San Diego, California

San Diego Public Facilities Financing Authority

New Issue

Ratings

New Issue

Subordinated Water Revenue Bonds, Refunding Series 2012A	AA–
Outstanding Debt	
Water Revenue Bonds	AA
Subordinated Water Revenue Bonds, Series 2002	AA–

Rating Outlook

Stable

Related Research

2012 Water and Sewer Medians, Dec. 8, 2011

2012 Outlook: Water and Sewer Sector, Dec. 8, 2011

San Diego County Water Authority, California, July 18, 2011

Analysts

Doug Scott
+1 512 215-3725
douglas.scott@fitchratings.com

Kathy Masterson
+1 415 732-5622
kathy.masterson@fitchratings.com

New Issue Details

Sale Information: Approximately $186,000,000 Subordinated Water Revenue Bonds, Refunding Series 2012A, expected to sell during the week of April 2 via negotiation.

Security: The bonds are secured by subordinated installment payments made by the city of San Diego, California (the city) to the San Diego Facilities and Equipment Leasing Corporation (the corporation). The corporation has assigned its rights to receive the installment payments to the San Diego Public Facilities Financing Authority (the authority), and the authority has likewise 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 a basis subordinate to senior lien obligations.

Purpose: To refund certain maturities of the series 2002 bonds for interest savings without extension and pay costs of issuance.

Final Maturity: Aug. 1, 2032.

Key Rating Drivers

Solid Financial Results: Consistently sound financial performance is the primary rating driver. While Fitch acknowledges that rising operating and debt service costs could create pressure, San Diego (the city) has a strong history of prudent expense management leading to budget surpluses.

Improving Debt and Capital Profile: Debt levels are moderately high to high and will increase further, but have declined from recent estimates along with expected capital spending.

Imported Water Mitigates Elevated Customer Charges: The system relies on imported water for up to 90% of supply, which contributes to the system's relatively high user charges. However, the city has demonstrated a willingness to raise rates where appropriate and pass through supply costs on a regular basis.

Extensive Service Territory: The service area is broad and diverse.

What Could Trigger a Rating Action

Reduced Financial Strength: Maintenance of sound financial metrics will be key to preserving credit quality.

Accelerating Costs: Rising capital and operating costs could reduce rate affordability further and pressure financial results.

Rating History — Senior Lien

Rating	Action	Outlook/ Watch	Date
AA	Affirmed	Stable	3/23/12
AA	Revision	Stable	4/30/10
AA–	Upgrade	Stable	12/11/08
BBB+	Affirmed	Positive	3/27/08
BBB+	Downgrade	Negative	5/27/05
A	Downgrade	Negative	2/16/05
AA–	Assigned	—	9/27/02

Rating History — Subordinate Lien

Rating	Action	Outlook/ Watch	Date
AA–	Affirmed	Stable	3/23/12
AA–	Revision	Stable	4/30/10
A+	Upgrade	Stable	12/11/08
BBB	Affirmed	Positive	3/27/08
BBB	Downgrade	Negative	5/27/05
A–	Downgrade	Negative	2/16/05
A+	Assigned	—	9/30/02

Related Criteria

Revenue-Supported Rating Criteria, June 20, 2011

U.S. Water and Sewer Revenue Bond Rating Criteria, Aug. 10, 2011

Credit Profile

System financial performance remains solid despite declining production in recent years resulting from drought restrictions and general customer conservation. For fiscal 2011, annual debt service (ADS) coverage of all debt was above 1.8x. Liquidity and cash flows were also strong, with the system maintaining 277 days cash for the year and generating surplus revenues equal to 122% of depreciation.

The city is projecting a weakening in ADS coverage through fiscal 2016 based on limited rate increases coupled with rising operating and ADS expenses. Overall, total ADS coverage is forecast to drop to 1.3x in fiscal years 2012–2014 before improving slightly to 1.5x by fiscal 2016. The projected weakening in ADS coverage is a concern, but Fitch Ratings notes that city has demonstrated tight expenditure controls and expects that actual performance is likely to be more favorable based on the city's history of outperformance of its forecasts in recent years.

Capital needs for fiscal years 2012–2016 total $471 million with about 55% of costs attributable to requirements under a regulatory consent order. The size of the capital improvement program (CIP) has declined significantly from previous estimates with the completion and reprioritization of certain projects as well as from a favorable construction environment. With the decline in CIP costs, planned borrowings have also decreased and now account for 56% of planned CIP funding sources. Favorably, the reduction in planned borrowing favorably will limit escalation in system leverage ratios, but debt levels continue to be relatively high and amortization of principal is below other similarly rated credits.

