STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

RatingsDirect®

Delaware; Appropriations; General Obligation

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Credit Profile		
US$225.0 mil GO bnds ser 2014 due 03/01/2034		
Long Term Rating	AAA/Stable	New
Delaware GO bnds		
Long Term Rating	AAA/Stable	Affirmed
Delaware GO		
Long Term Rating	AAA/Stable	Affirmed
Sustainable Energy Util, Inc., Delaware		
Delaware		
Sustainable Energy Utility, Inc. (Delaware) rev		
Long Term Rating	AA+/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services has assigned its 'AAA' rating, and stable outlook, to Delaware's general obligation (GO) bonds, series 2014. At the same time, Standard & Poor's affirmed its 'AAA' rating, with a stable outlook, on Delaware's GO debt outstanding.

Bond proceeds will fund various capital projects.

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

- Relatively diverse economy, which continues to expand at a modest pace and in line with national trends;
- 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 and progress in addressing other postemployment benefits (OPEB) liabilities, which are significant.

We believe Delaware's economy is relatively diverse following several decades of active economic development at the state level. Performance has been stable, in our view, with unemployment consistently below the nation's rate for the past 20 years. The 6.2% rate for 2013 through December 2013 compares favorably with the national rate of 7.4% and the mid-Atlantic region's 7.6%. 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. Although Delaware lost several large manufacturing firms during the recession, many of the sites have been acquired and are undergoing redevelopment. State income levels remain in line with the national average.

Delaware has a long history of what we view as prudent fiscal management. This includes making difficult decisions to restore budget balance when necessary, as well as managing surpluses when they occur, to retain structural budget balance.

The Delaware Economic and Financial Advisory Council (DEFAC) updates the revenue forecast six times per fiscal year. The most recent adjustment in December forecasts that revenues will be in line with 2012 levels and are performing in line with estimates. Based on the enacted budget for 2014, Delaware's budget reserve account ($201.7 million or 5% of budgetary revenue) will remain intact at year-end as it has since 1980 and an unencumbered cash balance of $113.8 million is forecast. We believe this provides significant flexibility to respond to any deterioration in the macroeconomic outlook or other potential budget gaps.

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 has implemented various debt management policies to decrease its debt burden and limit bond issuance. These measures have reduced the state's debt level despite the broad role it maintains in funding capital requirements for education, transportation, and corrections.

Delaware's pension funds have historically been well-funded with a long history of contributing the actuarial required contribution (ARC). Although the state's OPEB liability is substantial, it has been actively managing this in 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 '1.5' to Delaware.

Outlook

The stable outlook reflects what we view as the state's healthy reserve and liquidity position, which has been stable over a range of economic cycles. Proactive budget management has been a key to Delaware's credit stability and we believe that this will be an important consideration over our two-year outlook horizon, given the continued slow pace of economic recovery and spending pressures in key program areas of education and Medicaid as well as federal health care reform implementation.

Government Framework

In our opinion, Delaware has a strong government framework. Due to well-established policies, the state has maintained what we view as a 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. Although 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 Delaware's bonds, notes, or revenue notes. The state cannot carry forward operating deficits.

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 more than 60% in fiscal 2013. Delaware pays 60%-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, or if sufficient funds are unavailable at the time an amount is payable, 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 and the state's track record of adhering to policies has been what we consider to be 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 maintains 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 they expect 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 total 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.
- No new state GO debt can be issued if, in any fiscal year, the MADS on existing 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.

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

Delaware's economy has continued to improve after the recession, led by employment growth in the professional and business services, financial activities, leisure and hospitality, and information sectors in December 2013 compared to a year earlier despite continued employment declines in the manufacturing and construction sectors. The largest employment sectors in 2012 included trade transportation and utilities (18%), education and health services (16%), government (15%), and professional and business services (13.5%). Although Dover Air Force Base is one of the state's major employers, overall federal government employment is limited and accounts for about 1.3% of total nonfarm employment, according to IHS Global Insight Inc.

