

MOODY'S

INVESTORS SERVICE

New Issue: Moody's assigns Aa2 to \$162M Washington State COPs; outlook stable

Global Credit Research - 24 Sep 2015

Approximately \$835M COPs outstanding

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

Moody's Rating

ISSUE	RATING
Certificates of Participation, Series 2015C (State and Local Agency Real and Personal Property)	Aa2
Sale Amount	\$161,610,000
Expected Sale Date	10/06/15
Rating Description	Lease Rental: Appropriation

Moody's Outlook STA

NEW YORK, September 24, 2015 --Moody's Investors Service has assigned a Aa2 rating to the State of Washington's Certificates of Participation, Series 2015C (State and Local Agency Real and Personal Property). Following the issuance of these COPs, the state will have approximately \$835 million similarly-secured COPs outstanding, all rated Aa2.

SUMMARY RATINGS RATIONALE

The Aa2 rating on the COPs, one notch below the Aa1 rating on the state's general obligation bonds, reflects the limited subject-to-appropriation nature of the state's 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 payments under a variety of financing programs.

Washington's Aa1 general obligation rating incorporates the state'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. Revenue trends are positive, supported by employment gains and improvement in the state's housing market, and available reserves are increasing. These strengths are tempered by education spending mandates, exposure to the cyclical aerospace industry and other export markets, 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.

OUTLOOK

Washington's rating outlook is stable, reflecting economic gains that are boosting revenues, an 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, over time, 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 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

- Employment erosion
- Protracted structural budget imbalance
- Increased reliance on one-time budget solutions
- Deterioration of the state's cash position

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
- Increasing available reserves

CHALLENGES

- Significant future increases required in K-12 education funding
- Exposure to cyclical commercial aerospace industry and export market
- Above-average debt ratios
- Voter initiative activity adding element of fiscal uncertainty

RECENT DEVELOPMENTS

Job growth in the second quarter of 2015 was slightly higher than anticipated in the state's June forecast. In its recently-released September forecast, the state increased its estimate of job growth for the calendar year to 3.0% from 2.6%. The state also increased its revenue estimates by \$13 million for the 2013-15 biennium and by \$333 million for the 2015-17 biennium, which would increase reserves beyond the levels cited in the Detailed Rating Rationale.

DETAILED RATING RATIONALE

ECONOMY

Washington State benefits from a high-value-added, but often cyclical, commercial aircraft industry; a fast growing information-technology industry; and above average per capita income and household wealth. Large agriculture and timber sectors are vulnerable to volatile commodity prices and export demand. Officials indicate that a significant and growing share of the state's exports go to China, with China accounting for 22.8% of total exports in 2014.

The state's unemployment rate declined to 5.3% in June, from 6.1% one year earlier. The unemployment rate in the Seattle area fell to 3.9%. Personal income in the state grew by 5.4% in 2014, compared to 3.9% for the US, but growth slowed in the first quarter of 2015. Housing construction, driven by the Seattle area, was particularly strong in the first quarter of 2015. Transportation exports (primarily Boeing aircraft) increased by 14.4% in the first five months of 2015, compared to the same period in 2014, but overall exports dropped by 0.8% largely due to the stronger dollar and economic weakness overseas. The state's economic forecasts expect continued steady economic growth, with increasing employment in most sectors.

FINANCES AND LIQUIDITY

Driven by economic growth, state revenues have grown steadily since the recession, albeit at a relatively moderate rate. On a GAAP basis, the state's non-federal operating fund revenues grew at a compound annual rate

of 4.9% from fiscal 2010 through 2014. In its June 2015 forecast, the state projected that General Fund revenues for the fiscal 2015 will be 5.4% higher than 2014, and will increase by 3.8% and 5.1% in fiscal 2016 and 2017, respectively. The projections are generally higher than those of earlier forecasts.

Due to rising revenues and expenditure controls, reserves, which fell to negative levels during the recession, have been gradually rebuilt. On a GAAP basis, available reserves, which consist of Unassigned General Fund Balance plus the state's Budget Stabilization Account increased from a negative \$107 million (0.7% of revenues) at the end of fiscal 2011 to a positive \$751 million (4.2% of revenues) at the end of fiscal 2014. In the June forecast, the state projected that total budget-basis reserves will increase to \$1,423 million at the end of fiscal 2015, including \$910 million in General Fund unrestricted ending balance and \$513 million in the Budget Stabilization Account. This increase would bring reserves close to pre-recession levels.

