San Diego, California

Lease Revenue Bonds
New Issue Report

Ratings

New Issues

San Diego Public Facilities Financing Authority Lease Revenue Bonds and Lease Revenue Refunding Bonds, Series 2013A (Capital Improvement Projects and Old Town Light Rail Extension Refunding)	A+
San Diego Public Facilities Financing Authority Lease Revenue Refunding Bonds, Series 2013B (Balboa Park/Mission Bay Park Refunding)	A+

Outstanding Debt

Implied Unlimited Tax General Obligation Bonds	AA–
San Diego Public Facilities Financing Authority Lease Revenue Bonds, Series 2007A (Ballpark Refunding), Series 2010A (Master Refunding Project), Series 2012A (Capital Improvement Projects) and Series 2012B (Fire and Life Safety Facilities Project)	A+
Convention Center Expansion Financing Authority Lease Revenue Bonds, Series 2010A	A+

Rating Outlook

Stable

Related Research

San Diego, California (May 2012)

Fitch Rates San Diego, CA Implied GO at ‘AA–’, Outlook Stable (April 2012)

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New Issue Details

Sale Information: $40,030,000 San Diego Public Facilities Financing Authority Lease Revenue Bonds and Lease Revenue Refunding Bonds, Series 2013A (Capital Improvement Projects and Old Town Light Rail Extension Refunding), and $6,005,000 San Diego Public Facilities Financing Authority Lease Revenue Refunding Bonds, Series 2013B (Balboa Park/Mission Bay Park Refunding), selling the week of June 17 or June 24 via negotiation.

Security: San Diego’s lease rental payments that the city covenants to budget and appropriate annually, subject to abatement which is mitigated by standard rental interruption insurance.

Purpose: Series 2013A bonds will be used to fund a variety of capital improvement projects and refund all outstanding San Diego Metropolitan Transit Development Board 2003 Lease Revenue Refunding Bonds (San Diego Old Town Light Rail Transit Extension Refunding) for economic savings. Series 2013B bonds will be used to refund all outstanding San Diego COPs (1993 Balboa Park/Mission Bay Park Refunding), Series 2003, for economic savings.

Final Maturity: San Diego Public Facilities Financing Authority (SDPFFA) lease revenue bonds, series 2013A, serially, Oct. 15, 2013–2042. SDPFFA lease revenue refunding bonds, series 2013B, serially, Nov. 1, 2013–2023.

Key Rating Drivers

Fundament Credit Strengths: San Diego (the city) benefits from a diverse economy, improving key revenue streams, a declining unemployment rate, a recovering tax base and its desirable location as a place to live and work or visit.

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 with past content and timing deficiencies.

Solid Financial Operations: The city ended fiscal 2012 with a higher unrestricted general fund balance and higher reserves year over year and the prospect of outperforming its fiscal 2013 general fund budget and further increasing its reserves.

Moderate Debt Burden: The city’s overall debt burden is moderate and expected to remain so despite planned debt issuances to address large unmet infrastructure maintenance needs.

Significant Liabilities Going Forward: Other post-employment benefit (OPEB) reform has materially reduced the city’s unfunded OPEB liability, but rising annually required pension contributions continue to exert pressure on the city’s overall credit profile.

Rating Sensitivities

Stable Rating Outlook: The rating is sensitive to shifts in fundamental credit characteristics, including the city's maintenance of strong general fund balances and reserves and improved financial management and reporting practices. The Stable Rating Outlook reflects Fitch Ratings’ expectation that such shifts are unlikely, particularly given the improving economy, ongoing cost-control initiatives and plans to augment reserves.

Rating History — GOs

Rating	Action	Outlook/ Watch	Date
AA–	Affirmed	Stable	6/10/13
AA–	Affirmed	Stable	5/29/12
AA–	Affirmed	Stable	4/13/12
AA–	Affirmed	Stable	6/7/10
AA–	Affirmed	Stable	4/30/10
AA–	Revised	Stable	4/30/10
A+	Affirmed	Stable	6/8/09
A+	Upgraded	Stable	12/11/08
BBB+	Affirmed	Positive	3/27/08
BBB+	Downgraded	Negative	5/27/05
A	Downgraded	Negative	2/16/05
AA	Affirmed	Negative	9/23/04
AA	Downgraded	Negative	2/27/04
AAA	Upgraded	—	5/28/02
AA+	Assigned	—	4/3/98

