Revenue
New Issue

# San Diego Public Facilities Financing Authority, California

## Ratings

| | |
|---|---|
| **New Issue** | |
| Water Revenue Bonds, Refunding Series 2010A | AA |
| **Outstanding Debt** | |
| Water Revenue Bonds | AA |
| San Diego Facilities and Equipment Leasing Corporation Certificates of Undivided Interest, Series 1998 | AA |
| Subordinated Water Revenue Bonds, Series 2002 | AA– |

## Rating Outlook

Stable

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## New Issue Details

**Sale Information:** Approximately $126,155,000 Water Revenue Bonds, Refunding Series 2010A, during the week of June 14 via negotiation.
**Purpose:** To refund a portion of the city water system's outstanding obligations, fund a debt service reserve, and pay costs of issuance.
**Final Maturity:** 2028.

## Related Research

**Applicable Criteria**
- *Revenue-Supported Rating Criteria, Dec. 29, 2009*
- *Water and Sewer Revenue Bond Rating Guidelines, Aug. 6, 2008*

**Other Research**
- *2010 Water and Sewer Medians, April 6, 2010*
- *2010 Water and Sewer Sector Outlook, Feb. 10, 2010*
- *San Diego County Water Authority Financing Agency, California, Jan. 22, 2010*
- *Metropolitan Water District of Southern California, May 15, 2009*

## Rating Rationale

- The city of San Diego's water system (the system) financial performance is sound but could face pressure if drought conditions persist and/or economic conditions remain soft.
- Debt levels are moderately high to high and will increase rapidly over the near term to meet regulatory requirements and rehabilitation needs.
- User charges are somewhat elevated overall and will require additional increases to fund capital and operating costs, reducing long-term affordability.
- The service area is broad and diverse but has weakened commensurate with national economic conditions.

## Key Rating Drivers

- A continuing challenging revenue environment without corresponding rate hikes or operating adjustments could weaken the system's financial profile and possibly lead to negative rating action.
- Rising capital and operating costs could reduce rate affordability further.

## Credit Summary

The system provides retail service to about 1.3 million people within the city, in addition to limited wholesale service to certain customers in the outlying area. The city's diverse economy is driven by the healthcare, military, tourism, and educational sectors. The city experienced broad economic growth throughout much of this past decade, but, like many areas across the country, the collapse of the housing market and national recession have impacted job growth and led to rising foreclosure activity. Likewise, unemployment continues to rise, with the city's most recent results for March 2010 at 11%, up from 9% year over year.

Capital needs for fiscal years 2010–2014 total $694 million on an inflated basis, with the majority of costs attributable either directly or indirectly to requirements under a regulatory consent order. Approximately 80% of funding sources are expected to be derived from debt issuances, which will increase the system's leverage ratios substantially through the CIP period. Currently, debt levels are relatively high, and planned borrowings are expected to result in leveraging that will be well above that of other comparably rated systems by fiscal 2014.

In addition to a rising fixed-cost structure, the system faces near-term operational challenges as a result of drought conditions and certain legal constraints. These constraints have led the city's wholesale water provider, San Diego County Water Authority (CWA; revenue bonds rated 'AA+' by Fitch Ratings), to seek reductions in customer consumption levels beginning in fiscal 2010 and continuing through fiscal 2011. Despite these challenges, it is expected that the system will maintain a favorable financial profile over at least the next few years. Historically, system financial results have produced increasing annual debt service (ADS) coverage, sound liquidity, and good cash flows. For fiscal 2009, ADS coverage on senior lien bonds was 4.8x and 2.1x for all

### Rating History — Senior Lien

| Rating | Action | Outlook/ Watch | Date |
|---|---|---|---|
| AA | Affirmed | Stable | 6/4/10 |
| AA | Revised | Stable | 4/30/10 |
| AA– | Upgraded | Stable | 12/11/08 |
| BBB+ | Affirmed | Positive | 3/27/08 |
| BBB+ | Downgraded | Negative | 5/27/05 |
| A | Downgraded | Negative | 2/16/05 |
| AA– | Assigned | — | 9/27/02 |

### Rating History — Subordinate Lien

| Rating | Action | Outlook/ Watch | Date |
|---|---|---|---|
| AA– | Affirmed | Stable | 6/4/10 |
| AA– | Revised | Stable | 4/30/10 |
| A+ | Upgraded | Stable | 12/11/08 |
| BBB | Affirmed | Positive | 3/27/08 |
| BBB | Downgraded | Negative | 5/27/05 |
| A– | Downgraded | Negative | 2/16/05 |
| A+ | Assigned | — | 9/30/02 |

debt. Liquidity for the year ended with more than 310 days cash on hand and working capital, while free cash to depreciation was above 130%.

