FitchRatings

FITCH RATES WASHINGTON'S $717MM GO BONDS 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-14 January 2014: Fitch Ratings has assigned an 'AA+' rating to the following state of Washington general obligation (GO) bonds:

--$355,075,000 various purpose GO bonds, series 2014D;
--$273,915,000 motor vehicle fuel tax GO bonds, series 2014E;
--$88,110,000 GO bonds, series 2014T-2 (taxable).

The bonds are expected to be sold through competitive bid on Jan. 22, 2014.

In addition, Fitch has affirmed the 'AA+' rating assigned to $18 billion of outstanding state GO bonds.

The Rating Outlook is Stable.

SECURITY

The bonds are GOs of the state to which its full faith, credit, and taxing power are pledged. Motor vehicle fuel tax GO bonds are first payable from state excise taxes on motor vehicle and special fuels.

KEY RATING DRIVERS

SOLID ECONOMY: Washington's economy is characterized by generally sound performance and increased diversification. The manufacturing sector remains concentrated in the cyclical aerospace industry, although this concentration is sharply reduced. Economic growth prior to the recession was primarily due to strength in construction, aerospace (Boeing), and technology (Microsoft), and these remain economic drivers.

RESPONSIVE FINANCIAL MANAGEMENT: Frequent reviews of economic and financial forecasts allow the state to react to changing conditions. As the economy and revenues repeatedly underperformed estimates in the recession, the state demonstrated its willingness and ability to take actions to maintain budget balance. The state has since experienced steady improvement in its economic and revenue results, and the budget for the current biennium continues to replenish a cushion against future underperformance.

CONCENTRATED REVENUE SYSTEM: The state, with no income tax, relies on consumption-based revenues. This makes Washington particularly vulnerable to reductions in consumer spending.

ABOVE-AVERAGE DEBT; AVERAGE DEBT + PENSIONS: Debt ratios are in the upper moderate range and expected to remain so. This reflects funding of substantial capital needs, particularly for transportation. The combined burden of debt plus unfunded pension liabilities approximates the median for U.S. states rated by Fitch.

INITIATIVES AND REFERENDA A LIMITED RISK: The state's initiative and referendum environment creates a level of operating and financial uncertainty. However, any law approved by voters in this manner can be amended or repealed by the legislature by a two-thirds vote in the first two years after approval and by a simple majority thereafter.

RATING SENSITIVITIES

The 'AA+' rating and Stable Outlook assume the state's continued ability to maintain budget balance and an adequate reserve position in the face of funding demands presented by an education-funding court decision and transportation needs.

CREDIT PROFILE

Washington's 'AA+' GO bond rating reflects a generally solid economy and a demonstrated commitment to fiscal balance even as the state's financial position substantially weakened in the downturn. Credit strengths are offset by a concentrated revenue system that is reliant on the sales tax, with no income tax, as well as above-average debt levels. Economic and revenue growth in the recovery has allowed the state to begin to replenish its financial cushion, and the budget for the current fiscal 2013-2015 biennium, which began on July 1, continues to build reserves.

IMPROVED FISCAL POSITION

Washington's reliance on a broad-based sales tax makes it particularly vulnerable to reductions in consumer spending. State general fund revenue declines of 9.6% in fiscal 2009 and 4.1% in fiscal 2010 were followed by growth of 7.9% in fiscal 2011, reflecting in part tax increases enacted in April 2010, and 1.5% in fiscal 2012. Based on the most recent forecast, from November 2013, revenues for fiscal 2013, which ended on June 30, were up 6.1%. Expectations for growth in the current biennium appear achievable at 2.8% in fiscal 2014 and 3.2% in fiscal 2015.

The state reviews its general fund revenue forecast quarterly; actual revenue performance underperformed downwardly revised estimates in the recession repeatedly and significantly. Budget balance was maintained through a combination of ongoing and one-time actions, including a drawdown of reserves. More recent performance has been in line with expectations, and aggregate forecast changes in 2012 and 2013 were modest. The next forecast update is scheduled to be released in February.

Despite continued revenue growth, budgeting for the current fiscal 2013-15 biennium was challenging. Washington took extensive spending control action in the downturn and there was insufficient support for significant revenue increases. Adding to the challenge, a new statutory requirement mandated that the budget show projected balance over a four-year period rather than just the biennium.

