

**RATING ACTION COMMENTARY**

**Fitch Rates San Diego County, CA's \$173 Million COPs 'AA+'; Outlook Stable**

Wed 04 Oct, 2023 - 5:05 PM ET

Fitch Ratings - San Francisco - 04 Oct 2023: Fitch Ratings has assigned a 'AA+' rating to the following certificates of participation (COPs) to be issued by the County of San Diego, CA (the county):

--\$172,725,000 COPs series 2023 (County Public Health Laboratory and Capital Improvements).

In addition, Fitch has affirmed the following county ratings:

--Issuer Default Rating (IDR) at 'AAA';

--\$278 million outstanding pension obligation bonds (POBs) at 'AA+';

--\$150 million outstanding San Diego County COPs at 'AA+';

--\$80 million outstanding San Diego Regional Building Authority lease revenue bonds (LRBs) at 'AA+'.

The Rating Outlook is Stable.

**RATING ACTIONS**

ENTITY / DEBT ↕	RATING ↕			PRIOR ↕
San Diego County (CA) [General Government]	LT IDR	AAA Rating Outlook Stable	Affirmed	AAA Rating Outlook Stable
San Diego County (CA) /General Fund Contractual Obligations - Pension/1 LT	LT	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Stable
San Diego County (CA) /Issuer Default Rating - General Government/1 LT	LT	AAA Rating Outlook Stable	Affirmed	AAA Rating Outlook Stable
San Diego County (CA) /Lease Obligations - Standard/1 LT	LT	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Stable

[VIEW ADDITIONAL RATING DETAILS](#)

The COPs are scheduled to price via negotiation on Dec. 5. COP proceeds will be used to finance the construction of portions of the Public Health Lab, County Operations Center relocation, and major renovations to the County Administration Center as well as capitalized interest from closing until Oct. 1, 2026.

## **SECURITY**

The COPs and LRBs are supported by annually appropriated lease payments for use and occupancy of various leased assets, subject to abatement. The POBs are absolute and unconditional obligations of the county imposed by law and are payable from all lawfully available funds.

## **ANALYTICAL CONCLUSION**

The 'AAA' IDR reflects the county's superior gap-closing capacity, moderate long-term liabilities, strong revenue growth and solid expenditure control. Given the county's strong and growing economy and proactive budget management, Fitch expects the county to maintain its strong financial resilience throughout economic cycles.

The county's POBs, LRBs and COPs are rated one notch lower at 'AA+', which is consistent with Fitch's approach for contractual obligations and appropriation-backed debt.

## **Economic Resource Base**

San Diego County is the nation's fifth most populous county with about 3.3 million residents and 18 incorporated cities. The county's population is larger than 21 states. The core industries of its diverse economy include government, military and related defense industries, health care, technology, manufacturing and tourism. The county's net assessed value for tax purposes has experienced steady growth with an 84% increase in net assessed value since 2011.

## **KEY RATING DRIVERS**

### **Revenue Framework: 'aa'**

Fitch expects the county's revenue growth to keep pace with U.S. economic performance due to robust gains in property tax revenues, which are offset by more moderate growth in intergovernmental revenues. The county retains authority to increase fines, fees and charges for services, but its legal ability to raise revenues is constrained by state constitutional provisions that require voter approval for tax increases.

### **Expenditure Framework: 'aaa'**

The natural pace of spending growth is likely to roughly equal revenue growth over time, reflecting strong growth in the county's general purpose revenues and good matching of revenues and expenditures related to social welfare programs funded by higher levels of government. Expenditure flexibility is solid, and fixed costs for debt service and pensions are moderate.

### **Long-Term Liability Burden: 'aa'**

Fitch expects the county's long-term liabilities for overall debt and pensions to remain at the low end of the moderate range relative to the county's large economic resource base.

### **Operating Performance: 'aaa'**

The county has superior gap-closing capacity, reflecting strong reserve levels, limited revenue volatility and midrange inherent budget flexibility.

## **RATING SENSITIVITIES**

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Not applicable as the IDR is currently at the highest possible rating.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Over the longer term, pressured financial flexibility due to slower revenue growth, or expenditure growth that outpaces revenues and/or sustained reductions in reserves.

