

December 4, 2017

Mason County
411 N 5th Street
Building 1
Shelton, WA 98584
Attention: Ms. Lisa Frazier, Treasurer

Re: *Mason County, Washington, General Obligation Bonds*

Dear Ms. Frazier:

S&P Global Ratings has reviewed the rating on the above-listed obligations. Based on our review, we have lowered the underlying rating (SPUR) from "AA-" to "A+" and changed the outlook to negative from stable. A copy of the rationale supporting the rating and outlook is enclosed.

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S&P Global Ratings

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tel 415 371-5000
reference no.: 1504042

December 4, 2017

Mason County
411 N 5th Street
Building 1
Shelton, WA 98584
Attention: Ms. Lisa Frazier, Treasurer

Re: *US\$6,295,000 Mason County, Washington, Limited Tax General Obligation
Refunding Bonds, Series 2017, dated: Date of delivery, due: December 01, 2042*

Dear Ms. Frazier:

Pursuant to your request for an S&P Global Ratings rating on the above-referenced obligations, S&P Global Ratings has assigned a rating of "A+" . S&P Global Ratings views the outlook for this rating as negative. A copy of the rationale supporting the rating is enclosed.

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cc: ***Mr. Scott J. Bauer, Financial Advisor***
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Summary:

Mason County, Washington; General Obligation

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Related Criteria And Research

Summary:

Mason County, Washington; General Obligation

Credit Profile

US\$6.295 mil ltd tax GO rfdg bnds ser 2017 due 12/01/2042

Long Term Rating A+/Negative New

Mason Cnty ltd tax GO bnds

Long Term Rating A+/Negative Downgraded

Mason Cnty GO

Unenhanced Rating A+(SPUR)/Negative Downgraded

Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings lowered its rating on Mason County, Wash.'s limited-tax general obligation (LTGO) bonds to 'A+' from 'AA-'. At the same time, S&P Global Ratings assigned its 'A+' rating to the county's LTGO refunding bonds, series 2017. The outlook is negative.

The lowered rating reflects our view of the deterioration in the county's budgetary performance, leading to a significant reduction in budgetary flexibility. The negative outlook reflects our view of a one-in-three chance that we could lower the rating, potentially by multiple notches, within our two-year outlook horizon if the county finishes fiscal 2017 with another deficit and we come to view the county as structurally imbalanced.

The LTGO bonds are secured by the county's full faith and credit, including the obligation to levy ad valorem taxes, subject to statutory limitations on annual property tax revenue growth without a voter override and on a maximum levy rate per \$1,000 of assessed value. We understand that the proceeds will be used to refund the county's outstanding series 2002 LTGO bonds (payable from sewer revenue) and advance refund the county's outstanding series 2008 LTGO bonds.

The rating further reflects our assessment of the following factors for the county:

- Adequate economy, with market value per capita of \$110,643 and projected per capita effective buying income at 82.6% of the national level;
- Strong management, with good financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Weak budgetary performance, with operating deficits in the general fund and at the total governmental fund level in fiscal 2016;
- Strong budgetary flexibility, with an available fund balance in fiscal 2016 of 10.8% of operating expenditures;
- Very strong liquidity, with total government available cash at 39.9% of total governmental fund expenditures and 8.7x governmental debt service, and access to external liquidity we consider strong;
- Very strong debt and contingent liability position, with debt service carrying charges at 4.6% of expenditures and net direct debt that is 43.1% of total governmental fund revenue, as well as rapid amortization, with 73.4% of debt

- scheduled to be retired in 10 years; and
- Adequate institutional framework score.

Adequate economy

We consider Mason County's economy adequate. The county has an estimated population of 63,190. The county has a projected per capita effective buying income of 82.6% of the national level and per capita market value of \$110,643. Overall, the county's market value grew by 0.6% over the past year to \$7.0 billion in 2017. The county unemployment rate was 7.8% in 2016.

