MOODY'S
INVESTORS SERVICE

Rating Update: Moody's upgrades State of California to Aa3; outlook stable

Global Credit Research - 25 Jun 2014

Upgrade affects over $86B in outstanding debt

CALIFORNIA (STATE OF)
State Governments (including Puerto Rico and US Territories)
CA

Opinion

NEW YORK, June 25, 2014 --Moody's Investors Service has upgraded the rating on the State of California's general obligation debt to Aa3 from A1. Moody's has also upgraded various notched and related ratings (see list at end of report). The outlook is stable.

SUMMARY RATING RATIONALE

The upgrade to Aa3 from A1 reflects the state's rapidly improving financial position, high but declining debt metrics, adjusted net pension liability ratios that are close to the state median, strong liquidity, and robust employment growth. The Aa3 rating also reflects the state's volatile tax revenue structure and governance restrictions, in addition to certain recent governance changes and proposals that are meant to address those longstanding issues.

STRENGTHS

- Large and diverse economy;

- High wealth;

- Stronger liquidity in recent years;

- Significant improvement in budget deficits through revenue surges and conservative measures to rein in spending; and

- Governance improvement leading to on-time budgets for the past three years.

CHALLENGES

- Highly volatile revenue structure;

- Governance restrictions (such as supermajority requirement to raise taxes) that make it difficult for state to respond to revenue volatility;

- Lack of reserves built up to cushion the state's finances from downturns (although a recent proposal aims to address this); and

- Reliance in past on deficit borrowing and other one-time solutions to resolve budgetary gaps, which has led to negative audited fund balances.

DETAILED CREDIT DISCUSSION

ECONOMY: EMPLOYMENT, HOUSING SHOWING GROWTH

The State of California is large and diverse. With a Gross State Product of $2 trillion, the state is responsible for 12% of US Gross Domestic Product (GDP). By some accounts, if California were a country, it would have the 10th largest economy in the world.

The state's economy, after being hit harder in the recession than the national average, is now improving. Private sector employment is growing at a higher rate than the nation (2.6% in May on a year-over-year basis, compared to 2.1% for the US). The unemployment rate is still higher than that of the US (7.6% in May in CA, versus 6.3% in the US), but the gap is narrowing. The housing market appears to be in a rebound, with median sales prices of existing single-family homes up 19.4% in the first quarter of 2014 on a year-over-year basis.

FINANCES AND LIQUIDITY

2015 BUDGET INCLUDES TRANSFER TO RESERVES

The budget that was signed by Governor Brown on June 20, 2014 for fiscal year 2015 has revenues of $105 billion, spending of $107.9 billion, a prior year surplus of $4 billion (due to stronger-than-expected revenue growth in 2014), and ends the fiscal year 2015 with a reserve of $0.5 billion and a deposit of $1.6 billion into the proposed new Rainy Day Fund. The budget uses some of the revenue over performance, which it conservatively treats as non-recurring revenue, to fund one-time payments: the budget pays down $5 billion of the remaining $6 billion of the school deferrals made in the recession (which climbed to a peak of $10 billion by the end of fiscal 2011). It pays down the remainder ($4 billion) of the deficit bonds it sold in the recession, the Economic Recovery Bonds.

The Legislative Analyst's Office (LAO) has stated that it believes the budget is accurate in its forecasts for sales taxes and corporate income taxes in fiscal 2015, but thinks the state's personal income tax forecast is too conservative by $3 billion for fiscal 2015. The LAO projects 9% growth in personal income taxes in fiscal year 2015, while the budget calls for 5.6% growth.

The state's structural imbalance is very large. The GAAP-basis unassigned fund balance (fund balances reported in line with the new GASB 54 requirements) was more than $20 billion negative in fiscal year 2011 and 2012, and fell to negative $15 billion in 2013. In large part these GAAP deficits occurred because during the downturn the state solved budget gaps by deferring certain required payments, like payments to schools. As the state repays these obligations, we expect the negative balances on the audited statements to be dramatically reduced.

IMPROVED LIQUIDITY

The state's liquidity position has strengthened in the last three years after weakness in fiscal 2009 and 2010. According to the controller's office, the state had over $20 billion in unused available resources at the end of May 2014.

DEBT AND PENSIONS

DEBT STRUCTURE

Debt reported in our annual Debt Medians reports increased significantly in 2010 and 2011, but was flat in 2012 and declined in 2013. Growth will likely be modest in near term. As of June 1, 2014, there was about $25.9 billion in authorized and unissued long term GO debt.

California general obligation bond law permits the state to issue variable rate debt up to 20% of the aggregate amount of long-term general obligation bonds (including deficit funding bonds) outstanding. The state has about $4 billion in variable rate debt as of June 1, 2014, or approximately 5% of total general obligation debt outstanding.

PENSIONS AND OPEB

General Fund contributions to CalPERS and CalSTRS, the state's two main retirement systems, are estimated to be approximately $2.1 billion and $1.4 billion, respectively, for fiscal year 2014. The combined contributions, which include contributions for California State University, are about 3.5% of all General Fund expenditures in fiscal year 2014. The adopted budget for fiscal year 2015 calls for the state to make General Fund contributions of $2.7 billion for CalPERS and $1.5 billion for CalSTRS.

A full actuarial valuation for STRS as of 6/30/12 was released on March 26, 2013. The estimated unfunded actuarial obligation as of June 30, 2012 was $71 billion (compared to $64 billion as of June 30, 2011) with a reported funded ratio based on actuarial value of assets of 67% (compared to 69% as of June 30, 2011).