The city council passed a series of rate hikes in recent years to support the city's capital demands, as well as the need to recover pass-through costs from the San Diego County Water Authority (CWA, the city's wholesale water provider). In total, rates were increased more than 15% for fiscal 2009, 6.5% in fiscal 2010, and 6.5% in fiscal 2011. No additional escalations are currently forecast for fiscal years 2012–2013, but it is expected that a new rate study will be performed in calendar 2012 with the results subsequently recommended to city council. With these prior adjustments, as well as pass-through increases from CWA, the current average monthly residential bill has risen to a moderately high 1.4% of estimated median household income (MHI). While the level of customer charges is a credit concern given the diminished rate flexibility, user costs are not, nor are they expected to be, significantly higher than other major West Coast metropolitan providers through the projection period.

The system provides retail service to about 1.3 million people within the city 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 in recent months, with job growth in the city expanding by 1.6% in 2011 compared to the national rate of 1.0%. While unemployment of 8.9% for December 2011 remained above the national rate of 8.3%, the recent level of job creation has narrowed the gap with the national average and positions the city for continued positive movement.

Governance and Management

The system is owned by the city and operated by the city's water department. The director of public utilities oversees the water department, as well as the metropolitan wastewater department and, ultimately, reports to the mayor through the chief operating officer of the city. The City Council is solely responsible for setting rates and approving the department's budget and certain contracts.

The city also has created the Independent Rates Oversight Committee (IROC) in 2007, which serves as an advisory body to the mayor and City Council on matters relating to operations of the water and wastewater utilities that could affect rates. IROC members are appointed by the mayor and consist of representatives of each rate class and experts in areas pertinent to the operation of the water and wastewater utilities. IROC releases annual reports with recommendations for improvements related to the utilities. The relationship between the utilities and IROC is reportedly favorable and the utilities have and continue to actively work towards IROC's recommendations, many of which are items Fitch would consider best management practices.

Operating Profile

Customers

The system serves about 1.3 million people within the city, with the vast majority of the retail customer accounts residential in nature. The system also provides some recycled water service (equal to 1% of fiscal 2011 revenues) as well as wholesale service (3%) to four customers. There is limited revenue concentration among the retail accounts; for fiscal 2011, the top 10 retail customers accounted for only 9% of revenues. Of these customers, governmental entities made up seven of the 10 largest accounts. Customer growth over the past five fiscal years has been modest, with total accounts increasing an average of less than 1% annually; customer growth is expected to remain at about this level for the foreseeable future.

Water System

Water Supply

Due to a lack of local supplies, the city is heavily reliant on imported water sources from CWA. CWA, in turn, receives most of its supplies via the Metropolitan Water District of Southern California (MWD). The city is the largest purchaser of CWA water (the city accounts for around 40% of all CWA sales), and CWA is the largest purchaser of MWD water. Overall, about 85%–90% of the city's supplies annually are imported, with only about 10%–15% derived from local runoff. The city also maintains several emergency connections to and from neighboring water agencies.

MWD receives about 75% of its water from the California State Water Project and about 25% from the Colorado River. Both of these sources have experienced pressure from drought and legal constraints in recent years that have affected the amount of water available for MWD's wholesale customers, including CWA. CWA has initiated steps to reduce its reliance on MWD, including securing higher priority rights of Colorado River water above MWD, as well as participating in nontraditional supply expansion. However, full development of these supplies will take decades, which could lead CWA to require mandatory cutbacks in the immediate term from its retailers, including the city, if MWD deliveries to its members are reduced in any given year.

Beginning in late 2007, MWD notified member agencies of supply challenges that were expected to lead to shortages in core supplies to meet member demands. While MWD was able to meet member demands through 2008, MWD's board announced a reduction in deliveries of 13% for fiscal 2010, translating into an 8% average reduction in CWA deliveries to its members. For fiscal 2010, the system met CWA's cutback, reducing demand by almost 12%.

For fiscal 2011, MWD and CWA announced initial allocation estimates similar to fiscal 2010, although favorable precipitation eased drought conditions. Nevertheless, customers continued to conserve water, with the result that production declined nearly 5% in fiscal 2011; the city is projecting usage to grow at a reasonable 1% for fiscal years 2012–2016.

