S&P Global Ratings

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Summary:

Norwich, Connecticut; General Obligation

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Credit Profile		
US$3.575 mil GO bnds ser 2019 due 08/01/2039		
Long Term Rating	AA/Stable	New

Rationale

S&P Global Ratings assigned its 'AA' long-term rating to Norwich, Conn.'s series 2019 general obligation (GO) bonds. At the same time, we affirmed our 'AA' long-term rating on the city's outstanding GO debt. The outlook is stable.

Security and use of bond proceeds

The bonds are secured by the city's full faith and credit pledge to levy ad valorem taxes on taxable property, without limit on the rate or amount. We understand the city intends to use the series 2019 bond proceeds (approximately $3.6 million) to either reimburse the city for expenditures already made or to finance expected expenditures on various capital projects during the next 12 months.

Credit overview

The long-term rating includes our assessment of Norwich's strong management environment, which historically has helped yield stable financial operations, including strong financial flexibility and very strong liquidity to guard against state-level fiscal pressures, despite some draws on reserves in the last two fiscal years. We believe that recent negative operating performance in fiscal years 2018 and 2019 demonstrates Norwich's reliance on state aid as a significant revenue source, which could expose it to long-term risk exposure under a less predictable state fiscal environment.

While we expect Norwich to maintain measured economic growth that will likely generate new locally derived revenue, in addition to cost containment measures implemented by management, we believe prolonged state funding uncertainty and reaching full annual contributions toward its pension liabilities will remain principal challenges for the city in maintaining balanced budgetary performance and sustaining its long-term creditworthiness.

The long-term rating reflects our view of Norwich, specifically its:

- Weak economy, with projected per capita effective buying income at 83.3% of the national level and market value per capita of $67,051;
- Strong management, with good financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Adequate budgetary performance, with an operating deficit in the general fund and a slight operating deficit at the total governmental fund level in fiscal 2018;
- Strong budgetary flexibility, with an available fund balance in fiscal 2018 of 11.4% of operating expenditures;
- Very strong liquidity, with total government available cash at 24.6% of total governmental fund expenditures and 6.8x governmental debt service, and access to external liquidity we consider strong;

- Strong debt and contingent liability profile, with debt service carrying charges at 3.6% of expenditures and net direct debt that is 40.8% of total governmental fund revenue, as well as low overall net debt at less than 3% of market value, but a large pension and other postemployment benefit (OPEB) obligation; and
- Strong institutional framework score.

Weak economy

We consider Norwich's economy weak. The city, with an estimated population of 40,383, is in New London County. It has a projected per capita effective buying income of 83.3% of the national level and per capita market value of $67,051. Overall, the city's market value grew by 1.9% over the past year, to $2.7 billion in 2019. The county unemployment rate was 4.0% in 2018.

Norwich is a primarily residential community, complemented by a substantial commercial and industrial base, approximately 40 miles southeast of Hartford and 40 miles west of Providence, RI. Interstate 395 and State Route 2 traverse the city, connecting residents with regional employment centers.

The local economy and employment base are anchored by the health care, government (state and local), manufacturing and distribution, and commercial retail sectors. Norwich's leading employers include William W. Backus Hospital (1,439 employees); city government, public utility, and board of education (1,116); state of Connecticut (788); Bob's Discount Furniture (553); and U.S. Food Service (325). The city reports overall stability among its leading employers and taxpayers in recent years. Because of its largely residential composition, its 10 leading taxpayers account for just 7.1% of the grand list, representing a very diverse tax base, in our opinion.

Following a sharp 24.8% decline in its grand list in 2013 (following a property revaluation), Norwich has experienced modest, albeit steady, tax base growth in the last six years. The city also expects that the accelerating local real estate market, coupled with new housing construction and commercial development over this period, will yield favorable grand list growth subsequent to the Oct. 1, 2018, revaluation.

According to management, regional developments like Mohegan Sun Casino and General Dynamic's Electric Boat new submarine facility support commercial and residential activity in Norwich. The Norwich Community Development Corp. maintains relationships with regional partners, which allows management to identify and attract potential developments that stimulate the regional economy and the city's tax and employment base. One such development is Ponemah Mills, a $90 million adaptive reuse project. In addition, General Dynamics, a global aerospace and defense company, is generating significant economic activity in the region with its new Electric Boat facility, which broke ground earlier this year.

