FitchRatings

FITCH PLACES STATE OF ALASKA ON NEGATIVE WATCH; RATES GO BONDS 'AAA'

Fitch Ratings-New York-29 February 2016: Fitch Ratings has assigned an 'AAA' rating to the following obligation of the state of Alaska:

--$151.18 million general obligation (GO) bonds, series 2016A.

The bonds are expected to sell competitively on or about March 9, 2016.

In addition, the series 2016A bonds and the ratings noted below have been placed on Rating Watch Negative. The Negative Watch is expected to be resolved following the state's enactment of a budget for fiscal 2017:

--approximately $753.8 million of outstanding GO bonds rated 'AAA';
--approximately $244 million of outstanding appropriation bonds and certificates of participation (COPs) including the Matanuska-Susitna Borough, Alaska Goose Creek Correctional Center Project lease revenue bonds, series 2008, and the Anchorage, Alaska correctional facilities lease revenue refunding bonds series 2005 rated 'AA+';
--approximately $930 million of outstanding Alaska Municipal Bond Bank Authority (AMBBA) bonds (2005 resolution) rated 'AA+';
--approximately $4 million of outstanding AMBBA bonds (2010 resolution) rated 'AA'.

SECURITY
The GO bonds are general obligations of the state of Alaska to which the full faith, credit, and resources of the state are pledged.

KEY RATING DRIVERS

RATING WATCH REFLECTS UNCERTAINTY: The Rating Watch Negative reflects uncertainty in both the execution and impact of budget initiatives to mitigate reserve draws and reduce revenue uncertainty tied to the natural resources sector. Cornerstones of the governor's proposal include an ongoing and permanent use of investment earnings derived from the state's permanent fund (PF) and a redirection of natural resource market risk to the PF. The governor has also recommended various tax measures and expenditure reductions.
AMPLE RESERVES DESPITE DRAWS: In prior years, Alaska set aside very large reserves for unrestricted general fund (UGF) operating needs, principally in the Constitutional Budget Reserve Fund (CBR) and Statutory Budget Reserve Fund (SBR), two of the state's historically accessible reserves. The realized earnings reserve of the PF also maintains a substantial, accessible balance that is available to fund operating expenses. The balance in the state's PF ($45 billion as of Jan. 1, 2016) requires a constitutional amendment to access.

LARGE BUDGET GAPS, DEEP CUTS: The severe, global decline in crude oil prices has resulted in both current and projected declines in state revenue. To solve for the revenue shortfalls, the state has used a portion of its substantial, accumulated reserves, largely from the CBR and the SBR, in addition to implementing large expenditure reductions. The state's reserves are expected to continue to decline, albeit more modestly, over the next several fiscal years.

CONSERVATIVE FINANCIAL PLANNING: Conservative planning, particularly in the context of currently weak crude oil prices, supports the state's high-quality rating given a limited economy and a budget historically tied to natural resource revenue. Fitch expects Alaska to manage its reserve funds prudently and adjust its expenditures promptly as needed, consistent with the state's historical practice.

HISTORICAL DEPENDENCE ON NATURAL RESOURCES: Both natural resources and the federal government have provided sources of employment and income to Alaska's small population; the volatility inherent in the natural resource industry is the state's primary area of vulnerability. Petroleum-related revenue now accounts for a significantly lower percentage of UGF revenue, although the economy remains centered on the development of the state's natural resources.

MANAGEABLE LIABILITY POSITION: Alaska's debt burden is moderate. The state uses available cash to fund its capital needs and has cash-defeased outstanding obligations when cost-effective. To bolster the funding of its major statewide pension systems, the state deposited $3 billion from its CBR in fiscal 2015 to improve the funded ratios. In addition, the state's other post-employment benefit obligations are largely pre-funded based on current assumptions.

RATING SENSITIVITIES

SUSTAINED FLEXIBILITY: Fitch will resolve the Watch after analyzing the state's enacted budget for fiscal 2017, which begins on July 1. The 'AAA' rating would likely be assigned a Negative Outlook or downgraded if, in Fitch's view, enacted budget measures do not support appropriate levels of long-term financial flexibility relative to the state's revenue structure.

CREDIT PROFILE

Alaska's 'AAA' GO rating reflects the state's maintenance of very substantial reserve balances and conservative financial management practices to offset significant revenue volatility linked to oil production from the North Slope and global petroleum price trends. For many years, the state focused on expected declines in production at its oil fields, prudently dedicating a substantial share of its past oil tax revenue to reserves to ease anticipated revenue loss due to the declines. However, the steep drop in crude oil prices beginning in late 2014 exceeded expectation and significantly reduced tax revenues to the state, requiring sizable use of reserves to fund operations in fiscals 2015 and 2016.

