

San Diego, California; Appropriations; General Obligation

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Credit Profile		
US\$0.0 mil ICR due 04/30/2040		
<i>Long Term Rating</i>	AA-/Stable	New
San Diego 2003 certs of part (1993 Balboa Park/Mission Bay Pk Rfdg)		
<i>Unenhanced Rating</i>	A+(SPUR)/Stable	Upgraded
San Diego Pub Facs Fincg Auth, California		
San Diego, California		
San Diego Pub Facs Fincg Auth (San Diego) lse rev rfdg bnds ser 2007A		
<i>Long Term Rating</i>	A+/Stable	Upgraded
San Diego Pub Facs Fincg Auth (San Diego) lse rev rfdg bnds (San Diego) (Master Rfdg Proj) ser 2010A due 03/01/2040		
<i>Long Term Rating</i>	A+/Stable	Upgraded

Rationale

Standard & Poor's Ratings Services raised its long-term rating on San Diego Public Facilities Financing Authority, Calif.'s lease revenue bonds and certificates of participation (COPs), for the city of San Diego, to 'A+' from 'A-' due to the city's forecasting practices and proactive budget adjustments that have contributed to improved reserve levels even as the city managed fiscal pressures related to a sluggish economic cycle and rising pension costs. At the same time, Standard & Poor's assigned its 'AA-' issuer credit rating (ICR) to San Diego, Calif. The outlook on all ratings is stable.

The upgrade also reflects our view of improvements the city has made on its internal controls and processes, disclosure practices, and financial systems over the previous few years that officials believe should contribute to the future continued transparency, timeliness, and accuracy of its financial statements.

The ICR reflects our assessment of San Diego's:

- Strong financial management practices, including the practice of multiyear forecasting, which has allowed management to identify future fiscal imbalances in time to develop and implement solutions;
- Reserves that meet the city's reserve policies and that the city projects will remain at strong levels in fiscal years 2012 and 2013, particularly after the recent stabilization of general fund revenue; and
- Strong long-term economic fundamentals, including its role as the anchor and center for the majority of employment in the county, despite some dependence on tourism and the military.

These credit strengths are partially tempered by our view of the city's:

- Limited revenue-raising flexibility; and
- Significant pension and other postemployment benefits (OPEB) liabilities that, despite recent plan reforms and flat annual required contributions (ARC) in fiscal 2013, we believe continue to represent a large share of the city's annual budget.

The COPs represent an interest in, and the lease revenue bonds are secured by, lease payments by San Diego, as lessee, to the San Diego Public Facilities Financing Authority, as lessor, for the use and possession of the leased assets. The rating on the city's lease revenue bonds and COPs reflects our view of the city's general credit characteristics and its covenant to budget and appropriate annual lease payments for various properties' use.

Due primarily to higher revenues and transfers, and reduced expenditures in the previous couple of years, the city's available general fund reserves have improved in fiscal 2011. Including the emergency reserve and unassigned balances only, the city estimates it ended fiscal 2011 with \$115.5 million of available general fund reserves, or what we consider strong 11% of expenditures, which is above San Diego's minimum goal of 8% of general fund revenue. In fiscal 2011, San Diego's ending general fund balance included \$55 million in the city's emergency reserve restricted by council policy and requiring a two-thirds majority vote to release. Due to the implementation of Government Accounting Standards Board 54, fund balances previously accounted for as special revenue funds and designated for specific purposes were also consolidated into the \$38 million assigned general fund balance.

Based on the February 2012 midyear budget monitoring report, the city expects to end fiscal 2012 with an operating surplus due primarily to improved sales tax (which is up 9% compared with budget) and transient occupancy tax revenue collections that are contributing to an overall 2% increase in San Diego's estimated total general fund revenue compared to budget. The city intends to use \$5 million of the surplus in fiscal 2012 for one-time projects and recurring costs--including increasing police academy recruits and restoring library hours--which officials estimate would result in about \$125 million of available general fund balance, or 10.9% of expenditures at the end of the year. In fiscal 2013, city officials indicate the proposed budget is structurally balanced, although it reflects a small \$3.2 million use of designated reserves to bring the budgeted available general fund reserve to \$120.8 million, or a still strong 10.5% of expenditures. Risks to San Diego's projected fiscal 2013 budget, however, include another economic downturn and lower-than-estimated revenue, potential diversion of gas tax revenue to California, and potential higher costs to the general fund after the dissolution of redevelopment agencies (RDAs) in the state.

