STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

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Summary:

San Diego, California; Appropriations; General Obligation

Primary Credit Analyst:
Misty L Newland, San Francisco (1) 415-371-5073; misty.newland@standardandpoors.com

Secondary Contact:
Jaime B Trejo, San Francisco (415) 371-5033; jaime.trejo@standardandpoors.com

Table Of Contents

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Credit Profile		
US$105.33 mil lse rev rfdg bnds (San Diego) (Ballpark Rfdg) ser 2016 due 10/15/2031		
Long Term Rating	AA-/Stable	New
San Diego ICR due 04/30/2040		
Long Term Rating	AA/Stable	Affirmed
San Diego APPROP		
Long Term Rating	AA-/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services assigned its 'AA-' rating to San Diego, Calif.'s lease revenue refunding bonds, series 2016 (ballpark refunding). We also affirmed our 'AA' issuer credit rating (ICR) on the city and our 'AA-' long-term rating and underlying rating (SPUR) on various authorities' lease revenue bonds outstanding, issued for San Diego. The outlook on all ratings is stable.

The city's lease revenue bonds are secured by lease payments made by San Diego, as lessee, to various authorities as lessor, for the use and possession of the leased assets. The ratings on the authorities' lease revenue bonds reflect our view of the city's general credit characteristics and its covenant to budget and appropriate annual lease payments for various properties' use. Payments are triple net, without right of set-offs, and the city is responsible for maintenance, taxes, and utilities. Payments may be abated in the event of damage to, or the destruction of, the leased assets. To mitigate abatement risk in such a case, the city has covenanted to maintain rental-interruption insurance coverage equal to 24 months of maximum annual debt service.

We understand proceeds from the series 2016 lease revenue refunding bonds will be used to refund the series 2007A (ballpark refunding) lease revenue refunding bonds. The leased asset includes the Petco Park Baseball Stadium. We evaluated the seismic risk of the leased asset pursuant to our criteria and estimated that it does not have a greater than 5% probability of incurring 25% damage during the life of the bonds.

We understand that litigation challenging the validity of the city's 2016 lease revenue refunding bonds is currently pending in the California Court of Appeals. In the opinion of the city's bond counsel, the bonds constitute valid and binding limited obligations of the authority as provided in the indenture. The California Supreme Court upheld the validity of other bonds issued by the authority that were challenged by the same plaintiff on substantially the same grounds, according to the city.

The ratings reflect our view of the city's:

- Very strong economy, with access to a broad and diverse metropolitan statistical area (MSA);

- Very strong management, with strong financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Adequate budgetary performance, with a slight operating deficit in the general fund but an operating surplus at the total governmental fund level in fiscal 2015;
- Strong budgetary flexibility, with an available fund balance in fiscal 2015 of 14.9% of operating expenditures;
- Very strong liquidity, with total government available cash at 119.1% of total governmental fund expenditures and 27.5x governmental debt service, and access to external liquidity we consider exceptional;
- Very weak debt and contingent liability position, with debt service carrying charges at 4.3% of expenditures and net direct debt that is 72.0% of total governmental fund revenue, as well as a large pension and other postemployment benefit (OPEB) obligation and the lack of a plan to sufficiently address the obligation; and
- Strong institutional framework score.

Very strong economy

We consider San Diego's economy very strong. The city, with an estimated population of 1.4 million, is located in San Diego County in the San Diego-Carlsbad, Calif. MSA, which we consider to be broad and diverse. The city has a projected per capita effective buying income of 115% of the national level and per capita market value of $159,675. Overall, the city's market value grew by 6.0% over the past year to $218.4 billion in 2016. The county unemployment rate was 6.4% in 2014.

A primary employment center in San Diego County, the city represents about half of the county's total employment. The economy consists of various high-tech clusters, including biotech and telecommunications, combined with a reliance on tourism, and the military and defense industries. Higher education and scientific research institutions also support the economy, including the University of California-San Diego (28,459 employees), San Diego State University, Scripps Research Institute, the Salk Institute for Biological Studies, and the San Diego Supercomputer Center. We believe that, historically, the U.S. Navy and the U.S. Marine Corp. have provided a stabilizing presence in the regional economy. According to the city, the Naval Base San Diego was the city's largest employer in fiscal 2015, at 29,948, or 4.3% of total employment. Direct defense-related spending of $24.8 billion in the county for federal fiscal year ended 2015 resulted in about 22% of county jobs directly and indirectly related to military and a gross regional product in the county $45 billion.