The governor has proposed a fiscal 2017 budget that significantly alters the manner in which the state funds operations in light of its expectation that crude oil prices will remain low. The proposal shifts petroleum-related revenues from the GF to the PF, reducing commodity volatility to the state's revenues but replacing the funds with expected investment earnings off of the large corpus in the PF. While there are several additional fiscally prudent measures proposed in the budget, Fitch believes the reliance on investment earnings to support almost three-quarters of its operating budget is not without risk. Fitch expects to resolve the Rating Watch following an enactment of a budget for fiscal 2017.

Debt practices are conservative, with limited issuance and average amortization. Employment remains generally stable. Although the state has potential exposure to federal employment, its revenue system limits its budget exposure.

RESOURCE-DEPENDENT REVENUE SYSTEM

Alaska's economic and financial performance has been tied closely to its natural resource base, with the state typically deriving between 75% and 90% of its UGF revenues from petroleum-related activity. Fluctuating global energy prices have led to sharp surges and drops in the state's unrestricted general fund revenues, with strong revenue growth through fiscal 2012, together with sizable investment earnings, increasing balances in the state's various reserve funds. The CBR and SBR together grew from $8.1 billion in fiscal 2009 to $17.6 billion in fiscal 2014. The SBR needs only a simple legislative majority to access when the state's budget is in a deficit; a 3/4 majority vote of the legislature is required to access the CBR unless the current year's proposed budget is less than the prior year's budget, in which case the simple majority rule applies as well.

In fiscal 2014, the state approved the transfer of $3 billion of the CBR, to occur in fiscal 2015, to bolster the net position of the state's two largest pension systems, the public employees retirement system (PERS) and the teachers retirement system (TRS). The reduction in future annually required payments that results from the improvement in system funding provides out-year financial flexibility to the state, in Fitch's opinion.

The enacted fiscal 2015 UGF budget incorporated a forecast of oil prices decreasing to $105.06/bbl, with a slight decline in oil production assumed. Fiscal 2015 unrestricted general fund revenues were forecast at $4.5 billion, a 15.3% decline from estimated revenues in fiscal 2014, incorporating the reduced expectation for production tax revenue, decreased revenue related to various tax changes, and the close-out of outstanding capital credits issued under the prior oil production tax system. The enacted $5.9 billion in UGF appropriations (later revised to $6.1 billion) was a substantial decline from the prior year. The enacted budget included a $1.4 billion transfer from the SBR to fund expenditures to offset the lower revenue forecast.

The steep drop in crude oil prices in late 2014 led to the state substantially revising its revenue expectations for fiscal 2015, as the average oil price was revised to $76.31/bbl, increasing the anticipated revenue shortfall in fiscal 2015 to $3.5 billion. The fiscal year ended with oil prices even lower than forecast, at $72.58/bbl, resulting in a revenue shortfall of $3.8 billion that was funded by depleting the SBR, with a total draw of $3.1 billion. The state also drew approximately $706 million from the CBR. Combined with withdrawals for the deposits to the pension systems, the balance in the CBR was reduced to $10.1 billion at fiscal year-end from $12.8 billion in fiscal 2014. The state also recorded a substantial balance in the PF's earnings reserve (PFER) of almost $7.2 billion. Similar to the SBR, the PFER can be accessed by a simple majority vote of the state legislature. Even with these draws, the state's reserves remain substantial at almost 2.9x its operating budget.

The enacted budget for fiscal 2016 funds UGF expenditures of almost $5 billion, a 19% reduction as compared to fiscal 2015. The budget incorporated an expectation of continued soft crude oil prices ($66.03/bbl) and a planned $2.7 billion operating deficit to be funded by a draw of monies from the CBR. The state's fall 2015 revenue forecast recognized the continued turbulence in crude oil prices and lowered the state's revenue forecast to reflect an average price of $49.58/bbl. The forecast revision, despite additional expenditure reductions, has increased the expected budget gap in fiscal 2016 to $3.6 billion (69% of the UGF budget).

Reserves at the close of fiscal 2016 are expected to total $13.4 billion; equal to 2.6x the UGF budget, including about $6.5 billion in the PFER. The governor has proposed moving $5.5 billion from the CBR to the SBR to promote greater financial flexibility as part of his proposed fiscal plan for fiscal 2016, lowering the CBR balance to $1 billion. Access to the PF corpus itself would require an amendment to the state's constitution, a path the state has never pursued even during past multi-year periods of low petroleum prices. The PF, which currently receives an annual allocation of state-derived oil royalties, rents, and bonuses, has increased from $29.9 billion in fiscal 2009 to the current $45.6 billion, incorporating sizable investment earnings on the fund's corpus.