We believe Norwich's improving grand list projections, as well as a steadying job market that has shown signs of convergence with county, state, and national markets over the past year, are likely to support stable wealth and income metrics over the next two years.

Strong management

We view the city's management as strong, with good financial policies and practices under our FMA methodology, indicating financial practices exist in most areas, but that governance officials might not formalize or monitor all of them on a regular basis.

In development of its annual budget, management uses three to five years of historical data to build revenue and expenditure assumptions. The city reviews each department's annual operation requests and prioritizes operating expenditures. Because of uncertainty regarding state aid over the past several years, finance officials closely monitor state budget information to conservatively estimate state aid revenue. They also monitor grand list growth to evaluate changes in local tax revenue and mill rate. During each fiscal year, management monitors the budget regularly, reporting budget-to-actual results to the city council monthly. The city also adheres to state statutes governing investments and management reports earnings and holdings to the city council quarterly.

Norwich maintains a strong focus on capital planning, evidenced by a five-year capital improvement plan (CIP) that identifies projects and costs across all departments. The city updates its CIP annually and details pay-as-you-go funding, intergovernmental grants, and bond financing for all capital projects. Although the city does not currently maintain a long-term financial forecast, it does incorporate some forward-looking projections for debt service and other budget items in its annual budget.

The city adopted a formal general fund unrestricted fund balance policy which requires it to maintain a target fund balance of between 12% and 17% of annual general fund expenditures. While Norwich's available fund balance stood at 11.4% of general fund expenditures at fiscal year-end 2018, the city reduced the policy minimum level to 10% until 2022 to accommodate the use of fund balance, if necessary, to ease potential budget pressures over the next four fiscal years. The city also adopted a formal debt management policy that sets forth guidelines for issuing debt and measurable debt affordability benchmarks; this includes capping direct debt to 5% of the city's taxable assessed value and stipulating net utility income paying self-supporting debt to be no less than 125% of debt service.

Adequate budgetary performance

Norwich's budgetary performance is adequate, in our opinion. The city had deficit operating results in the general fund of 2.1% of expenditures, and slight deficit results across all governmental funds of 0.9% in fiscal 2018.

We adjusted total governmental funds and general fund results to account for the deferred pension payment of $717,000 in fiscal 2018. We also adjusted for annual transfers from the city's enterprise funds. Specifically, 10% of Norwich Public Utilities revenues is diverted to the city each year, as stated in the city charter. In addition, we adjusted general fund results for recurring transfers in and out of the general fund.

The city previously reduced its discount rate for its single-employer pension plan in 2013, which consequently increased outstanding liabilities and annual contributions. Norwich adopted an ordinance in fiscal 2015 which phases in its full actuarially determined contribution (ADC) over a five-year period, returning to 100% in fiscal 2020. With pension costs rising to about 6.6% of the operating budget, ongoing deferral of annual pension contributions could have medium- to long-term implications under a more constrained budgetary environment.

Despite its recent history of deferring annual pension contributions, we expect Norwich to maintain at least adequate budgetary performance over the next several years, as a result of management's frequent monitoring of budget performance and adjustment of expenditures to support historically balanced operations, in addition to its fund balance policy. The city also benefits from an overall stable property tax base, which generated approximately 59% of general fund revenue in fiscal 2018. Tax collections have remained strong, with collections averaging 99% over the past five years. Intergovernmental (state) sources represent the second-highest share of general fund revenue, at 38%, while charges for services and other local revenue constitute about 3.0%. However, as statutory aid makes up a significant component of Norwich's general fund revenue, we believe the city is more susceptible to performance volatility relative to other municipalities during extended periods of state fiscal uncertainty and moderate-to-severe state aid reductions, including education cost sharing and other state grants.

