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FITCH RATES SAN DIEGO PUBLIC FACILITIES FIN AUTH (CA) WASTEWATER REVS 'AA-'; UPGRADES OUTSTANDING

Fitch Ratings-Austin-14 April 2009: Fitch Ratings assigns an 'AA-' rating to the Public Facilities Financing Authority of the City of San Diego, California's(the authority) approximately $458.1 million sewer revenue bonds, series 2009A. In addition, Fitch upgrades to 'AA-' from 'BBB+' its rating on the authority's $893.7 million of outstanding parity bonds. The bonds are removed from Rating Watch Positive, where they were placed March 28, 2008. The Outlook is Stable.

The bonds are payable from net revenues of the city of San Diego's (the city) wastewater system (the system), on parity with the system's outstanding senior lien obligations. The series 2009A bonds are scheduled to sell the week of May 4th via negotiation. Bond proceeds will be used to construct various system improvements, refund a portion of the system's outstanding debt, fund a debt service reserve, and pay costs of issuance.

The upgrade to 'AA-' from 'BBB+' and Stable Outlook reflect the sound financial position of the system as evidenced in the recent release of the city's fiscal 2008 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 6% of operating expenses in fiscal 2009 and be around 8% by fiscal 2011.

The 'AA-' rating reflects the system's favorable financial results and expectation of continued sound operations; the relatively high debt levels; 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. This is expected to reduce financial margins somewhat, but both approved and assumed rate increases, along with sound financial policies, should preserve operating flexibility. Capital pressures could increase substantially if the system is required to convert its largest wastewater treatment plant - Point Loma Wastewater Treatment Plant (PLWTP) - to full secondary treatment. However, this is not expected to be a concern in the immediate future.

Capital needs for fiscals 2009-2013 total nearly $752 million on an inflated basis, with the majority of costs attributable either directly or indirectly to requirements under a regulatory consent decree. Approximately 80% of funding sources are expected to be derived from debt issuances, which will increase the system's already above-average leverage ratios through the capital improvement plan (CIP) period. While the current CIP addresses substantially all of the capital requirements related to the consent decree and there are limited growth pressures facing the system, capital costs could escalate substantially in the years following the CIP period if the system is required to convert PLWTP to full secondary treatment standards.

Currently, PLWTP operates under an expired 301(h) waiver of the federal Clean Water Act, allowing the facility to treat to advanced primary standards. The city has received a tentative indication from regulators that the waiver will be renewed for an additional five-year period, with the actual permit expected sometime later this year. However, it is likely that sometime after the expiration of the renewed permit around 2014 additional enhancements to the system will be required, which could include conversion of PLWTP's treatment process to full secondary. While the city will be working with regulators in the intervening timeframe to evaluate possible enhancements to the system without such a conversion of PLWTP, if the facility is required to upgrade to full secondary, capital costs are currently forecasted to be as high as $1.5 billion. Fitch will continue to monitor regulatory developments and assess the possible impact they could have on the system's credit profile.

Financially, the system's performance is good, characterized by upward trends in both annual debt service (ADS) coverage and liquidity over the last five fiscal years. More recently, operating results were enhanced with passage of a four-year package of annual rate hikes by the mayor and city council beginning in fiscal 2007. For fiscal 2008, ADS coverage on senior lien bonds reached 2.1 times (x), while ADS coverage of all system debt was 1.7x. For the same period liquidity was healthy: days cash and days of working capital were both above 520 days.

With the anticipated rise in fixed costs over the fiscal 2013 forecast period, financial margins are expected to face some pressure, but should still remain adequate. Over the next five fiscal years, senior lien and all-in ADS coverage is projected to decline somewhat to minimum levels of 1.6x and 1.5x, respectively, including the costs associated with additional debt issuances. Offsetting the decline in ADS, liquidity is expected to remain strong and even improve slightly as the city is planning to increase contributions to base reserves. Projections include moderate annual rate hikes of 4% beginning in fiscal 2011 above the amounts already approved by the mayor and city council through fiscal 2010. While rates for fiscal 2009 are considered relatively high at around 1% of median household income, the level of approved and assumed rate increases should keep rates in the affordability range through the forecast period.

The system provides retail service to around 1.3 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 health care, 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 had an impact on job growth and led to rising foreclosure activity. Likewise, unemployment is rising, with the city's most recent results for February 2009 at 8.8%, up from 5.0% year-over-year.

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