Moody's INVESTORS SERVICE

New Issue: **MOODY'S ASSIGNS Aa2 RATING TO WATER REVENUE BONDS OF SAN DIEGO, CA**

Global Credit Research - 15 Jun 2010

SUBORDINATE BONDS' Aa3 RATING AFFIRMED

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

Moody's Rating

ISSUE	RATING
Water Revenue Bonds, Refunding Series 2010A	Aa2

Sale Amount	$128,000,000
Expected Sale Date	06/15/10
Rating Description	Revenue

Opinion

NEW YORK, Jun 15, 2010 -- Moody's Investors Service has assigned an Aa2 rating to the Water Revenue Bonds, Refunding Series 2010A, of the City of San Diego's Water Enterprise. We have also affirmed the Aa2 rating on the utility's outstanding senior lien bonds and the Aa3 rating on the outstanding subordinate bonds. The rating is partly based on the system's significantly improved financial performance since 2004. 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 projections reflect no rate increase after 2011 and the resulting coverage levels are exceedingly low for the current rating level. However, the city is considering a rate study in Fiscal Year 2011. If actual debt service coverage levels beyond 2011 are in fact at the projected levels of 1.37x or below, the current rating would be under significant downward pressure.

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 proceeds of the current issue along with available reserve funds will be used to refund $141 million in long term debt issued in 1998.

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 and rate increases, combined with very tight controls on Operating and Maintenance (O&M) expenditures, which increased by an average annual rate of 3.0% between 2005 and 2009, enabled the utility to increase total debt service coverage from 1.02 times in 2004 to 2.04 times in 2009. Over this period coverage levels, which include capacity charge revenues, improved despite a notable decrease in such charges. In 2009 total coverage decreased to 2.04x largely as a result of the continuing slump in new connections as well as decreased sales due to conservation. 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 $4.2 million in 2009. This downward trend is continuing, despite a 19.5% increase in the capacity charge rate in 2008. The utility's strong financial performance in recent years enabled it to increase unrestricted cash from $141 million in 2004 to $233 million in 2009, 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 15% 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 15% are probably at the highest level of the likely range. The utility imports about 90% 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 reflects the prevailing water supply constraints throughout the state. While 15% reductions may be overly cautious, they do lead to severely reduced debt service coverage levels of just 1.1 times by 2014 for all senior and junior lien debt service. Debt service coverage on the senior lien obligations is estimated at a more robust 1.62x for 2014. 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 $20.4 million in fiscal 2009; it currently stands at 60 days, projected to increase to 70 days by 2013. The utility also maintains an emergency capital reserve of $5 million. A separate $7.5 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 2009. 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, although the trend appears to have reversed with an increase of 12% by April of 2010. 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% and decreased by 0.6% in 2010.

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 273,398 in 2008 and remaining flat in 2009. Single family domestic customers account for 41% and other domestic customers add 18% of water sales, while commercial/industrial customers represent 21%. There are no dominant commercial or industrial customers; the largest wholesale customer, California-American Water Company, accounted for 3.0% of fiscal 2009 revenues. The only retail customers responsible for more than 1% of total water fund revenues were the City of San Diego which accounted for 3.9% at fiscal year-end 2009, and the U.S. Navy which accounted for 2.65%.

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

At the end of 2009, the city's water system debt stood at approximately $900 million which resulted in a debt ratio of 37.6%, somewhat above the nationwide Aa2 median of 29.5%. 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 $615 million of new money borrowing is expected through 2014, increasing the utility's debt ratio to approximately 50%, which, though high, 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 and existing reserve of the refunded bonds. 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 dependent 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.. Approximately three-quarters of the water that the Authority provides its members it purchases from MWD. 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. 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 projections reflect no rate increase after 2011 and the resulting coverage levels are exceedingly low for the current rating level. The city is considering a rate study in Fiscal Year 2011. If actual debt service coverage levels beyond 2011 are in fact at the projected levels of 1.37x or below, the current rating would be under significant downward pressure. The utility's successful navigation through the recession, and its sizable capital plan could improve bondholder security.

KEY STATISTICS

2010 estimated population served: 1.3 million

Senior debt service coverage, fiscal 2009: 5.27x

Total debt service coverage, fiscal 2009: 2.04x

Rate Covenant: 1.20x

Additional Bonds Test: 1.20x

Operating Ratio, Fiscal 2009: 76.7%

Net Working Capital, fiscal 2009: $477 million (180% of operations and maintenance expense)

The last rating action with respect to the City of San Diego Water Enterprise was on June 8, 2009, when a municipal scale rating of A1 was assigned. The rating was subsequently recalibrated to a global scale rating of Aa2 on April 16, 2010.

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.moodys.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.

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