FITCH RATES STATE OF WASHINGTON'S $1.3B GO BONDS 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-17 June 2016: Fitch Ratings has assigned a 'AA+' rating to the following state of Washington general obligation (GO) bonds:

--$392,265,000 various purpose GO bonds, series 2017A;
--$101,345,000 GO bonds, series 2017T (taxable);
--$535,125,000 various purpose GO refunding bonds, series R-2017A;
--$272,470,000 motor vehicle fuel tax GO refunding bonds, series R-2017B.

The bonds are expected to be sold through competitive bid on June 28, 2016.

In addition, Fitch has affirmed the state's 'AA+' Issuer Default Rating (IDR) and the 'AA+' rating on the state's approximately $19 billion in outstanding 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

Washington's 'AA+' rating reflects the state's solid economy with strong growth prospects, a demonstrated commitment to fiscal balance, and combined long-term liabilities that place a low burden on resources despite an above-average debt load. Fitch believes that strong budget control will allow the state to continue to address challenges, including K-12 education funding demands pursuant to a court decision, while maintaining fundamental financial flexibility even at times of economic and revenue decline.

Economic Resource Base
Washington's economy is characterized by generally sound performance and increased employment diversification. The state economy is growing at a faster rate than the U.S., and the state is well positioned for above-average results going forward. The economy is still heavily influenced by Boeing and Microsoft, while Amazon and other technology companies continue to expand. The workforce is highly educated, income levels are comparatively high, and the state poverty rate is below the national average.

Revenue Framework: 'aaa' factor assessment
Washington relies on broad consumption-based revenues, with no income tax. This revenue mix means that consumer spending and construction trends are quickly reflected in revenue results. Revenue performance over time has tracked economic performance, and Fitch expects this to continue to support solid growth prospects. The state has complete independent control over taxation, with an essentially unlimited legal ability to raise operating revenues as needed.

Expenditure Framework: 'aa' factor assessment

Washington benefits from solid expenditure flexibility with a low burden of carrying costs for debt service and retiree benefits and the broad expense-cutting authority common to most U.S. states. Education is a key cost driver, as is Medicaid, but Fitch expects these costs to remain manageable.

Long-Term Liability Burden: 'aaa' factor assessment
The combined burden of debt plus pensions is low as a percentage of personal income, although solidly above the median for U.S. states. Elevated debt ratios incorporate the funding of substantial capital needs, particularly for transportation but are offset by a moderate unfunded pension liability.

Operating Performance: 'aa' factor assessment
Washington has responsive financial management and very strong gap-closing capacity. In a moderate economic downturn, Fitch expects the state would act in line with historical practice, drawing down reserves and managing revenues and spending to maintain balance and overall financial flexibility. As conditions improve, the state replenishes its cushion against future underperformance. The initiative and referendum environment creates some uncertainty, but this is limited by the legislature's authority to amend or repeal any law approved by voters in this manner.

RATING SENSITIVITIES
SOLID FINANCIAL & LIABILITY MANAGEMENT: The rating is sensitive to shifts in Washington's fundamental credit characteristics, including a low liability burden supported by an increased focus on debt affordability. The rating assumes that the state will address near-term budgetary challenges, primarily related to K-12 education funding requirements, in a sustainable manner.

CREDIT PROFILE

Washington State's economy, historically reliant on manufacturing supplemented by regional and international trade and tourism, has broadened. Areas of concentration, including 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, a trend that seems likely to continue.

Washington entered the last 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 recessionary decline in non-farm employment matched that of the nation. The recovery has been significantly more robust, and amongst the strongest of the states. The state's unemployment rate exceeds that of the U.S., incorporating labor force growth that is well ahead of the national pace.

Revenue Framework
Washington's revenue structure is based on a retail sales tax (about 50% of state general fund revenues) and, to a much lesser extent, a business and occupation gross receipts tax (20%) and state property tax (10-15%). The importance of the real estate excise tax (a projected 4% of revenues in fiscal 2016) varies considerably depending on the point in the economic cycle. The state does not have an income tax.

This revenue structure makes the state budget sensitive to trends in consumer spending. In addition, construction (labor and materials) is subject to the broad sales tax and significant to revenue performance. Fitch expects revenues to continue to reflect cyclical trends and the state's ongoing population growth.

Like most states, Washington has complete independent legal ability to control taxes, a significant credit strength. A 2013 state supreme court decision found a prior 2/3 legislative vote requirement for tax increases to be unconstitutional, making it easier to raise revenues. A November 2015 initiative that attempted to re-establish the restriction by other means also was found to be unconstitutional.

Expenditure Framework

As in most states, education and health and human services are Washington's largest operating expenses. Education is the larger line item, with state funding for local school districts and the public university and college system accounting for about 57% of state general fund expenditures. Human services programs represent another 33%. Initiative 601 (approved by voters in 1993) limits expenditure growth based on average growth in personal income over the prior 10 years; any excess revenue is deposited in the budget stabilization account.

