STANDARD & POOR'S

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Summary:

San Diego Public Facilities Financing Authority, California; Water/Sewer

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Credit Profile		
US$454. mil senior swr rev bnds (San Diego) ser 2009A due 05/15/2039		
Long Term Rating	A+/Stable	New
US$421.425 mil senior swr rev rfdg bnds (San Diego) ser 2009B due 05/15/2020		
Long Term Rating	A+/Stable	New
San Diego Pub Facs Fincg Auth, California		
San Diego, California		
San Diego Pub Fac Fing Auth (San Diego) Swr		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

Rationale

Standard & Poor's Ratings Services assigned its 'A+' long-term rating, and stable outlook, to San Diego Public Facilities Financing Authority, Calif.'s series 2009A and 2009B senior sewer revenue and senior sewer revenue refunding bonds, issued for the city of San Diego. At the same time, Standard & Poor's affirmed its 'A+' long-term rating, and stable outlook, on the parity debt outstanding.

The rating reflects what we view as:

- Good historical and projected debt service coverage (DSC);
- The authority's strong liquidity position supported by targeted cash reserve policies;
- Council-approved system rate increases through May 1, 2010; and
- A regional and municipal system serving a broad and diverse service area economy and customer base.

These strengths are offset in our opinion by the wastewater system's:

- Ongoing sewage treatment regulatory challenges, related primarily to a system-wide consent decree and the potential for future secondary treatment requirements at the Metropolitan Sewerage System's Point Loma plant, which have the potential to cause significant increases in the capital improvement plan (CIP); and
- Higher-than-average rates when compared with regional systems across the country.

A senior-lien pledge of installment payments from net revenues of the wastewater system secures the bonds. Proceeds of the series 2009A bonds will be used to fund $145 million of system improvements and refund all of the authority's $224 million series 2007 subordinate sewer revenue notes outstanding, as well as a portion of the 1997A and 1997B sewer revenue bonds. Proceeds from the series 2009B bonds will be used to refund bonds outstanding and fund a debt service reserve. After this issuance, the wastewater system will have about $1.4 billion of bonds and loans outstanding secured by the system's net revenues, including senior revenue bonds and subordinate state revolving fund (SRF) loans, secured by a subordinate lien of the net system revenues.

The wastewater system consists of both a sewage collection system for the city of San Diego (Municipal Wastewater Collection System) and a regional system (Metropolitan Sewerage System) that provides a transportation, treatment, and disposal system for a population of 2.1 million in the city of San Diego and 15 other cities and districts in a 450-square-mile service area. The municipal system serves a population of 1.3 million in the city. The leading 10 customers of the municipal system represent 7.5% of total sewer operating revenues in fiscal 2008 and include the U.S. Navy (2.85%), chemical manufacturer CP Kelco ApS (1.29%), and the University of California-San Diego (0.9%). While residential customers comprise about 94% of accounts, they represent 56% of total system revenues. Commercial and industrial customers represent 6% of the system's accounts and 24% of revenues; treatment plant services for other cities and districts make up the remaining 20% of system revenues.

Net system revenue covered senior-lien annual DSC by 1.9x and total senior and subordinate DSC by 1.6x in fiscal 2008. Excluding capacity charges, officials estimate fiscal 2009 senior DSC is 1.9x. When including existing subordinate-lien SRF loans and notes, officials estimate the coverage is what we consider a good 1.6x in fiscal 2009, excluding capacity charges. System officials project net revenues between fiscals 2010 and 2011 to cover existing senior-lien debt service by 1.6x and 1.8x, respectively.

Wastewater system liquidity remained strong in our view, with audited unrestricted cash at $291 million, or 527 days' cash on hand, at fiscal year-end 2008. Officials have identified reserve targets to maintain minimum amounts of cash reserves for operations, rate stabilization, and contingencies, including a targeted 70-day operating reserve to be used in the event of an emergency, a rate stabilization fund to be maintained at 20% of net system revenues, and a $5 million reserve for unexpected capital needs in its capital improvement reserve. At fiscal year-end 2008, officials also created a new reserve fund, a dedicated reserve for efficiency and savings (DRES), with a current balance of $21.2 million. The DRES is funded with savings achieved due to efficiencies and reduced costs of the system and may be used to mitigate future rate increases and contribute toward capital outlay needs. The system also maintains restricted cash reserves for debt service requirements on its series 1999 bonds. Management estimates that the wastewater fund has a total of $81.2 million (or about 125 days' combined cash) in the targeted reserves including $19.3 million available in its rate stabilization fund, or 96% of its target, and $32.3 million (or 50 days' operations) in its operating reserve. The system also maintains the targeted $5 million in its capital reserve and $3.4 million in the unallocated reserve as of April 1, 2009.

The system's large $752 million CIP for fiscals 2009 through 2013 is driven by regulatory concerns and an aging infrastructure. The system operates under a final consent decree by the Environmental Protection Agency (EPA) to reduce sewer spills, which drives 79% of the system's current CIP in the next few years. The council pre-approved wastewater rate increases of between 7.00% and 8.75% for fiscals 2007 through 2010, as recommended in a 2006 rate study, to cover the system's capital needs. Furthermore, since 1995, the system's Point Loma wastewater treatment plant has operated under two five-year waivers of secondary treatment standards for discharge of its treated wastewater as specified in the Federal Clean Water Act of 1972. In December 2008, the system received a tentative decision by the EPA to grant a new five-year waiver at its Point Loma plant and city officials expect a final determination in mid-2009. Without the waiver, however, we believe the system's capital needs would increase significantly, as potential capital costs necessary to upgrade the current plant to meet secondary treatment standards are estimated by system officials to be as high as $1.5 billion.

