Fitch Rates Washington's $944MM GO Bonds 'AA+'; Outlook Stable

Fitch Ratings-New York-17 September 2015: Fitch Ratings has assigned an 'AA+' rating to the following state of Washington general obligation (GO) bonds:

-- $497,800,000 various purpose GO bonds, series 2016A-1 (competitive sale) and series 2016A-2 (green bonds) (negotiated sale);
-- $191,995,000 motor vehicle fuel tax GO bonds, series 2016B;
-- $60,710,000 GO bonds, series 2016T (taxable);
-- $193,775,000 various purpose GO refunding bonds, series R-2016A.

The bonds are expected to be sold through competitive bid for the series 2016A-1, 2016B, 2016T, and R-2016A bonds on Sept. 30, 2015 and negotiated bid for the series 2016A-2 bonds on Sept. 28, 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, technology, 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 last 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. Fitch anticipates the state will address near-term budgetary challenges, primarily related to K-12 education funding requirements, in a sustainable manner consistent with historical practice.

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 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

Washington's '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 for transportation needs.

CREDIT PROFILE

Washington's 'AA+' GO bond rating reflects a generally solid economy and a demonstrated commitment to fiscal balance despite economic and revenue cyclicality. 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 estimates indicate that the state ended the fiscal 2013-2015 biennium (on June 30, 2015) with substantially increased reserves of $1.4 billion (including the general fund ending balance and the budget stabilization fund). Based on the recently enacted budget for the current 2015-2017 biennium, Washington anticipates a net decline in total reserves by the end of fiscal 2017 to $1.2 billion. Positively, the September 2015 revenue forecast update projects an additional $333 million in general fund revenues for the current biennium, leading to an improved projection for ending total reserves of $1.4 billion by June 30, 2017.

Education funding remains a key ongoing budgetary challenge for Washington, due mainly to the McCleary court decision in 2012 and initiative 1351 which passed in 2014 and sets class-size reduction targets. The enacted biennial budget makes progress towards addressing the demands with increased

K-12 spending, but sizable challenges remain and the state supreme court is actively fining the state for underfunding education pursuant to the terms of the court decision. The fines are insignificant compared to the size of the state's budget and the accumulated funds support education spending. Fitch sees this as mainly a policy rather than credit issue for the state.

An initiative certified for the November 2015 ballot could also have significant fiscal implications if approved by voters. Initiative 1366 would reduce the state's sales tax rate to 5.5% from 6.5% unless the legislature refers to voters a constitutional amendment requiring two-thirds legislative approval or voter approval to raise taxes, and a majority legislative approval for fee increases. The state estimates reducing the sales tax rate to 5.5% would reduce sales tax revenue by approximately $8 billion over the next six fiscal years.

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. Fiscal 2015 finished 5.5% up from the prior year. The most recent forecast, from September 2015, projects revenues up 5.1% in the current fiscal year 2016, and up 4.1% in the second half of the biennium (fiscal 2017).

The state reviews its general fund revenue forecast quarterly. Actual revenue performance underperformed revised estimates in the last 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 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, a new statutory requirement mandated that the budget show projected balance over a four-year period rather than just the biennium; Fitch viewed the requirement as a positive credit factor.

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 K-12 funding adequacy based on the McCleary decision, noted earlier. The court decision provided the state flexibility in terms of the timing and amount of supplemental funding. The state calculated that $1 billion in additional funding was provided towards the McCleary decision goals with the 2013-2015 budget, although that included the continued suspension of a scheduled raise for teachers that was passed by voter initiative.

Budgeting for the current 2015-2017 session proved equally challenging with the governor signing the budget on the last day of the fiscal year. Once again, education funding played a key role in the debate. The enacted budget includes $1.3 billion in additional basic education funding, and $618 million to support K-12 staff compensation increases. The legislature delayed implementation of class-size requirements passed by voters under Initiative 1351 until the 2019-2021 biennium. In August the state's supreme court acknowledged the additional education funding support, but determined the state had still not addressed several important aspects of the McCleary decision and issued an order instituting a nominal $100,000 daily fine until the legislature adopts a complete plan. The governor recently convened a joint executive and legislative working group to address the outstanding McCleary issues with the goal of developing a legislative proposal by late November. The state currently estimates meeting the remaining McCleary decision obligations could require as much as $3.5 billion per biennium above currently budgeted K-12 spending levels. Fitch anticipates this will continue to be a key source of budgetary pressure.

The ending balance and reserves for the biennium that closed on June 30, 2015 totaled $1.4 billion, 8.4% of fiscal 2015 general fund tax revenues. This is up significantly from the previous biennium, which ended on June 30, 2013 with a much more modest $438 million in reserves, or 2.7% of general fund tax revenues. The four-year budget outlook enacted with the 2015-2017 budget projects reserves stabilizing at $1.4 billion by June 30, 2019 with sizable growth in the budget stabilization account offset by draws in the unrestricted general fund balance.

Fitch views positively the state's solid funding provisions for its budget stabilization account. 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 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) 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.

Washington's economy 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 non-farm employment decline was slightly lower than that of the nation and the recovery has been stronger. Through July 2015, the state has recovered 192.9% of jobs lost in the downturn, compared to 142.5% for the nation.

Washington's year-over-year job growth of 3.7% in July 2015 compared very favorably to 2.2% for the nation (three-month moving averages). The state's unemployment rate in July was 5.3%, equivalent to the U.S. rate, with a labor force growth rate more than twice that of the nation.

Per capita personal income is above average, at 107.5% of the U.S. in 2014, 13th highest of the states. Recent personal income growth in Washington has been comparatively strong.

WELL-ABOVE-AVERAGE DEBT LEVELS; NEARER MEDIAN WHEN PENSIONS ADDED

Washington's debt levels are in the upper moderate range and well above average for a U.S. state, with pro forma net tax-supported debt as of Oct. 8, 2015 equal to 5.7% of 2014 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 in 2014 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 median for U.S. states (per Fitch's 2014 state pension update). Other post-employment benefit (OPEB) benefits are limited and funded on a pay-as-you-go basis.

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Fitch recently published an exposure draft of state and local government tax-supported criteria (Exposure Draft: U.S. Tax-Supported Rating Criteria, dated Sept. 10, 2015). The draft includes a number of proposed revisions to existing criteria. If applied in the proposed form, Fitch estimates the revised criteria would result in changes to fewer than 10% of existing tax-supported ratings. Fitch expects that final criteria will be approved and published by Jan. 20, 2016. Once approved, the criteria will be applied immediately to any new issue and surveillance rating review. Fitch anticipates the criteria to be applied to all ratings that fall under the criteria within a 12-month period from the final approval date.

In addition to the sources of information identified in the applicable criteria specified below, this action was informed by information from CreditScope, IHS, and Federal Reserve Bank of St. Louis Economic Data.

Applicable Criteria
Exposure Draft: U.S. Tax-Supported Rating Criteria (pub. 10 Sep 2015)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869942)
Tax-Supported Rating Criteria (pub. 14 Aug 2012)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015)
U.S. State Government Tax-Supported Rating Criteria (pub. 14 Aug 2012)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686033)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
(https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=990960)
Solicitation Status (https://www.fitchratings.com/gws/en/disclosure/solicitation?pr_id=990960)
Endorsement Policy (https://www.fitchratings.com/jsp/creditdesk/PolicyRegulation.faces?context=2&detail=31)

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