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Ratings

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Summary:

Watertown, Connecticut; General Obligation; Note

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Credit Profile		
US$11.0 mil Tax-Exempt GO bnds iss of 2018 ser A due 10/15/2038		
Long Term Rating	AA+/Negative	New
US$6.1 mil GO BANs dtd 10/25/2018 due 10/24/2019		
Short Term Rating	SP-1+	New
US$5.81 mil Taxable GO bnds iss of 2018 ser B due 10/15/2038		
Long Term Rating	AA+/Negative	New
Watertown GO		
Long Term Rating	AA+/Negative	Outlook Revised

Rationale

S&P Global Ratings changed its outlook to negative from stable on Watertown, Conn.'s outstanding GO debt, and affirmed the 'AA+' long-term rating on the debt. At the same time, we assigned our 'AA+' long-term rating to the town's series 2018A (tax-exempt) and series 2018B (taxable) general obligation (GO) bonds.

We also assigned our 'SP-1+' short-term rating to Watertown's series 2018 GO bond anticipation notes (BANs). The short-term rating on the notes reflects our criteria for evaluating and rating BANs. In our view, Watertown maintains a very strong capacity to pay principal and interest when the notes come due. We view the town's market risk profile as low because it has strong legal authority to issue long-term debt to take out the notes and is a frequent debt issuer that regularly provides ongoing disclosure to market participants.

The outlook change is based on our view of stress on the town's financial performance and flexibility, stemming from a less predictable operating environment that has led to pressure from higher-than-budgeted self-insurance expenditures and material reductions in statutory aid over the last two fiscal years. While we recognize the town maintains a strong economic profile and is undertaking structural reforms to alleviate rising insurance and employee benefit costs in fiscal 2019 and beyond, there is at least a one-in-three chance we could lower Watertown's rating due to internal budget pressure and ongoing state-level fiscal uncertainty that could materially weaken credit fundamentals to levels that no longer support its current rating in the near-term.

Watertown's full faith and credit pledge, payable from the levy of an unlimited-ad valorem tax on all taxable property in the town, secures the series 2018A and 2018B bonds, as well as the series 2018 notes. We understand official intend to use proceeds from the series 2018A bonds (approximately $11 million) to finance various general purpose, water, and sewer system projects. In addition, we understand official intend to use proceeds from the series 2018B bonds (approximately $5.81 million) to finance high school and middle school improvements and renovations.

In addition, we understand officials intend to use proceeds from the notes (approximately $6.1 million) to finance various general purpose, water system, and sewer projects.

The long-term rating reflects our opinion of the following factors for Watertown, specifically its:

- Strong economy, with market value per capita of $118,285 and projected per capita effective buying income at 124% of the national level;
- Strong management, with good financial policies and practices under our Financial Management Assessment methodology;
- Adequate budgetary performance, with operating results that we expect could improve in the near term relative to fiscal 2017, which closed with operating deficits in the general fund and at the total governmental fund level in fiscal 2017;
- Adequate budgetary flexibility, with an available fund balance in fiscal 2017 of 7.6% of operating expenditures;
- Very strong liquidity, with total government available cash at 15.8% of total governmental fund expenditures and 1.8x governmental debt service, and access to external liquidity we consider strong, but an exposure to a non-remote contingent liability risk; Strong debt and contingent liability position, with debt service carrying charges at 8.8% of expenditures and net direct debt that is 76.4% of total governmental fund revenue, as well as low overall net debt at less than 3% of market value and rapid amortization, with 67.2% of debt scheduled to be retired in 10 years; and
- Strong institutional framework score.

Strong economy

We consider Watertown's economy strong. The town, with an estimated population of 21,401, encompasses 29.8 square miles in Litchfield County. The town has a projected per capita effective buying income of 124% of the national level and per capita market value of $118,285. Overall, the town's market estimated full value was stable over the past year, reaching $2.5 billion in fiscal 2019. Its net taxable grand list is $1.77 billion

Watertown is a suburban and primarily residential community in west central Connecticut, approximately 30 miles north of New Haven and 35 miles southwest of Hartford. State Route 8 traverses the town, connecting residents with employment opportunities in the city of Waterbury and surrounding communities. Although the state has struggled to regain its economic footing, Watertown's overall economic and employment conditions have remained stable relative that of the regional labor market and the state. The county unemployment rate was 4.3% in 2017, which was slightly below the state's (4.7%) and the nation's (4.4%) averages.

