FitchRatings

FITCH RATES DISTRICT OF COLUMBIA'S $523MM GOS 'AA' & UPGRADES OUTSTANDING BONDS; OUTLOOK STABLE

Fitch Ratings-New York-29 September 2014: Fitch Ratings assigns an 'AA' rating to the following District of Columbia (DC) general obligation (GO) bonds:

--$386.5 million DC GO bonds series 2014C;
--$136.9 million DC GO bonds series 2014D.

The bonds are expected to sell via negotiation on or about the week of Oct. 6, 2014.

In addition, Fitch upgrades the rating on the District's approximately $2.8 billion in outstanding GO bonds to 'AA' from 'AA-'.

The Rating Outlook is Stable.

SECURITY

The bonds are general obligations of the District, with its full faith and credit pledged. Also pledged is revenue from a special real property tax, unlimited as to rate or amount and levied in an amount to pay debt service on GO and parity bonds.

KEY RATING DRIVERS

FINANCIAL PROFILE STRENGTH DRIVES UPGRADE: The upgrade to 'AA' from 'AA-' reflects the District's strong financial performance and clear fiscal flexibility, despite significant contraction in its primary economic driver. The District's financial management practices are sound. Reserve balances are solid, rebounding strongly after recessionary drawdowns. While the District's revenue projections incorporate estimates regarding federal sequestration, Fitch believes additional downside risk remains given the potential for more extensive federal deficit reduction. The 'AA' rating incorporates Fitch's expectation that the District will be able to address these challenges in a prudent and timely manner.

HIGHLY EFFECTIVE BUDGET MANAGEMENT: Institutionalized and effective oversight from the office of the independent chief financial officer (CFO), and demonstrated commitment to fiscal discipline from political leadership are also key factors supporting the 'AA' rating. The District's financial planning practices include frequent revenue estimates, reasonable multi-year expenditure and revenue forecasts, proactive budget monitoring and effective actions to address projected deficits.

ELEVATED DEBT BURDEN: The District's debt levels are comparatively high and expected to remain so, partially due to its position in serving as both sole funder and provider of government services for its residents. Federal and local statutory limitations should ensure debt remains a manageable burden for the District, although these limitations also lead to somewhat below-average amortization of debt.

RETIREE LIABILITIES WELL MANAGED: Pension and other post-employment benefit (OPEB) obligations are relatively limited, with significant federal government support. The District regularly makes its actuarially calculated annual required contributions for both pensions and OPEB liabilities, leading to very low unfunded positions.

LINKAGE TO FEDERAL GOVERNMENT: Government employees and spending, particularly federal, comprise a significant portion of the District's economic resource base. While historically this has been an important source of stability, sequestration, last year's government shutdown, and the potential for ongoing federal government contraction reflect the risks of this economic concentration. Fitch anticipates continued private sector expansion but believes federal austerity limits the District's economic growth prospects over the medium term, though at level manageable for DC given its financial performance and management strengths.

RATING SENSITIVITIES

The rating is sensitive to continued prudent fiscal management in the face of an potentially challenging economic environment as federal contraction continues.

CREDIT PROFILE

The 'AA' GO rating reflects the District's strong financial management practices, including sound reserve levels and timely actions to maintain budgetary balance, and a broad and diverse array of tax revenues. Importantly, these practices have remained consistent even as the District's economic engine, the federal government, has contracted steadily for several years. DC regularly delivers below budget expenditures, which allowed it to restore general fund reserves in recent years after several years of drawdowns during the recession. The rating also incorporates the District's high debt ratios, which are expected to remain elevated, as well as economic and revenue challenges due to reliance on the federal government at a time of federal deficit reduction. DC levies a dedicated property tax (the special real property tax) to cover debt service on all G.O. bonds. The dedicated tax is levied and collected in the same manner and in conjunction with the District's regular real property tax.

FISCAL POSITION STRONG DESPITE SLOWER GROWTH

Fitch views the District's fiscal position as strong. Fiscal 2013 ended with a GAAP-basis $329.5 million general fund operating surplus (before transfers and other financing sources) and an ending total general fund balance of $1.7 billion, representing a robust 25.5% of general fund revenues. This included $791 million in various statutory reserve funds, representing a solid 11.5% of general fund revenues and 12.1% of expenditures. Based on financial performance to date and the District's revised fiscal 2014 budget, Fitch anticipates another general fund operating surplus, though likely of a lesser magnitude, with cash reserves increasing modestly.