The enacted budget was passed unusually close to the start of the new biennium and following preparation for a possible partial government shutdown. A key source of debate was the amount of additional money necessary to address a 2012 state Supreme Court decision that found state education funding inadequate. The court decision provided the state flexibility in terms of the timing and amount of remediation, although a goal of $3 billion-$3.5 billion in total incremental revenue by 2018, consistent with 2009 legislation, is often cited. The state calculates that $1 billion in additional funding was provided towards this goal with the current biennial budget, although that includes the continued suspension of a scheduled raise for teachers that was passed by voter initiative but has been repeatedly suspended. Additional education funding in future biennia is believed necessary to satisfy the court mandate, and this is likely to be a key source of pressure in the budget for the next biennium. In addition, last week the Supreme Court expressed concern that the state is not meeting funding targets and ordered the state, by the end of April 2014, to submit a complete plan for increasing funding through 2018.

The estimated ending balance and reserve total for the biennium that closed on June 30 is now $438 million, 2.8% of fiscal 2013 revenues. Following the September and November 2013 forecast revisions, this is projected to rise to 5.5% of fiscal 2015 revenues by the end of the current biennium. Fitch views positively the replenishment of reserves and the state's reserve funding provisions. In

November 2007, voters approved a constitutional budget stabilization account that receives 1% of revenues off the top every year, capped at 10% of annual general revenues. Although there are restrictions on use, these monies were depleted during the recession. In 2011 voters approved another constitutional amendment that requires that any extraordinary growth in state revenue (defined as growth in general state revenues that exceeds by one-third the average biennial growth of the prior five biennia) shall be transferred to the budget stabilization account on top of the 1%.

Although budget balancing solutions for the current biennium did not include significant revenue-raising actions, Fitch notes that a 2013 court decision declared unconstitutional a voter initiative-based requirement that tax increases be passed with a supermajority legislative vote. This provides some increased flexibility in this area as the state confronts funding pressures in future biennia.

SOLID ECONOMIC PROFILE

Washington state's economy, historically reliant on manufacturing supplemented by regional and international trade and tourism, has broadened. Areas of concentration (Boeing and Microsoft) offer relatively high-wage employment, and the population is well educated. In addition, population growth has far exceeded that of the U.S. as a whole. Following a vote by the machinists union earlier this month and a state incentive package passed by the legislature last year, Boeing will manufacture its new 777X jetliner in the state. This is positive news for the Washington economy, as the company had been considering production in other states.

Washington's economy entered the recession later than the nation overall following a period when it performed much more strongly than the U.S. However, peak-to-trough the state's non-farm employment decline was slightly higher than that of the U.S. In November 2013, Washington's year-over-year job growth of 1.4% compared to the 1.7% rate for the nation, although performance in earlier months was stronger. The state's unemployment rate in November was 6.8%, 97% of the U.S. rate. Personal income per capita is above average, at 105% of the U.S. in 2012, and recent personal income growth has been comparatively strong.

The November 2013 forecast assumes continued employment growth of about 1.8% a year and personal income rising at just above 5% annually.

ABOVE-AVERAGE DEBT LEVELS; AVERAGE WHEN PENSIONS ADDED

Washington's debt levels are in the upper moderate range and well above average for a U.S. state, with net tax-supported debt of $19.8 billion equal to 6.3% of personal income. Debt is primarily GO. Capital needs are substantial, particularly for transportation, and tolling is part of the funding solution. Positively, the state has increased its focus on debt affordability. In November 2012 voters approved a constitutional amendment that tightened the constitutional debt limit.

The state administers 13 defined benefit retirement plans, three of which have hybrid defined benefit/defined contribution options. The closed public employees and teachers plans (PERS and TRS1), which have been closed since 1977, are underfunded. However, Fitch believes that the unfunded liability is manageable. On a combined basis, the burden of net tax-supported debt and adjusted unfunded pension obligations approximates the 7% of personal income median for U.S. states rated by Fitch.

The state has taken various steps to manage pension funding. Legislation passed with the fiscal 2011-2013 budget eliminated automatic annual COLAs for PERS and TRS1 retirees that had been in place since 1995, a change still subject to legal challenge. The state also passed legislation to lower the pension investment return assumption from 8% to 7.9% as of July 1, 2013, declining to 7.7% as of July 1, 2017.

OPEB benefits are limited and funded on a pay-as-you-go basis.

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In addition to the sources of information identified in Fitch's report 'Tax-Supported Rating Criteria', this action was additionally informed by information from IHS Global Insight.

Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria', dated Aug. 14, 2012;
--'U.S. State Government Tax-Supported Rating Criteria', dated Aug. 14, 2012.

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Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015
U.S. State Government Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686033