S&P Global
Ratings

RatingsDirect®

District of Columbia; General Obligation

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US$303.405 mil GO rfdg bnds ser 2018B dtd 08/01/2018 due 06/01/2043		
Long Term Rating	AA+/Stable	New
US$172.9 mil GO bnds ser 2018A dtd 08/01/2018 due 06/01/2043		
Long Term Rating	AA+/Stable	New
District of Columbia multimodal GO rfdg bnds var rate dem oblig		
Long Term Rating	AA+/Stable	Upgraded
District of Columbia GO		
Unenhanced Rating	AA+(SPUR)/Stable	Upgraded
Long Term Rating	AA+/Stable	Upgraded

Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings raised its long-term rating on the District of Columbia's general obligation (GO) debt to 'AA+' from 'AA'. The outlook is stable.

The upgrade reflects the District's sustained trend of economic growth supporting strong general fund revenue collections including seven consecutive years of operating surpluses, leading to considerably improved budgetary flexibility in recent fiscal years. In addition to strong revenue growth, management attributes its strong operating performance to its conservative budgeting and strong financial practices. In our view, this improved flexibility helps insulate the District from potential changes to federal employment levels, risks to the District's revenue profile from a federal government shutdown, or modifications to the funding methodology of certain programs like Medicaid.

At the same time, S&P Global Ratings assigned its 'AA+' rating, and stable outlook, to the District of Columbia's series 2018A GO bonds and series 2018B GO refunding bonds.

We base the GO rating on the District's full-faith-and-credit pledge, including a real property tax that is levied annually by the District, without limitation as to rate or amount, in amounts sufficient to pay debt service on all of the District's GO debt outstanding. The District has entered into a collection agreement whereby Wells Fargo Bank, N.A., acting on behalf of the District, collects all real property tax payments.

Proceeds of the series 2018A GO bonds will be used to support the District's overall capital plan and will either pay or reimburse the District for capital project expenditures under its capital improvements plan (CIP). The series 2018B bond proceeds will be used to refund a portion of the District's series 2008E and 2008F GO bonds outstanding.

The rating reflects our assessment of the following factors for the District:

- Very strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Strong management, with strong financial policies and practices under our Financial Management Assessment

(FMA) methodology;

- Strong budgetary performance, with an operating surplus in the general fund and a slight operating surplus at the total governmental fund level in fiscal 2017 after accounting for transfers and capital expenditures funded with bond proceeds;
- Strong budgetary flexibility, with an available fund balance in fiscal 2017 of 22% of operating expenditures;
- Very strong liquidity, with total government available cash at 10.7% of total governmental fund expenditures and 1.6x governmental debt service, and access to external liquidity we consider exceptional;
- Strong debt and contingent liability profile, with debt service carrying charges at 6.5% of expenditures and net direct debt that is 70.0% of total governmental fund revenue, as well as low overall net debt at less than 3.0% of market value; and
- Strong institutional framework score.

Mitigating these factors in our view is the District's lack of complete budget autonomy because both the District's federally funded budget and locally funded budget are subject to Congressional review, although we note that review of the locally funded budget is through a passive 30-day period without the need for affirmative approval by Congress. In addition, we view the District's large capital plan as a mitigating factor, even though the large amount of capital needs stems from the District's strong economic growth, commitment to fund the Metro, and to it being a unique government entity, effectively acting as a city, state, and school district.

Very strong economy

We consider the District of Columbia's economy very strong. The District, with an estimated population of 693,672, is located in the Washington-Arlington-Alexandria MSA, which we consider to be broad and diverse. It has a projected per capita effective buying income of 169% of the national level and per capita market value of $429,412. Overall, market value grew by 6.2% in 2016 to $298.0 billion in 2017. The unemployment rate was 6.1% in 2017.

The District of Columbia, the capital of the U.S., is a unique governmental entity in that it combines state, county, and municipal characteristics. Its employment mix reflects the District's unique nature, consisting of government, military contractors, services, and tourism. Despite having a significant amount of tax-exempt property within its boundaries, equal to roughly one-third of total property, the District's economic metrics, including tax base strength, remain very strong. Home prices have increased 4.0% annually, on average, in the past four years and had an average sales price of $829,000 in 2017 according to management.

