FitchRatings

Fitch Affirms Norwich, CT's IDR and GO's at 'AA'; Outlook Stable

Fitch Ratings-New York-16 October 2018: Fitch Ratings has affirmed the following City of Norwich, CT ratings:

--$1.2 million general obligation bonds, series 2009A at 'AA';
--Issuer Default Rating (IDR) at 'AA'.

The Rating Outlook is Stable.

SECURITY

The bonds are a general obligation of the city backed by its full faith, credit, and unlimited taxing authority.

ANALYTICAL CONCLUSION

The 'AA' IDR and GO rating reflects the city's very high gap closing capacity, given its superior level of inherent budget flexibility, adequate reserves, and limited historical revenue volatility, as well as a moderate long-term liability burden. These strengths are balanced against Fitch's expectations for slow revenue growth absent policy action.

Economic Resource Base
The city of Norwich is located adjacent to interstate 395 on the head of the Thames River, approximately 40 miles southeast of the city of Hartford. The city's census population was estimated at 39,470 for 2017, down about 2.5% since the 2010 census.

KEY RATING DRIVERS

Revenue Framework: 'aa'
The city's general fund revenues primarily consist of property taxes and state aid, which generally account for about 60% of 30% of general fund revenue, respectively. General fund revenues are additionally supported by revenues from the city-owned public utility system, which have been generally stable. Fitch expects general fund revenue growth, absent policy action, to be slow, driven by expectations for modest tax base growth and stagnant state aid. Management maintains an unlimited independent legal ability to raise taxes.

Expenditure Framework: 'a'
Fitch expects the natural pace of spending growth to trend above the city's slow revenue growth, absent policy action. Moderate carrying costs and adequate control over labor-related costs afford the city solid expenditure flexibility.

Long-Term Liability Burden: 'aa'

Norwich's long-term liability burden is moderate relative to its resource base and is largely driven by the city's net pension liability (NPL). Future debt needs are relatively modest and the pace of amortization is above average. Fitch expects the pension liability to continue to grow due to recent funding practices, but expects the overall debt and pension liability to remain moderate.

Operating Performance: 'aaa'
Fitch views the city as having the highest level of gap closing capacity to manage through future economic downturns while maintaining a high level of financial flexibility, supported by the city's unlimited legal ability to raise property taxes, solid expenditure flexibility, and adequate reserves.

RATING SENSITIVITIES

Operating Performance: Fitch expects the ratings to remain stable in the absence of a shift in management practices and/or policy and resultant weakening of the city's operating performance.

CREDIT PROFILE

The city's employment base is somewhat limited, although the presence of healthcare and governmental centers of employment lends some stability to the economy. The unemployment rate has been steadily improving, although it remains above county, state and national levels. Wealth levels are considerably below state levels, but more closely approximate the U.S. average.

The city's last statutorily required five-year tax base revaluation, effective Oct. 1, 2013 for fiscal 2015, resulted in a decline in net taxable value of about 25%, following an increase of about 27% in the previous revaluation that was effective Oct. 1, 2008, for fiscal 2010. Between valuations, tax base changes reflect only property improvements or new additions, changes due to appeals, but not the results of sales of property. Growth in between revaluations ranged between 0.2% and 1.1% from fiscal 2015 to fiscal 2018. Results from the October 2018 revaluation, effective for fiscal 2020 are not yet available, although city management is expecting modest growth in the grand list which Fitch believes is reasonable.

Revenue Framework
Property taxes are the city's primary revenue stream, representing approximately 62% of budgeted fiscal 2019 general fund revenues. State aid, which has been subject to recent cuts, accounts for approximately 30% of budgeted revenues. Norwich Public Utilities (NPU), a city-owned utility system, lends further operational support and revenue diversity to the general fund, making up approximately 5% of budgeted revenues.

General fund revenue growth over the last decade has remained below U.S. GDP but above inflation; however, this is partly reflective of tax rate increases during the period. Fitch expects that future revenue growth will generally be in line with the level of inflation, reflecting modest housing value appreciation and economic development as well as stagnant growth in state aid.

NPU operates gas, electric, water and wastewater systems and is a fully self-supporting utility system. City charter mandates an annual transfer to the city, set at 10% of NPU's gross revenues (excluding sewer revenues) as reported in the last completed fiscal year. NPU payments to the general fund have historically remained relatively stable. The utility rates are independently established by the city's Public Utility Commissioners, who are appointed by the city council, without regulatory approval.

Municipalities in Connecticut possess an independent legal ability to raise property taxes by the state constitution, which grants the city the legal capacity to offset revenue pressures associated with a periodic weakening of the tax base or reduction in state aid.

Expenditure Framework

The city's general fund expenditures are primarily driven by educational costs, which represent about 62% of budgeted fiscal 2019 expenditures. Public safety costs are the second largest expenditure item at about 15% of budgeted spending.

General fund revenues and expenditures have been fairly well aligned in recent history but largely due to millage rate increases and pension underfunding. Fitch expects the city will fully fund the pension actuarially determined contribution (ADC) in fiscal 2020. Service demands are expected to remain manageable at the city level, but additional state aid cuts could put pressure on school spending levels in the near future.

