



**New Issue: MOODY'S AFFIRMS THE A2 RATING OF SAN DIEGO CITY SEWER ENTERPRISE BONDS**

---

Global Credit Research - 25 Mar 2010

**APPROXIMATELY \$1.3 BILLION IN DEBT AFFECTED**

San Diego (City of) CA Sewer Enterprise  
Water/Sewer  
CA

**Moody's Rating**

| ISSUE  | RATING        |
|--|---------------|
| Senior Sewer Revenue Refunding Bonds, Series 2010A | A2            |
| <b>Sale Amount</b>                                 | \$165,000,000 |
| <b>Expected Sale Date</b>                          | 04/05/10      |
| <b>Rating Description</b>                          | Sewer Revenue |

**Opinion**

NEW YORK, Mar 25, 2010 -- Moody's has assigned an A2 rating to the Senior Sewer Revenue Refunding Bonds, Series 2010A of the City of San Diego's Wastewater Enterprise. We have also affirmed the A2 rating on the system's outstanding parity bonds in the amount of \$1.3 billion. The rating reflects the system's significantly improved financial performance since 2005, which is confirmed by the city's release over the past four years of seven Comprehensive Annual Financial Reports (CAFRs), for the fiscal years ending 2003 through 2009. The improved finances are primarily attributable to sizable and necessary rate increases which reflect the city's renewed commitment to financial health throughout its operations. The fundamental strength of the enterprise remains a key credit factor, including its essentiality and its large, strong, and diverse service area, which provides a relatively high degree of revenue stability. The rating also reflects the utility's favorable debt position, which is likely to remain manageable despite the expected addition of a significant amount of new debt during the next five years necessitated by the current Capital Improvement Program (CIP). However, the utility's debt position could be severely challenged in the long term if it is ultimately required to upgrade its treatment capability to full secondary standards. The stable outlook reflects our expectation that, despite the anticipated increase in debt, rate increases already in place through 2011 will continue to provide debt service coverage consistent with the current rating level, and with the planned capital improvements, the system will have met most of its capital needs for the near to mid- term. The proceeds of the Series 2010 A bonds along with cash on hand will be used to refund approximately \$180 million in parity debt issued between 1995 and 1999. The bonds are secured by net system revenues of the city's wastewater utility.

**FINANCIAL RESULTS HAVE IMPROVED SIGNIFICANTLY; CASH POSITION IS STRONG.**

Since their low point in 2003, the sewer system's financial operations have improved steadily. Increased system revenues, largely through rate increases with modest growth in customer accounts and flow, combined with very tight controls on Operating and Maintenance (O&M) expenditures, which have remained essentially unchanged since 2005, enabled the utility to increase total debt service coverage from 1.40 times in 2005 to 1.65 times in 2009. Senior lien debt service coverage increased from 1.53 times to 2.03 times during this period. These coverage levels, which include capacity charges, improved despite a notable decrease in such charges. Largely as a result of the weak housing market, which affected San Diego earlier than other parts of the state, capacity charge revenues decreased from \$16.6 million in 2007 to \$10.4 million in 2009. This downward trend is continuing, and significantly lower amounts are included in the utility's projections, despite an 11% increase in the capacity charge rate for 2008. The utility's strong financial performance in recent years enabled it to increase unrestricted cash from \$218.5 million in 2004 to \$345.9 million in 2009, which affords the system a very strong liquidity position, thereby enhancing operating flexibility.

Bolstered by a 7.5% rate increase in March 2005, followed by 8.75% annual rate increases for 2007 and 2008, and 7.0% for 2009 and 2010, the utility's favorable trend in financial operations is likely to continue for the near term. Despite the significant amount of additional planned debt, the city's reasonable projections indicate senior debt service coverage levels at or above 1.6 times through 2014. Coverage levels for all debt, which includes relatively

small amounts of subordinated state loans, are projected to remain above 1.5 times. In addition to the rate increases, only modest increases in connections are incorporated in the projections. Managing O&M expenses, which increase at an annual rate of 4.0% between 2010 and 2014, is also key to these projections and may be conservative given the trend through 2009.

