

## **FITCH RATES PUBLIC FACILITIES FIN AUTH OF SAN DIEGO, CA WASTEWATER REVS 'AA'; OUTLOOK STABLE**

Fitch Ratings-Bangkok-19 February 2016: Fitch Ratings has assigned an 'AA' rating on the following Public Facilities Financing Authority of the city of San Diego, CA (the authority) bonds issued on behalf of the city of San Diego, CA (the city):

--Approximately \$402 million senior sewer revenue refunding bonds, series 2016A.

The bonds are scheduled to sell via negotiation the week of Feb. 29. Proceeds will be used to refund a portion of the authority's outstanding parity obligations for level interest savings without extension of maturity.

In addition, Fitch has affirmed the 'AA' rating on the authority's \$971 million in outstanding parity bonds (pre-refunding).

The Rating Outlook is Stable.

### **SECURITY**

The bonds are secured by revenues which consist primarily of installment payments made by the city to the authority. The city's obligation to make installment payments constitutes a senior lien on net revenues of the city's wastewater system (the system).

### **KEY RATING DRIVERS**

**SOLID FINANCIAL RESULTS:** System financial performance is good and benefits from prudent formal policies and reserves.

**LEVERAGE DECREASING BUT POSSIBLE OUTYEAR ESCALATION:** Leverage ratios are moderate overall and are forecasted to improve over the next few years as rapid amortization outpaces the level of new borrowings. However, beyond the immediate fiscal 2016 - 2020 capital improvement program (CIP) debt levels may escalate as the city enters into the heavy construction phase of its Pure Water (PW) program.

**RATES HOLDING STEADY:** Rates are moderately high but are expected to remain unchanged over the forecast period.

**EXTENSIVE SERVICE TERRITORY:** The service area is broad and diverse and includes a sizeable wholesale component.

### **RATING SENSITIVITIES**

**CONTINUED FINANCIAL STRENGTH:** Maintenance of sound financial metrics commensurate with similarly-rated utilities will be key to preserving credit quality.

**CAPITAL ESCALATION:** Ultimate timing and costs associated with the Pure Water program will be a significant consideration in credit quality over the coming years.

### **CREDIT PROFILE**

## REGIONAL UTILITY WITH FAVORABLE ECONOMIC UNDERPINNINGS

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 healthcare, military, tourism, and educational sectors. Economic conditions in the city have shown positive signs over the last couple of years, with job growth, consumer spending, residential and commercial construction and tourism all experiencing positive trends. This favorable climate has pushed city unemployment levels down to 4.6% for November 2015, below those of the state (5.7%) and nation (4.8%).

## FINANCIAL RESULTS CONTINUE TO BE STABLE AND SOUND

System financial performance is good and includes strong liquidity and favorable cash flows. For audited fiscal 2015, the system maintained almost 800 days cash while free cash generated from operations equaled 108% of depreciation expenses. Fitch calculated annual debt service coverage (DSC) of all debt was also sound in fiscal 2015 at almost 1.7x, in line with last five fiscal years. DSC is net of a \$29.7 million transfer to the rate stabilization fund. Excluding the transfer, total DSC would have been just over 1.9x.

Management's financial projections anticipate some decrease in DSC through the fiscal 2020 forecast as a result of rising operating expenses, increased debt service from ongoing borrowings and no rate hikes. Operating revenues are expected to be affected due to conservation requirements associated with the drought, although the water utility will bear the bulk of the pressure as conservation savings will be derived largely from cuts to outdoor irrigation which do not impact wastewater flows. In light of the expected rise in system borrowings in the coming years, strong management of PW construction costs along with maintenance of solid DSC will be important offsets to preserving the current rating.

## IMPROVING DEBT PROFILE BUT OUTYEAR PRESSURES POSSIBLE

Capital needs for fiscals 2016 - 2020 total around \$574 million. The five-year capital costs have risen over the last few months as the city has refined estimates for PW and other rehabilitation needs, although planned outlays remain below estimates from a few years ago when the system was addressing requirements associated with a prior consent decree. The CIP is expected to be financed predominantly from non-debt sources (over 70%), which combined with the system's favorable principal amortization of existing debt, should keep debt levels relatively steady if not declining slightly.

Beyond the fiscal 2020 CIP period, debt levels may climb as a result of construction costs associated with PW. PW is a 20-year program (through 2035) that is expected to ultimately provide 83 million gallons a day of potable water supply by treating wastewater flows that otherwise would be treated by the system's Point Loma Wastewater Treatment Plant (PLWTP) to drinking water quality standards. As a result of the diverted effluent, PLWTP will continue its existing operations but will achieve 'secondary equivalency', alleviating the need for the system to invest an estimated \$2 billion to upgrade PLWTP to secondary treatment levels. The PW program also entails other benefits in that it provides the city with a drought-proof source of new water supply and reverses previous negative relations with regulators and local environmental groups as to the treatment of PLWTP flows that had often been very litigious.

The PW program is estimated to cost around \$3 billion, with the system responsible for \$1.8 billion of the total and the city's water system funding the balance. While timing and funding of the program beyond the near-term could change, Fitch expects ongoing borrowings will account for a significant portion of PW construction resources.

Contact:

Primary Analyst  
Doug Scott  
Managing Director  
+1-512-215-3725  
Fitch Ratings, Inc.  
111 Congress, Suite 2010,  
Austin, TX 78701

Secondary Analyst  
Shannon Groff  
Director  
+1-415-732-5628

Committee Chairperson  
Kathy Masterson  
Senior Director  
512-215-3730

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email:  
elizabeth.fogerty@fitchratings.com.

Additional information is available at '[www.fitchratings.com](http://www.fitchratings.com)'.

In addition to the sources of information identified in the U.S. Municipal Revenue-Supported Rating Criteria, this action was additionally informed by information from Creditscope.

#### Applicable Criteria

Revenue-Supported Rating Criteria (pub. 16 Jun 2014)

[https://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=750012](https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=750012)

U.S. Water and Sewer Revenue Bond Rating Criteria (pub. 03 Sep 2015)

[https://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=869223](https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869223)

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