Global Credit Portal®
RatingsDirect®

July 5, 2011

Washington; Appropriations; General Obligation; Liquidity Facility

Primary Credit Analyst:
Gabriel Petek, CFA, San Francisco (1) 415-371-5042; gabriel_petek@standardandpoors.com

Secondary Contact:
Chris Morgan, San Francisco (1) 415-371-5032; chris_morgan@standardandpoors.com

Table Of Contents

Washington; Appropriations; General Obligation; Liquidity Facility

Credit Profile		
US$387.86 mil Various purp GO bnds ser 2012A due 08/01/2036		
Long Term Rating	AA+/Stable	New
US$323.615 mil motor veh fuel tax GO bnds (Competitive & Negotiated Sale) ser 2012B-1&2 due 08/01/2041		
Long Term Rating	AA+/Stable	New
US$27.875 mil GO bnds (taxable) ser 2012T due 08/01/2014		
Long Term Rating	AA+/Stable	New
Washington GO		
Long Term Rating	AA+/Stable	Affirmed
Washington adj rate GO bnds ser VR-96A&B due 06/01/2020		
Long Term Rating	AA+/A-1+/Stable	Current

Rationale

Standard & Poor's Ratings Services assigned its 'AA+' long-term rating to the state of Washington's $387.86 million series 2012A various-purpose general obligation (GO) bonds, $323.62 million series 2012B-2 Motor Vehicle Fuel Tax (MVFT) GO bonds, and $27.88 million series 2012T (taxable) GO bonds. In addition, we affirmed our 'AA+' long-term rating and underlying rating (SPUR) on the state's outstanding GO debt. The outlook is stable.

The ratings reflect our view of the state's:

- Relatively well-educated workforce and good income indicators;
- Sales tax-based revenue structure that exhibits sensitivity to economic cycles, but to a lesser degree than those of states that rely primarily on personal and corporate income taxes;
- Strong financial policies and practices, including an automatic funding mechanism for its budget reserve; and
- Moderately high per capita debt burden and well-funded pension plans.

The state's full faith, credit, and taxing powers secure both new series of bonds. The state will have a total of 17.2 billion GO bonds outstanding after the current offering. Of this, $6.3 billion of the state's GO debt is payable first from state excise taxes on motor vehicle and special fuels.

Washington's $31.7 billion two-year budget, signed by Governor Chris Gregoire on June 15, 2011, addresses what had been a projected $4.9 billion deficit by making $4.5 billion in program reductions. The balance of budget solutions comes from fund transfers and from using the state's beginning balance left from the prior biennium. Although the legislature provided funding for a $723 million reserve through fiscal 2013, the budget reserve at the biennium ending in June 2013 is now projected to be $163 million, low in our view. The change is due to the recent downward revision to the revenue forecast for the biennium ending in 2013. By agreeing to a budget package that resolves the state's anticipated deficit largely with recurring measures, the state has helped preserve its credit strength in our view.

The new budget included no tax increases but made significant cuts. Among the largest spending reductions were the suspensions of two education initiatives for class-size reduction and teacher pay increases ($1.2 billion of budgetary savings), higher education ($535 million), pension benefit ($344 million), K-4 class size enhancement ($215 million), K-12 employee salaries ($179 million), and state employee pay ($177 million).

In November 2010, the Washington electorate rejected a state income tax on high-income earners, repealed a previously enacted tax on snack foods, and raised the threshold to two-thirds from a simple majority of the legislature to increase future taxes.

Washington's economy is tracking the nation's gradual emergence from the recession, which technically ended in June 2009. The state's revenue forecast is premised on national GDP growth in 2011 of 2.7%, which is consistent with our expectation. Job growth, according to the forecast, is also projected to mirror the nation at 0.9%. Personal income growth is expected to outpace job growth because the sectors with some of the higher rates of growth -- aerospace and software -- are among the state's faster growing industries.

Washington's financial liquidity remains adequate and shows improvement despite its negative $1.51 billion general fund cash balance as of April 2011. At the same point in 2010, general fund cash was negative by $2.0 billion. The state has access to cash for liquidity in its treasury and treasury trust funds, the former of which is subject to legislative appropriation. This cash is held in the custody of and invested on a comingled basis by the state treasurer. As of the end of April 2011, the treasury and treasurer's trust fund's cash balance was $2.68 billion, which is below the $3.28 billion balance at the same time in 2010. Investments are conservative in our view, with almost 50% of funds invested with U.S. Treasury and agencies. Repurchase agreements, which are subject to a maximum term of 180 days, represent 36.1% of investments. In addition to the state's investment guidelines, state policies require that collateral in repurchase agreements for U.S. Treasury, agency, and money markets be priced at 102% of market value. Mortgage-backed repurchase agreements of over seven days are subject to a higher, 105% requirement.

