

FITCH UPGRADES DC TO 'AA+' AND RATES \$476MM GOS 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-03 July 2018: Fitch Ratings has upgraded the District of Columbia's (the District) Issuer Default Rating and the ratings on approximately \$4.8 billion of general obligation (GO) bonds to 'AA+' from 'AA'.

Fitch has also assigned an 'AA+' rating to the following District GO bonds:

- \$172.9 million series 2018A general obligation bonds;
- \$303.4 million series 2018B general obligation refunding bonds.

The series 2018A and B bonds are scheduled to be sold through negotiated sale on or about July 18.

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.

ANALYTICAL CONCLUSION

The upgrade of the District's IDR and GO rating to 'AA+' from 'AA' reflects ongoing strong economic and fiscal performance despite federal contraction and the District's repeatedly demonstrated ability to manage its budget to meet identified needs, most recently by increasing revenues to provide enhanced funding for the Washington Metropolitan Area Transit Authority (WMATA, the local public transit operator). Fitch has raised the assessments of the District's revenue framework and long-term liability burden key rating drivers. A more than 40-year history without Congressional intervention in revenue policy substantially mitigates concerns about the theoretical limit to the District's independent revenue control implicit in the federal relationship while the improvement in the long-term liability burden assessment incorporates the strong growth prospects for the District's resource base and recognition of the notable share of its liability burden that is exported to non-residents.

The ratings continue to reflect the District's exceptionally strong budget control by an independent chief financial officer (CFO), prudent financial management throughout the business cycle and strong growth prospects. The federal government plays a key role in the District's credit profile given its economic importance to the District and direct fiscal support for retiree liabilities as well as Medicaid. A statutory cap on debt service, strong commitment to long-term capital planning with sizable pay-go commitments and steady economic growth should keep the long-term liability burden relatively stable.

Economic Resource Base

Government employees and spending comprise a significant portion of the District's economy and provide an important source of stability. The District's economic base has proven resilient to federal volatility, including sequestration and a federal government shutdown. Continued private sector expansion, supported by robust population growth and favorable demographic trends, offsets the exposure to federal spending.

KEY RATING DRIVERS

Revenue Framework: 'aa'

The District's revenue growth will likely be in line with or above the level of U.S. economic growth, driven by overall economic expansion. The District has unique limitations in its independent legal ability to raise revenues given the level of congressional oversight; however, a long record of District revenue actions without Congressional interference substantially reduces the risk presented by this factor.

Expenditure Framework: 'aa'

The District has solid flexibility to manage primary expenditure demands, with workforce challenges common to many highly unionized localities, offset by low carrying costs. Material federal support assists the District in managing key spending needs, including Medicaid and pensions. Federally mandated reforms also established structural budget management tools that impose spending discipline and limit the natural spending growth rate.

Long-Term Liability Burden: 'aa'

While pension and OPEB funded positions are very favorable, the District bears a substantial burden commensurate with its responsibility for services that are normally provided by a combination of state and various local levels of government. Statutory policies establish clear caps, but extensive capital needs indicate long-term liability burden metrics will remain around current levels for the foreseeable future. The liabilities as a percentage of market value metric, which incorporates the benefit of the strong tourism presence in the District's economy and other non-resident economic activity, indicates a lower burden than suggested by the resident personal income-based metric alone.

Operating Performance: 'aaa'

The District is well positioned to address cyclical downturns with robust reserve balances and related statutory funding requirements, midrange inherent budgetary flexibility and relatively strong expected general fund revenue growth. The CFO's office provides extensive budget monitoring and control, supporting the District's operating profile.

RATING SENSITIVITIES

FISCAL MANAGEMENT: The District's 'AA+' IDR is sensitive to shifts in fundamental credit characteristics, including continued strength in the District's concentrated economic profile, proactive and conservative financial management including solid reserve funding and continued careful management of a sizable long-term liability burden with debt issuance matched to economic and fiscal capacity.

FEDERAL OVERSIGHT AND SUPPORT: The federal government's role is a critical factor in the District's rating. Direct fiscal contributions support the District's strong expenditure framework and temper the long-term liability burden. Material changes in the federal government's relationship with the District could trigger rating movement. Congressional intervention in the District's revenue policy would lower the revenue framework assessment.

