FITCH RATES SAN DIEGO PUBLIC FACILITIES FIN AUTH, CA LEASE REVS 'A+'; OUTLOOK STABLE

Fitch Ratings-San Francisco-11 May 2015: Fitch Ratings has assigned the following rating to San Diego Public Facilities Financing Authority, California (the authority) lease revenue bonds:

--$116.9 million lease revenue refunding bonds, series 2015 (Ballpark Refunding) 'A+'.

The bonds will be sold via negotiation during the week of June 1, 2015. Proceeds will be used to refund $125.3 million in outstanding lease revenue refunding bonds, series 2007A (Ballpark Refunding) (rated 'A+' by Fitch) for debt service savings. This refunding does not extend or defer any debt service repayments.

The Rating Outlook is Stable.

SECURITY

The series 2015 lease revenue refunding bonds are payable from the city of San Diego's lease rental payments to the authority, which the city covenants to budget and appropriate annually from any legally available sources. The lease rental payments are subject to abatement, which risk is mitigated by standard rental interruption insurance provisions.

KEY RATING DRIVERS

SOLID FINANCIAL OPERATIONS: The city continues to demonstrate solid financial results resulting from its ongoing commitment to conservative financial management policies, general fund balance and reserves preservation, and strong financial disclosure practices, bolstered by a stabilized management environment.

FUNDAMENTAL ECONOMIC STRENGTHS: The city benefits from a diverse economy, strong key revenue streams, a declining unemployment rate, a healthy tax base, and its desirable geographic location.

ABOVE-AVERAGE DEBT; SIZEABLE CAPITAL NEEDS: The overall debt burden is expected to remain elevated as the city begins to address large identified capital needs, a significant portion of which are mandated by regulation. Those capital costs will become more defined over the next two years, as will the city's related funding options.

POSITIVE EFFECTS OF BENEFITS REFORM: Carrying costs are expected to remain substantial, in part because of the city's sustained focus on reducing unfunded pension and other post-employment benefit (OPEB) liabilities. Paydown of these liabilities is being facilitated by pension system reform and OPEB modifications made in the face of considerable labor opposition. However, litigation against pension reform remains unresolved.

SOLID LEGAL STRUCTURE: The legal structure underpinning the series 2015 refunding bonds is substantively comparable to that used for the series 2007A bonds being refunded, with largely standard bondholder protections. However, the requirements for a debt service reserve fund and bond insurance have been deleted.

RATING SENSITIVITIES

CONTINUED POSITIVE TRAJECTORY: The ability of the city's current administration and management team to continue achieving stable-to-positive financial operations, coupled with clear indications that capital and pension pressures will not increase pressure on operations, could lead to an upgrade of the credit over the next few years.

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, higher consumer spending, more residential and commercial construction, and increasing tourism. Nine new hotels are due to open in 2015 and 2016, adding 1,633 hotel rooms.

The city's unemployment rate (5.1% in February 2015) has declined to below the national average (5.8%), residents' socio-economic indicators are largely above-average, and the tax base is rebounding. The relatively minor cumulative 2.5% taxable assessed valuation (TAV) decline between fiscals 2010-2013 has been more than offset by the 10.9% TAV rebound occurring in fiscals 2014-2015. A further 3.4% TAV increase is projected for fiscal 2016. House prices are increasing, commercial vacancy rates are declining, and the numbers of delinquencies and foreclosures have fallen. Continuation of these factors will likely fuel further TAV growth, particularly given the lower inventory of housing currently available.

SOLID FINANCIAL OPERATIONS

The city ended fiscal 2014 with a total general fund balance of $350.1 million and an unrestricted general fund balance of $244 million, a strong 26.6% and 18.6% of spending, respectively. The total general fund balance benefited from a net operating surplus after transfers of $3.3 million, and the city is projecting an almost $5 million further net operating surplus after transfers in fiscal 2015.

However, the majority of the total general fund balance's growth from $222.5 million in fiscal 2013 (18.2% of spending) was due to accounting changes. These included reclassification of the self-insurance internal service fund into the general fund and consolidation of special revenue funds into the general fund where the majority of their expenditures occurred. Cumulatively, all accounting changes added $114.7 million to the general fund's beginning balance.

