Rating Update: **MOODY'S ASSIGNS Aa3 ISSUER RATING TO THE CITY OF SAN DIEGO**

Global Credit Research - 11 May 2012

**AFFIRMS OUTSTANDING LEASE RATINGS OF A2**

SAN DIEGO (CITY OF) CA
Cities (including Towns, Villages and Townships)
CA

**Opinion**

NEW YORK, May 11, 2012 --Moody's Investors Service has assigned an Aa3 Issuer Rating to the City of San Diego. We have also affirmed the city's A2 rating on outstanding lease supported obligations. The outlook on these ratings is stable. The issuer rating is identical to the city's previous general obligation rating, which was withdrawn as the General Obligation debt was repaid.

**RATING RATIONALE**

The ratings reflect the city's large and diverse economy which appears to have resumed growth after contracting in 2009 and 2010. Also key to the rating are stabilizing fundamental credit factors, including likely bottoming out of residential real estate prices, which should help the city's assessed valuations, and improved economically sensitive revenues, such as sales tax and transit occupancy tax.

The ratings also reflect the city's high unemployment rate, which continues to weigh on these credit factors. The city's financial operations continue to be stressed as the economically challenged revenues, which are improving but remain weak, prevent the city from improving its reserve position. Despite the city's lackluster general fund revenue growth, the city continues to aggressively control its expenditures to preserve its narrow reserve position which remains consistent with the current rating. The management's ability to operate effectively under these very tight financial conditions continues to be an important credit factor.

**Key credit Strengths**

- Above average wealth and income levels for a large city
- Well managed, closely monitored budget process
- Frequent midyear budget adjustments
- Reasonable 5 year financial outlook reviewed and adjusted frequently
- Stabilizing housing market
- Good debt position
- Pension commitments for new employees less generous than existing ones which improve long term pension position

**Credit Challenges**

- Below average reserves
- Budget burdened by large pension burden
- Market losses have increased annual pension contributions
The two notch rating distinction between the A2 on the lease rating and the city's Aa3- Issuer rating represents Moody's standard notching differential for fixed asset leases relative to a California issuer's general obligation rating. Broadly speaking the two notches reflect the risk of abatement and the narrower, general fund security pledge for leases compared to the very strong, voter-approved unlimited property tax pledge securing general obligation bonds.

DETAILED CREDIT DISCUSSION

FINANCIAL OPERATIONS ARE NARROWLY BALANCED BUT STABLE.

Since 2007 the city's financial operations have been generally balanced with minimal reliance on reserves. Although this period is characterized with sluggish revenue growth due to the recession, the city has been able to tightly control expenditures and modestly grow general fund reserves. Close monitoring with midyear adjustments are key to the city's ability to persevering financial stability. These adjustments include one-time measures as well as long term solutions such as permanent staffing reductions and modified pension benefits for new hires.

Since its low point of several years ago, the city's overall financial position has improved significantly in terms of stability and predictability. Through 2007, the city benefited from generally robust revenue growth. However, San Diego was among the first areas to be hit by the collapse of the statewide housing market and then the severe economic recession, which brought the previous revenue growth to a standstill. Therefore in 2008 and 2009, the city's financial operations were primarily focused on controlling expenditures to persevere financial health, and the city was largely successful.

As a result, the city's general fund suffered minimal erosion in 2008 and 2009 as the total general fund balance decreased from 12.3% of general fund revenues at the end of 2007 to 10.2% in 2009. The city has continued to grow its general fund reserves as defined by the city's comprehensive reserve policy. The city's goal was to increase its general fund reserves to 8% by 2011 from its June 30, 2008 level of 7.6%. With a reserve of 11.0% on June 30, 2011, this policy goal appears to have been met.

Market losses in 2009 and 2010 increased the general fund portion of the city's ARC to $180 million in 2012 from $125 million in 2010. This ARC level represents approximately 16% of the city's general fund revenues, is projected to increase steadily over the next several years and will continue to impair operating flexibility as it is a fixed expenditure. When combined with the lease burden of approximately 4%, approximately one fifth of the city's financial commitments are fixed, which impairs financial flexibility.

Next month the voters will be presented with a ballot measure to replace pension plans for new employees, other than police, with a defined contribution plan. If passed, the city's long term pension exposure would improve.

LARGE AND DIVERSE ECONOMY MAY HAVE REACHED ITS CYCLICAL BOTTOM

The city's economy is fundamentally diverse with tourism, the military, higher education, trade and biotechnology playing important roles. The population benefiting from this economy has historically boasted above average wealth and income levels. However, the city was among the first in the state to be affected by the downturn in the housing market and the subsequent recession. As a result, AV growth came to a halt in 2010 with a year-over-year decrease of 0.6%, although full value per capita remained relatively high at $127,000. The decrease widened to 2.1% in 2011. Employment also suffered, as approximately 55,000 jobs were lost in 2009 and 2010. However, just as San Diego was early to enter the recession, it may be a leader in coming out of the recession. Recent home price data suggest that among large cities throughout the country, the city's home values are stabilizing at a better than average rate. The city's AV grew by 0.8% in 2012.

THE CITY'S DEBT POSITION IS GENERALLY FA/AVORABLE

The city's direct and overall debt ratios of 0.4% and 3.1%, respectively, are in line with other cities in the state, but significantly better than most large cities in the country. The city's $545 million of direct debt is largely comprised of lease supported obligations. The resulting lease burden of approximately $50 million represents a manageable 4.1% of 2011 general fund revenues. However, the availability of substantial amount of non general fund revenues result in a much lower net lease burden. As economic and financial conditions improve, the city anticipates resumption of borrowing for deferred capital needs.

WHAT COULD CAUSE THE RATING TO GO UP

Significantly Stronger Reserve Position
Significantly stronger wealth and income levels

WHAT COULD CAUSE THE RATING TO GO DOWN

Significantly Weaker Reserve Position

Significant amount of additional debt

Outlook

The outlook on the ratings is stable. Moody's expects the city to continue to operate under generally tight but stable financial conditions. Given the city's modest reserves, significant deterioration of reserves can put downward pressure on bond holder security. By adhering to its reserve policy, the city can avert such credit deterioration. While the current economic conditions are suppressing revenues, in the long term the city's economy will benefit from its size and diversity.

KEY STATISTICS

Fiscal 2011, GAAP basis:

Net cash as % of revenue: 18.5%
Total fund balance as % of revenue: 20.3%
Available fund balance as % of revenue: 8.2%
Net direct debt as % of FY 2012 AV: 0.4%
Overall net debt as % of FY 2012 AV: 3.1%

2000 Census:

Median Family Income: $53,060 (100.1% of the state average)
Per Capita Income: $23,609 (104.% of the state average)

The principal methodology used in this rating was General Obligation Bonds Issued by U.S. Local Governments published in October 2009. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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