CREDIT PROFILE

The District's income levels are very high, but an income equity gap remains. The 2017 per-capita personal income was by far the strongest in the nation (relative to U.S. states) at approximately \$77 thousand, or more than 150% of the national level. However, the poverty rate is also high at 19% versus a national rate of 13%. Population growth has been triple the national rate since 2010, reaching nearly 700,000 in 2017. The District is responsible for funding its public schools,

including charter schools, and overall enrollment has grown steadily at roughly 3% annually between 2014 and 2017, with additional growth anticipated in coming years, commensurate with the overall population trends.

Revenue Framework

The District has diverse tax revenues with real and personal property taxes, personal and corporate income taxes and a sales and use tax. Combined, these sources account for approximately three-fourths of its general fund revenues.

Stability in property taxes offsets volatility in the income and sales taxes, while the growth potential of the latter two taxes supports Fitch's assessment of strong revenue growth going forward. Strong revenue growth over the past decade, well above the rate of national GDP, indicates fundamental resilience despite federal government contraction. Fitch's assessment recognizes that the actual historical growth rate that is somewhat overstated given revenue policy actions the District implemented during this period.

The District's independent legal revenue-raising capability is theoretically limited by federal oversight, but not fundamentally so given a long historical record without any Congressional interventions on District revenue measures. The federal Home Rule Act established the District as essentially a federal agency for budgeting purposes, requiring explicit congressional approval as part of federal appropriations bills before local budget bills become effective. Local budget bills are the only way for the District to authorize spending of revenues, including tax or fee increases implemented under separate local legislation.

Under a local Budget Autonomy Act enacted by the District council in 2012 and a local court decision upholding it, the District believes its local funds budget is now only subject to a 30-legislative days congressional review period. Some members of Congress have challenged this assertion and, in Fitch's view, the final outcome remains somewhat unclear.

Since a 2016 decision in the District's Superior Court, the District has followed the budgeting process outlined in the Budget Autonomy Act. After council and mayoral approval, the District submits the local funds budget bills to Congress and considers them fully enacted after a 30-legislative days congressional review period. However, Congress has continued to follow Home Rule Act provisions and included the District's local funds budget in its federal appropriation bills.

Historically, the federal appropriations bills have included all provisions, including revenue changes, in the local funds budget approved at the District's level. They have also usually included additional policy riders inserted by Congress that modestly restrict the District's expenditure authority. For fiscal 2018, Congress inserted provisions prohibiting any expenditure of local funds to legalize marijuana and tightly limiting expenditures for abortions. As it traditionally has, the District intends to comply with these provisions included in the federal appropriations bills.

The Home Rule Act also subjects all non-budget enacted local legislation, including revenue raising measures, to a 30- (for civil matters) or 60-(for criminal matters) legislative days congressional review period. Congress can void the legislation during the review period with a joint resolution of both houses, signed by the president. This represents a significant political hurdle, as locally approved legislation has been voided only three times and not since 1990. None of the voided legislation related to fiscal policy or revenue changes.

Beyond the federal provisions noted above, the District has no other legal limitations on its ability to raise revenues through tax or fee increases, or base broadenings. Since the 1973 enactment of the Home Rule Act, Congress has never voided or otherwise overturned revenue-raising measures approved by the District's council and mayor.

Expenditure Framework

The District's responsibilities are very broad, as it provides city, county and education services to its population. In addition, the District also functions as a state government sharing the most significant expenditure challenge facing most state governments, Medicaid. An enhanced Federal Medical Assistance Percentage (FMAP) match provides the District with a level of federal support exceeding that provided to most states, offsetting some of the burden.

Overall spending should continue to grow in line with revenues. The District faces a wide range of expenditure pressures but benefits from a resilient revenue stream primed for continued growth.

Federal action to revise Medicaid's programmatic and financial structure, including a basic restructuring of federal Medicaid funding to a capped amount, remains a possibility. Whether a change in Medicaid funding has consequences for Fitch's assessment of the District's credit quality would depend on the District's fiscal response to those changes. Responses that create long-term structural deficits or increased liability burdens could negatively affect both the expenditure framework assessment and the IDR.

