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Hawaii Moves To Tame Its OPEB Liability

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SAN FRANCISCO (Standard & Poor's) July 23, 2013--Helped by a stronger revenue outlook, Hawaii took steps on several fronts in its recently enacted budget to shore up its financial position. Benefits from the new provisions, passed as part of the budget and as distinct statutes during the legislative session, will strengthen the state's fiscal position in both the near and longer term, in Standard & Poor's Ratings Services' view. Most notably, in our opinion, the state initiated a multiple year process of increasingly prefunding its other postemployment benefit (OPEB) liability in the form of its large retiree health care benefit. It also took advantage of an improving revenue picture to rebuild budget reserves, which it had been drawing down in recent years. And finally, with an eye to the state's finances beyond the two-year budget window, the state made permanent some temporary tax revenue enhancements that were scheduled to sunset in fiscal 2015. Taken together, we view these actions as having favorable implications for the state's credit profile.

At the same time, however, we believe the budget also includes some new spending on program enhancements that could eventually result in fiscal pressure. In particular, general fund spending, budgeted to increase 10.9% in fiscal 2014 and a more modest 1.2% in fiscal 2015, is growing faster than the state's 4.7% average total personal income growth since 2000. Some of the growth relates to the state's new pre-kindergarten education program and some reinvestment in computer technology and accounting systems that may offer longer term efficiencies.

For the current biennium, the state's economic climate and rising revenue trajectory help accommodate the efforts at both fiscal consolidation and program expansion. And, in our view, by rebuilding its "rainy day" reserves and beginning to confront long-term debt pressures while the economy is

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growing, the state is exhibiting the financial management characteristics consistent with its rating category. A key to the state's future credit trajectory likely hinges on its ability to follow through on its OPEB funding measures when revenue growth ebbs lower. In our view, building up its budgetary reserves now helps enhance its future fiscal flexibility and better positions it to weather an economic slowdown should one occur.

CONTRIBUTING THE ARC TO OPEB IS A MULTIPLE-YEAR PROJECT

Initially, the state's higher OPEB contributions -- while material -- remain well below the annual (actuarially) required contribution (ARC). In fiscal 2013, the state spent $275.9 million on OPEB, which, given its pay-as-you-go approach, equaled just 28% of the ARC. The new budget includes $100 million of prefunding in fiscal 2014 and another $117.4 million for fiscal 2015. Separate legislation establishes an upwardly trending contribution glide path so that, by fiscal 2019, the state's annual funding would match the ARC.

Because the new funding policy will take several years to ramp up, the full benefits may not be realized in the short term (one to two years). Moreover, assuming economic and tax revenue trends soften at some point in the next several years, we believe the state's commitment to the new higher contributions could be put to the test.

In general, we view the state's willingness to begin confronting its OPEB liability as favorable. We have previously noted that, at $13.6 billion as of fiscal 2012 or $9,750 per capita (2012 population estimates), the state's OPEB liability poses a risk to the state's long-term credit quality. The new legislation, even if it does not result in immediate improvement to the state's rating, is beneficial to our view of its credit quality.

RECAPITALIZING RESERVES DEMONSTRATES COMMITMENT TO FISCAL SOUNDNESS

In another move with potential future-year benefit to the state's finances, Hawaii lawmakers included appropriations to the state's hurricane relief and emergency and budget reserve funds in the new budget. At $211 million across the two-year budget period, the total amount of reserve recapitalization exceeds the state's earlier plans for $161 million in reserve replenishment during the current biennium. We view the state's follow through on, and supplement of, its reserve replenishment effort as favorable for its credit quality. By the end of the biennium, the state will have a combined balance of $256 million in the hurricane relief and emergency and budget reserve funds, according to the budget. At this level, the rainy day reserves (not including the general fund ending balance) would equal 4.2% of fiscal 2015 general fund spending, offering what we view as a good cushion against periods of weaker economic and revenue performance. The state's rebounding economy is estimated to have resulted in a healthy, $500 million (or higher) ending general fund balance in fiscal 2013, equal to around 9% of general fund appropriations.

BOOST TO REVENUE BASELINE BENEFITS STATE'S FISCAL STRUCTURE BEYOND THE CURRENT BIENNIUM

On the revenue side, the legislature acted to prevent some temporary tax

enhancement provisions from expiring at the end of fiscal 2015, improving its future-year fiscal outlook. The changes include retaining a cap on the amount of transient occupancy tax (TAT) revenue distributed to local governments and maintaining a 9.25% TAT rate (instead of allowing it to revert to 7.25%). Without making these features permanent, the state's independent Council on Revenue (COR) forecasted in May that the state's general fund tax revenue growth rate would slump to 1.5% in fiscal 2016 from 7.0% in 2015. The new legislation boosts revenue by an estimated $175 million-to-$200 million, according to the state. Using the COR's May revenue forecast, we estimate that with the additional revenue, the state's general fund tax revenue would increase at a rate of 4.7% in fiscal 2016. As a permanent adjustment, the legislation will also similarly elevate the state's revenue baseline for future years beyond fiscal 2016, which we also view as favorable.