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Rating Update: Moody's affirms Aa3 on San Diego CA's Sewer Revenue Bonds; Outlook changes to Positive

Ratings apply to approximately $974 million in sewer revenue bonds

SAN DIEGO (CITY OF) CA SEWER ENTERPRISE
Sewer Enterprise
CA

NEW YORK, August 26, 2015 --Moody's Investors Service has affirmed the Aa3 rating on City of San Diego (CA) Sewer Enterprise's Revenue Bonds. The rating affirmation applies to approximately $974 million in outstanding sewer revenue debt. The outlook has changed to positive.

SUMMARY RATING RATIONALE

The Aa3 rating reflects the sewer enterprise's strong financial performance through the economic downturn and the inherent stability of the very large enterprise which serves a dynamic and growing service area with above average socio-economic indicators. The enterprise is well positioned for its next phase of significant capital plans given the strength of management and our expectation that it will again outperform financial projections over the long term. Also factored into the rating is the enterprise's exceptionally strong liquidity position, at more than 700 days of cash, which more than offsets a change in legal security applied to the 2015 refunding bonds (unrated by Moody's) which will have a springing debt service reserve amendment once legal thresholds are met.

OUTLOOK

The positive outlook reflects our opinion that the enterprise is poised to maintain its financial strength given strong performance through the economic downturn and the successful completion of capital program to comply with consent decree requirements. The positive outlook further considers the enterprise will fulfill future capital plans and maintain operational and financial strength as it awaits modified permit renewal for Point Loma Plant and further progress in its Pure Water Program.

WHAT COULD MAKE THE RATING GO UP

- Significant and sustained improvement in overall debt service coverage levels

- Successful implementation of long term capital plans while improving financial position of the enterprise

WHAT COULD MAKE THE RATING GO DOWN

- Material deterioration in debt service coverage levels

- Sustained decline in unrestricted liquidity

- Inability to preserve financial strength through long term capital plans and preserve strong financial and debt profile

STRENGTHS

- Large, highly diverse service area with above average resident socio-economic indicators

- Strong financial oversight with conservative budgeting and projections

- Exceptionally strong liquidity levels with days cash in excess of 700 days

CHALLENGES

- Significant long term capital plans that fundamentally transform sewer and city water operations over the long term

- Debt service coverage levels that are consistently thinner than the median for the current category

- Move towards elimination of debt service reserve funds

RECENT DEVELOPMENTS

Recent developments are incorporated in the Detailed Rating Rationale.

DETAILED RATING RATIONALE

SERVICE AREA AND SYSTEM CHARACTERISTICS: WASTEWATER ENTERPRISE SERVES GROWING, HIGHLY DIVERSE AND WEALTHY SERVICE AREA

The enterprise derives great benefit and stability from the highly diversified regional economy 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 2.2 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 120.5% of the nation. San Diego's wastewater enterprise provides collection, treatment, and disposal services within the city limits (the "municipal system") and treatment and disposal services to many of the surrounding communities ("participating agencies" in the "metropolitan system"). The municipal system accounts for about two-thirds of the metropolitan system's total flows. The enterprise is comprised of 273,000 customers. In FY 2014 domestic customers accounted for 55% of total sewer service charge revenues, while commercial and industrial customers represented 26%. There are no dominant customers within the municipal system; the largest is the U.S. Navy, which accounted for 3.25% of FY 2014 operating revenues, while the top ten customers account for 7.5% of revenues.

ENTERPRISE IS COMPLIANT WITH ALL REGULATORY REQUIREMENTS AND CONSENT DECREE HAS BEEN FULFILLED

As mentioned above, San Diego's sewer enterprise provides collection, transportation, treatment, and disposal services. The capacity of the treatment system is 285 million gallons per day (MGD), 15 MGD from its South Bay Plant, which discharges secondary-treated effluent through an ocean outfall; 30 MGD from its North City Plant, excess effluent from which is transported to Point Loma Plant, and 240 MGD from its Point Loma Plant. However, South Bay Plant and North City Plant were operating at 8 MGD and 7 MGD in 2014. The effluent from the Point Loma Plant is discharged through a 4.5 mile long ocean outfall that delivers treated sewage effluent at a depth of 320 feet of water. As a result, it is one of a handful of large urban systems nationwide which is permitted to provide a lower treatment level than is required of almost all other treatment plants in the country ("advanced primary" treatment vs. "secondary"). It does so pursuant to a continued Modified Waiver. The system is in full compliance with the Waiver, which expired July 31, 2015 and the city has submitted an extension to the current waiver and will likely receive a decision in 2016.

The enterprise's collection system has dramatically decreased the total number of sewer spills, from 365 in calendar 2000 to 28 in 2014. In 2014 the city has completed all of its capital improvements required under its final consent decree which had called for a total of 450 miles of pipeline replacement increased sewer spill response and tracking, increased root control. On August 4, 2015 the consent decree was terminated by all parties.

FINANCIAL OPERATIONS AND RESERVES: ADEQUATE COVERAGE LEVELS AND EXCEPTIONALLY STRONG LIQUIDITY POSITION

While debt service coverage ratios on senior lien and all debt are below medians for the current rating category, the enterprise's overall financial picture has been very stable. Debt service coverage on senior lien debt has averaged 1.79 times over the past five fiscal years and total debt service coverage has averaged 1.69 times annually over the same period of time. The median total debt service coverage for sewer enterprises nationwide is 2.27 times. Management projects FY 2015 coverage levels to approximate the five year averages on both senior and all in coverage at 1.73 times and 1.64 times, respectively.