To help increase its own supply portfolio in light of possible ongoing restrictions from CWA, the city has been evaluating all water supply augmentation methods contained in its long-range water resource plan. Projects currently being pursued include enhanced groundwater production (including brackish groundwater desalination), nonpotable recycled water, recycled water for indirect potable reuse, and increased conservation efforts. Some of these projects are in the demonstration stage, which could lead to rising CIP costs if proven feasible.

Treatment and Storage

The system operates three water treatment plants (WTPs), with a combined capacity of 298 million gallons per day (mgd). All three WTPs have undergone various upgrades and are expected to be rerated to a combined capacity of 455 mgd by the California Department of Public Health (CDPH) over the near term. Upon the rerating of the WTPs, the increased capacity will provide for growth demands through 2030 and ensure compliance with regulatory requirements. The WTPs are each fed by one or more of the system’s nine raw water reservoirs.

The raw water reservoirs have a total storage capacity of about 409,000 acre feet. By virtue of City Council policy, the city shall maintain 7.2 months of annual service requirements within the reservoirs to ensure sufficient supply in the event of emergencies, such as interruption in imported water service. Total water within the reservoirs at Jan. 31, 2012 was about 11 months of total production.

Regulatory Issues

The system is currently in compliance with all federal and state drinking water regulatory standards. However, the system has entered into a compliance order (the order) with the CDPH, dating back to 1994, which has been amended from time to time. The order stems from future reliability issues of the system and calls for various capital projects, of which the remaining projects are substantially contained in the CIP.

Service Territory

The system serves about 1.3 million people within the city and certain outlying areas. The city’s economy is anchored by the healthcare, military, tourism, and education sectors. The area was hard hit by the national recession, but recent signs are favorable. The city had a sharp positive turnaround in 2011, registering 1.6% job growth compared to just 1.0% for the nation. The job growth also represented a return to positive territory from overall job losses in 2009 and 2010. As a result of this level of job growth, unemployment declined to 8.9% in December 2011 from 10.1% in the prior year. Unemployment in the city remains above the national rate of 8.3% for December 2011, but the gap between the city’s rate and national rate is narrowing. Other economic characteristics are also favorable including MHI levels that are on par with the state and 20% higher than the U.S., as well as individual poverty rates that are only marginally higher than the nation’s.

Debt Profile

Capital Demands and Debt Burden

The fiscal years 2012–2016 CIP totals $471 million, of which roughly $260 million (55% of total costs) are attributable to regulatory requirements. While the CIP remains large, costs are down over 30% from the fiscal years 2010–2014 CIP as a result of progress on several large scale projects, including the expansion of the WTPs which were included in the order. As regulatory projects have decreased, the CIP is transitioning more to repair and replacement (R&R) of system assets, with the current focus on pipeline replacement associated with the distribution and transmission lines throughout the system (73% of CIP costs). Overall, the system is targeting replacement of approximately 20 miles per year of cast iron distribution mains that are beyond their useful life. The city's target for cast iron replacement is twice the rate required under the order, providing the city some flexibility should these projects proceed slower than anticipated.

Overall, the CIP is expected to be funded predominantly from debt sources (about 56%), which will elevate the system's already high leverage ratios even further. For audited fiscal 2011, debt per customer and debt per capita were about $3,250 and $680, respectively, while debt relative to funds available for debt service was 7.7x. Amortization rates after this issuance are average for the sector, with 35% and 80% of principal retired over the next 10 and 20 years, respectively. Fitch views the system's high debt levels as one of the most significant credit concerns, given the long-term pressure these will have on the rate base. Nevertheless, leverage ratios have declined over the last couple of years and future borrowing levels are down from a couple of years ago, decreasing the overall debt pressure on the system. Also positively, the system has no variable-rate debt or swaps outstanding.

Legal Covenants

Security

The bonds are subordinate lien obligations, secured by net system revenues after payment of operations and maintenance (O&M) expenses and senior lien obligations. Revenues include connection fees and standby charges. Revenues are also increased or decreased by any transfers from or to the rate stabilization fund, respectively.

Rate Covenant

The city covenants to set rates and charges sufficient to generate the greater of 1.0x all system obligations or 1.2x adjusted senior ADS from adjusted net revenues. The adjustment in revenues and ADS discounts the respective amounts by interest earnings from any reserve fund securing the bonds.

