Fitch Affirms District of Columbia's Income Tax Revs at 'AA+'; Outlook Stable

Fitch Ratings-New York-14 March 2017: Fitch Ratings has affirmed the 'AA+' rating on the District of Columbia's $4.24 billion income tax-secured revenue and revenue refunding bonds.

The Rating Outlook is Stable.

SECURITY
The income tax secured revenue bonds are special obligations of the District with a first lien on and pledge of personal income and business franchise tax revenues (collectively, the pledged taxes or pledged revenues).

KEY RATING DRIVERS

The 'AA+' rating reflects strong legal provisions, the strength and resiliency of pledged revenues, and the District's unique position under federal law. The bonds are secured by a statutory pledge of income tax and business franchise tax revenues, superior to that of any other person, including District GO bondholders. Pledged revenues are not reduced by amounts refunded to taxpayers. The District's Home Rule Act expressly stipulates that revenue debt can be issued with a valid, binding and perfected security interest in the revenues pledged, without a sale of the pledged revenues and without requiring annual appropriations.

Pledged Revenue Growth Prospects:
Fitch anticipates growth in the pledged income revenues for income tax-secured bonds (ITBs) will be healthy and ahead of national economic growth. Historical trends are robust reflecting resilience and strength of the local economy through recessions and federal contraction. Fitch links the performance and outlook for income tax and business franchise tax revenues to the District's overall economy.

Economic Sensitivity and Resilience of Security:
Coverage for the ITBs from pledged revenues should be very resilient through a moderate downturn given the leverage limitations and ample current coverage cushion.

Exposure to Issuer:
Fitch distinguishes the rating on the ITBs from the District's IDR of 'AA' with a Stable Outlook. Legal and statutory provisions separate pledged revenues from general operations, although the relationship between the U.S. Congress and the District tempers the amount of credit Fitch gives to the structure of the bonds.

RATING SENSITIVITIES
Sound Coverage Cushion: The rating on the District's income tax-secured revenue bonds is sensitive to Fitch's expectations for the maintenance of a sound coverage cushion from the pledged revenues.

Relationship to District IDR: The ratings are also sensitive to movement in the District's IDR given its unique position as neither a state nor a municipality under federal law.

CREDIT PROFILE

PLEDGED REVENUES TIED TO ECONOMIC GROWTH

Pledged revenues grew 4.5% on an average annual basis over the past decade reaching $2.5 billion in fiscal 2016, reflecting the District's overall economic expansion in that span. Income tax revenues comprised more than three-fourths of pledged revenues in fiscal 2016 (consistent with prior years) and also grew 4.5% on an average annual basis over the past decade, inclusive of several rate changes (increases and decreases).

The withholding portion of income tax revenues (two-thirds of pledged revenues in fiscal 2016) grew in nine of the past 10 years. This consistent growth offsets the much greater volatility inherent in non-withholding income tax revenues (11% of fiscal 2016 pledged revenues), which declined (as much as 74%) and increased (as much as 162%) widely on an annual basis over the past decade. On an average annual basis, non-withholding revenues increased 0.7% since 2006. Business franchise tax revenues (23% of fiscal 2016 pledged revenues) grew 4.5% on an average annual basis since fiscal 2006 but also exhibited considerable volatility with declines in four of the past 10 years.

STRONG COVERAGE LIKELY TO CONTINUE

Fitch anticipates continued leveraging of the income tax secured revenue lien, subject to the ABT, though coverage should remain robust. The Income Tax Secured Bond Authorization Act of 2008 initially authorized just over $2.9 billion in income tax-secured revenue bonds; after multiple legislative amendments, total authorization now stands at $9.2 billion with over $4.6 billion unused. Limiting future leverage, the two-tiered ABT requires two times (x) pro forma MADS coverage from withholding income tax revenues and 3x from total pledged revenues, based on any 12-month consecutive period of the preceding 15 months.

Based on a conservative baseline assumption of ITBs fully supporting the District's capital improvement plan (CIP; through fiscal 2020), fiscal 2016 withholding revenues and total pledged revenues cover projected baseline MADS of $610 million (excluding the federal Build America Bonds [BABs] and Qualified School Construction Bonds [QSCBs] subsidies) by 2.7x and 4x, respectively. Fitch anticipates coverage will remain strong and continue to exceed the ABT and that at least some portion of the planned issuance to support the CIP will be from GO bonds.

The District's calculation of debt service under the indenture (including for the ABT) nets federal interest subsidy payments to be received in connection with BABs or QSCBs, essentially allowing for slightly greater leveraging of the security. Due to sequestration, the federal government has withheld between 4% and 8% of the subsidy annually since fiscal 2013. Excluding all BABs and QSCBs subsidies, projected MADS coverage (baseline assumption of full CIP support from income tax-secured bonds) remains very strong as the subsidies totaled just $18.4 million in fiscal 2016 out of approximately $270 million in annual debt service.

ROBUST RESILIENCE

The security provided by the pledged income tax and business franchise tax revenues is very resilient to economic volatility. Fitch's analysis focuses on maximum leverage under the 3x total pledged revenues ABT as additional issuance is likely. To evaluate the sensitivity of the dedicated revenue stream to cyclical decline, Fitch considers both revenue sensitivity results (using a 1% decline in national GDP scenario) and the largest decline in revenues over the period covered by the revenue sensitivity analysis. Based on the District's pledged revenue history, the Fitch Analytical Sensitivity Tool (FAST) generates a 7.6% scenario decline in pledged revenues. The peak to trough decline was 19% between fiscal 2008 and 2011.