On an adjusted basis, California's adjusted net pension liability (ANPL) is $116 billion, the third highest of all states. The ANPL is 62.4% of revenues. As a percent of GDP and personal income, California's ANPL is quite moderate and close to the median for US states.

The state has passed several rounds of pension reform. In 2010 the state raised employer contributions, required that the salary at retirement be calculated as an average of the past three years, and raised the retirement age. In

2012 the state lowered defined-benefit formulas with higher retirement ages for new employees, prohibited retroactive benefits increases, prohibited contribution holidays, set a standard that employees pay at least 50% of normal cost, and increased some current employee contributions. In a preliminary actuarial analysis, CalPERS noted savings to the state of a modest $10.3 billion to $12.6 billion over the next 30 years, due primarily to increased employee contributions and, as the workforce turns over, lower benefit formulas that will gradually reduce normal costs.

A ballot initiative to give government employers the ability to change retirement benefits for future work of current employees has been moved to the 2016 election cycle.

The governor signed a bill in June that will increase contributions from the state, school districts, and teachers to CalSTRS. According to the state, the reform would eliminate the plan's unfunded liability in approximately 30 years.

Other post-employment benefits (OPEB) are paid on a pay-as-you-go basis, with $1.35 billion in OPEB costs for fiscal 2013. The state reports an actuarial accrued liability (AAL) of $63.8 billion as of June 30, 2012 and annual required contribution (ARC) of $4.9 billion for fiscal 2013, or about 5% of revenues.

DEBT-RELATED DERIVATIVES

The state has no swaps on any of its debt.

GOVERNANCE: STRUCTURAL ELEMENTS MAKE STATE REVENUES VOLATILE

California has significantly less flexibility relative to other states when it comes to budgeting and revenue raising. Approval by two-thirds of the legislature is required to raise revenues. In a year when revenues are underperforming, the governor does not have the power to order significant spending cuts or to raise revenues without the consent of the legislature. The state revises its revenue forecasts less frequently than many states, giving it less time to catch up to a downturn. The state's system of voter initiatives and referenda have resulted in expenditure mandates. Contentious political debates slow state reaction to budgetary stresses. Finally, voter approval is required to issue general obligation bonds or deficit bonds.

In addition, the state has a highly progressive personal income tax structure and taxes capital gains at the same rate as other income. As a result, a large portion of the taxes received are paid by a small portion of high-income taxpayers, which leads to a higher level of economic and revenue volatility relative to other states. Combined with the state's structural inflexibility, this volatility leads to steep downturns in periods of economic decline, with fewer available solutions.

The state legislature has passed a measure that attempts to deal with the above-noted volatility. The proposed constitutional amendment would create a rainy day fund for the state composed of annual deposits of 1.5% of annual general fund revenue and capital gains revenues in excess of 8% of general fund revenue (net of a portion that could go to a "Proposition 98" education fund under certain conditions). Capital gains revenues exceeded that 8% benchmark last year and the state expects them to do so again this year and next year. The amendment also states that the rainy day fund could grow to a maximum of 10% of General Fund tax revenues, which is over $10 billion for the fiscal 2015 budget. In addition, half of each year's deposits for the next 15 years would pay down the state's long-term liabilities.

The state would be allowed to withdraw funds or waive deposits into the fund if spending is at or below the highest level of spending for the past three years, adjusted for population and inflation. It would also be allowed to withdraw funds or waive deposits in the event of a natural disaster, such as the drought from which the state is currently suffering. These withdrawals are limited to half of the amount in the Rainy Day Fund in the first year of withdrawal.

The state projects that the proposed rainy day fund could put over $3 billion into reserves and $3 billion to pay down debt in the first three years, which would provide a cushion, albeit a small one, against possible future budget deficits.

RATINGS AFFECTED BY THE UPGRADE

TO Aa3 FROM A1:

-General obligation bonds

TO A1 FROM A2:

-Most state lease appropriation debt (most issued by State Public Works Board)

TO A2 FROM A3:

-California Judgment Trust Certificates of Participation, Series 2005

-Taft Public Financing Authority Lease Revenue (Community Correctional Facility Acquisition Project) Series '97A

-Shafter Joint Powers Financing Authority Lease Revenue (Community Correctional Facility Acquisition Project) Series '97A

TO A3 FROM Baa1:

- Revenue Bonds (South Central Los Angeles Regional Center Project) Series 2013

- Revenue Bonds (Harbor Regional Center Project), Series 2009

- Revenue Bonds (Kern Regional Center Project), 2009 Series A

- Revenue Bonds (Inland Regional Center Project) Series 2007

OUTLOOK

The outlook on the State of California is stable at this time, based on our expectation that the state's economy and finances will continue to show growth in the near term as the nation also improves.

WHAT COULD MAKE THE RATING GO UP

- Governance changes that significantly reduce budgetary inflexibility

- Governance changes that require state to build reserves large enough to cushion against revenue downturns, with a track record of maintaining the reserves

- Reduced revenue volatility

WHAT COULD MAKE THE RATING GO DOWN

- Prolonged economic weakness or stagnation, causing deterioration in finances and liquidity

- Dramatic increase in debt and/or a significant increase in long-term pension liabilities

- Movement away from structurally balanced budgeting, and/or a renewed reliance on one-time measures to balance budget

-Reduced liquidity, with an inability to meet monthly cash needs with available resources leading to a return to the issuance of IOUs or other cash management tools

- Reduced market access

RATING METHODOLOGY

The principal methodology used in this rating was US States Rating Methodology published in April 2013. An additional methodology used in rating the lease debt was The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in December 2011. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

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For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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