Additional Bonds Test

Additional senior and subordinate lien obligations may be issued, provided the system meets either a historical or projected coverage test. The historical test for senior lien obligations is the greater of 1.2x MADS on senior obligations or 1.0x MADS on all obligations, while the projected test is at least 1.2x MADS for five fiscal years following the earlier of either the end of capitalized interest or completion of the project(s) being financed. The historical test for subordinate lien obligations is an amount equal to at least 1.0x MADS, while the projected test has the same parameters as that for senior lien obligations, with the exception that the city must meet MADS by 1.0x. Net revenues may be adjusted for changes in rates and charges and revenue-producing components being financed by debt proceeds.

Debt Service Reserve Fund

The debt service reserve requirement is the standard least of 10% of bond proceeds, 125% average ADS, or MADS.

Flow of Funds

All system revenues are deposited into the system's water utility fund and dispersed in the following order of priority:

- **First:** For O&M expenses.
- **Second:** For the payment of senior lien obligations, including replenishment of any senior lien debt service reserve, if necessary.
- **Third:** For the payment of subordinate lien obligations, including replenishment of any subordinate lien debt service reserve, if necessary.
- **Fourth:** For any lawful system purpose.

Financial Profile

Rates and Charges

The system's rate structure includes a base charge as well as a commodity charge based on customer usage. The commodity charge for single-family units includes an inclining block, or conservation-based structure, while the commodity charge for all other rate classes is a single charge per hundred cubic feet of water consumed. In addition to ongoing user charges, the city also assesses a capacity charge for new customers based on the number of equivalent dwelling units. Exposure to these growth-sensitive fees is acceptable, historically accounting for less than 10% of system revenues over the last six fiscal years.

Residential customers generally are billed bimonthly, while industrial, commercial, and large multifamily units are billed monthly. Utility bills include charges for water, wastewater, and storm drain services. Enforcement provisions are typical, and delinquencies have been minimal.

Over the past several years, the City Council has demonstrated a willingness to raise rates to provide for capital funding and ensure sound financial performance. In April 2002, the City Council adopted a five-year rate package calling for 6% hikes annually, and in February 2007, the City Council approved additional increases of 6.5% annually for fiscal years 2008–2011. The City Council has also implemented adjustments regularly to recover CWA pass-through costs.

Rates have been on the high side relative to MHI in recent years and are currently 1.4% of MHI. While rates are higher than other major West Coast utilities, they are not significantly elevated. With the latest reduction in CIP costs, future hikes through fiscal 2016 are expected to be relatively modest apart from CWA pass-through adjustments which would likewise affect other southern California utilities similarly. In total, the city is projecting the need for a 4% increase in fiscal 2014 followed by 2% annual adjustments in fiscal years 2015 and 2016 to meet forecast results, excluding possible CWA pass-through hikes.

Financial Summary

($000, Audited Fiscal Years Ending June 30)

