FitchRatings

FITCH RATES SAN DIEGO, CA IMPLIED GO AT 'AA-'; OUTLOOK STABLE

Fitch Ratings-San Francisco-13 April 2012: Fitch Ratings has assigned San Diego, California an implied unlimited tax general obligation (GO) bond rating of 'AA-'.

In addition, Fitch affirms the following ratings:

--$7.7 million San Diego (CA) certificates of participation (1993 Balboa Park/Mission Bay Park Refunding), series 2003 at 'A+';
--$330.9 million San Diego Public Facilities Financing Authority (CA) lease revenue bonds, series 2002B, 2007A, and 2010A (Master Refunding Project) at 'A+';
--$10.7 million San Diego Metropolitan Transit Development Board (CA) lease revenue refunding bonds, series 2003 at 'A+';
--$156.8 million Convention Center Expansion Financing Authority(CA) lease revenue bonds, series 1998A at 'A+'.

The Rating Outlook is Stable.

SECURITY
The COPs and lease revenue bonds are secured by the city's lease rental payments which the city covenants to budget and appropriate annually.

KEY RATING DRIVERS

DIVERSE ECONOMY: The city benefits from a diverse economy, a variety of revenue streams, relatively stable taxable assessed valuation (TAV), and its desirable location as a place to live and work or visit.

ELEVATED UNEMPLOYMENT RATE: While the city's largest employers are in the traditionally stable military, education, government, and health care sectors, the city's unemployment rate rose significantly during the economic downturn and remains elevated.

SOLID FINANCIAL OPERATIONS: The city ended fiscal 2011 essentially breaking even and maintaining an adequate unrestricted general fund balance. The city projects similar performance for fiscal 2012. Recent city forecasts allude to measured progress in addressing the city's structural imbalance, with some continued vulnerability to economic volatility.

PRUDENT POLICIES: The city continues to demonstrate a commitment to conservative financial management policies, multiyear budget planning, and general fund balance and reserves preservation.

ADMINISTRATIVE CHALLENGES REMAIN: Fitch expresses some reservations about the city's ability to fully implement disclosure initiatives, given recent system implementation problems which delayed audits. The city's plan to resume timely audit reporting in November 2012 is an important positive step.

SIGNIFICANT LIABILITIES GOING FORWARD: The overall debt burden is moderate and expected to remain so despite planned debt issues to address what the city reports as significant unmet infrastructure maintenance needs. Pension and other post-employment benefit (OPEB) liabilities exert pressure on the overall credit profile despite the city's prudent approach to funding.

CREDIT PROFILE
San Diego is the second largest city in California, with a population of approximately 1.3 million.

While the city has diverse employment and tax revenue bases, and significant ongoing economic development, its socio-economic characteristics are somewhat mixed and its unemployment rate was still elevated at 9.3% in February 2012.

RELATIVELY MILD TAX BASE FLUCTUATIONS

The city's tax base has survived in relatively good shape despite the pressures on the wider county's property market during the economic downturn. Two years of small TAV declines (0.6% in fiscal 2010 and 2.1% in fiscal 2011) were followed by a slight rebound in fiscal 2012 (up 0.8%). In fiscal 2013, the TAV for secured property is projected to increase by a further 2.3% (this figure excludes state-assessed utility property, the incremental value for redevelopment project areas, and unsecured property). However, the county property market is still experiencing elevated levels of appeals, foreclosures, and delinquencies, which suggests that the city's tax base could continue to experience stress despite ongoing construction and a positive housing price trend.

SOLID FINANCIAL OPERATIONS

The city ended fiscal 2011 with a solid unrestricted general fund balance (the sum of committed, assigned, and unassigned general fund balances under GASB 54) of $99.9 million, equaling 8.9% of spending. Excluding an $87.3 million transfer to the general fund of RDA cash for projects not yet started (held in a separate trust account and subject to potential state claw back), fiscal 2011 operations were essentially break even.

The city reports minor budget surpluses for fiscal 2012 due to modest increases in property, sales, and hotel tax revenues and savings from previously implemented expenditure reduction measures. The city intends to spend a portion of these additional revenues on service enhancements in fiscal 2012 and carryover a small surplus to be used in fiscal 2013 for budget-balancing, if needed, and capital improvement projects. In addition to consistently exceeding its 8% general fund reserve goal, the city recognizes the need to bolster reserves for its public liability, workers' compensation, long-term disability, and enterprise funds and has concrete plans to incrementally build them up.