Despite the District's strong economic trends, we continue to monitor some uncertainty regarding the federal budget and some reduction of the federal workforce in the District, particularly in the past year. Federal job cuts could cause a reduction in total employment, which would likely result in lower income and sales tax revenues. Government jobs comprise slightly more than one-third of the District's total non-agricultural jobs, while about two-thirds are private-sector jobs, many of which are tied to government-sector needs. Over the past 10 years, the share of government jobs as a percent of overall jobs has declined, while professional, food services, education, health care, and leisure and hospitality have increased. Further diversification could stabilize the District's employment base, but the effect on the District of Columbia's overall revenue could be muted if the job growth occurs in typically lower-income job areas.

Looking ahead, we expect continued strong growth in the District's tax base due in part to a number of significant residential, commercial, and mixed-use developments currently in the planning or construction phase. District of Columbia is home to 350 historical sites and major cultural attractions, nine colleges and universities, more than 50 museums, 206 foreign embassies, a number of international organizations, and the nation's second-busiest rapid transit system (Metro). In the past five years, the downtown area has been revitalized with the construction of CityCenterDC, a large mixed-use development consisting of two condominium buildings, two apartment buildings, two office buildings, a luxury hotel, and public park. The nearly $1 billion project encompasses 2 million square feet and covers more than five city blocks.

Overall, we forecast stable-to-positive growth for the mid- and south-Atlantic regions because continued home price appreciation and vibrant regional economies will help boost local government tax receipts throughout much of the region, including for the District of Columbia. As a result, we expect the broader macroeconomic forces to support our view and expectation of good growth within the near future. For additional information, refer to our "U.S. State And Local Government Credit Conditions Forecast" (published April 26, 2018, on RatingsDirect).

Strong management

We view the District's management as strong, with strong financial policies and practices under our FMA methodology, indicating financial practices are strong, well embedded, and likely sustainable.

Offsetting the District's very strong management policies and practices is our view of the uncertainty regarding the role the federal government could play in future budgets and the Local Budget Autonomy Act, which has been the subject of lawsuits and repeal provisions.

The District's policies include:

- Budgeting practices that incorporate outside resources and trend analysis;
- Quarterly budget-to-actual reports, robust capital, and long-term financial planning documents posted on the District website;
- Formalized five-year financial projections and six-year capital plan, updated annually and reviewed by council, including a detailed inventory of deferred maintenance;
- The District's Home Rule Act limits debt service in any given year to 17% of revenue; in addition, in 2009, the District passed the Debt Ceiling Act, imposing a further limit on the issuance of tax- and fee-supported debt to 12% of GF expenditures and transfers;
- The District is required by federal law to maintain an Emergency Reserve Fund and a Contingency Reserve Fund combined equal to 6% of local annual operating expenditures; in addition, it is required by District law to maintain a fiscal stabilization reserve account and a cash flow reserve account, which were put into place in 2010 through the Sustainable Capital Investment and Fund Balance Restoration Act; and
- An investment policy with annual updates on holdings to council.

In addition to the policies and practices above, the District maintains number of additional financial policies and practices including a 20-year comprehensive master plan that helps drive its strategic decision making and guides future growth and development.

Strong budgetary performance

The District's budgetary performance is strong in our opinion. It had surplus operating results in the GF of 3.4% of expenditures, and slight surplus results across all governmental funds of 1.0% in fiscal 2017. GF operating results have been strong over the last three years due primarily to strong revenue growth supported by strong economic underpinning and strong financial policies and practices including conservative budgeting, with a result of 2.6% in 2016 and a result of 3.8% in 2015.

Our operating calculations account for annual transfers in and out of the GF, primarily to the capital projects fund and other nonmajor governmental funds. In addition, our total governmental calculations account for capital expenditures funded with bond proceeds.

On a total governmental basis, federal sources accounted for about $3.9 billion, or 29%, of the District's $13.4 billion in total governmental expenditures. However, a large portion of these funds is flow-through funding for Medicaid, with the remaining federal funding for programs such as Head Start, housing, and food stamps. According to management, these federal funds are unlikely to significantly decline.

The District's primary general fund revenue sources are real property taxes (31% of GF revenues), income and franchise tax receipts (30%), and sales-and-use tax receipts (18%). We understand federal revenue accounts for just a fraction of the District's remaining GF revenues (less than 1%). While we believe components of the revenue mix can be cyclical, we do not believe the District's performance has been volatile as a result.

GF expenditures are composed primarily of public education (26% of GF expenses), human support services (25%), and public safety and justice (15%).

