

**New Issue: San Diego (City of) CA Sewer Enterprise**

**MOODY'S UPGRADES TO A2 FROM A3 THE RATING ON SAN DIEGO SEWER ENTERPRISE**

**APPROXIMATELY \$1.3 BILLION IN DEBT AFFECTED**

San Diego (City of) CA Sewer Enterprise  
 Water/Sewer  
 CA

**Moody's Rating**

<b>ISSUE</b>	<b>RATING</b>
Senior Sewer Revenue Bonds, Series 2009 A	A2
<b>Sale Amount</b>	\$458,000,000
<b>Expected Sale Date</b>	05/06/09
<b>Rating Description</b>	Revenue
Senior Sewer Revenue Refunding Bonds, Series 2009 B	A2
<b>Sale Amount</b>	\$550,000,000
<b>Expected Sale Date</b>	05/18/09
<b>Rating Description</b>	Revenue

**Opinion**

NEW YORK, Apr 28, 2009 -- Moody's has assigned an A2 rating to the Senior Sewer Revenue Bonds, Series 2009A, and Senior Sewer Revenue Refunding Bonds, Series 2009B of the City of San Diego's Wastewater Enterprise. We have also upgraded to A2 from A3 the rating on the utility's parity senior lien sewer revenue bonds. In addition, we have changed the outlook on these ratings to stable from negative. The rating upgrade is based on the system's significantly improved financial performance since 2005, which is confirmed by the city's release over the past three years of six Comprehensive Annual Financial Reports (CAFRs), for the fiscal years ending 2003 through 2008. The improved finances are primarily attributable to sizable and necessary rate increases which reflect the city's renewed commitment to financial health throughout its operations. 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 ratings also reflect the utility's favorable debt position, which is likely to remain manageable despite the expected addition of a significant amount of new debt during the next five years necessitated by the current Capital Improvement Program (CIP). However, the utility's debt position could be severely challenged in the long term if it is ultimately required to upgrade its treatment capability to full secondary standards. The stable outlook reflects our expectation that, despite the anticipated increase in debt, rate increases already in place through 2011 will continue to provide debt service coverage consistent with the current rating level, and with the planned capital improvements, the system will have met most of its capital needs for the near to mid term. The proceeds of the Series 2009A bonds will be used to refund approximately \$224 million in privately placed short term debt maturing on May 15, 2009; refund approximately \$50 million in parity debt issued in 1997 and provide funds for the CIP. Proceeds of Series 2009B will be used to refund parity debt issued in 1993, 1995, 1997 and 1999. The bonds are secured by net system revenues of the city's wastewater utility.

**FINANCIAL RESULTS HAVE IMPROVED SIGNIFICANTLY. CASH POSITION IS STRONG.**

Since their low point in 2003, the sewer system's financial operations have improved steadily. Increased system revenues, largely through rate increases with modest growth in customer accounts and flow, combined with very tight controls on Operating and Maintenance (O&M) expenditures, which increased by a total of 3.5% between 2004 and 2008, enabled the utility to increase total debt service coverage from 1.22 times in 2004 to 1.59 times in 2008. Senior lien debt service coverage increased from 1.29 times to 1.95 times during this period. These coverage levels, which include capacity charges, improved despite a notable decrease in such charges. Largely as a result of the weak housing market, which affected San Diego earlier than other parts of the state, capacity charge revenues decreased from \$16.6 million in 2004 to \$11.9 million in 2008 and \$11.0 million is estimated for 2009. This downward trend is continuing, and significantly lower amounts are included in the utility's projections, despite an 11% increase in the capacity charge rate for 2008. The utility's strong financial performance in recent years enabled it to increase unrestricted cash from \$218.5 million in 2004 to \$291.2 million in 2008, which affords the system a very strong liquidity position,

thereby enhancing operating flexibility.

Bolstered by a 7.5% rate increase in March 2005, followed by 8.75% annual rate increases for 2007 and 2008 and 7.0% for 2009 and 2010, the utility's favorable trend in financial operations is likely to continue for the near term. Despite the significant amount of additional planned debt, the city's reasonable projections indicate senior debt service coverage levels at or above 1.6 times through 2013. Coverage levels for all debt, which includes relatively small amounts of subordinated state loans, are projected to remain above 1.53 times. In addition to the rate increases, only modest increases in connections are incorporated in the projections. Managing O&M expenses, which increase at an annual rate of 3.98% between 2010 and 2013, is also key to these projections and may be conservative given the trend through 2008.

Although the city's formal reserve policies call for the maintenance of a 50-day operating reserve, as of April 1, 2009 the utility boasted formal reserves of \$81.2 million which equals more than 40% of 2008 operating expenditures. However, our favorable view of the system's liquidity position is also based on its unrestricted cash, which is very strong as mentioned above. Although unrestricted cash in excess of formal reserve levels is available for capital expenditures, 80% of the utility's current CIP is expected to be funded with debt, and we expect the system's overall cash position to remain very strong. According to the system's projections, revenues net of O&M and debt service appear to be sufficient to fund the portion of the CIP which is intended to be funded from ongoing revenues.