We consider San Diego's management practices "strong" under our Standard & Poor's Financial Management Assessment (FMA) methodology. We revised the FMA to strong from good due to the city's identification of funding sources for its general fund deferred maintenance capital needs in the next five years as well as attaining its minimum general fund reserve policy goals in fiscal 2011. An FMA of strong indicates practices are strong, well embedded, and likely sustainable.

The city has made significant progress in improving its internal control and disclosure framework as a response to previous investigations and audit restatements at the beginning of the last decade. After implementing and making the transition to its enterprise resource planning system, which has integrated San Diego's payroll, budget modeling and accounts receivable, and financial controls functions, the city released its fiscal 2011 comprehensive annual financial report (CAFR) on time and management expects all future CAFRs will be released by the end of the calendar year.

San Diego (estimated population of 1.32 million) is a primary employment center in San Diego County representing about half 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. Its 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. The U.S. Navy and the U.S. Marine Corp. have a significant presence in

the region and directly and indirectly contributed \$30.5 billion of economic impact and 354,627 jobs (or about 26% of total county jobs) to the San Diego County economy in fiscal 2009 according to a San Diego Military Advisory Council Report dated April 2011. We believe that, historically, the military presence in the region has stabilized the regional economy, although it moderates income levels somewhat. Still, we consider the city's median household effective buying income strong at 114% of the national average in 2011. According to the Bureau of Labor Statistics, the city's unemployment rate was 9.9% in 2011 compared with California's rate of 11.7%. Net assessed value (AV)--excluding redevelopment area AV--stabilized and increased 0.8% year-over-year in fiscal 2012 to \$160 billion in fiscal 2012, after falling by a cumulative 3% in fiscal years 2010 and 2011. According to S&P/Case-Shiller, home prices in the region continued to fall but only slightly at a seasonally adjusted 0.3% in January 2012 compared with December 2011. On a per capita basis, we consider San Diego's market value extremely strong, at approximately \$121,137, based on fiscal 2012 AV.

In our view, overall net debt is a moderate \$4,185 per capita and 3.5% of market value. We consider amortization slightly below average, with 44% of principal retired in 10 years and 82% in 20 years. Annual debt service carrying charges represent what we consider a moderate 11.7% of governmental expenditures, less capital outlay, in fiscal 2011. City officials estimate several years of minimal debt issuance and deferring costs associated with maintaining capital have created an \$800 million-\$900 million need to maintain or restore streets, buildings, and storm drains in good condition. We understand the city expects to fund almost \$500 million of its capital improvement plan with bonds in the next six years, beginning with a \$80 million issuance in June 2012. San Diego also expects to issue \$15 million of additional lease revenue bonds in 2012 for a parking structure, subject to council approval. While a future convention center expansion could cost a total of \$520 million, officials expect future debt for the project would be secured primarily by a new hotel special tax and up to \$200 million of general fund-backed lease debt. Even if the city immediately issued all anticipated debt, we calculate the debt burden would remain moderate at about 4% of market value, although debt service carrying charges would likely rise. San Diego has no variable-rate debt outstanding.

The city has contributed the ARC to the San Diego City Employees' Retirement System (SDCERS) for its employee retirement benefits in the past several years, including \$231 million in fiscal 2011. In addition to pension benefits, the city provides OPEB for retirees hired before July 1, 2005. The unfunded OPEB actuarial liability was \$1.1 billion at fiscal year-end 2011 with an ARC of \$120 million. We calculate that the city's combined pension and OPEB ARC in fiscal 2011 represented about 20% of governmental expenditures, which we consider high. In addition, the general fund share of all retirement-related benefits costs, including a supplemental pension plan and employee contribution offsets, represent a high, in our view, 24% of the fiscal 2013 general fund budgeted expenditures.

Outlook

The stable outlook reflects what we consider management's history of proactive budget adjustments, practice of long-term financial and capital forecasting, and recent economic improvement. We don't expect to raise the rating in the next two years due to currently high fixed charges related to San Diego's combined pension and OPEB ARCs as well as city income levels that are only 14% above the national average due, in part, to the region's military presence. Although we expect the city will continue its practice of regular budget monitoring and midyear budget adjustments to offset additional potential costs and to maintain strong reserve levels, should it fail to maintain reserve levels that we consider strong and in line with its minimum targets in the next two years, we could lower the

rating.

