Los Angeles County, California; Appropriations; General Obligation

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Rationale

Standard & Poor's Ratings Services raised its issuer credit rating (ICR) and long-term rating on Los Angeles County, Calif.'s appropriation-backed debt outstanding to 'AA' and 'AA-', respectively from 'AA-' and 'A+'. The upgrade reflects the county's maintenance of very strong general fund reserves as it has controlled costs and experienced relatively minimal revenue declines in the previous four years. The upgrade also reflects our view of recent financial operations improvement of the County's Department of Health Services, which could help to stabilize county general fund loans to the department. Standard & Poor's also assigned its 'AA-' long-term rating to the Los Angeles County Public Works Financing Authority's series 2012 lease revenue bonds (multiple capital projects II). The outlook on all ratings is stable.

The ratings on the appropriation-backed debt reflect our view of:

- The long-term creditworthiness of Los Angeles County and
- A covenant to budget and appropriate pledged lease payments, subject to abatement in the event of damage or impairment to the leased properties.

The 'AA' ICR and the county's long-term general creditworthiness reflect our view of the county's:

- Very large, deep, and diverse economic base, albeit one still experiencing elevated unemployment levels;
- Relatively stable property tax revenue and assessed valuation (AV) in the county despite large home price declines in the past several years; and
- Historically strong unreserved general fund balances and strong financial management practices.

Partially offsetting the above factors, in our view, are Los Angeles County's:

- Limited revenue-raising capability combined with mandated costs and state funding cuts, including a recent state action to realign certain services at the local level that will require permanent funding sources in the future; and
- Long-term need to address a large, $24 billion unfunded other postemployment benefit (OPEB) liability.

Base rental payments made by the county, as lessee, to the Los Angeles County Public Financing Authority, as lessor, for the use and possession of various leased assets, including the county's LAC & USC Medical Center, which secure the series 2012 lease revenue bonds. The leased assets meet Standard & Poor's standards for seismic risk. We understand that the series 2012 lease revenue bond proceeds will be used to finance certain projects related to ambulatory care centers, a data center, and fire stations, as well to refinance the commercial paper used to fund these
projects. We understand the bond proceeds will also be used to fund a debt service reserve fund, which mitigates the risk of late budget adoption in our view. The trust agreement requires a reserve fund at the least of 10% of par, 1.25x average annual debt service, or maximum annual debt service. The sublease agreement permits the county to self-insure for risks other than rental interruption. The county's series 2010B bonds were eligible for federal interest subsidy payments; however, the federal interest subsidy payments were not pledged to the series 2010 bonds. Base lease rentals securing the series 2010B debt service were designed to cover gross taxable debt service on the bonds while the county covers all operating costs.

The regional economy of Los Angeles County, with an estimated population 10 million, has shown some signs of recovery with a moderation of the unemployment rate to a preliminary 11.9% in June 2012, from 13.2% in the same month of 2011 although it remains above the state and national level of 10.9% and 8.6%, respectively. Entertainment, international trade, and tourism are leading employment sectors for the county. Los Angeles County's net local property tax roll AV in fiscal 2012, including redevelopment value, increased by 1.4% to more than $1 trillion and by 2.2%, to $1.08 trillion, in fiscal 2013. Although the county reports median home prices fell by 48% between 2007 and 2012, property value has remained relatively stable due to underassessment of property with base-year values that predate Proposition 13 (estimated by the county assessor at about 14% of total county residential parcels and 17% of commercial-industrial parcels). Since value for these properties has not reset to market value levels in more than 30 years, home price declines have had less of an effect on the county's AV. We calculate per capita market value is extremely strong, in our view, at $108,000 based on 2013 values. Median household effective buying income was good in our view, at 104% of the national average.