Rolling the self-insurance internal service fund into the general fund eliminated auditor concerns about the city having an internal service fund with deficits. However, it also masked the associated liabilities because governmental funds do not report long-term liabilities. There was no corresponding transfer into the general fund of the $237.5 million in related long-term liability claims. Nevertheless, the city funds its workers' compensation, public liability, and long-term disability reserves at or above policy goals which have been modified in recent years. The policy goals were modified in light of the city's historical experience with the liabilities which each behave very differently. For example, the workers' compensation liability is long-term with a steady pattern of payments made in installments over years, while the public liability fund fluctuates significantly according to liability claim payouts that have to be made each year (the latter needs higher cash reserves than the former). The city's multiyear projections assume continued compliance with the revised reserve policy goals through fiscal 2020.

In February 2014, the city council voted to increase the general fund reserve requirement to 14% of general fund revenues, up from 8%. The city had already been exceeding the revised goal since fiscal 2012 and has continued to exceed it. The city expects to end fiscal 2015 with a general fund reserve of $169.8 million or 15.1% of revenues. The city's total and unrestricted general fund balances will continue to be higher than this specifically designated reserve.

California cities have limited revenue flexibility. Further, 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, and there would likely be considerable taxpayer and voter resistance to introducing or increasing such taxes. Nevertheless, its four primary general fund revenue sources (property, sales, and transient occupancy taxes, and franchise fees) recovered well from the recession and are all projected by management to continue increasing over the next five years, albeit returning to more stable levels of growth.

The city's general fund expenditures are dominated by personnel expenditures (68.6% of the fiscal 2015 adopted budget). Future labor costs have been rendered somewhat predictable by five-year labor agreements through fiscal 2018 which freeze pensionable pay but provide for increases in non-pensionable compensation. Such increases are currently projected to cost between $10 million and $13 million annually. The city has negotiated a modification and two-year extension to the police labor agreement to address specific police officer retention issues. The modified and extended contract provides for pensionable pay increases in both fiscal 2019 and 2020, after the five-year freeze expires, plus benefit, allowance, and leave increases in the interim, for a total fiscal impact of between $11 million and $25 million per year through fiscal 2020. Priority initiatives to be funded from surplus monies in fiscal years 2016 to 2020 will add to the city's overall personnel costs, with the expectation that general fund structural balance will be maintained.

The recently proposed fiscal 2016 general fund budget shows both increased revenues and increased expenditures as the city attempts to fund some of its priority initiatives, particularly related to street and infrastructure repairs. The city currently projects that it will maintain its 14% reserve target in fiscal 2016 with no additional transfers to reserves.

ABOVE-AVERAGE DEBT; SIZEABLE CAPITAL NEEDS

The city's overall debt burden is above average on a per capita basis ($4,953) but moderate at 3.5% of market valuation. Debt amortization is average at approximately 50% in 10 years. The city did not need to issue TRANs in fiscals 2014 and 2015, and does not expect to do so in fiscal 2016 either.

The city anticipates issuing $270 million in lease revenue bonds between fiscals 2017 and 2019 to further address capital funding needs. These bond issues would not greatly alter the city's debt burden on a per capita or market valuation basis; however, the amounts are small compared to the city's total capital needs.

The city has identified $3.9 billion in capital projects going forward. Of the estimated $2.3 billion that would be the general fund's responsibility, an estimated $1.7 billion is currently unfunded. These amounts could increase as an ongoing evaluation process works through the city's inventory of capital assets in more detail. However, there is also a strong possibility that currently unfunded storm water program capital and operating costs associated with new regulatory requirements could be reduced by as much as $980 million if all regulatory parties concur with the city's alternate proposals. Negotiations are presently underway.

Securing new primary funding sources for capital costs could prove challenging. Historically, the city's electorate has been resistant to new taxes. This is reflected in the city's less diverse revenue structure and recent successful litigation against a special tax district to partially fund expansion of the convention center. Raising storm water fees to assist with the storm water system upgrade costs would likely be difficult and the city will not be able to rely on lease revenue bonds to fund all of its capital needs.

POSITIVE EFFECTS OF BENEFITS REFORM

The city has undertaken considerable pension system reform and OPEB modification. Litigation against the pension reform is ongoing. In the event that pension reform has to be wholly or partially unwound in response to the litigation outcomes, there would be little near-term impact on the city's costs. However, the city's long-term liabilities would increase. An initiative to cap the city's annual OPEB contributions successfully withstood a legal challenge on the basis that OPEBs are an employment benefit rather than a vested contractual right and, therefore, can be modified.

