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New Issue

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Contacts

Kristina Alagar Cordero 415-274-1707
AVP-Analyst
kristina.cordero@moodys.com

Michael Wertz 212-553-3830
AVP-Analyst
michael.wertz@moodys.com

Christian Ward 415-274-1721
Analyst
christian.ward@moodys.com

City of San Diego Water Enterprise

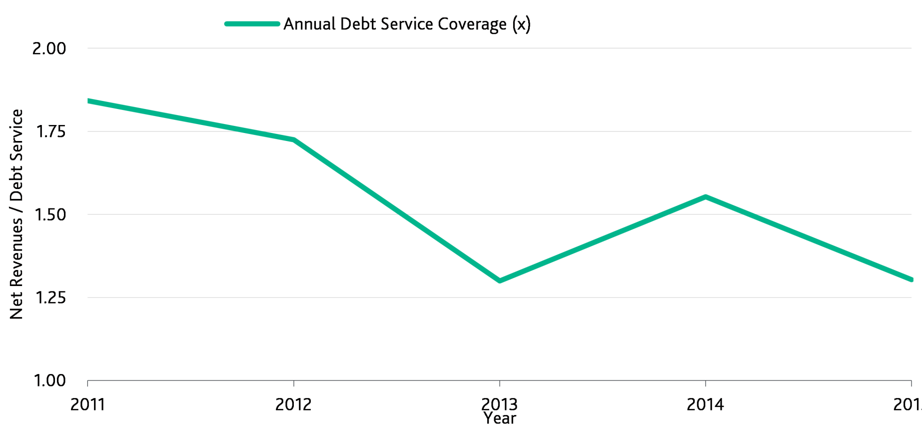
New Issue: Moody's Assigns Aa3 to San Diego Water Enterprise, CA's 2016 Subordinated Water Rev. Bonds; Outlook is Stable

Summary Rating Rationale

Moody's Investors Service has assigned an Aa3 rating to City of San Diego Water Enterprise's $46 million Subordinated Water Revenue Bonds, Series 2016 A and $659 million Subordinated Water Revenue Refunding Bonds, Series 2016B. At this time, Moody's has also affirmed the Aa2 rating on the enterprise's outstanding senior lien revenue debt and Aa3 rating on outstanding subordinate lien revenue debt. The outlook is stable.

The Aa2 senior lien and Aa3 subordinate lien revenue bond ratings reflect the economic strength and stability of the underlying service area, with above average socio-economic indicators and diverse customer base. The utility's stable and healthy water supply provided primarily by regional water wholesalers with diversifying water portfolios is also factored into the ratings. The utility's water supply is currently sufficient to buffer against the impacts of the drought in the current fiscal year and is bolstered by a healthy level of stored water. The high ratings incorporate the system's strong historical financial performance which has weakened, to still acceptable levels, including senior lien debt service coverage of 2.2 times and total debt service coverage of 1.3 times and 234 days of cash in fiscal year 2015 and a manageable long term capital plan which includes plans to develop new local sources of water.

Exhibit 1
Total Debt Service Coverage Levels Have Declined



Source: City of San Diego and Moody's Investors Service

Credit Strengths

- Large, highly diverse service area with above average resident socio-economic indicators
- Strong financial oversight with conservative budgeting and projections
- Strong senior lien debt service coverage ratios

Credit Challenges

- Ongoing pressure associated with long term California drought, including need to meet conservation requirements and increase rates to improve coverage by current revenues
- Significant long term capital plans

Rating Outlook

The stable outlook considers declines in coverage in FY 2016 as a low point due to the current drought conditions and the expectation that approved multi-year rate increase will restore coverages to healthier levels beyond fiscal year 2016. The stable outlook additionally considers the maintenance of healthy financial metrics through the enterprise's long term capital plans.