The recently revised draft five-year forecast included in the mayor's proposed fiscal 2013 budget shows continued improvement over prior year published forecasts. The forecasts show revenues offsetting known costs increases and benefitting from continued economic improvement, as well as decreased annual pension contributions as a result of prior reforms. If realized, the forecasts show elimination of general fund shortfalls of $12.2 million in fiscal 2013 and $5.9 million in fiscal 2014. Thereafter, the city now anticipates generating general fund surpluses, gradually improving to a surplus of $67 million by fiscal 2017. Fitch believes certain revenue assumptions may prove slightly aggressive but notes that overall revenue growth is modest.

REESTABLISHMENT OF TIMELY AUDITS

Following pension disclosure failures which significantly delayed its audits for fiscal years 2003-2008, the city has made significant investments in its financial reporting and accounting systems. However, after issuing its fiscal 2009 audit on a timely basis, problematic implementation of a new enterprise resource planning system delayed the fiscal 2010 audit by nine months and the fiscal 2011 audit by one month.

From a management and administration perspective, Fitch notes with concern the training weaknesses and inadequate management controls that led to the initial inaccurate data entry problem, the length of time taken to resolve the problem, and the failure to risk manage the implementation more successfully. The city expects to issue its fiscal 2012 CAFR on a timely basis (November 2012, ahead of the industry standard of December 2012).

MODERATE DEBT BURDEN BUT SIGNIFICANT PENSION & OPEB LIABILITIES

Due to past market access impediments, the city's overall debt burden is moderate at $3,712 per capita, or 3.1% of TAV. Debt amortization is average. The city plans to issue a further $261 million in long-term debt before the end of the 2012 calendar year which would not significantly increase the tax burden on either a per capita basis ($3,910) or as a percentage of TAV (3.2%).

In fiscal years 2011 and 2012, the city issued an elevated $161-$163 million in short-term TRANs annually because of significant increases in the pension ARCs for those years. The fiscal 2013

TRANs amount has yet to be determined.

The city emphasizes its continued focus on funding its capital backlog of $898 million (excluding water and wastewater system needs). The city is considering issuing between $80-$90 million annually during fiscal years 2013-2017. The city might also act as conduit issuer for $520 million in bonds to expand its convention center, if all the required project approvals are granted, but it would be responsible for repayment of only a small portion of that debt. Fitch believes the capital plan is manageable and should not dramatically alter the city's overall debt profile from both a tax base and budget burden perspective.

San Diego City Employees Retirement System (SDCERS) is 68.5% funded using the city's 7.5% discount rate and 64.9% funded using Fitch's more conservative 7% discount rate, levels that Fitch views as less than adequate. The city has already worked to stem the growth in its pension costs by establishing second tier pension benefits for new hires starting in 2009-2012 (depending on job classification), reducing the rate of return for its deferred retirement option plan, and eliminating its contributions on behalf of employees.

In June, the electorate will be asked to vote on further pension reform. A conservative analysis prepared by the city's independent budget analyst suggests that if successful, the considerable potential savings from this reform ($963 million net savings over 30 years) would come not from the proposed pension system changes that increase pension costs by $13 million. Rather, the savings would result from proposed restraints to employee remuneration growth so long as they are not rescinded by majority city council vote. Nevertheless, the ballot measure would benefit the city in the long-term by shifting investment and longevity risks to future city employees.

In terms of OPEB, the city still has an unfunded accrued actuarial liability of roughly $801 million, or a low 0.5% of fiscal 2012 TAV, when including the benefit of recent reforms. The city negotiated a new city retiree health plan in 2012 which is projected to save $714 million in health care costs over 25 years and caps the city's annual OPEB contribution at $57.8 million (5.1% of budgeted fiscal 2012 spending) in fiscal years 2012-2015, with annual increases of up to 2.5% thereafter.

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Additional information is available at 'www.fitchratings.com'. The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from Creditscope, University Financial Associates, S&P/Case-Shiller Home Price Index, IHS Global Insight, Zillow.com, and National Association of Realtors.

Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria' (Aug. 15, 2011);
--'U.S. Local Government Tax-Supported Rating Criteria' (Aug. 15, 2011).

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Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=648898
U.S. Local Government Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=648842