MOODY'S
INVESTORS SERVICE

New Issue: Moody's revises outlook to stable from negative and assigns Aa1 rating to State of Washington G.O. bonds Series 2014A, B, and T

Global Credit Research - 19 Jul 2013

Approximately $18.7 B outstanding G.O. bonds

WASHINGTON (STATE OF)
State Governments (including Puerto Rico and US Territories)
WA

Moody's Rating

ISSUE		RATING
Various Purpose General Obligation Bonds, Series 2014A		Aa1
Sale Amount	$532,940,000	
Expected Sale Date	08/07/13	
Rating Description	General Obligation	
General Obligation Bonds, Series 2014T (Taxable)		Aa1
Sale Amount	$55,725,000	
Expected Sale Date	08/07/13	
Rating Description	General Obligation	
Motor Vehicle Fuel Tax General Obligation Bonds, Series 2014B		Aa1
Sale Amount	$275,125,000	
Expected Sale Date	08/07/13	
Rating Description	General Obligation	

Moody's Outlook STA

Opinion

NEW YORK, July 19, 2013 --Moody's Investors Service has revised the outlook on the State of Washington's general obligation bonds to stable from negative and assigned an Aa1 rating to: $532.94 million Various Purpose G.O. Bonds, Series 2014A; $275.13 million Motor Vehicle Fuel Tax G.O. Bonds, Series 2014B; and $55.73 million G.O. Bonds, Series 2014T. Concurrently, Moody's has affirmed the Aa1 rating on the state's general obligation bonds (approximately $18.7 billion outstanding); the Aa1 rating on the Washington State School Bond Guarantee Program (approximately $8.3 billion outstanding); the Aa2 rating on the certificates of participation (approximately $666 million outstanding); and the Aa3 rating on the City of Aberdeen Special Revenue Bonds, Series 2002 (Stafford Creek Corrections Center Project) ($9.7 million outstanding as of June 30, 2012).

The state plans to sell the three series of bonds on August 7. Proceeds of the various purpose general obligation bonds will be used to fund various statewide capital projects and the motor vehicle fuel tax general obligation bonds will be used for transportation related construction projects. The motor vehicle fuel tax bonds are general obligations of the state, secured also by the state's excise taxes on motor vehicle fuels. The taxable bonds will fund non-transportation projects that cannot be financed with tax-exempt debt.

SUMMARY RATINGS RATIONALE

Washington's rating outlook is revised to stable reflecting the state's economic gains that are boosting revenues, improving reserve position, and budget balancing solutions that are largely recurring. Moody's expects that the

state will continue to address any budget gaps that emerge, as it has in the past, and absorb the substantial increase in mandated basic education funding.

The Aa1 general obligation rating incorporates Washington's sound management tools such as its quarterly consensus revenue forecasting process and demonstrated willingness to address budget shortfalls, along with an economy that is improving and expected to out-perform the nation over the long term, despite a slow recovery. Revenue trends are positive, supported by employment gains and improvement in the state's housing market, and available reserves are increasing, though they remain modest relative to historical levels. These strengths are tempered by exposure to the cyclical aerospace industry and above average debt ratios. Frequent voter initiative activity adds budget challenges although the state legislature has a history of responding effectively to maintain budget balance.

The Washington State School Bond Guarantee Program is rated at the same level as the state based on the pledge of the state's full faith and credit, and taxing power to guarantee debt service when due on qualified school districts' voter approved general obligation bonds. The Aa2 rating on the certificates of participation, one notch below the state's general obligation, reflects the limited subject-to-appropriation nature of the state's master financing contract payment obligations, active administration of the financing program by the state treasurer's office, and the state's established track record of making appropriation-backed debt payments under a variety of financing programs. The Aa3 rating on the City of Aberdeen revenue bonds reflects the credit standing of the state, the strength of the agreement between the city and the state's Department of Corrections relative to the construction of utility extensions to service a state correctional facility, the department's history of payment of similar capital project financings, the essentiality of the project financed, and the weaker security provided by the department payments - which are subject to biennial legislative appropriation.

STRENGTHS:

- Institutionalized governance practices such as consensus revenue forecasting, multi-year revenue and expenditure projections, and timely budget adoption.

- Strong demographic trends

- Satisfactory overall liquidity levels maintained in pooled resources

- Healthy pension funding levels and modest retiree health insurance liability

- Available reserves fund balances are increasing

CHALLENGES:

- Significant future increases required in K-12 education funding will pose out year budget challenges

- Diminished financial flexibility given financial reserves that are modest relative to historical levels

- Exposure to cyclical commercial aerospace industry

- Debt ratios above average and likely to increase.

- Voter initiative activity adds element of fiscal uncertainty

DETAILED CREDIT DISCUSSION

2013-15 BIENNIAL BUDGET ADDRESSES $2.5 BILLION GAP

Washington faced a $2.5 billion gap going into the 2013-15 biennium reflecting $800 million in projected expenses for existing programs and $1.7 billion in enhancements for K-12 education, health and human services programs, higher education, and early learning opportunities. The projected gap represented about 8% of the revenue forecast for the next biennium but was significantly lower than the $4.9 billion shortfall that Washington faced going into the 2011-13 biennium.

