STANDARD & POOR'S

PUBLIC FINANCE

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San Diego Public Facilities Financing Authority

Credit Profile		
US$364.78 mil wtr rev bnds (San Diego) ser 2009B due 08/01/2039		
Long Term Rating	AA-/Stable	New
San Diego certs of undivided int (payable from net sys revs of wtr util fd)		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services assigned its 'AA-' long-term rating, and stable outlook, to San Diego Public Facilities Financing Authority, Calif.'s senior-lien series 2009B water revenue bonds. At the same time, we affirmed our 'AA-' underlying rating (SPUR), with a stable outlook, on the authority's existing senior-lien water revenue certificates and bonds and our 'A+' SPUR, with a stable outlook, on the city's subordinate-lien water revenue bonds.

The ratings reflect our opinion of what we consider the city's following credit strengths:

- Good historical and projected debt service coverage, even after excluding one-time capacity charge revenue;
- Strong cash reserves bolstered by targeted cash reserve policies;
- Council-approved system rate increases through fiscal 2011; and
- A diverse service area economy and customer base.

Offsetting credit concerns in our opinion include of the system's:

- Significant capital improvement plan (CIP) driven by regulatory concerns in the next five years and additional long-term capital and rate pressures related to water supply needs;
- Required annual approvals by city council for customer water charge increases related to passed-through water purchase costs, which are also subject to Proposition 218 requirements; and
- Bond provisions that allow net system revenue calculations to include transfers from the rate stabilization fund and secondary purchase funds.

A senior-lien pledge of installment payments payable from the net revenues of the city's water system secures the 2009A and B water revenue bonds and the 1998 certificates have an interest in such revenues. A subordinate-lien pledge secures the series 2002 bonds and a 2004 state revolving fund (SRF) loan. We understand that a portion of the series 2009B bond proceeds will be used to pay off $150 million in note principal by August 2009, another portion of the proceeds will be used to fund $150 million of new water system projects, and the final portion of the proceeds will be used to refund about $40 million of 1998 senior certificates outstanding.

San Diego covers 400 square miles and has a population of 1.3 million. Its water system provides retail water services to a stable customer base consisting of 273,398 customers, of which 91% are residential. Single-family and multifamily residential customers represented about 64% of the system's water revenue, and commercial and industrial customers represented about 30% of system revenue in fiscal 2008. The city also serves wholesale customers, which account for 3% of total water sales revenue. As of fiscal year-end June 30, 2008, the water system's 10 leading retail customers, including governmental and nongovernmental customers, accounted for what we view as a very diverse 10.6% of total water utility fund revenues. San Diego (4% of water sales revenue) and the U.S. Navy (3%) remain the two leading customers. The water system is supplied primarily by raw water imported by the San Diego County Water Authority (CWA; 'AA+' SPUR), which accounts for more than 90% of the system's water supply. CWA, in turn, receives the majority of its water from the Metropolitan Water District of Southern California (MWD; 'AAA' SPUR; 'AAA' revenue bond rating).

After issuing the 2009B bonds, the water system will have about $990 million of revenue bonds and SRF loans outstanding secured by senior and subordinate liens of the system's net revenue. The system has no variable-rate debt outstanding. Coverage of annual senior debt service on the senior-lien debt by net system revenue in fiscal 2008 was a very strong 4.2x, in our opinion; after the issuance of the 2009B bonds, coverage of senior pro forma maximum annual debt service (MADS) is 1.8x. Total combined annual senior and subordinate debt service coverage—including the 2002 bonds, debt service on SRF loans, and interest on short-term notes outstanding—was also what we consider strong at 2.2x. Based on fiscal 2009 estimated results, system officials estimate net system income—including operating receipts, capacity charges, and interest earning revenue—provided what we consider strong senior and combined debt service coverage (DSC) of 4.4x and 2.0x, respectively. Capacity charges fell 30% in fiscal 2008 to $9.7 million from $13.7 million in the previous year. Fiscal 2009 estimated results reflect another 38% decline in one-time capacity charges due to slowing residential construction. Excluding all capacity charges, estimated senior and combined DSC in fiscal 2009 drops to what we view as a still strong 4.1x and 1.85x, respectively. Estimated fiscal 2009 revenue covers fixed water purchase charges and combined debt service, excluding capacity charges, by a good 1.5x in our opinion.

