

RatingsDirect®

California's GO Debt Upgraded To 'A+' From 'A' On Strengthened Budget Stabilization Account; Outlook Stable

Primary Credit Analyst:

David G Hitchcock, New York (1) 212-438-2022; david.hitchcock@standardandpoors.com

Secondary Contact:

Gabriel J Petek, CFA, San Francisco (1) 415-371-5042; gabriel.petek@standardandpoors.com

NEW YORK (Standard & Poor's) Nov. 5, 2014--Standard & Poor's Ratings Services has raised its rating on the State of California's general obligation (GO) debt to 'A+' from 'A', and raised its rating on the state's general fund annual appropriation-secured debt to 'A' from 'A-'. The outlook on both ratings is stable.

"The upgrades follow voter approval on Nov. 4, 2014, of a strengthened budget stabilization account under Proposition 2," said Standard & Poor's credit analyst David Hitchcock. "In our view, the new state constitutional provision will partially mitigate California's volatile revenue structure by setting aside windfall revenue for use during periods when state tax revenue could fall materially short of forecast," Mr. Hitchcock added.

The enacted provisions have become part of the state constitution and, as such, cannot be overridden during the annual budgetary process. California has had a history of leaving its budget stabilization account (BSA) unfunded until the current budget year.

The upgrade on California's general fund appropriation-secured debt follows the upgrade on the state GO debt. This rating is below the GO rating due to pledged revenues subject to annual state appropriation.

Other key factors supporting the 'A+' GO rating include our view of California's:

California's GO Debt Upgraded To 'A+' From 'A' On Strengthened Budget Stabilization Account; Outlook Stable

- Diverse economy of 38.3 million people, or 12% of the total U.S. population;
- Recent commitment to aligning recurring revenues and expenses, while simultaneously paying down budgetary debts, and an improved cash position;
- Timely enactment of budgets following a constitutional amendment requiring only majority legislative consent to approve budgets, which has reduced exposure to liquidity shortfalls; and
- Moderately high bonded debt.

Somewhat offsetting these strengths are what we consider the state's:

- Volatile revenue base, which is linked to difficult-to-forecast financial market performance because of a highly progressive income tax structure, and still relatively modest reserves as a percent of expenditures;
- Potential for current structural budget balance to erode when voter-approved tax hikes fully expire in 2018, or sooner if the legislature were to significantly increase ongoing spending; and
- Large retirement benefit and budgetary liabilities.

The state's general fund serves as the source of all GO bond repayment, to which California has pledged its full faith and credit.

The stable outlook reflects our view that California will build a material BSA fund balance in the coming years under recently passed Proposition 2, and that it will continue to pay down deferred liabilities and debt in advance of the 2018 expiration of a temporary income tax surcharge. The outlook also reflects a state financial position at the end of fiscal 2014 that was its strongest position of the past decade. The paydown of budgetary deferrals could accelerate if revenues come in ahead of budget, and trigger certain provisions in the budget. However, reserves are expected to remain slim in relation to budgeted expenses, while waiting for Proposition 2 to go into effect. Potential developments that could lead to a positive outlook or upgrade would include an improved budget process, with a midyear budget review and an institutional framework for timely midyear corrective budget actions; or a reduction in the state's very significant pension, other postemployment benefits (OPEB), and debt liabilities. A downgrade could occur if significant structural budgetary imbalances reappeared, potentially due to a sharp decline in budgeted revenues, or if the state developed cash flow problems. Although California has recently addressed its teacher pension underfunding, the state continues to carry a large unfunded OPEB that could prove troublesome if not eventually addressed.

RELATED CRITERIA AND RESEARCH

Related Criteria

- USPF Criteria: Contingent Liquidity Risks, March 5, 2012
- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- Criteria: Joint Support Criteria Update, April 22, 2009
- USPF Criteria: Appropriation-Backed Obligations, June 13, 2007
- USPF Criteria: Financial Management Assessment, June 27, 2006

California's GO Debt Upgraded To 'A+' From 'A' On Strengthened Budget Stabilization Account; Outlook Stable

Related Research

- U.S. State And Local Government Credit Conditions Forecast, Oct. 15, 2014

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.

Copyright © 2014 Standard & Poor's Financial Services LLC, a part of McGraw Hill Financial. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgement as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription) and www.spcapitaliq.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.