#### LARGE, STRONG AND DIVERSE SERVICE AREA

The ratings on the sewer revenue bonds are in large part based upon the size, diversity and economic strength of the system's service area. San Diego's wastewater enterprise provides collection, treatment, and disposal services within the city limits (the "municipal system") and treatment and disposal services to many of the surrounding communities ("participating agencies" in the "metropolitan system"). The municipal system accounts for about two-thirds of the metropolitan system's total flows. The largest participating agency represents less than 10% of the flow. In fiscal 2008 single family domestic customers accounted for 32% and other domestic customers added 24% of total sewer service charge revenues, while commercial customers represented another 24%. There are no dominant customers within the municipal system; the largest is the U.S. Navy, which accounted for 2.85% of fiscal 2008 revenues, while the top ten customer account for 7.5% of revenues.

The local economy is characterized by high technology industries including telecommunications, software development, biotechnology and electronics, as well as manufacturing, professional services and international trade. Tourism also is a major contributor to the local economy. The local economy is affected by the severe recession gripping the state and the nation, although the February 2008 unemployment rate of 8.8% remains below the statewide rate of 10.9% and the national rate of 8.98%. The February, 2008 to February, 2009 job losses are estimated to be less than 10,000 or just 1.4% of total. Total labor force continues to increase, which accounts for the increase from the February 2008 unemployment rate of 5.0%.

#### ENTERPRISE COMPLIANT WITH ALL REGULATORY REQUIREMENTS

As mentioned above, San Diego's sewer enterprise provides collection, transportation, treatment, and disposal services. The capacity of the treatment system is 285 million gallons per day (MGD), 15 MGD from its South Bay Water Reclamation Plant (SBWRP), which discharges secondary-treated effluent through an ocean outfall; 30 MGD from its North County Water Reclamation Plant (NCWTP), excess effluent from which is transported to Point Loma, and 240 MGD from its Point Loma treatment plant. However, SBWRP and NCETP currently operate 10 MGD and 9 MGD, respectively. The effluent from the Point Loma Plant is discharged through a 4.5 mile long ocean outfall that delivers treated sewage effluent at a depth of 320 feet of water. As a result, it is one of a handful of large urban systems nationwide which is permitted to provide a lower treatment level than is required of almost all other treatment plants in the country ("advanced primary" treatment vs. "secondary"). It does so pursuant to a Modified Waiver. The system is in full compliance with the Waiver, which is likely to receive a five year extension. A preliminary approval for the extension was granted in December, 2008.

The enterprise's collection system has dramatically decreased the total number of sewer spills, from 365 in calendar 2000 to 62 in 2008. No regulatory penalty has been incurred as a result of the spills. The city had been sued by the EPA and Baykeeper, but negotiated two partial consent decrees which expired on June 30, 2006 and June 30, 2007. In 2007 the city negotiated the Final Consent Decree which requires the city to invest in additional capital improvements and enhance operations. Compliance with this final consent decree between 2009 and 2013 is estimated to cost \$117 million for capital improvement projects and \$49 million for operations and maintenance expense, all of which have been included in the city's operating projections.

#### FAVORABLE DEBT POSITION WILL LIKELY BE MAINTAINED IF FULL SECONDARY TREATMENT IS AVOIDED

The system's current five year CIP addresses the requirements of the Final Consent Decree, the improvements that had been delayed while the city lacked access to the capital markets, and normal ongoing and capital improvements. Of the approximately \$750 million total CIP, trunk improvements of \$200 million and pipeline replacement of \$360 million represent the largest components. Eighty percent of the CIP is

expected to be funded with bond proceeds including the new money portion of Series 2009A. The city's reasonable projections reflect ample ongoing revenues to meet the remainder of the CIP. We estimate that with the expected additional debt for the CIP the system's debt ratio will remain less than 50% and in line with median of 56% for similarly rated large sewer utilities. However, if the system is required to convert to full secondary treatment, the estimated additional cost of \$800 million to \$1.5 billion will increase the debt ratio to levels which could become very onerous for rate payers and possibly impact credit strength.

## SATISFACTORY LEGAL STRUCTURE

The bonds are secured by net system revenues of the utility after payment of O&M expenses. Revenues include connection fees and transfers from the rate stabilization fund, while deposits into the rate stabilization fund are included in O&M expenses. The rate covenant is 1.2 times. The additional bonds test is also 1.2 times. The debt service requirement is subject to the common three tier test. Following the refunding included in the Series 2009A and 2009B bonds, the system will have outstanding nearly \$200 million in previously issued bonds, whose reserve requirement is met by sureties from Ambac. While Ambac's current rating is Ba3, the rating requirement was Aa or higher only at the time of issuance. Therefore the sureties remain in place and afford somewhat weaker security for the affected bonds.

## Outlook

The stable outlook for debt obligations of the sewer enterprise 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. The current economic recession poses some potential difficulties for the utility. The utility's successful navigation through the recession, could improve bondholder security.

## KEY STATISTICS

Senior debt service coverage, fiscal 2008: 1.95x

Total debt service coverage, fiscal 2008: 1.59x

Rate Covenant: 1.20x

Additional Bonds Test: 1.20x

Operating Ratio, Fiscal 2008: 61.5%

The last rating action was on February, 15 2006 when the ratings on the utility's ratings were affirmed.

The principal methodology used in rating the utility's bonds was Analytical Framework For Water And Sewer System Ratings which can be found at [www.moody.com](http://www.moody.com) in the Credit Policy & Methodologies directory, in the Ratings Methodologies subdirectory. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Credit Policy & Methodologies directory.

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