Fiscal 2009 estimates include a 6.5% rate increase approved by council and an 8.4% rate increase, effective Jan. 1, 2009, to offset rising water purchase costs and a one-year pilot project to study the viability of increasing potable water sources through reuse and reservoir augmentation. Together with the sewer rates, overall residential rates are somewhat above average for a regional system, at about $93 per 7,500 gallons per month, but what we believe is a still-manageable 2.4% of the city's 2008 median household effective buying income.

Officials have identified reserve policies to maintain cash within the system, including a targeted 70-day operating reserve to be used for unplanned operating expenditures, a secondary purchase reserve funded at 6% of annual water purchase costs to offset potential disruptions in the water supply, a $5.0 million emergency reserve for capital expenditures, and a $20.5 million rate stabilization fund. The system also established a new reserve, a dedicated reserve for efficiencies and savings (DRES) to track efficiencies and offset future water rate increases. The system also maintains restricted cash reserves for debt service requirements. System officials estimate that combined cash in the operation reserve, secondary fund, rate stabilization fund, emergency reserve, and DRES reserve in fiscal 2008 totaled $55.1 million, or what we consider to a good 78 days' cash. Total audited cash in the system at fiscal year-end 2008, including cash that was not designated per policy, was $213 million, equivalent to 301 days of operating expenses.

The system's CIP for 2009 through 2014 totals $872 million, with 60% of the capital project expenditures between fiscals 2010 and 2014 related to a California Department of Health compliance order to fund pipe replacement, improve treated water storage, and treatment facility upgrades. The system previously issued a total of $200 million in private placement notes in 2007 and 2008 and used 2009A bond proceeds to pay off $57 million of the 2007 note and will use $150 million of the 2009B bond proceeds to pay off the remaining notes. Officials intend to use $150 million of 2009B bond proceeds for capital improvement projects in the system's CIP. We understand that in the future, system officials intend to finance 80% of the CIP with additional debt, including $330 million of anticipated system revenue bonds in the next two fiscal years. System officials indicate they will complete the next master plan for the system to identify capital needs beyond 2012. We believe the CIP is likely to increase as San Diego continues to identify needs associated with long-term water resource planning and ongoing water main replacement.

In fiscals 2008 and 2009, water rates increased by 6.5% in each year and the city council has already approved a 6.5% annual increase for fiscals 2010 and 2011, effective July 1, 2009, and July 1, 2010. The city council also approved rate increases, effective Jan. 1, in fiscal 2008 (3.0%) and fiscal 2009 (8.4%) to cover pass-through charges to cover increased purchased water costs. A 3.1% portion of the 8.4% rate increase in fiscal 2009 includes a temporary rate increase to cover the costs of the one-year water reuse pilot project and sunsets in June 30, 2010. The council expects to annually determine pass-through charges to cover likely future increases in purchased water costs. Pass-through water charges are also subject to Proposition 218 hearings; we understand that the city has complied with notice and protest procedures and has not had any rate increase legally challenged pursuant to Proposition 218.

In our view, the senior-lien provisions in the master installment purchase agreement are somewhat permissive. Net system revenue calculations include transfers from the rate stabilization fund and secondary reserve, as well as capacity charges. The senior-lien 1.2x annual debt service (ADS) rate covenant allows debt service and revenue to be reduced to account for interest earnings on the debt service reserve of the certificates. The senior-lien provisions also require 1.2x MADS coverage using either historical revenues in 12 out of the past 18 months or future estimated revenues adjusted for rate increases and estimated revenue from expected water system additions, improvements, and extensions.

A subordinate-lien pledge of the water system's net revenues secures the series 2002 bonds. The system also has an SRF loan outstanding and issued short-term notes in 2007 and 2008 secured by a subordinate lien on par with the series 2002 bonds. The system covenants to maintain rates sufficient to cover total ADS by at least 1x. The series 2002 bond provisions allow additional bonds if the system can demonstrate at least 1x senior and subordinate MADS coverage by historical or future estimated net system revenues adjusted for rate increases and improvements. Provisions for both the senior and subordinate bonds include a fully funded debt service reserve for each series funded at the least of MADS, 10% of par, or 1.25x aggregate average ADS; the debt service reserve funds are cash-funded; however, the permitted investments are, in our view, somewhat permissive as they allow for investments in repurchase agreements rated in the three highest short-term rating categories.