To account for the constrained water supply situation, the city has prepared a financial forecast that incorporates a large 20% decrease in fiscal 2010 supplies from fiscal 2009 levels, equating to a 15% decline in sales. In addition, the forecast assumes only a 1% increase in annual sales from fiscal 2010 amounts through the fiscal 2014 forecast period and no additional rate hikes beyond those already approved through fiscal 2011. Under this forecast, senior lien and all-in ADS coverage fall to lows of 1.7x and 1.1x, respectively. While Fitch believes that the forecast assumptions are conservative and that actual results will be more favorable, if these results occur, they could put downward pressure on the system's ratings. Consequently, it will be important for the city to manage the challenging revenue environment and adjust rates and/or operations to maintain a financial profile commensurate with the existing rating levels.

The City Council passed a series of rate hikes in recent years in light of San Diego's capital demands, as well as the need to recover pass-through costs from CWA. In total, rates were increased more than 15% for fiscal 2009 and by 6.5% in fiscal 2010, and will be raised an additional 6.5% in fiscal 2011. No additional escalations are currently forecast for fiscal years 2012–2014, but it is expected that a new rate study will be performed in the fiscal 2011 time frame, with the results subsequently recommended to the City Council. With the adjustment for fiscal 2010, the current average monthly residential bill has risen to a moderately high 1.2% of estimated median household income. While the current and projected level of customer charges are a credit concern given the diminished rate flexibility, user costs are not, nor are they expected to be, significantly higher than those of other major West Coast metropolitan providers through the projection period.

## Legal

**Security:** The bonds are senior lien obligations, secured by net system revenues after payment of operations and maintenance (O&M) expenses. Revenues include connection fees, standby charges, and taxes available for operation. 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 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 bonds may be issued, provided the system meets either a historical or projected coverage test. The historical test for senior lien bonds is the greater of 1.2x maximum ADS (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 bonds 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:

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

## Water System

### Management

The system is owned by San Diego 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), 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.

### Customers

The system serves about 1.3 million people within the city, with more than 90% of the retail customer base residential in nature. The system also provides some recycled water service (equal to 2% of fiscal 2009 revenues), as well as wholesale service (4%) to five customers. There is limited revenue concentration among the retail accounts; for fiscal 2009, the top 10 retail customers accounted for only 10% of revenues. Of these customers, governmental entities made up eight 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.

### 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 (it accounts for roughly 35% 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 are experiencing pressure from drought, and legal constraints have affected the amount of water available for MWD's wholesale customers, including CWA. In recent years, 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 continue requiring 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 city has met CWA's cutback, reducing demand by 11% through March 2010. For fiscal 2011, MWD and CWA announced initial allocation estimates similar to fiscal 2010, although favorable precipitation through April 2010 has eased drought conditions somewhat.

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), recycled water for indirect nonpotable reuse, and increased conservation efforts. Some of these projects are in the demonstration stage, which could lead to rising CIP costs if proven feasible. While the current scope of these projects is relatively small individually, in the aggregate, they would assist in reducing the city's dependence on imported supplies by about 10,000 acre feet (approximately 5% of projected fiscal 2010 supplies) and provide the city greater flexibility in meeting demands if supplies continue to be restricted.

### Treatment and Storage

The system operates three water treatment plants (WTPs) with a combined capacity of 294 million gallons per day (mgd). All three WTPs are scheduled to have various upgrades completed by fiscal 2011, which will increase their combined capacity to 455 mgd, 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 March 2010 amounted to about 7.5 months of total production.

### Regulatory

The system is currently in compliance with all federal and state regulatory standards. However, the system has entered into a compliance order (the order) with the California Department of Public Health that dates 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, most of which are included in the current CIP. Some additional capital requirements beyond fiscal 2014 for cast iron main replacement are likely, but the major issues are expected to be addressed by fiscal 2014.

