FITCH DOWNGRADES ALASKA'S IDR TO 'AA'; RATES $29MM AMBB 'AA-'; OUTLOOK TO STABLE

Fitch Ratings-New York-02 November 2017: Fitch Ratings has assigned a 'AA-' rating to $28.955 million Alaska Municipal Bond Bank Authority (AMBB or the bond bank) general obligation (GO) bonds 2017 Series Three.

The bonds are scheduled to sell via competitive bid on Nov. 14, 2017.

In addition, Fitch has downgraded the following ratings linked to the state of Alaska:

--Issuer Default Rating (IDR) to 'AA' from 'AA+';
--Approximately $777 million state GO bonds to 'AA' from 'AA+';
--Approximately $243 million state appropriation bonds to 'AA-' from 'AA';
--Approximately $1 billion bond bank 2005 resolution bonds to 'AA-' from 'AA';
--Approximately $4 million bond bank 2010 resolution bonds to 'A+' from 'AA-';
--Approximately $140 million bond bank 2016 resolution bonds to 'A+' from 'AA-'.

The Rating Outlook has been revised to Stable from Negative.

SECURITY
The bonds are general obligations of the bond bank, for which the state maintains an annual standing appropriation of state general fund resources to replenish the bonds' reserve fund in the event of borrower default. GO bonds issued under the 2005 resolution also incorporate multiple layers of security on both the borrower and state level. The standing appropriation is the basis for the assigned rating on the 2005 resolution bonds.

State GO bonds are general obligations of the state of Alaska to which the full faith, credit and resources of the state are pledged. Lease-purchase obligations are secured by annual appropriations from the state's unrestricted general fund (UGF).

ANALYTICAL CONCLUSION

The downgrade of Alaska's IDR and GO rating to 'AA' from 'AA+' incorporates a material decline in financial resilience over the past several years as the state struggled with the economic and revenue effects of the downturn in energy markets. Despite significant expenditure reductions and the recent halving of the statutorily determined permanent dividend payment to residents, the state has relied on one-time resources, primarily reserve fund draws, to address large remaining revenue shortfalls, and prospects for growth in its petroleum-based operating revenue system remain constrained by the extended low price environment, which Fitch expects to continue. The state has applied balances in its substantial accessible reserves, principally the Constitutional Budget Reserve Fund (CBRF) and the Statutory Budget Reserve Fund (SBRF) to close budget gaps, depleting the SBRF and reducing the balance in the CBRF to a level that provides much reduced cushion.

The state expects to turn to its accessible permanent fund earnings reserve (PFER), an accessible reserve that accumulates realized earnings on the state's sizable permanent fund, to aid the operating budget and projects a continual reliance on appropriations from this reserve over the medium term. Fitch believes that this reliance could further weaken the state's resilience in the absence of changes to the state's current fiscal policies if the PFER is gradually reduced. Under certain assumptions, Fitch projects PFER depletion could occur as early as fiscal 2027, though depending on decisions for inflation proofing, growth in annual draws, and amount of dividend payout, the PFER could remain sufficient well beyond this date, providing the basis for the Stable Outlook.

The 'AA' rating continues to incorporate the state's ongoing reliance on revenues tied to oil production and related volatility, a moderate liability burden, and substantial independent control over revenue raising and expenditure decisions.

Economic Resource Base
Alaska's economy is largely based on the development and application of its abundant natural resources, the production of crude oil and natural gas deposits, prominent fishing industry, and mining and tourism. The oil and gas sector has a broad impact on the state's economy due to the direct, indirect, and induced impacts from the drilling and production effects of the turbulent oil and natural gas sectors; a primary source of vulnerability for the state. The state's gross state product (GSP) has notably declined in three of the last four years, reflecting the rapid deterioration in crude oil prices that began in late 2014 that reduced related employment and grew the state's 2016 unemployment rate to 135% of the nation's. Crude oil production continues to approximate recent averages despite ongoing soft prices reflecting the long-term nature of mostly conventional oil drilling in Alaska as compared to shale development in the lower 48 states.

