FitchRatings

Fitch Lowers $1.95B Of San Diego, California Debt: Remains on Watch Negative

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Fitch Ratings-San Francisco-May 27, 2005: Fitch Ratings has downgraded the following ratings for the city of San Diego, California:

--$22 million in outstanding general obligation bonds to 'BBB+' from 'A';
--$250 million in leased backed debt to 'BBB-' from 'A-'.

Fitch also lowers the following:

San Diego Public Facilities Financing Authority
--$1.1 billion in sewer revenue bonds to 'BBB+' from 'A'.
--$287 million in subordinate water revenue bonds to 'BBB' from 'A-'.

San Diego Facilities and Equipment Leasing Corporation
--$287 million in certificates of undivided interest, series 1998 (secured by a senior lien on water enterprise revenues) to 'BBB+' from 'A'.

All ratings remain on Rating Watch Negative by Fitch.

Fitch's rating actions reflects the city's continued delay in releasing its fiscal 2003 and 2004 audit and the negative effect the ongoing political conflicts and upcoming election have on the city's ability to resolve the its sizable financial challenges. Fitch continues to believe that San Diego's strong economic base and advantageous tax structure gives it a strong ability to pay, and that current credit quality concerns focus on the city's willingness to pay, hence the two-step rating difference between general obligation and lease secured bonds. Ratings for the enterprise system debt factor in the essential nature of these services.

Fitch believes that strong leadership and political consensus are needed to achieve budgetary balance in the next several fiscal years. In particular, Fitch notes the mayor's recent resignation announcement, upcoming election, and several ongoing investigations into criminal activity, irregular disclosure, and conflicts of interest as obstacles in drafting and adopting a sound budget for fiscal 2006. For future years, continued resilience to labor and constituent pressures will be needed to retain financial balance as pension contributions rise. Lastly, today's rating actions take into consideration mentions of bankruptcy by the city attorney and possible mayoral candidates, although the action remains strongly opposed by the mayor, city council, and city manager.

In retaining investment grade ratings on all city debt, Fitch recognizes the strength of the city's economy and its diverse revenue stream that benefits from the economic activity. Liquidity concerns are alleviated by a tentative agreement with Bank of America for purchase of the city's tax and revenue anticipation notes. Fitch also notes that tentative labor agreements with four of the city's five bargaining groups take steps to reduce costs by freezing salary and benefit packages, requiring employee contributions to reduce the San Diego City Employees Retirement System's (SDCERS) unfunded actuarial accrued liability, and restricting certain retirement benefits for new hires. However, the current agreements do not realize all of the savings envisioned in the city's multi-year financial plan. For the city to achieve financial balance over the forecast period, service reductions and additional personnel savings are needed.

The ratings remain on Rating Watch Negative to reflect continued uncertainty regarding the city's ability to achieve budgetary balance over the next several years as the required pension contribution rises significantly.

Fitch views the audits' release date as uncertain, largely the result of a stalemate making the auditing firm, KPMG, unable to gain comfort that illegal activities have not taken place. The SDCERS board is reconsidering its prior refusal to provide certain documentation requested for KPMG, citing attorney-client privilege. The mayor, city council, and city attorney have requested that the board provide the documentation. As a positive development, the city has hired a firm specializing in forensic accounting to work with KPMG to achieve their satisfaction and enable an audit to be released.

In San Diego's multi-year financial forecast, alternative scenarios are considered, with the base case indicating financial balance if sizable labor cost reductions are made. Tentative agreements with four of the city's five employee bargaining groups come close to the plan's targets. Service reductions as have been proposed for fiscal 2006 by the city manager also will be necessary, again requiring strong fiscal discipline and political resolve by San Diego's leaders. Fitch is concerned that with a investigations pending, allegations continuing, and a mayoral election pending, such cohesion and leadership are likely to continue to be absent.

Also, today's rating actions echo Fitch's previously expressed concern regarding the employee time and focus required to handle the multiple investigations underway, including those conducted by the Securities and Exchange Commission, Federal Bureau of Investigation, and U.S. Attorney. These efforts add to the city's work burden and distract needed attention from budgetary matters. Also, the District Attorney has indicated other charges will be forthcoming.

In an earlier rating downgrade, Fitch stated audited financial statements were needed to be able to view the city's financial condition as strong, as had been reported previously and is in accordance with prior year's operations. Nonetheless, Fitch's role as a rating agency dictates the responsibility to retain ratings whenever possible. Given the city's very strong reserve levels and financial operations through fiscal 2002 and the city's robust economy, Fitch expects the audited results for fiscal 2003 to be at least satisfactory.

Today's downgrade actions are in keeping with Fitch's emphasis on effective management as a key component of credit quality. Evidence of significant structural change and a resulting positive effect are crucial to Fitch's returning San Diego's ratings to higher levels. In fact, Fitch believes the city has the potential to return to a position of above average credit quality based on its economic strength and ability to translate positive economic performance into sound financial operations through its varied tax structure. Fitch awaits release of the city's audited financial reports for fiscals 2003 and 2004 along with a sound and balanced budget for fiscal 2006 and further evidence of ongoing fiscal stability.

Other ratings downgraded and remaining on Rating Watch Negative by Fitch include the following:

San Diego, California
--Certificate of participation refunding bonds, series 2003 to 'BBB-' from 'A-'.

San Diego Metropolitan Transit Development Board
--Lease revenue bonds (San Diego Old Town Light Transit Extension Refunding), series 2003 to 'BBB-' from 'A-'.

Convention Center Expansion Authority
--Lease revenue bonds, series 1998A to 'BBB-' from 'A-'.

San Diego Public Facilities Financing Authority
--Lease revenue bonds, (Fire and Life Safety Facilities Project), series 2002B to 'BBB-' from 'A-';
--Sewer revenue bonds to 'BBB+' from 'A';
--Subordinate water revenue bonds to 'BBB' from 'A-'.

San Diego Facilities and Equipment Leasing Corp.
--Certificates of undivided interest (water revenue), series 1998 to 'BBB' from 'A'.

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