

San Diego, California; Water/Sewer

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Credit Profile

US\$126.2 mil wtr rev rfdg bnds ser 2010A due 08/01/2028

Long Term Rating

AA-/Stable

New

Rationale

Standard & Poor's Ratings Services assigned its 'AA-' long-term rating, and stable outlook, to San Diego Public Facilities Financing Authority, Calif.'s senior-lien series 2010A water revenue refunding bonds. At the same time, we affirmed our 'AA-' underlying rating (SPUR), with a stable outlook, on the authority's existing senior-lien water revenue certificates and bonds and our 'A+' SPUR, with a stable outlook, on the city's subordinate-lien water revenue bonds.

The ratings reflect our opinion of what we consider to be the city's following credit strengths:

- Good historical and projected debt service coverage with pre-approved rate increases through fiscal 2011, even after excluding one-time capacity charge revenue;
- Strong cash reserves bolstered by targeted cash reserve policies;
- Council-approved system rate increases through fiscal 2011; and
- A diverse service area economy and customer base.

Partially offsetting credit concerns is in our opinion of the system's:

- Significant capital improvement plan (CIP) driven by regulatory concerns and additional long-term capital and rate pressures related to water supply needs;
- Required adoption of future rate increases by city council beyond fiscal 2011 as well as annual approvals by city council for customer water charge increases related to passed-through water purchase costs, which are also subject to Proposition 218 requirements; and
- Bond provisions that allow net system revenue calculations to include transfers from the rate stabilization fund and secondary purchase funds.

A senior-lien pledge on installment payments payable from the net revenues of the city's water system secures the 2010A water revenue bonds and the 1998 certificates represent an interest in such revenues. A subordinate-lien on the net revenues of the city's water system secures the series 2002 bonds and a 2004 loan from the State of California Department of Health Services Safe Drinking Water state revolving fund (SRF). We understand that the series 2010A bond proceeds will be used to refund the series 1998 certificates and a portion of the series 2002 subordinate-lien bonds.

San Diego covers 400 square miles and has a population of 1.3 million. Its water system provides retail water services to a stable customer base consisting of 273,656 customers, of which 91% are residential. Single-family and multifamily residential customers represented about 59% of the system's water revenue in fiscal 2009; commercial, irrigation, construction, and industrial customers represented about 35% of system revenue in fiscal 2009. The city also serves wholesale customers, which account for only 4% of total water sales revenue. The system's leading 10 retail customers represent what we view as a diverse 10.6% of water sale revenues. The water system is supplied

primarily by raw water imported by the San Diego County Water Authority (CWA; 'AA+' SPUR), which accounts for approximately 90% of the system's water supply and 44% of the utility's operating expenses. CWA, in turn, receives the majority of its water from the Metropolitan Water District of Southern California (MWD; 'AAA' SPUR; 'AAA' revenue bond rating).

The water system has about \$900 million of revenue bonds and SRF loans outstanding secured by senior and subordinate liens of the system's net revenue. The system has no variable-rate debt outstanding. Coverage of annual senior debt service on the senior-lien debt by net system revenue, without netting interest earnings from the reserve fund, in fiscal 2009 was a very strong 4.7x, in our opinion. Total combined annual senior and subordinate debt service coverage, including the 2002 bonds and debt service on SRF loans, was also what we consider strong at 2.5x. Coverage of senior and total pro forma maximum annual debt service (MADS) is 1.98x and 1.5x, respectively. Based on fiscal 2010 projected results, system officials estimate net system income--including operating receipts, capacity charges, and interest earnings--provides what we consider strong-to-good senior and combined debt service coverage (DSC) of 3.3x and 1.5x, respectively. Capacity charges fell 69% between fiscals 2007 and 2009, respectively, to \$4.2 million. Excluding all capacity charges, projected combined DSC in fiscal 2010 drops to what we view as a still-good 1.4x. Estimated fiscal 2010 revenue covers fixed water purchase charges and combined debt service, excluding capacity charges, by an adequate 1.25x in our opinion.

After annual 6.5% rate increases in fiscals 2008 through 2010 and an already-approved 6.5% annual increase as of July 1, 2010, the city has no additional pre-approved rate increases. The council expects to annually determine pass-through charges to cover likely future increases in purchased water costs. Pass-through water charges are also subject to Proposition 218 hearings; we understand that the city has complied with notice and protest procedures and has not had any rate increase legally challenged pursuant to Proposition 218. Together with the sewer rates, overall residential rates are above average for a regional system, at about \$105 per 7,500 gallons per month, but what we view as a still-manageable 2.6% of the city's median household effective buying income. Officials expect to conduct another rate study next year to evaluate the need for further rate increases.