The significant downturn in the state's operating revenues over this time has led to large cuts in state expenditures, further eroding the economic base, as government employment remains a key input for the state's economy, accounting for 19.5% of GDP. Federal employment contributes 7.7% to state GDP and has also declined over the past several fiscal years. Trade and transportation is a significant component of the economy, providing 18% of GDP. Overall employment growth as compared to the nation remains subdued with above-the-nation unemployment rates YTD through 2017.

KEY RATING DRIVERS

Revenue Framework: 'a'
The state is expected to continue to derive an outsized proportion of its operating revenues from taxation, leasehold interest, and royalty payments related to petroleum development. These narrow revenue sources will continue to reflect the economic volatility tied to the extensive natural resources sector. The state plans to supplement these sources by annual draws from the state's PFER over the medium term. The state has complete control over its revenues, with an unlimited independent legal ability to raise operating revenues as needed.

Expenditure Framework: 'a'
The state maintains solid expenditure flexibility with a manageable 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 and Fitch believes the state will be challenged in meeting expenditure growth well above the pace of natural revenue growth.

Long-Term Liability Burden: 'aa'
Debt levels are low but on a combined basis, the state's net tax-supported debt and unfunded pension obligations are well above the median for U.S. states as a percentage of personal income. Given the sizable support of the budget by natural resource activity, liabilities are viewed as a more moderate burden on GDP. Other post-employment benefit (OPEB) obligations are sizable but well-funded. Both pension and OPEB liabilities are constitutionally protected benefits.

Operating Performance: 'aa'

Historically, the state's strong management of its financial operations and extraordinarily sizable reserve balances has offset volatility in its revenue sources; however, the state ended fiscal 2017 with its fifth consecutive operating deficit, balancing its budget through an appropriation from its reserves, and sizable annual deficits are projected through the forecast horizon. Absent revenue reform, the state anticipates relying on annual draws from reserves to balance its budget through the forecast period. Based on Fitch's analysis, this could result in reserve depletion as early as fiscal 2027, although Fitch believes the many options available to the state in managing these reserves extend that date and could remove depletion risk. While the state's permanent fund is robustly funded, the corpus may only be accessed through an amendment to the state constitution.

RATING SENSITIVITIES

LINKAGE TO STATE OF ALASKA: The rating on obligations of the bond bank is sensitive to movement in the state's IDR to which they are linked.

FINANCIAL RESILIENCE: The Stable Outlook at the 'AA' level incorporates the sustainability of continued draws on the state's accessible reserves and Fitch's expectation that the state will act in a way so as to remain adequately positioned to address potential fiscal stress through a moderate downturn. An unexpected slump in crude oil prices that severely impacts the state's financial operations would put pressure on the rating.

CREDIT PROFILE

Revenue Framework

Historically, the state's operating budget (UGF) has been almost entirely supported by volatile petroleum-related revenues. In fiscal 2014, at the peak of oil prices, 88% of UGF revenues were derived from this sector; this ratio has declined to about 65% in fiscal 2017 due to the substantial decline in oil prices. Modest, additional sources of UGF revenue include various excise taxes, corporate income taxes, and fisheries and mining taxes. The state does not levy a personal income or sales tax. Historically, the state has applied funds from its accessible reserves to fund operations when petroleum-related revenue has fallen short.

Petroleum-related revenues include the state's tax on the value of oil and gas production and the collection of oil and gas royalties, lease payments, and bonuses. The state receives these revenues on its land leased for natural resource development as well as 50% of royalties and leases from development on federal land in the National Petroleum Reserve (NPR). A portion of these revenues are restricted with constitutional and statutory requirements for deposits to certain accounts including the state's permanent fund, the public school fund trust, and special revenue funds for municipalities that are affected by development in the NPR.

