S&P Global
Ratings

RatingsDirect®

Summary:
California; General Obligation

Primary Credit Analyst:
Geoffrey E Buswick, Boston + 1 (617) 530 8311; geoffrey.buswick@spglobal.com

Secondary Contact:
Oscar Padilla, Dallas + 1 (214) 871 1405; oscar.padilla@spglobal.com

Table Of Contents

Credit Highlights

Outlook

Related Research

Summary:

California; General Obligation

Credit Profile		
US$584.0 mil tax-exempt various purp GO rfdg bnds due 08/01/2035		
Long Term Rating	AA-/Stable	New
US$325.0 mil federally taxable various purp GO bnds due 08/01/2029		
Long Term Rating	AA-/Stable	New
US$55.0 mil federally taxable various purp GO rfdg bnds due 08/01/2031		
Long Term Rating	AA-/Stable	New

Credit Highlights

- S&P Global Ratings assigned its 'AA-' long-term rating to the State of California's $964 million general obligation (GO) bonds.
- The outlook is stable.

Security

The state's general fund is the source of all GO bond repayment, to which California has pledged its full faith and credit. State funding to the public K-12 school systems and higher education institutions is the only obligation that, according to the California Constitution, is a higher priority for general fund cash than GO debt service payments.

The issue is composed of three GO components:

- $584 million Tax-Exempt Various Purpose General Obligation Refunding Bonds (final maturity Aug. 1, 2035)
- $325 million Federally Taxable Various Purpose General Obligation Bonds (final maturity Aug. 1, 2029)
- $55 million Federally Taxable Various Purpose General Obligation Refunding Bonds (final maturity Aug. 1, 2031)

Proceeds of the bonds will be used to fund projects authorized by the bond acts; pay certain commercial paper obligations outstanding as they mature; pay capitalized interest through Dec. 31, 2025, on certain federally taxable various purpose GO bonds; refund certain GO bonds outstanding; and pay costs of issuance.

Credit overview

With the budgetary course correction now embedded in the state's fiscal 2025 budget, it is not yet clear whether enough was done to align expenditures with revenue expectations against the backdrop of a slowing national economy. As adopted, the state's fiscal 2025 budget reflects, in our view, a balanced mix of revenue and expenditure solutions that preserves sufficient reserves (for now) to address unexpected budgetary pressure should it arise, although not without credit risk. Overall, we anticipate credit metrics will remain near current levels. Our rating reflects a one-notch downward holistic adjustment within our methodology due to California's cyclical fiscal history and potential outyear spending pressures, which could affect future structural financial balance; the adjustment also reflects issues of financial transparency regarding timely release of financial audits.

Budget development for fiscal 2025, as in fiscal 2024, proved challenging, although this was met with responsive budgetary management, in our opinion, and the state took action to effectively rein in a $46.8 billion budget gap. The about-face to deficit from surplus is a common thread underpinning our view of California's cyclical financial results, in part due to the disproportionately high amount of general fund revenue generated through personal income taxes (PIT) from the state's top taxpayers. For context, relative to when the state's fiscal 2023 budget was adopted, the three principal revenue sources--personal income, corporate income, and sales taxes-- were estimated to be 24.2% and 22.6% higher in fiscal years 2024 and 2025, respectively, compared with the Department of Finance's (DOF's) latest forecast (May 2024). With hindsight to the degree of revenue softness, which did not become apparent until delayed income tax collections came through in November 2023, overlapping two fiscal years, we believe budgetary corrective actions would have occurred sooner, easing the task to achieve structural budget balance.

To resolve the operating deficit, much as in fiscal 2024, the state relied on a mix of budgetary maneuvers, including shifts, reductions, deferrals, and delays. Unlike in fiscal 2024, however, it opted to use about $5 billion from the budget stabilization account (BSA) and $900 million from the safety net reserve. The budget assumes that an additional $7.1 billion will be drawn from the BSA in fiscal 2026. The budget also cuts about $16 billion across agencies and incorporates the approximately $17 billion in savings in the legislative early-action package in April, which implemented solutions over the now-completed fiscal 2024 and the current year, fiscal 2025.