Factors that Could Lead to an Upgrade

- Significant and sustained improvement in debt service coverage levels
- Significant growth in unrestricted liquidity

Factors that Could Lead to a Downgrade

- Material and sustained deterioration in debt service coverage levels
- Sustained decline in unrestricted liquidity
- Inability to preserve financial strength through long term capital plans

Key Indicators

San Diego (City of) Water Enterprise, CA, CA					
System Characteristics					
Asset Condition (Net Fixed Assets / Annual Depreciation)	49 years				
System Size - O&M (in $000s)	377,722				
Service Area Wealth: MFI % of US median	120%				
Legal Provisions					
Rate Covenant (x)	1.0x all, 1.2x sr				
Debt Service Reserve Requirement	No DSRF				
Financial Strength					
	2011	2012	2013	2014	2015
Operating Revenue ($000)	371,515	408,119	414,508	447,565	455,222
O&M ($000)	282,863	300,657	334,242	355,539	377,722
Long-Term Debt ($000)	893,567	905,322	881,471	859,844	832,806
Annual Debt Service Coverage (x)	1.84	1.72	1.30	1.55	1.30
Cash on Hand	277 days	436 days	362 days	299 days	234 days
Debt to Operating Revenues (x)	2.4x	2.2x	2.1x	1.9x	1.8x

Source: City of San Diego and Moody's Investors Service

Detailed Rating Considerations

Service Area and System Characteristics: Essential Water Provider for Growing, Highly Diverse and Wealthy Service Area

The water enterprise serves the City of San Diego, the second largest city in the state, and certain surrounding areas covering an area of 404 square miles, including 342 square miles in the city. The city and regional economy is highly diversified with tourism, military, higher education, trade and biotechnology playing important roles. The enterprise customer base benefits from the highly diversified metropolis with a very large 1.4 million population base. The socio-economic profile for residents in the service area is above average with per capita income at 119% of the nation and median family income at a high 120% of the nation. The enterprise is comprised of nearly 280,000 retail connections, of which 91% are residential, 6% are commercial and industrial and the remainder are irrigation and other connections. The five year average annual growth rate in 2015 was 0.4%, below the 0.67% annual account growth rate assumed in the forward projections through 2020. Residential retail revenues made up a majority of total water sales revenues in fiscal year 2015 at 60% and the balance of revenues coming from commercial, industrial and other users. The water system has a highly diverse customer base with top ten retail customers making up 11.8% of total sales revenues in fiscal year 2015.

Water Supplies are Diminished but Still Sufficient; Rate of Water Reduction Will Decline as a Result of Conservation

The city's primary source of water is provided by regional wholesaler San Diego County Water Authority (CWA, Aa2/Stable revenue rating) which typically provides approximately 85-90% of the city's water supply with the remaining 10-15% coming from local sources. The CWA in turn obtains 57% of its water supply from the largest supplier of treated water in the US, Metropolitan Water District of Southern California (Met Water, Aa1/Stable revenue rating). The CWA has significantly decreased its reliance on Met Water supplies over the past two decades from a high of 95% in 1991. CWA reliance on MWD continues to decline, as of December of 2015, CWA began accepting desalinated water from the Carlsbad Desalination Plant in December 2015 which provides up to 56,000 acre feet of water per year (AFY) and will help move towards the goal of CWA reducing reliance on Met Water to 19% of CWA's regional portfolio by 2025. The city plans longer term diversification of its water supply with its 20 year, $3 billion Pure Water program. The program is projected to supply up to 1/3 of enterprise demand (83 MGD by 2035; 30 MGD by 2021) with safe, reliable and local potable re-use drinking water.

On average, the enterprise's annual water supply over the past five years has averaged 197.4 thousand AFY. In fiscal year 2015, the amount of water supplied was 191.7 thousand AFY reflecting an 8.7% reduction in water supplied over the prior year given mandatory water reductions imposed by the state and the city's successful water reduction achievements. In May of 2015, the state enacted mandatory water reductions for urban water distributors, the call was made for the city's water enterprise to reduce consumption by 16% when compared to 2013 consumption levels, the city has achieved the state imposed targets. As a result of classification of the Carlsbad Desal water as a new drought-resilient water source, the state has reduced the city's conservation mandate to 8% when compared to 2013 consumption levels. Positively, the city's forward projections conservatively project continuation of 16% conservation levels through the 2020 projection period. In response to the state's mandatory call for water reduction, the city has implemented various water conservation and restriction policies including the limitation of ornamental outdoor irrigation to 2 times per week for five minutes per watering station based and schedule based on address. As a result of this and other conservation and restriction efforts the city has exceeded the 16% water use reduction mandate as of February of 2016.