Oil and gas production tax revenue is a function of both price and production with significant declines in oil prices that began in late 2014 eroding recent collections. The state's preliminary 2017 fall oil production forecast continues to project long-term declines in production but at a much reduced rate compared to prior forecasts due to better operator performance as well as methodology changes, improving the outlook for future UGF revenue collections.

Historical growth in the state's revenues, after adjusting for the estimated impact of tax policy changes, was well ahead of national GDP growth over the 10 years through 2014, with solid growth in oil prices that reached a recent peak of $113 per barrel (bbl) in June 2014, more than offsetting some fiscal year declines, producing increasing but volatile state tax revenues. However, the loss of state tax revenues related to the dramatic decline in oil prices that began after this peak to lows reaching $30/bbl has resulted in sizable, annual operating deficits since fiscal 2015. The state's revenue forecast assumes steady growth in oil prices from the $49.43/bbl base in fiscal 2017; however, while the gradual price escalation to $75/bbl by 2027 and revenue performance expectations would result in positive growth, they build from a base that is insufficient to fund the state's current expenditures.

The governor has proposed a number of recurring revenue measures to reduce the reliance on petroleum-based revenues; however, most proposals have not received sufficient traction in either regular or special legislative sessions to move ahead. Sufficient support was received for implementing changes to the state's oil and gas production credit system that eliminated the ability of producers to significantly reduce their tax burden, resulting in a positive impact to revenues. The legislature is currently debating the governor's payroll tax proposal in a special session that would produce about $300 million in annual UGF revenue, an amount well below the state's current budget gap. Fitch believes it is unlikely that the tax will pass in the current special session.

Fitch's Analysis of PFER Draws

As noted above, the state expects to rely on draws from its PFER to fund operations and the state anticipates these annual draws to continue indefinitely. The state may choose to offset the magnitude of the draws by continuing to reduce the dividend payments and continuing to suspend the statutorily required inflation proofing of the permanent fund, a tactic taken over the past two fiscal years. Under these scenarios, the state forecasts continued growth in the PFER despite the annual draws, premised on a 6.75% annual return assumption on permanent fund investments and no UGF expenditure growth through 2026.

Fitch tested the state's expectations by applying a range of return assumptions for the Permanent Fund's investments, selecting a 6% investment return for the base case and assuming what Fitch views as a more realistic 2% annual growth in expenditures. Fitch considered scenarios where annual inflation proofing was implemented and those when it was not, as well as testing varying levels of annual dividend payments given the state's recent reductions.

Fitch's analysis determined a depletion date as early as fiscal 2027 based on the state making the full statutorily determined dividend payment, full inflation proofing, and a 2% growth rate in the annual draw on the PFER. Additional potential outcomes include depletion dates in the mid-2030s based on full inflation proofing and the recent reductions in the annual dividend, absent more robust revenue growth or actions by the state. These outcomes consider a dividend payment at 50% of the statutorily determined rate, full inflation proofing, and a 2% annual growth in the draw from the PFER, or a scenario with a 67% dividend payout ratio, full inflation proofing, and no growth in the draw rate. Variations around these forecasts depend on the level of annual investment return as well as the decision to inflation-proof the fund's corpus with possible outcomes either shortening or lengthening the life of the PFER, including outcomes that determined no depletion of the PFER. Note that this analysis, which is intended to provide general guidance as to the sustainability of drawing from the PFER, is predicated on numerous assumptions in a forthcoming Fitch special report on this subject.

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.

Expenditure Framework
As in most states, education and health and human services spending are Alaska's largest operating expenses. Education is the larger line item, as the state provides significant funding for local school districts and the public university. Health and human services spending is the second largest area of spending, with Medicaid being the primary driver. Beginning in fiscal 2017, the permanent fund dividend payment to residents is a UGF appropriation rather than a direct payment from the PFER ($695.7 million in fiscal 2017 and increasing to $760 million in fiscal 2018). The payment has been funded by a transfer from the PFER to the UGF.