Carrying costs (debt service, pension actuarially determined contribution [ADC] and OPEB actual contribution) are low at about 8% of spending and should be fairly stable (if actuarial assumptions for the pensions are achieved as noted below) as the District consistently pays full actuarial amounts for both pensions and OPEB. Debt amortization is relatively slow, reflecting statutory caps that limit annual debt service. Federal support also plays a key role in minimizing carrying costs. District employees except police, firefighters, and teachers participate in either the federal Civil Service Retirement System (for those hired before Oct. 1, 1987), with the District making percentage of payroll contributions as a participating employer or a District-managed defined contribution system.

Police, firefighters and teachers participate in single employer defined benefit plans managed by the District of Columbia Retirement Board (DCRB). Under the federal National Capital Revitalization and Self-Government Act of 1997, the federal government took on the liabilities and annual contribution requirements for police, firefighters and teachers accrued through June 30, 1997. District funding of actuarial liabilities accrued since then has been in line with actuarially determined amounts. Fitch anticipates annual pension spending will remain relatively stable given the DCRB's adoption of more conservative actuarial assumptions including a closed 20-year amortization, level dollar (as opposed to the more common level percent of payroll) amortization and 6.5% investment return assumption.

The District's workforce is highly unionized with approximately 75% of the workforce subject to collective bargaining, and Fitch views the workforce environment as a neutral to weaker factor in the District's overall expenditure flexibility assessment. Employees are not permitted to strike but all collective bargaining units are eligible for binding arbitration to resolve contract negotiations.

The District reports it has settled contracts with essentially all bargaining units, except for the police officers' union. While Fitch has not fully evaluated terms of other labor settlements, the District's CFO reviewed them for fiscal sustainability the costs and are incorporated into the fiscal 2019 budget and multi-year financial plan. The budget and fiscal plan also includes estimates for settlement of the police contract, on terms consistent with what the contract for fire and emergency medical services personnel. Given the anticipated strong growth in revenues, Fitch does not believe the new contracts will materially affect its expenditure framework assessment.

Recent action by the District, Maryland, Virginia (collectively the contributing jurisdictions), and the Washington Metropolitan Area Transit Authority (WMATA, the local public transit operator) addresses the authority's key capital needs without materially affecting the District's expenditure and long-term liability demands. In 2018 legislative sessions, the contributing jurisdictions all

implemented measures to provide a combined approximately \$500 million annually in new and permanent capital funding. This level of dedicated funding meets WMATA's recent request from the jurisdictions to allow it to fully fund an ongoing capital plan to improve safety and reliability. As the District's only public transit operator, WMATA's sustainability and success is an important factor in the District's economic growth prospects.

For the District, the increased contributions will be supported with a mix of recurring revenue increases and dedication of pay-go capital funding. The recurring revenue will derive first from a dedicated share of sales tax revenues. That dedication will be ultimately supported by several tax policy changes including rate increases in the sales tax to 6% from 5.75% (matching Maryland and Northern Virginia) and in the ride-sharing tax to 6% from 1%, as well as 3-cent of a 4-cent increase in the commercial property tax rate to \$1.89 per \$100 from \$1.85.

Importantly, this newly dedicated funding is on top of other capital and operating support the contributing jurisdictions have historically provided to WMATA, and Fitch anticipates that the other support will continue. The District's operating contributions have consumed between 4% and 5% of its general fund operating expenditures in recent years, while the District's annual share of WMATA's capital budget has been approximately \$130 million, or 10% of the District's capital spending.

Long-Term Liability Burden

Pensions and OPEB liabilities are very low with both obligations essentially fully funded, setting the District apart from the vast majority of U.S. governments. Federal support described earlier plays a key role in this extremely strong funded position. However, the debt burden reflects the District's responsibilities for functions that would normally be shared between state and local governments. Pro-forma combined debt and pension liabilities are approximately \$11.5 billion, or 22% of the District's 2017 personal income (debt represents 21%).

