FitchRatings

Fitch Rates State of Washington's $863.6MM GO Bonds 'AA+'; Outlook Stable

Fitch Ratings-San Francisco-28 August 2019: Fitch Ratings has assigned a 'AA+' rating to the following state of Washington general obligation (GO) bonds:

--$457,435,000 various purpose GO bonds, series 2020A;
--$222,925,000 motor vehicle fuel tax (MVFT) and vehicle related fees GO bonds, series 2020B;
--$38,435,000 GO bonds, series 2020T;
--$91,785,000 various purpose refunding GO bonds, series R-2020A; and
--$53,065,000 MVFT refunding GO bonds, series R-2020B.

In addition, Fitch has affirmed the state's 'AA+' Issuer Default Rating (IDR), the 'AA+' rating on the state's approximately $19 billion in outstanding GO bonds and the 'AA+' Washington School District Credit Enhancement Program.

The Rating Outlook is Stable.

The series 2020A, 2020B and 2020T GO bonds are expected to be sold via negotiation on Sept. 10, 2019. The series R-2020A and R-2020B are expected to be sold through competitive bid on Sept. 26, 2019. The series 2020A, 2020B and 2020T bond proceeds will fund new capital and transportation projects and reimburse the state for related advances of funds, including for projects identified as "Connecting Washington Projects" as authorized by the legislature in the 2019-2021 biennial transportation budget. Proceeds of the series R-2020A and R-2020B bonds will be used to refund various outstanding GO bonds.

SECURITY
The GO bonds and bonds supported by the Washington School Bond Guarantee Program are GOs of the state to which its full faith, credit, and taxing power are pledged. MVFT and vehicle related fee GO bonds are first payable from state excise taxes on motor vehicle and special fuels and other fees.

The Washington School District Credit Enhancement Program provides credit enhancement to school districts. The full faith, credit and taxing power of the state is pledged to guarantee full and timely payment of principal and interest on the debt of participating school districts. In the event a participating school district fails to remit the full amount of its debt service payment, the state treasurer is required to transfer sufficient money to the paying agent for such payment.

ANALYTICAL CONCLUSION

Washington's 'AA+' GO rating and IDR reflect the state's solid economy and revenue growth prospects, a demonstrated commitment to fiscal balance, and combined long-term liabilities that place a low burden on resources despite an above-average debt load for a U.S. state. Fitch believes that strong budget control will allow the state to continue to address challenges while maintaining fundamental financial flexibility even at times of economic and revenue decline.

Economic Resource Base
Washington's economy is characterized by generally sound performance and increased employment diversification. The state's economy is growing at a faster rate than the U.S., and the state is well positioned for above-average results going forward. The economy is still heavily influenced by Boeing and Microsoft, while Amazon and other technology companies continue to expand. The workforce is highly educated, income levels are comparatively high, and the state poverty rate is below the national average.

The state's industrial and agricultural bases have strong trading relationships with the Pacific Rim; however, recent economic data indicate a sharp 42% second quarter YoY decline in transportation equipment exports, which is largely due to Boeing suspending deliveries of the 737 Max in March. Agricultural exports were also down about 22% in the second quarter, reflecting global trade tensions, resulting in a 27.6% decline in total exports. According to management, the state's September revenue forecast will incorporate a further drop in Boeing deliveries with a return to normal production/delivery schedule in January 2020.

KEY RATING DRIVERS

Revenue Framework: 'aaa'
Washington relies on broad consumption-based revenues to fund operations and does not levy an income tax. This revenue mix results in collections that quickly reflect consumer spending and construction trends. Revenue performance over time has generally tracked economic performance, and Fitch expects this to continue to support solid growth prospects. The state has complete independent control over taxation, with an essentially unlimited legal ability to raise operating revenues as needed.

Expenditure Framework: 'aa'
Washington benefits from solid expenditure flexibility, although its flexibility is somewhat more restricted than is true for most states due to court mandates on education funding. The state has a low burden of carrying costs for debt service and retiree benefits and generally broad expense-cutting authority common to most U.S. states. In addition to education, Medicaid is a key cost driver, but Fitch expects these costs to remain manageable.

Long-Term Liability Burden: 'aaa'
The combined burden of debt plus pensions is low as a percentage of personal income, although above the median for U.S. states. Elevated debt ratios incorporate the funding of substantial capital needs, particularly for transportation, but are offset by a moderate net pension liability.

Operating Performance: 'aa'
Washington has responsive financial management and very strong gap-closing capacity. In a moderate economic downturn, Fitch expects the state would act in line with historical practice, drawing down reserves and managing revenues and spending to maintain balance and overall financial flexibility. As conditions improve, the state replenishes its cushion against future underperformance. The initiative and referendum environment creates some uncertainty, but this is limited by the legislature's authority to amend or repeal any law approved by voters in this manner.