Fitch expects that spending growth, absent policy actions, will be ahead of natural revenue growth, driven primarily by Medicaid, and require regular budget adjustments to ensure ongoing balance. The fiscal challenge of Medicaid is common to all U.S. states and the nature of the program as well as federal government rules that limit the states' options in managing the pace of spending growth. Fitch believes the state will be particularly hard-pressed to fund program requirements and other spending priorities from its recurring revenues given its forecast for an extended low oil price environment.

Federal action to revise Medicaid's programmatic and financial structure remains a possibility given recent federal legislative and administrative efforts. Most proposals to date include a basic restructuring of federal Medicaid funding to a capped amount. Whether a change in federal Medicaid funding has consequences for Fitch's assessment of a state's credit quality would depend on the state's fiscal response to those changes. Responses that create long-term structural deficits or increase liability burdens could negatively affect both the expenditure framework assessment and the IDR.

Alaska retains a solid ability to adjust expenditures to meet changing fiscal circumstances although that strength has been weakened by recent actions to reduce expenditures. While Medicaid remains a notable cost pressure, spending requirements for debt service and pension obligations are manageable. The state has taken important steps to improve pension funding through deposits from the CBRF to lower its actuarially determined employer contribution (ADEC). Pension and OPEB benefits for state employees and teachers are constitutionally protected, reducing the state's flexibility to make cuts as an employer or in additional contributions that are required by state statute; SB125 commits the state, subject to the annual appropriation process, to funding the difference between specified employer contributions and the ADEC.

Long-Term Liability Burden
The state has been an infrequent debt issuer, meeting most capital needs from annual revenues. The debt burden as of June 30, 2017 is low, with just over $1 billion in net tax-supported debt measuring 2.6% of personal income after excluding guaranteed debt of the Housing Finance Corporation's Veteran's Mortgage Program, which has never required state support, and reimbursable municipal general obligation debt issued for school construction.

The state has undertaken multiple pension reforms in recent years, including switching to defined contribution plans for new employees beginning July 1, 2006, and enacted legislation in 2007 obligating the state to consider appropriating for local government and school district contributions over a fixed percentage of payroll. The application of $3 billion of CBR funds in 2015 accelerated funding progress for the state employees' (PERS) and teachers' (TRS) systems. As of the June 30, 2016 financial statements, PERS' assets covered 66.4% of liabilities and TRS' assets covered 75.8% of liabilities, incorporating the one-time payments to the system and other programmatic adjustments.

Using a more conservative 6% return assumption for pensions, instead of the 8% rate assumed under the state's accounting valuation, results in a state liability burden of 22.1% of 2016 personal income; one of the highest among U.S. states. Fitch notes that the majority of state debt is currently repaid from petroleum-related revenue, so the debt-to-income ratio, with lower personal income metrics, is not as meaningful for Alaska as for other states. Retiree healthcare trusts were established for both PERS and TRS, and as of June 30, 2016, were funded at 96% and 101%, respectively.

Operating Performance
The state's financial performance has been tied closely to trends in its natural resource base with sizable accessible reserves bolstering operations during downturns. Fluctuating global energy prices have led to sharp surges and drops in the state's UFG revenues, with strong revenue growth

increasing balances in the state's various reserve funds. The CBRF and SBRF together grew from $8.1 billion in fiscal 2009 to $17.6 billion in fiscal 2014 prior to declining to about $4.7 billion in fiscal 2017. Funds in the SBRF were depleted in fiscal 2015 in response to the revenue shortfall and the state currently forecasts only a modest balance remaining in the CBRF, which is funded by legal settlement revenue, by fiscal 2020 due to anticipated operating deficits. A 3/4 majority vote of the legislature is required to access the CBRF unless the current year's proposed budget is less than the prior year's budget, in which case a simple majority rule applies; a simple majority rule also applies to accessing the PFER, which receives ongoing funding from investment earnings on the permanent fund. The PFER balance totaled $12.8 billion in fiscal 2017. Combined, available balances in fiscal 2017 were equal to 3.4x of the state's total annual UGF budget and are anticipated to increase in fiscal 2018 largely from investment earnings on the permanent fund.

