San Diego Public Facilities Financing Authority, California

Lease Revenue Bonds

New Issue Report

Ratings

New Issue

Lease Revenue Refunding Bonds, Series 2016 (Ballpark Refunding)	A+

Outstanding Debt

Implied Unlimited Tax General Obligation Bonds	AA–
Lease Revenue Bonds	A+
Convention Center Expansion Financing Authority Lease Revenue Refunding Bonds	A+

Rating Outlook[a]

Positive

[a]Revised from Stable on Feb. 2, 2016.

Related Research

Fitch Rates San Diego Public Facilities Fin Auth, CA Lease Revs 'A+'; Outlook Revised to Positive (February 2016)

San Diego Public Facilities Financing Authority, California (March 2015)

Fitch Affirms San Diego Public Facilities Financing Authority, CA Lease Revenue Bonds at 'A+'; Outlook Stable (March 2014)

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New Issue Details

Sale Information: $105,330,000 Lease Revenue Refunding Bonds, Series 2016 (Ballpark Refunding), scheduled to sell the week of Feb. 15 via negotiation.

Security: Payable from San Diego's (the city) lease rental payments to the San Diego Public Facilities Financing Authority (the authority), which the city covenants to budget and appropriate annually from any legally available sources. The lease rental payments are subject to abatement, the risk of which is mitigated by standard rental interruption insurance provisions.

Purpose: To refund the authority's lease revenue refunding bonds, series 2007A (ballpark refunding) for debt service savings.

Final Maturity: Mature serially, Oct. 15, 2016–2031, subject to optional and mandatory redemption prior to final maturity.

Key Rating Drivers

Solid Financial Operations: The city continues to demonstrate solid financial results through its ongoing commitment to conservative financial management policies, general fund balance and reserves preservation and strong financial disclosure practices, bolstered by a stabilized management environment.

Fundamental Economic Strengths: The city benefits from a diverse economy, strong key revenue streams, a declining unemployment rate, a healthy tax base and its desirable geographic location.

Above-Average Debt; Sizable Capital Needs: The overall debt burden is expected to remain elevated as the city begins to address large identified capital needs, a significant portion of which are mandated by regulation. The city continues to refine its capital cost estimates and develop related funding options.

Beneficial Benefits Reform; Uncertainty Remains: Carrying costs are expected to remain substantial despite the city's sustained focus on reducing unfunded pension and other post-employment benefit (OPEB) liabilities. The city successfully made OPEB modifications in the face of considerable labor opposition. However, litigation against pension reform remains unresolved.

Solid Legal Structure: The legal structure underpinning the series 2016 refunding bonds is substantively comparable with that used for the series 2007A bonds being refunded, with largely standard bondholder protections. However, the requirement for a debt service reserve fund (DSRF) has been omitted.

Rating Sensitivities

Continued Positive Trajectory: Management's ability to continue achieving stable-to-positive financial operations, coupled with clear indications that capital and pension pressures will not increase pressure on operations, could lead to a rating upgrade.

Rating History — COPs and Lease Revenue Bonds

Rating	Action	Outlook/ Watch	Date
A+	Affirmed	Positive	2/2/16
A+	Affirmed	Stable	3/23/15
A+	Affirmed	Stable	3/14/14
A+	Affirmed	Stable	6/10/13
A+	Affirmed	Stable	5/29/12
A+	Affirmed	Stable	4/13/12
A+	Affirmed	Stable	6/7/10
A+	Revised	Stable	4/30/10
A	Affirmed	Stable	6/8/09
A	Upgraded	Stable	12/11/08
BBB–	Affirmed	RWP	3/27/08
BBB–	Downgraded	RWN	5/27/05
A–	Downgraded	RWN	2/1705
AA–	Affirmed	RWN	9/23/04
AA–	Downgraded	Negative	2/27/04
AA+	Assigned	—	5/28/02

RWN – Rating watch negative.

Rating History — GOs

Rating	Action	Outlook/ Watch	Date
AA–	Affirmed	Positive	2/2/16
AA–	Affirmed	Stable	3/23/15
AA–	Affirmed	Stable	3/14/14
AA–	Affirmed	Stable	6/10/13
AA–	Affirmed	Stable	5/29/12
AA–	Affirmed	Stable	4/13/12
AA–	Affirmed	Stable	6/7/10
AA–	Revised	Stable	4/30/10
A+	Affirmed	Stable	6/8/09
A+	Upgraded	Stable	12/11/08
BBB+	Affirmed	RWP	3/27/08
BBB+	Downgraded	RWN	5/27/05
A	Downgraded	RWN	2/17/05
AA	Affirmed	RWN	9/23/04
AA	Downgraded	Negative	2/27/04
AAA	Upgraded	—	5/28/02
AA+	Assigned	—	4/3/98

RWN – Rating watch negative.