Spending cuts totaling $1.55 billion represent the largest portion of the solution to resolve the budget gap. These include: $320 million from the re-suspension of teacher cost-of-living adjustments pursuant to voter initiative I-732; $272 million from the extension of hospital safety net assessments; and $351 million in savings from Medicaid expansion offered through the Affordable Care Act. The adopted budget also relies on $259 million in new revenue, mostly through reforming the estate tax and reforms in the telecommunications tax; $519 million in fund transfers;

and $140 million in assumed reversions. One-time actions from the fund transfers represent less than 2% of the total budget and some of the revenue transfers can be considered ongoing since they are budgeted to continue over the next six years.

The budget plan also incorporates $1 billion in increased spending for basic education to begin addressing the state supreme court's McCleary decision last year. The ruling concluded that the state was not meeting its constitutional mandate to fully fund K-12 education. Continuing commitments are sizeable and will pose budget challenges over the near term. The governor has proposed increasing K-12 education funding by $3.0 to $3.8 billion over the following two budget cycles.

Assuming the revenue forecast holds, the enacted 2013-15 budget reflects substantially higher available reserves at the end of fiscal year 2015, including $53 million in General Fund balance and $577 million in the budget stabilization account (BSA) for a total of $630 million in combined available reserves. Preliminary results for the 2011-13 biennium that just ended show $363 million in available reserves, continuing a trend of improving balances that had turned negative on a GAAP basis during the recession. Even so, the balance budgeted for the end of the 2013-15 biennium is less than 3% of annual revenues, well below the state's 7% peak prior to the recession. Reserve levels are important given Washington's heavy reliance on sales taxes, which have still not fully recovered.

Budget deliberations were eased after the state's supreme court of the State of Washington struck down a new law requiring a two-thirds legislative majority to make tax changes as unconstitutional. The law, approved by voter initiative in November 2012, reduced the state's flexibility to raise revenues. It would have required either a two-thirds legislative approval or a vote by the people in order to raise taxes or repeal existing tax exemptions.

REVENUES STABILIZE AS STATE BEGINS TO EMERGE FROM RECESSION; RESERVES LEVELS IMPROVE

As a state with heavy dependence on sales tax receipts and no personal income tax, Washington's revenues were hit hard by the negative impact of the recession on consumer confidence. As a result, Washington confronted several consecutive years of substantial budget gaps. Revenues are gradually improving and fiscal 2013 total state tax revenue surpassed the prior peak (2008) by 1.7%. However, sales tax receipts remained 7.4% below the peak and are not expected to surpass that level until fiscal 2015 despite an increase of almost 6% in fiscal 2013 and projected growth of 4.7% and 4.4% in fiscal years 2014 and 2015, respectively.

Washington made the budgeted transfer to the BSA and unaudited results show a balance of $268.7 million at the end of the 2011-13 biennium plus an ending General Fund balance of $94.7 million. Combined available reserves totaling $363.4 million provide increased financial flexibility. The results continue a positive trend as the state recovers from two years' of negative balances during the recession. Still, available reserves are modest at about 2.3% of fiscal 2013 annual revenues.

In November 2007, Washington voters approved a constitutional amendment that permanently established a rainy day fund (RDF) and provided for annual automatic deposits to the fund amounting to 1% of General Fund revenues, up to a maximum of 10% of General Fund revenues. Going into the Great Recession, Washington had approximately $980 million in combined available reserves representing almost 7% of General Fund revenues, including $303 million in the emergency reserve and $677 million in unreserved, undesignated general fund balance.

SIGNS OF ECONOMIC STABILIZATION AND JOB GROWTH

Washington's economy continues to show signs of stabilization with all major employment sectors experiencing growth. Government sector jobs are growing slowly due to gains in state and local government employment which is offsetting declining federal employment. Washington's government employment sector accounted for 18.8% of statewide employment in 2012, greater than the 16.4% nationwide share, due in part to several military bases. The impact of federal sequestration may be greater in Washington which has a higher civilian share of employment than in many other states. Washington's construction sector is also improving although total employment in the sector in 2012 was about one-third below the pre-recession peak. The multi-family segment has largely recovered and single family construction is improving.

While the state's unemployment rate was above the national average during the recession, the level has steadily dropped and reached 6.8% in May 2013, comfortably below the national rate of 7.6% the same month. In 2012, aerospace regained the jobs that were lost during the recession and had added 15,700 jobs since the low point in May 2010, surpassing the previous peak by 10,000. Aerospace employment declined by 1,400 jobs between

December 2012 and May 2012, largely due to improved productivity rather than production cuts. Boeing (rated A2/stable outlook) has a production backlog of about seven years, although there is still a downside risk of global economic weakness that could result in cancellations of aircraft orders. The software publishing sector led in Washington by Microsoft (rated Aaa/stable outlook) has also recovered the jobs it lost during the recession and is expected to outperform overall employment. Software employment has increased by 1,000 jobs so far this year. Exports from the state's important aerospace and software publishing industries are expected to contribute to the state's economic recovery although the pace will be slower than in the past. Over the long term, the state should benefit from its educated work force and industry concentration in well-paying high technology and aerospace jobs. High wage jobs are an important factor for a state like Washington that has no personal income tax and relies heavily on consumer confidence to boost revenues from its sales tax.