FISCAL 2017 BUDGET PROPOSAL REALLOCATES STATE REVENUE

The governor's budget for fiscal 2017 fundamentally changes the way in which the state finances operations and attempts to shift volatility in the natural resource sector to the PF and PFER from the UGF. The proposal would shift petroleum-related revenues from the GF to the PF (both mineral royalties and production taxes) and replace these funds with a perpetual $3.3 billion annual allocation from the PFER to the UGF (about 69% of UGF expenditures in fiscal 2017). The proposal includes a $3 billion transfer from the SBR to the PFER in fiscal 2017 that would build the corpus to allow it to spin off the targeted investment earnings over the long term.

There are several additional fiscally prudent measures proposed in the $4.75 billion budget, including an over 50% cut to the annual PF dividend payment to residents and continued reductions in operating expenditures. The budget proposes the implementation or increase in several taxes, including re-instituting a state personal income tax; however, the proposals are contained within multiple pieces of legislation, resulting in uncertainty as to the passage of all measures. This potential impediment could increase the amount that is expected to be drawn from the SBR, currently estimated at $300 million in fiscal 2017. Going forward, the state anticipates annual draws on the SBR through fiscal 2018 to fund operations.

Also part of the budget proposal for fiscal 2017, the governor is recommending further reforms to oil production tax credits to increase future revenue to the state; however, the reforms would come at a $1.2 billion cost to the state in fiscal 2017. A revision to the state's oil tax policy was effective on Jan. 1, 2014 - the More Alaska Production Act (MAPA). MAPA taxes oil production on the North Slope of Alaska at 35% of the net value of that production (rather than under the prior taxing system where tax rates increased with additional production), with a credit for each barrel of oil produced and a special reduction in taxes for new oil developments. In Fitch's opinion, one positive of the tax change was the increase in the base tax rate from 25% to 35%, which has been beneficial in the current low price environment.

MANAGEABLE LIABILITY POSITION

The state is an infrequent debt issuer, meeting most capital needs from current revenues. The debt burden as of June 30, 2015 is manageable, with almost $1.1 billion in net tax-supported debt measuring 2.7% of personal income after excluding guaranteed debt of the Housing Finance Corporation, which has never required state support, and reimbursable school debt. Fitch notes that the majority of state debt is currently repaid from petroleum-related revenue, so the debt-to-income ratio is not as meaningful for Alaska as for other states.

The state has undertaken multiple pension reforms in recent years, including switching to defined contribution plans for new employees beginning July 1, 2006, and legislation enacted in 2007 obligating the state to annually consider appropriating for system employers' contributions over a fixed percentage of payroll. The application of $3 billion of CBR funds in 2015 to accelerate progress toward full funding has also improved both systems' funded ratios. As of their June 30, 2015 draft funding valuations, PERS' pension funded ratio was 67%, up from 59.7% a year earlier, and TRS' pension funded ratio was 76.9%, up from 54.5% a year earlier (ratios are not inclusive of employee health benefits).

Based on Fitch's state pension update report, on a combined basis the burden of the state's net tax-supported debt and unfunded actuarial accrued liability for pension obligations, adjusted by Fitch to reflect a 7% return assumption, equaled 14% of 2014 personal income; however, Fitch expects that figure to have moderated following the CBR transfer noted earlier.

Healthcare trusts were established for both PERS and TRS, and as of June 30, 2015, were funded at 98.5% and 100.3%, respectively.

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In addition to the sources of information identified in the Tax-Supported Rating Criteria, this action was additionally informed by information from IHS Global Insight.

Fitch recently published an exposure draft of state and local government tax-supported criteria (Exposure Draft: U.S. Tax-Supported Rating Criteria, dated Sept. 10, 2015). The draft includes a number of proposed revisions to existing criteria. If applied in the proposed form, Fitch estimates the revised criteria would result in changes to less than 10% of existing tax-supported ratings. Fitch expects that final criteria will be approved and published by the end of the first quarter of 2016. Once approved, the criteria will be applied immediately to any new issue and surveillance rating review. Fitch anticipates the criteria to be applied to all ratings that fall under the criteria within a 12-month period from the final approval date.

Applicable Criteria
Exposure Draft: U.S. Tax-Supported Rating Criteria (pub. 10 Sep 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869942
Tax-Supported Rating Criteria (pub. 14 Aug 2012)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015
U.S. State Government Tax-Supported Rating Criteria (pub. 14 Aug 2012)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686033

ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.