Large reserve balances provide important flexibility for the District, particularly given its unique operational and economic reliance on the federal government. When the federal government shut down last fall, the lack of a federal budget prevented DC from accessing revenues authorized under its fiscal 2014 budget. To cover payroll and other basic expenses, the District used a portion of its contingency reserve fund, which it has since fully repaid. Importantly, federal legislation enacted last year and this year authorized the District's budget for all of fiscal 2014 and 2015, even in the event of another federal shutdown.

District financial performance rebounded strongly from recessionary weakness, but revenues are showing signs of reduced, yet still positive, growth. Fiscal 2013 results were likely supported by federal tax increase-related income acceleration and a full-year with a new high earner surcharge (effective July 1, 2012). Estimated revenues for fiscal 2014 (on a GAAP basis for the year ended Sept. 30 as estimated by the CFO) indicate general fund tax revenues will grow 3.7% year-over-year (yoy) (net of earmarks to other funds) to $6.3 billion. While this would be the fifth consecutive annual increase, the pace has declined markedly from the fiscal 2012 yoy gain of 11%. The CFO estimates personal income tax (PIT) receipts will grow 4.9% yoy to $1.7 billion, while real property tax revenues will increase 4.4% to $2.1 billion. A third key revenue stream, general sales tax collections, is estimated to rebound to 5.4% growth after just 0.1% growth the prior year.

Fitch primarily attributes the reduced growth to ongoing contraction at the federal government level. The public sector drives a significant share of the District's economy and tax revenues. The CFO's July 2014 quarterly revenue estimate forecasts yoy general fund tax revenue growth over the next several years, but generally at lower rates than initially seen coming out of the recession. After a projected 5% increase in fiscal 2015 due to an anticipated sharp increase in property tax revenues of 8%, the CFO projects general fund tax revenues will grow more modestly between 2% and 4% through fiscal 2018. PIT, sales tax, and property tax revenues are all estimated to grow at 4% or less yoy between fiscal 2016 and 2018. Fitch notes that CFO's projections have historically proven conservative, though the level of federal uncertainty does add some downside risk.

LIMITED TAX CUT PACKAGE NOT A CREDIT CONCERN
The CFO's July 2014 projections do not include the effect of recently enacted tax law changes, but Fitch anticipates the revenue effect to be manageable for the District without materially affecting financial performance. As part of the fiscal 2015 budget adoption process, the District's city council enacted a series of tax changes including notable reductions to personal income and business franchise taxes. One set of tax cuts goes into effect on Jan. 1, 2015, while further reductions are subject to a revenue growth trigger. The cuts effective Jan. 1, 2015, should result in relatively modest annual reductions in District tax revenues estimated by the CFO at $43 million-$46 million through fiscal 2018. Fiscal 2013 general fund tax revenues totaled $5.7 billion.

Under the enacting statute, an additional set of tax cuts can only be implemented in the event of offsetting revenue growth as estimated by the CFO and, for fiscal 2016 only, an additional cushion of $181 million in revenue growth. Actual revenue growth could fall short of CFO estimates thereby risking implementation of tax cuts that are not fully offset with new revenues. The District estimates the cost of the additional tax cuts at approximately $127 million. The District's close fiscal monitoring, including quarterly official CFO revenue estimates, and ability and demonstrated willingness to make budgetary adjustments helps offset this limited risk.

FEDERAL EXPOSURE CHALLENGES ECONOMY
The District's economy outperformed the U.S. during the recession and rebounded more strongly than the national economy but has more recently shown signs of strain related to federal government reductions. Between 2008 and 2011, the District's yoy growth in employment, personal income, per capita personal income (PCPI), and real GDP all exceeded national rates. But in 2012 (and continuing through 2013), those trends reversed with District yoy growth trailing the nation in all four metrics due mainly to the onset of federal deficit reduction measures. Federal government employment in the District (more than a quarter of DC's non-farm payroll jobs) has been declining yoy since October 2011. Positively, the District's share of federal government employment in its metropolitan area has been increasing modestly over the past several years, indicating that DC's economy is actually absorbing the effects of federal contraction somewhat better than the surrounding region.