RATING SENSITIVITIES
SOLID FINANCIAL & LIABILITY MANAGEMENT: The rating is sensitive to shifts in Washington's fundamental credit characteristics, including its low liability burden and debt affordability. The rating assumes that the state will continue to address budgetary challenges, including recent increases in K-12 education funding requirements, in a sustainable manner.

CREDIT PROFILE

Washington's economy, historically reliant on manufacturing supplemented by regional and international trade and tourism, has broadened. Areas of concentration, including Boeing, Microsoft, and Amazon, offer relatively high-wage employment, and the population is well educated. In addition, population growth has far exceeded that of the U.S. as a whole for many years, a trend that seems likely to continue. The state's recovery from the Great Recession has been significantly more robust than the U.S. as a whole and amongst the strongest of the states. The state's unemployment rate is slightly above the U.S., while the labor force growth rate has been well above the national pace.

In addition to a drop in exports due to the issues with the Boeing 737 Max, other data indicate some softening in the state's rapid economic expansion. Namely, the median Seattle home price was down 4.3% in July 2019 according to Zillow compared to a year prior. However, state revenue collections through early August remain strong, and other economic indicators such as unemployment, job growth and personal income point to continued expansion.

Revenue Framework

Washington's revenue structure is based on a retail sales tax (about half of total general fund - state revenues) and, to a much lesser extent, a business and occupation gross receipts tax (about 19%) and state property tax (10%-12%). The importance of the real estate excise tax (5% of tax revenues in fiscal 2018) varies considerably depending on the point in the economic cycle. The state does not have an income tax.

This revenue structure makes the state budget sensitive to trends in consumer spending. In addition, construction (labor and materials) is assessed under the broad sales tax and receipts are significant to sales tax revenue performance. Fitch expects revenues to continue to reflect cyclical trends and the state's ongoing population growth.

Like most states, Washington has complete independent legal ability to control taxes, a significant credit strength. A 2013 state Supreme Court decision found a prior 2/3 legislative vote requirement for state tax increases to be unconstitutional, making it easier to raise revenues. A November 2015 initiative that attempted to re-establish the restriction by other means also was found to be unconstitutional.

Expenditure Framework

As in most states, education and health and human services are Washington's largest operating expenses. Education is the larger line item, with state funding for local school districts and the public university and college system accounting for more than half of state general fund expenditures. Human services programs represent another third.

Washington's spending growth, absent policy actions, will likely be marginally above revenue growth, requiring regular budget management to ensure ongoing balance. The fiscal challenge of Medicaid is common to all U.S. states and the nature of the program as well as federal government rules limit the states' options in managing the pace of spending growth. Federal action to revise Medicaid's programmatic and financial structure appears less likely in the near term given divided control in Congress.

Washington retains solid expenditure flexibility. While Medicaid costs are somewhat beyond the state's ability to materially change given federal requirements for the program, the state's carrying costs for liabilities are low. Like most states, Washington's operating budget (outside of Medicaid) goes largely toward funding of services rather than direct service delivery, allowing the state to shift costs to lower levels of government in times of fiscal stress. This is true even for education spending, as the state appropriates money to local school districts rather than operating any schools itself; however, given the recently resolved litigation related to school funding, Fitch considers the state's ability to reduce spending in this area to be more limited than is true in some other states.

Long-Term Liability Burden

On a combined basis, Washington's burden of direct debt and adjusted net pension liabilities, at 7.3%, is above the 6.0% median for U.S. states (both per Fitch's 2018 state pension report). Debt levels are more than twice the U.S. state median, while pension liabilities are below the median. The combined liabilities place a low burden on the state's resource base, and Fitch expects this to remain so even given the state's large capital projects.

Washington's debt alone equals about two-thirds of Fitch-adjusted long-term liabilities and is primarily GO bonds. Capital needs are substantial, particularly for transportation, and future borrowing is anticipated. The state has repeatedly demonstrated its ability and willingness to raise revenues in support of transportation capital investment, most recently through a new electrification fee for electric vehicles and an increase to the service fee for vehicle title transaction and registration. Tolling has also been utilized as part of the funding solution.

The state complies with constitutional debt affordability limits, which prohibits issuance of new debt when annual debt service as a percent of the six-year average of revenues reaches a certain threshold.