The bond provisions include a 1.2x annual DSC rate covenant, which includes one-time transfers in or out of the rate stabilization fund in its net system revenue calculation. Bond provisions also include an additional bonds test that requires 1.2x maximum annual debt service coverage by net system revenues in 12 out of the past 18 months and estimated revenues in the next 12 months.

Outlook

The stable outlook reflects Standard & Poor's expectation that pre-approved rate increases by the city council and cash reserve policies should help to maintain what we consider good projected debt service ratios and good system liquidity in the next several years, despite the city's implementation of a large CIP associated with regulatory requirements. The outlook also reflects our expectation that the system will receive all necessary final approvals to renew the five-year modified permit for its Point Loma plant, as it has twice before, to avoid significant near-term costs associated with secondary treatment requirements. Should the system's capital needs increase significantly or should the system fail to make sufficient rate increases to maintain adequate DSC ratios, the rating could be pressured.

System

The metropolitan system provides wholesale treatment services--including some sewage transportation, treatment, and disposal operations--to 15 participating agencies under a regional wastewater disposal agreement that became effective in 1998, and expires on Dec. 31, 2050. The participating agencies pay the system proportionate payments based on flow and strength for all facilities (currently representing 35% of the metropolitan wastewater system's flow). The wastewater treatment facilities of the metropolitan system primarily consist of three wastewater treatment plants and a biosolids center. The Point Loma wastewater treatment plant, the principal treatment facility, is an advanced primary treatment plant with a permitted treatment capacity of 240 million gallons per day (mgd) and a peak capacity of 432 mgd, compared with an average daily flow of 163 mgd in fiscal 2008, or more than 90% of the system's average daily flow in fiscal 2008.

Regulatory Issues And Capital Improvement Plan

The Point Loma wastewater treatment plant is an advanced primary treatment plant that removes from 85%-90% of suspended solids from the wastewater it discharges into the ocean. In 2002, the EPA granted the system a renewal of a five-year National Pollutant Discharge Elimination System modified permit (waiver) to exempt it from the more stringent secondary treatment requirement of the Clean Water Act. In December 2008, the system received a tentative determination by the EPA to renew the waiver for another five years; officials expect the final determination by the EPA later this year, which will be followed by a review by the Regional Water Board and the California Coastal Commission. San Diego also has negotiated agreements with two environmental groups to stem future challenges to the EPA order by agreeing to research the potential for reducing ocean discharge and increasing reclaimed wastewater usage. The plant is surrounded by land owned by the U.S. Navy and U.S. Park Service. Should the system fail to receive approval of an additional waiver, its CIP could substantially increase by up to $1.5 billion due to the cost associated with converting the system to meet secondary treatment requirements within a confined geographic space, assuming the city could not access land from its neighbors.

In addition, the municipal system is under a final consent decree that was entered into in October 2007 and requires the system to replace 250 miles of sewer pipeline by 2013 and rehabilitate its wastewater facilities to remediate system sewer spills. We understand the system is on track to meet the consent decree requirements, but a significant portion of the city's CIP is driven by the consent decree and officials expect $472 million of debt in addition to the series 2009 issuance through 2013 to continue primarily to make pipeline and trunk sewer repairs.

Rates

In 2007, the sewer system settled a lawsuit by agreeing to reimburse residential customers a cumulative $40 million, less $5 million for legal fees, for previous overcharges of their sewer bills (Shames Settlement). On Nov. 1, 2007, and May 1, 2008, the system increased rates by 3.05% for nonresidential customers to equalize the rate structure per the Shames Settlement. The city council pre-approved wastewater rate increases for four consecutive years between 2007 and 2010 to address the wastewater system's CIP. These scheduled rate increases do not account for any potential secondary treatment costs or increases related to the Shames Settlement. Current residential sewer rates are $48 for a single-family home using 7,500 gallons per month, after accounting for a $3.25-per-month adjustment on residential bills per the Shames Settlement. Together with the water rates, the overall rates are above average for a regional system, at about $93 per 7,500 gallons per month, but in our view a still-manageable 2.3% of the city's 2008 annual median household income.

Audits And Internal Controls

After several restatements in the fiscal 2003 audit related to the fiscal 2002 sewer utility fund, we believe the city has made progress toward improving internal controls and disclosure processes. However, San Diego acknowledges it still has to continue to bolster internal controls, particularly in the areas of financial reporting, information technology, and internal controls. City management expects the implementation of new enterprise resource planning software by January 2010 to help resolve internal control weaknesses and aid in the timely release of future financial reports. The city released its fiscal 2008 audit in March 2009.

Service Economy

San Diego's population of 1.3 million in 2008 has risen an average of about 1% per year since the 2000 U.S. Census. The economy consists of a mix of various high-tech clusters, including biotech and telecommunications, combined with a reliance on tourism and the military and defense industries. The city's economic base is also anchored by higher education and major scientific research institutions, including the University of California-San Diego, San Diego State University, Scripps Research Institute, the Salk Institute for Biological Studies, and the San Diego Supercomputer Center. On a per capita basis, market values are extremely strong, in our opinion, at approximately $141,000. Median household effective buying income is also what we consider strong, at 117% of the national average in 2008. City unemployment, which averaged 4.6% in 2007, rose to 8.7% as of January 2009, based on data from the Bureau of Labor Statistics. San Diego has seen an increase in foreclosure activity with 1.52% of the city's housing units in some stage of foreclosure; however, according to sewer officials, sewer bill collections in fiscal 2008 remain in line with historical levels of accounts receivable exceeding 120 days, which have represented an average of 0.7% of sewer service revenue in the past five years.

Related Research

"Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds," Sept. 15, 2008

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