As we said in our most recent U.S. State And Local Government Credit Conditions Forecast, throughout the past year, home prices have continued to rise, which has favorable implications for assessed values and property tax revenue trends. However, we don't see the housing market as overheated, as S&P/Case-Shiller 20-City Home Price Index is still below the prior peaks, according to the index. For San Diego, home prices are still 13% below the peak reached in November 2005. A key source of upward pressure on home prices nationally has been the lean inventory of new and existing homes available for purchase. The number of residential construction permits were up 2.8% for fiscal 2015 in San Diego; however, we anticipate demand will continue to outpace supply, resulting in continued upward pressure on home prices for San Diego. Tourism activity trends have also had a positive impact on the city's revenue trends. Visits and spending were up 1.4% and 7.6%, respectively, through October 2015, compared to the same period in 2014. Average hotel occupancy rates were also up to 80.9% as of October 2015, compared to 76.7% for December 2014, according to the city.

Very strong management

We view the city's management as very strong, with strong financial policies and practices under our FMA methodology, indicating financial practices are strong, well embedded, and likely sustainable.

The city council generally performs formal budget amendments in the midyear and year-end reviews; in addition, the financial management department publicly posts and presents quarterly budget monitoring reports on actual general fund performance to the city council's budget and finance committee. The city utilizes internal trend analysis and external information to make revenue and expenditure assumptions and takes into account current trends that may impact future results. A long-term financial outlook is prepared annually, which projects general fund operations, revenue and expenditure trends, and future budgetary gaps for the next five years. The city annually updates its long-term capital needs for the utility funds and general fund that includes estimated annual bonding requirements and pay-as-you-go funding needs in the next five years. The city reviews its formal investment policy annually and presents monthly reports on investment holdings and average yield to the city council. San Diego has a formal debt management policy that includes maximum debt burden thresholds for general obligation and lease revenue debt, as well as minimum coverage level targets for revenue bonds. The city also has a policy of maintaining a general fund emergency reserve of 8% and a stability reserve of 6%, for a minimum total general fund policy reserve of 14%. The reserve is calculated as a percentage of the most recent three-year average of general fund operating revenues. The stability reserve is held within the assigned and unassigned general fund balance. The emergency reserve is held in the restricted general fund balance and requires a two-thirds council vote to access the reserve. In January 2016, the city council directed staff to increase the reserve minimum to 16.7% and approved a separate Pension Payment Stabilization Reserve to mitigate unexpected increases to the actuarially determined contribution. The revised reserve policy, expected to be presented to city council in this fiscal year, recommends increasing the general fund reserve to 14.5% in fiscal 2016 and to 16.7% by fiscal 2021. Management estimates it would require an additional contribution of about $60.8 million to reach the 16.7% target. The revised reserve policy also recommends funding $16 million general fund reserve for the Pension Payment Stabilization Reserve.

Adequate budgetary performance

San Diego's budgetary performance is adequate in our opinion. The city had slight deficit operating results in the general fund of 1.3% of expenditures, but a surplus result across all governmental funds of 5.9% in fiscal 2015.

The adopted general fund budget is nearly break even, with a $6 million (less than 1% of expenditures) fund balance drawdown for various capital projects. Based on the midyear budget monitoring report, management projects a general fund budgetary surplus of about $7.6 million due to about $4.0 million of budgetary savings. In addition, the city received a $3.3 million unbudgeted one-time reimbursement for a Community Development Block Grant loan payment.

