MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns Aa1 rating to $554M State of Washington general obligation bonds and $996M general obligation refunding bonds

Global Credit Research - 16 Jan 2013

Approximately $17.7 B G.O. bonds outstanding

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

Moody's Rating

ISSUE		RATING
Motor Vehicle Fuel Tax General Obligation Refunding Bonds, Series R-2013D		Aa1
Sale Amount	$297,920,000	
Expected Sale Date	01/23/13	
Rating Description	General Obligation	
Various Purpose General Obligation Refunding Bonds, Series R-2013C		Aa1
Sale Amount	$698,230,000	
Expected Sale Date	01/23/13	
Rating Description	General Obligation	
Various Purpose General Obligation Bonds, Series 2013D		Aa1
Sale Amount	$240,045,000	
Expected Sale Date	01/23/13	
Rating Description	General Obligation	
Motor Vehicle Fuel Tax General Obligation Bonds, Series 2013E		Aa1
Sale Amount	$313,905,000	
Expected Sale Date	01/23/13	
Rating Description	General Obligation	

Moody's Outlook

Opinion

NEW YORK, January 16, 2013 --Moody's Investors Service has assigned a Aa1 rating to the State of Washington's general obligation bonds: $240.045 million Various Purpose G.O. Bonds, Series 2013D; $313.905 million Motor Vehicle Fuel Tax G.O. Bonds, Series 2013E; $$698.23 million Various Purpose G.O. Refunding Bonds, Series R-2013C; and $297.92 million Motor Vehicle Fuel Tax G.O. Refunding Bonds, Series R-2013D; the outlook is negative.

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 bonds are scheduled to be sold on January 23; proceeds from the refunding bonds will be used to refund outstanding debt for present value savings. A portion of the proceeds will also be used to refund the state's 1996 variable rate demand obligation bonds. 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.

SUMMARY RATINGS RATIONALE

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 strong demographic trends that will help propel the economic recovery once it firmly takes hold. These strengths are tempered by exposure to the cyclical aerospace industry, above average debt ratios, and an economy that proved more vulnerable to the housing downturn than expected. Frequent voter initiative activity adds budget challenges although the state legislature has a history of responding effectively to maintain budget balance. 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. Washington has confronted several consecutive years of substantial budget gaps and now faces a $1.4 billion shortfall projected for the 2013-15 biennial budget. Revenues are gradually improving but have not yet fully recovered, and employment continues to grow at a moderate pace. On top of the budget gap, the state faces a significant increase in the cost of K-12 education following last year's state supreme court ruling (McCleary) which ruled that the state's basic education funding is inadequate. To that end, outgoing Governor Gregoire proposed an additional $1 billion in education spending which would be financed with an increase in fuel, business and occupation, and beer taxes. Forward-looking economic indicators are positive and high paying aerospace and technology jobs will eventually help Washington outperform the nation. The state's construction industry is finally showing signs of stabilization although building permits remain well below the pre-recession peak. The housing downturn hit Washington later than most states and was worse than the state expected. While most sectors are adding jobs, public sector employment continues to decline as the state and local governments downsize in response to budget challenges.

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 despite recessionary stresses

- Healthy pension funding levels and modest retiree health insurance liability

- Fund balance level improved at fiscal yearend 2012

CHALLENGES:

- Continuing sizeable projected budget gaps reflecting the slow pace of economic recovery and a steeper-than-forecast housing downturn that put downward pressure on revenues.

- Diminished financial flexibility given reduced financial reserves, significant use of one-time actions to balance budgets, and implementation of large budget reductions over the past several years

- 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

PROPOSED BUDGET FOR 2013-15 BIENNIUM PROGRAM REDUCTIONS AND REVENUE ENHANCEMENTS

Washington faces an estimated gap of $1.375 billion for the upcoming 2013-15 biennium reflecting a revenue shortfall of $975 million relative to projected expenses; $275 million for policy additions; and $125 million due to a home care worker arbitration award. The projected gap represents about 4.2% of the revenue forecast for the next biennium, down significantly from the $4.9 billion shortfall that Washington faced going into the 2011-13 biennium. Outgoing Governor Gregoire presented two budget plans. The first relies on spending cuts and a reduced levy equalization for local school districts, but no new revenues. The second proposal includes $557 million in program cuts, reform savings, and new assumptions; $360 million from the renewed suspension of Initiative 732 (cost-of-living adjustments for teachers); $276 million from the extension of a hospital safety net assessment; $57 million in cost sharing with local governments; and $198 million in one-time balance transfers. The governor would fund the $125 million home care worker arbitration award by increasing taxes on soda, candy, and gum to raise the same amount in new revenues. The plan includes the required transfer to the budget stabilization account (BSA). The governor's second budget plan also incorporates a $1 billion increase in spending for basic education to begin addressing the state supreme court's McCleary decision last year. The ruling concluded that the state is not meeting its constitutional mandate to fully fund K-12 education. Commitments are sizeable at $3.4 billion per biennium when fully phased in by 2018. Funding for the additional education costs recommended by the governor would come from: 1) an excise tax on fuel based on the wholesale selling price ($368 million), and 2) the extension of two taxes through December 31, 2016, including a surcharge of service businesses ($534 million) and a 50-cent per gallon beer tax ($101 million).

