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San Diego Public Facilities Financing Authority, California; Water/Sewer

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Credit Profile		
US$165.7 mil senior swr rev rfg bnds (San Diego) ser 2010A due 05/15/2029		
Long Term Rating	A+/Stable	New
San Diego Pub Facs Fincg Auth, California		
San Diego, California		
San Diego Pub Facs Fincg Auth (San Diego) senior swr rev rfdg bnds ser 2009B		
Long Term Rating	A+/Stable	Affirmed
San Diego Pub Facs Fincg Auth (San Diego) sr swr rev bnds ser 2009A		
Long Term Rating	A+/Stable	Affirmed
San Diego Pub Fac Fing Auth (San Diego) Swr		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

Rationale

Standard & Poor's Ratings Services assigned its 'A+' long-term rating, and stable outlook, to San Diego Public Facilities Financing Authority, Calif.'s series 2010A senior sewer revenue refunding bonds, issued for the city of San Diego. At the same time, Standard & Poor's affirmed its 'A+' long-term rating, and stable outlook, on the parity debt outstanding.

The rating reflects what we view as:

- Good historical and projected debt service coverage (DSC);
- The authority's strong liquidity position supported by targeted cash reserve policies; and
- A regional and municipal system serving a broad and diverse service area economy and customer base.

These strengths are partially offset by our opinion of the wastewater system's:

- Ongoing sewage treatment regulatory challenges, related primarily to a system-wide consent decree and the potential for future secondary treatment requirements at the Metropolitan Sewerage System's Point Loma plant, which have the potential to cause significant increases in the capital improvement plan (CIP); and
- Higher-than-average rates when compared with regional systems across the country and future rate increase approvals necessary to maintain projected debt service coverage levels for the system's projected CIP needs unrelated to the secondary treatment requirements at the Point Loma plant.

A senior-lien pledge on installment payments from net revenues of the wastewater system secures the bonds. We understand that proceeds from the series 2010A bonds will be used to refund bonds outstanding. The wastewater system has about $1.3 billion of bonds and loans outstanding secured by the system's net revenues, including senior revenue bonds and subordinate state revolving fund (SRF) loans, secured by a subordinate lien of the net system revenues.

The wastewater system consists of both a sewage collection system for the city of San Diego (Municipal Wastewater Collection System) and a regional system (Metropolitan Sewerage System) that provide a transportation, treatment, and disposal system for a population of 2.1 million in the city of San Diego and 15 other cities and districts in a 450-square-mile service area. The municipal system serves a population of 1.3 million in the city. The municipal system's 10 leading customers represented what we consider a diverse 8.9% of total sewer operating revenues in fiscal 2009; the U.S. Navy is the system's largest customer, comprising 3.6% of the operating revenues. Residential customers continued to represent the largest component of system revenues (57%) in fiscal 2009, commercial and industrial customers represented 22% of revenues, and treatment plant services for other cities and districts comprised 12% of system revenues, down from 20% in 2008. The decline in treatment plant service revenue was due to a one-time adjustment for previous year credits.

Net system revenue covered senior-lien annual DSC by 2.0x and total senior and subordinate DSC by 1.7x in fiscal 2009 after a $3 million transfer to the system's rate stabilization fund. Excluding capacity charges, fiscal 2009 senior DSC was 1.90x and total DSC was 1.55x. Wastewater system liquidity remained strong in our view, with audited unrestricted cash and investments at $346 million, or 662 days' cash on hand, at fiscal year-end 2009. System officials project all pledged net revenues between fiscals 2010 and 2011 to cover existing senior-lien debt service by 1.75x and 2.00x, respectively. The fiscal 2010 estimates include a $2 million transfer to the system's rate stabilization fund and the fiscal 2011 estimates include a $9.6 million one-time settlement from the City of El Cajon, a participant of the Metropolitan Sewerage System for its proportionate share of previous capital improvement costs. Projections also assume a 4% annual system rate increase after fiscal 2011 although the rate study will not be conducted until 2011 and city council has yet to approve any future rate increases past May 1, 2010; sewer rate increases are also subject to Proposition 218 in California, which provides customers the opportunity to protest rate increases.