## Debt and Capital Improvement Program

The fiscal years 2010–2014 CIP totals $694 million and is driven by regulatory requirements. Altogether, there are 21 projects with $415 million of direct and related costs associated with the order in the CIP. Two major funding categories identified in the CIP attributable to requirements from the order include pipeline replacement ($300 million; 43% of the CIP) and WTP rehabilitation and expansion ($130 million; 18%).

The pipeline replacement focuses on the repair and rehabilitation (R&R) of distribution and transmission lines throughout the system, including the 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. Projects associated with the WTPs will ensure continued performance and add a significant amount of treatment capacity to meet scheduled build-out needs.

Overall, the CIP is expected to be funded predominantly from debt sources (about 80%), which will elevate the system's already high leverage ratios even further. For audited fiscal 2009, debt per customer and debt per capita were about $3,410 and $692, respectively, while debt relative to funds available for debt service was 9.2x. These fixed-cost pressures also will persist for some time given the system's weak amortization rates after this issuance of 28% and 71% over the next 10 and 20 years, respectively, and the city's planned use of 30-year terms for all new money issuances. Fitch views the system's high debt levels and weak amortization as two of the most significant credit concerns, given the long-term pressure they will exert on the rate base and the resulting decrease in rate flexibility to meet ongoing R&R or major new supply development beyond the current CIP.

## Rates

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 about 10% or less of system revenues.

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, it approved additional increases of 6.5% annually for fiscal years 2008–2011. The council has also implemented adjustments regularly to recover CWA pass-through costs and instituted a temporary adjustment that will sunset in September 2010 to provide funding for one of the new supply projects — the indirect potable reuse pilot study.

Rates have bordered on the high side relative to median household income, at about 1% for the past several years, and reached an estimated 1.2% in fiscal 2009. Given the rate adjustment in fiscal 2010 and the adopted hike that will go into effect for fiscal 2011, rates are expected to remain somewhat elevated. While rates are higher than those of other major West Coast utilities, they are not significantly elevated, affording the system some rate flexibility. However, given continued high leverage rates and ongoing pressures of servicing fixed costs, outyear flexibility will remain weakened.

## Finances

Fiscal operations have been good, trending upward over the past several years. For audited fiscal 2009, senior lien ADS was 4.8x, while total debt service coverage was 2.1x. Other key metrics for the year were similarly strong: days cash on hand and days working capital were both in excess of 310 days, while the system's quick and current ratios were both greater than 3.5x. System cash flows have also produced sound results. Demonstrating this flexibility, free cash for fiscal 2009 was more than 130% 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 remain so throughout fiscal 2014. Reserves established by the city include a rate stabilization fund and operating reserve, currently budgeted at 60 days of O&M and expected to increase to 70 days over the next few years. The city also has set aside funds for emergency capital and water purchase expenditures, among other things, to account for unforeseen events.

## Financial Summary

($000, Fiscal Years Ended June 30)

| | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|
| **Balance Sheet** | | | | | |
| Unrestricted Cash and Investments | 117,892 | 154,889 | 196,510 | 212,932 | 225,556 |
| Accounts Receivable | 42,973 | 36,385 | 42,697 | 43,854 | 43,573 |
| Other Current Unrestricted Assets | 32,835 | 31,042 | 32,200 | 41,114 | 40,449 |
| Current Liabilities Payable from Unrestricted Assets | (69,401) | (75,402) | (73,673) | (143,377) | (72,992) |
| **Net Working Capital** | **124,299** | **146,914** | **197,734** | **154,523** | **236,586** |
| | | | | | |
| Net Fixed Assets | 1,558,505 | 1,606,703 | 1,668,967 | 1,719,103 | 1,852,333 |
| Net Long-Term Debt Outstanding | 561,732 | 569,221 | 611,855 | 766,962 | 933,044 |
| **Operating Statement** | | | | | |
| Operating Revenues | 267,649 | 280,567 | 310,292 | 318,626 | 342,719 |
| Non-Operating Revenues | 8,624 | 7,749 | 12,203 | 18,215 | 14,491 |
| Connection Fees | 21,630 | 16,874 | 21,295 | 12,372 | 7,631 |
| **Gross Revenues** | **297,903** | **305,190** | **343,790** | **349,213** | **364,841** |
| Operating Expenses (Excluding Depreciation) | (234,274) | (240,636) | (253,828) | (258,430) | (262,898) |
| Depreciation | (27,277) | (29,230) | (27,644) | (29,870) | (39,627) |
| **Operating Income** | **36,352** | **35,324** | **62,318** | **60,913** | **62,316** |
| | | | | | |
| Net Revenues Available for Debt Service[a] | 63,629 | 64,554 | 89,962 | 90,783 | 101,943 |
| | | | | | |
| Senior Lien Debt Service Requirements | 21,355 | 21,355 | 21,351 | 21,354 | 21,354 |
| Total Debt Service Requirements | 34,861 | 35,549 | 40,759 | 43,082 | 49,600 |
| **Financial Statistics** | | | | | |
| Senior Lien Debt Service Coverage (x) | 3.0 | 3.0 | 4.2 | 4.3 | 4.8 |
| Total Debt Service Coverage (x) | 1.8 | 1.8 | 2.2 | 2.1 | 2.1 |
| Days Cash on Hand | 184 | 235 | 283 | 301 | 313 |
| Days Working Capital | 194 | 223 | 284 | 218 | 328 |
| Debt to Net Plant (%) | 36 | 35 | 37 | 45 | 50 |
| Outstanding Long-Term Debt per Customer ($) | 2,073 | 2,092 | 2,242 | 2,805 | 3,410 |
| Operating Margin (%)[b] | 12 | 14 | 18 | 19 | 23 |

