FITCH AFFS PUBLIC FACILITIES FINANCING AUTH OF CITY OF SAN DIEGO, CA SR & SUB WTR REVS AT 'AA'/'AA-'

Fitch Ratings-San Francisco-12 March 2014: Fitch Ratings affirms its ratings on the following Public Facilities Financing Authority of the City of San Diego, California (the authority) bonds issued on behalf of the City of San Diego, California (the city):

--$581 million in outstanding senior lien revenue bonds at 'AA';
--$171 million in outstanding subordinated water revenue bonds, refunding series 2012 at 'AA-'.

The Rating Outlook is Stable.

SECURITY

The bonds are secured by installment payments made by the city to the authority. The authority has assigned its right to such installment payments to bondholders. The obligation of the city to make installment payments is secured by a pledge of net revenues of the city's water system (the system) on senior basis with regards to senior lien bonds and a subordinate basis with regards to subordinate lien bonds.

KEY RATING DRIVERS

ADEQUATE BUT WEAKENED FINANCIAL RESULTS: System financial performance is sound, but softened in fiscal 2013 from rising purchased water costs and lack of rate action. The system will face ongoing purchased water cost increases along with rising debt service costs.

RISING DEBT PROFILE: Debt levels are on the higher end and are projected to climb further over the next five years as the system pushes forward with an aggressive renewal and replacement (R&R) program. Costs in the latter years of the capital improvement program (CIP) could see significant escalation if the city moves forward with full-scale implementation of its indirect potable reuse project (the IPR).

ELEVATED CUSTOMER CHARGES: User charges are relatively high and will face continued acceleration in the coming years as the city contends with further escalation in wholesale pass-through costs and also pushes forward with its own CIP and possible implementation of the IPR.

EXTENSIVE SERVICE TERRITORY: The service area is broad and diverse.

RATING SENSITIVITIES

REDUCED FINANCIAL STRENGTH: Maintenance of sound financial metrics will be key to preserving credit quality, particularly in light of expected operating and capital cost pressures.

CAPITAL ESCALATION: Ultimate timing and costs associated with expected construction of the IPR will be a significant consideration in credit quality over the coming years. Given the system's already elevated debt levels, additional debt over the forecast period to fund the IPR beyond the amounts already programmed into the CIP could result in negative rating action.

CREDIT PROFILE

BROAD SERVICE TERRITORY WITH FAVORABLE ECONOMIC UNDERPINNINGS

The system provides retail service to around 1.3 million people within the city (general obligation rating of 'AA-' Stable Outlook by Fitch) and also provides limited wholesale service to certain customers 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 in the city expanding by 2.3% in 2013 alone. The job growth pushed city unemployment levels in 2013 down to 7.4%, in line with that of the U.S. after lagging the national rate for the last several years.

ADEQUATE BUT WEAKENED FINANCIAL PROFILE

System financial performance remains sound but is down from historical highs as rates were held flat in fiscals 2012 and 2013 while the system absorbed increases in charges from the city's wholesale water provider, the San Diego County Water Authority (CWA; revenue bonds rated 'AA+' Stable Outlook by Fitch). For fiscal 2013, annual debt service coverage (DSC) of all debt was 1.5x after reaching 2.4x the year prior. Liquidity for fiscal 2013 continued to be very strong at around one year of operating expenses. However, cash flows for the year saw severe deterioration, generating just 50% of annual depreciation expense after historically generating well over 100% in the prior five years.

The city is projecting a weakening in DSC coverage through fiscal 2018 based on moderate rate increases coupled with further increases to operating and debt service costs. Overall, total DSC is forecasted to drop to around 1.2x in fiscals 2014-2015 before improving slightly to the 1.3x-1.4x range. The projected weakening in DSC is a concern, but Fitch notes that the city has demonstrated tight expenditure controls and has outperformed its forecasts in recent years. Erosion in financial results to forecast levels would likely result in negative rating action given the expected pressure to the system's debt profile over the coming years to address planned R&R as well as the possible funding of the IPR.

DEBT PRESSURES GROWING

Capital needs for fiscals 2014-2018 total $621 million, having increased around $150 million or over 30% from the fiscal 2012-2016 CIP as the city has aggressively pursued system R&R. The current CIP also includes remaining costs of around $145 million related to cast-iron pipe replacement under a regulatory consent order. The increase in the CIP is a concern given the additional projected debt funding expected. Overall, debt per customer and per capita - already on the high side at $3,182 and $659, respectively - will increase to around $4,260 per customer and $850 per capita by fiscal 2018, well above the 'AA' category median.

Debt concerns are further exacerbated by the likelihood of the city moving forward with the full-scale construction of the IPR in the coming years. The IPR, which consists of an advanced water purification facility to treat up to 15,000 acre-feet per year of wastewater flows to potable standards along with conveyance facilities to San Vicente Reservoir, is estimated to cost around $369 million. Construction of the IPR is expected to result in around $123 million of avoided capital costs for the city's sewer system, potentially allowing the sewer system to bear a sizeable amount of the IPR costs. However, the water system would be expected to shoulder the bulk of the capital costs, and much of the IPR would likely be debt financed. Depending on the ultimate scope and timing of the IPR, the system could face downward rating pressure given the system's already elevated debt profile.

RISING USER CHARGES TO COVER OPERATING AND DEBT COSTS

The city council typically has passed annual rate hikes to support system capital demands and maintain solid financial margins. However, the city council did hold off on increases in fiscals 2012 and 2013 to provide some rate relief to customers despite nearly 9% annual pass-through increases from CWA during this period. The city council approved rate hikes for fiscals 2014 and 2015 of 7.25% and 7.5%, respectively, to bolster financial margins and generate sufficient monies to offset additional CWA cost increases.

User charges are currently elevated at 1.4% of median household income (MHI), and with the fiscal 2015 adjustment residential charges will rise to a very high 1.6% of MHI. Charges are expected to rise even further by the end of the forecast period in order to offset further CWA escalations as well as rising carrying costs from planned borrowings in the CIP.

The level of residential charges is a concern, although there has been strong support to date for the reasons surrounding the escalating costs - namely building local supply sources at the city and CWA level to offset imported water purchased outside of the county. Customer support may erode as user charges continue to escalate, particularly in situations where significant adjustments would be required to fund major projects like the IPR. Difficulty or delays in achieving rate adjustments that preserve or enhance financial results would be viewed negatively.

Contact:

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

Kathy Masterson
Senior Director
+1-512-215-3730

Committee Chairperson
Arlene Bohner
Senior Director
+1-212-908-0554

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

Additional information is available at '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 and IHS Global Insights.

Applicable Criteria and Related Research:
--'Revenue-Supported Rating Criteria' (June 2013);
--'U.S. Water and Sewer Revenue Bond Rating Criteria' (July 2013);
--'2014 Water and Sewer Medians' (December 2013);
--'2014 Sector Outlook: Water and Sewer' (December 2013).

Applicable Criteria and Related Research:
Revenue-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=709499

U.S. Water and Sewer Revenue Bond Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=715275
2014 Water and Sewer Medians
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=724358
2014 Outlook: Water and Sewer Sector
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=724357