Mason County is located southwest of the Puget Sound in northwestern Washington. Shelton, the county seat, is located about 20 miles from Olympia. The Olympic National Forest and Olympic National Park encompass the northwestern portion of the county. The county's economy was historically concentrated in timber; however, the aquaculture industry, particularly shellfish, has been expanding, helping diversify the economy somewhat. According to management, exports to Asian markets account for a significant portion of the economic activity. The county's largest employers are the Little Creek Casino Hotel (800 employees), Washington Corrections Center (640), Mason General Hospital (625), and Shelton School District (624).

Strong management

We view the county's management as strong, with good financial policies and practices under our FMA methodology, indicating financial practices exist in most areas, but that governance officials might not formalize or monitor all of them on a regular basis.

Highlights of the county's approach to financial management include:

- A budget formation process that incorporates internal and external analyses of historical revenue and expenditure trends;
- An annual budget process with budget-to-actual reports presented to the county board quarterly and updated throughout the year if necessary;
- A lack of any formal long-term financial forecast beyond the budgeted year;
- A five-year rolling capital improvement plan, updated annually as part of the budget process, that identifies all known funding in the budgeted year;
- A formal investment policy coupled with quarterly presentation of holdings and earnings reports to the board's investment subcommittee;
- A formal debt policy that specifies qualitative and quantitative guidelines but does not contain monitoring requirements; and
- A recently adopted reserve policy of maintaining general fund reserves equal to 12%-15% of the prior year's actual expenditures in addition to a \$1 million contingency reserve. The policy specifies that the county will build up balances over the next five to six years into compliance with the new policy.

Weak budgetary performance

Mason County's budgetary performance is weak in our opinion. The county had operating deficits of 5.0% of expenditures in the general fund and of 3.8% across all governmental funds in fiscal 2016.

General fund revenue includes a mix of property taxes, sales and use taxes, and real estate excise taxes, which in 2016 accounted for \$12.3 million (or 41%), \$6.7 million (or 22%), and \$1.6 million (or 5%), respectively, of the county's

general fund revenue.

Between 2014 and 2016, the county's general fund supported a jail construction project that resulted in nearly \$4 million in one-time construction and inmate relocation costs over three years. In addition, the county made a \$1.2 million payment from the general fund in 2016 to settle an outstanding dispute over construction costs from an earlier project in the county's Belfair wastewater system. These amounts have been adjusted out of the county's general fund expenditures. The general fund recorded a \$1.2 million nonspendable receivable from the Belfair fund, which, according to management, was repaid in fiscal 2017.

After accounting for these one-time costs, the county ran a 1.5% (\$0.5 million) deficit in fiscal 2015 and a 5.0% (or \$1.7 million) deficit in fiscal 2016. According to management, the county used fund balance in 2015 and 2016 to support ongoing salary increases. Management suggested that the county's practice of including all available fund balance above the 5% reserve requirement as a budgeted revenue contributed to these deficits and has since changed this practice. While the county initially adopted its 2017 budget with a 9.2% deficit, it passed an amended budget in July 2017 that reduced expenditures, resulting in a revised deficit of \$866,000, or roughly 2.8% of operating expenditures. However, management expects to end the year with break-even results due mostly to general fund revenues coming in higher than budgeted.

The county also faces risks associated with two of its enterprise funds: Belfair and Rustlewood. In the county's 2016 financial statement audit, the auditor indicated that Belfair Wastewater system, which recently issued revenue debt to expand the system, did not receive sufficient additional users and so is not generating enough revenue to pay the system's debt service. According to management, the county is using real estate excise tax and sales tax revenue from other governmental funds outside the general fund to support the enterprise. As a result, the general fund is not currently subsidizing the enterprise. Management is currently finalizing plans to expand the system over the next several years in the hopes of stabilizing the fund. The county expects to resolve the auditor's concerns about the Rustlewood enterprise by adopting an updated rate structure that will keep pace with cost increases.

We also note that the county's November 2017 ballot measure for a levy lid lift to support general fund operations was not approved by voters. At this point, we don't view the county as operationally imbalanced; however, we note that the county is experiencing significant fiscal pressure.

