FITCH RATES OREGON'S $519MM GO BONDS 'AA+'; OUTLOOK STABLE

Fitch Ratings-San Francisco-28 January 2019: Fitch Ratings has assigned 'AA+' ratings to the following state of Oregon general obligation (GO) bonds:

--$310 million 2019 series A (Article XI-Q State Projects) (Tax-Exempt);
--$40 million 2019 series B (Article XI-Q State Projects) (Federally Taxable) (Sustainability Bonds);
--$20 million 2019 series C (Article XI-Q State Projects) (Federally Taxable);
--$150 million 2019 series D (Articles XI-M, XI-N and XI-P State Grant Programs) (Tax-Exempt).

The bonds are expected to sell via negotiation on or around Feb. 12-13, 2019. They will fund capital improvement projects across 14 state agencies.

Fitch also has affirmed the following ratings:

--Issuer Default Rating (IDR) at 'AA+';
--$6.1 billion in outstanding GO bonds at 'AA+';
--Oregon School Bond Guaranty Program at 'AA+';
--$241 million in outstanding state-appropriation backed bonds at 'AA'.

The Rating Outlook is Stable.

SECURITY
GO bonds are direct general obligations of the state of Oregon, with the full faith and credit of the state pledged to bond repayment.

The outstanding state-appropriation backed bonds are payable from monies appropriated by the state to debt repayment. The one-notch distinction reflects greater repayment optionality.

ANALYTICAL CONCLUSION

Oregon's 'AA+' Issuer Default Rating (IDR) and GO rating reflect the state's strong control over revenues and spending, low liabilities and record of prompt actions to maintain financial flexibility in challenging revenue periods. Strong financial management is critical to the rating given a revenue structure largely dependent on the cyclical personal income tax, exposure to voter initiatives that can have negative fiscal impacts and constitutional 'kicker' provisions that require the return of surplus revenues to taxpayers. There is no state-wide sales tax. The state's operating performance is sustained by a diverse economy with strong growth prospects.

Economic Resource Base
Oregon's economy tends to be more cyclical than the nation's due to its large high-tech sector and international trade activities that expose the state to global economic cycles. The economy has retained its large agriculture and natural resource sectors, although they now represent a smaller proportion of the economy due to the strong growth in the computer and manufacturing sectors, anchoring a diverse, growth-oriented economy.

The state has made steady economic gains in recent years, recording growth rates amongst the strongest of the states. However, based on historical experience, the state remains vulnerable

to sharp declines in economic performance during recessionary periods, a characteristic that Fitch does not expect will change. The state projects that its population and labor force gains will continue, albeit at a slower pace than in recent years, propelled by growing employment opportunities and wage expansion across the state and all major industries. As a result of this job and wage growth, the state is reporting that economic metrics have improved for its most disadvantaged populations and eight of its rural counties have now returned to pre-recession employment levels.

KEY RATING DRIVERS

Revenue Framework: 'aaa'
Fitch expects Oregon's revenues, which have a heavy dependence on personal income tax revenues, to continue to reflect the strength of the economy and its volatility. The state has an unlimited legal ability to raise operating revenues as needed.

Expenditure Framework: 'aaa'
The state maintains ample expenditure flexibility with a low burden of carrying costs for liabilities and the broad expense-cutting ability common to most U.S. states. As with most states, Medicaid remains a key expense driver, but one that Fitch expects to remain manageable.

Long-Term Liability Burden: 'aaa'
Combined debt and pension liabilities represent a low burden on resources, even when taking planned future debt issuances into account. Other post-employment benefit (OPEB) obligations are modest.

Operating Performance: 'aa'
The state's strong management of its financial operations offsets volatility in its revenue sources, leaving it well-positioned to deal with economic downturns. The state has very strong gap-closing capacity in the form of its control over revenues and spending. State balancing measures in downturns include reserve draws and there is a consistent history of rebuilding reserves as the economy strengthens. Voter initiatives periodically affect state finances.

RATING SENSITIVITIES

The rating is sensitive to shifts in the state's fundamental credit characteristics, including its proactive financial management and low liability profile.

CREDIT PROFILE

Revenue Framework
Oregon's general fund relies most heavily on the personal income tax (85% of fiscal 2018 general fund revenues), which has demonstrated some volatility. Further, the state does not fully capture revenue growth since increases more than 2% above the state's close of session forecast are subject to constitutional kicker requirements, whereby excess personal income tax revenue is returned to taxpayers. Corporate income tax collections above the 2% forecast threshold are also subject to kicker requirements; however, excess corporate income tax collections are directed to education in the subsequent biennium and have no impact on the state's general fund revenues.