Rating History — COPs and Lease Revenue Bonds

Rating	Action	Outlook/ Watch	Date
A+	Affirmed	Stable	6/10/13
A+	Affirmed	Stable	5/29/12
A+	Affirmed	Stable	4/13/12
A+	Affirmed	Stable	6/7/10
A+	Affirmed	Stable	4/30/10
A+	Revised	Stable	4/30/10
A	Affirmed	Stable	6/8/09
A	Upgraded	Stable	12/11/08
BBB–	Affirmed	Positive	3/27/08
BBB–	Downgraded	Negative	5/27/05
A–	Downgraded	Negative	2/16/05
AA–	Affirmed	Negative	9/23/04
AA–	Downgraded	Negative	2/27/04
AA+	Assigned	—	5/28/02

Related Criteria

Tax-Supported Rating Criteria (August 2012)

U.S. Local Government Tax-Supported Rating Criteria (August 2012)

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 hotel construction and increasing tourism. The city is expecting the number of tourist visits, visitor expenditures, hotel occupancy and hotel average daily rates to continue to grow over the next three years. Although defense is a major local employer, the city regards the local impacts of federal funding sequestration as absorbable given the large property and sales tax base.

The unemployment rate is declining to around the national average, resident socioeconomic indicators are largely above average and the tax base is rebounding. After a relatively minor cumulative 2.5% taxable assessed valuation (TAV) decline between fiscal years 2010 and 2013, that entire TAV loss is projected to be offset by a 2.6% increase in fiscal 2014. House prices are increasing, although still well below their peak, and the value of new construction permits in fiscal 2012 increased 43% year over year and 175% since their fiscal 2010 low.

Solid Financial Operations

The city's general fund balances and reserves, liquidity and operating margins are benefitting from increasing revenues and cost-containment measures successfully implemented throughout the recent recession (particularly related to personnel compensation and benefits). As a result, the city ended fiscal 2012 with a solid unrestricted general fund balance of $154.3 million, equaling 12.9% of spending. This represented a significant increase over fiscal 2011, which ended with an unrestricted general fund balance of $99.9 million, or 8.9% of spending.

The city has a general fund reserve policy (currently set at 8% of general fund revenues) that it consistently exceeds. In fiscal 2012, the general fund reserve was a strong $168 million, or 14.9% of revenues ($109.5 million was held in the unassigned general fund balance and $58.5 million in the restricted general fund balance). This represented an increase from $115.5 million, or 11.0% of revenues a year prior. The general fund reserve is projected to grow further to $170 million, or 14.5% of revenues at fiscal 2013 year end. The reserve is conservatively budgeted to decline to $146.2 million in fiscal 2014, which, at 12.2% of revenues, would still exceed the 8.0% policy threshold. Within that amount, $28 million has been identified for potential state claw-backs of former San Diego Redevelopment Agency (SDRDA) moneys.

The city also has concrete plans to incrementally bolster reserves for its public liability, workers' compensation, long-term disability and enterprise funds.

California cities have limited revenue flexibility. Furthermore, 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; there would likely be considerable taxpayer 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 increase through fiscal 2014.

The city is projecting a $17 million budget surplus for fiscal 2013 due to revenues coming in $7 million over budget plus $10 million in underexpenditures. Of this amount, $13.9 million is included in the fiscal 2014 proposed budget (the city performed a similar budgetary carry-forward in fiscal 2013). The balance will contribute to the $9.8 million cost in fiscal 2014 of the tentatively agreed five-year contracts with the city's six labor unions. The city plans to adopt a final budget by June 15.

The personnel cost increases in the tentatively agreed five-year labor contracts 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).

Reestablishment of Timely Audits

Following delayed audits for fiscal years 2003–2008, 2010 and 2011, the city issued its fiscal 2012 audit on a timely basis in November 2012. The city also anticipates issuing its fiscal 2013 audit within six months of the close of the fiscal year. Fitch notes that the city's significant investment in enhanced financial management systems is yielding improvements in its financial reporting practices.

The city is undergoing considerable managerial change, with a new mayor, an additional city council member and anticipated permanent hires in two key administrative positions (the chief financial officer and the chief operating officer). Fitch anticipates that these personnel changes will not alter the city's commitment to ongoing enhancement of its financial reporting practices.