General fund revenue is forecast to grow approximately 8% compared with fiscal 2024 (excluding transfers from the BSA). The forecast increase partially reflects strengthening personal income taxes and the effect of the net operating loss suspension and credit limitation (captured in corporate income tax), which collectively account for $14.6 billion of the forecast approximately $16 billion general revenue increase for the year. On the expenditure side, the general fund is 5.2% lower than in fiscal 2024. In a sign that the revenue has reversed course, the DOF reports personal income tax withholding cash receipts were up 7.8% year over year for the first half of the calendar year.

Lending credit support in the medium term, the state's BSA is estimated to total $17.6 billion, or 8.3% of general fund expenditure by fiscal year-end. This reflects the decrease from the estimated $22.56 billion, or 10% of general fund expenditures to close out fiscal 2024. While the revenue picture evolved quickly, California maintains a very strong liquidity position--approximately $97 billion of unused, internally borrowable resources at the end of September--and the ability to issue external cash flow notes provides the state with ample flexibility to maneuver through the fiscal year, in our view. Together with its reserves, albeit declining, these factors help offset, to some degree, the risk we see from the state's historically volatile revenue.

With the expectation of monetary policy gradually easing into next year, a soft landing remains on target, although a mix of geopolitical risks, a potentially disruptive U.S. election in the fall, and disorderly reaction by financial markets could weigh on the overall macroeconomic outlook. Currently, S&P Global Ratings' economists are forecasting steady U.S. real GDP growth of 2.7% in 2024, and are still expecting the economy to transition to below-trend growth of 1.8% in 2025. For 2024, S&P Global Market Intelligence (data compiled as of September 2024) forecasts that the state's economic growth will be slightly lower than the national level, although slightly exceeding the nation at 1.9% in 2025. Compared with our third-quarter forecast, national GDP growth projections were revised slightly up as a result of the positive financial conditions and stronger core goods consumption. For more information, see "Economic Outlook U.S. Q4 2024: Growth And Rates Start Shifting To Neutral," published Sept. 24, 2024, on RatingsDirect.

Budgetary and economic considerations aside, a credit constraint remains the state's chronically late release of financial audits, using generally accepted accounting principles (GAAP). The annual comprehensive financial report (ACFR) for fiscal year ended June 30, 2023, is not yet released. Although the release of the state's fiscal 2022 ACFR came sooner than in fiscal 2021, it was nevertheless also a year beyond its own regulatory deadline. However, the state has continued to release timely unaudited monthly agency cash revenue reports and monthly controller's reports on cash receipts and disbursements, although these are not reported on a GAAP basis and lack the ACFR's required supplementary financial notes regarding pensions, other postemployment benefits (OPEBs), and other disclosures. We believe timely release of ACFRs would aid California in reporting transparency and help validate budgetary-basis disclosures and trends in revenue and fund balances.

Credit fundamentals supporting the 'AA-' long-term rating include:

- A deep and diverse economic base, as might be expected in a state encompassing about 12% of the total U.S. population, coupled with comparatively higher income levels compared with those of peers;
- Currently high financial reserves with substantial internally borrowable nongeneral funds, partially due to the constitutional requirements of Proposition 2, along with ample liquidity, although it could be pressured should structural imbalance become a trend;
- Volatile revenue, because of the state's reliance on a highly progressive PIT structure and dependence on capital gains tax realizations, which have historically led large revenue swings when financial markets are volatile;
- Overall stable debt profile with manageable and generally stable pension liability funding progress, which we believe is sustainable although prefunding of its large retiree health care benefits (OPEBs) is minimal, which could escalate in the future; and
- An institutional framework that we believe is generally comparable with that of other states.

