

FITCH RATES PUBLIC FACILITIES FIN AUTH OF SAN DIEGO, CA WASTEWATER REVS 'AA'; OUTLOOK STABLE

Fitch Ratings-Austin-17 August 2015: Fitch Ratings assigns an 'AA' rating to the following Public Facilities Financing Authority of the city of San Diego, CA (the authority) bonds issued on behalf of the city of San Diego, CA (the city):

--Approximately \$258 million senior sewer revenue refunding bonds, series 2015.

The bonds are scheduled to sell via negotiation as early as the week of August 24. Proceeds will be used to refund a portion of the authority's outstanding parity obligations for interest savings without extension of maturity.

In addition, Fitch affirms the 'AA' rating on the authority's \$1.1 billion in outstanding parity bonds (pre-refunding).

The Rating Outlook is Stable.

SECURITY

The bonds are secured by revenues which consist primarily of installment payments made by the city to the authority. The city's obligation to make installment payments constitutes a senior lien on net revenues of the city's wastewater system (the system).

KEY RATING DRIVERS

SOLID FINANCIAL RESULTS: System financial performance is good and benefits from prudent formal policies and reserves.

LEVERAGE DECREASING BUT POSSIBLE OUTYEAR ESCALATION: Leverage ratios are moderate overall and are forecast to improve over the next few years as rapid amortization outpaces the level of new borrowings. However, beyond the immediate fiscal 2016-2020 capital improvement program (CIP), debt levels may escalate as the city enters into the heavy construction phase of its Pure Water (PW) program.

RATES HOLDING STEADY: Rates are moderately high but are expected to remain unchanged over the forecast period.

EXTENSIVE SERVICE TERRITORY: The service area is broad and diverse and includes a sizeable wholesale component.

RATING SENSITIVITIES

CONTINUED FINANCIAL STRENGTH: Maintenance of San Diego sewer system's sound financial metrics commensurate with similarly-rated utilities will be key to preserving credit quality given the expected increases in debt issuances associated with the Pure Water program.

CAPITAL ESCALATION: Ultimate timing and costs associated with PW will be a significant consideration in credit quality over the coming years.

CREDIT PROFILE

REGIONAL UTILITY WITH FAVORABLE ECONOMIC UNDERPINNINGS

The system provides retail service to around 1.4 million people within the city and also provides wholesale service to approximately 800,000 people in the outlying area. The city's diverse economy is driven by healthcare, military, tourism, and educational sectors. Economic conditions in the city have shown positive signs over the last couple of years, with job growth, consumer spending, residential and commercial construction and tourism all experiencing positive trends. This favorable climate has pushed city unemployment levels down to 4.8% for March 2015, below those of the state (6.5%) and nation (5.6%).

FINANCIAL RESULTS CONTINUE TO BE STABLE AND SOUND

System financial performance is good and includes strong liquidity and favorable cash flows. For audited fiscal 2014, the system maintained over 815 days cash while free cash generated from operations equaled 107% of depreciation expenses. Annual debt service coverage (DSC) of all debt based on Fitch's calculation which differs slightly from the city's calculations was also sound in fiscal 2014 at almost 1.8x, in line with last five fiscal years.

Preliminary results for fiscal 2015 point to continued favorable results although total DSC is down slightly to 1.6x on rising operating expenses. Financial projections provided by management anticipate some decrease in DSC through the fiscal 2020 forecast as a result of borrowings, rising operating expenses (particularly for electricity) and no rate hikes. In addition, fiscal 2016 results are expected to be somewhat softer as a result of conservation requirements associated with the drought, although the water utility will bear the bulk of the pressure as conservation savings will be derived largely from cuts to outdoor irrigation, which do not impact wastewater flows. In light of the expected rise in system borrowings, strong management of PW construction costs along with maintenance of solid DSC will be important offsets to preserving the current rating.

IMPROVING DEBT PROFILE BUT OUTYEAR PRESSURES POSSIBLE

Capital needs for fiscals 2016-2020 total around \$490 million. These costs are around 5% lower than the fiscal 2014-2018 CIP even though current costs now include over \$90 million for the initial design and construction of PW that were not part of prior CIPs. Current debt levels remain moderate and are forecast to decline over the immediate future in light of amortization of existing debt outpacing the issuance of new debt.

Beyond the fiscal 2020 CIP period, debt levels may climb as a result of construction costs associated with PW. PW is a 20-year program (through 2035) that is expected to ultimately provide 83 million gallons a day of potable water supply by offloading wastewater flows from the system's Point Loma wastewater treatment plant (PLWTP). As a result of the diverted effluent, PLWTP will continue its existing operations but will achieve 'secondary equivalency', alleviating the need for the system to invest an estimated \$2 billion in capital costs to upgrade PLWTP to secondary treatment levels. The PW program also entails other benefits in that it provides the city with a drought-proof source of new water supply and reverses previous negative relations with regulators and local environmental groups as to the treatment of PLWTP flows that had often been very litigious.

The PW program is estimated to cost around \$3 billion, with the system responsible for \$1.8 billion of the total and the city's water system funding the balance. While timing and funding of the program beyond the near term could change, Fitch expects ongoing borrowings will account for a significant portion of PW construction resources.

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In addition to the sources of information identified in the U.S. Municipal Revenue-Supported Rating Criteria, this action was additionally informed by information from Creditscope.

Applicable Criteria

Revenue-Supported Rating Criteria (pub. 16 Jun 2014)

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=750012

U.S. Water and Sewer Revenue Bond Rating Criteria (pub. 31 Jul 2013)

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=715275

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