System officials project what we consider to be adequate-to-good total debt service coverage; the officials' projections reflect that net system revenues will cover existing and future senior and subordinate debt service from 1.1x-1.6x through fiscal 2014. Fiscal 2010 projections assume 5.8% growth in water revenues--even after assuming a 15% water conservation factor--due to rate increases, including a 6.5% rate increase approved by council and a 7.8% increase to pass through rising water purchase costs. Fiscal 2010 rates also include a 3.1% rate increase, effective Jan. 1, 2009, through June 30, 2010, for a one-year pilot project to study the viability of increasing potable water sources through reuse and reservoir augmentation. The system projections also do not include any increases in imported water costs or corresponding pass-through rate increases beyond fiscal 2009. Officials estimate the water fund's proportionate share of contributions to the city's pension fund and the retiree health care obligations represent about 5.6% of estimated fiscal 2012 operations. The projections assume 32% higher capacity fees in fiscal 2010 that subsequently remain fairly flat through fiscal 2014. Excluding officials' projections of capacity charges and assuming no further rate increases, total senior and subordinate debt service coverage is thin at 1.03x in fiscal 2014.

Total audited cash in the system at fiscal year-end 2009, including cash that was not designated per policy, was \$226 million, equivalent to 313 days of operating expenses. System officials estimate that combined cash in its targeted reserve funds, including the operation reserve, secondary purchase fund, rate stabilization fund, emergency reserve, and dedicated reserve for efficiencies and savings (DRES) reserve, in fiscal 2010 totaled \$52.6 million, or

what we consider equivalent to a good 63 days of estimated annual operations.

The system's CIP for 2010 through 2014 totals \$695 million, with 60% of the capital project expenditures between fiscals 2010 and 2014 related to a California Department of Health compliance order to fund pipe replacement, improve treated water storage, and treatment facility upgrades. Officials indicate they are currently in compliance with the order. We understand that in the future, system officials intend to finance 80% of the CIP with additional debt in the next four fiscal years. System officials indicate they are currently looking at the next master plan to identify system capital needs into the future. We believe capital needs associated with long-term water resource planning, water quality regulations, and ongoing water main replacement are likely to spur future system capital requirements.

Outlook

The stable outlook reflects what we consider to be historical good debt service ratios bolstered by pre-approved rate increases, despite the city's implementation of a large CIP associated with regulatory requirements. The outlook reflects our expectation that pass-through charges for increased water purchase costs and future rate increases will be approved as necessary to maintain good debt service coverage, and the system will adhere to its cash reserve policies to maintain sufficient liquidity in the system. In addition, should failure to meet the requirements of the compliance order result in what we consider significant deterioration of DSC or liquidity, we could lower the ratings.

Cash Reserve Policies

Officials have identified reserve policies to maintain cash within the system, including a targeted 70-day operating reserve to be used for unplanned operating expenditures, a secondary purchase reserve funded at 6% of annual water purchase costs to offset potential disruptions in the water supply, a \$5.0 million emergency reserve for capital expenditures, and a \$20.5 million rate stabilization fund. The system also recently established a DRES to track efficiencies and offset future water rate increases. The system also maintains restricted cash reserves for debt service requirements. The operating reserve is currently funded at approximately 24 days' estimated operations in fiscal 2010, but officials expect to fund this reserve at the 70-day target by fiscal 2013.

Water Supply

California continues to face pressure to reduce its dependence on Colorado River water, which places additional strain on MWD, CWA, and the city system to maintain a sustainable water supply. The state of California, in total, is apportioned 4.4 million acre-feet per year of Colorado River water, plus one-half of the surplus Colorado River water available collectively for Arizona, Nevada, and California. These other states have increased their respective draws of water in recent years, reducing the amount of surplus water left for California. Apart from the increased draw by other states, the Colorado River system is also in the midst of a prolonged drought, further reducing Colorado River water availability.

Since its inception in 1944, the CWA has served as the key water delivery agency for San Diego County. Most of the water consumed in the San Diego County service area comes from the authority. In its historical role as a water delivery agency, the authority has depended on the MWD as its primary source of supply. Both the CWA and MWD

are augmenting imported water with storage and water transfers; however, due to drought conditions, the MWD reduced its water supply to CWA by 13% in fiscal 2010. The CWA, in turn, reduced its supply to member agencies by 8% in fiscal 2010. Both agencies estimate fiscal 2011 allocations will be similar to fiscal 2010.