Despite some contraction during the recession, the financial services sector continues to account for a relatively larger proportion of employment in Delaware than it does nationally at 10.1% of total state employment in 2012 compared with 5.8% nationally. 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. Primary employers in the state among financial institutions include Bank of America NA, JPMorgan Chase & Co., Barclays Bank Delaware, and Capital One Financial Corp. Other leading private employers include the DuPont Co. and Christiana Healthcare System.

The other important segment of the economy and state tax base are the volume of business entities registered in Delaware, which now exceed 1 million, after 152,000 were added in 2013 alone according to the state. Delaware attributes its flexible corporate and legal entity statutes as well as its competitive business and legal environment to the significant level of historical new business formation.

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. In addition to providing infrastructure grants for projects such as a proposed 288,000-square-foot self-powered data center at the former Chrysler plant in Newark, Del., the state has developed workforce development and education initiatives to foster innovation in targeted industries. The state also aims to diversify and bolster its gambling industry with a recent bill reactivating a sports lottery and legalizing internet gaming. Although AstraZeneca plc, a pharmaceutical company, announced job cuts as part of a restructuring and the state continues to see declines in manufacturing employment in the years since the recession, the state reports Allen Harim Foods, a poultry processor, has recently announced a $100 million investment and 700 new jobs; and ILC Dover L.P. has announced its plans to bring 115 new manufacturing jobs to a new plant in the state.

Delaware's population is 917,000 according to the most recent U.S. Census. Growth rates have been relatively strong in the past decade compared with the U.S., with more than 1% average annual population growth.

Per capita personal income is also above the national average, although we note it has increased more slowly than that of the nation in the previous decade. Personal income was 101% of the U.S. average in 2012 compared with 110% in 2002. DEFAC updated the state's economic forecast in December. Projections are reasonable in our view, given the pace of recent expansion, and are also in line with our projections of the national recovery. State personal income is projected to increase 3.3%-4.9% a year from fiscal year 2014 to 2016, due, in part, to higher forecast employment growth in the banking sector. The state also forecasts overall annual average population growth of 1.2% and employment growth of 1.5%-1.9% in the next three years. IHS Global Insight also forecasts real gross state product (GSP) to increase from 1.9%-3.6%. GSP per capita has historically remained well above GDP per capita at 145% of the U.S.; however Delaware's GSP growth has lagged the national rate in the previous few years.

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 '1.5' to the state'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 2014 update and proposed fiscal 2015 budget

At the December DEFAC meeting, the revenue forecast for fiscal 2014 was updated as were projections for fiscal years 2015 and 2016. Revenues to date are largely on track with the revised forecast and show no growth over fiscal 2013 revenues. The unencumbered cash balance at fiscal year-end 2014 is estimated at $113.8 million and the budget reserve account is fully funded at $201.7 million.

The governor released the proposed budget for fiscal 2015 on Jan. 27, within the 98% appropriation limit of revenues that DEFAC projects. The estimated gap that needed to be closed was $139 million or 1.3% of available revenue. Gap-closing solutions in the budget include a combination of agency program cuts; minor revenue adjustments; and certain nonrecurring measures, including a redirection of abandoned property revenue back to the general fund ($40 million) and a redirection of realty transfer tax revenue ($16 million) back to the general fund. The transfer of abandoned property follows a statutory change in 2013 that was intended to limit the amount of general fund reliance on this source. We believe that increasing reliance on this introduces the potential for greater volatility to the revenue base; it would account for about 14% of total revenues in fiscal 2015 if approved and is the third-largest revenue source for the general fund.

The primary revenue change is an increase in the annual tax on limited liability companies to $300 from $250, which is projected by the state to yield $33 million. An increase in the minimum annual corporation franchise tax to $175 from $75, which is projected to yield $18 million.

Total general fund revenues total $3.9 billion under the proposal. Personal income is the largest tax source (37% of total revenues) and is projected to grow by 4.5%. Franchise taxes are forecast to decline slightly, by 1%.

Total recommended general fund budget for fiscal 2015 is $3.8 billion or 3% above fiscal 2014 levels. The budget includes a 1% general salary increase for employees and continues with implementation of the Affordable Care Act, including the expansion of Medicaid. A key budget driver for fiscal 2015 is a lower Federal Medical Assistance Percentage (FMAP) for current Medicaid caseloads. The rate was lowered to 53% from 55% based on the relative improvement in Delaware's income levels. Another budget driver is education with a projection for higher enrollment in public schools.in fiscal 2015. Enrollment increases and any further FMAP changes could represent significant funding pressure given that they represent more than 60% of total general fund spending. The state's rainy-day fund remains fully funded in the budget, at $201.7 million.