The state's direct tax-supported debt burden (GO and appropriation-backed) is moderately high, in our opinion, at $2,707 per capita, 6.2% of general fund expenditures, 6.2% of total personal income, and 5.3% of gross state product. Gross GO and lease appropriation-backed debt service is also moderately high, at 5.27% of general government-wide (all funds) spending in fiscal 2010. Portions of the state's debt are funded from self-supporting or reimbursable sources. When adjusting for these offsetting revenues, debt service is moderate in our view, at 5.3% of general fund expenditures. We expect that continuing transportation needs, including two major urban highway projects, will likely translate into continuing GO issuance in the next two to three years. The state currently projects that it may issue $450 million in transportation and $1.25 billion in new GO bonds between now and the spring of 2012.

Unlike a majority of states (approximately 30) in the U.S., Washington maintains a positive balance in its unemployment insurance fund of $2.2 billion, sufficient to fund benefits for an estimated 12.2 months.

Based on the analytic factors we evaluate for states, on a scale of 1 (strongest) to 4, we have assigned Washington a composite score of '1.8'.

Outlook

The stable outlook reflects our view that the state's financial management is strong, as demonstrated by its continued willingness to make timely and proactive budget amendments as it deems necessary to maintain budgetary balance. The state's automatic budget stabilization fund deposits serve its credit well when the economy -- and revenues -- take a negative turn. Pending voter approval, the budget stabilization funding mechanism could become stronger, which would likely benefit the state's credit quality. At present, the state's reserves are low despite its practice of making regular reserve contributions -- a reflection of the severity and duration of the recent recession. The low reserves limit the state's rating from moving upward and, in fact, render its rating vulnerable to downward movement if revenues deteriorate further without very timely corrective budget action.

Governmental Framework

Managing toward ongoing fiscal solvency is encouraged by the state's statutory requirement to adopt a balanced budget as well as the state's discretion, subject to a majority vote of the legislature, to adjust the major components of its revenue base. Legal protections for the state's GO debt include a specific constitutional requirement that the legislature make appropriations in the budget for the interest and principal installment payments on its debt. Although the state does not offer debt a specific status, no other payment obligation enjoys a specific requirement that an appropriation be made. This has the practical effect of providing debt service with a strong legal position among the state's various payment obligations, in our view.

The governor has authority to make across-the-board reductions to spending allotments when a cash deficit in a particular fund is projected. However, authority to impose disbursement reductions does not include allotments for basic education, pension benefits, or general obligation debt service. The state's office of financial management monitors and makes recommendations about cash management activities to the governor.

An active voter initiative environment complicates the state's governmental framework. We have viewed the active voter initiative environment as limiting the state's fiscal flexibility somewhat. However, the legislature's willingness and ability to set aside provisions of voter-approved initiatives when fiscal conditions warrant has proven beneficial to credit quality, in our view. (Initiatives may be amended with a two-thirds vote of the legislature within two years of passage and a simple majority of the legislature thereafter.) For instance, as they did during the fiscal 2010 and 2011 biennium and during six of the past 12 years, the legislature temporarily suspended Initiatives 732 and 728 (for teacher cost of living salary increases and smaller class sizes, respectively) helping reduce the projected deficit for the upcoming biennium by $1.2 billion.

Similar to many other states, significant spending areas in the state's budget are largely nondiscretionary. The state approximates that as much as 60% of spending, primarily for K-12 education, Medicaid, foster care, debt service, and pensions, is effectively legally required by some combination of state constitution, statute, court decision, or federal mandate. In addition, Washington voters have, over the years, approved initiatives that have reduced the revenue and spending autonomy of the state. In the current budget cycle, a voter initiative added $281 million to the state deficit (through fiscal 2013) by repealing certain temporary taxes the legislature had adopted as a component of balancing the state budget. Other initiatives (I-732 and I-728, for example) mandate spending for certain purposes, such as education.