[a]Equals gross revenues less operating expenses. [b]Equals operating revenues less operating expenses divided by operating revenues. Note: Numbers may not add due to rounding.

Financial performance through the fiscal 2014 forecast period is expected to be weaker than recent historical performance, largely as a result of the constrained supply situation. For the forecast, the city used a water supply assumption for fiscal 2010 that is 20% below fiscal 2009 results, equating to a 15% drop in sales. For fiscal years 2011–2014, the city uses the fiscal 2010 sales level as a baseline, with modest increases in sales of 1% annually thereafter. As a result of these reduced sales and no rate increases beyond the hikes approved through fiscal 2011, revenues fail to keep pace with rising expenditures, and ADS coverage falls to 1.7x and 1.1x on a senior lien and all-in basis, respectively, by fiscal 2013. While Fitch notes that outyear forecast coverage levels are weaker than previous stress case figures, Fitch believes actual results are likely to be more favorable for a couple of reasons. First, as drought and economic conditions improve, it is possible that sales volume could rise, in which case, the base year sales amount of the forecast would increase and lead to increased revenue levels. Second, the city expects that a new rate study will be completed in the fiscal 2011 time frame, which could lead to adoption of additional rate hikes by the City Council prior to the end of the forecast period. 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.

### Financial Projections

($000, Fiscal Years Ending June 30)

| | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| Operating Revenues | 372,226 | 400,458 | 404,809 | 409,365 | 414,013 |
| Non-Operating Revenues | 8,313 | 8,599 | 10,854 | 12,822 | 12,809 |
| Connection Fees | 5,578 | 5,592 | 5,620 | 5,676 | 5,733 |
| **Gross Revenues** | **386,117** | **414,648** | **421,282** | **427,863** | **432,554** |
| Operating Expenses (Excluding Depreciation) | (303,768) | (311,605) | (318,655) | (325,937) | (333,461) |
| **Net Revenues Available for Debt Service** | **82,349** | **103,043** | **102,628** | **101,926** | **99,093** |
| | | | | | |
| Senior Lien Debt Service Requirements | 24,910 | 36,656 | 45,344 | 60,181 | 60,022 |
| Total Debt Service Requirements | 53,585 | 65,324 | 74,016 | 88,856 | 88,696 |
| | | | | | |
| Senior Lien Debt Service Coverage (x) | 3.3 | 2.8 | 2.3 | 1.7 | 1.7 |
| Total Debt Service Coverage (x) | 1.5 | 1.6 | 1.4 | 1.1 | 1.1 |

Note: Numbers may not add due to rounding.

## Service Area Economy

While experiencing weakening in the current economic environment, San Diego's economy is marked by a diverse employment base with strong underpinnings in tourism, the military, and related industries, and, more recently, biotechnology. San Diego's unemployment rate remains below the state average, but, beginning in 2008, monthly levels have exceeded those of the U.S. For March 2010, the city's unemployment rate was 11.0%, compared with the state and national rates of 12.3% and 10.2%, respectively. The city benefits from relatively high income levels that are on par with the state's and about 20% above the nation's, which is unusual for a central city with an above-average share of retirees.