FITCH AFFIRMS SAN DIEGO PUBLIC FACILITIES FINANCING AUTHORITY, CA LEASE REVS AT 'A+'; OUTLOOK STABLE

Fitch Ratings-San Francisco-14 March 2014: Fitch Ratings has affirmed the following ratings:

--$498.4 million San Diego Public Facilities Financing Authority (SDPFFA) lease revenue bonds, series 2007A (Ballpark Refunding), series 2010A (Master Refunding Project), 2012A (Capital Improvement Projects), 2012B (Fire and Life Safety Facilities Project), 2013A (Capital Improvement Projects and Old Town Light Rail Extension Refunding), and 2013B (Balboa Park/Mission Bay Park Refunding) at 'A+';
--$133 million Convention Center Expansion Financing Authority lease revenue bonds, series 2012A at 'A+';
--San Diego (CA) implied unlimited tax general obligation (GO) bond rating at 'AA-'.

The Rating Outlook is Stable.

SECURITY

The city's lease revenue bonds are secured by the city's lease rental payments, which the city covenants to budget and appropriate annually. The lease rental payments are subject to abatement, which is mitigated by standard rental interruption insurance provisions.

KEY RATING DRIVERS

POTENTIALLY GROWING DEBT BURDEN: The city's overall debt burden is on the high side of what Fitch considers to be moderate and is expected to grow as the city begins to address large unmet infrastructure capital needs and new storm water regulatory requirements.

SIGNIFICANT CARRYING COSTS GOING FORWARD: While other post-employment benefit (OPEB) reform has materially reduced the city's OPEB unfunded accrued actuarial liability (UAAL), annually required pension contributions and future debt needs will likely pressure the city's already sizeable carrying costs.

FUNDAMENTAL ECONOMIC STRENGTHS: The city benefits from a diverse economy, improving key revenue streams, a declining unemployment rate, a recovering tax base, and its desirable geographic location.

PRUDENT POLICIES: The city continues to demonstrate its commitment to conservative financial management policies, general fund balance and reserves preservation, and much improved financial reporting practices compared to past content and timing deficiencies.

SOLID FINANCIAL OPERATIONS: The city ended fiscal 2013 with a higher unrestricted general fund balance and higher reserves year-over-year and the prospect of outperforming its fiscal 2014 general fund budget.

RATING SENSITIVITIES

ESCALATING DEBT BURDEN: The ultimate timing, costs, and funding sources associated with addressing the city's deferred capital projects backlog and storm water regulatory requirements will be a significant consideration in credit quality over the coming years. Given the city's already sizeable carrying costs, significant additional debt without offsetting funding increases could negatively pressure the rating.

CREDIT PROFILE

San Diego is the second largest city in California, with a stable population of approximately 1.3 million. The city's diverse economy is experiencing good recovery in terms of job growth, more residential and commercial construction, and increasing tourism.

The unemployment rate has declined to around the national average, resident socio-economic indicators are largely above-average, consumer spending is increasing, and the tax base is rebounding. The relatively minor cumulative 2.5% taxable assessed valuation (TAV) decline between fiscal years 2010-2013 was more than offset by a 4.3% TAV increase in fiscal 2014. A further 3.5% TAV increase is projected for fiscal 2015. House prices are increasing, though still well below their peak, and the value of new construction permits in fiscal 2013 increased 21% year-over-year and 234% since their fiscal 2010 low.

The city's new mayor and executive management team are unlikely to change the city's current financial management policies and procedures. Continuity is being provided by elected officials and employees with long-term ties to city government.

SOLID FINANCIAL OPERATIONS

Although the city ended fiscal 2013 with a net operating deficit after transfers of $56 million, its unrestricted general fund balance grew to $162 million or 13.3% of spending, compared to $154.3 million or 12.9% of spending a year prior. This increase reflects the general fund's positive operations when excluding special revenue funds and extraordinary gains and losses associated with dissolution of the RDA. By contrast, the $56 million net operating deficit after transfers reflects establishment of an allowance for uncollectible interfund loans from the successor agency. The city has become increasingly doubtful, based on RDA-related litigation elsewhere in California, that it would be able to collect on its past loans to the former RDA.

The city is projecting a $28.4 million general fund net operating surplus after transfers for fiscal 2014 due to a $50.8 million budgetary surplus. There are three primary causes of the budget surplus: positive revenue trends in the first two quarters, $39 million as a result of the dissolution of the RDA (of which $34.9 million are one-time revenues as the RDA's assets are allocated between local taxing entities), and transfer of the $9.8 million cash balance from the city's dissolved data-processing center to the general fund. As a result of the budget surplus, the city is now anticipating that fiscal 2014 will end with an unrestricted general fund balance of $186.9 million or 15.1% of spending.

In February 2014, the city council voted to increase the general fund reserve requirement to 14% of general fund revenues, up from 8%. The city had already ended fiscal 2013 with a general fund reserve of $179.5 million or 16.8% of general fund revenues, well in excess of both the former and new reserve requirements. The city is projecting to continue its practice of exceeding its reserve requirement by ending fiscal 2014 with a general fund reserve of $164 million or 15.3% of revenues.

