
California LAO's Report Confirms State's Favorable Credit Position.

SAN FRANCISCO (Standard & Poor's) Nov. 19, 2015—Standard & Poor's Ratings Services said that the upbeat report issued yesterday by the nonpartisan California Legislative Analyst's Office confirms our interpretation of the state's finances that we published in August.

The findings in the new LAO report coincide with what we said in our Aug. 18 analysis of California (AA-/Stable) that we anticipated. Most significantly, the rules around how much of new revenue growth are mandated by Proposition 98 to go toward education are set to relax a bit. Essentially, in recent years, the state has paid down large obligations left over from the financial crisis that it owed to the schools. Now that the state has funded most of those requirements, the rules under Proposition 98 change and provide lawmakers with considerably more discretion over how to allocate revenues in the budget.

The fact that the state is in this position is favorable. Lawmakers have managed the state's finances well over the past several years, taking advantage of the requirement to allocate new revenues to education to reverse payment deferrals and pay down funding gaps dating to 2009. But it's clear that the sense of urgency in Sacramento is shifting away from ensuring the state's fiscal solvency toward addressing some of California's pressing needs in other policy areas. With high rates of poverty and a chronic shortage of affordable housing, there is an understandable demand from some in the legislature and other policy advocates for increased spending on various social services.

When we look at the state's credit profile overall we still see some meaningful long-term challenges. From a credit perspective, Governor Jerry Brown's first few budget proposals appropriately focused on stabilizing the patient, so to speak. California had deep cash and budgetary deficits that amounted to financial crisis. As time has passed, the governor's priorities have gradually evolved, from focusing on the immediate fiscal crisis to the longer-term issues facing the state. He has pushed for and achieved certain pension reforms and the rainy day fund measure—which voters approved last November. He also called a special session of the legislature to try to identify a source of funding for the backlog of deferred maintenance on the state's transportation infrastructure. The administration has also been working with the labor unions to try to get agreement on prefunding the state's retiree health care liability.

Some of those longer term liabilities and other challenges—along with the state's underlying propensity for revenue volatility—still weigh on California's credit rating. There is a zero-sum element to the upcoming budget negotiations. To the extent the state makes new spending commitments on the social service front, they would crowd out some of its fiscal capacity to address the longer term impediments to a higher rating. This dilemma is in a way the optimistic scenario. It's in the context of an ongoing economic expansion—now in its seventh year. The choices would become much more difficult if the economy—or stock market—were to go into a slide.

While the LAO report paints a relatively sanguine picture of the state's fiscal condition, the budget process is not likely to be any easier and may be even more complicated now. In a few years we might look back at this period as having been pivotal. The tradeoffs that lawmakers face are difficult. They can place a newfound dollar in the state’s OPEB trust for retiree health care or they can spend it on expanded social services. In other words, does the state follow through on its multiple-year fiscal recovery project or does it turn its attention to addressing other policy priorities? While we recognize that it’s far from the only consideration, the resilience of California’s credit rating under certain potential stress scenarios could hang in the balance.

We have determined, based solely on the developments described herein, that no rating actions are currently warranted. Only a rating committee may determine a rating action and, as these developments were not viewed as material to the ratings, neither they nor this report were reviewed by a rating committee. Standard & Poor’s Ratings Services, part of McGraw Hill Financial (NYSE: MHFI), is the world’s leading provider of independent credit risk research and benchmarks. We publish more than a million credit ratings on debt issued by sovereign, municipal, corporate and financial sector entities. With over 1,400 credit analysts in 26 countries, and more than 150 years’ experience of assessing credit risk, we offer a unique combination of global coverage and local insight. Our research and opinions about relative credit risk provide market participants with information and independent benchmarks that help to support the growth of transparent, liquid debt markets worldwide.

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