Management indicates that, overall, total revenues and expenses are tracking well relative to budget for fiscal 2018. At year-end, management indicates that it expects to at least maintain a similar level of reserves relative to the end of fiscal 2017 and that, given its conservative budget assumptions and upward revision in revenues, reserves will likely grow.

The District's conservative 2019 projections provide some cushion to potential headwinds. Federal policy regarding tax reform, health reform, and sanctuary city implications could affect the District, but we don't anticipate most of these reforms would have an immediate effect on finances. A change to the Affordable Care Act that withdraws federal money to support Medicaid could have the biggest effect on the District. District management notes that it would consider the balance between funding any financial gap and determining whether to cut back the District's services.

Strong budgetary flexibility

The District of Columbia's budgetary flexibility is strong, in our view, with an available fund balance in fiscal 2017 of 22% of operating expenditures, or $1.8 billion.

The available balance calculation includes committed reserves, which are available for operations and consist of the cash flow reserve and fiscal stabilization reserve, as well as assigned and contingency reserves. We expect available reserves to remain strong, in our view, given the District's projection for at least break-even operations in fiscal 2018. The District has significantly improved its available balance, with seven consecutive operating surpluses in fiscal years 2011-2017 despite the planned use of the fund balance in each of the approved budgets.

Included in the District's available reserves is a contingency reserve fund established by Congress through the Home Rule Act, which must be funded at 4% of operating expenditures. Management reports it can use the reserve to cover revenue shortfalls that meet certain standards as well as nonrecurring or unforeseen needs. If drawn on, the District is required to replenish the reserve to full funding over a two-year period, although we understand there are no penalties for failing to do so. Therefore, we believe this reserve enhances flexibility and have included it in our available balance calculation.

Very strong liquidity

In our opinion, the District of Columbia's liquidity is very strong, with total government available cash at 10.7% of total governmental fund expenditures and 1.6x governmental debt service in 2017. In our view, the District has exceptional access to external liquidity if necessary.

The District invests primarily in U.S.-government-backed securities, which we do not consider aggressive. We believe the District has exceptional access to external liquidity given its frequent debt issuances with various security types (including GO and income tax-secured debt).

The District of Columbia maintains four private placements, all of which were issued as variable-rate GO bonds with monthly resets. As of March 31, 2018, the District's private placements totaled $614 million. While we believe some of the bond conditions make the District vulnerable to non-compliance or to breaking the agreement, we believe the remedies to potential breaches are manageable. The District would be subject to a 12%-interest-rate maximum on the debt, and the debt cannot be accelerated for immediate payment. As a result, and given the District maintains cash and equivalents of more than $1.3 billion at the end of fiscal 2017, we do not believe the direct purchase GO bonds represent a material contingent liability risk.

We understand the District has hedged a portion of its variable-rate debt through the maintenance of floating-to-fixed-rate swap agreements on its series 2004B, and 2016C bonds, and floating-to-floating swaps related to its series 2001C and 2001D GO bonds. The current total notional amount is $377.1 million, or about 61% of the district's total variable-rate debt. The counterparty for the series 2001C and D, and 2004B swap agreements is JPMorgan Chase Bank N.A., and the counterparty to the series 2016C bonds is Morgan Stanley Capital. As of March 31, 2018, the cumulative mark-to-market of the swap agreements totaled negative $24.1 million, which is substantially down from the negative $33 million mark-to-market amount last year. We believe the termination event of the District rating falling below 'BBB-' to be remote.

Strong debt and contingent liability profile

In our view, the District's debt and contingent liability profile is strong. Total governmental fund debt service is 6.5% of total governmental fund expenditures, and net direct debt is 70.0% of total governmental fund revenue. Overall net debt is low at 3.0% of market value, which is in our view a positive credit factor.

In our view, the District's well-funded pension and other postemployment benefits (OPEB) plans help balance its large capital needs. The District's debt portfolio is largely fixed-rate, with about 9.0%, or $876 million, of its total variable-rate debt. The variable-rate debt is composed of four direct-purchase GO transactions, a $200 million revolving credit facility with U.S. Bank that is fully drawn, and $75 million in GO commercial paper, which the District can increase to a maximum of $300 million. If events of default are triggered on the direct purchase debt, the debt

would convert to an interest rate of 12%. The commercial paper has a maximum interest rate of 10%. With the District's small percent of debt as variable rate, we do not believe it will meaningfully increase debt service costs. However, if the District's variable-rate debt were to increase as a percent of overall debt and terms were to contain default triggers that we do not view as remote, over time, our view of the District's debt service costs could change.