Along with AV growth, the county saw a slight increase in property tax revenue in fiscal 2012 and projects a 2% increase in property tax revenue in fiscal 2013, net of surplus property tax revenue from the dissolution of redevelopment agencies in the state. Property tax, which is the county's main source of discretionary funding, composed 27% of general fund revenue in fiscal 2012. About half of the revenue for Los Angeles county's general budget comes from the federal and state governments for public service programs. A portion of federal and state revenue funds the county's public health system, which had operated with a deficit and posted negative unrestricted net assets for many years and has historically burdened general fund expenditures and cash. In fiscal 2012, unaudited results for the department of health services reflect a $27.6 million positive operating surplus due primarily to increased federal waiver funding and cost-control measures. The department has also begun to implement systems to streamline the claim process for Medi-Cal, which it expects will reduce its reliance on cash loans from the general fund. While the general fund continues to budget between a $650 million and $680 million transfer to subsidize department of health operations, officials expect the stabilized operations of the enterprise should make further increases to this subsidy less likely.

Since fiscal 2010, we understand the county has cut a cumulative $360.5 million and eliminated more than 2,000 budgeted positions to offset the decline in revenues due to the economic recession and to mitigate the county's use of reserve funds. While county officials report no significant layoffs during the past four years, the labor unions had agreed to no salary increases or cost-of-living adjustments as a result of the tighter budgetary environment.

Los Angeles County continues to maintain audited unreserved general fund balances on a generally accepted
accounting principles basis that we view as very strong. While it has posted annual general fund operating deficits after
transfers of about $200 million, on average, in the previous three audited fiscal years, fiscal 2012 unaudited results on a
Generally Accepted Accounting Principle basis reflect a marked improvement to an estimated $82 million operating
deficit, or only 0.6% of expenditures, compared with a budgeted $175 million budget gap for fiscal 2012. In addition,
despite these drawdowns, the fiscal 2012 unaudited unassigned and assigned general fund balance totals $2.3 billion,
which is still very strong, at 17% of expenditures, in our view. The unaudited unassigned balance totaled almost $1.6
billion, or 11.5% of expenditures and transfers, which we view as strong; the unassigned balance includes the county’s
$177 million combined “rainy day” and provisional financing economic reserves. The county attributes the
better-than-budgeted results to recent improvement in revenue trends, as well as more than $80 million in unbudgeted
property tax revenue received in fiscal 2012 from the dissolution of redevelopment agencies. In fiscal 2011, due in part
to the implementation of Government Accounting Standards Board Statement 54, the audited assigned and unassigned
balance totaled $2.4 billion, or 18% of expenditures and transfers, which we view as very strong. Roughly 19% of the
county’s fiscal 2011 general fund assets were composed of “advances to other funds,” primarily relating to cash
advances to the hospital and medical center funds, which are subject to short term delays in reimbursement payments
from the state and federal government. The unaudited fiscal 2012 results reflect an improvement in overall advances
from the general fund to 14% of general fund assets, primarily due to a recent trend of quicker reimbursement for
services from the state and federal governments.

The fiscal 2013 adopted general county budget grew by 2.2% compared with the prior year due primarily to higher
pension funding and health insurance costs. County officials estimate better-than-expected fiscal 2012 actual results
have improved its budgetary reserves and will allow the county to build slightly its rainy day and economic budgetary
reserves in fiscal 2013. The state budget for fiscal 2013 includes provisions for trigger cuts if voters do not approve a
measure to increase taxes in November 2012 (Proposition 30). Even if trigger cuts were implemented, the county
estimates that it could lose a relatively minimal $31 million, not including any additional property tax revenue from the
recent dissolution of redevelopment agencies. Although the county actually received $88 million of additional
unbudgeted annual property tax revenue from the dissolution of redevelopment agencies in fiscal 2012, the county has
not projected any additional property tax revenue in its budget for fiscal 2013. We understand the county has a policy
to not backfill cuts in federal and state program funding although its board would still need to approve any program
reductions. County officials maintain they would make concurrent reductions to county service levels and costs to
match any reduced state funding of certain programs. Furthermore, despite the county’s reliance on federal funding, as
well as state funding, and the threat of sequestration at the federal budget level, the county does not project a material
impact to its budget as it reports that the majority of federal revenue it receives is for mandatory entitlement programs
that are exempt from the sequestration cuts.