If enacted as proposed and assuming the revenue forecast holds, Washington would end the 2013-15 biennium with substantially higher available reserves, including $306 million in General Fund balance and $575.5 million in the BSA. The new governor (Inslee) may release his own budget proposal for the upcoming biennium.

Budget deliberations may be more challenging due to voter approval of Initiative 1185 (I-1185) last November. I-1185 requires either a two-thirds legislative approval or a vote by the people in order to raise taxes or repeal existing tax exemptions. Initiatives requiring a supermajority have repeatedly passed in the state of Washington. Since the 1990s, voters have approved the two-thirds restriction four times, to deter lawmakers from suspending the rule, which they were able to do with a simple majority vote after two years. The supermajority initiative was last approved in 2010 with 64 percent of the vote.

RESERVES EXPECTED TO IMPROVE AT END OF 2011-13 BIENNIUM AS REVENUES STABILIZE AND STATE BEGINS TO EMERGE FROM RECESSION

Washington budgeted the required transfers to the BSA for the 2009-2011 biennium but used the funds to address its budget gaps during the recession. On a GAAP basis, the state reported a negative available reserve position at the end of fiscal year 2010, the midpoint of the 2009-2011 biennium. The unreserved, undesignated General Fund balance was negative $561 million, equivalent to negative 4.1% of General Fund revenues, net of federal aid. For fiscal 2011, the balance sheet reflected the adoption of GASB 54 accounting statement. The GAAP-basis unassigned fund balance was also negative at the end of fiscal 2011 (-$107.8 million) and the BSA was effectively zero ($564,000).

Transfers to the BSA were restored in the adopted 2011-13 biennial budget and absent an unexpected revenue deterioration over the next few months, the state expects to end fiscal 2013 with combined reserves of $374 million, including $267 million in the BSA, which will help improve its financial flexibility. Still, available reserves will be modest at about 1.2% of biennial 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. Washington's emergency reserve (a precursor to the new RDF that was not constitutionally protected) peaked at $754 million at the end of fiscal 2000, just before the 2001 recession, and was depleted by fiscal 2004 as the state addressed previous revenue shortfalls. Going into the current 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 most employment sectors experiencing growth, except in state and local governments which are shedding staff as budgets remain tight . Washington's government employment sector accounted for 19.2% of statewide employment in 2011, greater than the 16.8% nationwide share, due in part to several military bases. These bases could be impacted by ongoing pressure on the federal budget. Washington's construction sector has finally begun to improve with modest year-over-year job gains in 2012. The multi-family segment has largely recovered and single family construction is improving.

While the state's unemployment rate has been above the national average for the past several years, the level dropped to 7.8% in November 2012, the same as the nation that month. In 2012, aerospace regained the jobs that were lost during the recession and has added 15,700 jobs since the low point in May 2010, surpassing the previous peak by 10,000. Boeing (rated A2/stable outlook) has a production backlog of 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. 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 2012 50-state median level; net tax-supported debt as a percentage of personal income is 6.0%, 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 $2,588, Washington's net-tax supported debt per capita is more than twice the national median of $1,117. 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 8.8% in fiscal 2011.

Washington published its first debt affordability study in January 2011, followed by a second report in January 2012, 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 37% 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.

Following the refunding of $108.8 million outstanding general obligation variable rate demand bonds with proceeds of the current offering, Washington will have no variable rate debt outstanding. The state has no 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 2011. 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 71% and 81%, respectively), despite statutory requirements for funding the closed plans' unfunded liabilities.

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 negative reflecting the magnitude of the revenue falloff that occurred during the recession and the continuing budget gaps that have challenged the state as it begins to recover; modest reserves at least through the end of fiscal 2013; and high fixed costs for the state's above-average debt position. Moody's expects that the state will continue to address any budget gaps that emerge, as it has in the past, although financial flexibility will remain limited over the near term and out year structural gaps will likely be challenging to resolve, particularly for 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

- Delayed or muted recovery that restrain consumer confidence, leading to revenue weakness and larger budget shortfalls

- Employment erosion

- Protracted structural budget imbalance.

- Increased reliance on one-time budget solutions.

- Deterioration of the state's cash position.

RATING METHODOLOGY

The principal methodology used in this rating was Moody's State Rating Methodology published November 2004. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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