The District of Columbia's recent update to its six-year capital improvement plan (CIP) identifies about $8.2 billion in capital funding. In 2017, legislation was passed to approve an increase in the District's pay-as-you-go funding for capital, which we understand could gradually increase to as much as $450 million annually by 2026. This increase supports funding for maintenance and new projects based on current estimates. We estimate the District will issue $5.7 billion in additional GO or income-tax debt over the next six years, in addition to $168 million funded with grant anticipation revenue vehicle bonds. There is another $1 billion in public-private partnership projects that may be addressed by the private sector. In addition, the District has identified dedicated funding for Metro transit, totaling about $179 million annually for its part of a $500 million annual capital plan jointly funded by the District, Maryland, and Virginia.

The District is currently continuing to provide subsidies to its financially beleaguered UMC, a component unit of the District In fiscal 2017, the District of Columbia provided $27 million in operational and capital support to the hospital. In fiscal 2018, the budget included $10 million for capital improvements. We understand the District is in the process of identifying a site for a new hospital to replace the existing UMC facility, which would be operated by another entity. There is $300 million in the current capital plan to provide for the costs of a new facility.

Despite the large capital plan, given the District's debt management policies, we do not believe the debt plans as outlined in the CIP will materially affect our assessment of the District's overall debt profile.

The District's combined required pension and actual OPEB contributions totaled 1.9% of total governmental fund expenditures in 2017. The city made its full annual required pension contribution in 2017.

We believe the District's pension and OPEB plans are well-funded and present limited long-term liabilities, providing some cushion to overall capital pressures. The District maintains two single-employer, defined-benefit pension plans for police and fire and for teachers; it has historically fully funded the actuarially determined contribution in each of the past three fiscal years. Based on a 2017 actuarial study, the police-fire plan was 114.7% funded, while the teachers' plan was 95.9% funded, assuming a discount rate of 6.5%. For the year ended Sept. 30, 2017, the District maintained a net asset of $727.1 million for its police-fire plan and a net liability of $89.7 million for its teachers' plan. In addition, the District sponsors a defined-contribution pension plan for permanent full-time employees hired after September 1987. We understand the federal government funds an "on-behalf" pension payment for general employees hired in the District through the year 1995. In fiscal 2017, this on-behalf payment totaled $452.2 million.

The District of Columbia offers OPEB to eligible employees. Following the release of the 2015 comprehensive annual financial report, the District completed a study of its OPEB plan that led to changes in the participation rate for the actuarial model and, as a result, led to a significant effect on the actuarial funding ratio and the annual required contributions. As of Sept. 30, 2017, the actuarial funding ratio stood at 111.8%. Based on its most recent valuation, the District projects fully funding its future annual required contributions, ranging from $31 million in fiscal 2018 to $38.2

million in fiscal 2020.

Strong institutional framework

The institutional framework score for the District of Columbia is strong.

Outlook

The stable outlook reflects our opinion that we expect the District of Columbia to maintain its strong budgetary flexibility and very strong liquidity given its strong management and budget practices, which have strengthened reserves during this period of strong economic expansion. In addition, we believe the District will continue to adjust spending as needed amid evolving budgetary constraints and what we view as a large capital program. Therefore, we do not expect to raise or lower the rating within the two-year outlook horizon.

Upward scenario

In our view, the District's relationship with the federal government remains a key factor in our analysis including its reliance on Congressional approval for its budget, albeit a passive approval process for the local budget. Furthermore, despite the District's employment diversification in private job growth, we believe there remains a substantial concentration in federal or federal-related employment activity that could fluctuate with the U.S. Government's policymaking decisions. In our view, these unique economic and policy circumstances continue to constrain the rating. However, should the District receive full and permanent budget autonomy while insulating itself from economic and financial decisions made at the level of federal government, we could raise the rating.

Downward scenario

Although unexpected, should budgetary performance weaken such that our flexibility assessment materially changes, or if the District's debt and contingent liability profile materially weakens due to its large capital program in such a way that is no longer consistent with the District's debt policies, we could lower the rating.