The city water enterprise has relatively healthy water levels. As of April 2016, the city's reservoirs were at 129,000 AF of total storage, or 34% of storage capacity. While the city's stored water is less than 50% of capacity the level of water would provide a minimum of 7.4 months of supply, presumably more if additional conservation measures would be implemented.

Debt Service Coverage and Liquidity: Strong Coverage and Liquidity Have Positioned City Well to Handle Immediate Financial Impact of Drought

The city water enterprise has maintained healthy debt service coverage ratios over the past three audited fiscal years, averaging 2.53 times on a senior lien basis from FY 2013 through FY 2015. Total debt service coverage, while narrower, is appropriate for the rating category, and has averaged 1.51 times over the same period. Management projects significantly reduced debt service coverage ratios for fiscal year 2016 as overall revenues have been impacted by conservation efforts, partial year impact of rate increases implemented in January 2016 as well as expenditure increases related to water purchases. Total debt service coverage is projected to significantly decline to 1.19 times inclusive of a $32 million transfer from the Rate Stabilization Fund counted as revenues, net of the transfer, debt service coverage would fall below sum sufficiency at 0.72 times. It is our expectation that fiscal year 2016 is a low point in coverage, given multi-year rate increases through fiscal year 2020 as well as a management's track record of conservative budget assumptions which have typically produced better than projected actual results.

Importantly, the city's forward projections on total debt service coverage show a return to true net revenue coverage beyond sum sufficiency to 1.36x in fiscal year 2017, and 1.41x in FY 2018, 1.46x in FY 2019 and 2.02x in FY 2020, respectively. Included in the city's assumptions are less than 1% growth in connections, continued water conservation levels at 16%, and annual rate increases. On the expenditure side, the city's projections include increases in personnel costs in accordance with bargaining agreements, 3.3% increases related to energy and utilities, 3.5% increases for contracts and supplies and cost of water rate increases from CWA. Total debt service coverage ratios are expected to recover in fiscal year 2017 beyond sum sufficiency and is a critical consideration in the assignment of the Aa3 rating to the current issue.

LIQUIDITY

The city water enterprise has maintained healthy liquidity levels and as a result has enabled the enterprise to fund capital improvements with cash on hand. Days cash on hand has been as high as 436 days in FY 2012 and has declined to still very healthy 234 days at the end of FY 2015. Enterprise liquidity will decline to its lowest level in FY 2016 as a significant portion of the Rate Stabilization Fund will be utilized as revenues for coverage. The projected ending days cash at the end of FY 2016 is 179 days. The city water enterprise will bring Rate Stabilization Fund below the $22.8 minimum established by policy, however has enacted a plan to replenish the reserve to policy levels over the projection period with Rate Stabilization Fund deposits beginning in FY 2018.

Debt and Legal Covenants: Low Ratio of Debt to Operating Revenues; Significant Long Term Capital Plans; Adequate Legal Covenants

The enterprise's debt position is low and is expected to stay manageable through the projection period. The system's debt to operating revenues ratio is low at 1.83 times in FY 2015 and the overall debt ratio is also low at 27.9% in FY 2015. The city's current capital program for the water enterprise from FY 2016 through FY 2020 calls for approximately $872 million in capital spending with the biggest drivers being the Pure Water program (39% of program), pipeline replacement (21% of program), pipeline transmission (17% of program), and storage facilities (12% of program). City officials expect the current program to be approximately 83% debt funded ($401 million in bonds and $320 million in state revolving fund loans) and the remaining funding from a combination of grants, capacity fees and cash funding. While the Pure Water program is the largest piece of the 5 year capital program, the bulk of its related costs are expected towards the tail end of the 5 year projection. The enterprise's ability to achieve or exceed projected financial metrics through the sizable capital program is an important consideration in the assignment of the Aa3/Stable rating.