Fitch recently published an exposure draft of state and local government tax-supported criteria (Exposure Draft: U.S. Tax-Supported Rating Criteria, dated Sept. 10, 2015). The draft includes a number of proposed revisions to existing criteria. If applied in the proposed form, Fitch estimates the revised criteria would result in changes to less than 10% of existing tax-supported ratings. Fitch expects that final criteria will be approved and published by the end of the first quarter of 2016. Once approved, the criteria will be applied immediately to any new issue and surveillance rating review. Fitch anticipates the criteria to be applied to all ratings that fall under the criteria within a 12-month period from the final approval date.

Related Criteria

Exposure Draft: U.S. Tax-Supported Rating Criteria (September 2015)

Tax-Supported Rating Criteria (August 2012)

U.S. Local Government Tax-Supported Rating Criteria (August 2012)

Credit Profile

San Diego is the second-largest city in California, with a stable population of approximately 1.4 million. The city's diverse economy continues to benefit from job growth, residential and commercial construction and increasing tourism. For example, the city is expecting 2,838 new hotel rooms to be constructed in 2016–2018.

The city's unemployment rate (4.6% in November 2015) remains in line with the national average (4.8%), residents' socioeconomic indicators are largely above-average and the tax base continues to grow strongly. The relatively minor cumulative 2.6% taxable assessed valuation (TAV) decline during fiscal years 2010–2013 has been more than offset by the 14.6% TAV growth which occurred in fiscal years 2014–2016. House sales and prices are increasing, permitted construction has rebounded and the numbers of delinquencies and foreclosures have fallen. Continuation of these factors will likely fuel further TAV growth.

Solid Financial Operations

The city ended fiscal 2015 with a total general fund balance of $377.8 million and an unrestricted general fund balance of $236.6 million, a strong 27.6% and 17.3% of spending, respectively. The total general fund balance benefited from a net operating surplus after transfers of $27.7 million (including proceeds from capital leases). The city is projecting balanced operations at fiscal year-end 2016, although it might choose to use a small portion of its general fund balance above the general fund reserve target for priority one-time expenditures.

The city has internal service fund deficits that are long term in nature. In fiscal 2016, the city intends to fund its workers' compensation reserve at the policy goal, which reflects the city's historical experience liabilities. In order to achieve that reserve policy goal, the city will need to increase the workers' compensation fund reserve to 25% of its outstanding actuarial liability for fiscal years 2013–2015 from 22% currently (at a cost of $6.1 million).

Similarly, in fiscal 2016, the city's current policy goal is to increase the public liability fund reserve to 40% of its outstanding liability for fiscal years 2013–2015 from 25% currently (at a cost of $13.8 million). However, city management anticipates, subject to mayoral and city council approval, only increasing funding to 31% in fiscal 2016 (at a cost of $5.8 million), and then incrementally building up to a public liability fund reserve of 50% by fiscal 2019. The long-term disability fund reserve is already 100% funded.

In February 2014, the city council voted to increase the general fund reserve requirement to 14% of the three-year average of audited general fund operating revenues, up from 8%. The city had already been exceeding the revised goal since fiscal 2012. In January 2016, the city council formally increased the general fund reserve requirement again, to 16.7%. The city budgets to end fiscal 2016 with a general fund reserve of $190.3 million, or 16.8% of revenues, which is in line with the amended general fund reserve policy. Furthermore, in January 2016, the city council created a separate pension payment stabilization reserve for unexpected increases to the city's actuarially required pension contributions. The city's multiyear projections for fiscal years 2017–2021 will need to be adjusted to ensure ongoing compliance with the city's amended reserve policies and ongoing commitment to general fund structural balance.