Cautious Growth Estimated For 2018 And 2019 Despite Strong Economic Underpinnings

The District benefited from growth in fiscal 2017 in all of its major revenue streams. Net property tax revenue rose 6.5% from the previous year, representing the District's strong property values, but also representing a slight decline from fiscal 2016 growth of 7.8%. Net income and gross receipts tax revenue grew less aggressively at 3.9%, in part due to a change in the District's income tax code. The modified tax code includes the creation of a new income tax bracket, lower income tax rates, and the lowering of the business franchise tax rate, phased in through fiscal 2018. Fiscal 2017 net sales tax spiked 7.2% from the previous year due to higher volumes of large events in both winter and spring.

The District's fiscal 2017 expenditures remained in line with budgeted numbers, with public safety and justice representing approximately 16% of expenditures, and remained relatively level with its 2016 expenditures. Education and health and human services make up about 25% each of the District's 2017 expenditures. Education expenses rose 13% from the previous year as part of a decade-long spending ramp-up for modernization projects in the school

system. Also incorporated into the 2017 expenditures is pay-as-you-go capital, with nearly $135 million transferred from the general fund (GF) to the capital improvement fund.

The District's expectations for fiscal 2018 incorporated a slightly more tempered estimate overall, even after accounting for the federal tax changes, with management anticipating revenue growth to slow to 1.3%. Sales tax revenue is likely to be in line with previous years' growth, also at about 1.3%. Property tax revenue and income and gross receipts taxes are expected to increase, but at slower rates. The District's 2018 expenditure projections show a modest increase in health and human services, while the education and public safety budgets show slight declines.

Despite the expected slight slowdown in growth, the District's forecast for 2018 revenues was actually revised upward by $42.5 million, excluding the impact of federal tax legislation, mainly due to stronger-than-expected income tax revenues. We understand District management estimates the impact of the federal tax law passed by Congress is expected to add an additional $34.8 million of revenues to fiscal 2018 and $51.9 million in fiscal 2019, as well as inject an estimated $1.0 billion into the District of Columbia's economy.

In total, the District's overall percentage revenue growth is about 1.3% for fiscal year-end 2018 compared with 2.2% for the same period the previous year. We understand management expects overall revenue growth to increase to an average of about 3.0% for fiscal years 2019-2022, reflecting the impact of federal tax law changes as well as steady population and employment growth, albeit at slightly declining levels in the past few years.

The fiscal 2019 governmental fund budget totals $14.4 billion, including $9.1 billion GF revenue, $3.44 billion of federal sources, and $1.9 billion of enterprise revenues. The primary expenditure increases relative to the previous year include a $135 million increase for public and charter schools, $49 million for debt service, and $18 million for human services. The fiscal 2019 budget also includes the District's full $179 million annual commitment to funding the Metro through a few dedicated tax increases, including increasing the sales tax rate for retail, alcohol, restaurant and hotel transactions by 0.25%; increasing the top commercial property tax rate to $1.87 from $1.85 per $100 of taxable value; and increasing the gross receipts tax on private-for-hire vehicles (excluding taxis) to 4.75% from 1.00%.

Potential Challenges

We believe the District has a positive trend of strong financial performance, strong economic activity, and property tax base strength, coupled with strong reserves for liquidity needs as well as well-funded pension and OPEB plans. We believe maintaining these strengths and adjusting to any potential declines or slower growth will be necessary to address some of the uncertainty the District faces regarding federal government policy, and expenditures that could arise from the District's school system, long-term infrastructure needs or the United Medical Center (UMC).

In addition, in our view, the District continues to deal with some uncertainty regarding the Local Budget Autonomy Act, which has been the subject of lawsuits and repeal provisions. The act, approved in 2013, granted the District the right to enact and appropriate its local funds budget without the need for affirmative approval by the U.S. Congress. Despite the act's passage and the historical infrequency of federal intervention to the District's budgets, we continue to have concerns about the role the federal government could play in future District budgets. We view this as an ongoing factor that has a negative effect on the District's finances and as a slight offset to the District's otherwise very strong

management policies and practices. Nevertheless, we believe the District should be insulated from any adverse federal budgeting gridlock given its ability to appropriate its own local funds; however, should the District's local fund budget be affected in any way by the federal budgeting process , this could cause us to question the effectiveness of the Local Budget Autonomy Act.

Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Incorporating GASB 67 And 68: Evaluating Pension/OPEB Obligations Under Standard & Poor's U.S. Local Government GO Criteria, Sept. 2, 2015
- U.S. Public Transportation Issuers Maneuver Around Obstacles To Maintain Stability In 2016, Jan. 12, 2016
- 2017 Update Of Institutional Framework For U.S. Local Governments

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