	2007	2008	2009	2010	2011	2012[a]	2013[a]	2014[a]	2015[a]	2016[a]
Balance Sheet										
Unrestricted Cash and Investments	196,510	212,932	225,556	221,585	214,550	246,515	151,883	182,325	122,127	222,518
Accounts Receivable	42,697	43,854	43,573	62,048	66,133	—	—	—	—	—
Other Current Unrestricted Assets	32,200	41,114	40,449	41,677	54,412	—	—	—	—	—
Current Liabilities Payable from Unrestricted Assets	(77,938)	(143,377)	(77,558)	(103,195)	(92,718)	—	—	—	—	—
Net Working Capital	**193,469**	**154,523**	**232,020**	**222,115**	**242,377**	—	—	—	—	—
Net Fixed Assets	1,668,967	1,719,103	1,852,333	1,955,769	1,999,677	—	—	—	—	—
Net Long-Term Debt Outstanding	630,631	766,962	933,044	904,499	893,567	—	—	—	—	—
Operating Statement										
Operating Revenues	310,292	318,626	342,719	376,461	371,515	427,344	428,339	449,109	462,340	475,961
Non-Operating Revenues	12,203	18,215	14,491	13,939	15,251	5,711	7,361	8,038	12,850	15,728
Connection Fees	21,295	12,372	7,631	5,103	11,752	6,100	7,000	7,000	7,000	7,000
Transfer (To)/From the Rate Stabilization Fund	—	—	—	—	—	(14,800)	11,800	3,000	—	—
Gross Revenues	343,790	349,213	364,841	396,330	398,518	424,355	454,500	467,147	482,190	498,689
Operating Expenses (Excluding Depreciation)	(253,828)	(258,430)	(262,898)	(285,774)	(282,863)	(338,074)	(365,972)	(376,892)	(377,362)	(378,292)
Depreciation	(27,644)	(29,870)	(39,627)	(38,525)	(43,054)	—	—	—	—	—
Operating Income	62,318	60,913	62,316	71,204	72,601	86,281	88,528	90,255	104,828	120,397
Net Revenues Available for Debt Service[b]	89,962	90,783	101,943	109,729	115,655	86,281	88,528	90,255	104,828	120,397
Senior Lien Debt Service Requirements	21,351	21,354	21,354	28,303	34,115	37,519	39,879	42,958	47,582	52,712
Total Debt Service Requirements	**40,759**	**43,082**	**49,600**	**56,978**	**62,784**	**66,191**	**67,104**	**69,988**	**74,613**	**79,367**
Financial Statistics										
Senior Lien Debt Service Coverage (x)	4.2	4.3	4.8	3.9	3.4	2.3	2.2	2.1	2.2	2.3
Total Debt Service Coverage (x)	2.2	2.1	2.1	1.9	1.8	1.3	1.3	1.3	1.4	1.5
Days Cash on Hand	283	301	313	283	277	266	151	177	118	215
Days Working Capital	278	218	322	284	313	N.A.	N.A.	N.A.	N.A.	N.A.
Debt to Net Plant (%)	38	45	50	46	45	N.A.	N.A.	N.A.	N.A.	N.A.
Outstanding Long-Term Debt per Customer ($)	2,311	2,805	3,410	3,301	3,253	2,954	2,949	3,257	3,160	3,616
Outstanding Long-Term Debt per Capita ($)	486	587	714	692	680	616	613	675	653	745
Free Cash to Depreciation (%)[c]	171	157	131	137	122	N.A.	N.A.	N.A.	N.A.	N.A.

[a]Projected. [b]Equals gross revenues less operating expenses. [c]Equals net revenues available for debt service less operating transfers out, less total debt service, divided by depreciation.. N.A. – Not available. Note: Numbers may not add due to rounding.

Financial Performance

Fiscal operations have been good, with the system exceeding prior forecast results despite significant declines in consumption related to drought and weak economic conditions in recent years. For fiscal 2011, senior lien ADS was 3.4x, while total debt service coverage was 1.8x. Other key metrics for the year were also strong: days cash on hand and days working capital were both in excess of 275 days, while the system's quick and current ratios were both greater than 3.0x. System cash flows have also produced sound results. Demonstrating this flexibility, free cash for fiscal 2011 was more than 120% of depreciation.

System performance is enhanced by the city's establishment of formal policies creating various reserves. These reserves are fully funded and expected to grow through fiscal 2016. Reserves established by the city include a rate stabilization fund and operating reserve, currently budgeted at 65 days of O&M and expected to increase to 70 days by fiscal 2013. The city also has set aside funds for emergency capital and water purchase expenditures, among other things, to account for unforeseen events.

Financial performance through the fiscal 2016 forecast period is expected to be weaker than recent historical performance, largely as a result of ongoing lower customer usage estimates, limited rate hikes, and rising debt service costs. Based on these factors, total debt service coverage is forecast to drop to a relatively low 1.3x in fiscal years 2012 through 2014 and then increase to 1.5x by fiscal 2016. While Fitch notes the lower forecast debt service coverage from historical levels, Fitch believes actual results are likely to be more favorable given the city's tight cost controls and outperformance of recent forecasts. Nevertheless, Fitch will continue to monitor actual performance and any changes in forecast assumptions. Should yearly results begin to drop and mirror the system's forecast or should the outlook for improvement in forecast figures deteriorate, it is possible that the system's financial profile could weaken to below the current level and possibly result in negative rating action.

For fiscal years 2012–2016, forecast assumptions include customer growth commensurate with recent experience. The city is also using the fiscal 2010 sales level as a baseline as opposed to fiscal 2011 actual results, with modest increases in sales of 1% annually. The fiscal 2011 sales results were excluded from the baseline as precipitation was well above average for the year. This increased precipitation led to an additional 5% decline in consumption for the year. Fitch believes both the customer growth rates and the usage of fiscal 2010 consumption amounts for the forecast's base consumption appear reasonable.

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.