Due to its location near major state and interstate highways and a low mill rate relative surrounding communities, Watertown maintains a sizeable commercial and industrial presence. The manufacturing sector anchor's the town's employment base, which also features education, health care, and commercial retail and services. Seven of its 10 leading employers are manufacturing firms, including The Siemon Co. (311 employees), Global Steering System (300), ALBEA (300), and Crystal Rock (285). Watertown is also home to a private boarding school, The Taft School (235 employees), which continues to attract a diverse domestic and international student body. The town's 10 leading taxpayers account for 5.3% of total AV, representing a very diverse tax base in our opinion.

While the town reports stability among its leading employers and taxpayers, management also indicates that several new residential developments and the completion of a new winery and assisted living facility could contribute to modest growth in Watertown's taxable grand list over the next two years. Based on our expectation that this slight uptick in tax base growth will continue to support Watertown's stable underlying wealth and income conditions, we believe its economic profile will remain strong over the next two years.

Strong management

We view the town's management as strong, with good financial policies and practices under our Financial Management Assessment 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 years of historical data to forecast annual revenue and expenditure assumptions and to identify outlying budget line items. The town reviews each department's annual budget request and prioritizes operating and capital expenditures. Due to uncertainty of state aid over the past several years, finance officials consult state information--including the governor's proposed budget--to conservatively estimate revenue from this source. While we note that the town continues to face difficulty budgeting for medical and workers' compensation claims, which has compounded its budgetary stress, we recognize that finance officials work with their insurance provider to analyze trends and develop budget solutions.

During each fiscal year, the town monitors the budget regularly, reporting budget-to-actual results monthly. Watertown also maintains a formal investment policy, which adheres to state statutes governing investments, and the town reports earnings and holdings in its annual audit.

Watertown has a formal five-year capital improvement plan (CIP) that identifies projects and costs across its various departments. While the town updates its CIP annually and incorporates these costs into its budget considerations, the plan does not identify funding sources across all years. However, Watertown does not current maintain a formal long-term financial forecast.

However, the town maintains a formal debt management policy, which features local debt affordability limitations and management incorporates debt analysis in its annual budget process. Furthermore, management has historically met and sustained unassigned reserves in accordance with its fund balance policy. The formal policy calls for unassigned fund balance to be maintained a target of 7% to 12% of the following year's operating revenue, and in the event the fund balance falls below the target minimum, the town will move to restore balance within a two-year period. The policy notes that this minimum reserve target assists with managing cash flows during the year and stabilize annual fluctuations in the property tax rate.

Adequate budgetary performance

Watertown's budgetary performance is adequate in our opinion. The town had operating deficits of negative 3.1% of expenditures in the general fund and of negative 3.6% across all governmental funds in fiscal 2017. We adjusted fiscal 2017 operating results for net transfers out of the general fund and capital outlay expenditures paid from bond proceeds. Our assessment accounts for the fact that we expect budgetary results could improve from fiscal 2017 results in the near term.

Historically, Watertown has maintained balanced operations, supported by its strong budget development and monitoring framework. However, given recent budgetary pressure associated with increasing medical claims and uncertainty relating to state funding, we have revised our assessment of budgetary performance to adequate from strong. While we recognize Watertown is making adjustments in the current fiscal year to reduce the impact of these budgetary pressures, we anticipate its performance to continue to fluctuate from year-to-year as it faces potentially more significant headwinds that will challenge its plan to restore balance in the general fund over our two-year outlook horizon.

