MOODY'S INVESTORS SERVICE

Rating Update: Moody's affirms Aa2 on San Diego CA's Senior Water Revenue Bonds and Aa3 on Subordinate Water Revenue Bonds

Ratings apply to approximately $580 million in senior lien and $171 million in subordinate lien debt

SAN DIEGO (CITY OF) CA WATER ENTERPRISE
Water Enterprise
CA

NEW YORK, August 10, 2015 --Moody's Investors Service has affirmed the Aa2 rating on City of San Diego Water Enterprise's (CA) Senior Water Revenue Bonds and has affirmed the Aa3 rating on the Subordinate Water Revenue Bonds. The outlook is stable.

SUMMARY RATING RATIONALE

The Aa2 senior lien and Aa3 subordinate lien revenue bond ratings reflect the economic strength and stability of the underlying service area, with above average socio-economic indicators and diverse customer base. The utility's stable and healthy water supply provided primarily by regional water wholesalers with diverse water portfolios is also a credit positive. The utility's water supply is currently sufficient to buffer against the impacts of the drought in the current fiscal year and is bolstered by a healthy level of stored water. The high ratings incorporate the system's strong financial performance with senior lien debt service coverage over 2.5x and total debt service coverage over 1.5 times over the past three years, a liquidity position of more than 230 days cash and a manageable long term capital plan which includes plans to develop new local sources of water.

OUTLOOK

The stable outlook considers declines in coverage in FY 2015 and 2016 as low points due to the current drought conditions. Additionally factored into the stable outlook are our expectations that the enterprise will increase rates to maintain satisfactory financial operations. These increases will result in debt service coverage consistent with historical levels. The stable outlook additionally considers the maintenance of healthy financial metrics through the enterprise's long term capital plans.

WHAT COULD MAKE THE RATING GO UP

-Significant and sustained improvement in debt service coverage levels

-Significant growth in unrestricted liquidity

WHAT COULD MAKE THE RATING GO DOWN

-Material deterioration in debt service coverage levels

-Sustained decline in unrestricted liquidity

-Inability to preserve financial strength through long term capital plans

STRENGTHS

-Large, highly diverse service area with above average resident socio-economic indicators

-Strong financial oversight with conservative budgeting and projections

-Strong senior lien debt service coverage ratios

CHALLENGES

-Ongoing pressure associated with long term California drought, including need to meet conservation requirements and increase rates to offset decrease in consumption

-Highly reliant on single wholesaler for 90% of water supply

-Significant long term capital plans

RECENT DEVELOPMENTS

Recent developments are incorporated in the Detailed Rating Rationale.

DETAILED RATING RATIONALE

SERVICE AREA AND SYSTEM CHARACTERISTICS: ESSENTIAL WATER PROVIDER FOR GROWING, HIGHLY DIVERSE AND WEALTHY SERVICE AREA

The water enterprise serves the City of San Diego, the second largest city in the state, and certain surrounding areas covering an area of 404 square miles, including 342 square miles in the city. The city and regional economy is highly diversified with tourism, military, higher education, trade and biotechnology playing important roles. The enterprise customer base benefits from the highly diversified metropolis with a very large 1.35 million population base. The socio-economic profile for residents in the service area is above average with per capita income at 119% of the nation and median family income at a high 120.5% of the nation. The enterprise is comprised of 278,694 retail connections, of which 90.8% are residential, 6.1% are commercial and industrial and the remainder are irrigation and other connections. The five year average annual growth rate in 2014 was 0.36% and informs the realistic assumptions on the 0.33% annual growth rate through 2019. Residential retail revenues made up a majority of revenues in fiscal year 2014 at 60% while commercial and industrial revenues made up the next largest revenue source at 21.9% of revenues. The water system has a highly diverse customer base with major non-governmental retail customers making up a small 2.25% of fiscal 2014 total sales revenues.

