

## **FITCH RATES WASHINGTON'S \$1B GO BONDS 'AA+'; OUTLOOK STABLE**

Fitch Ratings-New York-12 January 2015: Fitch Ratings has assigned an 'AA+' rating to the following state of Washington general obligation (GO) bonds:

- \$282,275,000 various purpose GO bonds, series 2015B;
- \$200,630,000 motor vehicle fuel tax GO bonds, series 2015C;
- \$58,205,000 GO bonds, series 2015T-2 (taxable);
- \$460,195,000 various purpose GO refunding bonds, series R-2015E.

The bonds are expected to be sold through competitive bid on Jan. 21, 2015.

In addition, Fitch has affirmed the 'AA+' rating assigned to \$19 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. Aerospace (Boeing), technology (Microsoft), and construction remain significant to the state economy. The manufacturing sector is concentrated in the cyclical aerospace industry, although this concentration is sharply reduced.

**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 continues to replenish its 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 LIABILITY BURDEN:** Debt ratios are in the upper moderate range and expected to remain so. This reflects funding of substantial capital needs, particularly for transportation. Although the state's unfunded pension liability is well below average, the combined burden of debt plus pensions is above the median for U.S. states.

**INITIATIVES AND REFERENDA A LIMITED RISK:** Washington's initiative and referendum environment creates a level of operating and financial uncertainty. However, it is significant that 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, as well as above-average debt levels. Economic and revenue growth in the recovery has allowed the state to replenish its financial cushion, and current forecasts project that the state will end the current fiscal 2013-2015 biennium with substantially increased reserves. Since the start of the biennium on July 1, 2013, the general fund revenue forecast has been raised repeatedly, 2% in aggregate, to \$33.4 billion.

With the economy and revenues continuing to improve, the key current challenge for the state is to develop a budget for the coming biennium (starting July 1) that satisfies the demands of the McCleary court decision related to school funding. The success of a November 2014 class size reduction initiative (initiative 1351) adds to funding demands. The governor has proposed a budget that would significantly increase education spending and fund pay raises for teachers and state employees. While meeting the McCleary school funding goals one year early, the proposal would only partially fund the provisions of initiative 1351.

The governor's proposed budget would institute new taxes, including on capital gains for high earners and carbon emissions, to support the increased spending, and draw down the budget stabilization account balance in the first year of the biennium before revenues from the new taxes are fully realized. Fitch believes that such a draw on the state's reserve account to support ongoing spending at this point in the economic recovery would be a negative credit consideration, particularly given uncertainty and volatility associated with the proposed new taxes. Fitch will evaluate the final enacted budget to determine whether the reserve level throughout the biennium is consistent with the state's level of revenue volatility. The governor's budget projects that reserves would total \$911 million at the end of fiscal 2017, compared to the \$1.3 billion forecast for the end of the current fiscal year.

With divided government and disagreement over the appropriate course of action, the final budget outcome is difficult to predict at this point. Making budgeting more challenging, certain proposals would require supermajority legislative votes. For example, suspending portions of initiative 1351 would require a 2/3 vote, as it is within two years of initial passage, and a draw on the budget stabilization account would only be permitted with a 60% vote. Providing the state some improved flexibility, a 2013 court decision declared unconstitutional a voter initiative-based requirement that tax increases be passed with a supermajority legislative vote.

## IMPROVING 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, 1.5% in fiscal 2012, 6.1% in fiscal 2013, and 3.8% in fiscal 2014. The most recent forecast, from November 2014, projects revenues up 4.1% in the current fiscal year 2015.

The state reviews its general fund revenue forecast quarterly. Actual revenue performance underperformed 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 positive, with modest upward forecast changes.

Despite continued revenue growth, budgeting for the current fiscal 2013-2015 biennium was challenging. Washington had already taken extensive spending control action in the downturn, and there was not sufficient support for significant revenue increases to support new spending demands. Adding to the challenge, though a positive credit factor, 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 the 2012 state Supreme Court decision that found state education funding inadequate (the McCleary decision). 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 calculated that \$1 billion in additional funding was provided towards this goal with the budget, although that included the continued suspension of a scheduled raise for teachers that was passed by voter initiative but has been repeatedly suspended.

Significant additional education funding is believed necessary to satisfy the court mandate, and, as noted above, this will be a key source of pressure in the budget for the coming biennium. In September 2014, the state supreme court found the state in contempt over its failure to provide a detailed long-term funding plan to meet the 2018 goal, but gave the state time to respond in the 2015 legislative session before taking any further action. Initiative 1351, approved by voters on the November ballot, calls for significant additional funding for class size reduction, although Fitch notes that the legislature has suspended and repealed such measures repeatedly in the past.

The ending balance and reserves for the biennium that closed on June 30, 2013 totaled \$438 million, 2.7% of fiscal 2013 revenues. This is projected to rise to \$1.3 billion, 7.4% of fiscal 2015 revenues, by the end of the current biennium. Fitch views positively the replenishment of reserves and the state's solid 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%.

## 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 in early 2014 and a state incentive package passed by the legislature last year, Boeing will manufacture its new 777X jetliner in the state. This was 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 U.S. overall following a period when it performed much more strongly than the nation. Peak-to-trough, the state's non-farm employment decline was slightly lower than that of the nation and the recovery has been stronger. Through November 2014, the state has recovered 143% of jobs lost in the downturn, compared to 119% for the nation. Washington's year-over-year job growth of 2.8% in November 2014 compared to 2.0% for the nation. The state's unemployment rate in August was 6.2%, 107% of the U.S. rate, with a labor force growth rate twice that of the nation.

Per capita personal income is above average, at 107% of the U.S. in 2013, 12th highest of the states. Recent personal income growth in Washington has been comparatively strong.

#### WELL ABOVE-AVERAGE DEBT LEVELS; NEAR MEDIAN 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 equal to 6% 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 (PERS1 and TRS1), which have been closed since 1977, are underfunded. However, Fitch believes that the unfunded liability is manageable. The state supreme court recently upheld pension reforms that had been subject to longstanding legal challenge.

On a combined basis, Washington's burden of net tax-supported debt and adjusted unfunded pension obligations, at 7.9%, is above the 6.1% of personal income median for U.S. states. 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

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