Historical growth in the state's revenues, after adjusting for the estimated impact of tax policy changes, has generally been above inflation, with robust growth in most years more than compensating for recessionary declines. Kickers for both the personal income and corporate income taxes (approximately $76 million) were triggered at the end of the fiscal 2015-2017 biennium (July 1, 2015 to June 30, 2017) following stronger than forecast growth. Payouts for the personal income tax kicker are distributed as a credit on subsequent tax year filings, while the corporate income tax kicker is dedicated to education funding.

The state's December 2018 economic and revenue forecast indicated that Oregon's economic expansion has slowed and stabilized; job growth has slowed to match population and labor force gains. Nevertheless, state revenue collections continue to outpace the forecast. In part this is due to temporary factors such as households' and businesses' response to federal tax law changes. Consequently, the state now expects to collect more revenue in the current fiscal 2017-2019 biennium and less during the fiscal 2019-2021 biennium. Other factors projected to slow fiscal 2019-2021 revenue growth are supply-side capacity constraints and federal monetary policy. While the December 2018 forecast indicated these factors could dampen the rate of revenue growth in the fiscal 2019-2021 biennium, the state is forecasting continued general fund revenue growth through the fiscal 2025-2027 biennium.

If this forecast comes to pass, both the personal income tax kicker (an estimated $724 million to be credited against 2020 income tax returns) and the corporate kicker (an estimated $230 million for K-12 public education funding) would be triggered for the fiscal 2017-2019 biennium.

The state has no legal limitations on its ability to raise revenues through base broadenings, rate increases, or the assessment of new taxes or fees. The state has a strong track record of adjusting revenues to accomplish programmatic goals. Voters did not approve two citizen initiatives in the November 2018 ballot that could have adversely affected the state's ability to raise revenues in the future.

Expenditure Framework

As in most states, education and health and human services spending are Oregon's largest operating expenses. Education is the larger line item, as the state provides significant funding for local school districts and an extensive public university and college system. Health and human services spending is the second largest area of spending, with Medicaid being the primary driver.

Spending growth, absent policy actions, will likely be slightly ahead of revenue growth driven primarily by Medicaid, requiring regular budget measures to ensure ongoing balance. According to a state forecast, Oregon Health Authority cost shifts to the general fund could increase by an estimated 44% during the fiscal 2019-2021 biennium, significantly contributing to a $623 million budget gap. This 44% estimated increase is being caused by shifting federal resources and the sunset of health care provider assessments. To address that, the Governor's proposed budget contains a $657 million new revenue package to offset increased general fund costs. Some of the new revenue package's components are expected to be politically controversial, potentially placing some of the solution at risk. Any shortfall would likely be met by reprogramming funding away from new policy initiatives.

To protect the general fund, the state has set aside $40 million in an emergency fund in case medical caseloads increase unexpectedly. The fiscal challenge of Medicaid is common to all U.S. states and the nature of the program as well as federal government rules limit the states' options in managing the pace of spending growth. Federal action to revise Medicaid's programmatic and financial structure appears less likely in the near term given divided control in Congress.

In other major areas of spending, Oregon is able to more easily adjust the trajectory of growth since it does not retain responsibility for direct service delivery, although the state has demonstrated strong support for education spending, a fundamental state responsibility. The state's voter initiative process remains very active and successful measures can place a financial burden on the state. The legislature retains the legal ability to modify voter-approved measures, which can provide some budgetary relief. However, the legislature must abide by voter-approved constitutional initiatives, which can only be modified by another voter-approved constitutional amendment.

Overall, Oregon retains ample ability to adjust expenditures to meet changing fiscal circumstances. Spending requirements for debt service, pension and OPEB are manageable at less than 5% of governmental expenditures. The state consistently funds its actuarially determined contributions for the pension system, subject to rate collars that limit and spread large contribution increases over multiple biennia. The state's funding methodology does not smooth asset performance.

Long-Term Liability Burden

Oregon's combined burden of debt and net pension liabilities is low at somewhat over 7% of personal income, assuming the issuance of all planned fiscal 2019 bonds and Fitch's 6% investment return assumption for pension plans.

Debt issuance is closely controlled by the state legislature under state constitutional guidelines. The largest portion of the state's outstanding debt is GO bonds, followed by debt issued for transportation purposes and funded by highway user and gasoline tax revenues. Fitch expects the debt burden to remain low despite the state planning to issue a further $447 million in GO bonds and general fund-backed certificates of participation through May, 2019. The Governor's budget proposal for the fiscal 2019-2021 biennium includes over $1 billion in GO bonds and $301 million in lottery revenue bonds. Fitch expects the debt burden would remain low.

