FITCH RATES OREGON'S $523MM GO BONDS 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-23 January 2017: Fitch Ratings has assigned an 'AA+' rating to the following general obligation (GO) bonds of the state of Oregon:

--$243.53 million 2017 series A tax-exempt Article XI-Q state projects (new money);
--$40.285 million 2017 series B federally taxable Article XI-Q state projects (new money);
--$107.23 million 2017 series C tax-exempt Article XI-M seismic projects (new money);
--$25.735 million 2017 series D tax-exempt Article XI-N seismic projects (new money);
--$62.795 million 2017 series E tax-exempt Article XI-J alternate energy projects (refunding);
--$19.67 million 2017 series F federally taxable Article XI-J alternate energy projects (refunding);
--$23.475 million 2017 series G federally taxable Article XI-Q state projects (refunding).

The bonds are expected to price via negotiation on or about Feb. 8, 2017.

The Rating Outlook is Stable.

SECURITY
The bonds are general obligations of the state of Oregon, with the full faith and credit of the state pledged to bond repayment. The bonds are being issued under the authority of Articles XI-J, M, N and Q of the Oregon Constitution.

KEY RATING DRIVERS

Oregon's 'AA+' rating and Stable Outlook 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 (PIT), 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 statewide 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 those sectors now represent a smaller proportion of the economy due to the strong growth in the computer and manufacturing sectors. Fitch expects the state's population and labor force growth to continue, propelled by growing employment opportunities.

Revenue Framework: 'aaa' factor assessment
Fitch expects Oregon's revenues, with a heavy dependence on the PIT, to continue to reflect the strength of the economy, as well as its volatility. The state has complete control over its revenues, with an unlimited legal ability to raise operating revenues as needed.

Expenditure Framework: 'aaa' factor assessment
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' factor assessment
Debt levels are above average for a U.S. state but are a low burden on resources. On a combined basis, the burden of the state's net tax-supported debt and unfunded pension obligations is below the median for U.S. states. Other post-employment benefit (OPEB) obligations are small.

Operating Performance: 'aa' factor assessment
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 revenue 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 affected 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

Oregon's economy continues to grow beyond once dominant natural resources, with significant high technology and manufacturing sectors now anchoring a diverse, export-oriented economy. Despite steady gains in recent years, economic performance is prone to sharp declines during recessionary periods, a characteristic Fitch expects to remain unchanged. Fitch believes recent solid growth trends will continue, supported by employment and wage expansion across the state and across all major industries. Employment growth in 2015 registered 3.3% compared to 2.1% for the nation and as of November 2016, the state is slightly ahead of the nation in jobs regained since the recession, at 180%. Unemployment rates are higher than the nation; 5% in November for the state compared with 4.6% for the nation; but the rate continues to reflect strong growth in the state's labor force; up 4.4% year over year compared with 1.3% for the U.S.

Revenue Framework
Oregon's general fund (GF) is largely dependent on the PIT, which accounted for about 87% of GF revenues in the 2013-2015 biennium. There is some volatility to PIT collections and increases more than 2% above the state's close of session (COS) forecast are subject to "kicker" requirements, whereby excess revenue is returned to taxpayers. Corporate income taxes (CIT) that are above the 2% forecast threshold are also subject to kicker requirements; however, excess CIT collections are directed to education in the following biennium and have no impact on the state's GF revenues.

Historical growth in the state's revenues, after adjusting for the estimated impact of tax policy changes, has generally been above inflation over the past 10 years, with robust growth in most years more than compensating for recessionary declines. In tandem with continuing economic growth, the state's recently updated revenue forecast includes 12.3% growth in the PIT from the prior biennium. The December 2016 revenue forecast projects PIT revenues just slightly below (0.2%) the forecast used to enact the current biennial budget while total net GF revenues continue to align with the COS forecast. The constitutional "kicker" provisions for the PIT and CIT were triggered under both taxes at the end of the 2013-2015 biennium following stronger growth than forecast coming out of the recession.

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 and the state has a strong track record of adjusting revenues to accomplish programmatic goals.

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. The fiscal challenge of Medicaid is common to all U.S. states and the nature of the program limits the states' options in managing the pace of spending growth. 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. A voter initiative, approved in 2012, now directs CIT revenue in excess of the revenue forecast to elementary and secondary education, providing an additional source of support. Federal action to revise Medicaid's programmatic and financial structure appears likely, although the magnitude and timing of changes for state budgets remains unknown. Both the new Presidential administration and Congressional leadership support significant Medicaid policy shifts. As one of the largest parts of state budgets and by far the biggest source of federal funding to the states, federal decisions could have significant implications for states' ability to manage this key budget item.
While Medicaid remains a notable cost pressure, spending requirements for debt service, pension, and OPEB are manageable; carrying costs total only 4.9% of expenditures. The state consistently funds its actuarially calculated annual required contributions (ARC) 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. OPEB obligations are modest and the state made 100% of the ARC payments for the two PERS' plans in fiscal 2016. Contributions toward the Public Employees Benefit Board OPEB plan are made on a pay-as-you-go basis.