A potential constitutional amendment which, if approved by voters in November 2011, would add rigor to the state's legal requirement to add funding to its budget reserve by placing "extraordinary" revenue growth in the reserve (defined as revenue growth that exceeds by one-third the average rate of growth during the past five biennia). During the 2011 legislative session, the legislature also added a debt commission to the state's recently approved first-time debt affordability study. The debt commission will evaluate the state's use of debt and make policy or constitutional change recommendations. Moreover, the reforms direct the state finance committee to develop a plan to gradually reduce the state's debt burden relative to its operating budget. Without altering the state's 9% of budget constitutional limit, the new law envisions implementing incrementally lower working debt limits to reach a target of 7.75% by 2021. Given that Washington's debt levels are somewhat higher than other states, we believe steps to contain the growth of its debt burden could have favorable implications for the state's credit quality.

On a scale ranging from 1 (strongest) to 4, we have assigned a score of '1.8' to Washington's governmental framework.

Financial Management

Financial Management Assessment: 'Strong'

We consider the state's management practices "strong" under our Financial Management Assessment (FMA) methodology. An FMA of "strong" indicates our view that practices are strong, well embedded, and likely sustainable. The state Economic and Revenue Forecast Council, which is made up of representatives appointed by the governor's office, both houses of the legislature, and both major political parties, produces an analytical report on economic and revenue performance each month and by statute presents quarterly revenue forecasts covering the current and upcoming biennium. The state uses the council's forecasts, which are based on a modified IHI Global Insight model of the U.S. economy, to set revenue parameters at biennial budget adoption. The state has a record of making budget adjustments within the biennium when the forecast council materially changes its projections. In addition, the state convenes a Caseload Forecast Council three times per year, which forecasts service requirements in such areas as public assistance, state corrections, medical assistance, and K-12 education. The executive branch uses these forecasts, along with historical expenditures, to formulate budget proposals and mid-biennium revisions.

Further guiding budgeting decisions is a rolling, four-year general fund forecast maintained by the governor's Office of Financial Management. The state uses these forecasts to quantify the timing and scope of potential deficits in the subsequent biennium and in some cases to begin to address structural imbalances before the next budget cycle begins. Although the state does not have a minimum reserve policy, the state constitution requires the state to set aside 1% of most unrestricted state revenues in each fiscal year into a budget stabilization fund, a form of "rainy-day" fund. That fund can and is being tapped in the current biennium under a provision that the state can draw on the fund when employment growth falls below 1% and is also available in the event of a catastrophic emergency, or by 60% supermajority vote of the legislature. When it reaches 10% of estimated general state revenues in that fiscal year, the state can also draw excess funds for education capital projects.

Other policies and practices include:

- Capital spending that the state budgets for on a biennial schedule but plans on a rolling, 10-year basis, including funding sources;
- A formal investment management policy that covers eligible investments, maximum maturities (10 years),

allocations of nongovernment securities, and internal and external controls; and

- Debt management under an issuance policy that, among other elements, addresses refunding savings thresholds.

Budget management framework

Washington adheres to what we consider generally strong budget management practices. Across different gubernatorial administrations, when confronted with projected budget gaps, the state's political leadership has demonstrated a willingness to consider difficult fiscal adjustments, including both expenditure and revenue measures. In addition, when deficits emerge mid-cycle, the state has generally responded with timely corrective actions. Revenue projections are apolitical and developed according to the state's independent revenue forecasts. When deficits do emerge, however, the state tends to include nonrecurring measures among its solutions and its updates to actual fiscal performance, considering both revenue and spending trends are not regularly available at intra-year intervals.

On a scale ranging from 1 (strongest) to 4, we have assigned a score of '1.5' to Washington's financial management.

Economy

Washington's economy enjoys several fundamental strengths, including an above-average education level among its populace (30% of whom have bachelor's degree or higher). Other positive features of the state's economy are its consistently strong population growth trends (more than 4% higher than the U.S.), relatively low age-dependency ratio (55.4), high per capita gross state product (GSP; 110% of the nation), and high per capita incomes (111% of the U.S.). Economic development prospects remain good in our view. In addition to the aforementioned health of Boeing, the state is also home to a vibrant high-technology sector, particularly in and around the Seattle metropolitan area. In addition to Microsoft, the state's second-largest private sector employer, there are approximately 4,200 software companies in the state. Microsoft reported record profits in the third quarter of 2010 and, after the software sector saw its first annual decline of jobs (2,400) in 2009, during 2010 the sector grew by more than 1,200 jobs. The outlook for economic growth is currently favorable due to strong rates of expansion in China and other Asian economies to which Washington exports. Washington's economy is trade-intensive and frequently at the top of per capita measures of export value in the U.S. Although during the past five years the state's annual rates of GSP growth have exceeded those of the nation's, in five of the past 12 years, national GDP grew at a faster clip, indicating some propensity for economic volatility.

