

RATING ACTION COMMENTARY

Fitch Rates California's \$807MM Lease Revenue Bonds 'AA-'; Outlook Stable

Thu 12 Sep, 2024 - 4:48 PM ET

Fitch Ratings - New York - 12 Sep 2024: Fitch Ratings has assigned 'AA-' ratings to \$807 million Lease Revenue Refunding Bonds 2024 series C (Various Capital Projects) to be issued by the California State Public Works Board (SPWB).

The bonds are scheduled to price via negotiation on Sept. 24, 2024. Bond proceeds will be used to refund and defease three series of outstanding lease revenue bonds

The Rating Outlook is Stable.

RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕	PRIOR ↕
California, State of (CA) [General Government]	LT AA- Rating Outlook Stable	Affirmed AA- Rating Outlook Stable

[VIEW ADDITIONAL RATING DETAILS](#)

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Strong fiscal management, institutionalized across administrations and demonstrated through the buildup of the budgetary stabilization account (BSA) and elimination of past budgetary borrowing, allows the state to withstand economic and revenue cyclicity.

The magnitude and timing of California's revenue shortfall in fiscal 2024, despite ongoing economic expansion, led the state to take both ongoing and temporary budgetary actions to balance in fiscal 2025. The enacted budget for fiscal 2025 better aligns revenue and expenditures, but is structurally imbalanced before reserve draws and leaves gaps in the outyears that the state will need to address in future budgets.

Fitch Ratings will continue to assess the state's ability to align its core spending with anticipated slower, more normal revenue growth, the scope of nonrecurring budgetary balancing actions, and the extent to which the state uses future economic growth to rebuild its financial resilience. While Fitch believes the enacted budget allows California to retain strong gap-closing capacity, supporting its 'AA' IDR/Stable Outlook, further steps to balance the budget using dedicated reserves could erode credit quality.

The 'AA-' rating on lease revenue bonds, one notch below California's IDR, reflects the slightly higher degree of optionality associated with payment of appropriation debt. Lease revenue bonds are payable from base rental payments made by participating state agencies to the SPWB.

SECURITY

The lease revenue bonds are payable from base rental payments made by participating state agencies to the SPWB from first lawfully available funds for use and occupancy of the facilities, subject to annual legislative appropriation or a continuing appropriation.

KEY RATING DRIVERS

Revenue Framework - 'aaa'

Tax revenues are dominated by personal income taxes, which are economically sensitive, particularly those related to capital gains. Long-term growth prospects for revenues are strong, driven by the state's robust economic fundamentals. The state retains the independent legal ability to raise taxes, subject to a legislative supermajority voting

California has a solid ability to reduce spending throughout the economic cycle, although its flexibility is somewhat more restricted than most states due to constitutional requirements for funding education and voter initiatives that limit state discretion. However, Proposition 98 school funding requirements also decline relatively quickly when revenues decline, acting as a form of automatic stabilizer during a downturn.

Long-Term Liability Burden - 'aaa'

Long-term liabilities, while above the median for U.S. states, remain a low burden on the resource base. The state is addressing its pension liabilities with measures including benefit changes, supplemental contributions, and a long-term plan to increase contributions to the teachers' system.

Operating Performance - 'aa'

California's strong budget management during the extended period of economic expansion and revenue growth following the Global Financial Crisis allowed the state to materially improve its financial position and enhance its ability to address future fiscal challenges. The state has eliminated budgetary liabilities and built a rainy day fund, enacted on-time, structurally balanced budgets and generally used a prudent approach to managing demands for additional spending. Addressing the revenue gap in the fiscal 2024 and 2025 budgets has utilized some of its available tools to balance, but the state retains adequate resilience to its relatively more cyclical economic environment.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

-- An inability to align spending demands and revenue growth in the context of ongoing economic and revenue growth, including further draws on dedicated reserves, leaving the combined balance below 10% of revenues and indicating weakened overall budgetary resilience.

-- A sustained slowing of economic growth that reduces Fitch's expectation for revenue growth prospects closer to the national rate of inflation

-- A material increase in the state's financial resilience and ability to absorb volatility in revenues, such as maintaining combined dedicated reserves closer to or above 20% of revenues.

PROFILE

California's economy is unmatched among U.S. states in size and diversity, leading to consistent overall growth despite a considerable presence of the more cyclical IT industry. Population growth has historically exceeded the U.S. average, with relatively high levels of immigration partially offsetting domestic outmigration, although growth has slowed and outmigration has increased. Although California's economic expansion between the Great Recession and the recent pandemic-related recession was among the strongest of the states, employment growth has slowed and now lags the U.S. average. Fitch Ratings expects California's long-term growth to return to the longer-term strong trend.

ADDITIONAL SECURITY DETAILS

The SPWB is one of California's primary means of financing state facilities, with bonds benefitting from a strong lease structure and the essential nature of leased assets. Debt service is paid from base rental payments made pursuant to specific facility leases. Base rental payments are appropriated annually by the legislature, with the lessee agency required to use the first funds lawfully available to it in each fiscal year for base rental payments on SPWB debt. Abatement is possible, but abatement risk is mitigated by a requirement to maintain rental interruption insurance.

State law provides a continuing appropriation for the base rental payments to be applied to pay debt service in the event required base rental payments have not been included in the annual budget adopted by the state or if the state is then operating without a budget but only if funds are available and the state (or state agency) has use and occupancy of the leased facility.

DATE OF RELEVANT COMMITTEE

15 August 2024

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

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Fitch notes an emerging issue related to Data Quality and Transparency, reflecting the state's lateness in producing GAAP-based audited financial statements. The state was significantly delayed in producing its fiscal 2021 (ended June 30) Annual Comprehensive Financial Report (ACFR), which was released in March 2023. Similarly, the fiscal 2022 ACFR was released in March 2024. This is reportedly due to difficulties in implementation of a new accounting program in fiscal 2019. The state controller anticipates bringing the timing of future ACFR releases current by March 2026, for the fiscal 2025 ACFR.

Habitually delayed publication of audited financial results, beyond 270 days of the end of the fiscal year, can be an indication of management weakness. Fitch remains confident that the state provides transparency on its financial operations through an abundance of financial, budgetary and revenue information that is robust and timely.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit

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APPLICABLE CRITERIA

[U.S. Public Finance State Governments and Territories Rating Criteria \(pub. 02 Apr 2024\)](#)
(including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.1.0 (1)

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