MOODY'S
INVESTORS SERVICE

New Issue: MOODY'S: CITY OF SAN DIEGO'S SUBORDINATED WATER REVENUE REFUNDING BONDS RATED Aa3

Global Credit Research - 27 Mar 2012

SENIOR LIEN BONDS' Aa2 RATING AFFIRMED

SAN DIEGO PUBLIC FACILITIES FINANCING AUTHORITY, CA
Water Enterprise
CA

Moody's Rating

ISSUE	RATING
Subordinated Water Revenue Bonds, Refunding Series 2012A	Aa3

Sale Amount	$212,000,000
Expected Sale Date	04/03/12
Rating Description	Revenue: Government Enterprise

Moody's Outlook STA

NOTE: On April, 2, 2012 the report was revised as follows: In the paragraph titled FAVORABLE DEBT POSITION WILL LIKELY BE RESTORED AFTER AMBITIOUS CAPITAL PLAN FUNDED LARGELY WITH NEW DEBT,the first sentence should be: At the end of 2011, the city's water system debt stood at approximately $865 million which resulted in a debt ratio of 37.1%, somewhat above the California median of 29.2% for similarly rated water enterprises.

Revised report follows:

Opinion

NEW YORK, March 27, 2012 --Moody's Investors Service has assigned an Aa3 rating to the Subordinated Water Revenue Bonds, Refunding Series 2012A, of the City of San Diego's Water Enterprise. We have also affirmed the Aa2 rating on the utility's outstanding senior lien bonds and the Aa3 rating on the outstanding subordinate bonds. The outlook on both ratings is stable.

RATING RATIONALE

The rating is partly based on the system's significantly improved financial performance since 2004. However, projected slow growth in water sales in the next several years and no new rate increases until 2014 dampen projected revenue growth and lower debt service coverage ratios, which are quite low for the current rating level. However, the city has a history of outperforming its debt service coverage projections. If actual, combined senior and subordinate debt service coverage levels beyond 2013 are in fact at the projected levels of as low as 1.3x, the current rating would be under downward pressure. The fundamental strength of the enterprise remains a key credit factor, including its essentiality and its large, strong, and diverse service area, which provides a relatively high degree of revenue stability. The overall economic conditions in the service area have begun to show improvement in the last year or so, including growth in assessed values, transient occupancy tax and sales tax. The ratings also reflect the utility's favorable debt position, which is likely to remain manageable despite the expected addition of a of new debt during the next five years necessitated by the current Capital Improvement Program. The proceeds of the current issue, along with available reserve funds, will be used to refund all or some of the utility's outstanding subordinated revenue bonds.

STRENGTHS

--Large, highly diverse service area, now slowly expanding

--Strong financial oversight with conservative budgeting and projections

--Strong senior lien debt service coverage levels

--Strong unrestricted cash position

CHALLENGES:

--Below average debt service coverage levels for total debt

--Large capital Improvement Program

DETAILED CREDIT DISCUSSION

FINANCIAL RESULTS HAVE IMPROVED SIGNIFICANTLY

Since their low point in 2003, the water system's financial operations have improved steadily. Increased water sales, largely through growth and rate increases, combined with very tight controls on Operating and Maintenance (O&M) expenditures, enabled the utility to increase total debt service coverage from 1.02 times in 2004 to 2.04 times in 2009 and 1.79x in 2011.

Over this period, coverage levels, which include capacity charge revenues, improved despite a notable decrease in capacity charges. In 2011 total coverage decreased to 1.79x largely as a result of increased debt service payments on a significant amount of new debt issued in 2009. The 2011 total coverage of 1.79x as well as the 2010 coverage of 1.89x were stronger than the 1.56x and 1.57x projected for 2010 and 2011 respectively, at the time of the prior debt issuance. For the current year, the utility's prior projection of $101 million in net revenues is on target, which would provide total debt service coverage of 1.53x, once again outperforming previous projections. However, the utility expects to deposit approximately $15 million in its rate stabilization fund, which would lower converge to 1.30x. The utility's strong financial performance in recent years enabled it to increase unrestricted cash from $141 million in 2004 to $215 million in 2011, which affords the system a very strong liquidity position, thereby enhancing operating flexibility.

The improved financial performance through 2011 was largely due to annual rate increases of 6.5%, which came into effect in 2008 and were approved through 2011. These rate increases were largely in anticipation of significant amounts of additional debt already issued. Similarly, the utility was anticipating another rate study in 2011, in anticipation of additional new debt beginning in 2011. However, as the utility was successful in securing substantial amount of grants for its capital program, new debt is not expected until 2013 and higher rates to accommodate the new debt is not expected until 2014. Therefore, for the immediate future, the utility's coverage levels are projected to be very low, although somewhat higher than the projections in 2010.