High-paying jobs with both of the state's largest employers, Microsoft and Boeing, support the state's forecast's for a personal income growth rate in excess of that of the U.S. through the forecast's timeframe of 2015despite a similar overall rate of job growth. Construction employment is still down and somewhat limits the state's recovery although the trend in building permits has stabilized. The state forecasts that construction employment won't reach bottom, however, until the fourth quarter of 2011. The extent of the drop-off in the sector is evidenced by the forecast, which indicates that even through 2015, total construction jobs are expected to remain approximately 45,000 below their peak in 2007.

State-projected 4.8% and 4.9% rates of nominal personal income growth in 2012 and 2013, respectively, compare to the state's 9.2% projected general fund revenue growth over the same period. The divergence in the growth rates indicates relatively stronger economic activity among the higher value sectors in the state.

Recent data from the S&P/Case-Shiller Home Price Index place the Seattle metropolitan area among the bottom quartile of performers, with a negative 6.9% year-over-year change in home prices through April 2011. We believe ongoing softness in the real estate and construction sectors may largely offset the state's strong export performance. State revenues, which depend on consumer activity via its retail sales tax (47% of total tax revenues), could be restrained by residents more focused on repairing their personal balance sheets and increasing savings than on returning to pre-recession levels of spending. A backlog of aircraft orders from Boeing represents seven years' worth of orders. Boeing's less severe experience through the recent recession (5,000 layoffs) pales compared to the 2001 recession (50,000 layoffs), suggesting that jobs are likely to be restored at a more tempered pace.

On a scale ranging from 1 (strongest) to 4, we have assigned a score of '1.4' to Washington's economy.

Budget Performance

The state has a strong track record of maintaining good reserves, but the recession's toll fully materialized in the state's budget reserve by fiscal 2010. At June 30, 2010, the state's ending unreserved fund balance eroded to $303 million, equal to a low 1.3% of expenditures (GAAP basis). The state's unrestricted balance ended the year in a negative position ($561 million), reflecting the depleted liquidity in the general fund. The total fund balance at the end of fiscal 2010 was only modestly higher, at $379 million, or 1.6% of expenditures. The state's balance sheet is weaker in fiscal 2011 as its economy works through the apparent gradual end of the recent recession. For much of the decade, the state's unreserved fund balance was in the range of 8% to 10% of annual expenditures. During expansionary phases of the economic cycle, the state consistently generates operating surpluses and good reserve positions. The state has authority to defer certain payments, to borrow from the treasury and treasurer trust funds, and, if needed, to issue cash flow notes. All serve as contingency liquidity measures, but they have not been necessary thus far through the recent cycle. The state's absence of a formal policy for its budget reserve level allows for low balances to persist through protracted periods of economic and revenue softness.

The state's reliance on retail sales and business and occupation (gross receipts) taxes for a combined 68% of general fund tax revenues typically afford more revenue stability than that of other states, many of which rely on personal income tax revenues. Spending priorities are regularly evaluated through the state's "priorities of government" approach to zero-based budgeting. Independent and formal revenue and caseload forecasts inform budget decisions, and political leaders have demonstrated a willingness to make difficult adjustments when necessary.

In addition to measures described above, to balance the fiscal 2012 and 2013 biennial budget, other spending reductions include a 3% salary reduction for state employees ($177 million of savings) and cuts to higher education funding to be offset by tuition increases ($535 million in savings). As mentioned above, the K-12 area, certificated staff are slated to receive 1.9% salary reductions while administrative staff will face 3% salary reductions, for a combined $179 million in general fund savings The amount of savings from teacher salary reductions may be subject to negotiation at the district level. Some labor contracts include provisions for districts to reduce salaries if state funding is lowered. For those that do not include such provisions, cutbacks in other areas or reopening of established labor contracts may be the end result.

On a scale ranging from 1 (strongest) to 4, we have assigned a score of '1.9' to Washington's budget performance.

Debt And Liability Profile

As noted, Washington's debt is moderately high by several of our measures. Debt paydown is average, in our view, with 44% of outstanding principal amortized over 10 years.

