New Issue: San Diego (City of) CA Water Enterprise

MOODY'S ASSIGNS A1 RATING TO WATER REVENUE BONDS OF SAN DIEGO, CA

SUBORDINATE BONDS A2 RATING AFFIRMED

Water/Sewer
CA

Moody's Rating

ISSUE	RATING
Water Revenue Bonds, Series 2009B	A1
Sale Amount $325,000,000	
Expected Sale Date 06/16/09	
Rating Description Water Revenue	

Opinion

NEW YORK, Jun 14, 2009 -- Moody's has assigned an A1 rating to the Water Revenue Bonds, Refunding Series 2009B, of the City of San Diego's Water Enterprise. We have also affirmed the A1 rating on the utility's outstanding senior lien bonds and the A2 rating on the outstanding subordinate bonds. The rating is based on the system's significantly improved financial performance since 2004, which is confirmed by the city's release over the past two years of six Comprehensive Annual Financial Reports (CAFRs), for the fiscal years ending 2003 through 2008. However, projected decreases in water sales in the next several years due to suppressed water supplies dampen projected revenue growth and lower debt service coverage ratios. 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 ratings also reflect 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. The stable outlook reflects our expectation that, despite the anticipated increase in debt, rate increases already in place through 2011 will continue to provide strong debt service coverage, and with the planned capital improvements, the system will have met most of its long term capital needs for the foreseeable future.

The proceeds of the current issue will be used to refund $150 million in privately placed short term debt maturing in August, 2009 and provide $150 million in funds for the utility's ongoing capital program.

FINANCIAL RESULTS HAVE IMPROVED SIGNIFICANTLY

Since their low point in 2003, the water system's financial operations have improved steadily. Increased water sales, largely through growth, combined with very tight controls on Operating and Maintenance (O&M) expenditures, which increased by an average annual rate of 3.0% between 2004 and 2008, enabled the utility to increase total debt service coverage from 1.02 times in 2004 to 2.13 times in 2008. These coverage levels, which include capacity charge revenues, 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 $17.7 million in 2004 to $9.7 million in 2008. This downward trend is continuing, despite a 19.5% increase in the capacity charge rate in 2008. Nonetheless, the system was able to continue to improve its financial position. The utility's strong financial performance in recent years enabled it to increase unrestricted cash from $141 million in 2004 to $200 million in 2008, which affords the system a very strong liquidity position, thereby enhancing operating flexibility.

Partly in anticipation of significant amounts of additional debt, annual rate increases of 6.5%, which came into effect in 2008 and are approved through 2011, will somewhat offset the rather conservative estimate of a 20% decrease in water sales to preserve minimal coverage levels of total debt service through 2014. Although significant cuts in water supply are likely, the city's projected conservation levels of 20% are probably at the highest level of the likely range. The utility imports more than 80% of its supply from the San Diego County Water Authority, which in turn relies on the Metropolitan Water District of Southern California, and the expected decreases in supply reflect the prevailing water supply constraints throughout the state. While 20% reductions may be overly cautious, they do lead to severely reduced debt service coverage levels of just 1.25 times by 2013 for all senior and junior lien debt service. Debt service coverage on the senior lien obligations is estimated at a more robust 1.82% for 2013. Less extreme estimates of 10% and 15%

conservation result in combined debt service coverage ratios of 1.63 times and 1.52 times by 2013, respectively. However, in addition to water conservation, actual results in the mid to near term will be affected by additional rate adjustments, modification in borrowing plans and growth in the service area. The utility's current financial policies are prudent and despite the complications presented by water supply, capital needs and operating costs, we expect the utility's overall financial health to remain strong.

The utility's formal reserve policies call for the maintenance of a 45-day operating reserve, funded at $19.9 million in fiscal 2008. The utility also maintains an emergency capital reserve of $5 million. A separate $7.1 million "Secondary Purchase Reserve" is available to fund emergency water purchases. The utility also established a rate stabilization fund, totaling $20.5 million in fiscal 2008. While these funds are part of its formal reserves, they are quite modest given the size of the system's operations. However, our favorable view of the system's liquidity position is based on its unrestricted cash, which is very strong as mentioned above. Given the utility's reasonable operating projections, we expect the system's overall cash position to remain strong.

LARGE, STRONG AND DIVERSE SERVICE AREA

The ratings on the city's water revenue bonds are in large part based upon the size, diversity and economic strength of the system's 330 square mile service area, which encompasses the city of San Diego as well as a few small areas outside the city limits. The enterprise provides primarily retail water service to the entire service area, which has a population of about 1.3 million. The city's economy and tax base exhibited strong and steady growth since the late-1990's until the onset of the recent statewide real estate downturn. The city is affected by the deterioration of the residential real estate market, with home prices falling about 30% year-over-year as of April 2009. However, given the disparity between market and assessed values, the decline in market value has not translated into a decrease in AV. The city's AV grew in fiscal 2009 by 5.7%, an annual rate substantially slower than any since 1998, but nonetheless positive. By comparison, San Diego County's total AV rose by only 2.7%. A modest decrease in AV may be neither surprising nor inconsistent with the current rating given that such AV adjustments are happening statewide in response to the residential real estate market downturn.