In May 2009, the city council declared mandatory water use restrictions, effective June 1, 2009, to target a 20% reduction in demand. In fiscal 2010, the city achieved a 11% reduction in water usage, above the 8% targeted level. Furthermore, above-average precipitation has improved reservoir levels in the state this year. Officials inform us that they have no plans for additional water use restrictions at this time. We understand that, in the long term, the city plans to increase its conservation efforts and reclaimed water sales to reduce its dependence on CWA to 83% of its water supply by fiscal 2015. In addition, the city has implemented a pilot indirect potable reuse demonstration project to determine the feasibility of augmenting the system's potable water supply with reused water.

Bond Provisions

In our view, the senior-lien provisions in the master installment purchase agreement are somewhat permissive. Net system revenue calculations include transfers from the rate stabilization fund and secondary reserve, as well as capacity charges. The senior-lien 1.2x annual debt service (ADS) rate covenant allows debt service and revenue to be reduced to account for interest earnings on the debt service reserve of the certificates. The senior-lien provisions also require a minimum 1.2x MADS coverage using either historical revenues in 12 out of the past 18 months or future estimated revenues adjusted for rate increases and estimated revenue from expected water system additions, improvements, and extensions.

A subordinate-lien pledge on the water system's net revenues secures the series 2002 bonds. The system also has an SRF loan outstanding. The system covenants to maintain rates sufficient to cover total ADS by at least 1x. The series 2002 bond provisions allow additional bonds if the system can demonstrate at least 1x senior and subordinate MADS coverage by historical or future estimated net system revenues adjusted for rate increases and improvements. Provisions for both the senior and subordinate bonds include a fully funded debt service reserve for each series funded at the least of MADS, 10% of par, or 1.25x aggregate average ADS; the debt service reserve funds are cash-funded; however, the permitted investments are, in our view, somewhat permissive as they allow for investments in repurchase agreements rated in the three highest short-term rating categories.

Service Area Economy

San Diego's population of 1.38 million has risen about 1% per year since the 2000 U.S. Census. The city is a significant employment center within the county, representing about 45% of the county's total employment. The economy consists of various high-tech clusters, including biotech and telecommunications, combined with a reliance on tourism, and the military and defense industries. Also anchoring its economic base are higher education and major scientific research institutions, including the University of California-San Diego, San Diego State University, Scripps Research Institute, the Salk Institute for Biological Studies, and the San Diego Supercomputer Center. Median household effective buying income is also strong, in our view, at 117% of the national average in 2008. However, given rising unemployment rates, we believe that this ratio might have moderated in the past year. According to the Bureau of Labor Statistics, the city's estimated unemployment rate has risen gradually from an annual average rate of 6% in 2008 to 9.7% in 2009. Net assessed value (AV) fell 0.62% in fiscal 2010 to \$162.6 billion, excluding redevelopment area AV, due to falling home prices between 2007 and 2009 and a rise in

foreclosures in the county to about 1.25% of housing units. For fiscal 2011, the county's preliminary estimates reflect a 2% decline in countywide AV.

Audits And Internal Controls

We understand that as part of a 2006 cease and desist order with the Securities Exchange Commission, the city hired an independent consultant to review its internal policies and disclosure processes. In March 2010, the independent consultant released his third and final report, which concluded that San Diego has made progress toward improving its internal controls and disclosure processes, although the report also noted the city needs to improve its internal controls over financial reporting. City management expects the full implementation of new enterprise resource planning software in 2010 to help resolve internal control weaknesses and aid in the continued timely release of future financial reports. San Diego released its fiscal 2009 audited financial statements in February 2010.

Related Criteria And Research

USPF Criteria: Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008

Ratings Detail (As Of June 7, 2010)		
San Diego certs of undivided int (payable from net sys revs of wtr util fd) ser 1998 dtd 08/01/1998 due 08/01/2001-2018 2021 2024 2028		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
San Diego certs of undivided int (payable from net sys revs of wtr util fd)		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
San Diego Pub Facs Fincg Auth, California		
San Diego, California		
San Diego Pub Facs Fincg Auth wtr rev rfdg bnds ser 2009A		
Long Term Rating	AA-/Stable	Affirmed
San Diego Pub Facs Fincg Auth (San Diego) sub wtr (wrap of insured) (MBIA & ASSURED GTY) (SEC MKT)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed
San Diego Pub Facs Fincg Auth (San Diego) sub wtr (MBIA) (MBIA of Illinois)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed
San Diego Pub Facs Fincg Auth (San Diego) wtr rev bnds ser 2009B		
Long Term Rating	AA-/Stable	Affirmed
Many issues are enhanced by bond insurance.		

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