JAMES L. McINTIRE
State Treasurer

State of Washington
Office of the Treasurer

February 2, 2012

Hon. Christine Gregoire, Governor
PO Box 40002, Olympia, WA 98504-0002

Hon. Lisa Brown, Senate Majority Leader
PO Box 40403, Olympia, WA 98504-0403

Hon. Frank Chopp, Speaker of the House
PO Box 40600, Olympia, WA 98504-0600

Hon. Mike Hewitt, Senate Minority Leader
PO Box 40416, Olympia, WA 98504-0416

Hon. Richard DeBolt, House Minority Leader
PO Box 40600, Olympia, WA 98504-0600

Dear Governor Gregoire, Senator Brown, Senator Hewitt, Speaker Chopp, and Representative DeBolt:

I am writing today to deliver good news – and an important warning from the financial markets.

This week, my office refinanced $978 million in high cost bonds to save $154 million over the life of the bonds – of which $11 million is saved in debt service costs for the general fund this biennium. Combined with earlier refinancings and our ability to sell new bonds at lower than expected rates, our total general fund savings since the budget was written is now $31 million – a sizable reduction to the state's $1.9 billion debt service costs for 2011-13.

As part of this week's bond sale, Washington's AA+/Aa1 credit ratings *were affirmed* by all three major credit rating agencies, reflecting improvements in our economy, our reputation for strong financial management and the Legislature's willingness to step-up to increasingly challenging circumstances.

However, two of the three rating agencies – Fitch and Moody's – revised their outlook for the state's credit from "stable" to "negative." Moody's said that their adoption of a negative outlook reflects "the magnitude of the revenue falloff that continues to challenge the state as it struggles to recover from the recession, depleted reserves and GAAP based balances that will remain negative at least through fiscal 2012; and high fixed costs relative to available revenues for the state's above average debt position." Meanwhile, Fitch noted that "[t]he state is operating in an environment of significantly constrained revenue raising and spending control flexibility. Maintenance of the 'AA+' rating will be contingent upon enactment of sustainable budgeting measures that provide an adequate cushion against future revenue underperformance."

Both agencies noted the state's recent history of significant spending reductions, use of one-time fund shifts and a long pattern of downward revenue revisions – along with the recent state Supreme Court decision finding state education funding to be inadequate. These factors, against the backdrop of the supermajority requirement for raising taxes and the voters' rejection of tax increases in 2010, led Moody's to conclude that "out year structural gaps will likely be challenging to resolve."

Maintaining Washington's AA+/Aa1 credit rating is critical to our plans to make new investments in schools, transportation and other public infrastructure. The state is currently scheduled to finance $6.8 billion of job-creating investments in public infrastructure construction between now and the end of the

2013-15 biennium. Should our credit rating drop these bonds will likely cost Washington taxpayers hundreds of millions more than necessary. Our ability to finance these investments at competitive, low interest rates requires that we maintain our bond rating so that we avoid driving up interest costs. Why send scarce taxpayer funds to Wall Street that could stay here to create jobs instead?

There are three steps that the Legislature could take to help maintain our credit rating:

1. **Close the Gap:** The most important step in maintaining our strong credit standing is the timely completion of a sustainable budget. While this will undoubtedly mean further budget reductions with painful consequences, outright revenue increases would also provide a more sustainable base for essential state services that would be seen positively by credit markets.
2. **Enact Debt Commission Recommendations:** The Commission on State Debt has recommended amending the state constitution's limit on debt service to smooth out gyrations in debt issuance and a modest reduction in the debt load relative to the current constitutional limit (SJR 8221/HJR4226). The Commission also recommended creating a bipartisan, legislative and executive Debt Advisory Council to oversee a lower working debt limit to sustain a more stable and predictable pattern of infrastructure investment (SB 6262/HB2494).
3. **Enact Pension Funding Reform:** Last year, a broad, bipartisan coalition of legislators joined me in supporting a constitutional amendment that would require the Legislature to fully fund its pension obligations (SJR8214/HJR4219). While the Legislature significantly reduced our unfunded liability and funded the minimum pension contribution recommended by the State Actuary for 2011-13 for the first time in several years, a constitutional framework requiring these payments would ensure long term sustainability of our pension system.

Washington's reputation for strong financial management is seen by credit markets as the key positive factor that offsets the negative impacts of high debt ratios, lower reserves, a narrow tax base, and an active initiative process. The Legislature's prudent actions to cut spending by over $10 billion in the last three years reinforced this view. The 2011-13 operating budget further bolstered Washington's good standing by relying on deep cuts to pension benefit costs, education, health and public safety programs instead of using too many one-time options.

All the remaining choices have lasting implications for our communities and the state's long-term financial stability as pressure grows to avoid more cuts to education, health and public safety. It will be tempting to consider a number of options that rating agencies consider "credit negatives" and could trigger a downgrade. Measures that securitize future revenues to provide one-time cash for the operating budget typically get harsh reactions from the markets. Their view is that raising money for the operating budget by borrowing against future revenue streams like the tobacco settlement, lottery revenue, or other revenue streams that support on-going costs in the operating budget is very expensive, corrodes the ability to pay for services in the future, and indicates a lack of liquidity. They also consider one time fund shifts, such as the transfer of one month's K-12 school allocation payments from one fiscal year to another, as unsustainable measures that risk becoming permanent structural imbalances.

As Fitch summarized, "[f]ailure to restore and maintain budget balance and an adequate reserve position using primarily recurring gap-closing measures likely would result in a downgrade of the rating."

We will continue to work with you on the legal, practical and financial details of using special tax bonds for additional, near term capital budget capacity. These bonds do provide a somewhat higher cost way to finance projects, but may also increase the marginal likelihood of a credit downgrade. For this reason I believe it is more important than ever to craft this proposal within a carefully structured long-term plan for how the state uses and manages debt as recommended by the Commission on State Debt.

As a former legislator and colleague, I understand the deeply painful decisions presented by our current circumstances – all of the options are awful. This is a very difficult situation with no easy way out, but by working together in common purpose I believe we are up to the task. We have much work ahead of us, and my office is ready and willing to do anything we can to help chart a fiscally prudent path through the challenges ahead.

Sincerely,

James L. McIntire
Washington State Treasurer

Cc: Marty Brown, Jim Justin, Senator Murray, Senator Zarelli, Representative Hunter, Representative Alexander, David Schumacher and Charlie Gavigan