The first source of downward budgetary pressure continues to be the town's rising medical claims. For fiscal 2017, the town reported higher-than-expected self-insurance medical claims, which accounted for the majority of the $2.5 million year-end general fund deficit. Although the town has stop loss coverage for its health care plans in fiscal 2014, it reported higher-than-budgeted claims that reached the stop loss threshold of $150,000 per claim. According to management, the town conservatively budgeted for $2.4 million in additional medical claims in fiscal 2018 and another $1 million in fiscal 2019. In an effort to better control these costs, management also negotiated changes to employee health benefits and switched its health insurance provider to build-in more predictable cost assumptions in its fiscal 2019 budget. Therefore, we will monitor how the town incorporates these medical claims costs into its future budgets.

Second, Watertown continues to operate in a less predictable state aid environment. Connecticut's budget impasse last year extended nearly five months into the 2018-2019 biennium harmful effect on municipal finances entering fiscal 2018. While the prospect for additional state cuts affects all local governments in the state, Watertown's budgetary performance is somewhat more vulnerable due to the amount of state funding its receives, particularly Education Cost Sharing (ECS) grants. For fiscal 2017, property taxes generated 71.8% of general fund revenues while state aid accounted for 25%. Should state funding gaps persist leading to declines in state aid, however, we believe the town will likely need to generate additional revenue from locally derived revenue sources to maintain balanced operations. This could prove difficult given Watertown modest grand list growth in recent years, which could place a substantial burden on its existing tax base.

For fiscal 2018, the state's biennial budget enactment in October 2017 provided some certainty to the town for the remainder of the current year, but projected state aid was approximately $1.4 million below the town's adopted budget. As a result, Watertown increased revenues slightly, reduced discretionary capital spending, and reduced its workforce by leaving positions unfilled. Based on its year-end budget projections, the town conservatively expects a $1.3 million deficit.

In May 2018, the state legislature revised the 2018-2019 biennial budget–due in part to better-than-expected income tax receipts--to increase funding and shield municipalities from additional state aid reductions in fiscal 2019. The town indicates that the state restored the $1.4 million in ECS grants withheld in the previous year, leading the town to enter fiscal 2019 with a more predictable state aid outlook compared to the prior fiscal year. However, a looming and potentially multi-billion dollar state deficit entering the next biennium could lead the state to make deep cuts to municipal grants that could harm Watertown.

For fiscal 2019, Watertown adopted a balanced $73.45 million general fund budget. The adopted budget incorporates the town's expectations for level statutory aid and 1.71 mill increase the property tax mill rate. Based on year-to-date performance, management anticipates a $2 million budget surplus, barring any significant changes to medical expenditures or mid-year state aid adjustments.

However, should we see medical costs escalate to unsustainable levels or if state aid reductions persist to a point of causing structural imbalance, we could modify our view of Watertown's budgetary performance.

Adequate budgetary flexibility

Watertown's budgetary flexibility is adequate, in our view, with an available fund balance in fiscal 2017 of 7.6% of operating expenditures, or $6.0 million. Watertown has a reserve policy to maintain an undesignated fund balance of 7%-12% of the ensuing year's operating revenue, to which it has historically adhered. According to finance officials, higher-than-budgeted medical claims have outpaced the budget and declines in statutory aid have contributed to drawdowns on fund balance over the last two fiscal years. Management expects another general fund deficit in fiscal 2018, that could reduce fund balance by another $1.3 million, but the town conservatively expects positive operating results for fiscal 2019 that could partly replenish past draws on general fund reserves. However, if Watertown is unable to balance budgetary performance, leading to sustained future draws on available fund balance, we could weaken our view of the town's liquidity.

Very strong liquidity

In our opinion, Watertown's liquidity is very strong, with total government available cash at 15.8% of total governmental fund expenditures and 1.8x governmental debt service in 2017. In our view, the town has strong access to external liquidity if necessary. Weakening Watertown's liquidity position, in our assessment, is the town's exposure to a non-remote contingent liability that could come due within 12 months. With the majority of Watertown's cash invested in money market funds, certificates of deposit, and the state investment pool, which maintain maturities of less than one year, we believe the town's investments are not aggressive. Furthermore, Watertown is a regular market participant that has issued debt periodically over the past 20 years, including GO bonds and notes.