Moderate Debt Burden

Due to past market access impediments caused by pension disclosure failures and delayed financial statements, the city's overall debt burden is moderate at $4,090 per capita, or 2.9% of fiscal 2012 market valuation. Debt amortization is average at approximately 41% retiring in 10 years. In fiscal years 2011 and 2012, the city issued an elevated $161 million–$163 million in short-term TRANs annually because of significant increases in the pension ARCs for those years. However, fiscal 2013 TRANs were lower, at approximately $101 million, due to improved fiscal 2012 year-end balances and earlier timing of interfund transfers. The city will decide on its fiscal 2014 TRANs needs in the second quarter of fiscal 2014

To address its capital backlog of $898 million (excluding water and wastewater system needs), the city is considering issuing between $80 million–$90 million in lease revenue bonds annually during fiscal years 2014–2017. The city's overall debt burden would remain moderate if all this debt is issued. The city might also act as conduit issuer for $520 million in bonds to expand its convention center if all the required project approvals are granted. 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 stormwater compliance permit. To achieve full compliance, the city expects that it will have to make considerable investments of between $1.5 billion–$2.7 billion over 20 years, some of which might need to be funded through bonds supported by stormwater fees and, potentially, the general fund. The impact on the city's general fund-supported debt profile is currently unknown, but the city does not anticipate that the general fund would be the primary funding support for such debt.

During the recent recession, the city shifted debt repayment costs associated with the SDPFFA lease revenue bonds, series 2007A (ballpark refunding) and the Convention Center Expansion Financing Authority lease revenue bonds, series 2012A, from the general fund to the former SDRDA. This arrangement has been invalidated by the state, which might also claw back

$27.1 million in previously approved support payments. The impact on the general fund should be minimal since the city has set aside $28 million to cover the potential claw-back and is also receiving, as general property tax distributions, approximately 21% of property tax revenues not attributable to approved enforceable obligations of the SDRDA successor agency. Nevertheless, the city is legally challenging the invalidation as it relates to an earlier ballpark bonds cooperation agreement that was intended to provide ballpark debt service funding through fiscal 2014.

Sizable Pension Liabilities

San Diego City Employees Retirement System (SDCERS) is 68.5% funded using the city's 7.5% discount rate, or an estimated 65% funded using Fitch's more conservative 7.0% discount rate, levels that Fitch views as weak. The city has already worked to stem the growth in its pension costs by establishing second-tier pension benefits for new hires starting in 2009–2012 (depending on job classification), reducing the rate of return for its deferred retirement option plan and eliminating its contributions on behalf of employees. Nevertheless, pension costs increased to 15.6% of general fund expenditures in fiscal 2013 from 6.5% in fiscal 1999, and will increase again in fiscal 2014 due to the impact of pension reform and the smoothing in of past investment losses.

In June 2012, the electorate voted in favor of further pension reform, which resulted in a closed plan and 15-year amortization. A conservative analysis prepared by the city's independent budget analyst suggested that the considerable potential net savings from this reform ($963 million over 30 years) would come not from the pension system changes that actually increase pension costs in the medium term. Rather, the savings would result from restraints on employee remuneration growth so long as they are not rescinded by a majority city council vote. Nevertheless, in terms of the pension system, 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 unfunded accrued actuarial liability ($2.3 billion in fiscal 2012). Litigation against this pension reform is ongoing.

In terms of the city's closed OPEB plan, the city still has an unfunded accrued actuarial liability of roughly $449.1 million, or a low 0.4% of fiscal 2012 TAV, after negotiating a new retiree health plan in 2012. The new retiree health plan is projected to save $714 million in healthcare costs over 25 years and caps the city's annual OPEB contribution at $57.8 million in fiscal years 2012–2015, with annual increases of up to 2.5% thereafter.

In fiscal 2012, the city's total carrying costs related to annual debt repayments, actuarially required pension contributions and OPEB pay-as-you-go payments represented a moderate 19.6% of total governmental expenditures and transfers out, less capital. These carrying costs are likely to increase as additional debt is issued and pension contributions continue to rise.

Large Cross-Collateralized Pool of Assets

The parity series 2012 and 2013 lease revenue bonds (estimated combined par amount of $136.7 million) are secured by a fully cross-collateralized pool of leased assets valued at $171.4 million. In the highly unlikely 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, three of which extend beyond the final maturity of the series 2012 and 2013 bonds, while 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 an essential revenue stream ($5.6 million in fiscal 2012) that would provide the trustee with a strong remedy in the event of a default (although they alone would be insufficient to cover a full debt service default of up to $9.7 million per year). Also, the ground leases have no meaningful abatement risk and cover inherently valuable properties (currently valued at $94.7 million) that 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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