FitchRatings

Fitch Rates State of Washington's $499MM GO Bonds 'AA+'; Outlook Stable

Fitch Ratings-San Francisco-27 November 2017: Fitch Ratings has assigned a 'AA+' rating to the following state of Washington general obligation (GO) bonds:

--Approximately $499,090,000 various purpose GO refunding bonds, series R-2018D.

The bonds are expected to be sold through competitive bid on Nov. 30, 2017 and will refund outstanding debt for interest savings.

The Rating Outlook is Stable.

SECURITY

The bonds are GOs of the state to which its full faith, credit, and taxing power are pledged.

ANALYTICAL CONCLUSION

Washington's 'AA+' GO rating and Issuer Default Rating (IDR) reflect the state's solid economy with strong 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. 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 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.

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 consumer spending and construction trends that are quickly reflected in revenue results. 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 with a low burden of carrying costs for debt service and retiree benefits and the broad expense-cutting authority common to most U.S. states. Education is a key cost driver, as is Medicaid, 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 a low liability burden supported by an increased focus on debt affordability. The rating assumes that the state will continue to address budgetary challenges, such as recent increases in K-12 education funding requirements, in a sustainable manner.

CREDIT PROFILE

Washington state's economy, historically reliant on manufacturing supplemented by regional and international trade and tourism, has broadened. Areas of concentration, including Boeing and Microsoft, 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, a trend that seems likely to continue.

Washington entered the great recession later than the U.S. overall following a period when it performed much more strongly than the nation. Peak-to-trough, the state's recessionary decline in non-farm employment matched that of the nation. The recovery has been significantly more robust, and amongst the strongest of the states. The state's unemployment rate exceeds that of the U.S., incorporating labor force growth that is well ahead of the national pace.

Revenue Framework

Washington's revenue structure is based on a retail sales tax (about half of state general fund revenues) and to a much lesser extent, a business and occupation gross receipts tax (about 20%) and state property tax (10%-15%). The importance of the real estate excise tax (a projected 4% of revenues in the current biennium) 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 tax increases to be unconstitutional, making it easier to raise revenues. A November 2015 initiative that attempted to reestablish the restriction by other means also was found to be unconstitutional.

The state recently addressed a court-imposed funding challenge for K-12 schools with a significant increase in property tax rates and other tax adjustments that is anticipated to generate $1.8 billion in new school funding during the 2017-2019 biennium. The McCleary state Supreme Court decision of 2012 found Washington's education funding to be inadequate and that efforts to comply with the court's decision, including funding increases adopted in the 2015-2017 biennium, had complicated the state's budget process for the past several years. The recently approved tax increase provides a path to resolving this challenge.

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 about 56% of state general fund expenditures. Human services programs represent another 33%.

Washington's spending growth, absent policy actions, will likely be marginally above revenue growth, requiring regular budget management to ensure ongoing balance. The ongoing fiscal challenge of Medicaid is common to all U.S. states. Federal action to revise Medicaid's programmatic and financial structure remains a possibility given recent federal legislative and administrative efforts. Most proposals to date include a basic restructuring of federal Medicaid funding to a capped amount. Whether a change in federal Medicaid funding has consequences for Fitch's assessment of a state's credit quality would depend on the state's fiscal response to those changes. Responses that create long-term structural deficits or increase liability burdens could negatively affect both the expenditure framework assessment and the state's 'AA+' IDR.

Washington retains ample 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.

Long-Term Liability Burden

On a combined basis, Washington's burden of net tax-supported debt and adjusted unfunded pension obligations, at 8%, is above the 5.1% median for U.S. states (per Fitch's 2016 state pension update). Debt levels are more than twice the U.S. state median while pension liabilities are below average. 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 80% of reported total long-term liabilities and is primarily GO. Capital needs are substantial, particularly for transportation. The state has repeatedly demonstrated its ability and willingness to raise revenues in support of transportation capital investment, most recently through a gas tax increase in the 2015 session. Tolling is also part of the funding solution.

Positively, the state has increased its focus on debt affordability in recent years. In November 2012, voters approved a constitutional amendment that tightened the constitutional debt limit, which limits annual debt service as a percent of revenues.

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 2016 financial statements, aggregate fiduciary pension assets covered 91.5% 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 71.8% based on Fitch's more conservative 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.

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 $11.6 billion in outstanding school district debt as of Sept. 1, 2017. 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 last 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 during future cyclical downturns.

Budgeting has remained challenging and sometimes contentious even in the current recovery, in part due to McCleary-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 $2.36 billion (including the general fund ending balance and the budget stabilization account), equal to 12.2% of tax revenues, and 7.5% of total general fund and related fund spending (including federal funds), in fiscal 2017 alone. The enacted budget for the current 2017-2019 biennium projected a modest net decline in total reserves by the end of fiscal 2019 to a still sizable $2.1 billion, but actual results have typically been much stronger than budgeted at times of economic growth.

The state has solid funding provisions for its budget stabilization account (BSA). The constitutional account was approved by voters in 2007. The BSA receives 1% of revenues off the top every year, capped at 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 revenue volatility.

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.

Current Developments
The state budget for the 2017-2019 biennium incorporates approximately $2.07 billion in new revenue, including $1.6 billion from increased property taxes and $456 million in other tax increases. Major spending increases include $1.8 billion in increased funding for K-12 public schools to address the McCleary decision, as well as $618 million in collective bargaining and related compensation costs. Revenue performance continues to be strong as of the state's November 2017 forecast, supported by ongoing construction activity and rising property values.

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Date of Relevant Rating Committee: Aug. 29, 2017

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis and InvestorTools.

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Applicable Criteria
U.S. Public Finance Tax-Supported Rating Criteria (pub. 31 May 2017) (https://www.fitchratings.com/site/re/898466)

Additional Disclosures
Solicitation Status (https://www.fitchratings.com/site/pr/1032920#solicitation)
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