California cities have limited revenue flexibility. Further, San Diego's revenue structure is less diverse than most other large California cities. For example, it does not levy a utility user tax or a trash collection fee, and has a relatively low business license tax rate, and there would likely be considerable taxpayer and voter resistance to introducing or increasing such taxes. Nevertheless, its four primary general fund revenue sources (property, sales, and transient occupancy taxes, and franchise fees) have been recovering well from the recent recession and are all projected to continue increasing.

The personnel cost increases in the city's five-year labor contracts beginning in fiscal 2013 relate to incremental restoration of the 6% remuneration reduction applied to all city employees over the past four years. These restorations will not increase pensionable pay (i.e. the gross base salary eligible for pension calculations). The 6% compensation reduction, coupled with tight position control, was one of the city's most significant expenditure controls. Over the past seven years, the city also controlled its expenditures through business process reengineering, managed competition, information technology outsourcing, employee pension and benefit reform, and service reductions (some of which have subsequently been restored).

SIZEABLE DEBT BURDEN

Taking into account former redevelopment agency tax allocation bonds and the imminent issuance of $66.4 million in lease revenue bonds, series 2014, the city's overall debt burden is at the higher end of the moderate range at $4,947 per capita, or 3.5% of fiscal 2013 market valuation. Debt amortization is average at approximately 54% in 10 years. The city did not need to issue TRANs in fiscal 2014 and is currently considering whether it will need to do so in fiscal 2015.

To begin addressing its capital backlog of an estimated $898 million (excluding water and wastewater system needs but including $235 million of storm water system deferred capital), the city is expecting to issue up to $378.4 million in bonds by fiscal 2017. The city's overall debt burden would remain similar to current levels if all this debt is issued. The city might also act as conduit issuer for $520 million in bonds to expand its convention center, after all legal challenges pertaining to the city's validation action are finally resolved. As currently envisioned, the general fund would be responsible for repayment of only a small portion of that debt.

There is also likely to be future bonded indebtedness to ensure the city's compliance with its new storm water compliance permit. To achieve full compliance, the city expects that it will have to make considerable capital and operations and maintenance investments of up to $3.9 billion over the next 17 years. Some of these costs might need to be funded through bonds supported by storm water fees and, potentially, the general fund. The impact on the city's general fund-supported debt profile is currently unknown but the city is looking for primary funding support from outside the general fund.

SIZEABLE PENSION LIABILITIES; MANAGEABLE OPEB COSTS

San Diego City Employees Retirement System (SDCERS) is 70.4% funded using SDCERS's 7.25% discount rate or an estimated 68.5% funded using Fitch's more conservative 7% discount rate, levels that Fitch views as weak.

In June 2012, following earlier pension reforms, the electorate voted in favor of closing the plan to all new employees except police, accelerating paydown of the system's UAAL, limiting pensionable salaries through fiscal 2018, and only offering defined contribution plans to new employees. This pension reform benefits the city in the long-term by shifting investment and longevity risks to future city employees, and accelerating the paydown of the pension system's UAAL ($2.2 billion in fiscal 2013). Litigation against this pension reform is ongoing.

In terms of the city's closed OPEB plan, the city still has a UAAL of roughly $444.1 million, or a low 0.3% of TAV, after negotiating a new health plan for the remaining OPEB plan members in 2012. The new retiree health plan is projected to save $714 million in health care costs over 25 years. Due to multiyear labor agreements, the city does not expect its annual OPEB contribution to exceed $57.9 million through fiscal 2015, with annual increases of up to 2.5% thereafter.

In fiscal 2013, the city's total carrying costs related to annual debt repayments, actuarially required pension contributions (which will remain a significant proportion of these costs), and OPEB pay-as-you-go payments represented a sizeable 23% of total governmental expenditures. These carrying costs are likely to increase as additional debt is issued.

LARGE CROSS-COLLATERALIZED POOL OF ASSETS

The parity series 2012, 2013, and proposed 2014 lease revenue bonds (estimated combined par amount of $206.6 million) are secured by a fully cross-collateralized pool of leased assets, valued at $218 million. In the event of default, the trustee could seek remedy across all of those properties up to the amount of the underpayment. The trustee, not the city, chooses which assets to use to cure any event of default, therefore protecting against the risk that the city would choose to default on the least essential assets in the pool.

Four of the leased assets are ground leases for land under facilities developed and owned by third parties. Two of these ground leases extend beyond the final maturity of all the parity bonds. A third lease extends beyond the final maturity of the series 2012 bonds at which time annual debt payments decrease significantly. The fourth lease extends beyond the final payment on the refunding components of the series 2013 bonds. Fitch evaluates the ground leases as very strong leased assets. They generate a significant revenue stream (approximately $5.6 million annually) which would provide the trustee with a partial but proportionately significant remedy in the event of a default (although they alone would be insufficient to cover a full debt service default of up to $14 million per year). Also, the ground leases have no meaningful abatement risk and they cover inherently valuable land (currently valued at $94.7 million) which the city has the option to sell. For all these reasons, the city has strong incentives to make the related lease rental payments.

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In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from Creditscope, University Financial Associates, S&P/Case-Shiller Home Price Index, IHS Global Insight, and National Association of Realtors.

Applicable Criteria and Related Research:

--'Tax-Supported Rating Criteria' (Aug. 14, 2012);
--'U.S. Local Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

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Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015
U.S. Local Government Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=685314