WATER SUPPLIES ARE DIMINISHED BUT STILL SUFFICIENT; RATE OF WATER REDUCTION

WILL DECLINE AS A RESULT OF CONSERVATION

The city's primary source of water is provided by regional wholesaler San Diego County Water Authority (CRWA, Aa2/Stable revenue rating) which typically provides approximately 85-90% of the city's water supply with the remaining 10-15% coming from local sources. The CRWA in turn obtains 51% of its water supply from the largest supplier of treated water in the US, Metropolitan Water District of Southern California (Met Water, Aa1/Stable revenue rating). The CRWA has significantly decreased its reliance on Met Water supplies over the past two decades from a high of 95% in 1991. CRWA reliance on MWD is expected to decline further with the acceptance of desalinated water from the Carlsbad Desalination Plant which will provide 10% of the authority's supply in 2016. The city plans longer term diversification of its water supply with its 20 year and $3 billion Pure Water program. The program is projected to supply up to 1/3 of enterprise demand (83 MGD by 2035; 30 MGD by 2021) with safe, reliable and local potable re-use drinking water.

On average the enterprise's annual water supply over the past five years has averaged 199,000 acre feet per year. In fiscal year 2014 the amount of water supplied was 209,876 acre feet and reflected the highest amount of water supplied over the five year period. We would expect significant declines in the amount of water supplied given the mandatory water reductions imposed by the state and the city's successful reductions thus far. In May of 2015 the state enacted mandatory water reductions for urban water distributors, the call was made for the city's water enterprise to reduce consumption by 16% when compared to 2013 consumption levels. In response to the state's mandatory call for water reduction, the city has implemented various water conservation and restriction policies including the limitation of ornamental outdoor irrigation to 2 times per week for five minutes per watering station based and schedule based on address. As a result of this and other conservation and restriction efforts the city has achieved 24% conservation as of the most recent reporting. As the city achieves these mandated reduction levels revenues will decline and rate increases will be necessary to maintain healthy coverage levels.

The city water enterprise has relatively healthy water levels. As of November 2014 the city's reservoirs were at 180,000 acre feet of water, or 44% of storage capacity. While the city's stored water is less than 50% of capacity the level of water would provide nearly one year's worth of normal water consumption, presumably more as various conservation measures have been implemented. The city had delivered nearly 200,000 acre feet of water in fiscal 2014 when only a voluntary water conservation order was in effect.

FINANCIAL OPERATIONS AND RESERVES: STRONG COVERAGE AND LIQUIDITY POSITION CITY WELL TO HANDLE IMMEDIATE FINANCIAL IMPACT OF DROUGHT

The city water enterprise has maintained healthy debt service coverage ratios over the past three audited fiscal years, averaging 2.94 times on a senior lien basis from FY 2012 through FY 2014. Total debt service coverage, while narrower, is appropriate for the rating category, and has averaged 1.70 times over the same period. Management projects significantly reduced debt service coverage ratios for fiscal year 2015 as overall revenues had been impacted by various conservation efforts. The senior lien debt service coverage for FY is projected to come down significantly to 2.05 times and the total debt service coverage is projected to narrow to 1.2 times.

The city has recently completed a cost of service study which informs rate increases necessary to maintain coverage at minimum levels moving forward. At this time, city management has proposed a total 17.1% rate increase, of which 9.8% would be implemented on January 1, 2016 and 6.9% on July 1, 2016. These proposed rate increases are still being discussed and have yet to be passed. Inclusive of the proposed rate increases, a significant decline in FY 2016 water supplied (148,000 acre feet), as well as a $32 million use of rate stabilization funds, FY 2016 projected debt service coverage will be 2.05 times on the senior lien and 1.24 times on all debt. Offsetting the projected decline is the management's consistent production of better than budgeted debt service coverage results over the past several years. Over the longer term cost of service study projection period, rate increases of 5% to 7% from FY 2018 through 2020 are included which would grow coverage back to historical levels. In the FY 2020 projection, senior lien coverage reaches 2.43 times and total coverage reaches 2.05 times. Rate increases are critical to the enterprise's ability to restore coverage to historical levels and maintain the current ratings.

Liquidity

The city water enterprise has maintained healthy liquidity levels and as a result has enabled the enterprise to fund capital improvements with cash on hand. Days cash on hand has been as high as 436 days in FY 2012 and has declined to still very healthy 231 days at the end of FY 2014. Enterprise liquidity will decline further in FY 2016 should a significant portion of the rate stabilization fund be utilized as is currently planned. The $32 million planned reduction in rate stabilization fund in FY 2016 would reduce days cash on hand to an approximate 170-190 days of cash, which is still consistent for the current rating category.