Debt service coverage projections for FY 2016 through 2020 decline somewhat from historical performance. Senior lien debt service coverage averages 1.5 times and total debt service coverage averages 1.42 times over the projection period. The projections include a 5% decline in revenues in FY 2016 related to water consumption declines due to the state mandated water conservation, no rate increases, and O&M increases associated with personnel costs, supplies and contracts and energy and utilities. The overall water conservation efforts, which thus far have proved significant with the city water enterprise recording 25% declines in consumption, should have a relatively modest effect on sewer enterprise operations as sewer rates are based on winter month, indoor water usages. These water conservation efforts are particularly focused on outdoor irrigation.

Liquidity

The city sewer enterprise has maintained exceptionally strong liquidity levels and has resulted in the enterprise's ability to fund capital improvements with cash on hand. In FY 2014 the city sewer enterprise ended with $455 million in unrestricted cash which amounted to 788 days cash on hand. Unaudited results show a modest decline to $431 million or a still exceptionally strong 724 days of cash. Included in the liquidity position is an Operating Reserve ($48 million) and Rate Stabilization Fund ($21.3 million) which could be used for operations or debt service. We expect the enterprise will maintain its exceptionally strong cash position over the five year projection period given the significant amounts of projected net revenues and their ability to cover cash for capital spending.

DEBT AND LEGAL COVENANTS: LOW RATIO OF DEBT TO OPERATING REVENUES; MANAGEABLE CAPITAL PLANS; ADEQUATE LEGAL COVENANTS

The enterprise's debt position is low and is expected to stay manageable through the projection period given no additional debt plans until FY 2020. The enterprise's current debt ratio was 31.4% in FY 2014 and will continue to decline through the projection period. Debt to operating revenue ratio for the enterprise was strong at 2.99 times in FY 2014 and consistent with the Aa rating level. The five year capital plan for the enterprise has identified $489 million in capital needs through FY 2020. The bulk of those needs are focused on pipeline replacement totaling $262 million as it continues on the same pace of pipeline replacement of 45 miles annually. The second largest capital spending in the plan is for the Pure Water Program at $92 million for treatment plant upgrades. The sewer enterprise expects to cash fund the majority of this program, approximately 65%, with cash, $82 million in capacity fees and $235 million in cash from net revenues and accumulated cash. The remaining funding would come from state revolving fund loans at 25% and 8% from sewer revenue debt.

The city's Pure Water Program is an advanced water purification program to produce potable water sources from recycled water. Pure Water is a 20 year program estimated to cost $3 billion, of which $1.8 billion would be funded by the sewer enterprise and the remaining $1.2 billion would be funded from the San Diego Water Enterprise (Senior Revenue Bond rating Aa2/Stable). The pursuit of the Pure Water Program serves multiple purposes including the diversification of local sources of water supply as well as assisting the sewer enterprise in receiving Modified Permits for its Point Loma Plant. Implementation of Pure Water would decrease wastewater flows and pollutants processed by Point Loma Plant and improve discharge into the ocean. If the city is unable to secure a Modified Permit implementation of secondary treatment would be required at the Point Loma Plant. The projected costs to bring the plant into compliance with the Clean Water Act would be approximately $2.1 billion through 2050, with $1.8 billion occurring by FY 2030. Operations and maintenance costs would also increase by approximately $39 million annually once the plan was fully operational at the secondary treatment level.

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 sewer enterprise participates in the city's pension and OPEB plans and contributions are manageable. The sewer fund's $17.5 million contribution to the city's core pension contribution of $263 million in FY 2015 made up 6.6% of the total and 5.1% of operations and maintenance. The sewer fund's $5 million contribution to the city's retiree health contribution of $57.8 million was 8.7% of the total and made up 1.5% of operations and maintenance.

MANAGEMENT AND GOVERNANCE: PAST RATE-SETTING RECORD AVERAGE; DEBT SERVICE COVERAGE ACTUALS CONSISTENT WITH PROJECTIONS

The city's passed its last multi-year rate increase in 2007 when a four year rate increase was approved. Sewer Rates were last increased on May 1, 2010 when they were increased 7%. The rate increases implemented in each consecutive year from 2007 were 8.75%, 8.75%, 7% and 7%. There have been no rate increases since 2010 and no rate increases are included in the enterprise's FY 2016-FY 2020 projections.

Management consistently budgets conservatively and has on average produced debt service coverage ratios consistent with projections for senior lien as well as total debt.

KEY STATISTICS

- Asset Condition (remaining useful life): 43 years

- System Size (O&M in 000s): $201,951

- Service Area Wealth (MFI): 120.5% of the US

- 2014 Annual Debt Service Coverage: 1.69 times (all debt; 1.79 times Senior)

- Days Cash on Hand: 788 days

- Debt to Operating Revenues: 2.99 times

- Rate Management: A

- Regulatory Compliance and Capital Planning: A

- Rate Covenant: 1.0 times all debt service, 1.20 times senior lien

- Debt Service Reserve Requirement: A

OBLIGOR PROFILE

The waste water enterprise serves the City of San Diego (Municipal Sub System), and surrounding cities and communities (Metropolitan Sub System). The enterprise serves a highly diversified metropolis with a regional population base of 2.2 million. There are currently 273,000 customers.

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 standard lesser of the three prong test, currently cash funded. The enterprise is amending its indenture with the issuance of 2015 Refunding Bonds with a springing reserve amendment that will eliminate the debt service reserve requirement on the 2015 Refunding Bonds once legal thresholds are met. The 2015 Refunding Bonds will be funded with a cash funded debt service reserve fund at issuance.

RATING METHODOLOGY

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

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