According to audited fiscal 2018 results, net of transfers and including the deferred pension payment, Norwich recognized a $2.8 million general fund deficit for the year. Finance officials attribute the result primarily to a reduction in state aid, in addition to increased education expenditures. The state's budget impasse had a harmful effect on municipal finances entering fiscal 2018. While statutory aid cuts challenged most local government budgets in the state, Norwich recognized a $1.2 million reduction in this funding source. In addition, expenditures came in $500,000 above budget, specifically because of special education costs coming in above budget. Although management tightened controls of spending throughout the year, the city realized a deficit that was close to expectations.

Norwich indicates unaudited results for fiscal 2019 were very similar to those of the previous year. In fiscal 2019, the city's budget included appropriation of $200,000 of reserves, as well as a mill rate increase to 41.01 mills, from 40.52 mills, which helped support year-over-year increases to employee salaries and benefits, pension costs, and education spending. Nonetheless, revenues came in $800,000 below budget because of timing of the state's audit relating to a school construction project, and expenditures were $800,000 above budget due primarily to continued increases in special education expenses for the year. As a result, the city expects to draw down reserves by about $2.0 million to $13.6 million or about 10.1% of expenditures.

The city adopted a balanced budget for fiscal 2020 without the use of reserves. Management indicates that increases to education expenses should be less than in the previous year, while state aid should increase slightly. So far through the first five months of the fiscal year, management indicates that revenues are slightly ahead of pace and expenditures are on track relative to budget. Management indicates it plans to identify and adjust expenditures as necessary to produce at least balanced results at fiscal year-end and maintain reserves in line with its 10% fund balance policy.

The city's largest collective bargaining contracts are current, reducing a potential area of cost uncertainty over the next two years. Despite state fiscal challenges in previous years, we believe Norwich is likely to maintain at least adequate performance over our two-year outlook period.

Strong budgetary flexibility

Norwich's budgetary flexibility is strong, in our view, with an available fund balance in fiscal 2018 of 11.4% of operating expenditures, or $15.6 million.

While management has historically budgeted to appropriate available funds to balance operations, revenue and expenditures have typically outperformed budget expectations, and the city reported positive operating results at fiscal year-end. Although Norwich improved its assigned and unassigned reserve position to approximately $15.6 million in fiscal 2018, from $10.4 million in fiscal 2015, it drew down reserves in the last two fiscal years.

Unaudited year-end results estimate that the city will recognize a $2.0 million drawdown in fiscal 2019, net of transfers, and we understand that assigned and unassigned reserves decreased to $13.6 million, or about 10.1% of general fund expenditures. This remains in compliance with the city's reserve policy, which was revised in 2018 given potential pressure from additional state funding shortfalls, and which stipulates the city will maintain an available fund balance of at least 10% of annual operating expenditures. Therefore, we expect the city's flexibility to remain at least strong over the next two years.

Very strong liquidity

In our opinion, Norwich's liquidity is very strong, with total government available cash at 24.6% of total governmental fund expenditures and 6.8x governmental debt service in 2018. In our view, the city has strong access to external liquidity if necessary, demonstrated by its regular issuance of GO bonds and notes over the past 20 years.

In addition, the city does not engage in any aggressive use of investments that could add significant volatility to its liquidity position. Furthermore, Norwich is not exposed to variable-rate or privately placed debt that could result in undue contingent liabilities through acceleration events or interest-rate risk. In our opinion, Norwich is likely to maintain its very strong liquidity over the near term.

Strong debt and contingent liability profile

In our view, Norwich's debt and contingent liability profile is strong. Total governmental fund debt service is 3.6% of total governmental fund expenditures, and net direct debt is 40.8% of total governmental fund revenue. Overall net debt is low at 2.4% of market value, which is in our view a positive credit factor.

Following the current bond issuance, Norwich will have approximately $68 million in total direct debt outstanding, of which $15.4 million is tax-secured enterprise debt that is self-supported by the net operating revenues of the city's utility system. Like most Connecticut municipalities, the city has no overlapping or underlying debt obligations.

As outlined in its CIP, Norwich could issue up to $5 million annually over the next two years for additional capital improvements for various capital projects, consisting primarily of infrastructure improvements, public safety equipment, and radio improvements. We also understand the city brought a $5 million infrastructure bond to voters on the November 2019 ballot. However, management indicates that the timing and magnitude of future debt issuances are dependent on the city's economic and fiscal conditions, and in its assessment the debt service payments are sustainable over the life of the bonds. Currently, about 53% of the direct debt is scheduled to be repaid within 10 years.