The state administers 14 defined benefit retirement plans, three of which have hybrid defined benefit/defined contribution components; most are multi-employer, with the state participating as either an employer or a non-employer contributing entity in all but one of the plans. Based on the state's fiscal 2018 financial statements, aggregate fiduciary pension assets covered over 90% of total pension liabilities on a reported basis, based on a 7.5% investment return assumption for most of the plans. This ratio would fall to an estimated 76% based on Fitch's standard 6% investment return assumption. Two plans for general government employees (PERS1, closed in 1977, and PERS2/3), account for the bulk of the state's direct net pension liability. The state has effectively made changes to manage pension costs, and a Supreme Court decision in 2014 upheld the elimination of cost of living adjustments that had been subject to longstanding legal challenge. The state has deferred full contributions to the closed pension systems in times of economic strain.

Non-contractual other post-employment benefits (OPEB) are limited and funded on a pay-as-you-go basis. Contingent liabilities include a school district credit enhancement program that provides a GO guarantee to $14.8 billion in outstanding school district debt as of Sept. 1, 2019. The enhancement has never been called upon.

Operating Performance

Frequent reviews of economic and financial forecasts allow the state to respond effectively to changing conditions. As the economy and revenues repeatedly and significantly underperformed estimates in the Great Recession, the state demonstrated its willingness and ability to take actions in response. The state implemented a combination of ongoing and one-time actions, and fully depleted accumulated reserves. Fitch expects the state to similarly make use of its very strong gap-closing capacity, supported by its solid, reinstated reserve position, during future cyclical downturns.

Budgeting has remained challenging and sometimes contentious even in the current recovery, in part due to the McCleary education lawsuit-related K-12 demands and a statutory mandate that the budget show projected balance over a four-year period rather than just the current biennium. However, the state has taken advantage of this time of growth to rebuild financial flexibility.

As the economy and revenues have recovered solidly, Washington has replenished reserves and strengthened reserve funding mechanisms. The state ended the fiscal 2015-2017 biennium on June 30, 2017 with reserves of $2.8 billion (including the general fund ending balance and the budget stabilization account), equal to 14% of general fund - state revenues in fiscal 2017 alone.

The state has solid funding provisions for its budget stabilization account (BSA.) The constitutional account was approved by voters in 2007. The BSA receives the first 1% of revenues collected every year, until it reaches its cap of 10% of annual general revenues. In 2011, voters approved another constitutional amendment that requires any extraordinary growth in state revenue (defined as growth in general state revenues that exceed by one-third the average biennial growth of the prior five biennia) be transferred to the BSA on top of the 1%. This measure also serves to limit the impact of revenue volatility on the operating budget.

Washington's initiative and referendum environment creates a level of operating and financial uncertainty. However, it is significant that any law approved by voters in this manner can be amended or repealed by the legislature by a two-thirds vote in the first two years after approval and by a simple majority thereafter. The legislature repeatedly has shown the ability and willingness to suspend initiatives. The state constitution may not be amended by initiative or referendum. The November 2019 ballot will include initiative 976, which would lower motor vehicle and light duty truck weight fees to $30, resulting in a loss of an estimated $477 million in state revenues for the 2019-2021 biennium ($1.9 billion over six years) and an estimated $2.3 billion in local revenues over the next six years. If passed, the legislature would need to determine if it would backfill lost revenue or vote to repeal the law.

Current Developments

The state's most recent estimate for the 2017-2019 biennium includes an increase in reserves to $3.5 billion at fiscal 2019 YE, equal to 16% of projected general fund - state revenues in fiscal 2019. This estimate improves upon the $2.4 billion reserve balance assumed in the enacted biennium budget, largely due to strong revenue performance. The 2019-2021 biennial budget estimates total reserves at the end of fiscal 2021 of $2.7 billion, of which $2.2 billion is in the BSA.

Washington's enacted $52.4 billion 2019-2021 biennial budget includes almost $1.0 billion in new or higher taxes, including a tax increase on professional services and high tech businesses that will fund a new account for expanding programs and financial aid for higher education. Other tax increases include a graduated real estate excise tax on the selling price above $1.5 million and increased taxes on large banks.

Following last year's resolution of McClearly v. Washington, the contentious multi-year Supreme Court funding mandate, the near general fund - state revenue budget increases K-12 funding by about $4.6 billion (20%) over the last biennium largely by prioritizing K-12 education funding growth over growth in other departments. In conjunction with the budget, the legislature also adopted a bill to allow the largest school districts to raise more from local property tax levies. The state also adopted a $4.9 billion capital construction budget and $10.0 billion transportation budget.

Revenue performance through early August 2019 continues to be strong and the state's baseline revenue forecast has been raised at every review since the start of the last biennium, supported by growth in all major tax revenues. The recent sharp decline in exports will be factored into the September revenue forecast.

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Additional information is available on www.fitchratings.com
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U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018)

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