The utility's formal reserve policies call for the maintenance of a 60-day operating reserve, funded at $30.4 million in fiscal 2011; projected to increase to 70 days by 2013. The utility also maintains an emergency capital reserve of $5 million. A separate $12.5 million "Secondary Purchase Reserve" is available to fund emergency water purchases. The utility also established a rate stabilization fund, totaling $20.5 million in fiscal 2011. While these funds are part of its formal reserves, they are quite modest given the size of the system's operations. However, our favorable view of the system's liquidity position is based on its unrestricted cash, which is very strong as mentioned above. Given the utility's reasonable operating projections, we expect the system's overall cash position to remain strong.

LARGE, STRONG AND DIVERSE SERVICE AREA

The ratings on the city's water revenue bonds are in large part based upon the size, diversity and economic strength of the system's 330 square mile service area, which encompasses the city of San Diego as well as a few small areas outside the city limits. The enterprise provides primarily retail water service to the entire service area, which has a population of about 1.3 million. The city's economy and tax base exhibited strong and steady growth since the late-1990's until the onset of the recent statewide real estate downturn. The city was affected by the deterioration of the residential real estate market, with home prices falling about 38% from their peak, but remained unchanged year-over-year as of February 2012.

Historical retail service connections had grown steadily at approximately 1% annually since 2000 to reach nearly 270,000 in 2004. However, since then annual increases have averaged a much lower 0.33% reaching just 273,398 in 2008 and 274,678 in 2011. It is notable that total connections never experienced a decline throughout the economic downturn. Single family domestic customers account for 43% and other domestic customers and 21% of water sales, while commercial/industrial customers represent 21%. There are no dominant commercial or industrial customers; the largest wholesale customer, California-American Water Company, accounted for 2.9% of fiscal 2011 revenues. The only retail customers responsible for more than 1% of total water fund revenues were the City of San Diego which accounted for 3.4% at fiscal year-end 2009, and the U.S. Navy which accounted for 2.3%.

FAVORABLE DEBT POSITION WILL LIKELY BE RESTORED AFTER AMBITIOUS CAPITAL PLAN FUNDED LARGELY WITH NEW DEBT

At the end of 2011, the city's water system debt stood at approximately $865 million which resulted in a debt ratio of 37.1%, somewhat above the California median of 29.2% for similarly rated water enterprises. The utility's capital needs are significant and it expects to spend nearly $471 million on projects between 2012 and 2016, of which $265 million is expected to be financed with debt. The largest component of the plan is pipe replacement ($347 million). At the end of the current Capital Improvement Program, the utility will be compliant with all regulations and have sufficient capacity for the foreseeable future.

The current offering will be secured by a subordinate lien on the net revenues of the system. The security provisions are typical with a rate covenant and additional bonds test of 1.2 times for senior lien debt and 1.0 times for all debt. The debt service reserve requirement is subject to a three tier test and will be met with bond proceeds and existing reserve of the refunded bonds.

Outlook

The stable outlook for our rating on the water enterprise's debt reflects the stable financial operations of the utility and our expectation that the city will be able to implement its capital plan while preserving its financial strength. However, slow growth in revenues is projected to dampen debt service coverage ratios. The projections reflect no rate increase until 2014 and the resulting coverage levels are very low for the current rating level. If actual debt service coverage levels beyond 2013 are in fact at the projected levels, the current rating would be under downward pressure.

KEY STATISTICS

2011 estimated population served: 1.3 million

Senior debt service coverage, fiscal 2011: 2.29x

Total debt service coverage, fiscal 2011: 1.79x

Rate Covenant: 1.20x; for senior lien; 1.0x all debt

Additional Bonds Test: 1.20x for senior lien; 1.0x all debt

Operating Ratio, Fiscal 2011: 76.7%

What Could Change the Rating--Up

--Significantly wider debt service coverage levels

--Significant improvement in the area economy

--Significant improvement In the utility's liquidity position

What Could Change the Rating--Down

--Debt service coverage levels well below recent levels

--Significant deterioration In the utility's liquidity position

The principal methodology used in this rating was Analytical Framework For Water And Sewer System Ratings published in August 1999. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

Although this credit rating has been issued in a non-EU country which has not been recognized as endorsable at this date, this credit rating is deemed "EU qualified by extension" and may still be used by financial institutions for regulatory purposes until 30 April 2012. Further information on the EU endorsement status and on the Moody's office that has issued a particular Credit Rating is available on www.moodys.com.

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