System officials estimate the system's contribution to San Diego's pension and retiree health benefits at $16.5 million in fiscal 2011, which represents about 8% of officials' projected net system revenues for that year. The previous rate study incorporated higher assumed pension and retiree health contributions than actually required based on historical actuarial valuations. Due to recent asset losses in the city's pension and other postemployment benefits funds, future valuations will likely increase the system's contribution requirements in our view. System officials indicate the 2011 rate study will incorporate actuarial valuations that reflect recent market changes, but officials don't expect a material impact on the system due to its small share of the overall city's pension contributions (4.7% in fiscal 2009).

The system's large $638 million CIP for fiscals 2010 through 2014 continues to be driven by regulatory concerns and an aging infrastructure. The system operates under a final consent decree by the U.S. Environmental Protection Agency (EPA) to reduce sewer spills, which drives 76% of the system's current CIP. Furthermore, since 1995, the system's Point Loma wastewater treatment plant has operated under two five-year waivers of secondary treatment standards for discharge of its treated wastewater as specified in the Federal Clean Water Act of 1972. In December 2008, the system received a tentative decision by the EPA to grant a new five-year waiver at its Point Loma plant and officials expect a final EPA determination in April 2010. Without the waiver, however, we believe the system's capital needs would increase significantly, as potential capital costs necessary to upgrade the current plant to meet secondary treatment standards are estimated by system officials to be as high as $1.5 billion.

The bond provisions include a 1.2x annual DSC rate covenant, which includes one-time transfers in or out of the rate stabilization fund in its net system revenue calculation. Bond provisions also include an additional bonds test that requires 1.2x maximum annual debt service coverage by net system revenues in 12 out of the past 18 months and estimated revenues in the next 12 months.

Outlook

The stable outlook reflects Standard & Poor's expectation that the system will receive final EPA approval for a five-year modified permit for its Point Loma plant, as it has twice before, to avoid significant near-term costs associated with secondary treatment requirements. The outlook also reflects our expectation that the system's cash reserve policies should help to maintain good system liquidity. The system's current projections rely on successful implementation of future rate increases to maintain what we consider good projected debt service ratios as the system continues work on its large CIP associated with regulatory requirements. Should the system's capital needs increase significantly or should the system fail to make sufficient rate increases to maintain adequate DSC ratios, the rating could be pressured.

System

The metropolitan system provides wholesale treatment services--including some sewage transportation, treatment, and disposal operations--to 15 participating agencies under a regional wastewater disposal agreement that became effective in 1998, and expires on Dec. 31, 2050. The participating agencies pay the system proportionate payments based on flow and strength for all facilities. The metropolitan system's wastewater treatment facilities primarily consist of three wastewater treatment plants and a biosolids center. The Point Loma wastewater treatment plant, the principal treatment facility, is an advanced primary treatment plant with a permitted treatment capacity of 240 million gallons per day (mgd) and a peak capacity of 432 mgd, compared with an average daily flow of 158 mgd in fiscal 2009; the treatment plant represents more than 90% of the total system's average daily flow.

Regulatory Issues And Capital Improvement Plan

The Point Loma wastewater treatment plant is an advanced primary treatment plant that removes from 85%-90% of suspended solids from the wastewater it discharges into the ocean. In 2002, the EPA granted the system a renewal of a five-year National Pollutant Discharge Elimination System modified permit (waiver) to exempt it from the more stringent secondary treatment requirement of the Clean Water Act. In December 2008, the system received a tentative determination by the EPA to renew the waiver for another five years. The Regional Water Board and the California Coastal Commission have approved the modified permit and officials expect the final determination by the EPA in April 2010. San Diego also has negotiated agreements with two environmental groups to stem future challenges to the EPA order by agreeing to research the potential for reducing ocean discharge and increasing reclaimed wastewater usage; the California Coastal Commission approval is contingent on completion of this study. The plant is surrounded by land owned by the U.S. Navy and U.S. Park Service. according to the city, should the system fail to receive approval of an additional waiver, its CIP could substantially increase by up to $1.5 billion due to the cost associated with converting the system to meet secondary treatment requirements within a confined geographic space, assuming the city could not access land from its neighbors.