Limited Revenue Flexibility; Expenditure Pressures

California cities have limited revenue flexibility. Furthermore, San Diego's revenue structure is less diverse than most other large California cities. For example, it does not levy a utility user tax or a trash collection fee, and has a relatively low business license tax rate. Fitch Ratings

considers that there would likely be considerable taxpayer and voter resistance to introducing or increasing such taxes. Nevertheless, the city's four primary general fund revenue sources (property, sales and transient occupancy taxes and franchise fees) are performing well, although sales tax revenues have been somewhat adversely affected by recent lower gas prices.

The city's general fund expenditures are dominated by personnel (68.2 % of the fiscal 2016 adopted budget). Future labor costs have been rendered somewhat predictable by five-year labor agreements through fiscal 2018, which freeze pensionable pay but provide for increases in nonpensionable compensation.

The city negotiated a modification and two-year extension to the police labor agreement to address specific police officer retention issues. The modified and extended contract provides for pensionable pay increases in both fiscal years 2019 and 2020, after the five-year freeze expires, plus benefit, allowance and leave increases in the interim, for an estimated total fiscal impact of $91.9 million through fiscal 2021. The city has also negotiated a successor agreement with its Municipal Employees Association for the same level of pensionable pay increases in fiscal years 2019 and 2020, which, in combination with other benefit increases, will cost an estimated $73.3 million through fiscal 2021 ($37.3 million for the general fund). All of these known personnel cost increases are incorporated into the city's multiyear projections.

Above-Average Debt; Sizable Capital Needs

The city's overall debt burden is above average on a per capita basis ($5,140) but moderate at 3.2% of assessed valuation. Debt amortization is average at approximately 51% in 10 years. The city last issued TRANs in fiscal 2013.

The city anticipates issuing $270 million in lease revenue bonds between fiscal years 2017 and 2019 to further address capital funding needs. These bond issues would not greatly alter the city's debt burden on a per capita or market valuation basis; however, the amount is small compared with the city's total capital needs.

The city has identified $4.2 billion in capital projects going forward. This figure includes $3.1 billion for the city's storm water system, which is $800 million less than at the time of Fitch's previous review, reflecting work the city has done to refine its estimates and negotiate with third parties who will be involved in individual capital projects. There is also a strong possibility that currently unfunded storm water program capital and operating costs associated with new regulatory requirements could be further reduced by as much as $500 million if all regulatory parties concur with the city's alternate proposals. Negotiations are presently under way.

Securing new primary funding sources for capital costs could prove challenging. Historically, the city's electorate has been resistant to new taxes. This is reflected in the city's less diverse revenue structure and successful litigation in 2014 against a special tax district to partially fund expansion of the convention center. Raising storm water fees to assist with the storm water system upgrade costs would likely be difficult, and the city will not be able to rely on lease revenue bonds to fund all of its capital needs given the debt repayment impact on the general fund.

Beneficial Benefits Reform; Uncertainty Remains

The city has undertaken considerable pension system reform and OPEB modification. Litigation against the pension reform is ongoing. In the event that pension reform has to be wholly or partially unwound in response to the litigation outcomes, the city's long-term liabilities would increase. However, there would be little near-term impact on the city's costs. An initiative to cap the city's annual OPEB contributions successfully withstood a legal challenge on the

basis that OPEBs are an employment benefit rather than a vested contractual right and, therefore, can be modified.

In June 2012, following earlier pension reforms, the electorate voted in favor of closing the San Diego City Employees Retirement System plan to all new employees except police, accelerating paydown of the system's UAAL, limiting pensionable salaries through fiscal 2018, and only offering defined contribution plans to new employees. These pension reforms benefit the city's budget in the long term by shifting investment and longevity risks to future city employees and accelerating the paydown of the pension system's net pension liability. If the city's pension reforms remain valid, the net pension liability is $1.535 billion and the pension system's fiduciary net position is 80.4% of its total pension liability. Using Fitch's more conservative 7% discount rate, the fiduciary net position is 78.2%.

The city plans to continue making actuarially based pension contributions of between $254.9 million and $267.9 million annually in fiscal years 2016–2025. This assumes annual investment returns of 7.125% in fiscal 2016 and 7% annually thereafter. Fitch anticipates that the city will continue to make full actuarial contributions given past practices.

In terms of the city's closed OPEB plan, the city still has a UAAL of roughly $537.3 million, or a low 0.3% of TAV, after negotiating a new health plan for the remaining OPEB plan members in 2012. Due to multiyear labor agreements, the city capped its annual OPEB contributions at $57. 8 million through fiscal 2015, with annual increases of up to 2.5% thereafter.