A 2015 state Supreme Court decision rejected some of the state's 2013 pension reforms, restoring cost of living (COLA) increases to retirees and current employees. Together with the adoption of more conservative actuarial assumptions, this will lead to higher employer contributions beginning in the 2017-2019 biennium. The decision preserved the COLA reduction for service performed after the reform law. Based on the 2015 state public employees' retirement system (PERS) actuarial valuation and bound by the contribution rate collar, the state's employer contribution will increase by the maximum allowed 3% of payroll in the upcoming biennium. The $315 million increase includes about $62 million for state employees and approximately $253 million for local school district employees. Overall, Oregon retains ample ability to adjust expenditures to meet changing fiscal circumstances.

Long-Term Liability Burden

Per Fitch's October 2016 State Pension Update report, the state's total long-term liability burden, including net tax-supported debt and net pension liabilities (NPL) for PERS, at 4.8% of 2015 personal income, was below the 50-state median of 5.1%; this figure does not incorporate the impact of the Supreme Court pension decision in 2015.

As of June 30, 2016, the state's debt burden at 4.4% of 2015 personal income is above U.S. state averages but remains a low burden on resources. The state issues debt for a variety of programs, including seismic rehabilitation, higher education, and to support mortgage loans for veterans' housing. As of June 30, 2016, there was $1.8 billion in outstanding GO pension obligation bonds; total GO bonds represent 60% of the state's outstanding debt. The next largest share of debt has been issued for transportation purposes and is funded by highway user taxes, including gasoline taxes.

Based on PERS' fiscal 2016 financial report, which accounts for the COLA ruling and the actuarial assumption changes, the system NPL was $15 billion as of June 30, 2016, up from $5.7 billion the prior year; the state's share of the liability is approximately 20%.

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 (RDF) and education stability fund (ESF) to attain balance.

The state's quarterly economic and revenue forecasts enable the state to quickly identify changes in the economically sensitive PIT. If the department of administrative services (DAS) declares a projected budget deficit due to insufficient revenues, with the governor's approval, DAS may reduce allotments. A separate state emergency board comprised of legislative leadership can reallocate appropriations when the legislature is not in session, and the legislature can apply holdbacks of appropriations.

Accurate revenue forecasting is also critical for the state's financial goals given constitutional kicker provisions. For the 2013-2015 biennium, kickers were triggered for both the PIT and the CIT following stronger than forecast economic and revenue growth. Due to actions undertaken by the 2011 legislature, a $402 million PIT kicker was applied as a credit on 2015 tax returns, reducing revenue in the current 2015-2017 biennium. A CIT kicker payment of $59 million is applied to K-12 funding in the 2017-2019 biennium due to a 2012 ballot measure that reallocated these funds.

The state historically makes a robust recovery post-recession, allowing it to restore programmatic cuts and bolster aid to education. Conservative fiscal management is reflected in its commitment to rebuilding reserves if they have been tapped during times of revenue weakness. The RDF is capped at 7.5% of GF revenues in the prior biennium and the ESF is capped at 5% of GF revenue received in the prior biennium. Total reserves at the conclusion of the 2013-2015 biennium totaled $391.2 million, equal to 4.6% of fiscal 2015 revenue alone.

Current Developments

The enacted budget for the 2015-2017 biennium included almost $18 billion in GF expenditures, supported by 12% growth in projected revenues at COS to $17.96 billion, and 12.6% growth in PIT; a December 2016 update left the state's revenue expectations unchanged. The state's reserve funds are expected to increase to a combined $770 million, up from $391 million at the conclusion of the 2015 biennium, and equal to 8.5% of revenue in fiscal 2017 alone.

The governor's proposed budget for the 2017-2019 biennium includes $19.6 billion in GF expenditures funded by 8.3% growth in projected GF revenues and proposed revenue enhancements. The slower growth rate for GF revenues in the next biennium reflects a slower pace of expected economic expansion although income and employment growth are projected to remain ahead of national averages. The proposal addresses a $1.8 billion forecast budget gap for the combined general and lottery funds that results from required pension contribution increases, escalating health care services expense, and new funding needs for three ballot measures that were approved by the electorate in November 2016. The revenue forecast will be next updated on Feb. 22, 2017.

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Date of Relevant Rating Committee: April 28, 2016

Additional information is available at 'www.fitchratings.com'.

In addition to the sources of information identified in the applicable criteria specified below, this action was informed by information from Lumesis and InvestorTools.

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