In June 2012, following earlier pension reforms, the electorate voted in favor of closing the San Diego City Employees Retirement System (SDCERS) plan to all new employees except police, accelerating paydown of the system's UAAL, limiting pensionable salaries through fiscal 2018, and only offering defined contribution plans to new employees. These pension reforms benefit the city's budget in the long term by shifting investment and longevity risks to future city employees, and accelerating the paydown of the pension system's UAAL. The UAAL is projected to decrease from $2.03 billion in fiscal 2014 to $560 million by fiscal 2025 (assuming a 7.25% annual investment return rate). The city will need to continue making substantial annual contributions to achieve this; they are projected to decline from $264 million in fiscal 2015 to a still significant $218 million in fiscal 2025. The general fund is currently responsible for 72% of annual pension contributions.

As a result of these pension reforms (assuming the city prevails against the pension reform litigation in its entirety) and improved investment returns, in 2014 SDCERS was 74.2% funded using SDCERS' 7.25% discount rate or 72.2% funded using Fitch's more conservative 7% discount rate. This represents a steady improvement from 2009 when, as a result of investment losses, the funded ratio hit a low of 66.5% using SDCERS' then 7.75% discount rate, or an estimated 61.4% using Fitch's 7% discount rate.

In terms of the city's closed OPEB plan, the city still has a UAAL of roughly $479.5 million, or a low 0.3% of TAV, after negotiating a new health plan for the remaining OPEB plan members in 2012. The new retiree health plan is projected to save $714 million in health care costs over 25 years by lowering the benefits' value and increasing employee contributions. Due to multiyear labor agreements, the city does not expect its annual OPEB contribution to exceed $57.9 million through fiscal 2015, with annual increases of up to 2.5% thereafter.

In fiscal 2014, the city's total carrying costs related to annual debt repayments, actuarially required pension contributions, and OPEB pay-as-you-go payments represented a high 26.2% of total governmental expenditures. These carrying costs are likely to increase as additional debt is issued while annual pension and OPEB contributions remain significant in order to reduce those unfunded liabilities.

SOLID LEGAL STRUCTURE

The legal structure underpinning the series 2015 refunding bonds is substantively comparable to that used for the series 2007A bonds being refunded. The leased assets, covenant to budget and appropriate from any legally available funds, and actual funding sources (primarily from the city's transient occupancy tax revenues) remain unchanged. The leased assets continue to be the 42,500-seat ballpark completed in 2004 (the city currently owns 70%) and an adjacent public park. In 2015, the city's 70% share of the ballpark and its 100% ownership of the adjacent public park were appraised by an independent company at $539 million. At the end of the lease term, the 30% owned by the ballpark's major league baseball tenant, the San Diego Padres Baseball Club (Padres), will revert to the city. The amended and restated site and facility leases remain substantively the same, as does the Joint Use and Management Agreement (JUMA) between the city and the Padres, under which the Padres have the right to use the ballpark during the term of the bonds but cannot relocate from it during that timeframe.

There are two noteworthy differences from the series 2007A bond legal structure. First, the series 2015 refunding bonds do not require a debt service reserve fund (DSRF). The $3.8 million currently in the series 2007A bonds' DSRF will be released and applied as a source of funds to reduce the series 2015 refunding bonds' issuance size. Second, limitations on amendments to agreements between the city and the Padres have been removed, since the ballpark is now a mature operating project. By contrast, at the time of the original bond issuance in 2002 (which was subsequently refunded by the series 2007A bonds replicating the 2002 legal documents) the ballpark had yet to be constructed so the contractual relationship was necessarily more restricted. The city does not anticipate needing to make contractual changes but wants the freedom to do so, without unnecessary restrictions, if the need arises.

Bondholder protections are standard with regard to: the circumstances under which additional bonds can be issued or leased property can be substituted, removed, or added; insurance coverage requirements; and no acceleration remedy in the event of default. The authority's rights, title, and interests in the site and facilities leases (including the receipt of lease rental payments) are transferred to a trustee. However, the authority has no right to re-enter the leased facilities in the event of a default.

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In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from Creditscope, University Financial Associates, S&P/Case-Shiller Home Price Index, IHS Global Insight, National Association of Realtors, and Bond Counsel.

Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria' (Aug. 14, 2012);
--'U.S. Local Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

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Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015
U.S. Local Government Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=685314

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