Fiscal 2013

On a generally accepted accounting principles (GAAP) basis, Delaware's total fiscal 2013 ending general fund balance grew by 3.6% from the previous year to almost $1.5 billion, or 23.5% of operating expenditures. Of that total, $1 billion was unassigned. Total general fund revenue has increased since fiscal 2009 to $4 billion in fiscal 2013, due primarily to growing combined personal income and corporate taxes. Approximately half of the state's general revenues are composed of business taxes and 27.6% of fiscal 2013 general fund revenue came from personal taxes. The state accounts for non-appropriated federal and local school district special funds outside of the general fund on a GAAP basis.

The state reported a $637 million total general fund balance in fiscal 2013, including continuing and encumbered appropriations of $276 million, an undesignated fund balance, and the budget reserve account of $199 million, fully funded at 5% of estimated budgetary general fund revenue. The state has not historically used its budget reserve account to fund operations.

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 with clearly defined debt affordability parameters and a commitment to cash-funding capital projects funding, especially when the economy is performing well. Most of Delaware's debt limitations are imbedded in statute, and the state has adhered to these limitations. Total GO debt is $1.98 billion following this issuance, of which local school districts support $546 million. The state issues debt for political subdivisions. It pays 60%-80% of the cost of capital improvements for public school districts upon approval of the costs; the school districts pay the rest. 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. Total tax-supported debt including GO, transportation, and appropriation obligations, is high relative to that of state peers, at $2,558 per capita and 5.8% of personal income. Total tax-supported debt service carrying charges were a moderate at 7.2% of governmental spending in fiscal 2013. Debt amortization is rapid, in our opinion, with about 70% of principal scheduled to retire in the next 10 years.

The governor's recommended bond and capital improvement act totals $460.9 million for state capital and transportation projects. This includes $194.0 million of GO bond authorization to fund state capital projects and a $37.5 million general fund contributions which should contribute to a stable debt burden in the near term. Transportation projects total $207 million, or about 45% of the total plan. A 10-cent motor fuel tax increase is proposed as part of an overall infrastructure investment proposal, and would be indexed to inflation. If approved, the state expects the tax to generate $50 million annually to support pay-as-you-go funding as well as increased leverage. This follows a period of debt reduction (24%) for transportation infrastructure from fiscal years 2011-2014.

Delaware does not have any variable-rate debt outstanding, and it has not entered any interest rate swap agreements or related derivative transactions.

Pensions and OPEBs

Compared with other state pension systems, the state 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 2013, the plan had what we view as a strong funded ratio of 91.1%. The state's fiscal 2013 contribution to this plan totaled $161 million, or about 4% of general fund expenditures. One of DPERS' nine pension funds, the Closed State Police Pension Plan, has a 0.9% funded ratio because the state funds this plan through pay-as-you-go financing. The liability for this plan is significant in our view, at $291 million. Other than the police pension plan, Delaware has funded its remaining pension plans well. The state lowered its investment return assumption to 7.5% from 8.0% which is more consistent with historic performance in our view.

As of July 1, 2013, Delaware's actuarially accrued liability for OPEBs is what we consider a sizable $6 billion, using a rate of return assumption of 4.25%. The ARC is estimated at $398 million in fiscal 2013, compared to actual contributions of $209 million (4.8% 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, which had limited assets of $222 accumulated as of July 1, 2013.

Legislation from 2011 instituted various reforms to the state's pension and OPEB. The legislation establishes a fixed cost share in the state'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). We expect these reforms to moderate costs.

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's debt and liability profile.

Related Criteria And Research

Related Criteria

- Ratings Above The Sovereign: Corporate And Government Ratings—Methodology And Assumptions, Nov. 19, 2013
- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- USPF Criteria: Financial Management Assessment, June 27, 2006

Related Research

- U.S. State And Local Government Credit Conditions Forecast, Dec. 17, 2013