Historical retail service connections had grown steadily at approximately 1% annually since 2000 to reach nearly 270,000 in 2004. However, since then annual increases have averaged a much lower 0.33% reaching just 274,398 in 2008. Single family domestic customers account for 42.5% and other domestic customers add 18.7% of water revenues, while commercial/industrial customers represent 20.5%. There are no dominant commercial or industrial customers; the largest wholesale customer, California-American Water Company, accounted for 3.4% of fiscal 2008 revenues. The only retail customers responsible for more than 1% of total water fund revenues were the City of San Diego which accounted for 4.0% at fiscal year end 2008, and the U.S. Navy which accounted for 2.76%.

FAVORABLE DEBT POSITION WILL LIKELY BE RESTORED AFTER AMBITIOUS CAPITAL PLAN FUNDED LARGELY WITH NEW DEBT

At the end of 2008, the city's water system debt, including approximately $20 million of State Revolving Fund debt, stood at approximately $757 million which resulted in a debt ratio of 36.7%, consistent with the nationwide A1 median of 30.1%. A portion of the current offering will refund $150 million which the city borrowed through private placement in 2008, as its market access limitations persisted. The utility's capital needs are significant and it expects to spend nearly $700 million on projects between 2009 and 2014, 80% of the cost of which is expected to be financed with debt. The largest components of the plan are improvement and expansion of its treatment plants ($130 million) and pipe replacement ($300 million). To fund this program, in addition to the current series, another $330 million of new money borrowing is expected through 2013, increasing the utility's debt ratio to approximately 50%, which remains manageable. And notably, at the end of the current capital improvement program, the utility will be compliant with all regulations and have sufficient capacity for the foreseeable future.

The current bonds will be secured by a senior lien on the net revenues of the system. The security provisions are typical with a rate covenant and additional bonds test of 1.2 times. The debt service reserve requirement is subject to a typical three tier test and will be met with bond proceeds. The additional bonds test for all debt is 1.0 times although we expect actual coverage levels to be much higher.

POSSIBLE SUPPLY REDUCTION IN THE NEAR TERM

As mentioned above, the city relies on the San Diego County Water Authority for more than 80% of its supply. Like most of Southern California, the Authority is dependant upon the Metropolitan Water District of Southern California (MWD) for most of its supply. MWD's supply, in turn, has been affected by drought conditions as well as various legal/environmental challenges affecting the state's ability to export water from the Bay-Delta. The Authority delivered an average of approximately 688,000 acre-feet of water per year over the past five years, supplying about 89% of its members' needs. Approximately three-quarters of the water that the Authority provides its members it purchases from MWD; the Authority is the largest single purchaser of MWD water, representing 26% of MWD deliveries. For 2008 the Authority assumed 81.7% of water sold would come from MWD, 8.6% from the Imperial Irrigation District, 6.2% from the All-American and Coachella Canals and 3.5% from spot water transfers. The Authority's storage capabilities are increasing. Within the service area storage is somewhat limited by comparison with annual deliveries: the Authority has 24,000 acre-feet of emergency storage in the Olivenhain Reservoir, and agreements to store approximately 60,000 acre-feet in member agency reservoirs. The Authority currently has a pilot groundwater storage project in the Central Valley which can store up to 30,000 acre-feet. The Authority's large capital improvement plan is focused mainly on diversifying its sources of supply and increasing its storage capacity.

Outlook

The stable outlook for debt obligations of the water 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 and water supply questions pose some potential difficulties for the utility. The utility's successful navigation through the recession, the drought and its sizable capital plan could improve bondholder security.

KEY STATISTICS

2008 estimated population served: 1.3 million

Senior debt service coverage, fiscal 2008: 4.55x

Total debt service coverage, fiscal 2008: 2.13x

Rate Covenant: 1.20x

Additional Bonds Test: 1.20x

Operating Ratio, Fiscal 2008: 81.8%

Net Working Capital, fiscal 2008: $401 million (155% of operations and maintenance expense)

The last rating action was on December, 12 2008 when the utility's ratings were upgraded and the outlook was changed to stable.

The principal methodology used in rating the utility's bonds was Analytical Framework For Water And Sewer System Ratings which can be found at www.moodys.com in the Credit Policy & Methodologies directory, in the Ratings Methodologies subdirectory. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Credit Policy & Methodologies directory.

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