Financial Management Assessment: 'Strong'

We consider San Diego's management practices "strong" under Standard & Poor's FMA methodology. An FMA of strong indicates our view that practices are strong, well embedded, and likely sustainable. The city council generally performs formal budget amendments in the midyear and year-end reviews; in addition, the comptroller publicly posts and presents monthly reports on actual general fund performance to the city council's budget and finance committee. San Diego annually prepares a long-term financial outlook, which projects general fund operations, revenue and expenditure trends, and future budgetary gaps for the next five years; the outlook also includes forecasts for additional debt service costs associated with future anticipated debt issuance related to its deferred maintenance capital plan. While the city has historically prioritized and identified long-term capital needs for its utility funds, it has just recently estimated annual bonding requirements and pay-as-you-go funding for its general fund deferred maintenance needs in the next five years. The city reviews its formal investment policy annually and presents monthly reports on investment holdings and average yield to the city council. San Diego has a formal debt management policy that includes maximum debt burden thresholds for general obligation and lease revenue debt, as well as minimum coverage level targets for revenue bonds. The city has exceeded its reserve policy targets, which include a combined emergency, unallocated, and appropriated reserve equal to 8% of general fund revenue; the emergency reserve, to be used as a contingency for natural disasters or unforeseen catastrophic events, requires a minimum 5% of general fund revenue and requires a two-thirds council vote to access the reserve.

Budget Outlook

The five-year budget outlook document released by the city in October 2011 projected annual budget gaps of between \$32 million and \$37 million in fiscal 2013 and fiscal 2014, or about 3% of expenditures; the projected gaps had improved significantly from previous projected gaps of up to \$170 million after the city reduced a net 1,536 full-time positions, or about 13%, between fiscal years 2007 and 2012 and made changes to its pension and OPEB benefits. Subsequent to the release of the budget outlook, San Diego's proposed fiscal 2013 budget is now balanced primarily due to a lower-than-anticipated pension ARC after better investment returns and revised actuarial assumptions. This budget assumes a 6% increase in sales tax revenue over estimated fiscal 2012 revenue due to some signs of economic improvement in fiscal 2012 and a small 0.8% increase in property tax revenue due primarily to higher assumed collection rates. The fiscal 2013 budget also reflects a 1.6% growth in general fund expenditures compared with estimated actual expenditures in fiscal 2012, including higher fire department costs, increased debt service costs associated with future debt plans, and contributions to the city's public liability and information technology outsourcing reserves.

Redevelopment Agency Dissolution

Under Assembly Bill 1X 26, a new law that dissolved RDAs in the state as of Feb. 1, 2012, San Diego is acting as successor agency to the RDA for both the nonhousing and housing functions.

A potential risk to the city's estimated fiscal 2012 balances is higher general fund costs that could exceed potential higher property tax revenue after the dissolution of California RDAs. After ABx1 26, which dissolved the RDAs,

agreements between the city and RDA are subject to review and approval by the state department of finance and the oversight board and could be deemed invalid under the new law. City officials estimate a \$13 million-\$20 million exposure to the general fund due to the RDA dissolution and have identified 40 positions that could be lost or redistributed after April 2012 due to the lost tax increment revenue. The city also transferred \$245 million of funds from the RDA into capital projects and \$85 million into restricted general fund balance, which should not affect the city's available general fund balances if reverted. ABx1 26, however, also provided for the additional distribution of property tax revenues to the underlying taxing entities, including the city, after the payment of former RDA obligations. While an early analysis by the city's independent budget analyst in July 2011 projected a minimal net impact to San Diego's general fund, city officials currently do not provide estimates due to the uncertainty surrounding implementation of the new law.

Other Debt

Due to a judgment against the city related to San Diego's underfunding of its pension system in previous years (the McGuigan Settlement), the city was obligated to pay into SDCERS approximately \$173 million more than its required pension contributions no later than June 8, 2011. It paid \$144 million before fiscal 2010 with tobacco revenue and securitizations and in June 2010, the city entered into a direct loan with Bank of America N.A. for \$32.7 million to pay the balance of the settlement. Under the agreement, the city agrees to pay the debt in four equal annual installments of about \$9 million with the final payment in June 2014. In addition, in April 2011, the city, as lessee, entered into a taxable qualified energy conservation bond equipment lease agreement with Bank of America Leasing & Capital LLC as lessor, to borrow \$13 million payable from lease payments appropriated from San Diego's general fund for energy conservation equipment; the lease agreement does not allow for acceleration of principal.