## **CURRENT DEVELOPMENTS**

### **Recent Fiscal Performance**

The county ended fiscal 2022 with a \$42 million surplus on \$5.3 billion in spending, with about a \$60 million increase to unrestricted fund balance (assigned, committed and unassigned), bringing its total to \$1.6 billion, equal to almost 31% of expenditures and transfers out. The county expects to end fiscal 2023 with \$130.2 million higher unassigned fund balance (one of the components of unrestricted fund balance).

The county's fiscal 2024 general fund budget totals about \$6.2 billion, with growth supported by increased general purpose revenue including property taxes, as well as state and federal funding. The growth in budgeted property taxes is based in part on a 7.1% gain in assessed valuation (AV) in fiscal 2024 supported by residential and commercial value appreciation as well as changes in ownership resetting the AV to higher market rates. The fiscal 2024 budget appropriates about \$59 million for capital projects, and the county anticipates receiving \$190 million in FEMA reimbursements in future years.

The county expects property value gains to taper off starting in fiscal 2025, with an expected increase in AV of about 3.5%. Like most areas, the county's volume of home sales have slowed due to higher interest rates. As discretionary revenue growth slows, the county will need to focus on maintaining structural balance as annual pension costs are expected to peak and increased spending for board targeted services, both anticipated in fiscal 2026. The annual pension expense is projected to increase due in part to a reduction of the assumed investment return rate to 6.5% from 7.0% as of fiscal 2022, which Fitch views favorably.

While the county may draw on its unrestricted fund balance as revenue growth slows or to fund board priorities, Fitch expects the county to maintain a 'aaa' financial resilience assessment given its strong starting position as well as other efforts to balance its revenues and expenditures over time.

## **CREDIT PROFILE**

The county's population growth rate has been modestly below average, rising 5.8% between 2010 and 2022 compared with 7.9% nationally. Prior to the pandemic, employment levels had increased steadily since 2010 while unemployment rates had fallen below 4%. Employment is weighted modestly above average in government, leisure and hospitality, and professional and businesses services compared to national employment trends, reflecting the large military presence in the county as well as the strong tourism foundation given its coastal location.

The number of visitors to San Diego remains modestly below pre-pandemic levels, likely due to slower convention and business activity; however, visitor spending has returned to prior levels.

## **Revenue Framework**

Intergovernmental revenues accounted for about 60% of total general fund revenues in fiscal 2022.

Intergovernmental funding largely represents state and federal support for mandated health and human services programs managed by the county, including transfer payments. Property taxes accounted for 29% of general fund revenues in fiscal 2022.

Fitch expects revenue growth to closely track U.S. economic growth. Trends in total general fund revenues are heavily influenced by the county's receipt of intergovernmental revenues, which are largely determined by caseload trends as well as state and federal service mandates. While intergovernmental revenues vary over time, these program revenues match related expenditure obligations well, and the county's disciplined practice of not back-filling cuts in social programs has allowed it to maintain fiscal balance even as state and federal funding changed over time.

The 10-year compound annual growth rate (CAGR) of total revenues through fiscal 2022 had exceeded inflation and GDP growth over time. Fitch expects revenue growth to continue to exceed GDP given continuing population and property value growth.

Locally generated tax revenues fund the county's general purpose budget and are driven by its strong property tax base and population growth. Taxable assessed value (TAV) growth (which drives the county's property tax revenues) rose 5.9% on average annually on average for the decade through fiscal 2024.

Like other California local governments, the county's independent legal ability to raise revenues is limited by state constitutional provisions requiring voter approval for tax increases. The county retains the ability to set fees and service charges at sufficient levels to recover costs and updates such items regularly as part of its annual budget process.

### **Expenditure Framework**

Health and Human Services spending represents about 54% of total general fund expenditures, and public safety accounts for less than 35% of spending in fiscal 2022. Transfer payments form a large part of the health and human services budget and compensation costs predominate general fund spending. The county does not own a public safety net hospital and does not face the same degree of healthcare spending pressures that other large urban counties must manage.

