Moody's Investors Service

New Issue: MOODY'S REVISES STATE OF WASHINGTON OUTLOOK TO NEGATIVE FROM STABLE AND ASSIGNS Aa1 RATING $487.95M VARIOUS PURPOSE G.O. BONDS SERIES 2010E

Global Credit Research - 31 Dec 2009

AFFIRMS Aa1 RATING ON APPROXIMATELY $15B OUTSTANDING G.O. DEBT; OUTLOOK IS NEGATIVE

State
WA

Moody's Rating

ISSUE	RATING
Various Purpose General Obligation Bonds, Series 2010E	Aa1
Sale Amount $487,950,000	
Expected Sale Date 01/13/10	
Rating Description General Obligation	

Opinion

NEW YORK, Dec 31, 2009 -- Moody's Investors Service has assigned a rating of Aa1 to the State of Washington's $487.95 million Various Purpose General Obligation Bonds, Series 2010E. Concurrently, Moody's has revised the outlook on the state's rating to negative from stable and affirmed the outstanding Aa1 rating on approximately $15 billion outstanding general obligation bonds as well as the Aa2 rating on approximately $806 million in outstanding certificates of participation. The Aa1 rating incorporates Washington's strong management tools such as its quarterly consensus revenue forecasting process and conservative budgetary controls; lack of liquidity strain; strong demographic trends that will help propel the economic recovery once it takes hold; exposure to the cyclical aerospace industry; above average debt ratios; and frequent voter initiative activity that introduces budget challenges.

As a state with heavy dependence on sales tax receipts and no personal income tax, Washington's revenues have been hit hard by the negative impact of the recession on consumer confidence. The state closed a sizeable combined budget gap of $9 billion as it ended fiscal year 2009 and enacted its 2009-2011 biennial budget. Since then, revenues have continued to under perform and spending pressures have risen, largely due to increased demand for social services. As a result, the state faces another large budget shortfall of approximately $2.6 billion for the 2009-2011 biennium, representing about 8% of projected general fund revenues. The negative outlook reflects Washington's vulnerability to further downward revenue revisions given the uncertainty surrounding the timing and strength of the economic recovery; likely depletion of the rainy day fund and significantly lower projected ending balances by the end of the biennium; and considerable out year structural gaps due to substantial one-time solutions already incorporated in the enacted budget.

The state expects to sell the Series 2010E general obligation bonds on January 13. Proceeds will be used for statewide capital projects.

State credit strengths are:

*Institutionalized conservative budgetary controls.

*Improved financial flexibility with increased rainy day fund (RDF) levels going into the 2007-2009 recession

*Strong demographic trends

*Maintenance of sound liquidity levels despite recessionary stresses

State credit challenges are:

*Economic weakness and steeper-than-forecast housing downturn drive large consecutive downward revenue revisions.

*Significant use of one-time actions to balance current biennial budget reduces flexibility to address unexpected revenue shortfalls

*Exposure to cyclical commercial aerospace industry.

*Debt ratios above average and likely to increase.

*Voter initiative activity adds element of fiscal uncertainty.

CONSECUTIVE DOWNWARD REVENUE REVISIONS ADD BUDGET CHALLENGES

Washington's regularly scheduled quarterly revenue forecast in November revealed another revenue shortfall of $760 million for the 2009-2011 biennium. This brings the cumulative revenue under performance to a sizeable $1.68 billion since June 2009. Weaker collections accounted for about $98 million of the shortfall while $663 million was due to a revised forecast. On the spending side, higher costs are being driven largely by increased social services as caseloads grow, particularly for Medicaid. Combined, the latest forecast resulted in a new budget shortfall of approximately $2.6 billion for the 2009-2011 biennium. The amount is sizeable at about 8% of projected expenditures for the biennium, based on the governor's recently proposed supplemental budget. In addition, the gap comes only six months after the state adopted a biennial budget that closed a $7.7 billion projected imbalance. Altogether the budget shortfalls for the 2009-2011 biennium total a staggering amount that is roughly one-third of Washington's general fund biennial budget, excluding federal aid. Given the one-time actions already incorporated in the budget, including rainy day funds, fund balance transfers, and federal stimulus money, the state has reduced flexibility to address continued budget challenges.