In March 2016, the city council voted to place a ballot measure on the June 7, 2016, ballot that would fund general fund infrastructure. The infrastructure funding measure would amend the city charter to require certain general fund revenue growth, above 2016 baseline levels, be restricted to the construction, repair, and maintenance of general fund infrastructure. This includes 50% of all new major general fund revenue growth (including property tax, transient occupancy tax, and franchise fees), year-to-year growth in general fund sales tax revenue in excess of Consumer Price Index growth over 25 years, and any reductions in certain pension contributions also over the next 25 years. Based on the five-year financial outlook (fiscal 2017 through fiscal 2021), the general fund baseline revenues exceed general fund baseline expenditures, with excess revenue allocated to spending on new initiatives for police services, technology, and infrastructure. In addition, we understand that the city's current budgeting practice is to allocate 50% of all new major general fund revenue growth toward infrastructure. However, if expenditure growth outpaces unrestricted revenue growth, we anticipate a charter amendment to reverse or ease the measure's revenue growth allocation restrictions would be difficult. As a result, the measure could undermine the city's options for balancing the budget if expenditure growth outpaces unrestricted revenue growth. In our view, city's budgetary flexibility could be constrained during the near term, as we expect economic recovery statewide will plateau and growth in key revenues will level off over the next year or two. In addition, after the release of the five-year outlook, the San Diego City Employees' Retirement System (SDCERS) lowered the discount rate to 7.125% from 7.25% effective for the June 30, 2015, valuation, and to 7% effective for the June 30, 2016, valuation, resulting in a projected additional cost of $13 million in fiscal 2017, growing to $35 million in fiscal 2021, which we view as manageable, at just 1% to 2% of projected general fund baseline revenue. If the infrastructure funding measure is implemented and revenues grows at a rate slightly slower than the 3% to 4% annual projected growth rate in the five-year outlook, the city would likely need to reduce services rather than capital outlay in order to balance the budget.

Strong budgetary flexibility

San Diego's budgetary flexibility is strong, in our view, with an available fund balance in fiscal 2015 of 14.9% of operating expenditures, or $195.6 million.

Available general fund reserves include the combined unassigned and assigned balance and the restricted balance for the city's policy-required emergency reserve. We expect that the city will continue to meets its reserve policy, which would maintain reserves at the currently strong levels.

Very strong liquidity

In our opinion, San Diego's liquidity is very strong, with total government available cash at 119.1% of total governmental fund expenditures and 27.5x governmental debt service in 2015. In our view, the city has exceptional access to external liquidity if necessary.

Due to the frequency of debt issuances and the diverse types of debt, we believe the city has exceptional access to external liquidity. The city is primarily invested in U.S. Agencies and certificates of deposits. The city currently has no short-term debt, variable rate debt, or alternative financing obligations outstanding.

Very weak debt and contingent liability profile

In our view, San Diego's debt and contingent liability profile is very weak. Total governmental fund debt service is 4.3% of total governmental fund expenditures, and net direct debt is 72.0% of total governmental fund revenue.

The city's net direct debt includes about $518 million of successor redevelopment agency tax allocation bonds.

The city plans to issue $270 million of lease obligations over three years starting in fiscal 2017 to fund the city's deferred capital program. We understand the city is considering contributing about $200 million for a new stadium for the San Diego Chargers. The $200 million alone would be a manageable addition to the debt burden, in our view. However, it could constrain the city's ability to issue additional debt for its other significant unfunded capital needs as fixed costs related to debt service rise as a proportion of its overall budget. In 2013, the city estimated the cost of meeting its storm water regulatory and deferred capital needs was $3.1 billion over a 20-year compliance period, the majority of which would be supported by the general fund. We understand that the city is currently in discussions with regulators and the estimated costs could change. In addition, in the five-year capital infrastructure planning (CIP) outlook (2017-2021), the city identified $4.2 billion of capital needs citywide, with a funding gap of $1.4 billion. For the general fund, the CIP identifies $0.9 billion of funding for an estimated $2.3 billion of estimated needs.

In our opinion, a credit weakness is San Diego's large pension and OPEB obligation, without a plan in place that we think will sufficiently address the obligation. San Diego's combined required pension and actual OPEB contributions totaled 16.6% of total governmental fund expenditures in 2015. Of that amount, 14.8% represented required contributions to pension obligations, and 1.8% represented OPEB payments. The city made its full annual required pension contribution in 2015.

San Diego contributes to SDCERS, a defined benefit pension plan. In addition, we understand some city employees participate in defined contribution pension plans, including a supplemental pension savings plan. The city's required pension contribution is its actuarially determined contribution. SDCERS was 75.6% funded at June 30, 2015, according to the most recent valuation, up from 68.6% as of June 30, 2012.