The enterprise has rate covenants to maintain 1.2x senior debt service coverage and a reserve requirement funded at the lesser of the standard three-prong test. Of note, after the completion of the refunding the city will have no outstanding senior lien debt, however, expects to keep the senior lien open for future debt issuances should coverages return to historic levels to meet additional bonds test requirements.

The subordinate lien bonds have a rate covenant of 1.0 times on all debt. Of note in the calculation of coverage, the city is able to use Rate Stabilization Fund monies as revenues. The current bonds do not have a debt service reserve fund.

DEBT STRUCTURE

The enterprise's outstanding debt is all fixed rate.

DEBT-RELATED DERIVATIVES

The enterprise has not entered into any derivative agreements.

PENSIONS AND OPEB

The water enterprise participates in the city's pension plan and OPEB plans and contributions are manageable. The water fund's $16.9 million contribution to the city's core pension contribution in FY 2015 and made up 3.9% of operations and maintenance. The water fund's $4.7 million contribution to the city's retiree health contribution was 1.1% of operations and maintenance.

Management and Governance: Rate Setting Record is Average; Debt Service Coverage Actuals Consistently Outperform Projections

The city passed multi-year rate increases through FY 2020 in November of 2015. The rate increases included a 9.8% rate increase in January of 2016, 6.4% increase in July 2016, 6.4% in July 2017, 5.0% in July 2018 and 7% in July 2019. Positively, if the actual CWA rate increases are beyond what the city assumed in forward projections, the city can pass on these increases onto rate-payers.

Management typically budgets conservatively and has demonstrated a positive variance of at least 0.2 times over projections on senior and total debt service coverage ratios with the exception of FY 2015 when state mandated conservation calls mid-year impacted system revenues. Conservative budgeting on both revenue as well as expenditures has produced a positive DSCR variance of at least 0.2 times and up to 0.5 times between FY 2012 through FY 2014.

Legal Security

The senior lien bonds are secured by a senior lien pledge of the net revenues of the system, a rate covenant of 1.2 times and a debt service reserve requirement of the lesser of the standard three prong test, currently cash funded.

The subordinate lien bonds, including the current issues, are secured by a subordinate lien pledge of the net revenues of the system and a rate covenant of 1.0 times for all debt. For the calculation of coverage Rate Stabilization Fund transfers are counted as revenues. The current bonds do not benefit from a debt service reserve fund.

Use of Proceeds

Proceeds from the Series 2016A Subordinate Revenue Bonds will be used to fund new enterprise projects, while proceeds from the Series 2016B Subordinate Revenue Refunding Bonds will be used to refund all of the outstanding senior lien revenue bonds outstanding as well as some senior lien state revolving fund loans.

Obligor Profile

The water enterprise serves the City of San Diego, and certain surrounding areas. The enterprise customer base benefits from a highly diversified metropolis with a very large 1.4 million population base . The enterprise is comprised of nearly 280,000 retail connections, of which 91% are residential, 6% are commercial and industrial and the remainder are irrigation and other connections.

Methodology

The principal methodology used in this rating was US Municipal Utility Revenue Debt published in December 2014. Please see the Ratings Methodologies page on www.moodys.com for a copy of this methodology.

Ratings

Exhibit 3

San Diego (City of) CA Water Enterprise

Issue	Rating
Subordinated Water Revenue Bonds, Refunding Series 2016B	Aa3
Rating Type	Underlying LT
Sale Amount	$659,010,000
Expected Sale Date	05/18/2016
Rating Description	Revenue: Government Enterprise
Subordinated Water Revenue Bonds, Series 2016A	Aa3
Rating Type	Underlying LT
Sale Amount	$46,309,000
Expected Sale Date	05/18/2016
Rating Description	Revenue: Government Enterprise

Source: Moody's Investors Service

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Contacts

Kristina Alagar Cordero 415-274-1707
AVP-Analyst
kristina.cordero@moodys.com

Christian Ward 415-274-1721
Analyst
christian.ward@moodys.com

Michael Wertz 212-553-3830
AVP-Analyst
michael.wertz@moodys.com

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

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