This month, the governor presented a supplemental budget to address the shortfall. Program cuts account for approximately two-thirds ($1.6 billion) of the proposed solution, including substantial reductions to K-12 and higher education, human services, and healthcare. The remaining actions would provide one-time resources from the depletion of the rainy day fund, other fund transfers and reserves as well as a lower ending fund balance. As proposed, Washington would end the biennium with a modest General Fund balance of $311 million, about 1% of projected expenditures. As currently forecast, without further action on the revenue and/or expenditure side, the state would end the following biennium (2011-2013) with a deeply negative balance of $2.55 billion net of a slim rainy day fund balance of $284 million. The legislature will begin deliberation of the governor's supplemental budget when its 60-day session begins on January 11.

Washington still faces forecast risks that include an extended recession that puts further downward pressure on the state's primary revenue source, sales taxes, which are vulnerable to the consumer confidence factors that are resulting in the current revenue underperformance. As in other states that have incorporated the receipt of federal stimulus money in their budget plans, Washington will need to formulate plans to achieve budget balance once these resources are exhausted.

Despite the weak revenue performance, Washington's liquidity position remains sound with no need to issue short-term notes for cash flow purposes. While Washington has not yet articulated a plan to cover expenditures once the one-time federal stimulus funds have been exhausted, due to the biennial nature of its budget, it has grappled with a reduction in federal stimulus funds for fiscal 2011.

ADOPTED 2009-2011 BIENNIAL BUDGET AND FISCAL YEAR 2009 SUPPLEMENTAL BUDGET CLOSED SUBTANTIAL $9 BILLION COMBINED GAP

Last spring, Washington faced a large shortfall of $1.3 billion for the 2007-2009 biennium and an even more substantial gap of $7.7 billion in the now current 2009-2011 biennium, a gap that amounted to about one-fourth of the budget. As one of nine states without an income tax, Washington was spared the recent precipitous decline in capital gains-related revenue that many states experienced this past spring. However, sales taxes account for approximately 54% of Washington's general fund collections, and much of the recent forecast revisions reflect historically low levels of consumer confidence. The weak economy is also hurting business and occupation taxes, which represent almost one-fifth of the state's general fund revenues. In addition, projections for real estate excise taxes were also sharply reduced due to the severity of the housing market downturn in the state.

To close the combined $9 billion budget shortfall, the adopted supplemental fiscal 2009 and 2009-2011 biennial budgets relied on a combination of $3.2 billion in spending cuts, $3 billion in federal stimulus funds, $445 million from the rainy day fund (RDF), and $400 million in fund transfers and new resources. The state expects the following expenditure savings: 1) $600 million from reduced Initiative 728 allocations to school districts for class size reduction; 2) $557 million in cuts to higher education; 3) $449 million from a change in pension actuarial assumptions and calculation methods; 4) $338 million due to the suspension of Initiative 732 salary increases for K-12 teachers and staff; 5) $255 million in administrative reductions across agencies; and 6) $255 million in health care spending cuts, including reduced enrollment in the basic health plan. One-time resources such as the federal stimulus money and RDF draws represent nearly half of the Washington's budget solution.

REDUCED RESERVES PROJECTED FOLLOWING DOWNWARD REVENUE REVISIONS; CONSTITUTIONAL AMENDMENT PROVIDES FOR AUTOMATIC RAINY DAY FUND DEPOSITS

Washington's combined available reserves as of the end of the 2007-2009 biennium are now estimated at $211 million on a GAAP basis, with $21 million in the RDF and the remainder in unreserved, undesignated General Fund balance. The total amount was relatively modest, a slightly over 1% of annual general fund revenues, net of federal aid. The 2009 legislature's supplemental budget for the 2007-09 biennium used most of the balance in the RDF to help fill gaps created as revenue forecasts were repeatedly revised downward as the recession took hold. The 2009 legislature also provided an unreserved, undesignated balance that was available to cover the revenue reductions made in the June 2009 and September 2009 quarterly forecast updates.

In November 2007, Washington voters approved a constitutional amendment that permanently established a rainy day fund 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 newly created RDF that was not constitutionally protected) peaked at $754 million at the end of fiscal 2000, just before the 2001 recession, and was rapidly 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, including $303 million in the emergency reserve and $677 million in unreserved, undesignated general fund balance.

JOBS DECLINE AS ECONOMY WEAKENS

Washington's recent downward revenue revisions correspond to continuing weakness in the economy. However, there are signs that the state's underlying economy is beginning to stabilize as job losses moderate. Moody's expects Washington's economic recovery to parallel that of the nation in the near term, although there are risks centering on the state's major employers, including Boeing and Microsoft. Over the long term, the state should benefit from its educated work force and industry concentration is well-paying high technology and aerospace jobs.