In fiscal 2012, California shifted certain public safety service responsibilities to the counties and budgeted for existing
state sales tax and vehicle license fee funding to counties to cover these realigned costs in the current fiscal year.
County officials estimate they received almost $125 million in realignment funding from the state in fiscal 2012 and
will receive about $272 million in fiscal 2013. The county has budgeted 1,100 positions and $280 million in total costs
in fiscal 2013, or about 2% of the county’s general fund expenditures and transfers. The county’s realignment budget
included 3% in budget contingencies, and county officials expect $7 million of unspent carryover from fiscal 2012 and
state funding in fiscal 2013 to cover the realignment costs. The county intends to continue to match the costs of
housing the realignment population, including costs of mental health and health care, with state funding levels. The county also adopted a realignment implementation plan that budgets for the additional costs in quarterly intervals with temporary staff to maintain the flexibility necessary in the event of future funding cuts. The state's budget includes funding in fiscal 2013 for counties to help cover realignment costs, but a measure on the November ballot, if approved, would amend the state constitution to provide a more permanent funding source to counties to provide these services. If future funding for additional costs associated with the realignment of services were cut, we believe the county could face additional future structural budget gaps. According to management, the county's jail system has a capacity of 21,700 inmates and currently houses 19,500 inmates on average. While current capacity is sufficient to meet immediate needs, the county reports the facilities are old and in need of capital improvements. The county is also exploring early disposition and training programs to foster rehabilitation and lower recidivism, which could reduce the jail population.

We consider Los Angeles County's financial practices "strong" under our financial management assessment (FMA) methodology. An FMA of strong indicates that, in our view, practices are strong, well embedded, and likely sustainable.

Overlapping county net debt is moderate, in our opinion, at 3% of property market value and $3,245 per capita. Amortization of general fund and special district principal is average, with 52% of principal retired in 10 years. The annual debt service carrying charge is low in our view at only 3.1% of governmental expenditures, less capital outlay, as of audited fiscal 2011.

The county contributes to the Los Angeles County Employees Retirement Assn. (LACERA). The unfunded actuarial accrued pension liability was $9.4 billion in fiscal 2011. Funded pension ratios have declined over the previous four years to 81% in fiscal 2011 as a result of a five-year smoothing method and market value losses in fiscal years 2008 and 2009. Los Angeles County has funded its full pension annual required contribution (ARC) to LACERA and estimates it increased by 9.7% in fiscal 2013 to $1.13 billion compared with fiscal 2012. The county's estimated OPEB contribution in fiscal 2013 is $440 million for a total of $1.57 billion in annual pension and OPEB payments, or 10% of fiscal 2011 governmental expenditures. The county had an unfunded OPEB and OPEB long-term disability liability of $24 billion and a $1.9 billion OPEB ARC as of fiscal year-end 2010. The OPEB contribution is funded on a pay-as-you-go basis and, in fiscal 2011, was $411 million, or only 21% of the OPEB ARC. Future OPEB actuarial liabilities are a contributing factor to the county's governmental unrestricted net asset deficit position of $4.2 billion at fiscal year-end 2011, despite what we see as the good health of the general fund. In fiscal 2013, the county plans to transfer at least $400 million of previous excess retirement fund earnings into an irrevocable OPEB trust fund to help pay for future obligations. In addition, the county is evaluating potential changes to retiree benefits, including changes for new hires and earlier enrollment in Medicare, which could reduce the long-term OPEB liability for the county by 50%.