Although the city's formal reserve policies call for the maintenance of a 50-day operating reserve (expected to increase to 70 days by 2012) as of March, 2010 the utility boasted formal reserves of \$85.3 million which equals more than 43% of 2009 operating expenditures. However, our favorable view of the system's liquidity position is also based on its unrestricted cash, which is very strong as mentioned above. Although unrestricted cash in excess of formal reserve levels is available for capital expenditures, 80% of the utility's current CIP is expected to be funded with debt, and we expect the system's overall cash position to remain very strong. According to the system's projections, revenues net of O&M and debt service appear to be sufficient to fund the portion of the CIP which is intended to be funded from ongoing revenues.

#### LARGE, STRONG AND DIVERSE SERVICE AREA

The ratings on the sewer revenue bonds are in large part based upon the size, diversity and economic strength of the system's service area. San Diego's wastewater enterprise provides collection, treatment, and disposal services within the city limits (the "municipal system") and treatment and disposal services to many of the surrounding communities ("participating agencies" in the "metropolitan system"). The municipal system accounts for about two-thirds of the metropolitan system's total flows. The largest participating agency represents less than 10% of the flow. In fiscal 2009 domestic customers accounted for 63% of total sewer service charge revenues, while commercial customers represented another 24%. There are no dominant customers within the municipal system; the largest is the U.S. Navy, which accounted for 3.6% of fiscal 2009 operating revenues, while the top ten customers account for 8.9% of revenues.

The local economy is characterized by high technology industries including telecommunications, software development, biotechnology and electronics, as well as manufacturing, professional services and international trade. Tourism also is a major contributor to the local economy. The local economy is affected by the severe recession gripping the state and the nation, although the city's December 2009 unemployment rate of 10.1% remains below the statewide rate of 12.1%. The December, 2008 to December, 2009 job losses are estimated to be 34,000. Total labor force also decreased by approximately 16,000 in 2009.

#### ENTERPRISE COMPLIANT WITH ALL REGULATORY REQUIREMENTS

As mentioned above, San Diego's sewer enterprise provides collection, transportation, treatment, and disposal services. The capacity of the treatment system is 285 million gallons per day (MGD), 15 MGD from its South Bay Water Reclamation Plant (SBWRP), which discharges secondary-treated effluent through an ocean outfall; 30 MGD from its North County Water Reclamation Plant (NCWRP), excess effluent from which is transported to Point Loma, and 240 MGD from its Point Loma treatment plant. However, SBWRP and NCWRP currently operate 8.5 MGD and 9 MGD, respectively. The effluent from the Point Loma Plant is discharged through a 4.5 mile long ocean outfall that delivers treated sewage effluent at a depth of 320 feet of water. As a result, it is one of a handful of large urban systems nationwide which is permitted to provide a lower treatment level than is required of almost all other treatment plants in the country ("advanced primary" treatment vs. "secondary"). It does so pursuant to a Modified Waiver. The system is in full compliance with the Waiver, which is likely to receive a five year extension. The final approval for the extension is expected in April 2010.

The enterprise's collection system has dramatically decreased the total number of sewer spills, from 365 in calendar 2000 to 38 in 2009. No regulatory penalty has been incurred as a result of the spills. The city had been sued by the EPA and Baykeeper, but negotiated two partial consent decrees which expired on June 30, 2006 and June 30, 2007. In 2007 the city negotiated the Final Consent Decree which requires the city to invest in additional capital improvements and enhance operations. Compliance with this final consent decree between 2010 and 2014 is estimated to cost \$99 million for capital improvement projects and \$42 million for operations and maintenance expense, all of which have been included in the city's operating projections.

#### FAVORABLE DEBT POSITION WILL LIKELY BE MAINTAINED IF FULL SECONDARY TREATMENT IS AVOIDED

The system's current five year CIP addresses the requirements of the Final Consent Decree, the improvements that had been delayed while the city lacked access to the capital markets, and normal ongoing and capital improvements. Of the approximately \$638 million total CIP, trunk improvements of \$158 million and pipeline replacement of \$299 million represent the largest components. Eighty percent of the CIP is expected to be funded with bond proceeds. The city's reasonable projections reflect ample ongoing revenues to meet the remainder of the CIP. We estimate that with the expected additional debt for the CIP the system's debt ratio will remain less than 50% and in line with the median of 56% for similarly rated large sewer utilities. However, if the system is required to convert to full secondary

treatment, the estimated additional cost of \$800 million to \$1.5 billion will increase the debt ratio to levels which could become very onerous for rate payers and possibly impact credit strength.