In 2012, voters approved Proposition B, which replaced defined benefit pension plans for new city hires (except sworn police officers) with a 401(k)-style plan and froze pensionable pay for five years. Although the subject to legal challenge before the California Public Employment Relations Board (PERB), we understand the actuarial pension report assumes the validity of the reform measure this is currently subject to legal challenge. In December 2015, PERB issued a decision that affirmed and adopted an earlier proposed decision that was issued by a PERB administrative law judge issued in 2013, which found the city violated state labor laws. The city has subsequently appealed the decision. If the city's appeal is unsuccessful, the litigation could repeal or unwind the implementation of some or all of Proposition B. The city is currently unable to quantify the impact on the pension liability. However, we would not expect there to be a significant immediate impact, as it would mostly affect the long-term future pension contributions as it only applies to nonsworn employees hired on or after July 20, 2012. We understand that freezes to pensionable pay increases and cost of living increases negotiated with employee organizations for fiscal 2014 through fiscal 2018 are not being challenged as part of this litigation.

Strong institutional framework

The institutional framework score for California municipalities required to submit a federal single audit is strong.

The institutional framework score is based on the state legislative and functional environment under which these local governments operate, including a framework that encourages transparency by requiring these local governments to perform annual financial statement audits of their entire operations if it is subject to the federal single-audit requirement due to federal awards in multiple programs exceeding $500,000 per year.

Outlook

The stable outlook reflects our view of the city's very strong economy and strong budgetary flexibility, which is supported by very strong management conditions. We do not anticipate changing the ratings during the current two-year outlook period.

Upside scenario

We could consider raising the ratings if the long-term obligations moderate, including potential capital infrastructure funding pressures; the combined annual pension and OPEB expense drops to 10% or less of total governmental fund expenditures; and there is no deterioration in other factors.

Downside scenario

Lower ratings are possible if fixed capital and pension costs pressure general fund flexibility or if the city fails to maintain reserve levels that we consider strong and in line with its minimum reserve policy.

Related Criteria And Research

Related Criteria

- USPF Criteria: Local Government GO Ratings Methodology And Assumptions, Sept. 12, 2013
- USPF Criteria: Financial Management Assessment, June 27, 2006
- USPF Criteria: Debt Statement Analysis, Aug. 22, 2006
- USPF Criteria: Appropriation-Backed Obligations, June 13, 2007
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- U.S. State And Local Government Credit Conditions Forecast, Jan. 11, 2016
- Standard & Poor’s Earthquake Model, Oct. 25, 2012
- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Incorporating GASB 67 And 68: Evaluating Pension/OPEB Obligations Under Standard & Poor's U.S. Local Government GO Criteria, Sept. 2, 2015
- Institutional Framework Overview: California Local Governments

Ratings Detail (As Of March 23, 2016)		
San Diego lse rev rfdg bnds (Balboa Park & Mission Bay Pk Rfdg)		
Long Term Rating	AA-/Stable	Affirmed
San Diego lse (Cap Imp Proj & Old Town Light Rail Rfdg)		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
San Diego APPROP		
Long Term Rating	AA-/Stable	Affirmed
San Diego APPROP		
Long Term Rating	AA-/Stable	Affirmed

Ratings Detail (As Of March 23, 2016) (cont.)		
San Diego Convtn Ctr Expansion Fing Auth, California		
San Diego, California		
San Diego Convtn Ctr Expansion Fing Auth (San Diego) lse rev rfdg bnds		
Long Term Rating	AA-/Stable	Affirmed
San Diego Pub Facs Fincg Auth, California		
San Diego, California		
San Diego Pub Facs Fincg Auth (San Diego) lse rev bnds (Cap Imp Proj)		
Long Term Rating	AA-/Stable	Affirmed
San Diego Pub Facs Fincg Auth (San Diego) lse rev rfdg bnds (Fire & Life Saftey Facs Rfdg)		
Long Term Rating	AA-/Stable	Affirmed
San Diego Pub Facs Fincg Auth (San Diego) APPROP		
Long Term Rating	AA-/Stable	Affirmed
San Diego Pub Facs Fincg Auth (San Diego) APPROP		
Long Term Rating	AA-/Stable	Affirmed

Many issues are enhanced by bond insurance.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.