Based on current spending practices, Fitch expects the natural pace of expenditure growth to generally track revenue growth in the absence of policy action. The assessment reflects the matching of social services spending to underlying funding and strong tax revenue growth that is expected to largely keep pace with rising salary and benefit costs within the general fund budget. The county is in the middle of three-year labor contracts (expiring at the end of fiscal 2025 and 2026) with the vast majority of its employees. Agreements include annual salary increases of between 2.75% and 5.00%, and a 5.00% increase in the county-funded health benefits.

The county's expenditure flexibility is solid. Fixed costs for debt service and retiree benefits are moderate at about 14% of governmental expenditures in fiscal 2022. The county's long-standing practices of funding capital needs from current resources and other post-employment benefits (OPEB) at actuarial levels provide ready sources of additional flexibility should the county need to reduce expenditures to address a budgetary imbalance. The county's labor framework is manageable and typical for California with management retaining the right to impose terms in the rare instances where labor negotiations reach an impasse.

### **Long-Term Liability Burden**

Long-term liabilities, including net pension liabilities and overall debt, are at the low end of the moderate range relative to the county's resource base at approximately 10% of personal income. Debt issuances of overlapping

jurisdictions account for about three-quarters of total liabilities, and direct debt makes up less than 5%.

Net pension liabilities are the county's largest direct liability, accounting for slightly more than a quarter of the total long-term liability burden. The county's 2022 net pension liability equaled about \$4.6 billion when adjusted to a standard 6% return rate assumption. While pension liabilities are significant, the county has worked to address the issue in recent years, having made additional pension payments beyond actuarial requirements, prepaying a significant amount of pension obligation bond debt service and setting aside \$214 million for future debt and pension payments in a fund legally restricted to pension-related payments. Pursuant to the county's charter, once funds such as these have been appropriated, they may not be used for any other purpose.

The county has also been increasing ongoing contributions to the plan by funding more than the actuarial determined contribution and as a result of the reduced rate of return assumption made in recent years (from 7.5% in fiscal 2015 to 7% in fiscal 2019 and 6.5% in fiscal 2022). The county closed its OPEB plan to new entrants in 2007 and its unfunded liability was very modest at \$71 million at the end of fiscal 2022. The county has been fully funding its OPEB actuarially determined contribution of about \$17 million for several years.

### **Operating Performance**

The FAST scenario analysis tool relates the county's historical general fund revenue volatility to GDP to support the assessment of operating performance under Fitch's criteria. FAST is not a forecast (actual revenue declines will vary from FAST), but it provides a relative sense of revenue risk exposure across Fitch's local government portfolio. The county's FAST revenue volatility is moderate relative to Fitch's U.S. local government sector, which is indicative of the county's stable revenue structure.

Fitch expects the county to maintain the highest degree of fundamental financial flexibility throughout economic cycles. This expectation reflects the county's strong reserve position, solid expenditure flexibility, satisfactory revenue raising capacity and thorough and conservative budget planning and reserve policies. The county's unrestricted general fund balance equaled \$1.6 billion, or almost 31% of spending, at the end of fiscal 2022. The county has a strong track record of making ongoing budget adjustments as needed to maintain or restore budgetary balance. The county only modestly drew on reserves in one year during the Great Recession and during the pandemic driven recession, Fitch expects the county to reduce expenditures and use a moderate amount of reserves while maintaining its reserve safety margin consistent with the 'aaa' resilience assessment.

Budget management is also quite strong. The county has built up reserves significantly during the current economic expansion with regular additions to its already healthy reserves. It makes actuarially determined pension and OPEB contributions, and it is actively working to reduce accrued liabilities.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

### **REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING**

The principal sources of information used in the analysis are described in the Applicable Criteria.

### **ESG CONSIDERATIONS**

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

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## **APPLICABLE CRITERIA**

[U.S. Public Finance Tax-Supported Rating Criteria \(pub. 04 May 2021\) \(including rating assumption sensitivity\)](#)

## **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, v3.0.0 (1)

## **ADDITIONAL DISCLOSURES**

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San Diego County (CA)

EU Endorsed, UK Endorsed

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The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. Sector-specific best- and worst-case scenario credit ratings are listed in more detail at <https://www.fitchratings.com/site/re/10238496>

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