Retirement Benefits

The city contributes to SDCERS, a defined benefit pension plan. The plan's fiscal 2011 unfunded actuarial accrued liability (UAAL) was almost \$2.2 billion as of June 30, 2011, and its funded ratio was 68.5% compared with 67.0% in fiscal 2010 based on improving plan asset value and better returns. The city's pension ARC was almost \$231 million in fiscal 2011 and remains generally stable in fiscal years 2012 and 2013, based on the SDCERS fiscal 2011 actuarial valuation. Rather than increasing, the fiscal 2013 ARC remained relatively stable due to better-than-expected investment performance as well as changes in wage increase and turnover assumptions, which more than offset a reduction in the assumed investment return to 7.50% from 7.75%. San Diego estimates its general fund portion of the pension ARC in fiscal 2013 will remain at about \$180 million, or a still large, in our view, 15.6% of general fund expenditures. In addition, we understand some city employees participate in defined contribution pension plans, including a supplemental pension savings plan to which the city contributed about \$15.5 million in fiscal 2011. San Diego's independent budget analyst estimates a citizen-driven pension reform initiative on the June 2012 ballot, if successful, could result in \$950 million in unadjusted savings to the city over 30 years, although the pension ARC would increase in the short term. We understand the estimated savings would be linked primarily to a provision that freezes salaries for five years, which could be legally challenged even if the measure is approved by the voters.

City employees who were hired after Oct. 6, 1980, and through July 1, 2005, receive health care benefits upon

retirement that we consider significantly higher than other employees' benefits. San Diego also provides limited retiree health benefits per year to employees who retired after July 1, 2005, and before Oct. 6, 1980; however, employees hired after July 1, 2005, do not receive OPEB under a defined benefit plan. We understand the July 1, 2005, cutoff date is still being challenged in court by some employee groups that argue the cutoff date should be Feb. 16, 2007. San Diego's OPEB UAAL was \$1.1 billion in fiscal 2011 and the city has funded the obligation on a pay-as-you-go basis, with some prefunding into a retirement benefits trust, which had a market value of almost \$117 million at June 30, 2011. In fiscal 2011, the city contributed \$25 million to the trust in addition to its \$33.8 million pay-as-you-go cost to fund about 49% of the \$120 million OPEB ARC. In fiscal 2012, San Diego estimates it paid \$20.6 million into the trust and paid \$37 million of OPEB pay-as-you-go toward its \$98.5 million OPEB ARC. City officials expect the next actuarial valuation will reflect a lower OPEB UAAL and ARC after the city negotiated reforms to its OPEB with its labor organizations. In fiscal 2010, it also established a defined contribution plan to fund retiree medical benefits for some employees hired after July 1, 2009.

Related Criteria And Research

- USPF Criteria: Appropriation-Backed Obligations, June 13, 2007
- USPF Criteria: GO Debt, Oct. 12, 2006
- USPF Criteria: Financial Management Assessment, June 27, 2006

Ratings Detail (As Of April 25, 2012)		
San Diego Convtn Ctr Expansion Fing Auth, California		
San Diego, California		
San Diego Convtn Ctr Expansion Fing Auth lse rev bnds ser 1998A		
<i>Unenhanced Rating</i>	A+(SPUR)/Stable	Upgraded
San Diego Mtdb Auth, California		
San Diego, California		
San Diego Mtdb Auth (San Diego) 2003 lse rev rfdg bnds (San Diego Old Tw n Lt Rail Transit Extension Rfdg)		
<i>Unenhanced Rating</i>	A+(SPUR)/Stable	Upgraded
San Diego Pub Facs Fincg Auth, California		
San Diego, California		
San Diego Pub Fac Fing Auth lse rev bnds (Fire & Life Safety Fac Proj) ser 2002B (MBIA of Illinois)		
<i>Unenhanced Rating</i>	A+(SPUR)/Stable	Upgraded
Many issues are enhanced by bond insurance.		

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