Funding of the Oregon Public Employees Retirement System (OPERS) has declined in the past several years as an adverse 2015 state supreme court ruling was incorporated and changes to actuarial assumptions and methods were executed. The state supreme court decision rejected some of the state's 2013 pension reforms, restoring cost of living increases to retirees and current employees. The decision preserved the cost of living reduction for service performed after the reform law. The adoption of more conservative actuarial assumptions and investment returns below assumptions raised the system's unfunded actuarial accrued liability (UAAL) and led to higher required employer contributions. The state is responsible for approximately 28% of the state-wide UAAL. Using a 6% discount rate results in a Fitch-adjusted increase in the state's proportionate share of the UAAL to an estimated $5.9 billion, with a funded ratio of 70%. Since the state's funding methodology does not smooth asset performance, the liability can change significantly year to year.

To help offset a portion of OPERS rate increases, the state legislature has dedicated portions of several revenue streams to assist school districts and local governments with rising pension system contributions. To begin the process, corporate tax revenues repatriated under federal tax law reform will seed a school district unfunded liability fund side account (up to $115 million) and an employer incentive fund (up to $100 million). Final allocation decisions will be made by OPERS in July 2023. The Governor's budget for the fiscal 2019-2021 biennium proposes augmenting the side account. The legislature also capped OPERS' contingency reserve fund at $50 million, reallocating $533 million to the OPERS benefits in force reserve to support future benefit payments and reduce the UAAL.

OPEB obligations are modest and the state funded the full actuarially required contribution in fiscal 2018. There are no plans to change OPEB entitlements.

Operating Performance

Oregon's ability to respond to cyclical downturns rests with its superior budget flexibility. The state typically takes a multi-prong approach to solving budget gaps during times of budgetary stress; tax rates are adjusted, expenditures are reduced, and the state applies reserves from its rainy day fund and education stability fund to attain balance.

Quarterly economic and revenue forecasts enable the state to quickly identify changes in economically sensitive personal income tax revenues. If the department of administrative services declares a projected budget deficit due to insufficient revenues, with the governor's approval

the department can reduce allotments to prevent the deficit. A separate state emergency board composed of legislative leadership can reallocate appropriations when the legislature is not in session, and the legislature can also apply holdbacks of appropriations.

Accurate revenue forecasting and strong financial management are critical to the rating given a revenue structure largely dependent on the cyclical personal income tax, exposure to voter initiatives that can have negative fiscal impacts, and constitutional kicker provisions that require the return of surplus revenues to taxpayers.

The state historically makes a robust recovery post-recession, allowing it to restore programmatic cuts, bolster aid to education and rebuild reserves. The rainy day fund and the education stability fund are capped at 7.5% and 5.0%, respectively, of general fund revenues in the prior biennium. The combined rainy day fund and education stability fund ending balances for the fiscal 2017-2019 biennium are projected to be $1.2 billion, almost 6% of this biennium's budgeted gross general fund revenues. This would represent a notable increase over the combined rainy day fund and education stability fund reserves at the end of the fiscal 2015-2017 biennium ($761 million, approximately 4% of that biennium's general fund revenues), benefitting from improved revenues.

The state plans to grow its combined rainy day fund and education stability fund reserves to $3.1 billion by the end of the fiscal 2025-2027 biennium (almost 11% of that biennium's projected general fund revenues). This projected growth would result from both automatic deposits and tight restrictions against withdrawals. Withdrawals require one of three triggers (employment decline, a projected budgetary shortfall or declaration of a state of emergency) and a three-fifths vote. Withdrawals from the rainy day fund are capped at two-thirds of the beginning balance for that biennium. General fund and lottery fund ending balances provide additional cushion.

The state's enacted $19.9 billion general fund budget for the fiscal 2017-2019 biennium addressed a $1.4 billion forecast budget deficit that resulted from strong projected growth in expenditures. These included required pension contribution increases, escalating health care services expenses and new funding needs under three ballot measures that were approved by the electorate in November 2016. Enacted measures to solve the budget deficit included the passage of higher assessments on health care providers and a new tax on insurance premiums, a significant reduction in agency budgets, appropriation of cash balances and various fund sweeps and transfers.

The gap was also closed by strong general fund revenue growth and the fiscal 2017-2019 biennium is now expected to close with a $1.3 billion surplus. As a consequence, the Governor's proposed $22.3 billion general fund budget for the fiscal 2019-2021 biennium needed to solve for a much smaller $623 million gap resulting from rising service delivery costs and implementation of governmental priorities, particularly related to health care.

Oregon School Bond Guaranty Program
The Oregon School Bond Guaranty Program provides credit enhancement to school districts. The state treasurer can pledge the full faith and credit and taxing power of the state to guarantee full and timely payment of principal and interest on school bonds. In the event a school district is unable to make a scheduled debt service payment, the state treasurer can make the payment on the school district's behalf and then be reimbursed by that school district for all debt repayment, interest, penalty and other costs incurred, through intercept of state revenues to that school district if necessary.

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Applicable Criteria
U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018)
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