DEBT AND LEGAL COVENANTS: LOW RATIO OF DEBT TO OPERATING REVENUES; MANAGEABLE CAPITAL PLANS; ADEQUATE LEGAL COVENANTS

The enterprise's debt position is low and is expected to stay manageable through the projection period. The system's debt to operating revenues ratio is low at 1.79 times in FY 2014 and the overall debt ratio is also low at 32% in FY 2014. The city's current capital program from FY 2015-FY2019 called for approximately $690 million in capital spending with the biggest drivers being pipeline replacement (34% of program), pipeline transmission (21% of program), and the Pure Water program (21% of program). City officials expect the current program to be approximately 54% bond funded with new bond issuances anticipated in FY 2016 through FY 2019. We would expect an update to the city's water capital program given the recent cost of service study and expectations for ramp up of the Pure Water program capital expenditures in the fifth year of the projection period, FY2020.

The enterprise has rate covenants to maintain 1.2x senior debt service coverage and a reserve requirement funded at the lesser of the standard three-prong test. The subordinate lien bonds have a rate covenant of 1.0 times on all debt and a reserve requirement funded at the lesser of the standard three-prong test. Additionally, the enterprise convenants to maintain 1.2 times senior lien coverage and 1.1 times aggregate coverage under water state revolving fund loans outstanding.

Debt Structure

The enterprise's outstanding debt is all fixed rate.

Debt-Related Derivatives

The enterprise has not entered into any derivative agreements.

Pensions and OPEB

The water enterprise participates in the city's pension plan and OPEB plans and contributions are manageable. The water fund's $14 million contribution to the city's core pension contribution of $236 million in FY 2014 made up 5.9% of the total and 3% of operations and maintenance. The water fund's $4 million contribution to the city's retiree health contribution of $57.8 million was 6.9% of the total and made up 0.9% of operations and maintenance.

MANAGEMENT AND GOVERNANCE: PAST RATE-SETTING RECORD AVERAGE; DEBT SERVICE COVERAGE ACTUALS CONSISTENTLY OUTPERFORM PROJECTIONS

The city's passed its last rate increase on November 21, 2013 where a two year increase was approved. The rate increases were 7.25% in January 1, 2014 and 7.5% in January 1, 2015. Fiscal year 2016 and FY 2017 rate increases have not been approved as they are being informed by a recently published cost of service study.

Management consistently budgets conservatively and has demonstrated a positive variance of at least 0.2 times over projections on senior and total debt service coverage ratios. Conservative budgeting on both revenue as well as expenditures has produced a positive DSCR variance of at least 0.2 times and up to 0.5 times between FY 2012 through FY 2014.

KEY STATISTICS

- Asset Condition (remaining useful life): 44 years

- System Size (O&M in 000s): $355,539

- Service Area Wealth (MFI): 120.5% of the US

- 2014 Annual Debt Service Coverage: 1.55 times (all debt; 2.55 times Senior)

- Days Cash on Hand: 231 days

- Debt to Operating Revenues: 1.79 times

- Rate Management: A

- Regulatory Compliance and Capital Planning: Aa

- Rate Covenant: 1.0 times all debt service, 1.20 times senior lien

- Debt Service Reserve Requirement: A

OBLIGOR PROFILE

The water enterprise serves the City of San Diego, and certain surrounding areas. The enterprise customer base benefits from a highly diversified metropolis with a very large 1.35 million population base . The enterprise is comprised of 278,694 retail connections, of which 90.8% are residential, 6.1% are commercial and industrial and the remainder are irrigation and other connections.

LEGAL SECURITY

The senior lien bonds are secured by a senior lien pledge of the net revenues of the system, a rate covenant of 1.2 times and a debt service reserve requirement of the lesser of the standard three prong test, currently cash funded. The subordinate lien bonds are secured by a subordinate lien pledge of the net revenues of the system and a rate covenant of 1.0 times for all debt and the standard lesser of the three prong test debt service reserve requirement.

RATING METHODOLOGY

The principal methodology used in this rating was US Municipal Utility Revenue Debt published in December 2014. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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