Fiscal 2016 pledged revenues of approximately $2.5 billion can withstand a 67% decline while still maintaining sum sufficient coverage of MADS, assuming issuance up to the ABT. This is equivalent to nearly 9x the scenario result and is more than 3x the worst actual decline in revenues, warranting an 'aaa' assessment for this rating factor. The additional ABT requirement of 2x withholding revenues enhances the resilience of the security.

HEALTHY GROWTH PROSPECTS

Fitch assesses growth prospects for income tax and business franchise tax pledged revenues as strong and in line with our economic expectations for the District. Pledged revenue growth in recent years has been robust, which Fitch attributes to expansion of the local economy. Going forward, Fitch considers the District Chief Financial Officer's (CFO) forecast for 3%-4% annual growth in pledged revenues in the out-years through fiscal 2021 to be reasonable. The possibility of significant federal tax changes under a Republican administration and congress creates some potential near-term uncertainty in this forecast as prior adjustments to federal tax rates shifted taxpayer behavior and affected the District's pledged revenues for several years. Regardless, Fitch anticipates strong growth at or exceeding the level of national economic growth over the medium to long term.

The CFO's official revenue estimate includes separate estimates for implementation of a final set of tax cuts arising from statutory changes initially adopted several years ago. In 2014 the city council enacted tax changes with a portion of the changes effective immediately and additional changes implemented only if the CFO's revenue estimate forecasts revenue growth that offsets the projected cost of the changes. The most recent February 2017 revenue estimate triggers implementation of the final round of tax cuts effective January 1, 2018.

Actual revenue growth could fall short of estimates thereby risking implementation of tax cuts that are not fully offset with new revenues. The District estimates the annual costs of these final tax cuts at $144 million by fiscal 2021 (nearly all in income tax and business franchise taxes), or a modest 5% of projected pledged revenues. The CFO's close fiscal monitoring, including quarterly official revenue estimates and management of debt issuance, further offsets the risk of a material shortfall in pledged revenues.

LINK TO DISTRICT IDR

The District of Columbia is a unique entity under federal law being neither fully a state nor a municipality. Unlike states, congress retains direct authority over the District including the ability to repeal any District statutes. But, like a state, it is not eligible to file for bankruptcy under chapter nine.

Accordingly, Fitch does not consider chapter nine of the federal bankruptcy code to be directly applicable to analysis of whether the rating on the ITBs can be distinct from the District's IDR and therefore does not apply the local government dedicated tax framework. Similarly, the state dedicated tax framework cannot be applied without variation given congress' oversight of the District. Instead, Fitch's approach allows for distinction of ratings on dedicated tax bonds from the District's IDR based on analysis of the legal structure. But the amount of credit Fitch will give to such a structure is tempered by the risk that congress, faced with extreme financial stress in the District, could exercise its oversight powers to the detriment of bondholders.

Fitch considers the flow of pledged revenues as structurally protected from the District's general operations. The local statutes authorizing ITB issuance provide bondholders with a first lien on income tax and business franchise tax revenues. The indenture and other financing documents establish District covenants to not impair the security provided to bondholders including a requirement limiting its ability to modify the individual income tax rates, or the income subject to those rates, only if such modification would not reduce the ratio of tax revenues generated by the withholding portion of the individual income tax for any 12 month consecutive period from the preceding 15 months to less than 2.0 times senior MADS on outstanding bonds. Further, the District's charter expressly provides that it is subject to the Contracts Clause of the U.S. Constitution as it relates to states.

In Fitch's view, congress' ultimate sovereignty over the District prevents complete distinction of specific security ratings from its IDR. Unlike a state, congress can impose statutory changes on the District that could potentially impair even ITB bondholders. Fitch views this as highly unlikely but nevertheless incorporates this risk into the rating on the ITBs and limits the distinction from the IDR.

VARIATION FROM PUBLISHED CRITERIA

The analysis supporting the 'AA+' rating on the District's income tax-secured revenue bonds includes a variation from Fitch's 'U.S. Tax-Supported Rating Criteria' dated April 18, 2016. A variation was made to the dedicated tax analysis because neither the state government nor local government approach regarding exposure to issuing entity operations is fully applicable. The District's unique legal standing requires a variation from the dedicated tax analysis applicable to U.S. states to cover the exposure to congressional action that is not currently anticipated in the criteria section on dedicated tax bonds.

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

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.

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

Additional information is available on www.fitchratings.com

Applicable Criteria
U.S. Tax-Supported Rating Criteria (pub. 18 Apr 2016)
(https://www.fitchratings.com/site/re/879478)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
(https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=1020537&cft=0)
Solicitation Status (https://www.fitchratings.com/gws/en/disclosure/solicitation?pr_id=1020537)
Endorsement Policy (https://www.fitchratings.com/regulatory)

connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed. The information in this report is provided “as is” without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001

Solicitation Status

Fitch Ratings was paid to determine each credit rating announced in this Rating Action Commentary (RAC) by the obligatory being rated or the issuer, underwriter, depositor, or sponsor of the security or money market instrument being rated, except for the following:

Endorsement Policy - Fitch's approach to ratings endorsement so that ratings produced outside the EU may be used by regulated entities within the EU for regulatory purposes, pursuant to the terms of the EU Regulation with respect to credit rating agencies, can be found on the EU Regulatory Disclosures (https://www.fitchratings.com/regulatory) page. The endorsement status of all International ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for all structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.