The public and private sectors in the District's economy are closely intertwined given the federal government's dominating presence, and continued federal contraction will dampen private sector growth. But given the private sector's demonstrated resilience through several years of federal austerity, Fitch anticipates the District's economy will not suffer a sustained contraction due solely to federal deficit reduction. Federal government concentration remains a risk, but Fitch views it as materially different than the risk faced by other state or local governments with significant economic concentration. Other economic sectors are more subject to severe weakening in times of stress and more able to relocate, while the District serves as the nation's capital and the federal government will therefore always maintain a base level of economic activity.

While the District's employment growth now lags national trends, it remains positive reaching 1.1% in August 2014 (vs. 1.8% nationally). Professional and business services employment growth (the second largest employment sector behind government) has been positive in all but three months since federal declines began in October 2011. Real estate indicators signal a still growing market with strong yoy growth in average single family home prices through July 2014, and a modest decline in the most recent quarterly reports on commercial office vacancy rate.

DC's income levels remain very high, but are no longer growing at the previously strong rates, and an income equity gap remains. 2013 PCPI is by far the strongest in the nation (relative to U.S. states) at nearly $74,513 (167.3% of the U.S. rate), reflecting a strong tax base, but actually declined 0.3% yoy versus national growth of 1.8%. The 2013 poverty rate was a high 18.9% versus a national 15.8%. Similarly, the District's total personal income growth slowed to 1.9% in 2013 versus 2.6% for the nation. Other demographic factors indicate the District's potential for further economic growth with above-average population growth and educational attainment. These benefits help mitigate Fitch's concerns regarding the District economy's reliance on a shrinking government sector.

COMPARATIVELY HIGH, BUT MANAGEABLE DEBT BURDEN
Debt levels are high compared to both U.S. states and most local governments, and are projected to increase given the District's sizable CIP. Importantly, Fitch notes that the District's debt levels are not directly comparable to commonly reported state and local debt levels which do not incorporate the full effect of overlapping jurisdictions. The district's debt metrics reflect the equivalent of a state and local tax burden combined. On a pro forma basis (including the current issue), net tax-supported debt of approximately $9.3 billion represents a high 19.4% of 2013 personal income and $14,482 on a per capita basis (2013 population estimate). Pro forma debt represents a more moderate 6.2% of DC's fiscal 2013 taxable market value. The District's six-year CIP for fiscal years 2015-2020 totals $6.5 billion with GO and income tax-secured debt providing approximately 61% ($4 billion) of financing sources.

Despite these significant plans, the rating incorporates Fitch's expectation that the District will remain in compliance with its Debt Ceiling Act that statutorily limits annual tax-supported debt service to 12% of expenditures and transfers out. For fiscal 2015, the District projects debt service will represent 10.1% (up from 9.55% in fiscal 2014) towards the 12% limit. Fitch expects the percentage will approach, but not exceed, the cap over the medium-term as DC finances its extensive capital needs. The District amortizes its GO and income tax-secured revenue bonds (81.6% of pro forma net tax-supported debt) at a below average rate with approximately one-third retired in 10 years. Extended debt maturities reflect the District's need to adhere to the 12% limit.

WELL-FUNDED PENSION AND OPEB LIABILITIES
The District's pension and OPEB obligations are well-managed, partially due to significant support from the federal government. DC's pension plans for police/fire employees is fully funded, while the teachers plan is over 90% funded (as of Sept. 30, 2013). Both systems utilize a conservative 6.5% investment rate of return assumption. In fiscal 2013, the systems received a combined $495.9 million in federal contributions, consistent with prior years. Other District employees are either covered by the federal civil service retirement system (CSRS, to which the District consistently contributes the full actuarially calculated annual required contribution, or ARC) or Social Security. The District's combined pro forma debt and unfunded pension liabilities represented 19.8% of 2013 personal income. Regarding OPEB, the District makes full ARC payments and reduced its unfunded liability to $150.2 million at the end of fiscal 2013, or a low 0.3% of the District's personal income. Fitch notes positively that the commitment to ARC funding began in fiscal 2008 and continued even through the depths of the last recession.

Contact:

Primary Analyst
Eric Kim
Director
+1-212-908-0241

Fitch Ratings, Inc.
33 Whitehall Street
New York, NY 10004

Secondary Analyst
Karen Krop
Senior Director
+1-212-908-0661

Committee Chairperson
Laura Porter
Managing Director
+1-212-908-0575

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: elizabeth.fogerty@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.

Applicable Criteria and Related Research:
--'U.S. State Government Tax-Supported Rating Criteria' (Aug. 14, 2012);
--'U.S. Local Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

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U.S. Local Government Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=685314
U.S. State Government Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686033