**Outlook**

The stable outlook reflects our expectation that the county will continue to adjust its budget, as necessary, to maintain very strong reserve levels and minimize potential future state funding cuts. The outlook also reflects our expectation
that revenue and economic trends in the county will continue to stabilize in the next year given the depth and diversity of its economy and the relative stability of the property tax base. The outcome of a ballot measure could make realignment funding more permanent through a constitutional mandate; however, if the measure does not pass, we understand the state is still currently funding these new mandates. Given ongoing state budget pressures -- including potential unfunded realignment measures and mandated program costs -- we don't expect to raise the rating during the next two years. Recently improved health system operations should continue to stabilize transfers to the hospital from the general fund; however, should health system operations or state funding cuts materially pressure the county's budget and should the county fail to maintain very strong reserve levels, we could lower the rating.

**County Department of Health -- Health Care Reform**

Los Angeles County's Department of Health Services oversees one of the largest public health systems in the nation. The county provides health care services to residents through its hospitals and health centers. Although these costs are primarily covered by federal and state funds, the county has advanced general fund cash for delayed reimbursements and unfunded costs in the past. Officials estimate that outstanding general fund advances to the health funds decreased $690 million in fiscal 2012, compared with a $1 billion balance in fiscal 2011, and it has transferred a flat amount of about $680 million directly to subsidize health system operations for the previous five years. In fiscal 2011, Los Angeles County's medical and care centers posted an operating deficit of $906 million before depreciation and transfers compared with $1.2 billion in fiscal 2010. All of the centers, except for the LAC & USC Medical Center, continued to post negative unrestricted net assets in fiscal 2011.

Officials estimate the department posted a small, $28 million budgetary operating surplus, after transfers, in fiscal 2012. Management indicates the county's department of health has seen improved liquidity and financial operations in fiscal years 2011 and 2012, with the introduction of a federal waiver of certain Medicaid statutory requirements that have provided federal matching funds for certain previously ineligible services, as well as certain cost saving and revenue-generating initiatives. In order to continue to receive the federal waiver funding, the department must meet certain performance-based measures. The waiver will expire in 2015, by which time the county expects expanded coverage under federal health care reform should cover currently uninsured patients and help reduce the health system deficits. While the county health system stands to lose a portion of disproportionate share hospital payments and other subsidies under federal health care reform, officials estimate recent programs it has implemented that have matched doctors to patients will pay off in patient loyalty and increased revenue.

**Financial Management Assessment: "Strong"**

We consider Los Angeles County's financial practices "strong" under our Financial Management Assessment (FMA) methodology. The government maintains most of the best practices we deem critical to supporting credit quality, and these are well embedded in its daily operations and practices. Formal policies support many of these activities, adding, we believe, to the likelihood that these practices will continue and transcend changes in the operating environment or personnel.
In particular, the county:

- Uses state economic data and actual historical trends in revenue forecasting;
- Reviews expenditures and revenues monthly against budget;
- Prepares a five-year revenue and expenditure forecast;
- Uses a seven-year long-term capital plan;
- Has adopted a written investment policy and prepares monthly investment performance reports submitted to the county board;
- Has an adopted debt management plan and monitors its commercial paper program monthly; and
- Has set a goal of building 10% of locally generated revenues in a rainy day and economic reserve, or about 2.5% of audited general fund expenditures and transfers.

**Employment**

The Los Angeles metropolitan statistical area's (MSA) diverse employment base grew slightly by 0.4% in 2011 after overall job declines in the previous two years. For fiscal 2012, IHS Global Insight forecasts service industry jobs will drive slight, 0.9% employment growth in 2012 and 1.2% growth in 2013 with a forecasted moderation in the unemployment rate to 10.9%. The MSA's employment base is diversified across the professional and business services, education and health services, retail trade, manufacturing, and state and local government sectors. Leading private sector employers in the county include Kaiser Permanente, Northrop Grumman Corp., University of Southern California, and Target Corp.

**Related Criteria And Research**

- USPF Criteria: GO Debt, Oct. 12, 2006

**Ratings Detail (As Of October 1, 2012)**

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