ABOVE-AVERAGE DEBT LEVELS REFLECT GROWTH-RELATED FINANCINGS

Washington's debt ratios are more than twice Moody's 2013 50-state median level; net tax-supported debt as a percentage of personal income is 6.4%, compared with Moody's 50-state median of 2.8%. Despite the significant increase in total debt outstanding during the previous decade, the debt-to-personal income ratio has remained fairly stable due to Washington's strong personal income growth. Even so, at $2,817 Washington's net-tax supported debt per capita is more than twice the national median of $1,074. The state's debt ratios will likely remain high given continued sizeable borrowing plans, especially for transportation purposes. Annual debt service costs relative to revenue available for debt service (Moody's calculation) was also relatively high at 9% in fiscal 2012 versus a median of 4.9%.

Washington publishes an annual debt affordability study to provide a framework for policymakers regarding debt financings. The state has managed its debt levels through a combination of statutory and constitutional debt limits, measured by debt service as a percentage of average general state revenues. This ratio was limited to 9% until a constitutional amendment approved by voters in November 2012. The debt service limit will be reduced in steps to 8% by July 1, 2034. In addition, beginning July 1, 2014, general state revenues will be averaged over the six (rather than the current three) immediately preceding fiscal years, and the definition of general state revenue will be expanded to include property taxes received by the state. One goal of the amendment was to lower the share of the state's operating budget used to pay debt service.

In recent years, Washington has substantially increased its transportation infrastructure funding program, which is largely financed through the issuance of motor vehicle fuel tax general obligation bonds. Effective July 1, 2005, the state gas tax increased by 9.5 cents (phased-in over a four-year period) in order to support the planned issuance of motor vehicle fuel tax bonds. Washington's motor vehicle fuel tax bonds are not subject to the state's debt limitation. The bonds are payable first from the state's excise taxes on motor vehicle and special fuels. The state legislature has agreed to continue to impose those excise taxes in amounts sufficient to pay debt service on the motor vehicle fuel tax general obligation bonds. On or before June 30 of each year, the State Finance Committee certifies to the state treasurer the amount required to pay principal of and interest on the bonds in the next fiscal year. The state treasurer is required to withdraw revenues from any general state revenues received in the state treasury and from the motor vehicle fund, as applicable, and deposit in the bond fund on or before each debt service payment date amounts required to pay debt service on the bonds. About 34% of the state's total general obligation debt is payable from motor fuel excise taxes. The state's full faith credit and taxing power are also irrevocably pledged to the payment of the bonds. Washington has no variable rate debt or interest rate swaps.

STRONG OVERALL PENSION FUNDED RATIOS

While debt ratios are above average, the state's aggregate pension funding ratio was strong at 101% as of June 2012. This represents over-funding of the state's open pension plans which masks underfunding of closed plans for state employees and teachers (funded ratios of 69% and 79%, respectively), despite statutory requirements for funding the closed plans' unfunded liabilities.

Based on the Washington's fiscal 2011 pension data, we have calculated that the overall retirement systems' adjusted net pension liability (ANPL) was 32.7% of revenues, below the 50-state median of 45.1%. Other pension ratios such as ANPL to personal income, GDP, and population are similarly below the median. However, the combined liability for debt and pensions is slightly above the median (8.2% versus 7.6%) due to the state's high debt levels.

In Washington, retiree benefits are set as part of the biennial budget process and funded on a pay-as-you-go-basis. As of June 30, 2011, Washington's other post-employment benefits (OPEB) liability for state employees was relatively modest at $3.49 billion (present value of future benefits), largely due to implicit rate subsidies. The annual required contribution (ARC) for fiscal year 2012 was $320 million,1.4% of the state's total governmental

revenues, excluding federal aid.

Outlook

Washington's rating outlook is stable reflecting the economic gains that are boosting revenues, improving reserve position, and budget balancing solutions that are largely recurring. Moody's expects that the state will continue to address any budget gaps that emerge, as it has in the past, and absorb the substantial increase in mandated basic education funding. Economic concentration in some industries that are historically volatile poses longer-term credit risk.

WHAT COULD MAKE THE RATING GO UP

- Sustained trend of structural budget balance, plus restoration and maintenance of strong reserve levels.

- Economic expansion and improved industry diversification.

- Reduction of debt ratios to levels closer to Moody's 50-state medians.

WHAT COULD MAKE THE RATING GO DOWN

- Slower recovery that restrains consumer confidence, leading to renewed revenue weakness and large budget shortfalls

- Employment erosion

- Protracted structural budget imbalance

- Increased reliance on one-time budget solutions

- Deterioration of the state's cash position

RATING METHODOLOGIES

The principal methodology used in this rating was US States Rating Methodology published in April 2013. An additional methodology used in rating the certificates of participation debt was the Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in December 2011. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

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