#### SATISFACTORY LEGAL STRUCTURE

The bonds are secured by net system revenues of the utility after payment of O&M expenses. Revenues include connection fees and transfers from the rate stabilization fund, while deposits into the rate stabilization fund are included in O&M expenses. The rate covenant is 1.2 times. The additional bonds test is also 1.2 times. The debt service requirement is subject to the common three tier test. Following the refunding the system will be free of any bonds previously issued with reserve requirements met by sureties from Ambac.

#### Outlook

The stable outlook for debt obligations of the sewer enterprise reflects the stable financial operations of the utility and our expectation that the city will be able to implement its capital plan while preserving its financial strength. The current economic recession poses some potential difficulties for the utility. The utility's successful navigation through the recession could improve bondholder security.

#### KEY STATISTICS

Senior debt service coverage, fiscal 2009: 2.03x

Total debt service coverage, fiscal 2009: 1.65x

Rate Covenant: 1.20x

Additional Bonds Test: 1.20x

Operating Ratio, Fiscal 2009: 59.9%

The last rating action was on April 21, 2009 when the utility's rating was upgraded.

The rating assigned to San Diego Sewer Enterprise was issued on Moody's municipal rating scale. Moody's has announced its plans to recalibrate all U.S. municipal ratings to its global scale and therefore, upon implementation of the methodology published in conjunction with this initiative, the rating will be recalibrated to a global scale rating comparable to other credits with a similar risk profile. Market participants should not view the recalibration of municipal ratings as rating upgrades, but rather as a recalibration of the ratings to a different rating scale. This recalibration does not reflect an improvement in credit quality or a change in our credit opinion for rated municipal debt issuers. For further details regarding the recalibration please visit [www.moody.com/gsr](http://www.moody.com/gsr).

The principal methodology used in assigning the rating was Analytical Framework For Water And Sewer System Ratings, published on August 31, 1999 and available on [www.moody.com](http://www.moody.com) in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

#### Analysts

Kevork Khrimian  
Analyst  
Public Finance Group  
Moody's Investors Service

Dari Barzel  
Backup Analyst  
Public Finance Group  
Moody's Investors Service

#### Contacts

Journalists: (212) 553-0376  
Research Clients: (212) 553-1653

© Copyright 2010, Moody's Investors Service, Inc. and/or its licensors including Moody's Assurance Company, Inc. (together, "MOODY'S"). All rights reserved.

**CREDIT RATINGS ARE MOODY'S INVESTORS SERVICE, INC.'S ("MIS") CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MIS DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. CREDIT RATINGS DO NOT CONSTITUTE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS ARE NOT RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. CREDIT RATINGS DO NOT COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MIS ISSUES ITS CREDIT RATINGS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.**

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT. All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The ratings, financial reporting analysis, projections, and other observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. Each user of the information contained herein must make its own study and evaluation of each security it may consider purchasing, holding or selling. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

MIS, a wholly-owned credit rating agency subsidiary of MOODY'S Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MIS have, prior to assignment of any rating, agreed to pay to MIS for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at [www.moody's.com](http://www.moody's.com) under the heading "Shareholder Relations - Corporate Governance - Director and Shareholder Affiliation Policy."

Any publication into Australia of this Document is by MOODY'S affiliate MOODY'S Investors Service Pty Limited ABN 61 003 399 657, which holds Australian Financial Services License no. 336969. This document is intended to be

provided only to wholesale clients (within the meaning of section 761G of the Corporations Act 2001). By continuing to access this Document from within Australia, you represent to MOODY'S and its affiliates that you are, or are accessing the Document as a representative of, a wholesale client and that neither you nor the entity you represent will directly or indirectly disseminate this Document or its contents to retail clients (within the meaning of section 761G of the Corporations Act 2001).