In our opinion, a credit weakness is Norwich's large pension and OPEB obligation. Norwich's combined required pension and actual OPEB contributions totaled 9.9% of total governmental fund expenditures in 2018. Of that amount, 6.6% represented required contributions to pension obligations, and 3.3% represented OPEB payments. The city made 94% of its annual required pension contribution in 2018. The funded ratio of the largest pension plan is 61.6%.

Norwich participates in the following plans as of July 1, 2018:

- City of Norwich Retirement System: 61.6% funded with a net pension liability of $108.3 million, assuming a 7.5% discount rate;
- Volunteer Firefighters Relief Plan: 44.5% funded with a net pension liability of $3.5 million, assuming a 7.0% discount rate;
- The city's teachers participate in a state-administered Teachers' Retirement System, which the state contributes to on behalf of the city; and

- Norwich also provides a retiree health care OPEB plan, 31% funded with an unfunded actuarial accrued OPEB liability of $40.1 million. The city is meeting 100% of its OPEB annual required contribution each year.

Since 2013, the city has modified its assumptions in its city-administered retirement plan to reduce the discount rate to 7.5%, from 8.25%, and changed the amortization from an open 30-year plan to a 20-year closed plan, reflecting more realistic market return assumptions and unfunded pension liability estimates.

While we believe the assumption changes were prudent, they have increased Norwich's ADC substantially and led to the underfunding of its annual payment in the last two fiscal years. However, we recognize the city council adopted a plan as part of its formal funding policies for pensions and OPEB in December 2014. Under these policies, the city will increase its pension contribution by 15% each year until it returns to funding 100% of the ADC, which will likely be in fiscal 2020.

Although we consider the combined pension and OPEB contributions elevated and likely to increase, we believe the city has a credible plan to address the liability, since contributions were the result of expected assumption changes, and management has a plan in place to fund its ADC in full. However, such contribution increases may pressure its ability to maintain balanced financial performance and sustain reserves, which could become a credit pressure beyond the two-year outlook period.

Strong institutional framework

The institutional framework score for Connecticut municipalities is strong.

Outlook

The stable outlook reflects our view of Norwich's good management practices and policies, and our expectation that the city will monitor changes in local expenditures and state revenue trends, exercising necessary expenditure controls to maintain at least balanced budgetary performance and sustain flexibility at currently strong levels, in compliance with its revised reserve policy. The outlook also reflects our expectation that Norwich's wealth and income characteristics will benefit from anticipated community economic development that will likely support tax base expansion. For these reasons, we do not expect to change the rating over the two-year outlook period.

Downside scenario

We could lower the rating should the city experience sustained deterioration in budgetary performance--from a decline in state aid, rising fixed costs, or otherwise--resulting in a decline of reserves to levels we no longer view as commensurate with those of its peers at the current rating. In addition, material weakening of the city's local income and wealth levels could put downward pressure on the rating.

Upside scenario

We currently view the city as having limited-upside potential, given recent draws on reserves in addition to wealth and income levels that are well below those of higher-rated peers, coupled with potential budgetary pressures that could stem from a less predictable state-funding environment and rising fixed costs associated with its pension and OPEB liabilities. Nevertheless, we could raise the rating if the city's wealth and income levels improve substantially, and if its flexibility and liquidity were to significantly improve because of consistently strong budgetary performance.

Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Criteria Guidance: Assessing U.S. Public Finance Pension And Other Postemployment Obligations For GO Debt, Local Government GO Ratings, And State Ratings, Oct. 7, 2019

Ratings Detail (As Of November 14, 2019)		
Norwich GO bnds iss (Cap Proj Bnds)		
Long Term Rating	AA/Stable	Affirmed
Norwich GO bnds iss (Taxable Bnds)		
Long Term Rating	AA/Stable	Affirmed
Norwich GO		
Long Term Rating	AA/Stable	Affirmed
Norwich GO		
Long Term Rating	AA/Stable	Affirmed
Norwich GO		
Long Term Rating	AA/Stable	Affirmed