Including the PFER, the state's Permanent Fund held a fund balance of $59.8 billion as of June 30, 2017. The fund receives an annual allocation of state-derived oil royalties, rents, and bonuses. Access to the almost $47 billion fund corpus itself would require an amendment to the state's constitution, a path the state has not pursued to date.

Through the current period of financial stress, the state has implemented substantial cuts to its expenditures and roughly halved the permanent fund dividend the past two fiscal years, yet these meaningful actions have been insufficient to balance the state's budget. Revenue proposals to date have not received sufficient traction for passage, resulting in the rapid depletion of the state's reserves and weakening its resiliency. While accessible reserves are expected to remain considerable in the short term, providing a buffer for prospective action, the balance reductions and their potential depletion in the absence of offsetting action is concerning given the state's limited economy and ongoing reliance on revenues tied to oil production.

Financial operations continue to be supported by fiscal management that closely tracks revenue collections and expenditures during the year. The state updates its revenue forecasts twice yearly and each forecast extends for 10 years. The forecast employs the state's extensive knowledge of ongoing and planned natural resource development.

Recent Operating Performance

Not inclusive of the permanent fund dividend of $695.7 million that was half of the statutorily determined allocation, UGF expenditures in fiscal 2017 totaled almost $4.5 billion, a 13.7% reduction from fiscal 2016. The budget incorporated continued soft crude oil prices and a planned $2.5 billion draw from the CBRF to fund operations but did not include any significant revenue raising measures despite the governor's proposals to increase taxes. Crude oil prices remained subdued but were fairly close to the state's expectations at $49.43/bbl.

The UGF budget for fiscal 2018 totals $4.3 billion, a 3.6% reduction from fiscal 2017, and does not contain any significant revenue-raising measures. The legislature is currently meeting in a special session to consider the imposition of a payroll tax for funding the budget although Fitch views prospects for passage as slim. Without enacting new revenue measures, the budget as approved by the legislature relies upon an additional $2.5 billion allocation from the state's reserves (57% of the UGF budget).

Alaska Municipal Bond Bank

In addition to the standing state appropriation, GO bonds issued under the 2005 resolution also incorporate multiple layers of security on both the borrower level and the state level. Issuance requires either a borrower's GO or revenue pledge or other evidence of pledged revenues for allowable debt obligations, with a borrower reserve available for revenue bonds. Bond bank borrowers must demonstrate project essentiality and ability to repay in order to access financing.

The 2017 series three bonds will be loaned to the Kenai Peninsula Borough's Central Peninsula General Hospital for various capital projects.

The bond bank maintains a pooled program reserve fund for the 2005 resolution bonds of approximately $63.2 million as of Sept. 1, 2017. No additional deposit to the reserve fund is required by the current issue, as existing assets, including cash and surety policies, exceed the post-issuance reserve requirement. The program reserve fund is backed by a moral obligation of the state established by state statute requiring establishment of a reserve and requiring that the bond bank chair seek a general fund appropriation to restore the program reserve to the required level in the event of a borrower's payment default. This pledge was strengthened with the bond bank's commitment in 2009 to seek an annual standing appropriation for these bonds and the state's subsequent annual appropriations, including in the fiscal 2018 budget. There have been no payment defaults under the program to date.

Payments by the borrowers are due seven days prior to a debt service payment, providing sufficient timing to access bond bank resources in the event of a missed payment. Further protections include a state intercept of local aid for borrowers and the ability to access the bond bank's unrestricted funds held in the custodian account. The custodian account is currently funded at approximately $11 million and is expected to be maintained at this approximate level in future years, although direct loans by the bond bank and deposits to reserve funds may diminish the custodian account balance.

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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.

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Applicable Criteria
U.S. Public Finance Tax-Supported Rating Criteria (pub. 31 May 2017)
https://www.fitchratings.com/site/re/898466

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