Fixed carrying costs for retiree benefits and debt are moderate at roughly 13% of governmental spending. Additionally, city charter includes a voter-approved provision requiring a minimum appropriation for capital improvements at 2% of the prior year's general fund budget (roughly $2.5 million for fiscal 2019). Fitch does not expect future debt issuance to have a material impact on fixed carrying costs given the city's relatively modest debt plans and above average amortization rate (69% repaid over the next 10 years).

Management is able to reduce some expenses tied to its programs. The city has the legal ability to reduce staff at any time, if necessary, although fire department employees are subject to minimum manning requirements. Union contracts are subject to arbitration, but a decision may be rejected by a two-thirds vote by the city's legislative body. A new arbitration panel would then be appointed by the state and their subsequent decisions are required to take into consideration the financial capability of the employer.

Long-Term Liability Burden

The city's long-term liability burden related to debt and pensions represents a moderate 13% of personal income. The city's long-term liability burden is mostly driven by its NPL. The net pension liability includes employees of the city's utility system, which make up about a third of the liability. When adjusting the pension liability for employees of business-type activities, the city's overall long-term liability burden drops to about 10% of personal income.

Most of the city's non-certified employees are members of the city's single-employer defined benefit plan. As of June 30, 2017, the plan's NPL, when adjusted by Fitch to reflect a 6% discount rate assumption, was $166 million (equal to about 10% of personal income), or $114 million when backing out the liability related to business-type employees. The Fitch adjusted ratio of assets to liabilities was roughly 50%. Since 2013, the city has adopted more conservative actuarial assumptions, including a lower assumed discount rate and a shortened amortization period, leading to a significantly increased actuarially determined contribution (ADC) which the city has not been fully funding. The city has been increasing its contributions by 15% annually and plans to continue until the ADC is funded in full, as mandated by city charter policy. As stated earlier, the city projects to reach full funding of the ADC by fiscal 2020. Teachers participate in the State of Connecticut Teachers' Retirement System, for which the state is responsible for funding.

Future debt issuance plans are modest. The city is planning to issue up to $8 million in bonds later this year, which are expected to be used to finance various city projects and reimburse the city for past expenditures, and may issue an additional $5 million in 2019 for gas line extensions, infrastructure improvements, and public safety equipment.

The city has fully funded the OPEB ADC since fiscal 2014. City council recently voted to temporarily suspend its requirement to fully fund OPEB until fiscal 2022 to provide for additional financial flexibility in light of uncertainty in future state aid funding. The city's fiscal 2019 budget still funds 94% of the ADC and city management expects to continue funding well in excess of the pay-as-you-go amount. Unfunded OPEB liabilities total $44 million, representing less than 2% of personal income.

Operating Performance

Fitch views the city's gap closing capacity as very high given the city's unlimited legal ability to raise revenues and solid expenditure flexibility. Norwich maintained sound reserve levels throughout the most recent economic downturn by adjusting its millage rate to meet expenditure needs and offset grand list declines. In May 2018, management temporarily revised its formal fund balance policy, reducing its target floor of unrestricted fund balance to 10% of spending from 12% until fiscal 2022, which Fitch believes still provides for a high level of financial resilience given the city's revenue volatility and other budget management tools.

During the most recent economic downturn, management demonstrated its ability to reduce spending through cost controls, eliminating positions, and implementing a hiring freeze. Fitch would expect the city to take similar action during future periods of economic decline.

The city ended fiscal 2017 with a general fund surplus of $2.8 million, increasing unrestricted fund balance to about $18 million, equal to 13% of spending. Unaudited fiscal 2018 results indicate a general fund deficit of $1.8 million, reducing unrestricted fund balance to approximately $16 million, or a still sound 12% of spending. The deficit was largely driven by reductions in state aid, which came in roughly $1.3 million under budget, as well as additional general fund support for the school district to help close a $1.1 million school operating deficit. Expenditure savings throughout various other departments helped to reduce the general fund deficit.

The 2019 budget totals approximately $126 million, up about 2% from the prior year. The budget includes a modest increase in the property tax rate and an increase in the motor vehicles tax rate to the statutory limit of 45 mills, as well as a $0.2 million appropriation of general fund balance. Budgeted state aid is generally in line with prior year receipts, aside from additional capital reimbursements for school construction. The adopted fiscal 2019 Norwich Public Schools (NPS) budget shows an approximately $4.6 million budget deficit. NPS has subsequently taken several actions to reduce the gap, including negotiating high deductible health plans with the teachers union, and renegotiating vendor agreements. Fitch expects the city will closely work with NPS and monitor its financial situation as it has the potential to negatively impact the city's general fund position and Fitch's operating performance assessment

Contact:

Primary Analyst
Andrew Hoffman
Director
+1-212-908-0527
Fitch Ratings, Inc.
33 Whitehall Street
New York, NY 10004

Secondary Analyst
Kevin Dolan
Director
+1-212-908-0538

Committee Chairperson
Michael Rinaldi
Senior Director
+1-212-908-0833

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email: sandro.scenga@fitchratings.com

Additional information is available on www.fitchratings.com

Applicable Criteria

U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018) (https://www.fitchratings.com/site/re/10024656)

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