Washington's spending growth, absent policy actions, will likely be in line with to marginally above revenue growth, requiring regular budget management to ensure ongoing balance. The ongoing fiscal challenge of Medicaid is common to all U.S. states. The state is facing a more acute and near-term challenge related to K-12 education funding, although this emerges from a court decision rather than the natural trajectory of growth.

The McCleary state supreme court decision of 2012 found Washington's education funding inadequate.

The state has made progress towards addressing the court's demands with increased K-12 spending in the current and prior biennial budgets; however, in August 2015, the court determined the state had still not addressed several important aspects of the McCleary decision and issued an order instituting a daily fine until the legislature adopts a complete plan. The state has estimated that meeting the remaining McCleary decision obligations could require as much as $3.5 billion per biennium above currently budgeted K-12 spending levels.

Fitch sees this as mainly a policy rather than credit issue for the state; the fines ($100,000 a day into an account segregated for K-12 spending) are insignificant compared to the size of the state's budget and the accumulated funds support education spending. Nevertheless, it does place some limit on the state's still solid expenditure cutting flexibility. K-12 education will continue to require significant focus and may limit spending in other areas, absent revenue-raising increases.

Long-Term Liability Burden

On a combined basis, Washington's burden of net tax-supported debt and adjusted unfunded pension obligations, at 8.5%, is above the 5.8% median for U.S. states (per Fitch's 2015 state pension update), reflecting a debt burden that is more than twice the U.S. state median. The pension burden is below average and the state has successfully implemented pension reforms. The combined liabilities place a low burden on the state's resource base, and Fitch expects this to remain so even given the state's large capital projects.

Washington's debt alone equals about 65% of total long-term liabilities. Debt is primarily GO. Capital needs are substantial, particularly for transportation. The state has repeatedly demonstrated its ability and willingness to raise revenues in support of transportation capital investment, most recently through a gas tax increase in the 2015 session. Tolling is also part of the funding solution.

Positively, the state has increased its focus on debt affordability in recent years. In November 2012, voters approved a constitutional amendment that tightened the constitutional debt limit, which limits annual debt service as a percent of revenues.

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, account for the bulk of the unfunded liability. The state has effectively made changes to manage pension costs; a supreme court in 2014 upheld pension reforms that had been subject to longstanding legal challenge. The state has deferred payments to the closed pension systems in times of economic strain.

Other post-employment benefits (OPEB) are limited and funded on a pay-as-you-go basis.

Contingent liabilities include a school district credit enhancement program that provides a GO guarantee to $9.9 billion in school district debt. The enhancement has never been called upon.

Operating Performance

Frequent reviews of economic and financial forecasts allow the state to respond effectively to changing conditions. As the economy and revenues repeatedly and significantly underperformed estimates in the last recession, the state demonstrated its willingness and ability to take actions in response. The state implemented a combination of ongoing and one-time actions, and fully depleted accumulated reserves. Fitch expects the state to similarly make use of its very strong gap-closing capacity during future cyclical downturns. The governor can enact across-the-board cuts to eliminate a projected deficit.

Budgeting has remained challenging and sometimes contentious even in the current recovery, including due to the McLeary-related K-12 demands and a new statutory mandate that the budget show projected balance over a four-year period rather than just the current biennium. However, the state has taken advantage of this time of growth to rebuild financial flexibility.

As the economy and revenues have recovered solidly, Washington has replenished reserves and strengthened reserve funding mechanisms. The state ended the fiscal 2013-2015 biennium on June 30, 2015 with reserves of $1.5 billion (including the general fund ending balance and the budget stabilization account), equal to 9% of tax revenues and 5.6% of total general fund and related fund spending (including federal funds). The enacted budget for the current 2015-2017 biennium projected a net decline in total reserves by the end of fiscal 2017 to a still sizable $1.2 billion.

The state has solid funding provisions for its budget stabilization account (BSA). The constitutional account was approved by voters in 2007. The BSA receives 1% of revenues off the top every year, capped at 10% of annual general revenues. In 2011, voters approved another constitutional amendment that requires any extraordinary growth in state revenue (defined as growth in general state revenues that exceed by one-third the average biennial growth of the prior five biennia) be transferred to the BSA on top of the 1%. This measure also serves to limit revenue volatility.

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. The legislature repeatedly has shown the ability and willingness to suspend initiatives. The state constitution may not be amended by initiative or referendum.

Current Developments

Quarterly forecast revisions since budget enactment have increased general fund-state revenue estimates for the current biennium to $37.4 billion. The most recent revision added $294 million to the estimate on June 15th, reflecting stronger-than-expected revenue collections. Revenues in the current biennium are now expected to grow at the fastest pace since fiscal 2005-2007.

Expenditure projections also have increased since budget enactment. A 2016 supplemental budget added spending, including an appropriation from the BSA for wildfire-related costs of $190 million that were well above the historical averages on which the budget was based.

The net effect of these changes is a projected ending reserve and balance for the biennium that is increased from budget enactment to $1.5 billion.

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

Applicable Criteria
U.S. Tax-Supported Rating Criteria (pub. 18 Apr 2016)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=879478