Pension reform will likely reduce unfunded actuarial liabilities

Other long-term state liabilities include pension and retiree health care. As of June 30, 2009, the actuarial accrued liability (AAL) of the defined-benefit portion of the state's 13 pension plans totaled $61.8 billion, of which actuarial assets ($57 billion) in aggregate accounted for 92%. However, the funded ratio is likely to improve after the recent changes to the plan 1 (PERS and TRS) are actuarially accounted for. During its 2011 session, the legislature rescinded automatic cost of living adjustments (COLA) to the public employees' retirement system plan 1 and the teachers' retirement system plan 1. Elimination of the uniform cola (UCOLA) generates $344 million in general fund savings for the fiscal 2012 and 2013 biennium. More importantly, in our view, over the longer run, elimination of the UCOLA reduces the plan 1 unfunded actuarial accrued liabilities (UAAL) to$3.18 billion from $6.88 billion, or 54% of the prior plan 1 UAAL, according to estimates from the state actuary. This could represent a significant improvement in the state's overall pension funded status since, as we reported in our recent survey, Washington's total combined UAAL across all plans, as of its 2010 comprehensive annual financial report, which was as of 2009, was $4.83 billion. (See "U.S. States' Pension Funded Ratios Drift Downward", published March 31, 2011 on RatingsDirect on the Global Credit Portal.)

The state's total UAAL for its pension plans is $4.94 billion, equal to $719 per capita, which we view as moderate. However, relative to total personal income, it is just 1.6%, which is low in our view. Contributions to pension funding are generally less than the actuarial required contribution (ARC), and for fiscal 2010, total actual contributions were 52.5% of the ARC.

OPEB is funded on a pay-as-you-go basis

The state's OPEB includes an implicit liability from allowing retired employees to purchase health, life, and vision insurance in the same pool as current employees at a subsidized rate. The explicit benefit subsidizes retired members' monthly premiums for enrollment in Medicare parts A and B. On an actuarial basis, the state's portion of the AAL made up $3.8 billion of the total, and the annual OPEB cost was $354 million according to the most actuarial valuation report from January 2009.In fiscal 2010, the state contributed $70.1 million for current pay-as-you-go expenses of the retiree benefits, equal to less than 1% of annual general fund expenditures. We understand that the state does not plan to fully fund the annual required contribution for the foreseeable future.

Fixed-charge (pension, OPEB, and debt service) analysis

Actual contributions to the pension plans (fiscal 2010), at $984 million, are equal to 3.5% of tax-supported (general, debt service, and motor vehicle) funds. Considering the portion of pension contributions paid from the general fund, pension contributions (at $378 million) are equal to 1.6% of expenditures. On a combined basis, gross debt service and pension contributions costs equal 8.11% of general fund expenditures (7.21% when considering self-support and reimbursable debt service funding sources). Full pension ARC and gross debt service would equal 8.77% of the tax-supported fund expenditures. If the state funded the ARC for OPEB and pensions, when combined with debt service, these costs would represent 10.03% of tax-supported fund expenditures (9.27% when considering self-support and reimbursable debt service funding sources).

On a scale ranging from 1 (strongest) to 4, we have assigned a score of '2.3' to Washington's debt and liability profile.

Related Criteria And Research

- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- USPF Criteria: Appropriation-Backed Obligations, June 13, 2007

Ratings Detail (As Of July 5, 2011)		
Washington certs of part (Washington St Dept of Gen Admin Tacoma Co-Location Proj) dtd 12/01/1996		
Long Term Rating	AA/Stable	Affirmed
Washington mtr veh fuel tax go bnds ser 2004C dtd 08/06/2003 due 06/01/2009-2030		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed
Washington GO		
Long Term Rating	AA+/Stable	Affirmed
Washington GO bnds		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed
Washington GO Mtr Veh Fuel Tx		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed
Washington GO (wrap of insured) (AMBAC) (ASSURED GTY - SEC MKT)		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed
Washington GO (wrap of insured) (FGIC & AGM) (SEC MKT)		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed
Washington GO (Motor Vehicle Fuel Tax)		
Long Term Rating	AA+/Stable	Affirmed
Washington (St Office Bldg Proj - Dept of Ecology) ser 91 A 99		
Long Term Rating	AA/Stable	Affirmed
Washington certs of part rfdg (Dept of Ecology St Office Bldg Proj) ser RE-2003-B		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Washington GO		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed
Aberdeen, Washington		
Washington		
Aberdeen (Washington) spl rfdg rev bnds (Stafford Creek Corrections Ctr) ser 2009		
Long Term Rating	AA/Stable	Affirmed
FYI Properties, Washington		
Washington		
FYI Properties (Washington) Lease rev bnds (State Of Washington Dis Proj) ser 2009		
Long Term Rating	AA/Stable	Affirmed

Many issues are enhanced by bond insurance.