NEW YORK--(BUSINESS WIRE)--Fitch Ratings upgrades the rating on $4.58 billion in outstanding State of California economic recovery bonds (ERBs) to 'AA' from 'A+'.

The Rating Outlook is Stable.

KEY RATING DRIVERS

UPGRADE BASED ON ECONOMIC AND REVENUE IMPROVEMENT: Pledged revenues have continued to gain strength reflecting the gradual improvement of the state's economy, resulting in higher coverage and accelerating the early retirement of the bonds.

CONSTITUTIONALLY DEDICATED PLEDGE: The bonds' security is provided by a one-quarter-cent sales tax, constitutionally dedicated to the bonds. In addition, the bonds carry a general obligation pledge of the state.

EXCESS REVENUES FOR EARLY RETIREMENT: Excess collections are dedicated to early retirement of the bonds, rather than diverted to the state general fund, and pledged sales taxes cannot be borrowed by the general fund. The state may change the base on which sales taxes are levied.

CLOSED LIEN: No additional borrowing is possible, except for refunding purposes.

SOLID COVERAGE: Coverage by sales taxes has remained sufficient since a 2009 restructuring. Sales taxes have historically been a stable source despite weakening significantly during the downturn.

RATING SENSITIVITY

ECONOMIC AND REVENUE PERFORMANCE: The rating is sensitive to economic and revenue performance deviating materially from forecast assumptions.

SECURITY

The bonds are payable from and secured by a pledge of net proceeds of a statewide special $0.25-cent sales tax deposited to the fiscal recovery fund and certain other revenues. The bonds are also general obligations of the state to which the state's full faith and credit are pledged.

CREDIT PROFILE

The upgrade of the rating on California's ERBs, to 'AA' from 'A+', is based on the state's gradually improving economic performance, leading to stronger special sales tax collections and accelerated early retirements on the bonds. ERBs benefit from strong structural features and solid coverage of debt service, with a pledge of a one-quarter-cent sales tax constitutionally dedicated to debt service and deposited daily to the fiscal recovery fund. Although the ERBs also carry the state's GO full faith and credit pledge (rated 'A' by Fitch), Fitch's 'AA' rating is based on the ERBs' structural features and coverage, which Fitch believes to be the stronger of the two pledges.

Pledged sales taxes are deposited daily to the fiscal recovery fund, a special fund in the state treasury from which semiannual bond interest and principal are paid along with certain administrative expenses. A coverage account equal to one-quarter of annual debt service provides further bondholder protection; the coverage account balance is currently $188 million. After payment of debt service, administrative expenses and rebate payments, excess collections are available to cover any shortfalls in the flow of funds or may be released for early redemption of outstanding bonds. As of July 1, 2013, $8.94 billion in early redemptions have been made to date, the majority of which has derived from excess collections.

SALES TAX PERFORMANCE IMPROVING

Sales tax collections have historically benefited from the range and diversity of the state's economy. However, severe recessionary conditions during the 2008-2010 period weakened collections and previously adequate coverage. Special sales taxes, after peaking at $1.411 billion in fiscal year (FY) 2007, dropped a total of 17.6% through FY 2010. Narrowing coverage triggered temporary draws from the coverage account in December 2008 and June 2009 per the master indenture, under which the coverage account makes up any insufficiency in funds available for debt service five days prior to payment. The shortfalls were rectified by additional deposits prior to payment of debt service. In response, the state restructured the bonds in October 2009, lowering forecast debt service and providing a stronger margin of excess coverage by pledged revenues.

Since the downturn, special sales tax collections have improved rapidly, providing considerable excess collections for early redemptions. FY 2011 special sales taxes rose 4.7%, to $1.217 billion, and FY 2012 revenues rose another 8.4%, to $1.319 billion, with excess collections of $415 million in FY 2011 and $579 million in FY 2012.

The state's forecast of FY 2013 special sales taxes as of January 2013 assumed growth of 6%, a level subsequently elevated to 8.4% as of June 2013, at the time of the FY 2014 budget adoption. Actual deposits in FY 2013 to the fiscal recovery fund totaled $1.435 billion, 8.8% higher than FY 2012; excess collections totaled $674 million. The state's FY 2014 adopted budget forecast assumed growth of 6.7% over the FY 2013 forecast level, to $1.526 billion. The controller's cash flow report for FY 2014 through September shows year to date general fund retail sales taxes 2.1% ahead of the state's adopted fiscal 2014 forecast, suggesting similarly solid performance for pledged revenues.

SOLID COVERAGE

Coverage of current and projected future debt service remains solid based on recent actual collections. Annual coverage in FY 2011 and FY 2012 was 1.1x and 2.43x, respectively. FY 2013 collections covered originally scheduled FY 2013 debt service and administrative expenses 1.85x, and would cover currently forecast maximum annual debt service (in FY 2019) 1.68x. Although the bonds' nominal final maturity is in FY 2024, the state forecasts that the bonds will be paid off during FY 2016 assuming continuation of rapid early redemptions.

ERBs were authorized in response to the state's FY 2002-2004 budget crisis. Approved by voters in March 2004, Proposition 57 authorized a maximum issuance of $15 billion in ERBs to be supported by a one-quarter-cent sales tax. Under separate constitutional provisions, 50% of transfers to the state's budget stabilization account (BSA), up to an aggregate of $5 billion, and proceeds of surplus property sales are also dedicated to early retirement. About $1.5 billion in early redemptions have been derived from BSA transfers.

The state issued $10.9 billion in ERBs in FY 2004 and $3.2 billion in FY 2008 to address general fund cash and budgetary shortfalls; no further issuance is possible except for refunding. Since issuance, almost $9.1 billion has been applied to early retirement. Approximately $4.58 billion in ERBs are currently outstanding, including $110.4 million of variable rate bonds and $500 million of term bonds with a mandatory tender in 2014.

ERBs are well insulated from state general fund stress. The pledged tax may not be transferred to the general fund, and the state covenants not to reduce the tax, with excess collections dedicated solely to early repayment. Cash receipts in the fiscal recovery fund are not borrowable for general fund cash flow purposes, and a continuous appropriation of debt service removes exposure to budget delays. The base on which retail sales taxes are levied may be changed; in fiscal 2013, the state expanded the taxable sales base to include online sales of goods.

ECONOMIC GAINS UNDERWAY

California's economy is unmatched in size and diversity, and the economic recovery is gaining momentum across most sectors and regions. August 2013 employment is up 1.4% from August 2012, below the 1.7% national rate for the same period and slower than recent months. However, employment gains are widespread, particularly in key service sectors, and construction employment is expanding rapidly as the housing sector recovers. California's unemployment rate has fallen considerably in the last year, to 8.9% in August 2013 versus 10.4% one year earlier, although it remains elevated relative to the nation's 7.3% unemployment rate. The state's latest economic outlook, released with the revised budget proposal in May 2013, foresees slower economic activity in 2013 given broader macroeconomic uncertainties, particularly from federal government actions, after better-than-expected growth in 2012, stronger growth is projected to return in 2014. The unemployment rate is expected to remain at historically elevated levels.

Additional information is available at ' www.fitchratings.com '

Applicable Criteria and Related Research:

--'Tax-Supported Rating Criteria' (Aug. 14, 2012);

--'U.S. State Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

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Tax-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015

U.S. State Government Tax-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686033

Additional Disclosure

Solicitation Status

http://www.fitchratings.com/gws/en/disclosure/solicitation?pr_id=805199