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Fitch Provides Follow-Up Comments on San Diego, California Water Revs Upgrade

Ratings
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Fitch Ratings-Austin-12 December 2008: As described in Fitch Ratings' press release 'Fitch Upgrades San Diego, California GOs to 'A+'; Lease Revs to 'A' & Water Revs to 'AA-'', dated Dec. 11, 2008, Fitch assigned a rating of 'AA-' to approximately $63 million San Diego Public Facilities Financing Authority water revenue bonds, refunding series 2009A. The bonds are payable from net revenues of the city of San Diego's (the city) water system (the system), on parity with the system's outstanding senior lien obligations. Bond proceeds will be used to refund a portion of the system's outstanding debt, fund a debt service reserve, and pay costs of issuance. The bonds are scheduled to sell via negotiation the week of January 12, 2009 through a syndicate managed by Morgan Stanley & Co. Incorporated.

Within the previously mentioned press release, Fitch also upgraded the following outstanding debt secured by net system revenues:

San Diego Facilities and Equipment Leasing Corporation
--$245 million certificates of undivided interest, series 1998 (secured by a senior lien on water revenues) to 'AA-' from 'BBB+'.

San Diego Public Facilities Financing Authority
--$272.8 million subordinated water revenue bonds, series 2002 to 'A+' from 'BBB'.

The Rating Outlook was revised to Stable from Rating Watch Positive.

The upgrades and Stable Outlook reflect the strong financial position of the system as evidenced in the recent release of the city's fiscal 2007 audited financial statements. Also reflected in the upgrade is the progress the city has made to date in addressing disclosure and internal control issues. The city continues to face pressures related to long-term funding of pension and other post employment benefit (OPEB) obligations. However, the system's portion of these liabilities is manageable and is not expected to place a substantial burden on operations. Overall, combined pension and OPEB costs are estimated to account for just over 4% of operating expenses in fiscal 2009 and reach a maximum of 5% by fiscal 2011.

The ratings reflect the system's historically favorable financial results and expectation of continued sound operations; the moderately high to high debt levels that are expected to increase rapidly over the near term; rising user charges; and broad and diverse service area. The system faces regulatory-driven capital needs over the intermediate term, which will lead to rising leverage pressures. In addition, drought conditions within the state and region have necessitated increased conservation efforts, reducing sales over the immediate future. Recognizing these challenges, the city council recently passed a multi-year rate package that should preserve the system's financial flexibility.

Capital needs for fiscals 2009-2013 total $724 million on an inflated basis, with the majority of costs attributable either directly or indirectly to requirements under a regulatory consent order. Approximately 80% of funding sources are expected to be derived from debt issuances, which will increase the system's leverage ratios substantially through the CIP period. Currently, debt levels are relatively high and planned borrowings are expected to result in leveraging that will be well above other comparably rated systems by fiscal 2013.

In addition to a rising fixed cost structure, the system faces near-term operational challenges as a result of drought conditions and certain legal constraints that have led the city's wholesale water provider, San Diego County Water Authority (CWA, revenue bonds rated 'AA' by Fitch), to seek reductions in customer consumption levels. Consequently, the city is forecasting a 6% reduction in water sales in fiscal 2009 followed by a 15% decrease in fiscal 2010; a return to full consumption amounts are anticipated in fiscal 2011 and beyond.

Despite these challenges, it is expected that the system will maintain a favorable financial profile through at least the fiscal 2013 projection period. System financial results over the last several fiscal years have produced increasing annual debt service (ADS) coverage, sound liquidity, and good cash flows. For audited fiscal 2007, ADS coverage on senior lien bonds was 4.2 times (x) and 2.2x for all debt. Liquidity for the year ended with over 280 days of cash and working capital, while free cash to depreciation was in excess of 170%; fiscal 2008 margins are also anticipated to be positive.

Through fiscal 2013, senior lien and all-in ADS coverage is projected at no less than 2.6x and 1.5x, respectively, including the costs associated with rising debt levels and reduced demand. If drought conditions persist and water sales remain suppressed beyond fiscal 2011, debt service coverage is expected to be impacted somewhat. However, given the city purchases most of its water from CWA, operational costs would be partially offset thereby limiting the impact to financial margins.

In light of the city's capital demands, as well as the need to recover pass-through costs from CWA, the city council passed a series of rate hikes in recent years. In total, rates were increased over 15% for fiscal 2009 and will increase an additional 6.5% in fiscals 2010 and 2011; no additional escalations are currently forecasted for fiscals 2012-2013. With the adjustment for fiscal 2009, the current average monthly residential bill has risen to a moderately high 1.2% of estimated median household income. While the current and projected level of customer charges is a credit concern given the diminished rate flexibility, user costs are not, nor are they expected to be, significantly higher than other major West Coast metropolitan providers through the projection period.

The system provides retail service to around 1.3 million people within the city and also provides limited wholesale service to certain customers in the outlying area. The city's diverse economy is driven by healthcare, military, tourism, and educational sectors. The city experienced broad economic growth throughout much of this decade, but like many areas across the country the collapse of the housing market and national recession have impacted job growth and led to rising foreclosure activity. Likewise unemployment is rising, with the city's most recent results for September 2008 at 6.4%, up from 4.8% year-over-year.

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Fitch issued an exposure draft on July 31, 2008 proposing a recalibration of tax-supported and water/sewer revenue bond ratings which, if adopted, may result in an upward revision of this rating (see Fitch research 'Exposure Draft: Reassessment of the Municipal Ratings Framework'.) At this time, Fitch is deferring its final determination on municipal recalibration. Fitch will continue to monitor market and credit conditions, and plans to revisit the recalibration in first quarter-2009.

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