Environmental, social, and governance

California faces exposure to various physical risks, including wildfires, drought, floods, and natural disasters such as earthquakes, which can affect its economy and disrupt population migration. In response to these risks, the state incorporates increased spending into its long-term financial and capital planning. Compounding the potential demographic and economic disruptions from physical risks are the shortage of affordable housing--including insurance costs and availability, high social service costs, and the income disparity that exists throughout the state. In addition, about one-third of the population relies on Medicaid. However, we believe California is addressing these issues through increased funding for various social programs, such as bond-financed programs for housing of the homeless and mentally ill, changes to residential zoning laws, and higher social service spending.

A governance weakness, cited above, is that the state has persistently provided audited results well after the end of its fiscal year. Its most recent available audited financial statements are for fiscal 2022, and were released in mid-March 2024, which is well beyond that of similarly rated peers and that we consider very late.

Outlook

The stable outlook reflects our view that the state's overall strong fiscal position and tools position it to manage through potential budgetary strain stemming from weaker-than-estimated revenue collections. In addition, we expect California will work to achieve longer-term structural balance, even if it opts to use available reserves to balance its budget beyond fiscal 2025.

Downside scenario

An inability to readily adapt to an evolving revenue and economic outlook, with an eye toward long-term structural balance, could lead to a lower rating.

Upside scenario

The possibility of a higher rating is limited. All else equal, it would depend in large part on the state's ability to achieve a higher degree of revenue stability and predictability, while continuing to build stronger reserves to guard against periods of volatile revenue.

Table 1

California--credit summary	
Institutional framework (IF)	2
Individual credit profile (ICP)	1.81
Economy	1.0
Financial performance	2
Reserves and liquidity	1
Debt and liabilities	3.00
Management	2.05

Table 2

California--key credit metrics

	Most recent	2022	2021	2020
Economy				
State population ('000s)	38,967	39,031	39,131	39,445
GSP per capita ($)	82,975	81,158	80,377	74,051
GSP per capita % of U.S.	125	125	126	122
State PCPI ($)	80,252	77,032	77,014	70,161
State PCPI % of U.S.	117	118	120	119
State unemployment rate (%)	4.7	4.3	7.3	10.2
Financial performance - S&P Global Ratings adjusted				
Operating fund revenues (mil. $)	179,227	223,503	186,810	145,082
Operating fund expenditures (mil. $)	195,189	216,785	162,129	146,285
Operating result (mil. $)	(15,962)	6,718	24,681	(1,203)
Operating result % of revenues	(8.9)	3.0	13.2	(0.8)
Reserves and liquidity - S&P Global Ratings adjusted				
Available reserves (mil. $)	67,571	81,288	52,453	20,632

Table 2

California--key credit metrics (cont.)				
	Most recent	**2022**	**2021**	**2020**
Available reserves % of operating revenues	37.7	36.4	28.1	14.2
Debt and liabilities				
Net direct debt cost % of revenues	--	3.9	2.5	3.9
Pension and OPEB cost % of revenues	--	3.3	2.4	4.9
Total current cost % of total government revenues	--	7.2	4.9	8.8
Net direct debt (mil. $)	--	80,973	81,219	82,054
Net direct debt per capita ($)	--	2,075	2,076	2,084
Direct debt 10-year amortization (%)	--	52	49	50
Combined net pension liabilities (mil. $)	--	61,904	54,663	58,143
Net pension liabilities per capita ($)	--	1,586	1,397	1,477
Combined pension plan funded ratio (%)	--	81.8	85.4	78.4

GSP--Gross state product (real). PCPI--Per capita personal income (nominal). OPEB--Other postemployment benefits. The economic data is being sourced directly from S&P Market Intelligence and is updated frequently as national sources update their data including the U.S. Bureau of Ecoomic Analysis, Bureau of Labor Statistics, and Census. Data is annual. Available reserves include the budget stabilization account, public school system stabilization account, special fund for economic uncertainties, and the safety net reserve. Most recent financial numbers reflect unaudited results.

Related Research

- Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022