Washington's unemployment rate in November was 9.2%, below the national level of 10% the same month. There have been large scale layoffs at both Boeing and for the first time at Microsoft. Of Boeing's nationwide 10,000 expected total layoffs, Washington has lost 4,500 so far and the forecast assumes another 1,400 in job cuts. Boeing's employment reductions in this recession are relatively modest compared with approximately 52,000 layoffs in 2001. The forecast for Microsoft assumes Washington job losses of about 2,400 out of a total of 5,000 company-wide. Exports from the state's important aerospace and software publishing industries are expected to contribute to the state's economic recovery although slower national and international economic improvements would affect Washington's economic outlook.

ABOVE-AVERAGE DEBT LEVELS REFLECT GROWTH-RELATED FINANCINGS

Washington's debt ratios are about twice Moody's 50-state median level; net tax-supported debt as a percentage of personal income is 5.1%, compared with Moody's 50-state median of 2.5% in 2009. 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 $2,087, Washington's net-tax supported debt per capita is more than twice the national median of $865. The state's debt ratios will likely remain high given continued sizeable borrowing plans, especially for transportation purposes.

Washington 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 for the preceding three fiscal years. This ratio is limited to 7% by statute and 9% by constitution. The state legislature recently adopted a bill to align the statutory debt limit with the constitutional limit. This creates a single transparent constraint and also provides some flexibility to support debt issuance at a time of weak revenue performance.

In recent years, Washington substantially increased its transportation infrastructure funding program, which is largely financed through the issuance of motor vehicle fuel tax general obligation bonds. As of the end of June 2009, approximately $6.9 billion in motor vehicle general obligation bonds will be authorized but unissued. 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 vehicles 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 Senate 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. While the state's gas tax receipts have been negatively affected by the recession, fiscal 2009 coverage of annual debt service on outstanding motor vehicle fuel tax general obligation bonds is expected to remain satisfactory at about 2.91 times. Almost one-third 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.

While debt ratios are above average, the state's pension funding ratio was 100% funded on a combined basis as of 2008. However, the state budgeted approximately $449 million in savings in the current biennium from a change in pension actuarial assumptions and calculation methods. Based on an August 2008 valuation released by the State Actuary, Washington's other post-employment benefits (OPEB) liability for state employees is $4 billion and $3.5 billion for K-12 employees. Both amounts are largely due to implicit rate subsidies. The annual required contribution (ARC) for fiscal year 2009 is $331.7 million and $314.5 million for K-12 employees. In Washington, retiree benefits are set as part of the biennial budget process and funded on a pay-as-you-go-basis. In 2009, the explicit subsidy cost was $107 million and the implicit cost was $50.7 million. Now that states are required to disclose actuarially compliant figures, the size of the liabilities relative to one another and their impact on states' financial statements are becoming clearer. As a result, OPEB funding status will become more visible among the many attributes Moody's assesses in the municipal credit rating process.

Washington has about $140 million in general obligation variable rate demand bonds outstanding, representing about 1% of the state's total outstanding. The bonds are remarketed weekly and are supported by a standby bond purchase agreement with Helaba. The state has no interest rate swaps.

LAST RATING ACTION AND METHODOLOGY

The last rating action was on October 14, 2009, when Moody's assigned a Aa2 rating and stable outlook to the State of Washington's Certificates of Participation Series 2009H (Quarterly) issuance.

The principal methodology used in rating the State of Washington's Various Purpose General Obligation Bonds, Series 2010E was Moody's State Rating Methodology, published in October 2004 and available on www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

Outlook

Washington's rating outlook is negative reflecting the state's vulnerability to further downward revenue revisions given its significant reliance on sales tax income in an environment of continued weak consumer confidence. Economic concentration in some industries that are historically volatile poses longer-term credit risk. However, the state demonstrated impressive financial flexibility through the 2001 recession as it accommodated resulting economic and revenue swings and has shown a willingness to curtail spending during this economic cycle.

Moody's expects that the state's finances will remain well-managed despite its recent sizeable budget shortfalls although uncertainty surrounding the timing and strength of the economic recovery could pose additional budget challenges. Given the substantial use of one-time actions to balance budget gaps thus far, Washington's reserve levels will likely remain slim over the near term. In addition, considerable out year structural gaps will likely be challenging to resolve.

What would change the rating - 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 change the rating - DOWN

*Deeper and longer recession or muted recovery that restrains consumer confidence, leading to prolonged revenue weakness and employment erosion.

*Protracted structural budget imbalance.

*Increased reliance on one-time budget solutions.

*Cash flow narrowing, leading to strained liquidity.

*Failure to adopt plan to cover expenditures once federal fiscal stimulus monies are no longer available

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