In fiscal 2015, the city's total carrying costs related to annual debt repayments, actuarially required pension contributions and OPEB pay-as-you-go payments represented a sizable 22% of total governmental expenditures. Fitch anticipates that these carrying costs will remain sizable as additional debt is issued to address identified capital needs and the city seeks to reduce its unfunded pension liabilities, particularly if pension reform is overturned.

Solid Legal Structure

The legal structure underpinning the series 2016 refunding bonds is substantively comparable with that used for the series 2007A bonds being refunded. The leased assets, covenant to budget and appropriate from any legally available funds, and actual funding sources (primarily from the city's transient occupancy tax revenues) remain unchanged.

The leased assets continue to be the 42,500-seat ballpark completed in 2004 (the city currently owns 70%) and an adjacent public park. In 2015, the city's 70% share of the ballpark and its 100% ownership of the adjacent public park were appraised by an independent company at $539 million. At the end of the lease term in fiscal 2032, the 30% owned by the ballpark's major league baseball tenant, the San Diego Padres Baseball Club (Padres), will revert to the city. The amended and restated site and facility leases remain substantively the same, as does the Joint Use and Management Agreement between the city and the Padres, under which the Padres have the right to use the ballpark during the term of the bonds but cannot relocate from it during that timeframe.

There are three noteworthy differences from the series 2007A bond legal structure. First, the series 2016 refunding bonds do not require a DSRF. The $3.8 million currently in the series 2007A bonds' DSRF will be released and applied as a source of funds to reduce the series 2016 refunding bonds' issuance size. Second, limitations on amendments to agreements between the city and the Padres have been removed, since the ballpark is now a mature operating project. The city does not anticipate needing to make contractual changes but wants the freedom to do so, without restrictions, if the need arises. Third, both semi-annual payments

are required to be deposited with the trustee on Oct. 15 each year. Consequently, the annual April 15 payment is deposited six months in advance.

Bondholder protections are standard with regard to: the circumstances under which additional bonds can be issued or leased property can be substituted, removed or added; insurance coverage requirements; and no acceleration remedy in the event of default. The authority's rights, title and interests in the site and facilities leases (including the receipt of lease rental payments) are transferred to a trustee. However, the authority has no right to re-enter the leased facilities in the event of a default.

Series 2016 Refunding Bond Litigation

The series 2016 refunding bond sale had been delayed by a lawsuit challenging the validity of the bonds and related indenture and lease documents, asserting (among other claims) that abatement leases violate the constitutional debt limit. The superior court recently decided in favor of the city. The litigants are now appealing that decision to the state court of appeal.

In the event that the state court of appeal decides against the city, the city plans to appeal to the state Supreme Court. Subsequently, if the state Supreme Court was to rule in the plaintiff's favor, the series 2016 refunding bonds and related indenture and lease documents would be invalid. Under that scenario, purchasers of the series 2016 refunding bonds would not be entitled to repayment and could lose their entire investment. The city would not be obligated to make, and might be precluded from making, lease rental payments, thereby adversely affecting bondholders.

Bondholders could be required to repay to the authority any previous principal and interest payments made on the series 2016 refunding bonds. It is unclear what remedies, if any, bondholders would have. If they were to file a suit for damages or recovery against the city in this situation, they would be unsecured creditors. In the event that the city is unable to make a timely payment of bond principal and interest, Fitch would indicate that a default had taken place and withdraw the rating.

Fitch has reviewed the opinion of the city's bond counsel, which states that that the allegations against the city are without merit. The bond counsel's opinion is based, in part, on the 1998 state Supreme Court decision, which upheld the principal that abatement leases do not violate the constitutional debt limit. Furthermore, bond counsel considers that the joint powers authority has the necessary powers to issue the series 2016 refunding bonds and has met all the procedural requirements to do so.

The city is proceeding with the series 2016 refunding bond issuance now because of the significant annual cost savings to the general fund effective from fiscal 2017.

Fitch notes that the same litigants used substantially the same arguments against the authority's earlier lease revenue bonds, series 2015A (capital improvement projects) and 2015B (capital improvement projects) (both rated 'A+'/Stable by Fitch Ratings). The state court of appeal upheld the validity of the series 2015A bonds. The litigants are now appealing that decision to the state Supreme Court. The series 2015B have been returned to the state superior court to be disposed of in a manner consistent with the decision regarding the series 2015A bonds.

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

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