Fitch Rates San Diego Public Facilities Fin Auth, CA's $126MM 2010A Senior Water Revs 'AA' Ratings

04 Jun 2010 2:59 PM (EDT)

Fitch Ratings-Austin-04 June 2010: Fitch Ratings assigns the following rating to the San Diego Public Facilities Financing Authority, issued on behalf of the City of San Diego, California's (the city) water system (the system):

--Approximately $126.2 million water revenue bonds, refunding series 2010A rated 'AA'.

Bond proceeds will be used to refund a portion of the system's outstanding debt, fund a debt service reserve, and pay costs of issuance. The bonds are scheduled to sell via negotiation the week of June 14, 2010. At this time, Fitch also affirms the following ratings on outstanding system-supported debt:

San Diego Public Facilities Financing Authority
--$156.2 million water revenue bonds, refunding series 2009A (secured by a senior lien on water revenues), at 'AA';
--$328.1 million water revenue bonds, series 2009B (secured by a senior lien on water revenues), at 'AA';
--$258.5 million subordinated water revenue bonds, series 2002 at 'AA-'.

San Diego Facilities and Equipment Leasing Corporation
--$141.3 million certificates of undivided interest, series 1998 (the certificates, secured by a senior lien on water revenues) at 'AA'.

The Rating Outlook is Stable.

RATING RATIONALE:

--The system's 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.

SECURITY:

The bonds are payable from net revenues of the system, on parity with the system's outstanding senior lien obligations. The 2002 bonds are payable from net system revenues on a basis subordinate to the senior lien bonds and the certificates.

CREDIT SUMMARY:

The system provides retail service to around 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. The city experienced broad economic growth throughout much of this 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 fiscals 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 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 that have led the city's wholesale water provider, San Diego County Water Authority (CWA; revenue bonds rated 'AA+' by Fitch), 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 4.8 times (x) and 2.1x for all debt. Liquidity for the year ended with over 310 days of cash and working capital, while free cash to depreciation was over 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, it 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 the city's capital demands, as well as the need to recover pass-through costs from CWA. In total, rates were increased over 15% for fiscal 2009, 6.5% in fiscal 2010, and will increase an additional 6.5% in fiscal 2011. No additional escalations are currently forecasted for fiscals 2012-2014, but it is expected that a new rate study will be performed in the fiscal 2011 timeframe with the results subsequently recommended to 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 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.

Applicable criteria available on Fitch's website at 'www.fitchratings.com':
'Revenue-Supported Rating Criteria', dated Dec. 29, 2009.
'Water and Sewer Revenue Bond Rating Guidelines', dated Aug. 6, 2008.

Contact: Doug Scott +1-512-215-3725, Austin; or Alan Gibson +1-415-732-7577, San Francisco.

Media Relations: Cindy Stoller, New York, Tel: +1 212 908 0526, Email: cindy.stoller@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.