013 followed by growth of 1.4% in fiscal years 2014 and 2015. 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 '1.7' 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 2012 Budgetary Results

On a budgetary basis, the state ended fiscal 2012 with a cumulative general fund cash balance of \$565 million or 15.7% of general fund expenditures compared with \$798 million at fiscal year-end 2011. 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. Although the cash balance was lower at fiscal year-end 2012, it reflects a planned use of funds for capital, economic development initiatives, and other nonrecurring items including capital appropriations (\$115 million) and targeted grants (\$41 million).

Fiscal 2012 Audit

On a generally accepted accounting principles basis, business taxes accounted for almost 47% of general fund revenues in fiscal 2012, followed by personal income tax at 28.6%. At the close of fiscal 2012, Delaware's total general fund balance was \$1.4 billion or 32.8% of general fund expenditures. Of this amount, \$964 million was unassigned.

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. We believe that this will contribute to a stable debt profile in the future. Total tax-supported debt including GO and transportation bonds equaled \$2,372 per capita and 5.7% of personal income, which we view as moderately high. The recommended bond and capital improvement act for fiscal 2014 totals \$423.5 million: \$239.3 million for state projects and \$184.2

million for transportation. The plan includes GO debt issuance of \$185.8 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 the 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 2012, the State Employees' Pension Plan had a strong funded ratio of 91.5%. Fiscal 2012 saw a 2% return on investments on a market value basis. The state's fiscal 2012 contribution to this plan totaled \$147 million, or 4.1% of general fund expenditures. One of DPERS' nine pension funds, the Closed State Police Pension Plan, has a 0.9% funded ratio since the state funds this plan through pay-as-you-go financing with only one active employee in the plan. The liability for this plan is significant in our view at \$291 million. 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%. In the past 5, 10, and 15 years, the fund has had annualized total returns of 3.9%, 7.6%, and 7.3%, respectively.

As of July 1, 2012, Delaware's actuarially accrued liability for OPEB is what we consider a sizable \$5.8 billion, using a rate of return assumption of 4.25%. The ARC is estimated at \$553 million in fiscal 2012, compared with actual contributions of \$183.5 million (4.3% of general fund expenditures). The state has actively managed this liability, in our view, and we expect these efforts to continue. In 2007, Delaware created an OPEB trust fund that had assets of \$163 accumulated as of July 1, 2012. 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, as well as 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 '2.5' to Delaware.

Related Criteria And Research

- U.S. State And Local Government Credit Conditions Forecast, Jan. 17, 2013
- State And Local Government Ratings Are Not Directly Constrained By That Of The U.S. Sovereign, Aug. 8, 2011
- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- USPF Criteria: Financial Management Assessment, June 27, 2006

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