The recently enacted budget for the 2015-17 biennium includes a significant increase in K-12 education funding in response to the State Supreme Court's ruling in the "McCleary" case. The budget also includes additional funding for higher education. In conjunction with the approval of the budget, the legislature suspended for three years Initiative 1351 which would have required additional increases in K-12 funding. Based on the enacted budget and the June forecast, the state projected that the ending balance at the end of the biennium will total \$1,237 million, including \$343 million in the General Fund unrestricted ending balance and \$894 million in the Budget Stabilization Account.

Subsequent to the adoption of the 2015-17 budget, the Supreme Court ruled that the state had still not complied fully with its ruling in the McCleary case and imposed a fine on the state of \$100,000 per day. Addressing the court's ruling could reportedly cost as much as \$3.5 billion more per biennium above the recently adopted funding levels. The legislature has not yet responded to the court's ruling.

Liquidity

The state's overall liquidity is sound and has improved notably over the last four years with the improvement in GAAP-basis financial position. Average daily balances in the Treasury and Treasurer's Trust Fund were \$4.3 billion for the 12 months from August 2014 through July 2015. The state does not issue cash flow notes.

DEBT AND PENSIONS

Debt Structure

Washington's debt ratios are more than twice Moody's 2015 50-state median level; net tax-supported debt as a percentage of personal income is 6.2%, compared with Moody's 50-state median of 2.5%. 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. Washington's net-tax supported debt per capita (\$2,892) is more than twice the national median of \$1,012. Annual debt service costs relative to revenue available for debt service (Moody's calculation) was also relatively high at 9.8% in fiscal 2014 versus a median of 5.3%.

Debt-Related Derivatives

The state has no variable rate debt and no debt-related derivatives.

Pensions and OPEB

While debt ratios are above average, the state's aggregate pension funding is relatively strong. Based on the Washington's fiscal 2013 pension data, Moody's has calculated that the overall retirement systems' adjusted net pension liability (ANPL) was 43.5% of governmental revenues, well below the 50-state median of 60.3%. Other pension ratios such as ANPL to personal income, GDP, and population are similarly below the medians.

In Washington, retiree benefits are set as part of the biennial budget process and funded on a pay-as-you-go basis. As of January 1, 2015, the most recent date for which a full valuation was prepared, the actuarial accrued liability attributable to the state (after retiree contributions) was \$5.274 billion. The annual required contribution (ARC) for fiscal year 2014 was \$354 million, about 1.4% of the state's total governmental revenues, excluding federal aid.

GOVERNANCE

The state has strong governance practices including a quarterly consensus revenue forecasting process, multi-year revenue and expenditure projections, timely budget adoption, and a demonstrated willingness to address

budget shortfalls. Although frequent voter initiative activity can create budget challenges, the state legislature has broad powers to amend or suspend voter-approved initiatives.

KEY SCORECARD STATISTICS

Per capita income relative to U.S. average: 107.5%

Industrial diversity (1=most diverse): 0.66

Employment volatility (U.S.=100): 116

Available balances as % of operating revenue (5-yr. avg.): 0.04%

NTSD/total governmental revenue: 56.2%

3-year avg. adjusted net pension liability/total governmental revenue: 33.0%

OBLIGOR PROFILE

Washington is the thirteenth largest state by population, at 6.9 million. Its state gross domestic product is fourteenth largest. The population is wealthy, with per capita personal income equal to 107.5% of the US level and a poverty rate in the bottom third among states.

LEGAL SECURITY

The Series 2015C COPs are secured by and expected to be paid from payments made by participating agencies including: (1) lease payments made by a state agency, the State Board for Community and Technical Colleges, for real property projects financed with the COPS, and (2) installment purchase payments made by participating state and local agencies for the personal property financed with the COPs.

Payments made by the state agencies are subject to appropriation by the legislature and executive order reduction by the governor. The state has never failed to make needed appropriations to meet the payment obligations related to its COPs.

Payments made by the local agencies are secured by the full faith and credit of the local agencies, effectively general obligation, limited tax obligations. In the event any local agency fails to make its scheduled payment, the state treasurer is obligated to make the payment on behalf of the local agency using state funds; such payments, if necessary, are subject to appropriation by the legislature and executive order reduction by the governor. The treasurer is further obligated to withhold an amount equal to the payment advance from the local agency's share of state aid, to the extent legally permissible. No local agency has ever failed to make a payment obligation related to state-issued COPs.

USE OF PROCEEDS

Proceeds of the Series 2015C COPs will be used to: (1) pay all or a portion of the costs of acquisition and installation of statewide tax and licensing system for the state's Department of Revenue; (2) pay all or a portion of the costs of constructing a new office building at the state capital; and (3) refund outstanding COPs for debt service savings.

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in December 2011. Please see the Credit Policy page on www.moody.com for a copy of this methodology.

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