In addition, the municipal system is under a final consent decree that was entered into in October 2007 and requires the system to replace 250 miles of sewer pipeline by 2013 and rehabilitate its wastewater facilities to remediate system sewer spills. We understand that one sewer pump station has missed its deadline as of Jan. 1, 2010, and system officials are estimating a minimal $217,500 cost to the system in fines on the assumption that they will complete this project early in April 2010. The delay also exposes the system to potential EPA fines should any major sewer spills occur while the project remains incomplete. According to the city, a significant portion of its $638 million CIP is driven by the consent decree and officials expect to issue $375 million of additional debt through 2014, primarily to make pipeline and trunk sewer repairs. System projections anticipate previously issued bond proceeds and cash on hand will fund the remainder of the five-year CIP costs.

Rates

The council pre-approved wastewater rate increases of between 7.00% and 8.75% for fiscals 2007 through 2010, as recommended in a 2006 rate study, to cover the system's capital needs. The last of these pre-approved rate increases is scheduled to occur on May 1, 2010, and system officials intend to conduct the next rate study in 2011. The system's financial and debt service coverage projections do not include a rate increase in fiscal 2011. In 2007, the sewer system settled a lawsuit by agreeing to reimburse residential customers a cumulative $40 million, less $5 million for legal fees, for previous overcharges of their sewer bills (Shames Settlement). The system officials expect that this settlement amount will have been raised for all single-family residential customers by the fall of 2011.

As of May 2010, current residential sewer rates will be $51 for a single-family home using 7,500 gallons per month, after accounting for a $3.25-per-month adjustment on residential bills per the Shames Settlement. Together with the water rates, the overall rates are above average for a regional system, at about $99 per 7,500 gallons per month, but in our view a still-manageable 2.4% of the city's 2008 annual median household income.

Reserve Policies

Officials have identified reserve targets to maintain minimum amounts of cash reserves for operations, rate stabilization, and contingencies, including a targeted 70-day operating reserve to be used in the event of an emergency, a rate stabilization fund to be maintained at 20% of net system revenues, and a $5 million reserve for unexpected capital needs in its capital improvement reserve. Officials also recently created a new reserve fund, a dedicated reserve for efficiency and savings (DRES), with a current balance of $22 million as of February 2010. The DRES is funded with savings achieved due to efficiencies and reduced costs of the system and could be used to mitigate future rate increases and contribute toward capital outlay needs. The system also maintains restricted cash reserves for debt service requirements on its series 1999 and 2009 bonds and officials intend to cash-fund a debt service reserve for the series 2010 bonds. As of February 2010, management estimates that the wastewater fund has a total of about $85.3 million (or about 157 days' fiscal 2009 operations) in the targeted reserves including $21.3 million available in its rate stabilization fund and $33.7 million (or 50 days' budgeted operations in fiscal 2010) in its operating reserve. System officials intend to change the operating reserve policy to target the 70-day reserve by 2012. The system also maintains the targeted $5 million in its capital reserve and $3.5 million in the appropriated reserve for unanticipated maintenance and operations expenses.

Service Economy

San Diego's population of 1.3 million in 2008 has risen about 1% per year since the 2000 U.S. census. The city is a significant employment center within the county, representing about 45% 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. The city's economic base is also anchored by higher education and major scientific research institutions, including the University of California-San Diego, San Diego State University, Scripps Research Institute, the Salk Institute for Biological Studies, and the San Diego Supercomputer Center. Median household effective buying income is also strong, in our view, at 117% of the national average in 2008. However, given rising unemployment rates this ratio might have moderated over the past year. According to the Bureau of Labor Statistics, the city's unemployment rate has grown gradually from an annual average rate of 4.6% in 2007 to a monthly rate of more than 10% between June and November 2009.

Audits And Internal Controls

As part of a 2006 cease and desist order with the Securities Exchange Commission, the city hired an independent consultant to review its internal policies and disclosure processes. In March 2010, the independent consultant released his third and final report, which concluded that San Diego has made progress toward improving its internal controls and disclosure processes although the report also noted the city needs to improve its internal controls over financial reporting. City management expects the full implementation of new enterprise resource planning software in 2010 to help resolve internal control weaknesses and aid in the continued timely release of future financial reports. San Diego released its fiscal 2009 audited financial statements in February 2010.

Related Criteria And Research

USPF Criteria: Standard & Poor’s Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008