We have additionally adjusted general fund expenditures upward and the corresponding net transfers downward in 2014, 2015, and 2016 to reflect ongoing transfers out for to various special funds to support maintenance and operations. We have also adjusted general fund revenues upward and the corresponding net transfers upward in 2014, 2015, and 2016 to reflect ongoing transfers in from various other governmental funds.

Strong budgetary flexibility

Mason County's budgetary flexibility is strong, in our view, with an available fund balance in fiscal 2016 of 10.8% of operating expenditures, or \$3.6 million.

The county has drawn down available reserves significantly in recent years--to \$3.6 million (or 11% of operating expenditures) in fiscal 2016 from \$9.2 million (or nearly 35% of operating expenditures) in fiscal 2014. And while \$4 million of the drawdown was related to one-time costs associated with the jail construction project, the county also

used some fund balance in 2015 and 2016 to support ongoing salary increases.

In 2017, the county adopted a new fund balance policy of 12%-15% of operating reserves plus a \$1 million contingency reserve; the policy stipulates that the county will build the reserve over the next five to six years. Based on budget projections for fiscal 2017, we expect the ending available general fund balance to remain slightly above 8% of adjusted expenditures in the current and subsequent fiscal years.

The county has nearly \$200,000 in "banked" levy capacity, or flexibility to raise its property taxes above a statutory limit on growth in property tax revenue, in its general fund.

Very strong liquidity

In our opinion, Mason County's liquidity is very strong, with total government available cash at 39.9% of total governmental fund expenditures and 8.7x governmental debt service in 2016. In our view, the county has strong access to external liquidity if necessary.

We believe the county's investment policy restricts its ability to maintain an aggressive investment portfolio, and we have not identified any contingent risks that would jeopardize the county's liquidity. On Dec. 31, 2016, the county had \$123.9 million, or 90% of the county's \$137.4 million in total cash and investments, invested with the state's local government investment pool. We do not expect the county's liquidity position to deteriorate over the medium term, based on historical performance and a lack of identified material risks to liquidity.

Very strong debt and contingent liability profile

In our view, Mason County's debt and contingent liability profile is very strong. Total governmental fund debt service is 4.6% of total governmental fund expenditures, and net direct debt is 43.1% of total governmental fund revenue. Approximately 73.4% of the direct debt is scheduled to be repaid within 10 years, which is in our view a positive credit factor.

According to management, the county has no authorized but unissued bonds outstanding, nor does it anticipate issuing additional long-term general fund bonds in the medium term.

Mason County's combined required pension and actual other postemployment benefit contributions totaled 4.1% of total governmental fund expenditures in 2016. The county made its full annual required pension contribution in 2016.

The county participates in the Public Employees' Retirement System (PERS), the Public Safety Employees Retirement System (PSERS), and the Law Enforcement Officers and Firefighters' Retirement System (LEOFF), each cost-sharing, multiemployer plans managed by the state. Using updated reporting standards in accordance with Governmental Accounting Standard Board (GASB) Statement No. 67 and 68, the county's net pension liability as of June 30, 2016, was \$7.5 million for PERS 1, \$7.8 million for PERS 2/3, and \$222,000 for PSERS 2. As of the same date, the county had a net pension asset in the LEOFF 1 and LEOFF 2 of \$196,000 and \$866,000, respectively.

Adequate institutional framework

The institutional framework score for Washington counties is adequate.

Outlook

The negative outlook reflects our opinion that there is a one-in-three chance that we could lower the rating within our two-year outlook horizon. If the county finishes 2017 with another deficit and we come to view the county as structurally imbalanced, we could lower our rating--potentially by multiple notches. However, we could revise the outlook to stable if the county ends 2017 and 2018 with at least balanced results and the county adopts a plan for its Belfair Wastewater system, which, in our view, sufficiently mitigates risk to the county's general fund.

Related Criteria And Research

Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Incorporating GASB 67 And 68: Evaluating Pension/OPEB Obligations Under Standard & Poor's U.S. Local Government GO Criteria, Sept. 2, 2015
- 2017 Update Of Institutional Framework For U.S. Local Governments

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