As of fiscal year-end June 30, 2017, the town had a deficit of nearly $1.69 million related to workers' compensation claims in its internal service fund, which could expose the town to non-remote liquidity pressure. We note that Watertown reduced the net deficit by approximately $694,000 in fiscal 2017. Nevertheless, restoring balance in the medical insurance fund has been elusive in recent years. However, management has instituted several reforms to reduce medical expenses, including switching to a new insurance provider and moving over current employees to high deductible medical insurance plans. We recognize that the town has introduced a potentially plausible plan to control these costs; however, if medical insurance expenses continue to rise, placing pressure on budgetary performance and resulting in a deterioration of available cash, we could weaken our view of the town's liquidity position.

Strong debt and contingent liability profile

In our view, Watertown's debt and contingent liability profile is strong. Total governmental fund debt service is 8.8% of total governmental fund expenditures, and net direct debt is 76.4% of total governmental fund revenue. Overall net debt is low at 2.4% of market value, and approximately 67.2% of the direct debt is scheduled to be repaid within 10 years, which are in our view positive credit factors.

Following this bond issue, Watertown has about $62.1 million of total direct debt outstanding, which includes $6.1 million in notes. The town has no overlapping or underlying debt.

Other than permanently financing outstanding notes over the next year, management has no specific plans to issue new debt over the next two years. In addition, it does not currently have any variable-rate or direct-purchase debt. Due to what we believe to be its low and affordable overall debt metrics, coupled with rapid amortization of existing debt, we do not expect Watertown's direct debt profile to change materially.

Watertown's combined required pension and actual other postemployment benefits (OPEB) contributions totaled 4.2% of total governmental fund expenditures in 2017. Of that amount, 1.9% represented required contributions to pension obligations, and 2.3% represented OPEB payments.

The town administers two pension plans: the town employee retirement system and the police benefit fund. The town also participates in Connecticut Municipal Employees Retirement Fund for all water and sewer employees hired before 1986. Watertown teachers participate in the State of Connecticut Teachers' Retirement System, a cost-sharing, multiple-employer, public employee retirement system, which is entirely funded by the state. The combined total pension liability for the police and town plans is $53.2 million. Watertown has made its full actuarially determined contributions to all three plans over the last three fiscal years, totaling about $1.55 million in fiscal 2017. The funded status of the town employee plan is 88.5% and the police benefit fund is 72.3%.

Watertown also administers an OPEB plan for its employees. The OPEB liability is funded on a pay-as-you-go basis, and the town contributed $1.9 million, or 41.2% of the annual required contribution, in fiscal 2017. The OPEB unfunded actuarial accrued liability was $56.05 million, and was 0% funded as of July 1, 2016. At this time, we view the town's pension and OPEB liabilities as manageable, and we do not expect any changes to these plans to present a material pressure on the town's debt or financial profiles.

Strong institutional framework

The institutional framework score for Connecticut municipalities is strong.

Outlook

The negative outlook reflects a one-in-three chance we could lower our rating on Watertown's GO debt over a two-year outlook horizon. This is based on our expectation that Watertown continues to operate in an uncertain budget environment and faces risks of additional reductions to state support over the two years. The negative outlook also reflects the potential for the town's finances to remain imbalanced in fiscal 2019, despite undertaking recent reforms to reduce the ongoing deficit in its self-insurance accounts and limit discretionary spending, which could lead to further deterioration of its finances and flexibility.

Therefore, we could lower the rating if Watertown's planned budgetary reforms are not able to effectively absorb costs related to medical insurance claims, or if state financial support weakens, contributing to structural imbalance and decline in available reserves to levels we no longer view as commensurate with higher-rated peers. Conversely, we could revise our outlook to stable should the town demonstrate sustainable structural reforms that strengthen budgetary performance and decrease the deficit in its internal service funds, while materially improving its flexibility.

Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Incorporating GASB 67 And 68: Evaluating Pension/OPEB Obligations Under Standard & Poor's U.S. Local Government GO Criteria, Sept. 2, 2015

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