Outlook

The stable outlook reflects our expectation that pre-approved rate increases should help to maintain good debt service ratios in the next couple of years, despite the city's implementation of a large CIP associated with regulatory requirements. The outlook also reflects our expectation that pass-through charges for increased water purchase costs and future rate increases will be approved, as necessary, and the system will adhere to its cash reserve policies to maintain sufficient liquidity in the system. Should a failure to continue to meet the requirements of the compliance order result in significant deterioration of DSC or liquidity, we could lower the ratings.

Water Supply

California continues to face pressure to reduce its dependence on Colorado River water, which places additional strain on MWD, CWA, and the city system to maintain a sustainable water supply. The state of California, in total, is apportioned 4.4 million acre-feet per year of Colorado River water, plus one-half of the surplus Colorado River water available collectively for Arizona, Nevada, and California. These other states have increased their respective draws of water in recent years, reducing the amount of surplus water left for California. Historically, the state of California as a whole drew 5.2 million acre-feet of water per year in total due to the use of surplus water. Apart from the increased draw by other states, the Colorado River system is also in the midst of a prolonged drought, further reducing Colorado River water availability.

Since its inception in 1944, the CWA has served as the key water delivery agency for San Diego County. Most of the water consumed in the San Diego County service area (by more than 3 million residents) comes from the authority (75%-95% historically). In its historical role as a water delivery agency, the authority has depended on the MWD ('AAA' revenue bond rating) as its primary source of supply. Both the authority's role and the extent of its reliance on MWD are undergoing a transformation, however, as the authority is increasingly, albeit gradually, providing water supply of its own, plus storage and delivery services, while continuing with its water diversification strategy under the guise of a water delivery enterprise.

In May 2009, the city council declared mandatory water use restrictions, effective June 1, 2009, to target a 20% reduction in demand. We understand that, in the long term, the city plans to increase its conservation efforts and reclaimed water sales to reduce its dependence on CWA to 83% of its water supply by fiscal 2015. In addition, the city has implemented a pilot indirect potable reuse demonstration project to determine the feasibility of augmenting the system's potable water supply with reused water.

Service Area 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 9.5% as of March 2009, based on data from the Bureau of Labor Statistics. Although San Diego has seen an increase in foreclosure activity, according to water officials, water bill collections in fiscal 2008 remain in line with historical levels of accounts receivable exceeding 120 days, which have represented an average of 1% of water service revenue in the past five years.

Coverage Projections

System officials project what we consider to be good-to-strong total debt service coverage; the officials' projections reflect that net system revenues will cover existing and future senior and subordinate debt service, excluding note principal, from 1.2x-2.0x through fiscal 2014. Fiscal 2010 projections assume a 20% water conservation factor with a reduction in water sales and offsetting costs in fiscal 2010. The system projections also do not include any increases in imported water costs or corresponding pass-through rate increases beyond fiscal 2009. Officials estimate the water fund's proportionate share of contributions to the pension fund and the retiree health care obligations represent about 3% of budget in fiscals 2010 and 2011. In fiscal 2009, system officials originally budgeted for $11.5 million in capacity charges but, due to ongoing weakness in the construction sector, only expect to receive $6 million of this amount by year-end. Excluding capacity charges, system officials project that fiscal 2009 revenue will cover senior and subordinate debt service by a still-strong 1.85x, in our opinion.

Audits And Internal Controls

After several restatements in the fiscal 2002 water utility fund, we believe San Diego has made progress toward improving internal controls and disclosure processes. However, the city 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 full implementation of new enterprise resource planning software in 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.

Related Research

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

Ratings Detail (As Of 05-Jun-2009)		
San Diego certs of undivided int (payable from net sys revs of wtr util fd) ser 1998 dtd 08/01/1998 due 08/01/2001-2018 2021 2024 2028		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
San Diego certs of undivided int (payable from net sys revs of wtr util fd) (wrap of insured) (FGIC & BHAC) (SEC MKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed

Ratings Detail (As Of 05-Jun-2009) (cont.'d)		
San Diego Pub Facs Fincg Auth, California		
San Diego, California		
San Diego Pub Facs Fincg Auth wtr rev rfdg bnds ser 2009A		
Long Term Rating	AA-/Stable	Affirmed
San Diego Pub Facs Fincg Auth (San Diego) sub wtr (wrap of insured) (MBIA & ASSURED GTY) (SEC MKT)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed
San Diego Pub Facs Fincg Auth (San Diego) sub wtr (MBIA) (MBIA of Illinois)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.