Given the District's position as one of the nation's premier tourist destinations and other significant economic activity generated by non-residents including commuters, Fitch also considers a total liabilities-to-market value metric. Relative to fiscal 2017 taxable assessed value of just over \$200 billion, the ratio is approximately 6%. As the nation's capital and home to many not-for-profit groups, one-third of the District's tax base is tax-exempt, somewhat overstating this ratio.

Fitch's analysis includes outstanding debt as of March 31, 2018 and an estimated \$550 million in new money issued since then or anticipated later this year. This includes recent GO bond anticipation notes, the new money portion of the bonds rated here and an additional new money issuance anticipated for later this year.

Fitch expects the District's long-term liability burden to remain relatively stable driven by a steady flow of capital needs, offset by likely steady and strong economic growth. The District's annual long-range capital financial plan report provides an extensive assessment of foreseeable capital needs over a multi-decade timeframe and its ability to fund them. This type of explicit very long-term capital planning is uncommon for state and local governments. Fitch anticipates the District will remain committed to addressing what it considers a long-term capital needs gap identified in its report by regularly issuing new debt but also by increasing other financing sources including pay-go.

Operating Performance

The District's resilient revenue base, solid spending flexibility and sizable reserves leave it very well positioned to manage through a moderate economic downturn. Available general fund balance was approximately 24% of spending at almost \$2 billion at the end of fiscal year 2017 (ended Sept. 30), aided by a roughly \$300 million operating surplus. The revised budget for fiscal 2018

forecasts a roughly \$100 million surplus, which should allow the District to further boost its sizable reserves.

Available general fund balance includes all unrestricted fund balance (including the cash flow reserve and fiscal stabilization reserve), and two components of the restricted general fund balance (the contingency cash reserve fund and emergency reserve fund). The latter two funds were established under federal statute to provide fiscal flexibility and both are available for intra-year cash flow needs, supporting Fitch's view that they are part of the District's available financial cushion.

Fitch views the extensive powers and responsibilities of the independent CFO and other federally established mechanisms as key strengths of the District's operating environment. Fiscal discipline instilled following the District's financial crisis in the 1990s is institutionalized, largely in the form of the CFO's office. The CFO establishes the official binding revenue forecast used for budgeting and regularly updates it; monitors annual revenue and expenditure trends to ensure budget compliance and to flag any unanticipated shortfalls; scores all local legislation with potential fiscal consequences and can essentially block legislation that leads to a projected budget deficit; and develops annual multi-year revenue estimates.

Under the Federal Home Rule Act, the District's annual budget also includes a detailed multi-year outlook for operating and capital revenues and spending. Revenues in particular (presented by the CFO) tend to be based on conservative assumptions. While the federal financial control board is dormant, federal law establishes clear guidelines for its automatic reinstatement (namely, signs of significant District fiscal distress).

During the current economic expansion, the District made rapid progress in restoring fiscal flexibility with measures like steady rebuilding of its general fund balance (including establishing the cash flow reserve and fiscal stabilization reserve accounts in fiscal 2011) and rolling back temporary personal income tax increases implemented to address effects of the great recession.

CURRENT DEVELOPMENTS

In the June 2018 quarterly revenue estimate, the CFO projected modest growth in local sources, general fund revenue growth of 2.4% in fiscal 2018, and then approximately 3% growth in the outyears through 2022. The fiscal 2018 projection is particularly affected by short-term stimulus effects of the recent federal tax changes enacted in December 2017. The CFO's overall revenue outlook derives from an expectation of continued economic growth, but at a slightly reduced pace. Fitch considers the revenue estimates prudent and achievable, assuming continued national economic stability.

The District's council-approved fiscal 2019 budget includes modest increases in local funds spending of less than 2%, supported by revenue growth and use of between \$100 million to \$200 million of the prior year's ending balance specifically designated for fiscal 2019 spending. Given the District's historical practice of conservative revenue and expenditure budgeting, Fitch anticipates actual performance could exceed the forecast leading to another operating surplus.

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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.

Applicable Criteria

U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018)
<https://www.fitchratings.com/site/re/10024656>

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