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

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:

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.